New York State Bar Association
Tax Section

Report on Qualified Intermediary and Related Withholding and Information Reporting Legislation Proposed by the Administration

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Report No. 1189

REPORT ON QUALIFIED INTERMEDIARY AND RELATED WITHHOLDING AND INFORMATION REPORTING LEGISLATION PROPOSED BY THE ADMINISTRATION*

I. INTRODUCTION

This report comments on provisions of the Administration's Fiscal Year 2010 Revenue Proposals relating to offshore tax evasion, released in May of this year. Specifically, the report comments on proposals relating to (a) reporting and withholding rules applicable to payments made to qualified intermediaries and non-qualified intermediaries, (b) reporting requirements relating to transfers of money and property to foreign accounts and the establishment of new foreign accounts and entities, and (c) several proposals relating to the obligation of a taxpayer with a foreign bank or other financial account to file a Report of Foreign Bank and Financial Accounts, known as an "FBAR." We also comment on one FBAR-related provision in a bill released by Senator Max Baucus in March 2009.[1]

This report is divided into four parts. Part I introduces the issues. Part II summarizes the recommendations we make in the report. Part III provides background on the current withholding system applicable to intermediaries and the developments that have led to the belief that the U.S. reporting and withholding system needs further modification. Part IV discusses the Administration's proposals and section 4 of the Baucus bill and provides our comments relating to the proposals.

The proposed changes discussed in this report are:

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* The principal drafters of this report were Peter Connors, S. Douglas Borisky and Diana Wollman. Helpful comments were received from Kim Blanchard, Peter Blessing, Andrew Braiterman, Michael Farber, Stephen Lessard, Andrew Needham, Erika Nijenhuis, Michael Schler, Jodi Schwartz and Bryan Skarlatos.

1 The Administration's proposals are set forth in DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 41-57 (2009) (hereinafter Greenbook), available at http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf. This report discusses the proposals set forth on pages 41-53 and page 56. The text of Senator Baucus's proposals can be found at http://finance.senate.gov/press/Bpress/2009press/prb031209c.pdf (the "Baucus bill").

We intend to submit a separate report discussing the proposals made on pages 54-55 and 57 of the Greenbook, together with many of the provisions in the "Stop Tax Haven Abuse Act" bill introduced by Senator Levin, also in March 2009 (the "Levin bill") (S. 506, 111th Cong. (2009), available at http://levin.senate.gov/newsroom/supporting/2009/PSI.StopTaxHavenAbuseAct.030209.pdf) and the Baucus bill. Our conclusion on the page 54 Greenbook proposal, relating to certain extensions of the statute of limitations, is also briefly described herein.

Opinions expressed herein are those of the Tax Section of the New York State Bar Association, and do not represent those of the New York State Bar Association unless and until they have been adopted by the Association's House of Delegates or its Executive Committee.

1. Require greater reporting by qualified intermediaries ("QIs") regarding U.S. account holders.

2. Require withholding on payments of fixed or determinable annual or periodical ("FDAP") income through nonqualified intermediaries ("NQIs").

3. Require withholding on gross proceeds paid to certain nonqualified intermediaries.

4. The adoption of a "negative presumption" regarding withholding on FDAP payments made to certain foreign entities.

5. The adoption of a number of new information reporting requirements relating to the transfer of money and property to foreign accounts and entities and the creation of foreign accounts and entities.

6. Require a new schedule with the tax return that includes all information required to be reported on a Report of Foreign Bank and Financial Accounts, known as an FBAR report (a "shadow FBAR"); impose a higher level of penalties if the shadow FBAR is not filed and there is an understatement arising from a transaction involving the foreign account, and adopt adverse presumptions if a taxpayer fails to file an FBAR relating to an account maintained at an NQI. (We are preparing a separate report discussing other issues with respect to FBARs.)

Very generally, our comments on specific proposals are based on the belief that it is likely that the most effective means of preventing tax abuse without creating significant ancillary burdens on compliant taxpayers is to pierce the veil of secrecy by increasing the flow of information to the IRS about hitherto secret transactions, through increased reporting of those transactions, coupled with robust enforcement on both the civil and criminal sides. There is very recent evidence that such steps can be highly effective.

Not so many years ago, government attention was focused on a different kind of tax shelter – the complex transactions carried out by large corporations that were widely promoted in the 1990's. In March 2002 the Treasury Department proposed a series of reforms both to shut off the supply of such transactions and to dampen demand for them. Those changes were animated by the belief that the transactions flourished in large part because taxpayers often were legally obligated by contract to reveal nothing about the transactions to third parties, including their own regular tax advisers, and by the belief that "sunshine is the best disinfectant." The new rules generally require taxpayers to report transactions designated as "listed" or "reportable" transactions, and require promoters to register such transactions with the government and to maintain lists of taxpayers that engage in them. These disclosure rules have, in our view, changed the cost/benefit analysis in a dramatic way for taxpayers considering transactions within their scope, except when those transactions clearly "work" as a matter of substantive law. The disclosure rules, coupled with the government's reinvigorated enforcement policy, also have served as an effective deterrent to the promotion of transactions of this kind.

These rules work because they are aimed at a class of taxpayers that typically is not willing openly to break the law by failing to report income. Because it appears that many taxpayers engaged in offshore tax evasion either do not know their tax obligations or simply choose to disregard them, shutting down offshore tax evasion may require a different strategy, with respect to the details of who is required to report what to whom. The basic concept that the cost/benefit analysis to a taxpayer considering a tax-motivated transaction alters radically if information about the transaction is provided to the IRS in a usable manner should not, however, change. Indeed, for individuals whose principal method of evading tax is to avoid scrutiny, increased reporting of such transactions should have an even greater effect than it has had on corporate taxpayers.

We favor increased reporting, as compared to many other possible techniques for shifting the cost/benefit analysis for tax evaders, because very generally speaking it appears to us to be easier to change the reporting rules in a way that does not have severe negative consequences for the very large number of taxpayers who comply with the law than it is to change other types of rules. As discussed in greater detail throughout this report we believe that enhanced reporting will be effective at addressing the Administration's concerns, and may obviate the need for some of the withholding proposals discussed herein, which may be disruptive to markets and market participants.

We understand that the proposals in the aggregate are intended both to increase the level of reporting by QIs, and to encourage investors to hold their accounts through QIs. There is a trade-off between these two objectives, however, because the greater the burden on QIs—taking into account both new legislation and the initiatives that the IRS already has under way—the less likely, on balance, it may be that a financial institution will become or remain a QI. Accordingly, we have sought in our comments to find ways to minimize the burden on QIs while achieving the maximum increase in additional reporting of potentially useful information. We also recommend that any withholding tax obligations be modified so that they do not impose new substantive requirements upon foreign persons fully eligible for the benefits of income tax treaties that the United States has entered into, in order to avoid overriding the United States' commitments under those treaties.

One other general theme of our recommendations is that the proposals should be reshaped to distinguish between intermediaries that are banks or other financial institutions with customers that are subject to regulatory "know your customer" rules, on the one hand, and other types of intermediaries such as investment funds structured as partnerships, who are not subject to those rules. Only intermediaries of the first kind are eligible to be QIs, and we believe that new reporting and withholding obligations should take that into account. As a general matter, we agree that all such intermediaries should be subject to enhanced obligations to ensure the accuracy of the information that they provide about U.S. customers or investors to withholding agents, and that they should be required to provide additional information about significant indirect U.S. investors; however, the details of those requirements should take the differences between these different classes of intermediaries into account. In the case of foreign corporations, we support a more limited version of the proposed negative presumption proposal that would require such entities to provide information only about significant U.S. investors therein, subject to our comments above about recasting the proposal as an information reporting requirement and not overriding treaty commitments.

II. SUMMARY OF RECOMMENDATIONS

A. Proposal to Expand QI Reporting[2]

The objectives of the proposal to expand reporting to include foreign source income are a reasonable response to the problems identified. However, if the proposal is adopted, it should include simplifying assumptions that will allow QIs to report the income based on information readily available to them. The rule also should be implemented with significant transition rules so as to provide QIs with sufficient time to implement the proposal effectively.

The proposal to grant regulatory authority to Treasury to expand the QI rules to commonly controlled entities may provide Treasury and the IRS with a valuable tool in administering the QI program. However, if it is adopted the rules should be limited to commonly controlled entities with customer relationships, and should be applied in a flexible manner that takes into account the characteristics of the particular financial institution.

Cost considerations are a significant aspect of any proposal. A limited version of the QI agreement ("QI Limited") should be available where a customer has only a relatively small amount of income or assets.

B. Proposal to Require Withholding on FDAP Payments to NQIs[3]

As an alternative to automatic withholding, a majority of the Tax Section's Executive Committee favors a more limited approach requiring enhanced reporting by NQIs that are banks and other financial entities, which are the only types of entity that are eligible to become QIs under the current structure of the QI system. If the proposal to impose withholding on payments of FDAP income through NQIs (even if IRS Form W-8BENs were received) would be enacted, it would need to be highly tailored so as to not disrupt capital markets. For example, it should be limited to NQIs that are banks and other financial entities of the kind described above, treaty exemptions should be provided, and transition rules should be adopted to provide for grandfathering of outstanding securities.

C. Proposal to Require Withholding of Gross Proceeds Paid to NQIs[4]

As with the prior proposal, we believe that a more limited approach requiring enhanced reporting by NQIs would be adequate to achieve the government's objectives. This proposal is, however, different in kind from the prior proposal, because it would impose withholding tax as a compliance measure on amounts that are not subject to a substantive withholding tax in the hands of any foreign person. We strongly recommend that this proposal not be adopted, and that it be reformulated instead as an enhanced reporting requirement. If, however, the proposal is adopted, exclusions should be self-executing and the refund mechanism should be streamlined.

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[2] Greenbook at 41.

[3] Greenbook at 43.

[4] Greenbook at 44.

D. Proposal to Impose Negative Presumption Regarding Withholding on FDAP Payments to Certain Foreign Entities[5]

The negative presumption, if adopted as proposed, would in effect deny the benefit of domestic exemptions and treaty relief in any case where the entity could not obtain the requisite proof of its owners. As an alternative, we favor a more limited approach focusing on enhanced reporting and limiting withholding for corporate entities to situations in which identification of significant owners is not available.

Entities that are treated as partnerships for U.S. tax purposes would continue to file Form W-8IMY with respect to all owners (which might be supplemented by, *e.g.*, a requirement to certify as to the accuracy of the information) but also would be subject to rules requiring identification of significant owners of investor entities in order to avoid withholding on U.S. source FDAP corresponding to such ownership.

Where withholding is required, the amount withheld should be limited to the amount that relates to any missing documentation. Refunds should be available if the required documentation is provided after payment.

E. Additional Information Reporting Proposals[6]

We generally concur with the proposals to require (a) U.S. individuals and their controlled entities to report transfers to or from foreign accounts, (b) U.S. financial intermediaries and QIs that open an account on behalf of a U.S. person or U.S.-controlled entity to file an information return regarding that account, and (c) U.S. persons or QIs that form a foreign entity on behalf of U.S. individuals or their controlled entities to file a similar information return. Specific recommendations are noted.

We do not support the proposal to require U.S. financial intermediaries and QIs to report transfers of more than $10,000 to or from a foreign account on behalf of a U.S. person. This proposal would impose very substantial obligations on reporting entities, given the number and size of normal cross-border commercial cash flows, and is not likely to provide correspondingly substantial benefit to tax enforcement.

F. FBAR Proposals[7]

As a general matter, we believe that compliance with FBAR filing requirements would be substantially enhanced, and the burden on taxpayers required to file FBARs would be reduced, if the rules and procedures governing FBAR filing requirements were conformed to the extent consistent with the purposes of those requirements to tax rules and procedures. We also recommend that the imposition of any new FBAR obligations or penalties be postponed for a period sufficient to allow the IRS to issue guidance clarifying a number of very significant

5 Greenbook at 53.

6 Greenbook at 46, 48, and 50.

7 Greenbook at 47 and Baucus bill section 4 (shadow FBARs); Greenbook at 51, 52. We also comment briefly on the statute of limitations proposal on page 54 of the Greenbook.

questions about who is required to file FBARs, given the severe penalties associated with noncompliance.

We support a modified version of the proposal to require taxpayers to file a shadow FBAR with their tax return, under which the taxpayer would file the FBAR itself, or a duplicate copy, with its tax return, rather than a separate form with the same information. Ideally the taxpayer would be required to make only a single filing. If duplicate filings are required, we recommend that they be filed at the same time rather than having wholly separate filing schedules for the FBAR and shadow FBAR. The shadow FBAR filing obligation should be limited to taxpayers that have a financial interest in a foreign account, so that taxpayers subject to FBAR filing requirements solely because they have signature authority over a foreign account would not be required to file a shadow FBAR with their tax return.

We support the proposal to double penalties if a taxpayer required to file a shadow FBAR fails to do so and there is an understatement that arises from a transaction involving the undisclosed foreign account. We do not support the proposal to make the penalty a strict liability penalty if the understatement arose from a reportable transaction.

We support the proposal to adopt a rebuttable evidentiary presumption in civil proceedings that a foreign financial account held at an NQI has an account balance of at least $10,000, thus triggering an FBAR filing requirement, provided that it is made clear that the taxpayer can rebut the presumption by providing bank account statements or similar documents showing the actual balance in the account. We do not support the proposal to adopt a rebuttable presumption that any failure to file an FBAR as willful if the account balance is at any time during the year greater than $200,000.

III. BACKGROUND

During the 1990s, the regulations issued under Chapter 3 of the Code were overhauled. This initiative resulted in the release of proposed regulations on April 15, 1996, which were later finalized in 1997. The effective date of the revised regulations was initially January 1, 1999, but was subsequently moved back to January 1, 2001. The revisions clarified and revised the documentation requirements applicable to payments made through intermediaries. Of particular concern was the need to look beyond an intermediary to the ultimate beneficial owners of payments in determining whether the payments were subject to withholding. For example, under prior law in some cases in which payments were made to foreign financial institutions that served as custodians for their private banking clients, the financial institutions interpreted the withholding tax rules as providing that the analysis would stop at the level of the foreign banks, even if the foreign bank was not the beneficial owner. Under this interpretation, it was not unusual for foreign payees to provide a certification in their own name, without disclosing whether they were acting as an intermediary, and for U.S. banks to determine their withholding obligations based on such certifications.

The revised regulations that became effective in 2001 address the issues described above by defining the term “payee” as the person to whom payment is made, distinguishing between payees and beneficial owners, and describing when the withholding tax analysis is to be based on the status of the payee or that of the beneficial owner.[8] In applying these regulations, the key issue generally is determining the beneficial owner of a payment, which is defined as the person who, under U.S. tax principles, is required to include the payment in gross income.[9] In part to alleviate the burden on foreign banks, the revised regulations introduced the concept of a qualified intermediary. The IRS began signing QI agreements in 2000 and, currently, there are over 5,000 agreements in place.

A. Withholding and Back-up Withholding

A withholding agent generally must withhold tax at a rate of 30 percent from the gross amount of all U.S.-source FDAP income of a nonresident alien individual or foreign entity.[10] FDAP income includes interest and dividends, but generally does not include gross proceeds or gains from sales of property.[11] This 30 percent withholding tax may be reduced or eliminated pursuant to certain statutory provisions or pursuant to the terms of a tax treaty. The withholding system operates as a final tax.

By contrast, there is also an information reporting system that is primarily directed to U.S. taxpayers, which is backstopped by back-up withholding. A "payor"[12] is generally required to withhold tax at a rate of 28 percent on a "reportable payment"[13] made to a U.S. non-exempt recipient if the payee fails to provide a taxpayer identification number or fails to certify, when required, that the payee is not subject to back-up withholding, or the payor is notified by the IRS or a broker that the payee is subject to back-up withholding.[14] Information reporting is not required for any payment made to an exempt recipient, and such a recipient is generally exempt from information reporting without filing a certificate claiming exempt status.[15] The regulations contain "eyeball" tests that permit a payor to determine the exempt status of the payee without

8 Treasury Regulation section 1.1441-1(b)(2). All citations to sections herein are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

9 Treasury Regulation section 1.1441-1(c)(6)(i).

10 Section 1441(a).

11 Treasury Regulation section 1.1441-2(b).

12 In general, "payor" means the person that is required to make an information return under sections 6041, 6041A(a), 6042, 6044, 6045, 6049, 6050A, or 6050N, with respect to any reportable payment, as described in section 3406(b). Treasury Regulation section 31.3406(a)-2(a).

13 Section 3406(b)(1).

14 Section 3405(a); Treasury Regulation section 31.3406(a)-1.

15 Treasury Regulation section 1.6049-4(c)(1). Exempt recipients include corporations, tax-exempt entities, individual retirement accounts, the U.S. and state governments (or any political subdivisions), a foreign government, an international organization, a foreign central bank of issue, a securities or commodities dealer, a real estate investment trust, an entity registered under the Investment Company Act of 1940, a common trust fund, a financial institution, a charitable remainder annuity trust or a charitable remainder unitrust, a trust described in section 4947(a)(1) (certain charitable trusts), a nominee or custodian, a broker, or a swap dealer. Treasury Regulation section 1.6049-4(c)(1)(ii).

documentation. Typically, these tests rely on indications from the payee's name that it is a particular type of exempt recipient or the payor's knowledge of the particular industry that the payee is an exempt recipient. For example, a payor may treat a payee as a corporation and an exempt recipient if it meets certain eyeball requirements prior to making the payment, except when a payor actually knows that this information is incorrect.[16]

Both U.S. and non-U.S. payors have information reporting responsibilities, although those of a non-U.S. payor generally are more limited (for instance, it is not required to report foreign source income paid outside the United States). A U.S. payor includes a controlled foreign corporation and the foreign branches of U.S. corporations.[17] A foreign payee may claim a refund of any overpayment of tax which is withheld at the source.

Brokers and certain other payors also generally are required to withhold tax at a rate of 28 percent on certain reportable payments made to a U.S. non-exempt recipient if the payee fails to provide a taxpayer identification number or fails to certify that the payee is not subject to back-up withholding, or the payor is notified by the IRS or a broker that the payee is subject to back-up withholding.[18] Reportable payments include the gross proceeds from certain transactions effected by brokers for their customers. A broker is exempt from reporting a payment (and thus back-up withholding) where the broker can, prior to payment, associate the payment with documentation upon which it can rely to either treat the customer as a foreign beneficial owner, or treat the payment as made or presumed to be made to a foreign payee.[19] This generally requires collecting an IRS Form W-8BEN or similar form.

Intermediaries—that is, persons acting on behalf of beneficial owners—fall into two broad categories—qualified intermediaries and nonqualified intermediaries.[20] A QI is an entity

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16 Treasury Regulation section 1.6049-4(c)(1)(ii)(A). For example, if the name of a payee contains an unambiguous expression of corporate status, including "Incorporated," "Inc.," "Corporation," "Corp.," "P.C.," "insurance company," "indemnity company," "reinsurance company," "assurance company," or the name indicates that it is an entity that is listed as a *per se* corporation, it can be assumed that the entity is a corporation. Alternatively, if an entity does not meet the above test, but a payor has on file a corporate resolution or similar document clearly indicating corporate status, it may treat the payee as an exempt recipient. This includes a copy of Form 8832 (Entity Classification Election) electing corporate status under the check-the-box rules. *Id.*

17 Treasury Regulation section 1.6049-5(c)(5). The term "U.S. payor" also includes (1) a foreign partnership, if at any time during its tax year, one or more of its partners are U.S. persons (as defined in Treasury Regulation section 1.1441-1(c)(2)) who, in the aggregate hold more than 50% of the income or capital interest in the partnership or if, at any time during its tax year, it is engaged in the conduct of a trade or business in the United States; (2) a foreign person 50% or more of the gross income of which, from all sources for the three-year period ending with the close of its taxable year preceding the collection or payment (or such part of such period as the person has been in existence), was effectively connected with the conduct of trade or business within the United States; or (3) a U.S. branch of a foreign bank or a foreign insurance company described in Treasury regulation section 1.1441-1(b)(2)(iv).

18 Treasury Regulation sections 31.3406(b)(3)-2(a); 31.3406(d)-4(a)(1).

19 Treasury Regulation section 1.6045-1(g)(1)(i).

20 Treasury Regulation section 1.1441-1(c)(13).

that enters into a contract with the IRS (a QI agreement) to assume certain responsibilities related to compliance with the U.S. withholding and information reporting regime. The QI regime is intended to allow the IRS to ensure that reductions in withholding tax to non-U.S. persons are properly policed and proper back-up withholding or identification of U.S. persons occurs. At the same time, the QI procedures reduce significantly the paperwork requirements for everyone involved, including U.S. withholding agents, and eliminate the need for the identities of certain foreign investors to be given to the IRS or to other intermediary financial institutions. An NQI, on the other hand, remains subject to the increased requirements.

To determine whether the recipient of a payment is exempt from withholding tax or eligible for a reduced rate, withholding agents generally must rely on beneficial ownership documentation provided by the payee certifying that the beneficial owner is entitled to an exemption from withholding tax or a reduced rate of withholding tax under a Code provision or relevant tax treaty. In general, withholding agents are entitled to rely on the self-certification they receive absent actual knowledge or reason to know that the information provided is incorrect or unreliable.[21] Subject to the discussion of the QI rules below, in the case of payments made through an intermediary, the intermediary generally provides to the withholding agent the appropriate documentation on behalf of the payment's beneficial owners.[22] Presumption rules exist to determine how a withholding agent should treat an undocumented payee for withholding and reporting purposes.[23] Those rules help a withholding agent (or payor) classify a payee who has failed to provide documentation (*i.e.*, generally, Form W-8 or W-9) or has provided documentation that lacks information. These rules also apply if the withholding agent knows or has reason to know that the information associated with the required documentation is incorrect or unreliable. The presumption rules make certain assumptions as to the status of a payee as an individual, trust, estate, corporation, or partnership. Presumptions are also made as to the status of the payee as a U.S. or foreign payee. The presumption rules generally make the least favorable assumption based on the information the withholding agent has, so they maximize potential withholding/backup withholding. However, in certain instances, the payment is presumed to be made to an exempt recipient, such as where the payee is a *per se* foreign corporation or the payment is made outside the United States.[24]

Intermediaries use Form W-8IMY (Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding). On it, the payee represents that it is a foreign person and that it is an intermediary (whether qualified or nonqualified) with respect to a payment and not the beneficial owner.[25] An NQI[26] is required to

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21 Treasury Regulation section 1.1441-7(b)(1) (withholding agent may rely on certificate unless it has knowledge or reason to know that it is unreliable or incorrect).

22 Treasury Regulation section 1.1441-7(b)(1).

23 Treasury Regulation section 1.1441-1(b)(3)(ii).

24 Treasury Regulation section 1.1441-1(b)(3)(iii)(A)

25 Treasury Regulation section 1.1441-1(e)(3)(i); 1.1441-1(e)(3)(iii).

provide a Form W-8IMY certifying that it is acting as a nonqualified intermediary for reportable amounts it receives. For these purposes, the term "reportable amount" generally means a payment of (1) an amount subject to withholding under Treasury Regulation section 1.1441-2(a), (2) bank deposit interest (including original issue discount) and similar types of U.S.-source deposit interest described in sections 871(i)(2)(A) or 881(d) of the Code, and (3) any amount of U.S.-source interest or original issue discount paid on the redemption of certain short-term obligations described in sections 871(g)(1)(B) or 881(e).[27] Amounts received on the sale or exchange (other than a redemption) of a short-term obligation that is effected outside the United States are not reportable amounts.[28]

B. Qualified Intermediary Program

Foreign financial institutions may contract with the IRS to operate according to a set of withholding and reporting rules under the qualified intermediary program.[29] A "qualified intermediary" may be:

- A foreign financial institution or a foreign clearing organization (as defined in Treasury Regulation section 1.163-5(c)(2)(i)(D)(8), without regard to the requirement that the organization hold obligations for members), other than a U.S. branch or U.S. office of such institution or organization;
- A foreign branch or office of a U.S. financial institution or a foreign branch or office of a U.S. clearing organization (as defined in Treasury Regulation section 1.163-5(c)(2)(i)(D)(8), without regard to the requirement that the organization hold obligations for members);
- A foreign corporation for purposes of presenting claims of benefits under an income tax treaty on behalf of its shareholders; or
- Any other person acceptable to the IRS.

QIs agree to collect identifying documentation from their customers, file withholding tax returns and information returns, and submit to periodic audits performed by external auditors supervised by IRS examiners.[30] A QI may furnish a withholding certificate to a withholding agent with summary attachments allocating income to withholding tax categories on a pooled basis in lieu of transmitting to the withholding agent documentation for persons for whom the QI

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26 NQIs fall into three categories: (i) the typical financial intermediary that has chosen not to be a QI; (ii) funds, which are often partnerships for tax purposes; and (iii) non-financial intermediaries who act as agents (an example might be a literary agent that receives royalties on behalf of an author).

27 Treasury Regulation section 1.1441-1(e)(3)(vi).

28 *Id. See also* Treasury Regulation section 1.6045-1(g)(3) to determine whether a sale is effected at an office outside the United States.

29 Treasury Regulation section 1.1441-1(e)(5)(ii)(A).

30 Treasury Regulation section 1.1441-1(e)(5).

receives the payment. In the case of U.S. non-exempt recipients, a QI may also assume primary Form 1099 reporting and back-up withholding responsibility.[31]

QIs may assume primary responsibility for withholding tax compliance without assuming primary Form 1099 reporting and back-up withholding responsibility.[32] If a QI nevertheless assumes primary Form 1099 reporting and back-up withholding responsibility with respect to an account, it must assume such responsibility with respect to all reportable amounts paid by a payor to that account.[33] Further, a QI that assumes primary Form 1099 reporting and back-up withholding responsibility with respect to U.S. persons is not required to assume that responsibility for all accounts. Moreover, in the case of financial institutions that are part of a controlled group, one member of the controlled group may contract to be a QI while other members of the controlled group do not, and thus accounts and clients may be divided between commonly controlled QI and NQI institutions. In its current form, therefore, the QI program provides a degree of flexibility that allows a QI some choice about how much responsibility it wishes to take on for enforcing U.S. law, in order to make the QI program more attractive to potential participants.

According to the IRS, the objective of the QI agreement is to simplify withholding and reporting obligations for payments of income made to an account holder through one or more non-U.S. intermediaries (*e.g.*, non-U.S. financial institutions).[34] This is accomplished by: (1) permitting QIs to rely on existing documentation (*i.e.*, account holder identification) procedures that are enforced under local law; (2) permitting QIs to shield from the IRS and other intermediaries the identities of their non-U.S. account holders; (3) reducing the flow of documentation to U.S. custodians by permitting QIs to report the characteristics of their account holders in a pooled format rather than by individual account holder; (4) reducing the information reporting obligations with respect to non-U.S. account holders by permitting such reporting to be done in a pooled format rather than by individual account holder; (5) permitting QIs to assume certain withholding and information reporting tasks; and (6) permitting QIs to elect not to assume certain withholding and information reporting tasks.[35]

C. Revenue Procedure 2000-12

In January 2000, the IRS issued Revenue Procedure 2000-12,[36] which set forth the specific rules under which a foreign person can become a QI, the application procedures for

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31 Treasury Regulation section 1.1441-1(e)(3)(ii).

32 Treasury Regulation section 1.1441-1(e).

33 *See* Section 3.07 of the form of Qualified Intermediary Withholding Agreement, set forth in Rev. Proc. 2000-12, 2000-1 C.B. 387.

34 Rev. Proc. 2000-12, 2000-1 C.B. 387.

35 MARNIN J. MICHAELS, INTERNATIONAL TAXATION: WITHHOLDING ¶4.01 (2008).

36 2000-1 C.B. 387 (supplemented by Announcement 2000-50, 2000-1 C.B. 998 and modified by Rev. Proc. 2003-64, 2003-2 C.B. 306).

becoming a QI and the text of the withholding tax agreement governing QI status which a QI must enter into with the IRS (the "Model Agreement"). To protect U.S. interests, the Model Agreement includes provisions designed to ensure that (1) U.S. persons pay appropriate amounts of tax, (2) non-U.S. persons do not claim benefits under treaties to which they are not entitled, and (3) appropriate amounts of tax are withheld. QI agreements have a six year term, but may be renewed upon application by a QI.[37]

The parties to a QI agreement include the IRS and all offices of the QI located in countries identified in the agreement. These are generally countries whose know-your-customer ("KYC") rules have been approved by the IRS. KYC rules refer to the applicable laws, regulations, rules, and administrative practices and procedures governing the requirements of a QI to obtain documentation confirming the identity of the QI's account holders. In the United States, these rules derive from section 352 of the Patriot Act. Similar rules have been enacted around the world. Some financial institutions have adopted the practice of identifying "major shareholders."[38] However, there is no uniform standard for determining what are considered major shareholders, or the extent to which it is necessary to track changes in shareholders. A QI is required to follow KYC rules under local law regardless of its QI status. The IRS will not enter into a QI agreement if it has not received and approved the KYC rules for an applicant's country. That approval is based on a country's KYC practices and procedures for opening accounts, and on eighteen specific questions listed in Revenue Procedure 2000-12. The standard QI withholding agreement in Revenue Procedure 2000-12 includes an attachment listing the kind of "documentary evidence" (evidence other than Form W-8 or Form W-9 sufficient to establish the account holder's status as foreign) that will be deemed sufficient.[39]

D. <u>The 2007 GAO Study</u>

In December 2007, the GAO reported on a study it conducted to (1) describe QI program features, (2) assess whether weaknesses exist in the U.S. withholding system for U.S. source income, and (3) identify any weaknesses in QI external reviews and the IRS's use of program data.[40] The GAO made several recommendations to the IRS.[41] First, the GAO recommended that the IRS measure U.S. withholding agents' reliance on self-certified documentation and use that data in IRS compliance efforts. When dealing with indirect account holders, U.S.

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37 Model Agreement sections 11.01, 11.06.

38 *See, e.g.*, 31 U.S.C. section 103.121(b)(ii)(C); 31 U.S.C. section 103.122(b)(ii)(C); 31 U.S.C. section 103.131(b)(ii)(C).

39 Documentary evidence is (1) any documentation obtained under the appropriate KYC rules, (2) any documentary evidence described in Treasury Regulation section 1.1441-6 sufficient to establish entitlement to a reduced rate of withholding under an income tax treaty, or (3) any documentary evidence described in Treasury Regulation section 1.6049-5(c) sufficient to establish an account holder's status as a foreign person for purposes of Form 1099 information reporting. Rev. Proc. 2000-12, 2000-1 C.B. 387.

40 U.S. Government Accountability Office, *Tax Compliance: Qualified Intermediary Program Provides Some Assurance That Taxes on Foreign Investors Are Withheld and Reported, But Can Be Improved*, GAO-08-99 (Dec. 2007), available at http://www.gao.gov/new.items/d0899.pdf.

41 *Id.* at 34-35.

withholding agents may rely on the self-certified identity information (*i.e.*, W-8BENs) forwarded by QIs and NQIs for their customers, and NQIs may not have rigorous processes for identifying their account holders. Accordingly, the GAO believes that correct determination of U.S. tax liability may be at risk.[42] As of the date of the report, the GAO found that the IRS had not determined what portion of U.S. withholding agents' accounts are with, and U.S. source income goes to, NQIs and QIs.[43] Doing so may help the IRS in assessing the Treasury's exposure to unaudited documentation and exposure to tax benefits flowing to unaudited accounts. The GAO believes this information might help policymakers decide whether documentation requirements should be modified for unaudited accounts or whether other changes should be made to improve the likelihood that tax benefits are properly determined.[44] In addition, if certain NQIs account for a large portion of U.S. withholding agents' accounts, the IRS might be able to take steps to encourage them to join the QI program, and if certain countries are the source of a large portion of the accounts Treasury might focus efforts on improving applicable tax treaties or information exchange agreements.

Second, the GAO suggested the IRS determine why U.S. withholding agents and QIs report billions of dollars in funds flowing to unknown jurisdictions and to unidentified recipients. Based on this determination, it was believed that the IRS should take appropriate steps to recover any withholding taxes that should have been collected and to better ensure that U.S. taxes are withheld when account owners do not properly identify themselves.

Third, the GAO recommended that the IRS work to enhance the international standard on agreed-upon procedures ("AUPs") by requiring the external auditor to report any indications of fraud or illegal acts that could significantly affect the results of the review. Under current AUPs, the external auditor is required to report whether, based on information from the QI or its own information, the QI is in material violation of, or is under investigation for violation of "know your customer" rules applicable to the QI. It was suggested that the IRS should direct the head of the QI program office to expand this reporting requirement in the QI contractual agreement to require the external auditor to report any indications of fraud or illegal acts encountered while performing AUPs that could significantly affect the results of the review. The GAO believed that this would give the QI program office the information necessary to pursue any indications of significant fraud or illegal acts identified during the AUP review through additional targeted procedures in phase 2 of the AUPs.

Finally, the GAO recommended that the IRS require electronic filing of forms in QI agreements whenever possible, thereby reducing the need to manually process data reported from abroad. It further suggested that the IRS should invest the funds necessary to perfect these data.

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42 *Id.* at 33.

43 *Id.*

44 *Id.*

E. Announcement 2008-98

In Announcement 2008-98,[45] the IRS sets forth, and solicits public comments regarding, proposed amendments that the IRS intends to make to the Model Agreement set out in Revenue Procedure 2000-12, and to the Guidance for External Auditors of Qualified Intermediaries set out in Revenue Procedure 2002-55.[46] These amendments are intended to ensure that QIs are taking the steps necessary to comply fully with their obligations under the QI agreement. The amendments are proposed to be effective for calendar years beginning after December 31, 2009. The Announcement proposes three areas requiring amendment.

First, the QI agreement will be amended to provide that a QI must notify the IRS whenever the QI becomes aware of a material failure of internal controls relating to its performance under the QI agreement, any employee allegations of such failures, or any investigation by regulatory authorities of such failures.

Second, the QI audit guidance will be amended to add an audit procedure testing certain accounts for characteristics that suggest that a U.S. person has authority over the account. The QI audit guidance will also be amended to add additional procedures for fact gathering by the external auditor relating to the IRS's evaluation of the risk of a material failure of internal controls.

Finally, the QI audit guidance will be amended to require the external auditor to associate a U.S. auditor with the audit and to require the U.S. auditor to accept joint responsibility for performance of the procedures under the audit guidance. The aim in joining a U.S. auditor is to assure appropriate application of U.S. withholding rules and to enhance accuracy and accountability in the audit process.

F. Withholding Partnerships

Revenue Procedure 2003-64[47] contains the final draft of the withholding foreign partnership ("WP") agreements with the IRS. Similar to the QI agreement, the WP agreement is designed to simplify withholding and reporting obligations for payments to partners of a WP. The agreement is tailored to fit the unique situations of foreign partnerships in much the same way that the QI agreement is designed to meet the needs of foreign financial institutions. These agreements primarily benefit investment funds.

Under U.S. withholding tax and information reporting rules, foreign partnerships that are not WPs are generally required to provide each withholding agent from which they receive an "amount subject to withholding" with a Form W-8IMY.[48] They are also required to include documentation from each of their partners, as well as a withholding statement allocating the

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[45] 2008-44 I.R.B. 1087.

[46] 2002-2 C.B. 435.

[47] 2003-2 C.B. 306.

[48] Treasury Regulation sections 1.1441-5(c)(3)(iii), 1.1446-1(c)(2).

amount attributable to each partner.[49] The withholding agent then withholds the appropriate amount of U.S. tax from payments to the partnership. Further, the withholding agent is required to report on Forms 1042-S and 1099 payments to and tax withheld for each individual partner.[50]

Much like a QI, a WP is permitted to provide a withholding agent with a Form W8-IMY as a WP, without the attached documentation of partners.[51] Instead of the withholding and information reporting taking place at the withholding agent level, WPs receive payments from the withholding agents in gross and then withhold the appropriate amount of tax based on the Forms W-8 or W-9 that they receive from their partners.[52] WPs also are responsible for completing the necessary information reporting tasks associated with payments to and tax withheld for their partners.[53] However, for foreign partners, WPs are allowed to report this information on a pooled basis rather than individually for each partner.[54] Reporting on a pooled basis requires an affirmative election and results in an audit by a QI auditor every second year.[55] However, unlike a QI agreement, there is no general audit requirement. It should also be noted that WPs, which are typically funds, will not be subject to KYC rules, although in the subscription process, funds require detailed information regarding a proposed investor.

G. Congressional Concern Regarding Use of Offshore Accounts.

1. Recent Hearings and Reports

The public record contains many reports, hearings and articles on the problem of offshore tax evasion by U.S. taxpayers. Some of the more significant ones are described below.[56] There

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49 Treasury Regulation section 1.1441-5(c)(3)(iii).

50 Treasury Regulation section 1.1461-1(c)(4).

51 Treasury Regulation section 1.1441-5(c)(2)(iii).

52 *Id.*

53 *Id.*

54 Treasury Regulation section 1.1461-1(c)(4)(i)(B).

55 Rev. Proc. 2003-64, 2003-2 C.B. 306.

56 Among the materials in the public record that are not discussed herein are a July 2001 hearing by the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs ("PSI") on "What is the U.S. Position on Offshore Tax Havens?" (S. Hrg. 107-152); a March 2007 report by the General Accountability Office ("GAO") entitled "Additional Time Needed to Complete Offshore Tax Evasion Examinations (GAO-07-237, March 30, 2007); a May 2007 hearing by the Senate Finance Committee on "Offshore Tax Evasion: Stashing Cash Overseas" (S. Hrg. 110-677, May 3, 2007); a May 2007 report by the GAO on "Tax Compliance: Challenges in Ensuring Offshore Tax Compliance" (GAO-07-823T, May 3, 2007); a July 2008 report by the Joint Committee on Taxation on "Tax Compliance with respect to Offshore Accounts and Entities" (JCX-65-08, July 23, 2008); a December 2008 report by the GAO on "Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions" (GAO-09-157, Dec. 18, 2008); a March 2009 PSI Hearing on "Tax Haven Banks and U. S. Tax Compliance - Obtaining the Names of U.S. Clients with Swiss Accounts" (March 2009) (transcript not yet available); and a March 2009 report by the Joint Committee on Taxation

are also voluminous additional materials on tax evasion by European taxpayers, and the related tax haven initiative by the Organisation for Economic Co-operation and Development ("OECD"), which are not discussed herein.

a. 2003 Report on Tax Professionals.

In November 2003, the Senate Permanent Subcommittee on Investigations ("PSI") held hearings and issued a report on the role of accountants, lawyers and financial professionals in the U.S. tax shelter industry.[57] The hearing and report dealt principally with the institutionalization by such professionals, notably by employees of KPMG – one of the "big 4" public accounting firms that audits most large U.S. corporations – of a practice of developing generic tax-driven transactions and mass-marketing them to clients, both individuals and corporations.

The transactions described in the hearing and report shared some characteristics with offshore tax evasion transactions, including the use of legal entities that purported to have a particular function but in fact served no purpose, and the structuring of the transactions in a manner intended to avoid discovery by the Internal Revenue Service (the "IRS"). The courts have subsequently held that many of these transactions are invalid.

b. 2006 Report on Tax Haven Abuses.

In August 2006, the PSI held hearings and issued a report on the role of tax havens in facilitating tax abuse.[58] The report is based upon an investigation that began in 2005, apparently in response to numerous studies and reports conducted by other bodies estimating the amount of U.S. tax evasion facilitated by tax havens and secrecy jurisdictions. The investigation found that offshore tax havens with secrecy laws and practices are used by U.S. citizens to conceal and secretly utilize offshore assets while avoiding U.S. tax, security and anti-money laundering laws. The report focused on the roles played by offshore service providers and U.S. and offshore professionals and the sophisticated schemes they developed, using six case histories. Some of these case histories clearly involved a flaunting of tax, securities and/or money-laundering laws.

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on "Tax Compliance and Enforcement Issues With Respect to Offshore Entities and Accounts" (JCX-23-09, March 30, 2009).

The descriptions of the reports in the text are largely taken from the reports themselves.

57 Report Prepared by the Minority Staff of the PSI, *U.S. Tax Shelter Industry: the Role of Accountants, Lawyers and Financial Professionals* (S. Prt. 108-34, Nov. 2003), http://www.access.gpo.gov/congress/senate/senate12cp108.html, and related hearings (S. Hrg. 108-473, Nov. 18 & 20, 2003, also accessible at the GPO website).

58 Report of the PSI, *Tax Haven Abuses: The Enablers, the Tools and the Secrecy*, 109th Cong., 2d Sess. (Aug. 1, 2006), printed as part of the record of the related hearings at http://www.access.gpo.gov/congress/senate/senate12sh109.html (S. Hrg. 109-797; report begins on p. 161).

Most of the cases involved abusive transactions, in many instances instigated by promoters utilizing shell corporations with bearer shares.[59]

The report's findings included that offshore trusts and corporations are used to mask a U.S. person's beneficial ownership of an entity organized in a tax haven, that the beneficial owner controls the entity indirectly through the trustees, directors or officers who act at the U.S. client's direction, and that the secrecy laws and practices of the tax haven make it difficult for the United States to ascertain the true beneficial owners. The report's recommendations included that U.S. tax, securities and anti-money laundering rules should presume that offshore trusts and shell corporations are controlled by U.S. persons supplying or directing the use of the assets, whenever the entity is located in a jurisdiction designated as a tax haven by the Secretary of the Treasury.

c. 2008 Report on LGT and UBS.

In July 2008, the PSI held hearings and issued a report on certain practices of two foreign banks: LGT, a privately held Lichtenstein bank, and UBS AG, a publicly held Swiss bank that is one of the world's largest financial institutions.[60] The report described how these banks used secrecy and deception to facilitate tax evasion by U.S. persons.

The underlying investigation by the PSI began in February 2008 after a former employee of LGT provided data to tax authorities around the world about 1,400 people with accounts at LGT. In May of 2008, a former employee of UBS was arrested on charges of having conspired with a U.S. citizen to defraud the IRS of $7.2 million in taxes on $200 million of assets hidden in offshore accounts. Accordingly, the investigation and report focused on case studies of LGT and UBS clients.

The report uncovered the use of "elaborate, deceptive offshore structures, using foundations, trusts, and corporations, to hide a client's ownership of assets from tax authorities," and abuse of the QI program. The investigation revealed that the banks had actively promoted their services to individuals in the United States. The hearing concluded that UBS had opened Swiss accounts for 19,000 U.S. clients and had assisted the clients in hiding the accounts from the United States. During these hearings, UBS announced that it would take responsibility for its actions and cooperate fully with the U.S. tax authorities. Subsequently, UBS entered into a settlement with the U.S. government under which it entered into a deferred prosecution agreement and agreed to pay a $780 million penalty, and the U.S. and Swiss governments have negotiated an agreement under which the names of thousands of UBS's clients will be turned over to the IRS.

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59 For example, one of the case histories in the report involved Robert Holliday. Holliday transferred approximately $450,000 in untaxed income to an Isle of Man shell corporation he controlled in payment for non-existent feasibility studies. In order to utilize the funds placed offshore, Mr. Holliday paid his bills using a credit card issued by an offshore bank, directed the offshore companies to pay designated expenses, and instructed Nevada companies to borrow money from his offshore entities. *Id.* at 6.

60 Report of the PSI, *Tax Haven Banks and U.S. Tax Compliance* (July 2008), printed as part of the record of the related hearings at http://www.access.gpo.gov/congress/senate/senate12sh110.html (S. Hrg. 110-614; report begins on p.87).

The report recommended that Congress (1) strengthen the QI program, (2) require any U.S. or non-U.S. financial institution that obtains information that a foreign-owned financial account is beneficially owned by a U.S. person to file an annual return with the IRS, (3) create a presumption that any entity located or operated in an offshore secrecy jurisdiction is controlled by any U.S. taxpayer that formed it, sent assets to it, or received assets from it, (4) extend the statute of limitations to 6 years if the matter involves an offshore tax haven with secrecy laws and practices, and (5) enact the Stop Tax Haven Abuse Act (as introduced in Congress in 2008). In introducing the Stop the Tax Haven Abuse Act, Senator Levin noted in particular the activities of LGT Bank, a private bank owned by the Liechtenstein royal family. At the hearings, a former LGT employee, now in hiding for disclosing LGT client information, provided videotaped testimony during the hearing describing a long list of practices used by LGT to conceal client assets.[61]

d. 2008 Report on Ugland House.

In July 2008, the GAO released a report stating that over 18,000 Cayman Island-incorporated companies have their registered address at one building in the Cayman Islands, Ugland House; that the only occupant of the building is a Cayman Islands law firm; and that it is estimated that 40 to 50 percent of the companies registered at Ugland House have a U.S. billing address.[62]

H. Administration Concern Regarding Use of Offshore Accounts.

Concerned about the use of offshore accounts and entities by certain U.S. and foreign persons to evade U.S. tax, the Obama Administration is proposing a series of measures to strengthen the information reporting and withholding systems that support U.S. taxation of income earned or held through offshore accounts or entities.

A principal focus of the Administration's proposals is the role of intermediaries. Intermediaries fall into several classes. In very general terms, there are financial intermediaries acting as agents, such as banks, intermediaries such as funds that are owners of financial assets acquired on a pooled basis using investor contributions (which may or may not be pass-through entities for tax purposes; these pass-through entities generally are referred to as "intermediaries" for withholding tax purposes) and miscellaneous non-financial intermediaries.[63] Financial intermediaries can be either QIs or NQIs, depending on their willingness to enter into QI agreements and their willingness to provide the broader type of information required of NQIs.[64] As set forth below, the proposals would expand the scope of the QI program.

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61 Reprinted in 2009 TNT 41-38 (March 4, 2009).

62 GAO, *Cayman Islands: Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist* (GAO-08-778, July 2008).

63 Non-financial intermediaries also include agents, such as literary agents, which are not the subject of this report.

64 Non-financial intermediaries *generally* cannot qualify as QIs under the current regulations and procedures governing the QI program.

In general, financial intermediaries might have more access to investor information than non-financial intermediaries. Funds will typically have information regarding at least their immediate investors, which they obtain through the subscription process. Each type of intermediary is unlikely to have full information regarding investors higher in their ownership chain.

Under current law, there are different information reporting schemes applicable to different classes of debt instruments. For instance, portfolio debt is divided between bearer debt instruments and registered debt instruments.[65] Payments on bearer debt are not subject to documentation requirements, while holders of registered debt must provide a Form W-8 (without a taxpayer identification number).[66] Debt issued in bearer form must be targeted only to foreign investors and must be paid outside the United States. Bank deposits and commercial paper are not subject to withholding under section 1441 and are not subject to any certification requirements.[67] Treaty claims relating to interest paid on debt instruments require the provision of a Form W-8BEN (which, in the case of non-actively traded debt obligations, must include a taxpayer identification number, thereby facilitating cross-checking by the IRS).[68]

One target of the proposals is the U.S. person that masquerades as a foreign person in order to claim an exemption from U.S. withholding taxes. Foreign corporations, absent unusual circumstances, are considered the owner of the assets and related income of their shareholders. Thus, it is appropriate and indeed common for foreign corporations to issue documentation in their own names. However, misuse of foreign corporations by U.S. taxpayers has occurred, as the UBS matter has demonstrated. It is certainly appropriate for the IRS to attack misuse of foreign corporation status. However, we note that, while treaties may require that the composition of shareholders be evaluated to determine whether treaty benefits apply, the determinative question is whether the foreign corporation itself qualifies for the treaty.[69] Most treaties treat U.S. shareholders as "good" shareholders for the purpose of determining whether a corporation is a qualified resident for purposes of applicable Limitation on Benefits ("LOB") clauses.[70] Thus, having a U.S. shareholder is favorable for this purpose.

A number of the Administration's proposals were loosely modeled on proposals in the Levin bill introduced in March of this year.

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65 Sections 871(h)(2), 881(c)(2); Treasury Regulation sections 1.1441-2(a)(1), 1.6049-5(e)(3).

66 Treasury Regulation section 1.1441-1(b)(4)(i). While not directly germane to this report, the Treasury and IRS may wish to consider modifying the W-8BEN and other withholding tax forms in order to require or permit taxpayers to specify the items of income to which the form relates.

67 Treasury Regulation section 1.1441-2(a).

68 Treasury Regulation section 1.1441-6(b)(1).

69 *See, e.g.*, United States Model Income Tax Convention of November 15, 2006, art. 22; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, U.S.-Ir., art. 23, July, 28, 1997, S. TREATY DOC. NO. 105-31.

70 *Id.*

IV. DISCUSSION

This Part IV of the report discusses most of the proposals made by the Administration under the heading "Combat Under-Reporting of Income Through Use of Accounts and Entities in Offshore Jurisdictions". In order to more readily analyze these proposals, the discussion is divided into three sections: Part IV.A discusses four proposals that would impose new reporting and withholding obligations on payments made by QIs and NQIs, Part IV.B discusses several proposals that would impose additional reporting obligations on U.S. taxpayers and financial intermediaries, and Part IV.C discusses four proposals relating to FBAR reporting.

A. QI and NQI Reporting and Withholding Proposals.

1. Greater Reporting by QIs[71]

a. Description of Proposal

Under the proposal, a foreign financial institution would qualify as a QI only if it identifies all of its account holders that are U.S. persons. A QI would be required to report all reportable payments (for this purpose, treating the QI as a U.S. payor) received on behalf of all U.S. account holders. Thus, a QI would file Form 1099s with respect to payments to those U.S. account holders as though the QI were a U.S. financial institution.

The principal impact of this proposal is that a QI (like U.S. payors) would be required to report foreign source income of its U.S. account holders, which is not the case today with respect to QIs that are not treated as "U.S. payors" (*e.g.*, controlled foreign corporations). In addition, QIs apparently would no longer be permitted to decline to assume Form 1099 reporting and back-up withholding responsibility, even if they do not assume regular withholding tax responsibility.

The Treasury Department would be authorized to issue regulations to implement the purposes of this proposal, including authority to require that for any financial institution to be a QI, commonly controlled foreign financial institutions must meet certain reporting obligations with respect to account holders or must also be QIs. The Treasury Department would also be given authority to require that for any financial institution to be a QI, it must collect information indicating the beneficial owners of foreign entity account holders and specifically report if a U.S. person is a beneficial owner.

The proposal would clarify that under section 6103 the IRS may publish the list of QIs, and it is expected that the IRS would do so. This is necessary in order to facilitate the implementation of other proposals that are intended to encourage investors to hold their accounts through QIs, by imposing harsher rules on payments to NQIs.

The stated reason for the proposal is that "[s]trengthening the withholding and reporting rules under which QIs operate with respect to U.S. persons while creating incentives for the use

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71 Greenbook at 41.

of QIs would help to ensure that U.S. persons are properly paying tax on income earned through foreign accounts and that proper withholding tax applies with respect to foreign persons."

b. Recommendation

The objectives of the proposal to expand reporting to include foreign source income are a reasonable response to the problems identified. However, we believe a number of modifications should be made in order to limit the additional burden on QIs to what is necessary to achieve the proposal's objectives.

Accordingly, we recommend that the proposal include simplifying assumptions that will allow QIs to report the income based on information readily available to them. The rule also should be implemented with significant transition rules so as to provide QIs with sufficient time to implement the proposal effectively.

The proposal to grant regulatory authority to Treasury to expand the QI rules to commonly controlled entities may provide Treasury and the IRS with a valuable tool in administering the QI program. However, if it is adopted the rules should be limited to commonly controlled entities with customer relationships, and Treasury should be encouraged to implement these rules taking individualized facts into account rather than by adopting across-the-board requirements.

We recommend that a limited version of a QI's obligations under the expanded reporting requirements be adopted where a customer has only a relatively small amount of income or assets.

c. Discussion

The QI program is intended to bring foreign financial institutions more directly into the U.S. information reporting and withholding tax system, thereby helping to ensure that foreign persons are subject to the proper U.S. withholding tax and U.S. persons do not underreport income. Strengthening the withholding and reporting rules under which QIs operate with respect to U.S. and foreign persons while creating incentives for more foreign financial institutions to become QIs is intended to help ensure that U.S. persons are properly paying tax in connection with foreign income and accounts, and that proper withholding tax applies with respect to foreign persons.

The rules need to take into account, though, that while there are U.S. persons that are evading U.S. taxation with foreign bank accounts, there are also many U.S. persons with foreign bank accounts for legitimate reasons, including: (1) students; (2) expatriates and (3) foreign persons such as immigrants who are technically U.S. citizens or residents. The new burdens imposed on QIs should be evaluated in this light.

It is our understanding that QI status is unevenly distributed. While there are currently 59 countries approved for QI status, there are no QIs, for example, in Brazil, Mexico, or New Zealand and very few in Japan. There are likely more countries that would qualify for QI status than have entered into QI agreements. It is likely that the IRS will need significant time to expand the list of countries that are approved for the purposes of the QI program. Transition rules should be designed to take this into account.

As described in more detail below, we believe that it would be acceptable in principle to expand the QI rules to certain affiliates (see *Expansion to Affiliates* below) and to foreign source income, *provided* some transitional and "tier" approach is adopted and the reporting is done in a way that minimizes the cost burden to the QI.

(1) Foreign Income Reporting Issues

The requirement to report on Form 1099 all foreign source FDAP income received on behalf of U.S. persons would impose substantial burdens on QIs, in particular with respect to income derived from securities originally issued outside the United States with no disclosure describing the U.S. federal income tax treatment of the securities. We believe that it would be unduly burdensome if QIs were required to perform an independent analysis of the U.S. federal income tax treatment of such securities, including in particular securities such as hybrid instruments or debt securities issued at a discount where the U.S. tax treatment may not be readily apparent.[72] Similarly, a requirement that QIs comply with the new basis reporting requirements[73] could be burdensome for QIs that do not currently have systems to collect basis information, or that calculate basis in a manner that is not comparable to the U.S. federal income tax rules regarding the computation of basis.

Thus, some form of simplifying default rule should apply. One approach would be to use a gross proceeds approach—that is, to report a cash payment without classifying it. This would give the IRS information about the amounts of potential income that a U.S. taxpayer is deriving from foreign sources, which should help the IRS determine whether the taxpayer is one that deserves further investigation. A possible variation would to be follow the form of the transaction where the form provides for payments that fit on their face into existing tax payment categories, *e.g.*, amounts denominated as interest would be reported as such; but such an approach should not be adopted without consideration of how much of an additional burden this would impose on the QI. This variation would not in any event cover all transactions. For example, it would not work with respect to hybrid instruments that provide for payments not denominated as interest or dividends, so that in such cases a gross proceeds approach should be the simplifying default rule. In determining which approach to follow, the goal should be to maximize the benefit of having the QI report the payment in a way that it can then be readily reported on the taxpayer's tax return in a manner consistent with the QI's reporting to the IRS, while minimizing the burden on the QI of classifying payments under U.S. tax principles. Finally, implicit in our suggestion that simplifying assumptions be used for gross income reporting is a suggestion that we believe that QIs should be exempt from the basis reporting requirements of section 6045(g) for the foreseeable future.

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72 Compare Treasury Regulation sections 1.1441-2(b)(3) and 1.6049-5(f), which generally permit payors and withholding agents to rely on IRS Publication 1212 to determine whether a security has original issue discount and the amount of such discount.

73 *See* Sections 6045(g), 6045A and 6045B.

A gross proceeds reporting approach has the disadvantage that taxpayers may report amounts that are in fact income to them as gross proceeds. An investor that has a U.S. tax advisor familiar with the transaction is likely to be in a better position than the QI to determine the proper characterization of a payment received on an investment that has no U.S. tax disclosure, in which case the investor should be responsible for the proper characterization of the payment. In other cases, an investor may not have any more information than the QI. While that would not relieve the taxpayer of its obligation to properly report its income, consideration should be given to whether it is appropriate to limit the application of penalties in such a case.

(2) QI Limited Alternative

The audit costs associated with the QI program are significant for smaller institutions, and will increase under this proposal (and under the IRS's proposals in Announcement 2008-98).[74] Alternatives that reduce the burden on QIs, and permit limited exemptions from the QI program, while focusing reporting requirements on the taxpayers most likely to be of concern should be considered. For example, Congress should consider requiring expanded reporting only if the investor's income or assets exceed a specified threshold. The FBAR reporting threshold ($10,000) might be a convenient asset threshold.

(3) Application to Non-Financial Institution Intermediaries

See discussion below under *NQI FDAP Withholding Proposal*.

(4) Transition Rules

An appropriate transition rule is very important—and in fact critical to any proposed expansion of the QI role in light of the possible impact this could have on the capital markets. Intermediaries that are currently QIs will need time to decide whether to stay in the program, and if so they will need time to revise their systems. Intermediaries that are not QIs similarly will need time to decide whether to enter the program, and if so they will need time to negotiate QI agreements with the IRS and to modify their systems.

A phased transition should be considered, so that the most important items of information can be reported first. For example, perhaps for the first year or two, expanded reporting obligations should be limited to requiring QIs to identify all of their U.S. account holders, so that the IRS has information on U.S. account holders that derive solely foreign source income.

Subsequent phases could then expand reporting with respect to taxpayers that have assets or income in excess of a specified threshold or both (see *QI Limited Alternative*).

(5) Expansion to Affiliates

Any requirement that affiliates of a QI must also become QIs should be limited to entities that have custodial relationships, such as banks, brokers, custodians, and trust companies. Even if the proposal is limited to affiliates that have custodial relationships, consideration should be

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[74] 2008-44 I.R.B. 1087.

given to whether to exclude affiliates that have only foreign accounts, or no more than a *de minimis* amount/size of U.S. accounts as long as they have only foreign source income.

Given that many small- or medium-sized foreign financial institutions are likely to have solely local (foreign) customers, broad application of the proposal, requiring all affiliates of all QIs to themselves become QIs, could be very burdensome for foreign financial institutions, who may have affiliates in many jurisdictions and/or affiliates with a small number of, or no, U.S. taxpayer customers, and is likely to lead some to consider terminating their QI status or terminating their account relationship with legitimate U.S. customers.[75] Legislative history should encourage Treasury to implement the affiliate rules in a manner that mitigates these burdens. For example, Treasury should exercise its authority to include/exclude particular QI affiliates taking individualized facts into account, rather than requiring that all QI affiliates become QIs. Banks that have a history of not complying with the program or that have been identified as involved in tax abuse, might be treated differently. Likewise, procedures could be developed which encourage the use of consolidated audits to a greater extent than they are currently being utilized. Similarly, the use of higher audit thresholds should also be considered.[76]

In addition, Treasury should consider exercising this authority only with respect to new or renewed QI agreements, and should require that affiliates be covered only on a going-forward basis. Treasury also will need to develop a way to deal with countries that currently do not have approved KYC rules—this is a transition issue dealing with the amount of time and resources it takes to add a country and to enter into new QI agreements.

See *Transition Rules* for possible interim steps.

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75 There are already news reports that some foreign banks are informing their U.S. customers, including long-time expatriates, that they must take their business elsewhere. *See, e.g.*, Carl Mortished, *Long arm of the US taxman must be resisted*, THE TIMES (London), July 2, 2009, at 45 (According to the British Bankers' Association, "some British institutions are considering whether to opt out of QI altogether, so onerous is the proposed new regime."); Warren Giles, *Swiss banks closing Americans' accounts amid US pressure*, THE BOSTON GLOBE, June 30, 2009, at 9 ("UBS AG and Credit Suisse Group AG, [Switzerland's] biggest banks, have told Americans to move their money into specially created units registered in the United States, or lose their accounts. Smaller private banks such as Geneva-based Mirabaud & Cie. are closing all accounts held by US taxpayers."); Louise Armitstead, *Lloyds Bank hit by Obama tax purge*, THE SUNDAY TELEGRAPH (London), June 14, 2009, at 1 ("American private client account-holders at Lloyds's received letters informing them of an 'important change in policy regarding clients who are resident, domiciled or linked to the United States by property or asset holdings'. . . . Bank bosses say that under plans to extend the [QI] system, which includes paying for the figures to be audited twice, the costs and legal liabilities of the system will soar.").

76 Rev. Proc. 2002-55, 2002-2 C.B. 435, section 4.02(v) and sections 10.01.3 to 6.

2. Nonqualified Intermediary (NQI) FDAP Withholding Proposal[77]

a. Description of Proposal

Any withholding agent making a payment of FDAP income to a nonqualified intermediary would be required to treat the payment as made to an unknown foreign person, and therefore to withhold tax at a rate of 30 percent. This would apply even if an NQI received Forms W-8BEN or other documentation from its investors and passed such documentation through to the relevant withholding agent. It appears (but it is not clear this was intended) that it would apply even if under current law no certification is required, *i.e.*, for bank deposits, short-term debt such as commercial paper, and bearer bonds.

The stated reason for the proposal is that "some persons that are not entitled to an exemption from withholding tax or a reduced rate of withholding tax may attempt to avoid U.S. tax by arranging to receive payments through foreign intermediaries that are not qualified intermediaries (nonqualified intermediaries)." The proposal would discourage U.S. and foreign persons from attempting to avoid U.S. tax or to obtain a lower rate of withholding tax by providing incorrect self-certification or otherwise relying on the lack of information reporting associated with using NQIs. The proposal would encourage use of the strengthened QI system, by requiring withholding of tax on payments made through NQIs.

The Treasury Department would receive regulatory authority to provide exceptions, including exceptions for payments collected by NQIs for foreign governments, central banks, foreign pension funds, and foreign insurance company payees, and other similar investors, and for payments that the Treasury Department concludes present a low risk of tax evasion.

The Greenbook says that the rules will be designed so as not to disrupt ordinary and customary market transactions. Achieving this goal is challenging, and will require narrowing of the provision in some important ways. One short-term issue is whether the new rules will apply to outstanding securities, which could trigger tax calls.

Foreign persons that are subject to over-withholding as a result of this proposal would be permitted to apply for a refund of any excess tax withheld.

b. Recommendation

As an alternative to automatic withholding, a majority of the Tax Section's Executive Committee favor a more limited approach requiring enhanced reporting by NQIs. The enhanced reporting obligations would apply to NQIs that are banks and other financial entities, which are the only types of entity that are eligible to become QIs under the current structure of the QI system, and would take advantage of the fact that such entities are subject to KYC rules. Other NQIs, *e.g.,* investment funds classified as partnerships, would be subject to the rules we discuss under Part IV.A.4 (*Presumption that Payments are Made to a Non-Qualified Person in the Absence of Documentation*).

77 Greenbook at 43.

If the proposal to impose withholding on payments of FDAP income through NQIs (even if Form W-8BENs were received) is enacted, as favored by a substantial minority of the Tax Section's Executive Committee, it would need to be highly tailored so as to not disrupt capital markets. For example, it should be limited to NQIs of the kind described above – that is, potential QIs, payments allocable to beneficial owners who qualify for the benefits of a treaty should be subject to reduction or elimination of U.S. tax to the same extent as under current law, and transition rules should be adopted to provide for grandfathering of outstanding securities.

c. Discussion

As discussed below, a majority of us believe that enhanced reporting rules should be adopted, rather than this proposal for automatic withholding. If, however, the proposal is adopted, then, careful attention to impact on the capital markets and to transition rules will be required.

QI status is very geographically segmented. Even though a substantial number jurisdictions have financial institutions which have entered into the QI agreements, there are no QIs in a number of countries that represent significant sources of inbound investment to the United States, including China, Brazil and Mexico. Congress should consider whether imposing this regime would have a substantially adverse impact on U.S.-issuer securities, in particular Treasury securities. For example, Congress should consider the extent to which jurisdictions that have not yet been approved for purposes of the QI regime could qualify. If in fact, a substantial majority of financial intermediaries are in jurisdictions that qualify, or can qualify, for the QI regime, it may be easier to justify imposing more adverse treatment on intermediaries located in jurisdictions that do not, or cannot, so qualify.[78]

We note that an effect of the NQI withholding tax rules is likely to be that foreign institutions with a small number of U.S. accounts will cease doing business with those customers, which may be viewed as appropriate in the context of the overall objective, but which will impose considerable burdens on those affected.

(1) A More Limited Approach – Revise the Form W-8IMY

Most countries have KYC/anti-money laundering rules that apply to financial institutions. Nevertheless, a NQI that is a financial institution subject to such rules currently can submit Form W-8IMY with attachments without any requirement to take into account any knowledge that the NQI may have about its customers, or verify that attachments to the Form W-8IMY are correct. While an NQI generally has responsibilities and liability as a withholding agent where it must apply a reason to know standard,[79] there is nothing that expressly obligates it to inspect any

78 As an example of the issue regarding scope, one might consider the percentage of U.S. Treasuries that are held by non-exempt investors through NQIs, *e.g.*, Mexican individuals holding through a Mexican bank.

79 Treasury Regulation section 1.1441-7(b)(4)(i) (withholding agent must apply reason to know standard; it has reason to know certification is unreliable or incorrect where the withholding certificate is incomplete with respect to any item on the certificate that is relevant to the claims made by the direct account holder, the withholding certificate contains any information that is inconsistent with the direct account holder's claim, the withholding agent has other account information that is inconsistent with the direct account

Form W-8BENs that it passes along to payors. Indeed, for financial institutions, the reason to know standard is expressly limited.[80] Finally, while the NQI technically would be liable as a withholding agent, the IRS may have limited or no jurisdiction to effectively enforce the withholding tax rules against it.

Consideration should be given to requiring NQIs providing Form W-8IMY to affirmatively certify (under penalties of perjury) that the information in any attached Form W-8s or W-9s is not incorrect based on knowledge that the NQI has (without subjecting the NQI to a U.S. audit requirement). Consideration also should be given to requiring an NQI to disclose owners of foreign recipients, subject to certain thresholds, as suggested at Part IV.A.4.c.(2) below in order to avoid withholding on U.S. source FDAP corresponding to ownership by such persons. Finally, consideration should be given to permitting an NQI that is the type of financial institution eligible for the QI program (disregarding whether the institution's country is eligible) to provide a certification in the form of an enhanced Form W-8IMY in lieu of being subject to automatic withholding tax only if the NQI enters into an agreement with the IRS that, inter alia, would subject the NQI to U.S. jurisdiction. These suggestions would bring the rules for NQIs that are potential QIs closer to the rules that apply to actual QIs, although NQIs would still be required to pass through information on a customer-by-customer basis rather than being permitted to pool information as QIs are permitted to do.

(2) <u>Treaties</u>

Implementation of the proposal will lead to withholding in some cases in which the beneficial owners of the relevant items of income are eligible for treaty benefits with respect to such income. We believe that new legislation should respect the balance struck with foreign treaty partners, and should not override U.S. treaty obligations. The simplest approach would be simply to carve out treaty-eligible corporate beneficial owners from the disclosure obligation. The Greenbook explanation indicates that certain classes of recipients should be exempt. Unlike the gross proceeds proposal which is discussed below, it does not list treaty residents. Congress should consider modifying the list of exempted investors to include corporate treaty residents that qualify under the LOB provisions of an applicable tax treaty.

A possible variation on treating treaty residents as exempt investors would be to impose procedural (rather than substantive) requirements on a treaty resident payee that would require it to use reasonable diligence to determine the identification of its significant owners. Under this variation, if a U.S. treaty resident corporation that satisfies the requirements of the LOB provisions of the U.S.-U.K. treaty receives a payment that is exempt from withholding tax under the treaty, (i) the payment would remain exempt from withholding tax if the corporation identified its significant owners, regardless of the identity of those owners (*i.e.,* regardless of whether the owners are U.K., Hong Kong or U.S. taxpayers), (ii) the payment also would be

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holder's claim, or the withholding certificate lacks information necessary to establish entitlement to a reduced rate of withholding).

80 Treasury Regulation section 1.1441-7(b)(5)(i)(B) (financial institution may rely on certificate unless it is unreliable or incorrect; it may treat entity as a foreign organization if it has evidence that the entity was created outside the United States, unless it has knowledge that the entity is a pass-through).

exempt from withholding tax if the payee certified that, after reasonable due diligence, it was unable to determine the identification of its owners, and (iii) the payment would be subject to withholding tax if the payee failed to identify its significant owners or certify that it had exercised reasonable due diligence to do so. We believe that imposing merely procedural requirements upon a treaty resident in order to allow it to claim treaty benefits does not constitute a treaty override, provided that the requirements can be satisfied in a reasonable manner.

If payments beneficially owned by treaty residents are subject to withholding tax, it will be critical for the IRS to implement a workable refund process, in order to mitigate the impact of the provision on non-U.S. investors that properly qualify for relief from U.S. withholding tax. If refunds are not readily available to non-U.S. investors that qualify for relief under an income tax treaty, that could have the effect of overriding treaty obligations. Overriding a treaty is a significant event that should not be done unnecessarily or unintentionally.

In this regard, we understand that, under the current refund system, non-U.S. investors have experienced significant practical problems in obtaining refunds, in particular in situations in which income is reported on a "pooled" basis. We are concerned that a large-scale refund program, especially one involving a significant number of claims from foreign individuals, would not be workable. The IRS will need to be given the time and resources to develop a workable refund system before a proposal that relies on the availability of refunds can be implemented successfully.

(3) Meaning of "Intermediary"

The term "intermediary," under the section 1441 regulations, includes flow-through entities, such as foreign funds treated as partnerships for U.S. tax purposes.[81] However, in the context of this proposal, it is not clear whether the term was meant in that sense and whether it was intended to include such funds. We do not believe that automatic withholding was intended to apply to institutions or vehicles that by their nature (rather than by reason of *e.g..*, incompatibility of the country's information exchange regime or institution-specific deficiencies) are ineligible for the QI regime. We also believe that, in a world of elective classification as a flow-through entity, it would not be appropriate to have applicability of an automatic withholding regime to an entity that is not eligible to be a QI depend on whether flow-through status was elected.

Moreover, the reporting rules for financial institutions may not work seamlessly for nonfinancial institutions such as partnerships, for several reasons. Non-financial institutions

[81] Under the regulations, an intermediary means, with respect to a payment that it receives, a person that, for that payment, acts as a custodian, broker, nominee, or otherwise as an agent for another person, regardless of whether such other person is the beneficial owner of the amount paid, a *flow-through entity*, or another intermediary. Treasury Regulation section 1.1441-1(c)(13). Interestingly, under the instructions to Form Q-8IMY, a partnership is not a NQI. Instead, a partnership is required to fill out the special sections for partnerships (Parts V and VI of Form W-8IMY).

The term "intermediary" also applies to persons that are not financial institutions or investment funds acting in a variety of capacities. Although a discussion of the applicability of the proposals to these persons is beyond the scope of this Report, we note that such persons are not eligible to be QIs.

generally are not subject to KYC or comparable regulations, although they have independent means of determining the identity of their investors. It is common commercial practice for investments in funds to be made through multiple tiers of entities, and one fund often has limited access to information about its investor funds. A hedge fund that is held by a "fund of funds", for example, will not have access to information about investors in the fund of funds unless it negotiates to receive that information. In addition to differences in access to information on beneficial owners, financial institutions and funds differ in other respects that should be taken into account. For example, if a payment is received by a foreign bank, the foreign bank will know whom to allocate it to. With a partnership, the payment generally may not be capable of being allocated until the end of the year, making it difficult to determine the beneficial owner with respect to a payment made during the year.

On the other hand, we recognize that it would not be appropriate to have dramatically different regimes applicable to types of vehicles that from an investor's standpoint may be relatively interchangeable.

Rather than adopting an automatic withholding proposal for NQIs at all, we believe enhanced Form W-8IMY reporting rules, together with some obligation to either investigate and disclose the identity of beneficial owners of foreign entities above a certain ownership percentage threshold or be subject to withholding (similar to the negative presumption proposal discussed in Part IV.A.4.c.(2) below with the modifications suggested there) may be appropriate.

(4) Transition Issues

As noted, we recommend that there be enhanced reporting, rather than adoption of the withholding regimes. Should withholding be adopted, however, transition rules will be important to successful implementation of the proposals in a manner that does not disrupt the financial markets. For example, the tax "gross-up" provisions of debt instruments that are issued in a cross-border context typically provide an exception to the issuer's obligation to pay "additional amounts" in respect of withholding taxes if the holder fails to comply with applicable certification requirements. However, the proposal would impose a withholding tax without regard to whether beneficial owners provided a Form W-8BEN. Thus, in many cases, the adoption of the proposal would require that issuers bear the cost of any withholding taxes imposed as a result of a non-U.S. person receiving interest through an NQI. (This result would be particularly troublesome if the lenders were able to claim refunds of withholding taxes for which they had received a payment of additional amounts or claim tax credits or similar relief for such withholding tax under the laws of their home jurisdiction.) Additionally, if the provision is adopted, it is not realistic to assume that all holders will move their accounts to QIs.

Such instruments also typically permit the issuer to redeem the securities in order to avoid the obligation to pay additional amounts, although such redemption generally can be effected only within a limited period of time (*e.g.*, 90 days) of the effective date of a change of law. These redemption provisions would provide issuers with some ability to mitigate the cost of any withholding tax imposed under the proposal. However, the narrow window for refinancing outstanding instruments may lead to significant market disruption because issuers may effectively be required to refinance their outstanding debt in circumstances in which market conditions are unfavorable. (This would be the case even if the effective date of the proposal is deferred for some period of time since tax redemptions typically can only be exercised shortly prior to the effective date of a change in law.)

Thus, we recommend that securities be grandfathered regardless of term to maturity remaining. We note that the EU Savings Directive adopted a permanent grandfather provision, although that provision is limited to debt that had a gross-up and tax redemption.

As an alternative, consideration should be given to grandfathering outstanding securities for a substantial period of time, such as 5 years. A long but limited grandfathering period would have the advantages that all debt outstanding on the effective date of the proposal would be subject to uniform rules after the period expires, thus simplifying administration of the withholding tax rules, and that U.S. taxpayers would no longer be able to invest in such securities as a means of evading tax. It would also give issuers time to develop an orderly plan for refinancing their debt. We note, however, that the tax redemption provisions of many outstanding debt securities would not permit issuers to redeem such securities at par prior to the end of the grandfather provision. Thus, a temporary grandfather rule either would require issuers to tender for their debt during that period at a cost that under normal market conditions often will exceed the par amount of the debt (although under current market conditions the tender price may well be below par, many issuers are liquidity-constrained and cannot take advantage of that situation), or would only defer any disruption relating to issuers' need to refinance such securities to the end of that period.

As a further transition matter, perhaps NQIs should be permitted to apply a more limited set of rules (described above) for a period of time that is sufficient to (i) permit financial intermediaries in jurisdictions that are not currently approved for purposes of the QI program to request an IRS review of the applicable KYC procedures, (ii) allow the IRS to review QI applications from such intermediaries, and (iii) allow such intermediaries to be able to implement the procedures and processes required by the QI rules.

3. Proposal to Withhold on Gross Proceeds Paid to an NQI[82]

a. Description of Proposal

A withholding agent would be required to withhold tax at a rate of 20 percent on gross proceeds from the sale of any security of a type that would be reported to a U.S. non-exempt payee, when paid by the withholding agent to a nonqualified intermediary that is located in a jurisdiction with which the United States does not have a comprehensive income tax treaty that includes a satisfactory exchange of information program.

The Treasury Department would receive regulatory authority to provide exceptions, including exceptions for payments collected by nonqualified intermediaries for foreign governments, central banks, foreign pension funds, and foreign insurance company payees, and other similar investors; payments to nonqualified intermediaries located in jurisdictions with which the United States has a tax information exchange agreement; and payments that the Treasury Department concludes present a low risk of tax evasion.

[82] GREENBOOK at 44.

The Greenbook says that rules will be designed so as not to disrupt ordinary and customary market transactions. Nonqualified intermediaries would be eligible to claim a refund on behalf of their direct account holders for any taxable year in which they identified all of their direct account holders that are U.S. persons and reported all reportable payments received on behalf of U.S. account holders.

Foreign persons that are subject to withholding tax in excess of their income tax liability as a result of this proposal, and on whose behalf a refund claim is not made by a nonqualified intermediary, would be permitted to apply for a refund of any tax withheld.

The stated reason for the proposal is that "U.S. persons seeking to evade U.S. tax may arrange to receive payments, with respect to which gross proceeds would otherwise be reported, through nonqualified intermediaries and certify that they qualify as foreign persons". A broker making a payment through a nonqualified intermediary is unlikely to be in a position to verify whether self-certification by a customer of the nonqualified intermediary regarding foreign status is accurate.

b. Recommendation

As with the prior proposal, we believe that a more limited approach requiring enhanced reporting by NQIs would be adequate to achieve the government's objectives. This proposal is, however, different in kind from the prior proposal, because it would impose withholding tax as a compliance measure on amounts that are not subject to a substantive withholding tax in the hands of any foreign person. We strongly recommend that this proposal not be adopted, and that it be reformulated instead as an enhanced reporting requirement.

If the proposal is adopted, we recommend that the exception for NQIs located in jurisdictions with exchange of information agreements be self-executing and that withholding refund procedures be streamlined.

c. Discussion

This raises all the same issues as the FDAP withholding proposal, other than the treaty override issue, but with much more draconian effect given that gross proceeds withholding would apply to persons that are not taxed on the gains. By contrast, FIRPTA—the one provision of the Code that imposes a withholding tax on gross proceeds paid to non-U.S. persons—applies to persons who actually are subject to substantive tax liability with respect to the related gains. In addition, the required withholding under FIRPTA is only 10 percent of gross proceeds, and FIRPTA generally does not apply to publicly traded securities. However, the proposal is tempered to the extent that Treasury is empowered and does exercise its authority exclude certain non-intermediaries, particularly those in jurisdictions with an exchange of information agreement (which is contained in all recent U.S. tax treaties).

In view of the extraordinary reach that this proposal would have, the balance between the benefits of adopting it versus the costs of doing so weighs much more heavily toward costs than in the case of the FDAP withholding proposal. We believe that this proposal should be enacted only if it is clear that no other reasonable alternative is available, taking into account all of the other proposals discussed herein, and if a workable tax refund process is made available.

If this proposal is adopted, it is the type of proposal that would merit a delayed effective date in order to permit the IRS to issue guidance implementing the requirement (including identifying the jurisdictions that have "comprehensive income tax treaties" and "satisfactory exchange of information programs"[83]) and to permit withholding agents to develop procedures to collect withholding tax with respect to a class of income that has not previously been subject to withholding. Alternatively, implementation of the proposal could be made contingent on a finding by the Secretary that it is necessary to prevent the evasion of tax by U.S. persons.[84] Even under these circumstances, such a provision should not be adopted without a clear understanding of its effects on the capital markets.

4. Presumption that Payments are Made to a Non-Qualified Person in the Absence of Documentation[85]

a. Description of Proposal

Any withholding agent making a payment of FDAP income to a foreign entity would be required to treat the payment as made to an unknown person (and therefore subject to 30 percent gross-basis withholding tax), unless the foreign entity provides documentation of the entity's beneficial owners. It appears (although this is not clear) that this proposal is not aimed at financial institutions, but instead is intended to be limited to looking through corporate beneficial owners (as defined under current law) of FDAP income. That is, the proposal would apply a variant of the current rules applicable to partnerships to non-pass-through entities such as corporations. It would affect pass-through entities as well, however, assuming that they would be required to look-through direct or indirect corporate partners or beneficiaries.

Exceptions would be provided for payments to publicly traded companies and their subsidiaries, foreign governments, and pension funds. The Treasury Department would receive regulatory authority to provide additional exceptions for payments to entities engaged in the active conduct of a trade or business in their country of residence, charities, widely held investment vehicles, entities that enter into an agreement with the IRS to collect documentation for all owners and report all U.S. non-exempt owners to the IRS, and for any other payment that the Treasury Department concludes presents a low risk of tax evasion.

The stated reason for the change is that persons that are not entitled to receive such income exempt from withholding tax or subject to a reduced rate of withholding tax "may arrange to receive payments through entities that appear to qualify for an exemption or a reduced rate. A withholding agent making a payment to such an entity is unlikely to be in a position to

83 *Cf.* Section 1(h)(11) (Treasury has provided guidance on which countries have comprehensive income tax treaties) and Section 457A (Treasury has not provided guidance, legislative history suggests that the determination may be different from that under section 1(h)(11), and Treasury officials have been reported as saying that they do not plan to provide guidance). Accordingly, legislative history should either direct Treasury to provide guidance, or provide standards that can be applied in the absence of such guidance.

84 *Cf.* Section 871(h)(6)(A) (allowing Secretary to revoke portfolio debt exemption where it is determined that exchange of information procedures in a country are not adequate to prevent evasion of tax by U.S. persons).

85 GREENBOOK at 53.

determine whether the entity's self-certification is accurate." In contrast, where payments are made though an intermediary, the intermediary generally provides to the withholding agent the appropriate documentation on behalf of the payment's beneficial owners.

b. Recommendation

The negative presumption, if adopted as proposed, would in effect deny the benefit of domestic exemptions and treaty relief in any case where the entity could not obtain the requisite proof of its owners. As an alternative, we favor a more limited approach focusing on enhanced reporting and limiting withholding for corporate entities to situations in which identification of significant owners is not available. Identification of corporate owners with a small stake or limited amounts of income should not be required. Entities that are treated as partnerships for U.S. tax purposes would continue to file Form W-8IMY with respect to all owners (which might be supplemented by, *e.g.,* a requirement to certify as to the accuracy of the information) but also would be subject to rules requiring identification of significant owners of investor entities in order to avoid withholding on U.S. source FDAP corresponding to such ownership. Where withholding is required, the amount withheld should be limited to the amount that relates to any missing documentation. Refunds should be available if the required documentation is provided after payment.

c. Discussion

The proposal seems to be primarily directed at U.S. persons who may be masquerading as non-U.S. investors by hiding behind corporate "shell" entities. This proposal is not by its terms limited to corporate entities, and so could apply to pass-through entities as well. It does not appear to be aimed at financial institutions. The proposal uses the potential imposition of withholding tax as a club to get beneficial ownership information. In addition, by requiring documentation relating to the payees of portfolio interest and their shareholders, the proposal would effectively override the portfolio interest exemption as it applies to bearer-form debt securities.

We believe that this proposal should be modified and limited as discussed below.

(1) Level of Withholding

Where insufficient documentation exists, withholding should be proportional. Withholding is currently described as an all or nothing approach. For example, assume that there is a 1 percent non-compliant investor (*i.e.*, the investor provides documentation with respect to 99 percent of its beneficial owners). Withholding should be imposed with respect to only 1 percent of the relevant FDAP income, not 100 percent.

(2) A More Limited Alternative

The principal benefit of the negative presumption rule would appear to be that U.S. shareholders lurking behind foreign corporations that they control or have a substantial investment in will be flushed out. For that purpose, it may be sufficient if such taxpayers are identified as such. Consideration should be given to limiting any new reporting obligation to providing the name and identifying information of such taxpayers. Flow-through entities also would, as now, be required to provide for Form W-8IMYs, which might include additional requirements as described at Part IV.A.2.c.(1) above. See Part IV.A.4.c.(3) below.

In connection with the obligation of identifying owners, some threshold should be adopted. For instance, information reporting should only apply to shareholders beneficially owning (including indirectly through tiered entities) a specified percentage of the entity's beneficial ownership interests or of any class having a disproportionate interest in certain income (we would suggest a threshold in the range of 10 percent to 25 percent) or to shareholders whose share of the relevant income exceeds a specified dollar threshold.

In any event, consideration should be given to exemption for small accounts and/or amounts. In this regard, the FBAR threshold may be a useful reference point.

(3) Application to Non-Financial Institution Intermediaries (Flow-Through Entities)

As discussed above, we believe that this information reporting requirement is better suited to non-financial institution intermediaries such as offshore funds than the NQI withholding requirement. However, the requirement should be tailored to take into account the special characteristics of offshore funds organized as partnerships discussed in Part IV.A.2.b.(3) (*Meaning of "Intermediary")* above.

Partnerships that are not WPs are already obligated to provide information about the identity and U.S. source income of their partners. Foreign partnerships are not required, however, to "look through" a direct or indirect partner that is a foreign corporation. Generally, we believe that the partnership rules should continue to apply to partnership funds as they do today, but expanded to require the reporting of identities of investors in foreign corporate partners and to require reporting of foreign source income or asset balances of U.S. investors, subject to the threshold limitations discussed above, with possible certification by the fund. In addition, because of the difficulties in estimating such a fund's income allocations, simplifying assumptions should apply where partnerships are involved. This could, for example, include permission to rely on the previous year's allocation or estimates unless a material change has taken place.[86]

We note that a trust may or may not be a flow-through entity, but that in any event determining the beneficiary (the equivalent of "owner") of a trust may be complicated for many reasons, some of which also raise the issue that income may be received by a trust at a time when it is not certain to whom that income will ultimately be allocated.

(4) Treaties

We assume that the proposal simply is intended to provide for the collection of information regarding the beneficial owners of foreign entities and not to reconsider which

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86 *Cf.* Treasury Regulation section 1.1441-3(c)(2)(ii) (withholding agent allowed to rely on reasonable estimate of earnings and profits in determining whether a corporate distribution is to be subject to withholding).

persons are treated as the beneficial owners of income, which would in many cases be inconsistent with the LOB provisions of U.S. tax treaties, which define the circumstances in which a non-U.S. entity is eligible for withholding tax relief. To eliminate any uncertainty, the proposal should be clarified that it is not intended to modify fundamental concepts of beneficial ownership.

Even assuming that is the case, however, the proposal in its application would have the effect of denying treaty benefits to otherwise eligible treaty payees unless owner documentation can be provided, which is a condition that is not in the treaty and in many cases is extraneous to the actual treaty requirements. Therefore, corporations resident in treaty countries should be added to the list of exempt investors to avoid overriding existing treaty obligations. (As discussed above, the proposal could also be revised to provide that, if a treaty-eligible corporate payee certifies that, after due diligence, it was unable to determine the identity of a significant investor, the corporate payee may avoid the effect of the proposal to such extent.) Treaty LOB provisions exist to police look-through issues. In addition, every treaty has exchange of information provisions that the IRS should utilize before taking actions that would effectively override a treaty. We believe that it is important that treaties not be overruled inadvertently as a result of the owner disclosure requirement.[87]

(5) Refunds

The description of the proposal does not state whether non-U.S. persons will be eligible to obtain a refund if the required documentation is provided after a payment is made. It is unclear whether this is intentional. Thus, it should be compared to the back-up withholding regime, which has similar objectives, but for which a credit or refund is available upon the filing of a tax return. A refund should be made available if a corporation provides shareholder information within the applicable statute of limitations for refund claims after payment has been made.

The implementation of any refund process with respect to this proposal also is subject to the concerns relating to the effectiveness of a refund process discussed above under Part IV.A.2 (*NQI FDAP Withholding Proposal)*.

(6) Transition Issues

To the extent this proposal adversely impacts the portfolio interest exemption for bearer debt securities, outstanding bond issues should be grandfathered or otherwise provided with transition relief, to mitigate the adverse impact on issuers, which typically would be obligated to gross-up interest payments or redeem such securities pursuant to their terms.[88] In addition, the implementation of the proposal will need to provide sufficient time for the IRS to issue needed guidance and for market participants to implement the required procedures. Finally, if our recommendations regarding the adoption of certain minimum thresholds for reporting are not

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87 *See*, *e.g.*, *Casanova Co. v. Comm'r*, 87 T.C. 214, 217-218 (1986) (requirement imposed by Revenue Procedure would overrule treaty).

88 *See* Part IV.A.2.b.(4) (*Transition Issues)*.

adopted, consideration should be given to permitting the use of such thresholds on a transitional basis to facilitate withholding agents' and payees' implementation of the proposal.

B. Additional Information Reporting Proposals.

1. Description of Proposals

The Greenbook includes a number of proposals to increase information reporting relating to transfers of funds to and from foreign accounts and the creation of foreign accounts and entities as a means of helping detect and prevent potential tax evasion. In particular, the proposals would enact the following requirements:

- U.S. individuals would be required to report on their tax returns any transfer of money or property made to, or the receipt of money or property from, any foreign bank, brokerage or other financial account by the individual, or by any entity of which the individual owns (actually or constructively) more than 50 percent of the ownership interests (the "Tax Return Reporting Requirement").

- Any U.S. financial intermediary or QI that transfers money or property having a value of more than $10,000 to, or receives money or property having a value of more than $10,000 from, a foreign bank, brokerage or other financial account on behalf of a U.S. person (or on behalf of an entity of which a U.S. person owns, actually or constructively, more than 50 percent of the ownership interests) would be required to file an information return regarding such transfer (the "Funds Transfer Reporting Requirement").

- Any U.S. financial intermediary or QI that opens a foreign bank, brokerage or other financial account on behalf of a U.S. person (or on behalf of an entity of which a U.S. person owns, actually or constructively, more than 50 percent of the ownership interests) would be required to file an information return regarding such account (the "Foreign Account Reporting Requirement").

- Any U.S. person or QI that forms or acquires a foreign entity on behalf of a U.S. individual (or on behalf of an entity of which a U.S. person owns, actually or constructively, more than 50 percent of the ownership interests) would be required to file an information return regarding the entity that is formed or acquired (the "Foreign Entity Reporting Requirement").

The Greenbook provides certain specified exceptions to these requirements including, in particular, in respect of accounts held at QIs. In addition, the Greenbook provides Treasury with the authority to adopt additional exceptions by regulation. The proposals generally would be effective for transfers effected, accounts opened and entities created after December 31 of the year of enactment.

2. Recommendations

We support the Tax Return Reporting Requirement, the Foreign Account Reporting Requirement, and the Foreign Entity Reporting Requirement, with certain modifications discussed below. To facilitate U.S. persons' and QIs' ability to implement the proposals effectively, persons that are subject to the reporting requirements should be able to rely on information that they have on hand, pursuant to applicable KYC rules or otherwise, in determining whether an entity is owned by a U.S. person.

The Funds Transfer Reporting Requirement would be extremely burdensome for the financial institutions that would be required to comply with the reporting requirements and would produce a large volume of information that would be difficult for the IRS to use in an effective manner. Thus, we would suggest as an alternative, in cases in which the IRS needs additional information regarding financial transactions involving offshore accounts, that the IRS use its existing summons authority, including "John Doe" summonses, to obtain the information needed. Accordingly, we recommend that this proposal not be enacted.

The proposals should become effective only after a reasonable period of time following the issuance of implementing regulations by the IRS.

3. Discussion

These proposals are intended to help the IRS to prevent tax evasion by creating additional tools that will provide it with information regarding activities that may give rise to the potential for evasion. We generally support that objective and the use of these particular proposals to accomplish that objective, subject to the comments outlined below.

a. Standard of Knowledge

The Funds Transfer Reporting Requirement, the Foreign Account Reporting Requirement and the Foreign Entity Reporting Requirement all require that a person subject to the reporting requirement determine that the relevant action is being effected on behalf of a U.S. person, or an entity that is more than 50 percent owned, directly or constructively, by a U.S. person. Although the proposals do not provide details of the constructive ownership rules that will apply, the application of constructive ownership rules under the Code can be complex and it is not always readily apparent that an entity is deemed to be more than 50 percent owned by another person. Moreover, the Foreign Entity Reporting Requirement applies to foreign entities formed or acquired by any U.S. person, not merely financial intermediaries. Thus, in many cases, this proposal will apply to persons that do not regularly file information returns in the ordinary course of their businesses and that are not subject to detailed regulatory KYC rules that would require that they collect detailed ownership information regarding the persons for whom they act.

Thus, to facilitate U.S. persons' and QIs' ability to implement the proposals effectively, persons that are subject to the reporting requirements should be able to rely on information that they have on hand, pursuant to applicable KYC rules or otherwise, in determining whether an entity is owned by a U.S. person.

b. Scope of Proposals

The scope of the Funds Transfer Reporting Requirement is so broad that it is likely to be unadministrable in practice. The proposal broadly applies to *all* transfers to and from foreign bank, brokerage and other financial accounts on behalf of U.S. persons and U.S.-controlled entities. As a result, the proposal will apply to a broad range of routine, day-to-day ordinary business transactions. We anticipate that the broad scope of the proposal, in combination with the proposal's $10,000 threshold, will result in enormous numbers of information returns being filed with the IRS each year, with some individual financial institutions being required to file thousands of returns annually, if not more. In addition, depending on the nature of the specific information that is required to be reported once the proposals are implemented, affected financial institutions may be required to undertake substantial systems revisions in order to be able to comply with the new requirements. Thus, adoption of the proposal would be extremely burdensome for the financial institutions that would be required to comply with the reporting requirements. We also question whether the IRS would be able to use the large volume of information that would be produced in an effective manner. If not, then it is difficult to justify the burdens that the proposal would place on financial institutions.

As an alternative, in cases in which the IRS needs additional information regarding financial transactions involving offshore accounts, we recommend that the IRS use its existing summons authority, including "John Doe" summonses, to obtain the information needed. If the existing summons authority is inadequate for this purpose, then we would suggest that Congress consider broadening the summons authority to enhance its utility.

Unlike the other proposals, the Foreign Entity Reporting Requirement applies to <u>any</u> U.S. person that forms or acquires a foreign entity on behalf of a U.S. person, not merely a financial intermediary. Thus, it would appear to apply to categories of persons who are not normally required to do information reporting in the ordinary course of their business. In order to ensure that the proposal can be administered effectively, Congress should consider limiting it to persons that regularly form or acquire foreign entities in the ordinary course of a trade or business—including, perhaps, lawyers who participate in the creation of a foreign subsidiary or holding company.[89] Consideration should be given to whether or how such reporting should be carried out where a foreign entity is formed before specific investors in the entity have been identified, which is common in transactions in which the equity in the entity is expected to be sold in an underwritten offering or private placement.

These reporting proposals generally apply to the creation of, and transfers of funds to and from, foreign bank, brokerage "or other financial account[s]". The concept of an "other financial account" is not defined in the Greenbook and is susceptible to a broad range of potential interpretations.[90] The Greenbook's references to "other financial accounts" in the context of these reporting provisions should be revised to clarify that it is intended to apply only to other

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89 *Cf.* Section 6050I (requiring the reporting of cash payments of $10,000 or greater by filling Form 8300). However, the proposal does raise important attorney-client privilege concerns. *See* "Comments Of The ABA Task Force On Gatekeeper Regulation And The Profession On The Financial Action Task Force Consultation Paper Dated May 30, 2002", available at www.abanet.org/crimjust/taskforce/comments.doc.

90 For discussion of the manifold uncertainties that have resulted from the use of a similarly vague term in the FBAR context, see New York State Bar Association Tax Section, *Request for Formal Guidance on FBAR Reporting Obligations* (Report No. 1186, July 17, 2009), available at www.nysba.org (Sections/Tax Section/Tax Section Reports). Many other taxpayers have commented on the same issue.

financial accounts that serve a function comparable to that of a conventional bank or brokerage account.

c. Effective Dates

These proposals generally would become effective on January 1 of the year following the year of enactment. This proposed effective date is unlikely to provide sufficient time for the IRS to issue regulations and forms implementing the reporting requirements and for persons with a reporting obligation to develop the systems and processes necessary to permit them to comply with the requirements. This is particularly significant with respect to the Foreign Entity Reporting Requirement, which may apply to persons that are not financial intermediaries and thus do not have existing information reporting systems in place. The proposals thus should only become effective a reasonable period of time—we would suggest no less than one year — following the issuance of implementing regulations by the IRS.

d. Other Issues

The section of the Greenbook discussing the Foreign Entity Reporting Requirement also would provide Treasury with regulatory authority to require withholding agents to collect, and report to the IRS, information to determine whether U.S. persons are the beneficial owners of foreign entities. This proposal appears to be related to the "negative presumption" proposal described under Part IV.A.4 (*Presumption that Payments are Made to a Non-Qualified Person in the Absence of Documentation)*, above. However, the Greenbook does not coordinate the two proposals, which creates some ambiguity. For example, the proposed Treasury authority is limited to obtaining information about *U.S. persons* that beneficially own foreign entities, but it is not clear that the negative presumption proposal is intended to be applied so narrowly. If both proposals are included in the final legislation, the statutory language or legislative history should provide clarification as to how the two proposals are intended to interrelate.

C. FBAR Proposals.

This Part IV.C of the report discusses four FBAR-related proposals in the Greenbook, and one FBAR-related proposal in the Baucus bill. Under current law, very generally, a Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts" (commonly referred to as an "FBAR"), is required to be filed by any U.S. person (and certain non-U.S. persons) if (a) the person has a *financial interest in*, or *signature authority* or other authority *over*, any financial account in a foreign country, and (b) the aggregate value of all such accounts exceeds $10,000 at any time during the calendar year.[91] The FBAR is due by June 30 of the year following each calendar year during which the $10,000 threshold is met.

The FBAR is not a tax return, but is a separate report filed with the Secretary of the Treasury. An individual filing a U.S. tax return (IRS Form 1040), however, is required to state on Schedule B, Part III whether the taxpayer has an interest in a financial account in a foreign country by marking "Yes" or "No" in the designated box. If the individual checks "Yes," the Form 1040 instructs the taxpayer to file the FBAR. Similar questions and instructions appear in

[91] 31 U.S.C. section 5314.

the U.S. tax return forms for corporations (IRS Form 1120, Schedule N) and the U.S. information return for partnerships (IRS Form 1065, Schedule B). The FBAR must be sent to the U.S. Treasury Department at a P.O. box in Detroit, Michigan.

Until April 2003, the Financial Crimes Enforcement Network (FinCEN) of the Department of the Treasury had official authority for enforcement of FBAR reporting. In an effort to improve compliance and enforcement, FinCEN delegated this enforcement authority to the IRS by a memorandum of agreement, announced in IRS News Release 2003-48.[92] This enforcement authority includes the ability to investigate possible civil violations related to FBAR filings, employ summons power, assess and collect civil FBAR penalties, issue administrative rulings, and take any other reasonably necessary action for the enforcement of these provisions.

The FBAR rules are, however, in Title 31 of the U.S. Code, and are not part of the Internal Revenue Code (which is in Title 26), and accordingly an FBAR is not protected by the disclosure restrictions of section 6103 (relating to confidentiality and disclosure of tax return information).[93] Accordingly, the information in the FBAR may be (and is) shared with other agencies. FBARs are posted by the IRS to the Currency and Banking Retrieval System ("CBRS") financial database at the IRS's Detroit Computing Center. Information in the database is accessible to IRS field agents in the Small Business Self Employed (SB/SE) and Criminal Investigations Divisions (CID), as well as local, state and federal law enforcement agencies (Customs, Justice, DEA, etc) for research in tax cases, tracking money-laundering activities, investigative leads, intelligence for the tracking of currency flows, corroborating information, and probative evidence. Federal Regulatory agencies (Federal Reserve, Securities and Exchange Commission, etc) also use CBRS for general examination, compliance and enforcement efforts.[94]

A failure to file an FBAR can result in severe civil or criminal penalties. Civil penalties may be imposed for willful or non-willful violations, and criminal penalties may be imposed for willful violations (or for knowingly making false, fictitious or fraudulent statements or representations). The civil penalties for failure to file are: (a) if the violation is non-willful, up to $10,000 for each violation (and for a pattern of negligent activity, an additional penalty of up to $50,000); and (b) if the violation is willful, up to the greater of $100,000 and 50 percent of the amount in the accounts.[95] Criminal violations may result in the imposition of a fine of up to $250,000 and/or five years imprisonment, and if part of a pattern of illegal criminal activity, violations may result in a fine of up to $500,000 and/or ten years imprisonment.[96] In addition,

92 *See* 68 Fed. Reg. 26, 468 (May 16, 2003) (codified at 31 C.F.R. section 103.56(g)) and IRS News Release, IR 2003-48, April 10, 2003.

93 *See, e.g., A Report to Congress in Accordance with Section 361(b) of the Uniting and Strengthening America By Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001*, submitted by the Secretary of the Treasury, April 26, 2002, n. 4 ("The FBAR is not a tax return and is not to be attached to a taxpayer's Form 1040. Because an FBAR is a Title 31 report, it is not subject to the dissemination restrictions of 26 U.S.C. 6103.").

94 Information on the CBRS system is posted online on the IRS's website at http://www.irs.gov/privacy/article/0,,id=134898,00.html.

95 31 U.S.C. section 5321. We note that currently the only guidance with respect to how the IRS administers the civil penalties is located in the Internal Revenue Manual.

96 31 U.S.C. section 5322; 31 C.F.R. section 103.59; 18 U.S.C. section 1001.

both civil and criminal penalties may be imposed in combination on any person for a single failure.[97] There is a six-year assessment period with respect to civil penalties, and a five-year statute of limitations for criminal violations.[98]

The IRS website's FAQ's on the FBAR explain the purpose of the FBAR obligations as follows:

> The FBAR rules were established because of the utility of the information required in criminal, tax, and other regulatory matters and in the conduct of intelligence or counterintelligence activities including analysis to protect against international terrorism.
>
> The reports filed as a result of this regulation provide leads to investigators that facilitate the identification and tracking of illicit funds or unreported income, as well as providing additional prosecutorial tools to combat money laundering and other crimes.[99]

In practice, FBAR filings have become increasingly important as a tool for tax enforcement. One example of this is that the IRS's revamped voluntary disclosure program for taxpayers with undisclosed offshore accounts addresses both tax and FBAR reporting obligations, and both tax and FBAR civil and criminal penalties. It is clear that the very substantial potential penalties for failing to file FBARs serve as one of the "sticks" encouraging taxpayers to take advantage of the voluntary disclosure program. It is more difficult for us to ascertain the extent to which FBARs provide information useful for tax enforcement purposes. There are anecdotal reports that FBARs have become principally a tool for tax enforcement and are of less current significance for other law enforcement purposes.

Before turning to the specific FBAR-related proposals in the Greenbook and Baucus bill, we have some general observations on current law and practice. The enforcement by a Title 26 agency (the IRS) of Title 31 statutory requirements is less than ideal in a number of respects from the perspective of professionals advising clients on the application of the rules, as well as from the perspective of taxpayers and, it appears, the government. Among the resulting difficulties are:

> (i) The use of terms for FBAR purposes that have meanings different from those that apply for U.S. Federal tax purposes. This is not just an inconvenience for taxpayers and tax professionals trying to learn a new set of rules – for example, whether a taxpayer is a U.S. or U.S.-connected person required to file a return is not determined by reference to the Internal Revenue Code's definition of that term.[100] It also means that any

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97 31 U.S.C. section 5321(d).

98 See 31 U.S.C. section 5321(b)(1) and 18 U.S.C. section 3282, respectively.

99 IRS Workbook on the Report of Foreign Bank and Financial Accounts (FBAR), http://www.irs.gov/businesses/small/article/0,,id=159757,00.html.

100 31 U.S.C. section 5314 refers to "a resident or citizen of the United States or a person in, and doing business in, the United States." 31 C.F.R. section 103.24(a) imposes a filing obligation on "[e]ach person subject to the jurisdiction of the United States." The concepts of a person "in" or "subject to the

ambiguities or gray lines cannot safely be interpreted based on what would make sense as a matter of *tax* enforcement. Tax professionals are not experts on other law enforcement regimes. The resulting uncertainty about how to apply the rules has led to thousands of recent filings that may be unnecessary and unwanted by the government, and that have certainly imposed a great burden on taxpayers. We believe that taxpayers' obligations to comply with their legal obligations can best be satisfied if those obligations are clear, and that achieving that clarity is very difficult under the current system.

(ii) A lack of adequate guidance on the application of FBAR filing requirements.[101] FBAR guidance consists of a very limited set of regulations, supplemented by the instructions to the FBAR form and information on the IRS's website.[102] No substantive guidance has been issued of a kind similar to the Revenue Rulings, Revenue Procedures, or Notices typically provided to inform taxpayers as to the government's interpretation of tax law. We understand that there may be questions as to how the IRS and Treasury would go about providing formal guidance. These stem in large part from the fact that the 2003 delegation of enforcement authority from FinCEN to the IRS does not expressly address authority to promulgate formal guidance, such as regulations (although it does specifically mention "administrative rulings").[103] We understand that some IRS and Treasury officials believe that there may be limits on the IRS's authority to do so, and that this perceived lack of authority has contributed to a lack of timely and clear guidance on the application of the FBAR rules. We express no views as to whether there is in fact a lack of authority or, if so, whether the most appropriate solution is a statutory one or an administrative or regulatory one (such as a re-delegation of authority within the Treasury Department). We believe, however, that potential-FBAR

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jurisdiction of" the United States have no direct correspondence under the Internal Revenue Code. While the concept of "doing business in" the United States has a parallel under the Code, it appears that this term's scope is quite different for FBAR purposes.

101 We submitted a letter to the Treasury Department, IRS and FinCEN earlier this year expressing our dismay over the process by which the IRS informally communicated an interpretation of the scope of the term "financial account" – which determines which taxpayers are required to file FBARs -- that was perceived by many taxpayers to be much broader than had previously been understood, with less than three weeks to go before the June 30, 2009 FBAR filing deadline. The letter sets out in detail the miscellany of unofficial and semi-official devices subsequently used by IRS officials to express their views on these issues in response to taxpayers seeking additional clarification, and the resulting chaos and extraordinary state of confusion among taxpayers and their tax advisors as they struggled to comprehend where the new lines were being drawn and to comply with newly discovered filing obligations at the risk of significant penalties for noncompliance. *See* New York State Bar Association Tax Section, *Request for Formal Guidance on FBAR Reporting Obligations* (Report No. 1186, July 17, 2009), available at www.nysba.org (Sections/Tax Section/Tax Section Reports). The IRS subsequently issued a Notice that extended filing deadlines for certain classes of taxpayers to June 30, 2010. Notice 2009-62, 2009-35 I.R.B. 260. The Notice provides substantial temporary relief. However, it does not address the fundamental problem about the workings of the guidance process. In view of the penalties associated with failing to file an FBAR and the burden imposed on taxpayers by expansive FBAR filing requirements, it is essential that the rules be clear.

102 Instructions to the FBAR may have some weight because 31 C.F.R. section 103.24 requires persons subject to the jurisdiction of the United States to "provide such information as shall be specified in a reporting form prescribed by the Secretary to be filed by such persons." Website statements have no such official authority.

103 *See* 31 C.F.R. section 103.56(g) and IRS News Release, IR 2003-48, April 10, 2003.

filers are entitled to the same type of guidance on FBARs as they receive on other issues administered by the IRS, and we urge that Congress and the Administration take such action as may be necessary in order to ensure that the appropriate agencies of the Treasury Department have the authority and encouragement to do so.

(iii) Questions about how to harmonize the nondisclosure rules of section 6103 with the intent behind the Title 31 FBAR rules that government law enforcement agencies share FBAR information. These issues are discussed in more detail below.

(iv) More limited enforcement tools than would be the case if the FBAR filing requirements were in Title 26.[104] If taxpayers are required to file both Title 31 FBARs and Shadow FBARs, a single unified procedure should be used to enforce both requirements, preferably one that permits the government and taxpayers to resolve the issue through a well-understood administrative process (in addition to litigation) such as the deficiency procedures established under Title 26.

If legislation is enacted that brings FBAR or FBAR-like reporting more directly into the U.S. Federal tax system, we urge Congress and the Administration to give careful thought to how the different rulemaking and enforcement schemes applicable under Titles 26 and 31 should be harmonized. While we cannot judge the relative importance of FBAR filings for tax enforcement vs. non-tax enforcement purposes, we believe that compliance with FBAR requirements is likely to be substantially enhanced to the degree that FBAR rules and procedures can be conformed with corresponding tax rules and procedures. Our recommendations below are based on this principle. Indeed, if Congress and the Administration conclude that FBARs are, or should be, used primarily for tax compliance purposes, a possible course of action would be to move the FBAR filing requirement into Title 26, subject to the section 6103 carve-out discussed in Part IV.C.1.b below.

A final general comment is that there is currently a high degree of confusion and uncertainty as to how the FBAR filing obligations apply to taxpayers that have "financial accounts" other than traditional financial accounts such as bank accounts, as a result of recent statements by the IRS addressing that issue. We recommend that no additional filing requirements, penalties or other adverse rules be imposed on taxpayers until guidance has been issued that resolves those uncertainties, or that any such new rules have a delayed effective date, perhaps for one year to permit Treasury to issue that guidance.

Turning now to the legislative proposals made in the Greenbook and Baucus bill, Part IV.C.1 discusses a proposal to require an individual to file a new schedule with his or her U.S. Federal income tax return that includes all FBAR information (the Greenbook version), or to

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[104] Currently, we understand that while the IRS can assess a FBAR penalty in a manner similar to a tax penalty, it cannot use its Title 26 collection powers of liens and levies. If the taxpayer disagrees with the assessment, the only route for the government to enforce the FBAR filing requirement is to bring suit against the taxpayer in Federal District Court and then to collect on any judgment; that is, the more efficient and procedurally fair collection administrative procedures established under Title 26 are not available because the FBAR filing requirement is imposed under Title 31.

require any taxpayer to file a duplicate FBAR with its return (the Baucus bill version) (in either case, a "Shadow FBAR").

Part IV.C.2 discusses a proposal to make the section 6662 understatement penalty harsher if the taxpayer fails to file a shadow FBAR, by providing that if there is an understatement arising from a transaction involving the foreign account, then (a) the 20 percent understatement penalty is raised to 40 percent; and (b) if the transaction is also "6011 reportable", then there is no reasonable cause and good faith defense to the 40 percent penalty (*i.e.*, strict liability, even if the section 6011 filing was completed correctly).

Part IV.C.3 discusses proposals to adopt two new evidentiary presumptions when a "real" FBAR (a Title 31 FBAR) is not filed with respect to a foreign account maintained at an NQI, pursuant to which (a) there would be a rebuttable presumption that the $10,000 account balance filing threshold was met; and (b) if the account balance is more than $200,000, there would be a rebuttable presumption that the failure to file was "willful" (meaning that the civil penalty for failing to file would be up to the greater of (i) $100,000 and (ii) 50 percent of the amount in the account).

All of these proposals are based upon a perception that much U.S. tax evasion involves undisclosed foreign accounts and that requiring disclosure of a foreign account with the tax return and adding harsher consequences for nondisclosure will improve compliance and assist the IRS in identifying and investigating evasion. The final proposal is also designed to encourage U.S. persons to use QIs. But, even if a taxpayer uses a QI, it will still have a obligation to file a "real" FBAR and, if the first proposal is enacted, a "Shadow FBAR".

1. Shadow FBAR Filing with Tax Return[105]

a. Description of Proposals

Under the Greenbook proposal, any *individual*[106] required to file an FBAR under Title 31 would be required to include an additional schedule with the individual's U.S. Federal income tax return that would include the information that is currently required on the FBAR (we refer to this herein as a "Shadow FBAR"). There would be no specific penalty for failing to include the Shadow FBAR with the return. The Greenbook explains that failure to include the Shadow FBAR with the income tax return would trigger the normal consequences that flow from the failure to file a complete return, as well as two other additional new consequences which are contained in other Greenbook proposals. One of these is an extension of the statute of limitations on the return linked to when the missing Shadow FBAR information is provided;[107]

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105 Greenbook at 47; Baucus bill section 4.

106 The Title 31 FBAR filing obligation currently applies to both individuals and entities. The Greenbook's Shadow FBAR proposal would apply only to individuals, although the Greenbook does not explain why the proposal is limited in this way. By contrast, the Baucus proposal would apply to any person obligated to file an FBAR.

107 The statute of limitations is generally three years from the date the return was filed. There is a special rule in current law that provides that if the taxpayer has omitted from the return any one of certain specified

and the other is harsher penalty rules in the event there is an understatement connected to the "undisclosed" foreign account (this is addressed in detail below).

The Baucus bill proposal would add a new section 6680 to the Code that would impose a penalty on any person required to file an FBAR under Title 31 who did not file a duplicate copy of the FBAR with the person's U.S. Federal income tax return.[108] The penalty for failure to include this Shadow FBAR with the tax return would be the same as the Title 31 penalties for failing to file the FBAR on June 30th, but the penalty could be imposed on a person only once each year.[109] That is, if a taxpayer filed the Title 31 FBAR but did not file the Shadow FBAR, or vice versa, a single penalty would apply; and if the taxpayer filed neither form, a single penalty would still apply.

Under both proposals, the Title 31 FBAR would still be required to be filed with the Treasury Department on June 30th pursuant to Title 31, even though the Shadow FBAR filed with the tax return would be due on a different date (which would be either before or after June 30, depending upon the type of taxpayer, the taxpayer's fiscal year, and whether an extension is obtained). The proposals would not change the Title 31 penalties applicable to the Title 31 FBAR filing (other than, in the case of the Baucus bill proposal, the "one penalty per year only" rule described above).

The Greenbook explains that disclosure of more information regarding foreign accounts on an income tax return "would assist the IRS in identifying and investigating situations where taxpayers have used foreign accounts to evade U.S. taxes"; and requiring the disclosure of the FBAR information with the taxpayer's income tax return "would improve awareness and compliance" with the FBAR filing requirements and "improve the IRS's ability to review FBAR compliance."

b. Recommendation

We recommend that taxpayers be obligated to file a copy of the FBAR with their tax return; and that the filing of the FBAR with the tax return replace the Title 31 filing obligation (or, alternatively, require that the single FBAR be filed twice on the same day, once with the

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forms, the three years does not begin to run until the information that was supposed to be reported on the form is provided to the IRS. The Greenbook would make two changes to this special statute of limitation rule: first, it would add the Shadow FBAR to the list of forms the omission of which triggers the rule, and second it would change the three years to six years such that the statute would be six years from the date the Shadow FBAR information is provided to the IRS.

We intend to address the statute of limitation proposal in more detail in a separate report discussing various other international tax legislative proposals relating to offshore accounts. Our recommendation with respect to that proposal is summarized in Part IV.C.1(c)(3), below.

108 If this provision is enacted, we recommend it be clarified by stating an affirmative obligation to file the FBAR with the tax return rather than just imposing a penalty for not doing so.

109 The Baucus bill would also amend section 6103 so as to enable "tax return information" to be used to assist in enforcing the Title 31 FBAR reporting requirements. *See* Baucus bill Section 4(b) (proposing to amend section 6103(b)(4)) and section 6103 (h)). We briefly discuss that proposal in note 111, *infra*.

Federal tax return and once with the Treasury Department). In addition, as provided elsewhere in the Greenbook, if the FBAR is not included with the return, the statute of limitations with respect to any understatement arising from income from the relevant financial account or transactions therein on the return should not begin to run until the FBAR information is provided to the IRS.

c. Discussion

(1) File the FBAR (or Shadow FBAR) with the Tax Return and Move the FBAR Filing Date

The two proposals would require that a Shadow FBAR (whether it is the FBAR itself, or a different form with the FBAR information) be included with the taxpayer's annual U.S. Federal income tax return. We support the idea of having a Shadow FBAR filed with the U.S. Federal tax return. We also recommend that if the separate FBAR filing is retained, the due data for that filing be made the same as the tax return date due. In part for the reasons discussed in Part IV.C.1.c(2) below, we believe that the Shadow FBAR should be the actual FBAR or a copy thereof, as provided in the Baucus bill, rather than a schedule with FBAR information.

We think having the FBAR included with the tax return would assist in the enforcement of the Title 31 and Title 26 rules. There are many overlaps between the Title 31 FBAR regime and the Title 26 tax return regime, including that they are both enforced by the IRS, the information gathered under each regime is (or could be) useful in enforcing the other regime (including, in the case of Title 26 enforcement, determining which taxpayers to audit and in identifying issues to be pursued in the audit), and the problems that the two regimes are aimed at preventing (such as money laundering and tax evasion) often occur in tandem. Consistent with this, the Greenbook's explanation of the rationale for this proposal indicates that it is expected to assist in the enforcement of both the Title 31 rules and the Title 26 rules.

We also think having the FBAR filed with, or at the same time as, the tax return would improve compliance with the FBAR filing obligation. As the Greenbook explains (in support of its Shadow FBAR proposal) compliance would be expected to improve because taxpayers are already aware of the obligation to file an annual income tax return (and include therewith all the schedules and attached forms discussed in the instructions to the income tax return form). A filing that is required to be made with, or at the same time as, the taxpayer's income tax return it is less likely to be overlooked. While the income tax return instructions do currently remind taxpayers of the obligation to file the FBAR, the FBAR filing requirement currently is a completely separate requirement from the tax return and the filing is due by June 30th, which may well be before the tax return due date or after the tax return due date (since many taxpayers obtain automatic extensions until September or October). As a result, we believe that many persons who have failed to file FBARs have done so inadvertently because they overlooked the requirement to file the FBAR or mistakenly thought that filing a tax return and paying all the taxes due absolved them of the FBAR filing obligation. We believe these kinds of confusion and mistakes would be greatly reduced if the FBAR was made part of the tax return (or filed simultaneously).

Aligning the FBAR due date with the tax return due date would mean that, for taxpayers whose returns are due and filed by March 15th or April 15th, the FBAR would be due earlier than it is currently. For taxpayers who obtain extensions until September 15th or October 15th, the FBAR would be due later than it is currently. It seems to us that this delay should not be so problematic as to outweigh the benefits of this proposal, but we are basing that on our understanding of how the FBAR information is used by the government.

Coordinating the FBAR filing with the tax return filing may also improve compliance with the Title 31 document retention rules (contained in 31 C.F.R. section 103.32). Current law requires FBAR-related documentation to be retained for five years. We believe this obligation is more likely to be complied with if the FBAR preparation is made part of tax return preparation because taxpayers generally are aware that certain documents must be retained for tax purposes, and adding the FBAR-related documents to this list is more likely to result in retention than imposing the FBAR-retention obligations separately.

(2) One Annual Filing or Two?

As discussed in more detail below, from the perspective of the taxpayer and the tax system alone, it clearly would be preferable for a taxpayer to be required to file an FBAR or the equivalent only once, with the taxpayer's tax return. On the other hand, it appears that from the perspective of the government, it may be preferable for there to be two separate filings, one attached to a tax return and a separate FBAR filing as under current law. Striking the appropriate balance between these two conflicting goals requires an evaluation both of tax administration considerations and law enforcement considerations, which is for the Administration and Congress to make. Our recommendations below are set forth in the order that would be most desirable, in our view, from the perspective of the tax system.

Recommendation #1: We think the ideal solution would to completely replace the June 30 FBAR filing requirement with a requirement that the FBAR be filed only once, at the same time as and with the annual tax return.

A single annual filing, coordinated with the tax return, would we believe have a positive impact on taxpayers' perceptions of the system as fair and manageable. Our self-assessment tax system depends in large measure on taxpayers believing that the system is fair and reasonable and that compliance is manageable. Consciously or unconsciously taxpayers will start to "give up" if the system is unwieldy and confusing. Currently, many taxpayers who are aware of the FBAR rules (dare we say, "most" taxpayers who are aware of the FBAR rules) do not understand why the FBAR is required to be filed on a different date than the tax return and why this separate FBAR form is required at all if a tax return is being filed. Most taxpayers probably do not notice or understand the difference between filing the FBAR with the Treasury Department and filing the tax return with the IRS, particularly since the IRS website seems to be the source of the government's "guidance" on the FBAR rules.[110]

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110 We do not mean to suggest that taxpayers are intentionally not filing the FBAR because they think it is too onerous. Rather, taxpayers who perceive the system as overly bureaucratic, unreasonably burdensome and difficult to understand and navigate are more likely to get discouraged, frustrated, and anxious enough that compliance starts to decline.

The Treasury Department (of which the IRS is a part) should be able to get all the information it needs from a single annual filing. The IRS is already given the responsibility of enforcing both the Title 31 FBAR filing obligations and tax return filing obligations. Mechanically, the IRS could continue to submit FBARs to the CBRS database, so that other law enforcement agencies would continue to have access to them.

We understand, however, that one of the reasons for, and benefits for the government from, having the FBAR filed under Title 31 and separately from the Federal tax return is that the data obtained from the FBAR may legally be shared with other arms of the Treasury Department (such as FinCEN) and other U.S. Federal agencies (*e.g.*, the FBI) for law enforcement purposes. Section 6103 generally prohibits the IRS from sharing information obtained from tax returns and tax return information with anyone outside the IRS. If the FBAR was filed as part of the tax return it would be subject to these section 6103 restrictions.

It is not our intent to alter the current access to and use for law enforcement purposes of FBAR information. Accordingly, we would recommend that an exception be added to section 6103 providing that the FBARs received as part of tax returns may be shared with other federal (or state or foreign) agencies for law enforcement purposes. The general prohibition contained in section 6103(a) is already followed by a long and detailed list of exceptions, each providing that tax return information may be shared with other governmental bodies or persons for certain purposes. We recommend this as the best solution and call this Recommendation #1.

We understand, however, that currently the process of obtaining information from the IRS pursuant to one of the section 6103 exceptions can be time consuming and complicated,[111] and that for that reason the idea of filing the FBAR with the tax return only has not found favor within the government. It is not clear to us, however, whether the same problems would be encountered if the exception provided that all FBAR forms, no matter who has filed them, are exempt from the section 6103(a) prohibition. We can imagine that IRS personnel might still be concerned about providing the FBAR data to persons outside the IRS without some type of guarantee that the data was being requested for an appropriate purpose and that might result in the same delays and limitations on availability of the data.

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[111] A review of the Internal Revenue Manual provisions explaining the procedures for the release of information pursuant to the section 6103 exceptions and the harsh penalties that apply to IRS personnel in the event of a violation of section 6103 explain, at least in part, why obtaining tax return information pursuant to a section 6103 exception can be so difficult. *See* IRM Sections 9.3 and 11.3.

Currently, there are two legislative proposals that would address the relationship between the protection that section 6013 affords to taxpayer return information and the benefits of allowing government agencies to share FBAR information (Levin bill section 205 and Baucus bill section 4), both of which would make changes that would permit tax return information to be used to enforce the Title 31 FBAR penalties. (Levin would do this through an amendment to Title 31 and Baucus would do it by amending section 6103.) Another section of the Levin bill (section 306) would also amend section 6103 to permit Treasury to share tax return information with the SEC, federal banking agencies and the Public Company Accounting Oversight Board, provided certain conditions are met. Section 6013 encourages taxpayers to provide detailed personal information to the government in the belief that that information will be kept private, and is thus an important part of our voluntary compliance-based tax system. We believe that there are important issues raised by these section 6103-related proposals and they should be considered together with the other administrative and enforcement questions set out above.

Accordingly, we have developed the following alternative recommendations:

Recommendation #2: Have the FBAR filed only once, with the annual tax return, but require, by statute, the IRS to automatically provide a copy of all FBARs the IRS has received to FinCEN or another Federal government department or agency that would make the FBAR available to other government agencies for law enforcement purposes, through the existing mechanism of posting the FBAR to the CBRS database. This would eliminate the need to go through the IRS and comply with the IRS's section 6103 procedures on an individualized basis. The mandate would presumably be clear and affirmative and the precise form that is subject to the mandate would be clear, so it would seem unlikely that IRS personnel would be concerned that complying with this new law would violate section 6103.

We are not aware of any precedent for this, however. We can imagine that the IRS might view the need to transfer copies of the FBAR from the databases that hold tax filings to the CBRS database as burdensome. That burden exists under the current system and would exist under the Greenbook and Baucus bill proposals, however; but it is borne by the many taxpayers who must file both tax returns at their normal filing address and FBARs with the Detroit office. We think that shifting this burden to the IRS, which can develop standardized procedures for dealing with it, and which already obtains many tax return filings electronically, is both more efficient and more likely to result in broad compliance.

In the event that Recommendations #1 and #2 are not considered viable, we have included a third recommendation.

Recommendation #3: Require each taxpayer to file a Shadow FBAR with the taxpayer's annual U.S. Federal tax return (a duplicate of the Title 31 FBAR) and simultaneously file a duplicate copy (the Title FBAR) with the Treasury Department,[112] in the manner required by Title 31, except this Title 31 filing would be due on the same date (taking into account extensions) as the tax return.

This dual-filing proposal is not ideal from the perspective of improving compliance by making the rules easier to comply with, but we believe it would be an improvement over the current system because the due dates for the tax return and the Title 31 FBAR would be coordinated.

To assist taxpayers in complying, the instructions to the tax return forms would highlight the need to file the FBAR in two places. The instructions could briefly explain that the second filing (the Title 31 filing) is required because the FBAR filing obligation was enacted to gather information that is relevant to enforcement of various laws that are not related to the tax laws. This may result in some taxpayers finding the system to be more comprehensible than it is to them currently.

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[112] We oppose the Shadow FBAR concept in so far as it requires taxpayers to state the same information on two different forms (one being the FBAR and the other being a new tax return schedule (the Shadow FBAR)). Completing the annual tax return is already time consuming and frustrating. There seems to be no benefit from adding an additional form in this way when a duplicate of the FBAR would have the same information.

While some may view obligating taxpayers to make an additional filing as overly burdensome, we note that most taxpayers are already making multiple filings on the day they file their tax returns (a Federal filing, and one or more state and local filings). We believe requiring taxpayers to add an additional envelope to the pile, while not ideal, can be justified given the important government interests involved. A similar duplicate filing obligation currently applies if a taxpayer has participated in a "reportable transaction" within the meaning of section 6011: a Form 8886 must be filed once with the taxpayer's tax return and again, at the same time, with the Office of Tax Shelter Analysis ("OTSA").

(3) Statute of Limitations

We recognize the importance of maintaining the current statute of limitations for the FBAR. The current statue of limitations with respect to a failure to file an FBAR is six years, whereas the statute of limitations on tax collections is generally three years. We do not think the difference in the statute of limitations is a reason to reject our Recommendation #1. If the FBAR is made part of the tax return, the six year statute of limitations for a failure to file the FBAR could be retained.

Another one of the Greenbook proposals provides that the failure to include the Shadow FBAR with the return would extend the statute of limitations on the return so that it would not even begin to run until the missing FBAR information was provided to the IRS and then it would last for six years from that date.[113] We support the proposal to extend the statute of limitations to six years if a taxpayer fails to file a Shadow FBAR, provided that the extension relates solely to any understatement arising from income from, or transactions in, the undisclosed foreign account.[114]

(4) Which Taxpayers Would Be Required to Include the FBAR With Their Tax Returns: Individuals Only or Also Entities?

The Baucus and Greenbook proposals differ in their scope: the Baucus bill proposal would apply to any person required to file an FBAR, whereas the Greenbook would apply only to individuals. We agree that the obligation to file the FBAR or duplicate FBAR with the tax return should apply to individuals that have a financial interest in an account, as it is clearly the case that under any of the recommendations described above the result would be simpler than the current system, provided that no additional separate filing is required. Since most individual taxpayers file their tax returns by April 15, this would accelerate the timing of the filing of FBARs. (Even if a separate filing with a June 30 deadline were still required, if the instructions to Schedule B were properly formulated, many individuals might mail the envelope at the same time as they submit their tax returns.)

Requiring corporations and partnerships to file the FBAR or a Shadow FBAR with their return raises more complicated issues. Such entities may have a fiscal rather than a calendar

113 Greenbook at 54-55.

114 We intend to discuss this recommendation in more detail in a forthcoming report.

year; and they are likely to file their returns after June 30. The FBAR filing requirement is based on a calendar year, not the taxpayer's taxable year. Accordingly, requiring an FBAR or Shadow FBAR filing with a tax or information return is likely to delay the date on which the FBAR filing takes place, assuming there is no separate filing of the FBAR as under current law. We doubt, however, that the delay of a few months would have any significant effect on the enforcement of the tax laws. (We do not address the effect on other law enforcement.) Accordingly, provided that the FBAR filing deadline is modified so that it is based on the filer's taxable year, we support the extension of the FBAR or Shadow FBAR filing requirement to entities.

Finally, we believe that the rules regarding the FBAR filing obligations of individuals with only signature authority over (and not a financial interest in) accounts in their capacity as employees or officers of an entity that also has FBAR filing obligations with respect to those accounts should be revisited in order to avoid duplicate filings. We expect to address that issue in a later report.

(5) The Consequences of Failing to File the FBAR With the Tax Return

We believe that the consequences of failing to file the FBAR with the return should be two-fold: (i) as provided in the Baucus bill proposal, the Title 31 penalties should apply to a failure to file the FBAR either with Treasury or with the return, but only one penalty should be imposed on a taxpayer for any year, so that a taxpayer that files neither the Title 31 FBAR (if that filing is retained) nor the Shadow FBAR is subject to one penalty rather than two; and (ii) as provided in the Greenbook proposal referred to above, if the Shadow FBAR is not included with the return, the statute of limitations with respect to any understatement relating to income from or transactions in the undisclosed foreign account should not begin to run until the Shadow FBAR information is provided to the IRS.

2. Harsher Understatement Penalties for Failure to File Shadow FBAR[115]

Under current law, a 20 percent accuracy-related penalty is imposed on any understatement that (i) results from negligence or disregard of rules or regulations, (ii) is part of a "substantial understatement", or (iii) arises from a "reportable transaction"[116] that was properly disclosed under section 6011.[117] There is a "reasonable cause and good faith" defense to this 20 percent penalty.[118]

115 Greenbook at 56.

116 More precisely, the penalty applies to any "listed transaction" and any other reportable transaction provided that a significant purpose of the transaction was U.S. Federal tax avoidance or evasion. *See* Section 6662A(b)(2).

117 Section 6011 requires that a special Form 8886 disclosing the reportable transaction be filed with the tax return and that a duplicate copy of that Form be filed with OTSA.

118 Section 6664(c) for negligence or substantial understatement; section 6664(d) for an understatement from a reportable transaction with a significant purpose of tax avoidance.

In the case of an understatement from a reportable transaction, there are a number of harsher rules: (i) the reasonable cause and good faith defense is more limited and thus harder to satisfy; (ii) if the reportable transaction was not disclosed in the manner required by section 6011, the 20 percent penalty is increased to 30 percent *and* there is no defense at all (*i.e.,* there is strict liability for the 30 percent penalty);[119] and (iii) in certain cases, a SEC reporting company is required to publicly disclose that it incurred a penalty under one the special reportable transaction rules.[120]

a. Description of Proposal

If an individual fails to file the Shadow FBAR with the individual's tax return and there is an understatement that "arises from a transaction involving" the "undisclosed" foreign account, then (a) the 20 percent penalties would be doubled to 40 percent, and (b) if the understatement also arose from a reportable transaction, the reasonable cause exception would not be available with respect to the increased penalty.

It is not clear what penalty percentage would apply to an understatement from a reportable transaction involving a foreign account if the taxpayer had filed neither the section 6011 form nor the Shadow FBAR. The current understatement penalty when there is no section 6011 filing is 30 percent (and it is imposed with strict liability); it is unclear if this penalty would be also be "doubled" (and thus be 60 percent) or would be increased to 40 percent.

This proposal would apply only to individuals (not to entities) because the Shadow FBAR proposal would apply only to individuals.

The rationale for the proposals is described in the Greenbook as follows:

> **"United States persons may seek to evade U.S. tax liability by transferring assets to foreign accounts. Increasing the penalties on understatements from transactions that involve undisclosed foreign accounts would encourage proper disclosure of such accounts and deter the use of foreign accounts to evade U.S. tax liability."**

b. Recommendations

We support the doubling of penalties in cases where the Shadow FBAR is not included with the tax return, with the modification that it should apply to both individuals and entities. As stated above, we believe that this proposal should have a delayed effective date to permit the Treasury Department to issue clearer guidance on when FBAR filings are required. The statute also should clearly specify the type of "link" required between the undisclosed foreign account and the understatement.

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119 *See* Sections 6662A(c) and 6664(d)(2)(A).

120 Section 6707A(e); *see also* Announcement 2002-63, 2002-2 C.B. 72 (IRS will routinely request the tax accrual workpapers of a taxpayer that engages in a transaction specifically identified by the IRS as abusive (a "listed transaction")). The IRS's policy set forth in this Announcement has been the subject of vigorous litigation, and has not as yet prevailed in court.

We recommend against enacting the proposal that would eliminate the reasonable cause defense to the underpayment penalty in the case of a reportable transaction linked to a foreign account for which no Shadow FBAR was filed with the return.

c. Discussion

(1) Increase Penalties to 40 Percent Where Shadow FBAR Not Included With Return

The proposal would increase the understatement penalty from 20 percent to 40 percent in any case where the Shadow FBAR was not included with tax return and the understatement is from a transaction that "involves" the foreign account.

First, we identify some considerations which support this proposal.

(i) Harsher understatement penalties would generally be expected to encourage greater taxpayer compliance with the Shadow FBAR reporting obligation because taxpayers are expected to be more vigilant if they are aware that noncompliance could have such harsh consequences.[121]

(ii) A failure to file the Shadow FBAR with the tax return, combined with an understatement that involves that "undisclosed" foreign account, is a combination of circumstances that suggests the taxpayer was trying to hide income. Such behavior would seem to be more egregious than an understatement that arose without such additional circumstances. Thus, a larger than usual penalty would seem appropriate in these circumstances.

Some countervailing considerations are as follows.

(i) A failure to file an FBAR already triggers significant penalties, and we are recommending, consistent with the Baucus bill (above) that those same penalties apply to a failure to include the Shadow FBAR with the tax return. If that becomes law, then a failure to file the Shadow FBAR with the return will already subject the taxpayer to significant penalties, so there would be no need to add an increase in the substantial understatement penalties.

(ii) If the taxpayer's failure to file the Shadow FBAR with the return was motivated by an intent to hide income, then the IRS could pursue harsher penalties for the underpayment such as the civil fraud penalty under section 6663 (75 percent of the underpayment) or the criminal penalty for willful tax evasion under section 7201 (up to five years in prison and monetary penalties). We understand however that it is difficult to pursue and establish "fraud" and "willful evasion" and that the IRS may feel that, where a Shadow FBAR is omitted and the understatement arises from the undisclosed foreign account, a harsher penalty than 20 percent is

121 As described in the text, the penalty would apply if a taxpayer filed a Title 31 FBAR but failed to file a Shadow FBAR, and there was a related understatement. The penalty would not apply if the taxpayer filed a Shadow FBAR but failed to file a Title 31 FBAR. This distinction may be the result of a determination that the IRS can more easily access a Shadow FBAR than a Title 31 FBAR. It is unfortunate, however, that two equally "culpable" taxpayers could face very different penalties, particularly if the purpose of the penalty is to encourage taxpayers to comply with all FBAR filing requirements.

warranted but not feel confident that a fraud case could be proven or that the conduct was criminal.

(iii) There are some fairness and administrability concerns with having such onerous understatement penalty consequences result from laws that are unclear. There are two ways in the which the laws are unclear. First, as discussed in a separate letter, there are currently numerous uncertainties regarding when an FBAR is required to be filed by any specific person (who the rules apply to, what types of accounts are covered, what type of control over the account triggers the obligation to file, etc).

Second, the increased penalties would be triggered, as described in the Greenbook, if the understatement "arises from a transaction involving a foreign account" that was not disclosed in the tax return on a Shadow FBAR. It is extremely important that the requisite link to the financial account be specified clearly in the statute and that the link be one that justifies the doubling of the penalties. Ideally, the statute would require a link where the "secrecy" of the account was intentional and was motivated (at least in part) by an intent to avoid U.S. Federal taxes. We recognize however that such a facts and circumstances test for the "link" could reduce the benefit of an automatic harsher penalty that would apply without imposing an obligation on the IRS to prove that the taxpayer intended to hide income.

We considered whether there should be a dispensation from the increased understatement penalties if the taxpayer had filed the FBAR under Title 31 but omitted it from the return. In support of such a dispensation would be the notion that any taxpayer in that circumstance would in all likelihood have failed to include the FBAR with the return unintentionally. On the other hand, we considered whether it was possible that such a rule might encourage taxpayers to intentionally omit the FBAR from the return, (but complete the Title 31 filing) in the hopes that the IRS does not obtain any information regarding the Title 31 filing and does not realize that the taxpayer has omitted income from the return.

One possible way to address these countervailing concerns, at least in part, would be to provide for some defense to the increase in the penalty. For example, if the taxpayer could establish that there was reasonable cause and good faith for failure to file the Shadow FBAR, then the increase in the penalty would not apply. This would be a separate defense from the reasonable cause and good faith defense that would apply with respect to the understatement itself. One significant disadvantage of this idea is that it would add even more complication to an already overcomplicated regime. These issues would not need to be resolved, of course, if our recommendation that there be only a single filing, with the return, is adopted.

(2) <u>Elimination of Reasonable Cause and Good Faith Exception To Reportable Transactions Involving an Undisclosed Foreign Account</u>

This aspect of the proposal would eliminate the reasonable cause exception to the section 6662A underpayment penalty that applies to a reportable transaction if the transaction involved a foreign account for which a Shadow FBAR was not filed with the tax return.[122] The result of this would be strict liability for the 40 percent understatement penalty because the reasonable cause defense is the only defense available to the section 6662A understatement penalty for reportable transactions. As a practical matter, this proposal would apply only to a taxpayer that properly filed a reportable transaction form pursuant to section 6011, but failed to file the FBAR data with the tax return. The reason that we say this is that, if the taxpayer had not adequately disclosed the transaction pursuant to section 6011, then there would already under current law be strict liability for the 30 percent penalty.

If the taxpayer has properly reported a transaction under section 6011 but not filed a copy of the FBAR with the taxpayer's tax return, it seems unfair to us to deny that taxpayer the reasonable cause exception that is currently permitted under sections 6662A and 6664(d). The requirements for meeting that reasonable cause exception in the case of a reportable transaction are already extensive.

We have for many years supported "strict liability" penalties as a means of combating abusive transactions, and of increased penalties in the case of nondisclosure.[123] Abusive transactions undermine the fairness and public trust that are essential to our system of self-assessed taxes. We have also consistently recommended, however, that strict liability penalties be imposed only when the conduct to be subject to penalty is described in terms sufficiently precise and clear to give taxpayers fair notice of what is proscribed, and when the penalty is limited to cases where the indicia of an inappropriate intent are very strong.

Currently, as previously noted, the FBAR filing rules are very unclear. Moreover, in this case, the strict liability would apply only if the transaction was "reportable." Experience with the reportable transaction rules has shown that many transactions trigger a reportable criterion (most often this is the "loss" criterion) but are not what we would consider abusive or tax avoidance or even aggressive interpretations of current law.

Strict liability also seems inappropriate unless it is shown that the failure to disclose the foreign account information on the Shadow FBAR was linked to the understatement – that is, that the link between the account and the transaction relates to the failure to file the Shadow FBAR. We endeavored to develop a rule that would link the understatement to a taxpayer's attempt to hide its actions from the scrutiny of the IRS, and could not come up with a workable rule. It seems to us that a black letter rule accomplishing an appropriate link would be difficult if

122 We are assuming this proposal is intended to apply only to reportable transactions that are subject to the rules of section 6662A – *i.e.*, reportable transactions that are listed transactions or are otherwise reportable and have a significant purpose of tax avoidance.

123 New York State Bar Association Tax Section, *Report on Corporate Tax Shelters* (Report No. 950, April 23, 1999), New York State Bar Association Tax Section, *Report on the Treasury's Proposal to Codify the Economic Substance Doctrine* (Report No. 977, July 24, 2000), New York State Bar Association Tax Section, Report No. 979 (Sept. 18, 2000), New York State Bar Association Tax Section, *Report on Tax Shelter Legislation* (Report No. 1019, Aug. 27, 2002), and New York State Bar Association Tax Section, *S. 1637 – JOBS Act – Tax Shelter Penalty Provisions* and *H.R. 2896 – Tax Shelter Penalty Provisions* (Report Nos. 1055 and 1056, March 18, 2004). Restricting the imposition of "strict liability" penalties to clearly defined and egregious cases serves the values of deterrence, fairness (and the perception of fairness), and avoidance of disputes between taxpayers and the IRS.

not impossible to draft and without such a rule a taxpayer should have the right to present a defense to the understatement penalty.

3. Two New Rebuttable Evidentiary Presumptions if Taxpayer Fails to File "Real" FBAR[124]

a. Description of Proposals

These two evidentiary presumptions would apply if any person (this is not limited to individuals) had failed to file an FBAR (this applies with respect to the Title 31 FBAR, not the Shadow FBAR). The Greenbook states that both presumptions would apply only in "civil administrative or judicial proceeding[s]" and would not apply in criminal proceedings. Neither presumption would apply if the financial account was at an institution that is a QI and Treasury would be given regulatory authority to provide additional exceptions to either presumption.

The first presumption relates to the $10,000 account balance threshold that triggers the obligation to file the FBAR. If the person has the requisite financial interest in or control over a foreign account, there would be a rebuttable evidentiary presumption that the $10,000 threshold had been met.

The second presumption would apply only if the account balance is greater than $200,000 at any time during the year. In that case, there would be a rebuttable evidentiary presumption that the failure to file the FBAR was "willful". The presumption would not apply to a person who has authority with respect to a foreign account only by virtue of being an employee or officer of a corporation and "no more than a *de minimis* financial interest in that corporation". Because the presumption would apply only in civil proceedings, the consequences of the presumption would be that, if the person could not disprove the presumption, the civil penalties would be up to the greater of $100,000 and 50 percent of the amount in the account at the time of the violation.

The Greenbook explains that the Administration is concerned that U.S. persons are not complying with the Title 31 FBAR filing requirements, and that when the IRS is aware of a foreign account but cannot obtain information from the foreign financial institutions on the amount in the account, the IRS has difficulty providing that the $10,000 threshold was met and thus imposing the penalty. The Greenbook also states that both presumptions "would encourage voluntary disclosure of account information and assist the IRS in its enforcement efforts with respect to undisclosed foreign accounts."

b. Recommendations

We support the proposal to adopt a rebuttable presumption that the $10,000 threshold is met. We oppose the proposal to adopt a rebuttable presumption of "willfulness" when the foreign account balance exceeds a certain amount. If this latter proposal were enacted, we recommend the threshold be set at $5 million (not $200,000).

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124 Greenbook at 51-52.

c. Discussion

The principle behind both presumptions is that the party with access to the information should be the one with the burden of producing it. In practice, we believe both presumptions would encourage knowledgeable taxpayers to have their accounts at institutions that are QIs.

(1) Presumption with respect to the size of the account

Provided that it is clarified that a taxpayer can rebut this presumption by producing bank account statements or other evidence that show that the account did not reach the $10,000 threshold, we believe this presumption would be a fair allocation of the burden of proof as to whether the $10,000 threshold had been exceeded. It makes logical sense that the IRS has difficulty in providing that the threshold was exceeded if the taxpayer and the foreign institution are not forthcoming.

It also does not seem to us to be onerous to require a taxpayer with a foreign financial account that has a balance of below $10,000 at all times during the year to produce bank statements establishing this. In reaching this conclusion, we considered the situation of a U.S. individual living outside the U.S. and maintaining a foreign bank account for purposes of his or her ordinary every-day banking needs. The individual may not be aware that if he or she chooses a bank that was a QI that would eliminate the need to "rebut" this presumption, or there may be no local bank available that is a QI. Is it fair or appropriate to subject this individual to an FBAR investigation where the individual must produce foreign bank statements to avoid a harsh FBAR non-filing penalty? We think that the burden is so minimal that it is fair and appropriate.

(2) Presumption that a failure to file is willful

We believe that a presumption that a failure to file an FBAR is willful in any case where the account balance was, at any point during the year, greater than, $200,000 is likely to be unfair.

We believe that it is inappropriate for the government to have the benefit of a rebuttable presumption regarding something like "intent" which is so difficult to disprove, at least in the absence of factors suggesting that the failure was unlikely to be inadvertent. We are concerned that a taxpayer may have difficulty in proving that he or she did not know of the filing requirement – how can someone prove a *lack of knowledge*? We believe therefore that this proposal may well be the equivalent of strict liability for the penalties applicable to willful failures to file.

The FBAR penalty rules have a harsher penalty for willful failures for a reason. Because lack of knowledge would be so hard to prove, this proposal would seem to conflict with the reasoning behind providing a harsher penalty for willful failures than for non-willful failures. Failing to be faithful to the rationale behind the penalty regime is particularly troubling because the penalties at issue are so severe (up to 50 percent of the amount of the account at the time of the violation).

We also stress that harsh enforcement rules (like presumptions that amount to strict liability) are quite problematic when the obligations of the law are both unclear and far from intuitive.

For example, consider the relative ease with which one could inadvertently become obligated to file an FBAR and trigger this presumption without such individual having any intent at all of hiding an account, hiding income, or even reducing his or her taxes. The presumption would be triggered if the account balance is greater than $200,000 *at any point during the year*. A U.S. person living outside the U.S. could have a large amount of cash in a foreign account for a short period of time (even a day or two) for a one-time event, such as a transfer of funds in and out of an account in connection with the sale and purchase of a home, or a transfer of funds from a deceased relative's estate into a foreign account from which the funds are promptly withdrawn and moved to a U.S. account. In such a situation, the person may never think of these events as triggering an FBAR filing obligation because the money was in the account for such a short period of time and the foreign account was used for a legitimate reason. Think of the penalty such a person could face: 50 percent of the highest balance in the account during the year.

Accordingly, we recommend that this proposal not be enacted in its current form.

If, however, Congress goes forward with this proposal, we believe it is important to modify the proposal. Given how draconian the consequences of this presumption could be, we believe that the threshold balance that would trigger such consequences should be significantly higher. The balance should be high enough that it would be very unlikely that the failure to file the FBAR was inadvertent. A presumption of willfulness should apply where the objective facts suggest willfulness. A $200,000 threshold is too small a threshold for this purpose. We would recommend a threshold of $5 million. We think this is high enough to eliminate transactions that may commonly be engaged in by U.S. persons living abroad or U.S. persons with relatives abroad, but not so high that it would not capture the type of tax avoidance that the proposal is aimed at.