An Analysis of the Green Book's International Tax Enforcement Provisions for U.S. Persons

By Dean Marsan

Dean Marsan examines the Green Book's international tax enforcement provisions for U.S. persons.

On May 4, 2009 the U.S. Treasury released a proposal entitled, "Leveling the Playing Field: Curbing Tax Havens and Removing Incentives for Shifting Jobs Overseas" ("Treasury Proposal"), and on May 11, 2009, the Treasury released the "Green Book" entitled, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals," which cracks down on the abuse of tax havens by U.S. individuals illegally hiding income (and assets) offshore.

The Treasury Proposal points out wealthy Americans can evade paying taxes by hiding their money in offshore accounts with little fear that either the financial institution or the country that houses their money will report them to the IRS. In addition to initiatives taken with the G-20, Treasury has proposed its own comprehensive package of disclosure and enforcement measures to make it more difficult for financial institutions and U.S. persons to evade tax.

If a U.S. person can arrange his affairs so that he appears to be a foreign person, he may be able to evade U.S. tax entirely. The typical structure involves the creation of a foreign corporation either directly or through a trust or other transparent entity that is beneficially owned by a U.S. person. These nominee or sham entities for all intents and purposes have caused the U.S. person to fly under the radar and not only evade U.S. tax, but also permit him to launder his money through these investment vehicles. According to the Treasury Proposal, in the Cayman Islands, one address alone houses 18,857 corporations, very few of which have any physical presence in the islands.

The Treasury Proposal gives a specific example of the kind of abuse under current law it is targeting by suggesting that if a U.S. account holder at a nonqualified intermediary (non-QI) sells $50 million worth of securities through his or her U.S. broker the IRS may have limited tools to detect any fraud. The example assumes the seller will falsely self-certify that he or she is not a U.S. citizen, which is then passed along to the U.S. broker, who relies on the statement and does not withhold any money from the transaction. As a result, the U.S. taxpayer avoids paying U.S. taxes since the non-QI has not signed an agreement with IRS to share information about its U.S. customer, and the IRS has no way to determine that the investor is actually a U.S. citizen committing a crime.

The proposals provide that the changes to the current law for U.S. individuals are expected to raise $8.7 billion over 10 years and are generally effective for tax years beginning in 2011. If enacted into law in their current form, they can be expected to impose significant tax law changes on the U.S. tax reporting and withholding relating to U.S. investors investments in foreign bank and brokerage accounts either directly or through their brokers and may likely also generate more revenue than this estimate.

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Strengthening the Existing "Qualified Intermediary" System to Crack Down on Tax Evasion

Background

Under current law, foreign investors who receive U.S. source "Fixed and determinable, annual or periodic" (FDAP) income are subject to a 30-percent withholding tax[1] unless reduced by treaty, and U.S. investors are subject to backup withholding tax[2] at the rate of 28 percent if they do not provide the payor with a taxpayer identification number (TIN) and make certain certifications. The Qualified Intermediary, or QI, program was intended to put the burden of information reporting and withholding tax returns on the foreign financial institutions who were presumably closer to their customers under "know your customer" or KYC principles.[3] The theory being that the foreign financial institutions would not only be in the best position to collect the required documentation (*e.g.,* Forms W-8s, W-8BENs, W-8IMYs or W-9s), but would also be able to verify that such information about their clients was correct.

The QI would agree to assume responsibility for obtaining documentation from its customers covered by the QI agreement with the IRS and to substantiate the status of its customers as the beneficial owners of such income. However, in a telling exception, the QI rules under current law continue to treat a foreign corporation as such for U.S. tax purposes, even though it was beneficially owned by U.S. persons (absent actual knowledge that the beneficial owners were U.S. persons). This would hold true even though the foreign corporation was located in a tax haven.

Under the QI regulations,[4] the foreign financial institution or clearing house (or foreign branch or office of a U.S. financial institution or clearing house[5]) would enter into a contract with the IRS,[6] agree to verify the identities and beneficial ownership of its customers (and generally not look beyond the customers' foreign entities in which they had an ownership interest) and be subject to an annual audit by an external auditor.[7] Unless the QI had agreed to assume the U.S. withholding responsibilities, which was atypical, it would certify to the U.S. withholding agent or payor as to the amount of withholding (or reduced treaty rate) by providing withholding rate pool information as to the portion of each payment that qualifies for exemption or a reduced rate of withholding. Thus, identifying customer information was effectively shielded from both the IRS, as well as the U.S. withholding agent with respect to foreign persons, although the QI was generally required to provide Form W-9s to the withholding agent so that it could provide 1099s to its U.S. customers.

Treasury Proposal/ Green Book for QIs

The Treasury Proposal would increase the reporting requirements on international investors and financial institutions, especially QIs who would be required to report information on their U.S. customers to the same extent as U.S. financial intermediaries. The Green Book goes further and stresses that strengthening the withholding and reporting rules under which QIs operate will help ensure U.S. persons are paying tax on income earned through foreign accounts and that proper withholding tax applies for foreign persons. U.S. customers at QIs would no longer be able to hide behind foreign entities and would also be required to report transfers of money or other property made to or from non-QIs foreign financial institutions on their income tax returns. Thus, a QI, like UBS would now have to file 1099s for its U.S. customers. Treasury would also be authorized to permit the IRS to publish a list of the QIs (at present there are approximately 5,600 QIs).[8]

Strengthen QI Reporting of Foreign Accounts Held by U.S. Persons

Under the Green Book, no foreign institution would qualify as a QI unless it identifies all of its U.S. account holders and the QI would be required to report all reportable payments (foreign source, as well as U.S. source) received on behalf of all U.S. account holders (treating the QI as the payor).

Strengthen 1099 Reporting

Under these rules, a QI would no longer be exempt from information reporting because the QI is a foreign financial institution. A QI would now be required to report both U.S. and foreign source dividends to a U.S. person, as well as be responsible for information on other payments made to U.S. persons in excess of $600 (*e.g.*, interest income on bank or brokerage checking, savings or other margin accounts).[9] Similarly, a QI would have to information-report the gross proceeds on all sales of stock or securities whether or

not the U.S. person owns only U.S. or foreign stock or securities or receives domestic or foreign source income for U.S. tax purposes.

Neither the Treasury Proposal nor the Green Book creates a minimum threshold or minimum number of customer accounts to which the new rules would apply. Thus, even a small investment by a U.S. person or a small number of such account holders through a QI would impose the full panoply of 1099 reporting by the QI and presumably would now require a robust information reporting system for its U.S. customers to be put in place by the QI similar to what U.S. financial institutions have now established for their U.S. clients.

It can be expected that both the volume of transactions to be reported, as well as the cost of implementing and maintaining such an information reporting system will go up considerably. Presumably, economies of scale will reduce the burden of reporting by a much greater number of QIs. It is possible that Treasury may create a *de minimis* rule in regulations, for example, to address the situation where a U.S. expatriate or temporary visitor or student opens a foreign checking or saving account for his or her own personal use.

Look-Through Foreign Entity Rule

Treasury would be authorized to issue regulations which would provide in order for a financial institution to be a QI it much also collect information about the beneficial owners of the foreign entity account holders and specifically report if a U.S. person is a beneficial owner. Presumably, these regulations would have broad look-through rules to find out the identities of the U.S. beneficial owners of the accounts even though they are in the name of a foreign corporation, trust, limited liability company, foundation or other foreign entity.

Neither the Treasury Proposal nor the Green Book imposes any threshold ownership amount in such foreign entity before the QI would have a duty to collect information about the beneficial owners and make them an integral part of the overall QI information reporting and withholding program.

For entities that are treated under U.S. tax law as controlled foreign corporations, foreign partnerships, personal foreign investment companies, foreign limited liability companies or foreign trusts, the IRS already imposes certain information reporting on certain U.S. owners of these entities, which may be duplicative of the information reporting that would be required by the QIs for the U.S. owners of these foreign entities.

Closing of KYC Gap

It can also be expected that the Treasury may close any perceived KYC gap by requiring in its regulations that (i) senior officers of the QI certify that they are responsible for oversight of the QIs performance; have the authority to prevent, deter or correct failures; and provide internal controls and risk management to prevent such failures under the QI agreement; (ii) require employees to establish guidelines and processes that provide that the QI will take steps to prevent, deter and correct failures in performance; (iii) requires the QI to promptly notify the IRS of any material failure to perform or maintain adequate internal controls, of any exceptions to an unqualified audit opinion, of any employee allegations of such failures or of any issues raised by any administrative or regulatory authority of the QI.[10]

In addition, based on the principles articulated in Treasury Announcement 2008-98,[11] it can be expected that these regulations may add additional audit procedures for testing QI accounts to ascertain whether the U.S. person has direct or indirect authority over such account through the use of among other strategies, creation of a foreign nominee or shell company. An additional procedure may likely be added to the regulations to address and obtain an assessment by the independent auditor relating to the IRS evaluation of the risk of a material failure or lack of internal controls for a QI.

These regulations will likely require a QI external auditor to associate with a reputable U.S. auditor (who may have to be pre-approved by Treasury) and who would review the application of the U.S. tax rules as part of the engagement and presumably be made jointly and severally liable for the QI opinion under the engagement letter and would require this auditor to report to the IRS any evidence of failures under the QI or fraudulent or illegal activity.

Lastly, these regulations may seek to impose penalties on QIs that impede U.S. tax enforcement or fail to disclose accounts held directly or indirectly by U.S. customers by terminating their QI status. It is also possible that Treasury may seek to amend Section 311 of the USA Patriot Act[12] to preclude such QIs from doing any business with U.S. financial institutions.

Eliminate Loopholes That Allow Qualifying Institutions to Still Serve As Conduits for Evasion

Under present law, financial institutions can qualify as QIs even if they are affiliated with non-QIs. As a result, it is possible for a financial institution and its officers to assist in tax evasion by acting as conduit in a non-QI and can still enjoy the benefits of being a QI—QIs are not currently required to report the foreign income of their U.S. customers, so U.S. customers may commit tax evasion by hiding behind their foreign entities to evade U.S. taxes through QIs.

Both the Treasury Proposal and the Green Book would authorize regulations requiring that a financial institution may be a QI only if all "commonly controlled" financial institutions are also QIs. Thus, these firms could not benefit from siphoning business from their legitimate QI operations to non-QI affiliates or fund businesses, and would be denied status as a QI.

It is possible the Treasury may decide to use a broad-based securities law definition of "common control" in which beneficial ownership may found either directly or indirectly through an equity, profits interest or compensation arrangement, and may include a direct and indirect interest in a variety of funds and other investment vehicles sponsored by financial institutions. Presumably, the regulations may require these non-QIs to register also with the IRS and the Treasury; have reporting procedures similar to the tougher QI rules outlined above; as well as subject them to the new proposed withholding taxes for FDAP income and the remittance of gross proceeds from the sale of stock and securities.

It can be expected that these rules would not only apply to financial institutions but also to a broad range of firms including banks, insurance companies, hedge funds, venture capital, private equity, real estate, financial service businesses and their intermediaries.

Impose Significant Tax Withholding on Transactions Involving Nonqualified Intermediaries or Foreign Legal Entities ("Non-QIs")

Current Law

In general, U.S. source income FDAP, such as dividends paid on U.S. stock that is made to foreign persons, is subject to a U.S. withholding tax at a rate of 30 percent, unless the withholding agent can establish that the beneficial owner is eligible for an exemption or a reduced rate of withholding under an income tax treaty.[13] The withholding agent is any person (U.S. or foreign) who has control, receipt, custody, disposal or payment of income that is subject to U.S. withholding.[14] Thus, a person who has custody or control over such income is potentially a withholding agent and has joint and several liability for the tax to be withheld to enable the Treasury to enforce the taxation of such payments.

Treasury Proposal

It has been estimated by the GAO that QIs handle only a relatively small percentage of U.S. source income flowing through foreign intermediaries and much of this income is also subject to reduced withholding under the tax treaties.[15] However, the GAO remains concerned that significant amounts of income may have flowed to undisclosed recipients and undisclosed jurisdictions and why the rate of withholding taxes has been at rates significantly below 30 percent. Because beneficial ownership and residence typically is the basis for reduced withholding tax rates, these rates according to the GAO suggest some amount of noncompliance by both foreign investors as well as U.S. investors.[16]

In a strongly worded statement, the Treasury Proposal indicated that Administration will now assume non-QIs are facilitating tax evasion and will require these firms to prove they and their account-holders are not avoiding U.S. tax on such income. More specifically, the Treasury has expressed concern that foreign investors are not eligible for a reduced or nil withholding rate and are evading U.S. withholding tax. The Treasury Proposal would require U.S. financial institutions to withhold 20 to 30 percent of U.S. payments to individuals who use non-QIs and to require investors to identify themselves and demonstrate they are obeying the law by requesting a refund from the IRS.

Green Book Proposals

The Green Book breaks the proposed withholding rules for non-QIs into two categories and then provides more meat to the bones for these proposals. Both categories would permit the Treasury to draft regulations that would exempt from withholding payments collected by non-QIs for foreign government, central bank, foreign pension fund, foreign insurance company payees and other similar investors and for

jurisdictions where Treasury concludes there is a low risk of tax evasion (*e.g.*, for payments to non-QIs located in jurisdictions in which the United States has a tax information agreement). The proposal without any additional guidance stated "the rules would be designed so as not to disrupt ordinary and customary market transactions." Given the tone of the Treasury Proposal, the exemption for ordinary market activity may be indeed drafted narrowly.

Imposes Withholding on Payments of FDAP Income Made Through Non-QIs

Under the Green Book, a withholding agent making a payment of FDAP income to a non-QI would be required to treat the payment as if made to an unknown foreign person and withhold at the rate of 30 percent on such payments unless the non-QI provides documentation of the beneficial owners. The Treasury would permit foreign persons that have been over withheld to apply for a refund which presumably would require the issuance of a TIN as part of the filing—something many foreign investors would be loathe to provide to the Treasury and the IRS.

Imposes Withholding on Gross Proceeds Paid Through Non-QIs

Under current law, U.S. financial institutions that remit the proceeds from the sale or exchange of stock or securities through a non-QI must generally back up withholding at the rate of 28 percent, unless the U.S. financial institution has received documentation to treat the payment as made to a foreign investor.[17] The Treasury was concerned that some U.S. persons are trying to avoid U.S. tax by fraudulently self-certifying that they are foreign persons. Under the Green Book proposal, a withholding agent would be required to withhold 20 percent of the gross proceeds from the sale of any security of a type that would have been reported to a U.S. nonexempt payee, if it was paid by the withholding agent to a non-QI that was located in a jurisdiction in which the United States does not have a comprehensive tax treaty that includes satisfactory exchange of information provisions.

Non-QIs would be eligible to file a claim for refund on behalf of their direct account holders for any tax year in which they identified all of their direct account holders who are U.S. persons and reported all reportable payments received on behalf of such holders, and, like its companion proposal, would permit foreign persons subject to over withholding themselves to file a claim for refund provided the non-QI has not already made such a claim.

U.S. Withholding Tax Imposed on for Foreign Source and U.S. Source FDAP Income and Gross Proceeds on the Sale of Securities Paid Through Non-QIs

The Green Book would now impose U.S. withholding tax at the rate of 30 percent on all FDAP income that is either U.S. source or foreign source and impose a 20-percent withholding tax rate on the gross proceeds on the sale or exchange of stock or securities made by the U.S. paying agent whether or not it is U.S. source or foreign source, notwithstanding the above assumptions—the believe being that there is more U.S. tax evasion through non-QIs then has been previously been identified.

These withholding obligations would typically be imposed on a U.S. financial institution or clearinghouse on payments made to the non-QI. Presumably, this withholding tax is in lieu of, and not in addition to, the U.S. withholding tax imposed on payments of U.S. source FDAP income to foreign persons, however, neither the Green Book nor the Treasury Proposal are clear on this point.

By using "gross proceeds" from the sale or exchange of stock or securities made through a non-QI in the withholding formula, this proposal causes both U.S. and foreign investors to suffer a U.S. withholding tax of 20 percent off the top and acts as club to coerce investments to be made only through QIs. This results in a dramatically different cost to foreign investors then withholding tax only imposed only on U.S. source dividends paid by U.S. corporations which historically have returned investors three to four percent annually and which have been taxed at 30 percent (or more typically, 15 percent under a tax treaty with the United States).[18]

It is likely that this proposal will put a cold chill on investments made by foreign investors who in the past invested through a non-QI, and who in turn were paid through a U.S. financial institution or clearinghouse broker. While foreign investors may have been willing to take a haircut for U.S. withholding taxes on their U.S. source dividends for their U.S. stock investments made under such a structure, they will very likely not be willing to

invest through non-QIs or U.S. financial institutions that make payments to them through non-QIs since there will now be a large withholding tax imposed on the gross proceeds from sale or exchange of their securities, albeit which may be refundable after they both identify themselves and provide sufficient proof to the IRS that all U.S. taxes have been paid.

Additionally, U.S. financial institutions, clearinghouse brokers and other U.S. intermediary payors will refuse to underwrite the potential tax exposure by failing to withhold in cases where there is any doubt as to the status of a foreign institution as a QI or whether the foreign institution is satisfying the Treasury's rules for information reporting and withholding. This is especially the case when coupled with the conduit rules, which would prohibit a QI from having any non-QI affiliates or feeder entities that are under their "common control."

Although not explicitly stated, it can be expected that the new withholding tax regime for non-QIs would be also required for the non-QIs of banks, insurance companies, hedge funds, mutual funds, venture capital and private equity, real estate and other financial service businesses and their investment advisors and other financial intermediaries who are not qualified intermediaries who have signed an agreement with the government to share information about their U.S. customers with the IRS.

Additional Reporting and Disclosure of Foreign Financial Accounts and Foreign Business Entities by Financial Institutions and U.S. Persons

If the Green Book proposals are enacted into law, U.S. persons and financial institutions will also face enhanced information reporting requirements for transactions that transfer money or assets to or from foreign financial accounts on behalf of U.S. individuals or establish a foreign business entity.

Impose Reporting on U.S. Persons of Transfers of Money or Property to or from Foreign Financial Accounts

Under existing law, U.S. persons must disclose whether they had an interest in or signature or other authority over financial accounts in a foreign country if the aggregate value of these accounts exceeds $10,000.[19] The Administration is concerned that this disclosure does not adequately reduce U.S. tax evasion and that U.S. citizens and residents are using these accounts to evade tax. The Green Book would require that a U.S. individual report on his or her tax return any transfer of money or property to or from a 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 interest. The proposal would exempt from reporting both transfers to, or receipts from accounts held by U.S. persons at QIs and also has a *de minimis* exception that would eliminate such reporting if the cumulative amount of such receipts which would otherwise be reportable is less then $10,000 for the tax year.

Presumably, the exemption for the accounts held by U.S. persons at QIs are exempted because the QIs themselves would have the obligation to report transfers to or receipts from foreign financial accounts or the creation of a foreign legal entity and identify the beneficial owners of such entity.

The Treasury would have regulatory authority to issue rules to address abuse of these reporting exceptions and also provide additional exceptions to the reporting requirements, such as an exception for "arms-length payments in the ordinary course of business for services or tangible property." Significantly, failure to report a covered transfer would result in the imposition of a penalty equal to the lesser of $10,000 per reportable transfer or 10 percent of the cumulative amount or value of the unreported covered transfers.

Require Disclosure of FBAR Accounts to Be Filed with Tax Return

In a companion proposal, the Green Book extends the reporting of what had been required on individual taxpayer's returns. Under current law, individual taxpayers must check a box to indicate whether they had an interest in or signature or other authority over a financial account in a foreign country during the year[20] and have a separate FBAR disclosure requirement if these accounts in the aggregate exceeded $10,000 during the year (*e.g.*,

the FBAR requires disclosure regarding the foreign account, including the account number, financial institution, maximum value during the year, and is not required to be filed with Treasury (and not the IRS) by June 30 of the year following the close of the calendar year to which it relates).[21]

Under this proposal, individual taxpayers who are required to file an FBAR will now have to provide more information about the foreign account on their income tax returns in addition to the regularly required FBAR filings. In a separate schedule which would become part of the income tax return the taxpayer would provide the account number, financial institution and maximum value during the year and would be required to be prepared when the income tax return is due, even if the FBAR would be filed on a later date.

Interestingly, the proposal indicates that the tax return disclosure does not replace or mitigate the individual's obligation to separately report an FBAR with the Treasury under the Bank Secrecy laws.[22] The penalties imposed under the Bank Secrecy laws will continue to apply for failure to file an FBAR even though the individual may have separate penalties under the tax law and other consequences under the Internal Revenue Code, including extension of the statute of limitations if he or she fails to provide this information on his or her tax return (presumably for failure to file a complete and correct income tax return).[23]

Impose Reporting on QI and U.S. Financial Intermediaries (FIs) for the Creation or Transfer of Assets to or from Foreign Financial Accounts

The Green Book points out that the Administration was concerned U.S. persons are failing to comply with the requirement to report certain foreign financial accounts, so that in addition to the two direct reporting proposals outlined above, they have proposed that QIs and FIs that transfer or receive money or property of more then $10,000 to a foreign bank, brokerage or other financial account on behalf a U.S. person or significantly on behalf of any entity in which a U.S. person owns actually or constructively[24] more than 50 percent ownership interest would be required to file an information return reporting such transfer or receipts. Similarly, any QI or FI that opens a foreign bank, brokerage or financial account on behalf of a U.S. person or on behalf of any entity of which a U.S. person owns actually or constructively more than 50-percent ownership interest would be required to file an information return with the IRS regarding such account.

This proposal exempts from the reporting requirement foreign financial accounts opened and transferred to or from, or on behalf of publicly traded companies and their subsidiaries (but does not explicitly exempt reporting for funds and other investment vehicles sponsored by such companies (*e.g.,* public-private investment funds or PPIFs)) and also grants the Treasury regulatory authority to provide certain exemptions for accounts opened or transfers made to or received by QIs or FIs on behalf of a U.S. persons (or on behalf of any entity of which U.S. persons own actually or constructively more than 50 percent of the ownership interest).

Impose Reporting Regarding the Establishment of Offshore Entities

While current law imposes a reporting requirement on U.S. persons with respect to certain foreign business they control,[25] it does not generally require third-party information reporting in connection with the acquisition or formation of a foreign business entity on behalf of a U.S. individual.

The Green Book would require any U.S. person or any QI that forms or acquires a foreign entity on behalf of a U.S. individual (or on behalf of any entity which the individual owns, actually or constructively more than a 50-percent ownership interest) to file an information return with the IRS. The Treasury would receive regulatory authority to determine the information to be reported and the exceptions to such reporting. The Treasury also would be granted regulatory authority to require withholding agents to collect additional information to determine whether a U.S. person is the beneficial owner of a foreign entity and specifically report if a U.S. person is a beneficial owner.

Impose Negative Presumptions for U.S. Persons or Non-QIs for Failure to File an FBAR

Current FBAR/Bank Secrecy Law

Under current law, a U.S. person must file an FBAR if he or she has a financial interest in a foreign

financial account or signature or other authority over such account if the aggregate value exceeds $10,000 at any time during the preceding year.[26]

If the U.S. person fails to disclose a foreign financial account on a timely filed FBAR, he or she may be liable for a civil penalty up to $10,000 absent a willful violation, and the penalty may be abated if reasonable cause and the balance in the account were properly reported to the Treasury.[27] For willful violations, the law imposes a maximum penalty of the greater of $100,000 or 50 percent of the balance in the account at the time of the violation and criminal penalties includes a maximum fine of $250,000 and a maximum term of five years imprisonment or both.[28] Additionally, higher penalties can apply if the U.S. person violates any other U.S. laws or if the violation was part of a pattern of illegal activity involving more than $100,000 in a 12-month period.[29]

Under the Treasury proposal, similar to Senator Carl Levin's earlier proposed legislation,[30] a rebuttable presumption would be created that a U.S. citizen who has a foreign bank account, brokerage or other financial account at a non-QI contains enough funds to require an FBAR to be filed and that any failure to file an FBAR is willful if an account at a non-QI has a balance of greater than $200,000 at any point during the calendar year.

The Green Book has broken the Treasury proposal into two separate rebuttable presumptions, one for foreign financial accounts held directly by U.S. persons and one for accounts held through non-QIs. The purpose for these presumptions would be to "encourage voluntary disclosure of account information and assist the IRS in its enforcement efforts with respect to undisclosed foreign financial accounts."

Rebuttable Presumption for Foreign Financial Accounts Owned or Controlled by U.S. Persons

For U.S. citizens or residents of the United States or persons in or doing business in the United States, the Green Book creates a rebuttable presumption, if such person has any foreign bank, brokerage or other financial account or signature or other authority over such account, that the account contains enough funds to require an FBAR to be filed. An exception would apply for such accounts held through a QI and the Treasury would be granted regulatory authority to provide additional exemptions. It should be noted that this presumption will apply only to civil administrative or judicial proceedings but not in criminal proceedings.

Rebuttable Presumption for Foreign Financial Accounts Held Through Non-QIs

Since foreign intermediaries are not QIs and generally do not perform U.S. information reporting with respect to U.S. account holders of foreign financial accounts, the IRS has been hampered in its ability to discover unreported accounts owned or controlled by U.S. persons and to enforce compliance. A rebuttable presumption with respect to non-QIs will assist in Treasury enforcement effort over such accounts.

Under the Green Book, a rebuttable presumption will exist that failure to file an FBAR with respect to any foreign financial account held with a nonqualified intermediary will be treated as "willful" if the account has a balance of more than $200,000 at any point during the year.

The proposal would exempt an officer or employee of a corporation who has signature or other authority over the account from the presumption provided such officer or employee has "no more than a *de minimis* financial interest in that corporation. If regulations are drafted by the Treasury to explain this exemption (and possibly other exemptions), it is hopeful that the "*de minimis* financial interest" will be defined to give such corporations and their U.S. officers and employees bright line rules to assess their risk of joint and several penalties for failure to file FBARs, which may now be heightened significantly under the "willful" category of noncompliance.

It can also be expected under the proposal that both the Treasury and the IRS will now be reviewing the substance of the information obtained from FBAR and income tax return disclosure statements to reconcile on a taxpayer-by-taxpayer basis if both the FBAR and tax return compliance obligations have been met.

For QIs responsible for FBAR information reporting, it is reasonable to expect that a senior officer in the QI will now have to certify (and be held accountable) he or she has identified all of its U.S. account holders and has reported all reportable payments for the U.S. account holders and presumably the sources of those funds (whether or not

the income is from U.S. or foreign sources) in the accounts are properly known and reported to the Treasury and the IRS.

Because of the negative rebuttable presumption for foreign financial accounts held through non-QIs, it is also reasonable to assume that as a matter of corporate governance the Board of Directors of a non-QI will want a senior officer to certify that he or she has met the non-QIs FBAR information reporting obligations.

Impose Negative Presumption Regarding U.S. Withholding Tax on FDAP Payments to Certain Foreign Entities

In a companion provision to the Green Book's proposal to require withholding tax to be imposed on payments of FDAP income made through a non-QI as if made to an unknown foreign person, the Treasury would now also impose a rebuttable presumption that a withholding agent will be required to withhold at the rate of 30 percent on payments of FDAP income made to a foreign entity, unless such foreign entity provides documentation of the entity's beneficial owners.

Exemption from Presumption to Withhold on Payments of FDAP

Payments to publicly traded companies and their subsidiaries, foreign governments and pension funds would be excluded from this requirement and the Treasury would be authorized to grant additional exemptions for payments to entities engaged in the active conduct of a trade or business in their country of residence, charities, widely held investment vehicles and entities that enter into an agreement with the IRS to collect documentation of all owners and report all U.S. nonexempt owners to the IRS and a catch-all, for any other payment that the Treasury concludes presents a low risk of tax evasion.

It can be expected that until guidance is issued by the Treasury, this provision leaves many unanswered questions as to the intended scope of the new rebuttable presumption enforcement tool and whether it applies broadly or narrowly to banks, insurance companies, hedge funds, mutual funds, venture capital and private equity, real estate and other financial services businesses and their financial intermediaries.

Extend Statute of Limitations for Certain Reportable Cross-Border Transactions and Foreign Entities to Six Years After Filing FBAR Information and Returns

The Administration was concerned that the current statute of limitations did not always allow sufficient time for the IRS to determine a taxpayer's tax liability if the taxpayer did not properly satisfy its record maintenance obligations. Under current law, certain foreign-owned corporations must file information returns containing information with respect to related-party transactions and also maintain records to determine the correct treatment of such transactions under Code Sec. 6038A.[31]

In general, current law provides for a three-year statute of limitations for the IRS to assess tax, interest and penalties from the date the return is filed. If the IRS does not make this assessment within this time period, it is generally precluded from assessing additional liabilities afterwards.[32] Under current law, the IRS is permitted to extend the statute of limitations an additional three years if the taxpayer did not furnish certain information returns with respect to certain foreign transfers, contributions or distributions of property to a foreign corporation in certain liquidations and reorganizations or to a foreign partnership, foreign entities and foreign-owned entities including certain foreign corporations, foreign partnerships and foreign trusts.[33] Thus, failure to file the required information returns triggers the extended six-year statute of limitations.

The Green Book would extend the statute of limitations to six years after the taxpayer furnishes the information required to be reported to the IRS as now broadened to include the proposed tax return disclosure of FBAR information, the information returns proposed for U.S. individuals with respect to certain transfers of money or assets to or from certain foreign financial accounts and the returns required for qualified electing funds (those foreign corporations who have 75 percent or more of their gross income as passive income or where the average percentage of assets producing such passive income is at least 50 percent) whose shareholders have elected to pay tax currently on such income and file returns under the passive foreign investment company rules.[34] In addition, the six-year statute of limitations would also now

apply to the taxpayer reporting requirements under Code Sec. 6038A and now be made applicable to the entire tax return, with appropriate regulatory exceptions to be provided by the Treasury.

Impose 40-Percent Accuracy-Related Penalties on Understatements of Income Tax Involving Undisclosed Foreign Accounts

The Administration believes that U.S. persons will be deterred from using foreign accounts to evade tax if it increases the penalties on understatements from transactions that involve using undisclosed foreign accounts. The Green Book would double the existing 20-percent accuracy-related penalty[35] to 40 percent when a transaction arises from a transaction involving a foreign account where the taxpayer failed to disclose properly the FBAR related information on separate schedules as part of their tax returns. The 40-percent penalty would be imposed (as under current law) on (i) a substantial understatement of income tax, (ii) an understatement resulting from negligence or disregard of rules or regulations, and (iii) an understatement related to a reportable transaction.[36] As is generally the case in a reportable transaction understatement,[37] the reasonable cause exception would no longer apply.

Presumably, this increased 40-percent penalty would also be imposed on such understatements for a transaction involving a foreign account where the taxpayer fails to file the information reporting that is imposed on certain U.S. owners who invest in entities that are treated under U.S. tax law as controlled foreign corporations, foreign partnerships, personal foreign investment companies, foreign limited liability companies or foreign trusts.[38]

Improve the Foreign Trust Reporting Penalty

Historically, the IRS has had difficulty assessing a penalty for the continued failure to file a timely return or where an incomplete or incorrect return was filed for certain foreign trusts because the 35-percent penalty was based upon the calculation of the "gross reportable amount," which was defined as the gross value of property involved in a reportable transaction such as a gratuitous transfer to the trust, the gross value of the trust's assets at the close of the year that is treated as owned by a U.S. person, or the gross amount.[39] In the past, if the IRS couldn't ascertain the gross reportable amount, it may not have been able to assess the penalties, including a $10,000 penalty for each 30-day period the taxpayer fails to comply (after a failure that extends for more than 90 days). The total penalty could not exceed the gross reportable amount.

The Green Book would now impose the penalty on the greater of $10,000 or 35 percent of the gross reportable amount (if this amount is known) and the additional $10,000 per month penalty for continued failure to file would remain unchanged. Even if the gross reportable amount is unknown, the IRS would be able to impose a $10,000 penalty for each failure to report timely or correctly as required and may impose the $10,000 monthly penalty for failure to continue to comply.

If the taxpayer subsequently provides the IRS with enough information to determine the gross reportable income, the total penalties would continue be capped at that amount and any excess penalty would be refunded. The proposal would be effective for information returns required to be filed after December 31 of the year of enactment.

Money Laundering, Non–Income Tax Issues and State and Local Follow-on Impact

Although not specifically mentioned in the proposals, it can be expected that the Treasury, FinCEN, the IRS and the Department of Justice may now take a harder look to ascertain if non-QIs are facilitating money laundering schemes, as well as tax evasion relating to not only income taxes but also possible social security taxes which these firms and their investors' portfolio companies may not have paid.

Piggyback Efforts by State and Local Taxing Authorities

In addition, it can be expected that many states will enact piggyback legislation to either follow these proposals or elect to have their own international tax enforcement provisions for persons over which they have nexus. Since many states are running at deficits, it can also be expected that relatively few states will opt out of the provisions that they can enforce against their residents and nonresidents.

Coercion to Use QIs and Establishment of Robust Information Reporting and AML Processes

The practical effect of these tough new enforcement rules will likely be to coerce by means of a broad-based withholding tax on payments of FDAP income and on proceeds from the sale or exchange of stock or securities made through non-QIs, negative presumptions and increased penalties financial institutions including banks, insurance companies, hedge funds, venture capital, private equity, real estate and other financial service businesses to enter into qualified intermediary agreements with the IRS and to develop and implement robust AML and tax reporting systems to ensure these firms "know their customers" and to ensure that the U.S. tax is paid on such income to avoid liability as the withholding agent.

It is reasonable to assume that few firms will want to impose the above-described withholding taxes on payments that are funneled through U.S. financial institutions to individuals who use non-QIs and have to face the evidentiary presumptions relating to FBAR information reporting when a foreign financial account is held by U.S. individuals or their beneficially owned foreign entity.

Sharing of FBAR Information by International and State and Local Law Enforcement and Banking and Securities Regulators

It can be expected that information about U.S. customers' foreign accounts, which formerly had been retained by financial institutions, will likely be audited by both the IRS as well as by the banking regulators and the information obtained from the FBAR filings will be shared by both the financial and nonfinancial regulators on a federal, international and a state and local level for a variety of purposes (*e.g.*, criminal prosecutions, mail fraud, tax evasion, *etc.*).

Grant of Enforcement Tools to Prosecute International Tax Evasion

The Treasury Proposal states that the IRS will be provided with funds to support the hiring of nearly 800 new employees devoted specifically to international enforcement to enable it to crack down on offshore fraud, including through transfer pricing and financial products and transactions such as purported securities loans.

Increased Likelihood of Prosecution

While there may be an interim period to establish a more robust regulatory and tax reporting systems, it can be expected noncompliance may be treated as "willful," and substantial civil and criminal penalties against responsible officers and directors may be sought. Possible defenses based on segregation of functions, lack of knowledge, good faith and the like will not likely dissuade the IRS or the U.S. Department of Justice from vigorously pursuing aiding and abetting tax evasion and money laundering cases in appropriate cases.

Prosecution is especially likely if it can be shown either through direct or indirect evidence (*e.g.*, e-mail traffic) or other corroborative evidence that there has been a plan or scheme to evade or avoid U.S. tax. For example, if a foreign shell company is set up which is beneficially owned by U.S. individuals with no real business purpose and no substance in the tax haven, it is likely that the government may attack the structure as abusive or as a scheme to evade tax or launder money. If the U.S. Department of Justice or the IRS learns of an attempt to conceal documents and other evidence of the real purpose for the structure or can prove that there has been a pattern of activity to fraudulently support the taxpayer's position the case is ripe for prosecution. One can anticipate that law firm favorable "should" opinions and other memoranda of support related to international structures in tax havens for U.S. persons will likely not provide an insurance policy that such structures will not be questioned by the government.

It can also be reasonably be expected based on the Treasury, the IRS and the U.S. Department of Justice successes in the tax shelter area that these governmental agencies will now focus their resources and energies on getting successful civil and criminal convictions in the international enforcement arena to act as a deterrent mechanism to ensure that a new broader base of reporting is implemented by using QIs to develop robust money laundering and tax reporting regimes and to prevent what these agencies and what many others believe is white collar crime and not business as usual on Wall Street.

ENDNOTES

[1] Code Sec. 1441 and Reg. §1.1441-1(b).

[2] Code Secs. 3406, 6041–6049 and the Treasury Regulations thereunder. Unless otherwise indicated, all Cod Sec. references are to the Internal Revenue Code of 1986, ("the Code"), as amended, or the Treasury Regulations thereunder. U.S. persons may be subject in certain cases to a backup withholding tax with respect to payments of investment income and serves to support the regular information and reporting and tax return requirements for U.S. persons and does not apply where the U.S. payee provides a Form W-9 to the payor or where the U.S. payee is an exempt recipient such as a corporation, tax-exempt organization or governmental entity.

[3] Reg. §1.1441-1(e)(5). At the time the QI program was adopted, the IRS explained its scope and purpose in Announcement 2000-48, 2000-1 CB 1243.

[4] *Id.*

[5] Under Reg. §1.1441-1(e)(5)(ii), a QI includes a foreign branch or office of a U.S. financial institution or U.S. clearing organization or any other person acceptable to the IRS.

[6] Rev. Proc, 2000-12, 2000-1 CB 387, supplemented by Announcement 2000-50, 2000-1 CB 998, and modified by Rev. Proc. 2003-64, 2003-2 CB 306, and Rev. Proc. 2005-77, 2005-2 CB 1176.

[7] *See* Rev. Proc. 2002-55, IRB 2002-35, 435. T.D. 8881 (May 16, 2000).

[8] *See* Written Testimony of Douglas H. Shulman, Commissioner, Internal Revenue Service Hearing on Tax Haven Banks and U.S. Tax Compliance Before the Permanent Subcommittee on Investigations, S. Committee on Homeland Security and Governmental Affairs, 110th Congress, July 17, 2008.

[9] Code Sec. 6049.

[10] Joint Committee on Taxation, *Tax Compliance and Enforcement Issues with Respect To Offshore Accounts and Entities* (JCX-23-09), Mar. 30, 2009, at 36–37.

[11] Announcement 2008-98, IRB 2008-44, 1087.

[12] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (P.L. 107-56) ("USA Patriot Act").

[13] Reg. §1.1441-1(b).

[14] Reg. §1.1441-7(a)(I).

[15] Government Accountability Office, Testimony of Michael Brostek Before the Committee on Finance, U.S. Senate: Tax Compliance: Offshore Financial Activity Creates Enforcement Issues for IRS, GAO-99-478T (Mar. 17, 2009), at 10.

[16] Government Accountability Office, Report to the Committee on Finance, U.S. Senate, *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; Joint Committee on Taxation, *Tax Compliance and Enforcement Issues with Respect To Offshore Accounts and Entities* (JCX-23-09) Mar. 30, 2009.

[17] *See* Code Sec. 3406 and Code Secs. 6041–6049, *supra* at note 2, for a general explanation of the backup withholding rules applicable to U.S. investors.

[18] Stephen E Shay, J. Clifton Fleming & Robert J. Peroni, *The David R. Tillinghast Lecture "What's Source Got to Do With It?" Source Rules and U.S. International Taxation*, 56 TAX L. REV. 125–27.

[19] 31 CFR 103.24 and Instructions to the Report of Foreign Bank and Financial Accounts TD F 90-22.1 (otherwise referred to as "FBAR").

[20] As part of the FBAR reporting requirement, U.S. persons filing a Form 1040 are questioned on their Form 1040, Schedule B, Part III whether the individual has an interest in a financial account in a foreign country by checking "Yes" or "No" in the appropriate box. If the taxpayer checks "Yes," he or she is directed to the FBAR to report a financial interest in a foreign bank or brokerage account.

[21] Instructions to FBAR.

[22] 12 USC 1829b, 12 USC 1951–1959, and 31 USC 5311–5330.

[23] 31 USC 5321(a)(5)(B)(i); 31 USC 5322(a); 31 USC 5322(b).

[24] It is unclear from the proposals what the definition of "constructive ownership" will be for purposes of this test. Presumably, the Treasury will use an expansive definition and may choose follow to definitions under Code Secs. 318 or 267 or choose a securities law definition under common control principles.

[25] *See* Code Sec. 6038, Information reporting with respect to certain foreign corporations, Code Sec. 6038A, Information with respect to certain foreign-owned corporations, Code Sec. 6046, Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock, Code Sec. 6046A, Returns as to interests in foreign partnerships and Code Sec. 6048, Information with respect to certain foreign trusts.

[26] *See supra* note 19.

[27] 31 USC 5321(a)(5)(B)(i).

[28] 31 USC5321(a)(5)(C)(i); 31 USC 5322(a).

[29] 31 USC 5322(b).

[30] *See Stop Tax Haven Abuse Act*, S. 506, 111th Cong. (2009).

[31] Code Sec. 6038A.

[32] Code Sec. 6501.

[33] Code Sec. 6501(c)(8) permits the IRS to extend the statute of limitations period an additional three years until after the required report is filed, if the taxpayer failed to information report certain transfers to foreign entities. Included in this extension of the statute of limitations is information reporting under Code Sec. 6038, Information reporting with respect to certain foreign corporations, Code Sec. 6038A, Information with respect to certain foreign-owned corporations, Code Sec. 6038B, Notice of certain transfers to foreign persons, Code Sec. 6046, Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock, Code Sec. 6046A, Returns as to interests in foreign partnerships and Code Sec. 6048, Information with respect to certain foreign trusts, in addition to several additional exceptions which are proposed in the Green Book which are discussed in the article.

[34] Code Sec. 1295(b).

[35] Code Sec. 6662.

[36] Code Secs. 6662 and 6662A.

[37] Code Sec. 6664(d).

[38] *See* Code Sec. 6038, Information reporting with respect to certain foreign corporations, Code Sec. 6038A, Information with respect to certain foreign-owned corporations, Code Sec. 6038B, Notice of certain transfers to foreign persons, Code Sec. 6046, Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock, Code Sec. 6046A, Returns as to interests in foreign partnerships and Code Sec. 6048, Information with respect to certain foreign trusts.

[39] Code Sec. 6677.

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