

Be Careful in Designing International Tax Reform Measures

By Alan W. Granwell

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Industrialized countries have heightened their scrutiny of offshore financial centers (a multitrillion-dollar industry) and the use of offshore accounts in efforts to recoup much-needed revenue from taxpayers improperly using those centers to evade tax.

G-20 countries have been working together to prevent abuses of the global financial system in several areas, including taxation. The G-20 countries have focused on international cooperation of tax authorities and on establishing effective exchange of information arrangements whereby countries can obtain stricter compliance with their national tax laws. In the past few months, a fundamental transformation has taken place in international tax cooperation practices. Numerous well-known offshore financial centers that previously had bank secrecy have endorsed the OECD exchange of information standards, and several of those centers have taken steps to implement those standards.

In "The Global Plan for Recovery and Reform," the G-20 leaders agreed to "take action against uncooperative jurisdictions, including tax havens" and to use sanctions to protect their public finances and financial systems. The leaders after their London meeting in April said that "the era of bank secrecy is over."

Current IRS Enforcement Initiatives

The IRS uses many methods to find noncompliant taxpayers using offshore accounts or tax haven entities. They include: (1) international collaboration through the exchange of information

provisions of bilateral tax agreements and cooperative information agreements that the United States has entered into with more than 70 countries; (2) the qualified intermediary program that the IRS has with foreign financial institutions that agree to become QIs; (3) criminal investigations with the Justice Department; (4) the whistle-blower program through which the IRS receives many tips; and (5) the John Doe summons authority, which the IRS uses when it suspects U.S. taxpayers are using offshore bank accounts to avoid paying taxes but does not know their identities.

The IRS commissioner has said that international tax issues are a major priority and that the IRS needs more resources, information from both foreign countries and financial institutions, and regulatory and legislative changes.

Legislative Proposals

The Obama administration and various lawmakers have proposed legislation that would enhance international tax enforcement. In general, the proposals are designed to combat offshore tax evasion, specifically by strengthening and expanding the QI program. The overall objective is to facilitate compliance by U.S. taxpayers and require that foreign financial intermediaries provide the IRS with additional information on U.S. account holders. The proposals are also intended to create disincentives for those U.S. taxpayers who choose to do business with a financial institution that is not a QI.

The QI-related proposals would require foreign financial institutions — apparently wherever situated and not necessarily in an offshore financial center — to enter into a QI agreement with the IRS. Under that agreement, the foreign financial institution would be required to undertake significant new obligations regarding U.S. account holders. QIs would be required to: (1) identify all account holders that are U.S. persons; and (2) report all payments (both U.S.- and foreign-source) received on behalf of U.S. account holders and to backup-withhold on those payments if documentation was not received from the U.S. account holders (similar to the obligations imposed on U.S. financial institutions). Also, the IRS would be authorized to publish a list

of QIs, and Treasury would be authorized to promulgate regulations designed to control abuses of the existing program — for example, regulations that would require QIs to collect information on the beneficial owner of a foreign account holder, such as a shareholder of a foreign corporate account holder, and to report that information to the IRS. The regulations also could provide that all commonly controlled financial institutions must either register as QIs or implement similar reporting procedures as the affiliated QI.

The proposals would encourage non-QIs to become QIs to avoid such disadvantages as the potential imposition of full U.S. withholding tax on all payments to non-QIs (including those for the benefit of foreign account holders who have bona fide treaty claims to reduced rates) and the application of negative legal presumptions that would be created against U.S. users of non-QIs, such as (1) a presumption that any foreign financial account owned by someone otherwise subject to the requirement to file a foreign bank account report (FBAR) contains sufficient funds to trigger the FBAR filing obligation and (2) a presumption of willfulness that would apply if a U.S. person fails to file an FBAR for an account with a non-QI containing more than \$200,000, which could support significant civil penalties.

The proposals' other provisions would implement stricter withholding rules, broader information reporting, strengthened penalties, and a longer statute of limitations that would enhance the IRS's ability to obtain information and enforce U.S. tax laws. The IRS would also be allowed to hire many more revenue agents.

Comments

With the globalization of financial markets and the financial crisis, initiatives to achieve greater fiscal transparency, exchange of information, and international cooperation in tax matters have become increasingly important. Those initiatives, however, should be carefully tailored in the least burdensome manner to achieve their intended objectives.

The Obama proposals would place significant new and expansive obligations and financial burdens on foreign financial institutions that want to function as intermediaries regarding

investments in U.S. stock and securities. A foreign financial institution that did not agree to those obligations would find itself at a competitive disadvantage compared with a financial institution that agreed to undertake the new obligations as a QI.

The QI/non-QI proposals raise several issues. For example, in terms of providing incentives for financial institutions to become QIs, how would they affect financial institutions resident in important developing countries that may not have become QIs? Also, consideration should be given as to whether foreign countries would retaliate by seeking to impose similar types of obligations on U.S. financial institutions.

In summary, proposals to enhance international tax enforcement are important but should be drafted to achieve their intended and necessary purposes and should also be considered in the context of how our major foreign trading partners may react. ■