

FOREIGN ACCOUNT TAX COMPLIANCE ACT: A STEP IN THE WRONG DIRECTION

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"The power of taxing people and their property is essential to the very existence of government." - James Madison¹

I. INTRODUCTION

Taxes have become the lifeblood of modern society and epitomize the power of the collective over the desires of the individual. When a group of people comes together and joins a society, it surrenders some individual rights and desires for the greater good. For the desires of the collective to be effectuated, there needs to be a physical representation of that collective will. As the physical manifestation of the collective will comes together it requires a collection from the individuals to effectuate the needs of the many, and this is the basis of taxation. However, because the physical manifestation of the collective will requires an individual to sacrifice the fruits of her labor, there is an inherent conflict between the individual and society as a whole.² This conflict between the individual and society boils down to basic human nature³ and is at the root of any discussion regarding tax avoidance.

Tax collection by the government and tax avoidance by citizens are manifestations of the desires of the individual conflicting with the needs of the collective. In the United States, tax avoidance is a zero-sum game⁴ between the taxpayer and the United States with the deck stacked heavily in favor of the government.⁵ An apt metaphor for the interactions between the

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1. *Selected Tax Quotes*, INTERNAL REVENUE SERV., <http://www.irs.gov/uac/Tax-Quotes> (last updated Mar. 27, 2013, archived at <http://perma.cc/J4CY-X9XC>).

2. See MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1965) (Individuals are rational wealth maximizers, and resist being placed into the will of a group unless there is an external force compelling them.).

3. See *id.* (stating that individuals seek out the best result for themselves, and do not concern themselves with a group unless compelled).

4. A "zero-sum game" is a game in which the cumulative winnings equal the cumulative losses. See MERRIAM WEBSTER'S COLLEGIATE DICTIONARY 1376 (10th ed. 1994).

5. The principal tool used by the government is the withholding system in which an employer or other income source withholds a portion of income to be paid to the IRS on the individual's behalf. *Tax Withholding*, INTERNAL REVENUE SERV., <http://www.irs.gov/individuals/employees/tax-withholding> (last updated Dec. 2, 2013, archived at <http://perma.cc/84A4-KYF3>); see also I.R.S. Pub. 505 (2012).

government and taxpayers is a game of poker. In this game, the United States is the “house” or the player with large resources who uses its large resources to cripple the opposing players. The taxpayers’ approach to this game will vary based on their individual risk tolerance levels. The less risky players will devise capitulating strategies designed to control their losses, recognizing that the odds are too great for them to attempt anything else. The risk-takers however, will employ elaborate bluff strategies designed to minimize the amount of tax they must pay.

In order to play poker effectively, you are trained to play your opponent, not your cards.⁶ And for the past several decades, individuals with the right mix of resources and risk tolerance have recognized a way to beat the house: offshore accounts.⁷ Offshore bank accounts designed to conceal assets from the Internal Revenue Service (IRS) have been a thorn in the side of the US tax system for quite some time.⁸ To continue the poker metaphor, by “stashing” some money off of the playing table, individuals are able to safeguard their assets by keeping them out of the game altogether. By keeping this money off the table, the taxpayers are bluffing the government, tricking it into believing that the taxpayers are capitulating and merely trying to limit their losses. Individuals have used this method of bluffing effectively, with some estimates claiming between \$40 and \$70 billion of tax revenue are lost each year.⁹

The US Government has been unable to go after these evaders primarily because of the incompatibility of the domestic taxation system to the international realm.¹⁰ The domestic taxation system, or the game upon the poker table, works because it compels a majority of employers to enter into tax withholding and reporting requirements which force all the chips on the table.¹¹ In the international realm, withholding systems do not have the same effect,¹² and thus the risk assessment for those with international accounts has not been strong enough to compel compliance.

Over the past several years, the US Government has taken action to close this loophole¹³ and force the risk-taking taxpayers to bring all their

6. *See generally* DAVID SKLANSKY, *THE THEORY OF POKER* (1987).

7. *Abusive Tax Schemes*, CARL LEVIN – UNITED STATES SENATOR FOR MICHIGAN, <http://www.levin.senate.gov/issues/abusive-tax-schemes> (last visited Feb. 20, 2014, *archived at* <http://perma.cc/P6TR-EY9S>).

8. *Offshore Tax Evasion, Stashing Cash Overseas: Hearing Before the Subcomm. on Finance*, 110th Cong. 3-4 (2007) (statement of Sen. Chuck Grassley).

9. Mike Godfrey, *Senate ‘Offshore’ Hearing Called ‘One-Sided,’* TAX-NEWS (Aug. 3, 2006), http://www.tax-news.com/archive/story/Senate_Offshore_Hearing_Called_OneSided_xxxx24430.html, *archived at* <http://perma.cc/DGM7-GEJJ>.

10. *See infra* Section II (discussing the development of international tax law).

11. *See Tax Withholding, supra* note 5.

12. *See infra* Part IV.

13. 26 U.S.C. §§ 1471-1474 (2010).

assets to the table. A major part of this push to action has been due to the increasing public awareness of the severity of the tax avoidance problem from several high profile events such as the prosecution against the Swiss bank UBS.¹⁴ With \$104 million rewarded to whistleblower Bradley Birkenfeld,¹⁵ increased media attention on offshore tax evasion led to a heightened public awareness of its severity.¹⁶ Even the 2012 presidential election was not immune to discussions of offshore tax avoidance, as Mitt Romney was questioned repeatedly about his bank accounts in foreign countries.¹⁷

Coupled with the increase in media interest, the economic climate has made the idea of closing the loophole political gold. In the middle part of the last decade, Senator Levin and the Committee on Homeland Security and Governmental Affairs have held several hearings regarding tax havens¹⁸ and brought light to the severity of the problem. The often-quoted statistic from these hearings was that the United States loses \$100 billion in tax revenue each year.¹⁹ With the federal debt standing more than \$17 trillion as

14. See generally Press Release, US Dep't of Justice Office of Public Affairs, UBS Enters into Deferred Prosecution Agreement (Feb. 18, 2009, archived at <http://perma.cc/WW24-66YN>); James B. Stewart, *For UBS, a Record of Averting Prosecution*, N.Y. TIMES (July 20, 2012), <http://www.nytimes.com/2012/07/21/business/ubss-track-record-of-averting-prosecution-common-sense.html>, archived at <http://perma.cc/8C8E-QPC4>; David Voreacos, *Offshore Tax Scorecard: UBS, Credit Suisse, HSBC, Julius Baer*, BLOOMBERG BUSINESSWEEK (Oct. 12, 2011), <http://www.businessweek.com/news/2011-10-12/offshore-tax-scorecard-ubs-credit-suisse-hsbc-julius-baer.html>.

15. David Kocieniewski, *Whistle-Blower Awarded \$104 Million by I.R.S.*, N.Y. TIMES (Sept. 11, 2012), <http://www.nytimes.com/2012/09/12/business/whistle-blower-awarded-104-million-by-irs.html>, archived at <http://perma.cc/M79V-3XHD>.

16. See Gretchen Morgenson, *Death of a Loophole, and Swiss Banks Will Mourn*, N.Y. TIMES (Mar. 27, 2010), <http://www.nytimes.com/2010/03/28/business/28gret.html>, archived at <http://perma.cc/AW8C-5KGQ>. The Birkenfeld case against UBS, when coupled with the Senate Subcommittee hearings conducted by Senator Levin over the past decade, has led to an increase in concern amongst the American public regarding offshore tax evasion, especially after the 2008 financial crisis. *Id.*

17. Joseph Tanfani, *Romney, Obama Trade Jabs over Outsourcing and Offshore Investments*, L.A. TIMES (Oct. 17, 2012), <http://articles.latimes.com/2012/oct/17/news/la-pn-presidential-debate-outsourcing-20121017>, archived at <http://perma.cc/NXC6-4S2W>; Rachel Weiner, *What Mitt Romney Got from Offshore Investments*, WASHINGTON POST (Oct. 2, 2012), <http://www.washingtonpost.com/blogs/post-politics/wp/2012/10/02/what-romney-got-from-offshore-investments/>, archived at <http://perma.cc/HBR4-4EU9>; Michael Luo & Mike McIntire, *Offshore Tactics Helped Increase Romneys' Wealth*, N.Y. TIMES (Oct. 1, 2012), <http://www.nytimes.com/2012/10/02/us/politics/bains-offshore-strategies-grew-romneys-wealth.html>, <http://perma.cc/E5QP-6YDC>.

18. *Permanent Subcommittee on Investigations*, CARL LEVIN – UNITED STATES SENATOR FOR MICHIGAN, <http://www.levin.senate.gov/senate/committees/investigations/> (last visited Feb. 20, 2014, archived at <http://perma.cc/E8RB-F5Q9>).

19. *Id.*; Press Release, Office of Senator Carl Levin, Levin Unveils Stop Tax Haven Abuse Act (July 12, 2011, archived at <http://perma.cc/5E4-8H3T>).

of the publication of this Note,²⁰ an additional \$100 billion in annual revenue is an appealing avenue for politicians to pursue.²¹ In addition, many Americans have become increasingly upset with the perceived leniency towards wealthy individuals by the federal government.²² Between the growing public awareness, difficult economic climate, and the stigma of the “one percent,” the political climate was ripe for a change in how the government deals with offshore tax shelters.

The Foreign Account Tax Compliance Act (FATCA) was passed as part of the 2010 Hiring Incentives to Restore Employment Act (HIRE), and added four new sections to Chapter 4 of the Internal Revenue Code.²³ The basic idea of FATCA is to create an information disclosure system for foreign banks to disclose the account information of US clients.²⁴ To compel banks to enter into this system, FATCA threatens mandatory 30 percent withholding on certain “withholdable payments” made to, or in some circumstances by, financial institutions.²⁵ These “withholdable payments” include all interest, dividends, and gross proceeds from US sources,²⁶ so even foreign individuals will be affected, for “as soon as you invest in the US, you are in [the regulation’s] scope.”²⁷

While the decision to implement such a draconian structure is understandable given the background within which FATCA was created,²⁸ the system itself has some questionable implications. There are potential negative impacts upon the US capital markets and international relations which could have a severe detrimental effect upon the country.

20. *The Debt to the Penny and Who Holds It*, TREASURY DIRECT, <http://www.treasurydirect.gov/NP/BPDLogin?application=np> (last visited Feb. 20, 2014, archived at <http://perma.cc/RV7A-DRKH>) (amount as of Feb. 20, 2014).

21. See generally Chales Kadlec, *The Choice of 2012: Obama Austerity vs. Romney Growth*, FORBES (Oct. 8, 2012), <http://www.forbes.com/sites/charleskadlec/2012/10/08/the-choice-of-2012-obama-austerity-vs-romney-growth/>, archived at <http://perma.cc/8KG-QC2F>; ROBERT CARROLL & GERALD PRANTE, LONG-RUN MACROECONOMIC IMPACT OF INCREASING TAX RATES ON HIGH-INCOME TAXPAYERS IN 2013 (2012), archived at <http://perma.cc/3SFM-DC55>.

22. See Damla Ergun, *Among Cliff-Avoidance Options, Most Favor Targeting the Wealthy*, ABC NEWS (Nov. 28, 2012, 7:00 AM), <http://abcnews.go.com/blogs/politics/2012/11/among-cliff-avoidance-options-most-favor-targeting-the-wealthy/>, archived at <http://perma.cc/VJ3X-7QLR>.

23. Jennifer Wheeler, *FATCA and Funds - Where Are We Now?*, 14 BUS. L. INT'L 143, 143 (2012); I.R.S. Notice 2011-53, I.R.B. 2011-32.

24. 26 U.S.C. § 1471 (2010).

25. Wheeler, *supra* note 23, at 145.

26. Luisa Porritt, *European Investors Deterred from US Investments by FATCA*, INV. EUR. (June 7, 2011), <http://www.investmenteurope.net/investment-europe/news/2076630/european-investors-deterred-investments-fatca>, archived at <http://perma.cc/74J4-DUYS>.

27. *Id.* (quoting Georges Bock, head of tax and banking at KPMG Luxembourg).

28. See *infra* Part III (illuminating combination of financial problems).

Furthermore, when the system is examined in conjunction with the individuals it seeks to capture, there arise several concerns as to its potential effectiveness.²⁹ With the fervor surrounding the role of the upper classes in the 2008 financial crisis, it is important that this system be thoroughly examined and analyzed with a detachment from its political undertones. By taking the system for what it is and working it through to its logical conclusion, we will be able to determine whether its benefits outweigh its costs.

II. ISSUES

1. This Note begins by illustrating the progression of the international tax collection efforts. The first type of effort examined is the use of bilateral tax treaties, which have been the primary means of reigning in offshore tax evasion since World War II. Regarding the second type of effort, the Note examines the recent developments of Organization for Economic Cooperation and Development (OECD) “blacklisting” and multinational pronouncements.

2. Next, the Note examines the development of FATCA, how it works, and what effects should be anticipated.

3. This Note then discusses the domestic voluntary tax compliance system employed by the United States and how FATCA is attempting to replicate such a system for the very different international realm.

4. The Note then turns to the potential negative effects of FATCA on international relations and the US capital and investment markets.

5. Finally the Note argues that due to the overwhelming negative effects of FATCA, and the type of person who still holds offshore accounts, the US Government should instead attempt a more enticing approach to regain some of the lost tax revenue. By using the “carrot” instead of the “stick,” the United States will have greater success in gaining back tax revenue lost in overseas accounts.

III. HISTORY/DEVELOPMENT

A. Development of International Tax Collection Efforts Prior to FATCA

FATCA developed as a result of a growing public awareness of the failures of prior international tax collection efforts³⁰ and a social climate of

29. See *infra* Part V.

30. See generally Niels Jense, Note, *How to Kill the Scapegoat: Addressing Offshore Tax Evasion with a Special View to Switzerland*, 63 VAND. L. REV. 1823 (2010); Beckett G. Cantley, *The UBS Case: The U.S. Attack on Swiss Banking Sovereignty*, 7 B.Y.U. INT'L L. & MGMT. REV. 1, 2 (2011); Godfrey, *supra* note 9.

powerful resentment towards wealthy individuals.³¹ In order to understand why FATCA developed into such a strenuous regulatory regime,³² we must begin by examining the previous inadequate attempts to regulate offshore accounts. The foundations of international tax regulation began with bilateral treaties.

1. Bilateral Treaties

US laws on offshore accounts have been around since the post-World War II era³³ but did not focus on tax evasion until much later.³⁴ Similar to the development of international law in general, the regulation of offshore accounts began with the promulgation of bilateral treaties.³⁵ By their very nature, bilateral treaties are as effective as the two countries want them to be.³⁶ The often voluntary nature of bilateral treaty negotiations can lead to a severe limitation in the scope of the treaty's application.

One of the historic problems with the implementation of an international legal structure is the conflict with domestic sovereignty.³⁷ As separate sovereign entities, when countries negotiate with each other they are often reluctant to surrender any of that sovereignty,³⁸ even if it effectuates a mutually beneficial outcome.³⁹ In the realm of international tax avoidance, the element of sovereignty that has caused the greatest problem in effectuating binding obligations is banking privacy law.⁴⁰ Banking

31. Ergun, *supra* note 22; *see generally* Press Release, Office of Senator Carl Levin, *supra* note 19.

32. *See infra* Part III.

33. *See* 1951 Income Tax Convention, U.S.-Switz., Sept. 27, 1951, 127 U.N.T.S. 227 [hereinafter 1951 Convention].

34. *See* 1996 Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, U.S.-Switz., May 29, 1997, S. Treaty Doc. No. 105-8 [hereinafter 1996 Convention].

35. *See* 1951 Convention, *supra* note 33.

36. Bilateral treaties are treaties between two countries that are negotiated similar to a contract setting in which the terms will be as strict or lenient as the parties agree to. *See Bilateral Treaty Law and Legal Definition*, USLEGAL, <http://definitions.uslegal.com/b/bilateral-treaty/> (last visited Feb. 26, 2014, *archived at* <http://perma.cc/58J3-CABG>).

37. *See generally* Cantley, *supra* note 30; Laura Szarmach, *Piercing the Veil of Bank Secrecy? Assessing the United States' Settlement in the UBS Case*, 43 CORNELL INT'L L.J. 409 (2010); Richard A. Martin, *Problems in International Law Enforcement*, 14 FORD. INT'L L.J. 3 (1990).

38. *See* 1951 Convention, *supra* note 33, art. XVI (information disclosure limited to "information available under the respective taxation laws of the contracting States"); 1996 Convention, *supra* note 34, protocol par. 8, art. 26 (article 26 sets forth the information exchange based on "tax fraud" which is defined in paragraph 8 of the protocol to rely on Swiss laws); *see also* Cantley, *supra* note 30, at 14.

39. *See infra* Part IV (discussing prisoner's dilemma situation).

40. Brief of UBS AG in Opposition to the Petition to Enforce the John Doe Summons at

privacy laws vary from country to country, but in general they prevent banks from disclosing information about their customers in all but very limited circumstances.⁴¹ As the basic goal of US tax regulators is to gain information about accounts held by citizens in a foreign country,⁴² it is understandable how strong banking privacy laws can severely hinder those attempts. Perhaps the most significant bearings on successful treaties are whether or not the other country is also concerned about offshore tax evasion,⁴³ and if it is vulnerable to US influence.

Some countries, like the United Kingdom, are so similar to the United States that their domestic interests in preventing tax avoidance are often aligned, yielding an effective treaty.⁴⁴ Often containing well-developed economies, these countries utilize similar taxation philosophy,⁴⁵ and are also concerned with taxpayers' attempts to avoid taxation.⁴⁶ Because these countries are similar to the United States in terms of taxation methods,⁴⁷ it follows that they are concerned with tax avoidance themselves, and thus are amenable to entering into more strenuous and effective bilateral treaties.⁴⁸ As a result of the similarities between these countries and the United States,⁴⁹ their treaties often reflect a shared desire to curb tax avoidance, resulting in effective agreements.⁵⁰

Conversely, there are countries whose domestic interests are often in direct opposition to those of the United States. Some of these countries have found that banking privacy laws⁵¹ benefit their economy.⁵² Countries such

1-4, *United States v. UBS AG*, 2009 U.S. Dist. LEXIS 66739 (S.D. Fla. Apr. 30, 2009) (No. 09-20423); Amicus Brief of Government of Switzerland at 11, *United States v. UBS AG*, 2009 U.S. Dist. LEXIS 66739 (S.D. Fla. Apr. 30, 2009) (No. 09-20423); *see also* Cantley, *supra* note 30.

41. Jense, *supra* note 30, at 1827.

42. Treas. Reg. § 9022-01 (2012).

43. If a country is concerned about offshore tax evasion by its own citizens, it follows that the country will be more likely to be willing to aid another country to rein in tax avoiders.

44. The U.K. income tax rates are quite similar to what we have in the United States and thus have not attracted those trying to evade paying higher taxes. *Income Tax Rates and Allowances*, HM REVENUE & CUSTOMS, <http://www.hmrc.gov.uk/rates/it.htm#2> (last visited Feb. 20, 2014, archived at <http://perma.cc/HT2R-RXFW>).

45. *Id.*

46. *See* Agreement Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland to Improve International Tax Compliance and to Implement FATCA, U.S.-U.K., Sept. 12, 2012, archived at <http://perma.cc/S8CF-WALA> [hereinafter U.K. FATCA Agreement].

47. *Income Tax Rates and Allowances*, *supra* note 44.

48. U.K. FATCA Agreement, *supra* note 46.

49. *Income Tax Rates and Allowances*, *supra* note 44.

50. U.K. FATCA Agreement, *supra* note 46.

51. Laws such as Switzerland's make it a criminal offense to reveal a client's identity. *Swiss Banking Secrecy: Don't Ask, Won't Tell*, *ECONOMIST* (Feb. 11, 2012), <http://www.economist.com/node/21547229>, archived at <http://perma.cc/CW27-GH78>.

52. The Islands, an island country that is only 102 square miles, is the fifth largest

as the Cayman Islands, Isle of Mann, Sri-Lanka, and others have found that by increasing banking secrecy laws and keeping taxes low they are able to attract a great deal of foreign capital.⁵³ This influx of foreign capital creates a powerful industry that carries significant weight in policy decisions due to the significant impact of the industry upon the country's economy. This gives the politicians of the country little incentive to align their interests with the United States, which would require them to go against their domestic interests.⁵⁴ These countries are so reliant upon these capital markets that it is likely that no amount of regulation short of a world-wide multinational taxation system will compel their compliance.⁵⁵

Similar to the countries described in the preceding paragraph, Switzerland also has domestic interests that have historically clashed with the interests of the United States and have led to several inadequate treaties.⁵⁶ Because Switzerland is a more significant player on the international stage and has a more storied banking history, it has developed over the years as one of the preeminent offshore tax havens.⁵⁷ Because of this, Switzerland is the perfect example to evaluate the development of bilateral treaties between the United States and a country with a strong interest in banking privacy laws.

Swiss banking privacy laws developed in response to the threat of Nazi Germany executing German citizens who did not disclose assets held outside of Germany.⁵⁸ The Swiss passed legislation establishing specific duties for bankers and criminalized the disclosure of information in order to protect the national sovereignty of the Swiss economy as well as the assets of bank customers.⁵⁹ These strong laws and the country's historical economic stability⁶⁰ helped Switzerland become a premier banking center, which to this day remains an important part of its economy.⁶¹

banking center in the world. *Places in the Sun*, ECONOMIST (Feb. 22, 2007), <http://www.economist.com/node/8695139>, archived at <http://perma.cc/6ACF-R2DJ>.

53. Taking the Cayman Islands as an example: they are the domicile for an estimated 35 percent of the world's hedge funds, the top foreign jurisdiction for US-held asset-backed securities, and they have the highest level of US banking liabilities and second highest level of US banking claims of any foreign jurisdiction as of mid-2007. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-778, CAYMAN ISLANDS BUSINESS AND TAX ADVANTAGES ATTRACT U.S. PERSONS AND ENFORCEMENT CHALLENGES EXIST 7 (2008); see also *Places in the Sun*, *supra* note 52.

54. *Places in the Sun*, *supra* note 52.

55. Through a worldwide taxation reporting system, the assumption is that the international pressure would be overwhelming.

56. Swiss treaties have been rewritten several times to attempt to close the loopholes. Jense, *supra* note 30, at 1851.

57. Jense, *supra* note 30, at 1825.

58. Greg Brabec, *The Fight For Transparency: International Pressure to Make Swiss Banking Procedures Less Restrictive*, 21 TEMP. INT'L & COMP. L.J. 231, 233 (2007).

59. *Id.* at 234.

60. *Id.* at 238.

61. SWISS BANKING, THE ECONOMIC SIGNIFICANCE OF THE SWISS FINANCIAL CENTRE 3

The post-World War II world marked a turning point in international affairs. After the wars, the development of multinational organizations and technology connected the world more than ever before. In the realm of taxation, the post-war period also made it easier for individuals to hide money in different countries.⁶² The recognition of this problem led to the development of the first bilateral tax treaties between the United States and other countries.⁶³ The 1951 convention between the United States and Switzerland focused mainly on setting up a system that prevented double taxation.⁶⁴ While the system set up the exchange of information, it was only for information “as is necessary for carrying out the provisions of the present Convention or for the prevention of fraud or the like in relation to the taxes which are subject of the present Convention.”⁶⁵ Without defining “fraud or the like”⁶⁶ and by leaving the specifics of information exchange up in the air,⁶⁷ the convention was not constructed to deal with tax evasion as much as it set up a framework for dealing with double taxation.⁶⁸

With the changing tax laws⁶⁹ and growing public awareness⁷⁰ towards the end of the last century, the treaties began to change.⁷¹ In the case of the treaty between Switzerland and the United States, the treaty has been amended three times since the mid-1990s.⁷² The first change resulted in a whole new convention in 1996,⁷³ followed by 2003 and 2009 agreements, all focusing on remedying the inadequacies of Swiss reporting of accounts held by US citizens.⁷⁴

(2012), archived at <http://perma.cc/8Z89-B2Q5>.

62. See generally 1951 Convention, *supra* note 33.

63. 1951 Convention, *supra* note 33.

64. 1951 Convention, *supra* note 33.

65. 1951 Convention, *supra* note 33, art. XVI.

66. 1951 Convention, *supra* note 33, art. XVI.

67. 1951 Convention, *supra* note 33, art. XVI.

68. 1951 Convention, *supra* note 33, art. XVI.

69. The 1986 Amendment of the US Tax Code took away a lot of domestic tax shelter loopholes that were being used by the wealthy to avoid taxes. Calvin Johnson, *What's A Tax Shelter*, 68 TAX NOTES 879, 879 (1995), archived at <http://perma.cc/AC7Y-J58P> (“[T]he Tax Reform Act of 1986 intended to get rid of tax shelters . . .”) (alterations added).

70. The idea of foreign tax shelters was becoming more mainstream, appearing in books and movies. See, e.g., JOHN GRISHAM, *THE FIRM* (1991) (The Book and subsequent movie focused on a tax attorney who utilized the benefits of the Cayman Islands.).

71. See e.g., 1996 Convention, *supra* note 34.

72. See 1996 Convention, *supra* note 34; Mutual Agreement of January 23, 2003, Regarding the Administration of Article 26 of the Swiss-U.S. Income Tax Convention of October 2, 1996, U.S.-Switz., Jan. 23, 2003, archived at <http://perma.cc/3KFG-W49D> [hereinafter 2003 Agreement]; Agreement Between the U.S.A. and Swiss Confederation on the Request for Information from the Internal Revenue Service of the United States of America regarding UBS AG, a corporation established under the laws of the Swiss Confederation, U.S.-Switz., June 18, 2009, archived at <http://perma.cc/54SA-VH9V> [hereinafter 2009 Amendment].

73. 1996 Convention, *supra* note 34.

74. Jense, *supra* note 30, at 1826.

By its terms, the 1996 Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation [1996 Convention] appeared to be a major step forward,⁷⁵ but in practice the treaty's inadequacies became clear.⁷⁶ The provisions relating to the exchange of information were praised as expanding the scope of information exchanged by allowing US authorities to access bank information in cases of tax fraud.⁷⁷ The protocol of the Convention defines "tax fraud" as "fraudulent conduct that causes or is intended to cause an illegal and substantial reduction in the amount of the tax paid to a Contracting State"⁷⁸ as well as acts that "constitute fraudulent conduct under . . . [the] laws or practices" of a contracting state.⁷⁹ This dual approach⁸⁰ to classifying and reigning in tax evasion may appear effective, but the stringent domestic laws and interpretations of Switzerland⁸¹ led to an inability to effectively reign in US account holders,⁸² and prompted the need for future amendments to the treaty.⁸³

The 2003 Agreement was put forth to expand upon the exchange of information section of the 1996 Convention and was "intended to facilitate more effective information exchange between the two countries."⁸⁴ The 2003 Agreement focused primarily upon fleshing out an effective definition of "tax fraud or the like,"⁸⁵ even publishing a set of fourteen "illustrative"

75. Jense, *supra* note 30, at 1826.

76. Jense, *supra* note 30, at 1826.

77. Letter of Transmittal from William J. Clinton, Pres. of the United States, to the Senate of the United States (June 25, 1997), *archived at* <http://perma.cc/6UEL-4RS9>.

78. 1996 Convention, *supra* note 34, protocol, par. 10.

79. 1996 Convention, *supra* note 34, protocol, par. 10 (alteration added).

80. Beckett G. Cantley, *The New Tax Information Exchange Agreement: A Potent Weapon Against U.S. Tax Fraud?*, 4 HOUS. BUS. & TAX L.J. 231, 237 (2004) (citing W. Warren Crowds, *U.S. Switzerland Sign Income Tax Treaty*, 13 Tax Notes Int'l 1983, 1991-92 (1996)).

81. In Switzerland, tax fraud is defined very narrowly and can be achieved one of two ways: either by using falsified documents (other than the tax return) to deceive, or without those documents, by willfully deceiving to evade taxes. Jense, *supra* note 30, at 1833. Without meeting either of these standards, the conduct will fall short of "tax fraud" under Swiss domestic law, and thus forecloses one of the two-pronged approaches. Jense, *supra* note 30, at 1833. Furthermore, the 1996 Convention provides that no "trade, business, industrial or professional secret" may be disclosed, and because in Switzerland banking privacy is considered a professional secret it does not fall under the second provision either. Jense, *supra* note 30, at 1833. So while the two-pronged approach towards reigning in "tax fraud" appears beneficial, a deeper look shows the problems with the system. Jense, *supra* note 30, at 1833.

82. Jense, *supra* note 30, at 1833.

83. 2003 Agreement, *supra* note 72; 2009 Amendment, *supra* note 72.

84. Press Release, US Dep't of the Treasury, Treasury Announces Mutual Agreement with Switzerland Regarding Tax Information Exchange (Jan. 24, 2003), *archived at* <http://perma.cc/8PF3-AMKF>.

85. 2003 Agreement, *supra* note 72, par. 4.

hypotheticals.⁸⁶ Commentators were optimistic that this agreement would result in a change,⁸⁷ heralding the Agreement as “an easing of Swiss banking secrecy laws with respect to fraud committed by US persons.”⁸⁸

The optimism regarding the 2003 Agreement’s effectiveness did not survive long. In 2008, Bradley Birkenfeld, an American citizen and a director of the United Bank of Switzerland (UBS), pleaded guilty to aiding in the evasion of taxes.⁸⁹ At the time, it was estimated that US clients held about \$18 to \$20 billion in assets at UBS,⁹⁰ which is one of the largest financial institutions in the world.⁹¹ Mr. Birkenfeld’s startling testimony elaborated the extent to which UBS aided US citizens in evading taxes, such as smuggling diamonds into the United States in a tube of toothpaste.⁹² In addition to being subject to the terms of the 2003 Agreement, UBS had also taken the additional step of entering into a Qualified Intermediary (QI) Agreement⁹³ with the IRS, which required it to identify and document any customers who held US investments or received US source income in their accounts.⁹⁴ So when Mr. Birkenfeld testified against UBS, the inability of both the government-mandated requirements from the 2003 Agreement and the further requirements of the voluntary QI Agreements exposed the considerable flaws in the US efforts to reign in offshore accounts in Switzerland.⁹⁵ Coinciding with the “great recession,” the news of the number of wealthy Americans evading taxes struck a chord with the American public and produced a great deal of animosity.⁹⁶

The UBS debacle revealed that the promising language in the 2003 Agreement still suffered from the debilitating effects of Switzerland’s strong banking privacy laws. The main failing elements of the 2003

86. 2003 Agreement, *supra* note 72, par. 4.

87. Jense, *supra* note 30, at 1832.

88. Cantley, *supra* note 80, at 253.

89. Lynnley Browning, *Ex-UBS Banker Pleads Guilty in Tax Evasion*, N.Y. TIMES (June 20, 2008), <http://www.nytimes.com/2008/06/20/business/20tax.html>, archived at <http://perma.cc/B74E-PX5G>.

90. Kocieniewski, *supra* note 15.

91. US SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, TAX HAVEN BANKS AND U.S. TAX COMPLIANCE 2 (2008).

92. Kocieniewski, *supra* note 15.

93. Agreements are entered into with the IRS to “simplify withholding and reporting obligations for payments of income made to an account holder through one or more foreign intermediaries.” I.R.S. Rev. Proc. 2000-12 s. 1(01), archived at <http://perma.cc/6BKH-7TST>.

94. STAFF OF THE JOINT COMM. ON TAXATION, TAX COMPLIANCE AND ENFORCEMENT ISSUES WITH RESPECT TO OFFSHORE ACCOUNTS AND ENTITIES 31-33 (2009); *Tax Compliance: Offshore Financial Activity Creates Enforcement Issues for IRS: Testimony Before the Subcomm. on Fin.*, 111th Cong. 1 (2009) (statement of Michael Brostek, Dir. Strategic Issues Team).

95. Jense, *supra* note 30, at 1833.

96. Press Release, Office of Senator Carl Levin, *supra* note 19.

Agreement are that it still excludes tax evasion short of “tax fraud”⁹⁷ and requires US officials to find the tax evader and obtain enough evidence to support a “reasonable suspicion” of tax fraud.⁹⁸ These inadequacies can be attributed to Switzerland’s domestic interest in maintaining its strong banking privacy laws.⁹⁹

In order to address the inadequacies of the 2003 Agreement exposed by the UBS debacle, the United States and Switzerland negotiated a 2009 amendment.¹⁰⁰ This treaty has not been ratified by the US,¹⁰¹ presumably because the United States has recognized the flaws in using bilateral treaties to rein in tax evasion. The bilateral treaty efforts by the United States in attempting to rein in offshore tax evasion have not been effective when it faces opposition from strong domestic laws such as Switzerland’s.¹⁰² These treaties have illustrated the need for compulsory reporting requirements on foreign banks in order to effectively curb tax evasion.¹⁰³ Unfortunately for the United States, the framework of international law does not lend itself to compulsory requirements on sovereign nations unless those nations voluntarily comply.¹⁰⁴ Because it will be nearly impossible for all countries to voluntarily comply with the disclosure requirements of the United States,¹⁰⁵ treaties are an inadequate mechanism for dealing with offshore tax evasion.

2. “Blacklisting”

With growing discontent over the ineffectiveness of bilateral treaties

97. Jense, *supra* note 30, at 1836-37:

Even under the 2003 Agreement, tax fraud still excludes simple tax evasion. Without more, tax evasion does not amount to the kind of conduct that may trigger information exchange obligations. A U.S. taxpayer who underreports his income and hides his undeclared funds in a Swiss bank account does not have to fear disclosure to U.S. authorities. He will not come within the ambit of the 2003 Agreement until he fabricates documents, fails to maintain legally required records, hides behind a scheme of sham corporations, or fails to file a tax return altogether.

Jense, *supra* note 30, at 1836-37.

98. Jense, *supra* note 30, at 1837.

99. Jense, *supra* note 30, at 1837.

100. 2009 Amendment, *supra* note 72.

101. Jason Connery et al., *Current Status of U.S. Tax Treaties and International Tax Agreements*, 42 TAX MGMT. INT’L JOURNAL 106, 4 (2013), archived at <http://perma.cc/M6FT-T6UJ>.

102. See generally *United States v. UBS AG*, No. 09-20423, 2009 U.S. Dist. LEXIS 66739 (S.D. Fla. July 7, 2009) (the existence of this case shows the inability of the 2003 Agreement to break through the strong Swiss privacy laws).

103. Jense, *supra* note 30, at 1840.

104. See generally Martin, *supra* note 37.

105. See *supra* Part I.A.1.

to address offshore tax evasion,¹⁰⁶ countries such as the United States began to seek out different solutions.¹⁰⁷ One strategy was to use international organizations and multinational political pressure to condemn tax haven countries via “blacklisting.”¹⁰⁸ In 2000, the Organization for Economic Cooperation and Development released a list of countries considered to be “uncooperative tax havens.”¹⁰⁹ This list contained a total of thirty-eight countries, which included: the Cayman Islands, the Bahamas, Bermuda, Malta, the Isle of Man, and Panama.¹¹⁰ This “blacklist” was a publicly disseminated list¹¹¹ intended to deter investment in those locations,¹¹² and use international pressure to compel change.¹¹³ Inclusion on the list did prompt action amongst the blacklisted countries, as thirty-one of the thirty-eight countries were removed by 2002, and by 2009 all of the thirty-eight countries were removed from the list.¹¹⁴

While the international pressure did instigate a desire to get off the “blacklist”¹¹⁵ the steps required for de-listing left much to be desired. In order for a country to get off the “blacklist” they were required to “make formal commitments to implement all the OECD’s standards of transparency and exchange of information.”¹¹⁶ Using the Cayman Islands as an example, in order to comply with the “formal commitment” requirement, it sent the OECD a letter pledging to refrain from:

- (1) introducing any new regime that would constitute a harmful tax practice under the OECD;
- (2) for any existing regime related to financial and other services that currently does not constitute a harmful tax practice under the OECD Report, modifying the regime in such a way that, after modifications, it would constitute a harmful tax practice under the OECD Report; and
- (3) strengthening or

106. One example is the UBS debacle, evidencing the loopholes in the US-Swiss tax treaties, discussed *infra* Part II.A.

107. Press Release, Office of Senator Carl Levin, *supra* note 19; *see generally* U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 53.

108. *Jurisdictions Committed to Improving Transparency and Establishing Effective Exchange of Information in Tax Matters*, ORG. FOR ECON. COOPERATION AND DEV., <http://www.oecd.org/countries/virginislandsuk/jurisdictionscommittedtoimprovingtransparencyandestablishingeffectiveexchangeofinformationintaxmatters.htm> (last visited Feb. 21, 2014, <http://perma.cc/T5G-239X>).

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

113. These jurisdictions all have low tax rates and strong banking security laws, which make them appealing tax havens. *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

extending the scope of any existing measure that currently constitutes a harmful tax practice under the OECD Report.¹¹⁷

These “commitments,” even upon first glance, are no more than empty promises. What the Cayman Islands “promises” to do is to not increase its tax avoidance structure.¹¹⁸ It is not promising to get rid of “harmful tax practices” or commit to reforming them, but just to stop their development or progression. Many of these countries, including the Cayman Islands, already have a developed system of “harmful tax practices”¹¹⁹ which garnered them a spot on the list in the first place. So by telling these countries just not to go any further, it has almost no practical effect because they are already in a position where they have the practices in place and will gain little from expanding them. Without requiring any change in the currently existing “harmful tax practices,” the OECD appears to be doing nothing more than officially listing common knowledge.

Towards the end of the prior decade, it became clear¹²⁰ that the use of bilateral treaties and “blacklisting” was ineffective in regulating offshore tax evasion, and a new solution was needed.¹²¹ After years of negotiations¹²² Congress decided upon a solution in 2010.¹²³ Instead of using bilateral and multinational treaties, the traditional tools of international law, Congress took a bold step in a new direction, promulgating a unilateral imposition of domestic law on foreign banks and companies.¹²⁴

IV. FOREIGN ACCOUNT TAX COMPLIANCE ACT

The Foreign Account Tax Compliance Act (FATCA) was part of the

117. Commitment Letter from PJ Smith, Governor, Cayman Islands, to Donald Johnston, OECD Sec’y General (May 18, 2000), *archived at* <http://perma.cc/BP7B-6EHA>.

118. *Id.*

119. An example of harmful tax practices includes the banking secrecy laws which put them on the OECD list in the first place.

120. With the limited practical effect of “blacklisting” as evidenced above, and the failures of the bilateral treaty system exposed by the UBS case, the state of tax-haven regulation was not effective. *See generally* Press Release, Office of Senator Carl Levin, *supra* note 19.

121. Press Release, Office of Senator Carl Levin, *supra* note 19.

122. US SENATE SUBCOMM. ON INVESTIGATIONS, COMM. ON HOMELAND SEC. AND GOV’T AFF., TAX HAVEN ABUSES: THE ENABLERS, THE TOOLS AND SECRECY 3 (2006) *archived at* <http://perma.cc/N2T6-JBA9>; Press Release, Office of Senator Carl Levin, *supra* note 19; Stop Tax Haven Abuse Act, H.R. 2669, 112th Cong. (2011); Stop Tax Haven Abuse Act, S. 1346, 112th Cong. (2011).

123. Hiring Incentives to Restore Employment Act (HIRE), Pub. L. No. 111-147, 124 Stat. 71 (2010), *archived at* <http://perma.cc/859B-YCGK>.

124. See explanation of FATCA provisions and how they are a unilateral imposition of domestic law into the international sphere in Part III, *infra*.

2010 Hiring Incentives to Restore Employment Act (HIRE)¹²⁵ and the solution proposed by Congress¹²⁶ and the Obama administration¹²⁷ to combat the problem of offshore tax evasion.¹²⁸ FATCA adds sections 1471 through 1475 to the Internal Revenue Code,¹²⁹ and has led to the promulgation of several Treasury Regulations designed to explain and help implement those provisions.¹³⁰ The goal of FATCA is to improve tax compliance involving foreign financial assets and offshore accounts to thereby increase tax revenue.¹³¹ FATCA achieves this goal by forcing¹³² three categories of foreign businesses¹³³ to enter into disclosure agreements with the IRS:¹³⁴ “foreign financial institutions,”¹³⁵ foreign companies with a “substantial US owner,”¹³⁶ and “passthru” companies.¹³⁷ These businesses are forced into disclosure agreements by an ultimatum: comply with the onerous¹³⁸ and expensive regulations¹³⁹ or have 30 percent of their US source income withheld.¹⁴⁰ The thought process is that by threatening foreign institutions where US citizens conceal their money to comply with IRS information reporting requirements, they will create an international withholding system similar to the one currently being used for US domestic income.¹⁴¹

A. Definitions and Implementation of the Withholding Ultimatum to Compel Information Disclosure

1. Foreign Financial Institutions

The regulation of “foreign financial institutions” is of perhaps the

125. HIRE §§ 501-535.

126. *Id.*

127. *100 in 100: Accomplishment No. 6*, ORGANIZING FOR ACTION (July 17, 2012), <http://www.barackobama.com/nv/entry/nv-100-in-100-accomplishment-no-6-071712/>, archived at <http://perma.cc/HF36-58R5>.

128. *Id.*

129. I.R.S. Notice 2011-32 I.R.B. 124 (Aug. 8, 2011) (Chapter 4 Implementation Notice).

130. Treas. Reg. § 9022-01 (2012).

131. *Id.*

132. 26 U.S.C. § 1471(a) (2010).

133. 26 U.S.C. §§ 1471-1475.

134. 26 U.S.C. § 1471(b).

135. 26 U.S.C. § 1471(d).

136. 26 U.S.C. §§ 1471-1475.

137. 26 U.S.C. §§ 1471-1475.

138. *See infra* Part III.A.3.

139. An estimated \$30-40 per investor. Porritt, *supra* note 26.

140. 26 U.S.C. § 1471(a).

141. This idea will be fleshed out further in the following sections, but the domestic income tax system relies heavily upon the withholding of income by third parties, and the provisions of FATCA give the appearance of an international withholding system.

most important type of entity regulated by FATCA.¹⁴² These institutions are banks and other financial businesses which have presented the United States with the biggest tax avoidance problem.¹⁴³ Under section 1471(a), any “withholdable payment” to a “foreign financial institution” that does not meet the reporting requirements of subsection (b) will have 30 percent of the payment deducted by a “withholding agent.”¹⁴⁴ Thus, “foreign financial institutions” have a choice: face a 30 percent withholding tax on all “withholdable payments” or subject themselves to the reporting requirements of subsection (b).¹⁴⁵ As the withholding system provision demonstrates, the definitions for the operative FATCA terms are very important to the operation of the system,¹⁴⁶ and these definitions are broad so as to achieve the purpose of mandating a withholding regime.¹⁴⁷ To determine who falls under the withholding regulations of section 1471, there are three key terms which need to be defined: “foreign financial institution,” “withholdable payment,” and “withholding agent.”¹⁴⁸

The term “foreign financial institution” is the gatekeeper definition, signaling to which institutions the withholding ultimatum applies.¹⁴⁹ “Financial institution” is defined as any entity that “accepts deposits in the ordinary course of a banking or similar business,” or “as a substantial portion of its business, holds financial assets for the account of others,” or “is engaged primarily in the business of investing, reinvesting, or trading in securities, partnerships interests, commodities, or any interest in such securities, partnership interests, or commodities.”¹⁵⁰ Under section 1471(d)(4), the definition of “foreign financial institution” is further refined as “any financial institution which is a foreign entity.”¹⁵¹ Through these definitions, “foreign financial institutions” are broadly defined¹⁵² so as to include all foreign owned institutions that are involved in financial business.¹⁵³ This definition includes banks, investment firms, hedge funds, and even any entity which “hold[s] itself out as being engaged” primarily in

142. These institutions are the banks and financial centers where many Americans conceal their wealth overseas and are what FATCA was designed to regulate. Treas. Reg. § 9022-01.

143. *Id.*

144. 26 U.S.C. §§ 1471(a)-(b).

145. *Id.*

146. They are important in order to determine what entities fall under the scope of regulation. 26 U.S.C. § 1471(d).

147. See Dimitri Semenov et al., *FATCA Proposed Regulations*, 23 J. INT'L TAX'N 26, 27 (2012); Wheater, *supra* note 23, at 145.

148. 26 U.S.C. § 1471(d).

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

the business of investing¹⁵⁴ in order to encompass almost all institutions that could aid a US citizen to avoid income taxes under the breadth of FATCA.¹⁵⁵

The next step in the definitional framework is to find out what “withholdable payments” of the “foreign financial institutions” will be subject to the 30 percent withholding. Section 1473(1)(A) defines “withholdable payment” as

any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the United States . . . [and] any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States.¹⁵⁶

Again, this definition is broad so as to include almost any type of monetary transfer on which foreign financial institutions depend for their business.¹⁵⁷ These withholdable payments are so broad that some industry experts have advised that “as soon as you invest in the US, you are in [the regulation’s] scope.”¹⁵⁸

The final key definition in the withholding scheme is for “withholding agents.”¹⁵⁹ These agents are defined as “all persons, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of any withholdable payment.”¹⁶⁰ Designed to implement the withholding at an intermediary level before the funds exit the country,¹⁶¹ the duty will most likely fall to US financial industry counterparts who oversee the transactions that lead to the foreign institutions obtaining the source income. The wording of these “withholding agents” as “all persons” in “whatever capacity” follows along with the broad definitions located in the other sections, designed to encompass all those who will be able to

154. 26 U.S.C. § 1473; Regulations Relating to Information Reporting by Foreign Financial Institutions and Withholding on Certain Payments to Foreign Financial Institutions and Other Foreign Entities, 78 Fed. Reg. 5874 (Jan. 28, 2013); *see also* Semenov et al., *supra* note 147; Wheater, *supra* note 23, at 145.

155. 26 U.S.C. § 1473; 26 C.F.R. §1.1473-1; Semenov et al., *supra* note 147, at 27-28; Wheater, *supra* note 23, at 145.

156. 26 U.S.C. § 1473.

157. *Id.*; 26 C.F.R. §§1.1471-1.1474; Wheater, *supra* note 23, at 145.

158. Porritt, *supra* note 26.

159. 26 U.S.C. § 1473.

160. *Id.*

161. Treas. Reg. § 9022-01.

withhold a portion of the income.¹⁶² With these broad definitions, the drafters of FATCA succeeded in their purpose of creating a large enough net to compel the foreign institutions that aid US citizens in avoiding tax reporting to comply with the FATCA reporting requirements.¹⁶³

2. Beneficial Ownership of Foreign Companies

In addition to applying to “foreign financial institutions,” FATCA, through section 1472, extends its reach to foreign companies who have a US citizen as a “substantial” owner.¹⁶⁴ Borrowing the definitions contained in the other areas of FATCA, section 1472 applies to any “withholdable payment” made to a “non-financial foreign entity.”¹⁶⁵ “Non-financial foreign entity” is defined literally to mean a foreign entity that is not a financial institution.¹⁶⁶ Section 1472 also revolves around an ultimatum provision: subject to the reporting requirements or face a 30 percent withholding tax on all “withholdable payments.”¹⁶⁷

The term “substantial United States owner” is the key phrase when dealing with non-financial foreign entities, and is defined in section 1473(2).¹⁶⁸ Under section 1473(2), a “substantial United States owner” means with respect to any corporation, partnership, or trust, “any specified United States person which owns, directly or indirectly, more than 10 percent” of the stock in the corporation, or percent of the profit or capital interests in such partnership, or beneficial interests of such trust.¹⁶⁹ Furthermore, if the entity is a financial institution engaged primarily in the business of investing or trading in securities and the like, the 10 percent requirement is placed aside in favor of a 0 percent ownership requirement.¹⁷⁰

3. Information Disclosure Agreements

The alternative to the 30 percent withholding for “foreign financial institutions” under section 1471 and “non-financial foreign entities” under section 1472 is to enter into an Information Disclosure Agreement.¹⁷¹ Section 1471(b) sets out the web of onerous reporting requirements with

162. *Id.*

163. 26 U.S.C. § 1473; 78 Fed. Reg. 5874; Wheater, *supra* note 23, at 145; Porritt, *supra* note 26.

164. 26 U.S.C. § 1472.

165. *Id.*

166. *Id.*

167. *Id.*

168. 26 U.S.C. § 1473.

169. *Id.*

170. *Id.*

171. 26 U.S.C. §§ 1471-1472.

which a “foreign financial institution” must comply.¹⁷² In order to comply, a “foreign financial institution” must enter into an agreement with the IRS under which the institution agrees to:

Obtain such information regarding each holder of each account maintained by such institution as is necessary to determine which (if any) of such accounts are United States accounts, to comply with such verification and due diligence procedures as the Secretary may require with respect to the identification of United States accounts . . . [and] to comply with requests by the Secretary for additional information with respect to any United States account maintained by such institution.¹⁷³

“United States accounts,” which the reporting requirements seek to discover, are defined as “any financial account which is held by one or more specified United States persons or United States owned foreign entities.”¹⁷⁴

If an entity makes a reporting agreement with the IRS under subsection (b) as outlined above, it will be required to institute a system that will allow it to separate its clients based on US and non-US citizenship.¹⁷⁵ For all US accountholders, the financial institution will have to report the following information:

The name, address, and TIN [Taxpayer Identification Number] of each account holder which is a specified United States person and, in the case of any account holder which is a United States owned foreign entity, the name, address, and TIN of each substantial United States owner of such entity; the account number; the account balance or value; and except to the extent provided by the Secretary, the gross receipts and gross withdrawals or payments from the account.¹⁷⁶

To implement the type of recording required by the FATCA provisions, most financial institutions are projecting a large cost increase¹⁷⁷ which will most likely be passed on to their customers.¹⁷⁸

172. 26 U.S.C. § 1471.

173. 26 U.S.C. § 1471(b).

174. 26 U.S.C. § 1471(d).

175. 26 U.S.C. § 1471(c).

176. *Id.* (alteration added).

177. *Supra* note 139 and accompanying text.

178. *See supra* note 139 and accompanying text; David Jolly & Brian Knowlton, *Law to*

In addition to the costs of complying with the disclosure requirements, there is the potential for foreign entities to be subjected to potential lawsuits and fines.¹⁷⁹ One thing to keep in mind with these FATCA statutes is that they are US domestic laws which attempt to bind foreign entities who engage in business within the United States.¹⁸⁰ Because this applies to foreign entities, the drafters included section 1471(b)(1)(F) to provide that in regards to a financial institution:

[A]ny case in which any foreign law would . . . prevent the reporting of any information referred to in this subsection or subsection (c) with respect to any United States account maintained by such institution: to attempt to obtain a valid and effective waiver of such law from each holder of such account, and if a waiver . . . is not obtained from each such holder within a reasonable period of time, to close such account.¹⁸¹

Designed to tackle banking secrecy laws head-on,¹⁸² this provision allows entities that enter into disclosure agreements to circumvent their domestic laws.¹⁸³ While the United States may not favor the banking secrecy laws of foreign nations, they are still the laws of those foreign nations, and asking an entity to violate its domestic laws for the sake of an agreement with a foreign government is a highly questionable practice. For Swiss banks, violations of banking secrecy laws have led to bankers getting their licenses removed, fines, and even imprisonment.¹⁸⁴

With the potential for negative legal effects in their home countries,¹⁸⁵ and a large cost with complying, the disclosure agreements are a strenuous requirement upon foreign institutions. Asking banks as large as UBS to identify and classify their customers based on US citizenship versus non-US citizenship, FATCA is quite an imposition.

Find Tax Evaders Denounced, N.Y. TIMES (Dec. 26, 2011), <http://www.nytimes.com/2011/12/27/business/law-to-find-tax-evaders-denounced.html>, archived at <http://perma.cc/H2XP-5AYJ>.

179. In several of these countries, such as Switzerland, the domestic laws prevent a bank from disclosing customer information, and could lead to criminal penalties within Switzerland. See *Swiss Banking Secrecy: Don't Ask, Won't Tell*, *supra* note 51 (description of the Swiss banking secrecy laws).

180. 26 U.S.C. §1471.

181. *Id.*

182. This provision directly challenges banking secrecy laws in other countries and attempts to circumvent them.

183. 26 U.S.C. §1471.

184. Federal Act on Banks and Savings Banks, art. 47, SR 952 (1934), archived at <http://perma.cc/T6VU-K93H>.

185. These effects include penalties and litigation associated with violating domestic secrecy laws. *Id.*

4. *Passthru Payments*

Perhaps the most controversial aspect of the FATCA reporting requirements is in regards to “passthru payments.”¹⁸⁶ “Passthru payments” are defined as “any withholdable payment or other payment to the extent attributable to a withholdable payment”¹⁸⁷ and are utilized within the structure of the regulations as a stop-gap prevention against one of the more obvious loopholes.¹⁸⁸

Under section 1471(b)(1)(D), a foreign financial institution that enters into a reporting agreement with the IRS must also deduct and withhold a 30 percent tax on any “passthru payment” made by such institution to a “recalcitrant account holder” or another foreign financial institution which has not entered into an agreement with the IRS.¹⁸⁹ “Recalcitrant account holders” are account holders in the financial institution who fail to comply with requests for information or fail to provide the foreign law waiver.¹⁹⁰ The passthru payment provision mandates a foreign financial institution to withhold money that is not its own. This includes money that belongs to individuals who do not fully disclose who they are or waive their rights under their domestic law, as well as money belonging to another financial entity who for whatever reason has decided not to comply with the FATCA regulations.¹⁹¹ The IRS has recognized both the difficulty in implementing this part of the FATCA system, as well as the negative comments received from the financial industry, and as a result has pushed back the implementation of “passthru payment” regulation until 2017.¹⁹²

B. *Implementation through International Treaties*

FATCA is not subtle.¹⁹³ It unilaterally imposes US domestic law on

186. James Barry et al., *U.S. Treasury Department and Internal Revenue Service Issue Supplementary FATCA Guidance*, 128 BANKING L.J. 638, 644-45 (2011); Wheater, *supra* note 23, at 153-54; Tom O'Donnell et al. *FATCA Proposed Regulations - Is It Finally Becoming More Manageable?*, 23 J. INT'L TAX'N 23, 25 (2012).

187. 26 U.S.C. § 1471(d)(7).

188. Barry et al., *supra* note 186, at 644 (noting the possible loophole allowing financial institutions using an intermediary that complies with FATCA as a conduit for all of their US source income, in order to keep US account holders anonymous and retain their US source income).

189. 26 U.S.C. § 1471.

190. 26 U.S.C. § 1471(d)(6).

191. *Id.*

192. O'Donnell, et. al, *supra* note 186, at 27; Regulations Relating to Information Reporting by Foreign Financial Institutions and Withholding on Certain Payments to Foreign Financial Institutions and Other Foreign Entities, 26 C.F.R. §§1.1471-1.1474.

193. The very definitions within the statute directly state their application to foreign companies. 26 U.S.C. §1471.

foreign entities.¹⁹⁴ Although the FATCA supporters within the US government have charged forward headstrong in their resolve, they do appear cognizant of how other countries might negatively perceive this system.¹⁹⁵ As a result, there has been a recent push by the US government to compel compliance through another route: bilateral treaties.¹⁹⁶

Claiming that these treaties minimize the burden upon foreign entities,¹⁹⁷ while facilitating coordination with local law restrictions¹⁹⁸ and improving collaboration with foreign governments,¹⁹⁹ the IRS and Treasury Department view this as a powerful tool in their arsenal.²⁰⁰ Similar to the bilateral treaties that have been relied upon in the past,²⁰¹ these treaties allow a foreign financial institution located in a FATCA partner country an alternative means of complying with the requirements.²⁰²

There are two types of these intergovernmental agreements that the IRS has been using.²⁰³ The first type is a hybrid between the bilateral tax information exchange agreements and the reporting requirements of FATCA, where a partner country agrees through a treaty to pass domestic legislation implementing FATCA's provisions.²⁰⁴ With this domestic legislation, those entities subject to FATCA reporting will send the information to their countries' tax authorities, who in turn will exchange the information with the United States under the existing framework of tax information exchange agreements.²⁰⁵

The second type of intergovernmental agreement does not mandate legislation in the partner country to implement the collection of information and taxes, but merely requires the partner country not to impede the IRS in

194. *See id.*

195. Regulations Relating to Information Reporting by Foreign Financial Institutions and Withholding on Certain Payments to Foreign Financial Institutions and Other Foreign Entities, 77 Fed. Reg. 9022-01, at 9023.

196. *Id.*

197. *Id.*

198. *Id.*

199. *Id.*

200. *Id.*

201. They are similar in that both bilateral treaties and these FATCA agreements are negotiations between the two countries to effectuate the tax information disclosure between the countries.

202. Thomas A. Humphreys et al., *IRS Rolls out FATCA Intergovernmental Agreements*, MORRISON & FOERSTER LLP (Jan. 24, 2013), <http://www.lexology.com/library/detail.aspx?g=79a2d0e4-0d3c-4a7f-905f-0f3db477896c>, archived at <http://perma.cc/V3FT-ZYT8>.

203. *Id.*; Alan Granwell & Witold Jurewicz, *U.S. Treasury Department Announces Countries Engaging in FATCA Intergovernmental Agreement Discussions*, DLA PIPER (Nov. 14, 2012), <http://www.dlapiper.com/us-treasury-announces-countries-engaging-in-fatca-discussions/>, archived at <http://perma.cc/GVK2-E27C>.

204. *Id.*

205. *Id.*

implementing FATCA.²⁰⁶ This version is an agreement that waives bank secrecy laws of the partner state and requires all of its financial institutions to enter into an “FFI agreement” with the IRS.²⁰⁷ The second part of the agreement requires the partner jurisdiction to honor its obligations under existing bilateral treaties.²⁰⁸ Not surprisingly, the United States has entered into negotiations with the Swiss government to implement this type of agreement and facilitate FATCA requirements on Swiss banks.²⁰⁹

By the end of 2012, the United States was in the process of finalizing intergovernmental agreements with four countries: the United Kingdom, Denmark, Mexico, and Ireland.²¹⁰ A review of the Treasury Department’s website shows thirty-two countries have signed an intergovernmental agreement as of the publication of this Note.²¹¹ Significantly, countries such as Switzerland, Bermuda, Luxembourg, Isle of Mann and the Cayman Islands have all signed agreements.²¹²

The prevalence of these negotiations within the past two years,²¹³ and the comments of the treasury²¹⁴ indicate an increasing focus on implementing FATCA bilaterally through agreements with other countries, rather than unilaterally through US law.²¹⁵ As the introduction of the agreement with the United Kingdom indicates, international tax evasion is not just a problem for the United States, and the underlying policy goals of FATCA reporting requirements to improve tax compliance is important to other countries as well.²¹⁶ So while the use of intergovernmental agreements is primarily for the purpose of addressing legal impediments of implementing the domestic law of the United States upon foreign entities, it also serves the purpose of putting forth a multinational effort to reign in tax

206. *Id.*

207. *Id.*; 26 U.S.C. § 1471.

208. Granwell & Jurewicz, *supra* note 203.

209. Granwell & Jurewicz, *supra* note 203; Press Release, US Dep’t of the Treasury, Treasury, Switzerland Agree to Pursue Framework for Cooperation for Implementing FATCA (June 21, 2012), *archived at* <http://perma.cc/JF6Y-RFHY> [hereinafter Treasury Press Release].

210. Granwell & Jurewicz, *supra* note 203.

211. *FATCA-Archive*, U.S. DEP’T OF TREASURY (May 16, 2014), <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx>, *archived at* <http://perma.cc/NA8J-XZSL>.

212. *Id.*

213. Granwell & Jurewicz, *supra* note 203; Treasury Press Release, *supra* note 209.

214. Treasury Press Release, *supra* note 209.

215. Treasury Press Release, *supra* note 209; Granwell & Jurewicz, *supra* note 203.

216. “Whereas, the Government of the United Kingdom of Great Britain and Northern Ireland is supportive of the underlying policy goal of FATCA to improve tax compliance...[w]hereas, the Parties are committed to working together over the longer term towards achieving common reporting and due diligence standards for financial institutions.” U.K. FATCA Agreement, *supra* note 46 (alterations added).

avoidance.²¹⁷

V. THEORY BEHIND IMPLEMENTING A WITHHOLDING SYSTEM IN THE INTERNATIONAL REALM

By requiring foreign companies to disclose certain taxpayer information under FATCA or face severe penalties, the US government is attempting to replicate the success of the domestic withholding system.²¹⁸ In the United States, the government uses a voluntary compliance system with the threat of penalties²¹⁹ and a withholding system by employers²²⁰ to effectuate compliance. With the risk of audit at just above 1 percent of individual returns filed²²¹ and the average penalty for tax evasion close to 20 percent of the underpayment,²²² a lot of the heavy lifting is done by the employer withholding.²²³ By putting the onus on the employers to disclose the earnings information and withhold the adequate amount of taxes, the government is taking the decision out of the hand of the taxpayer. While many would acknowledge that taxes are beneficial to some degree,²²⁴ the idea of voluntarily giving up a portion of hard-earned cash for slight, if any, recognizable quantifiable return²²⁵ seems to be a tough sell.

This conflict between the individual and society is perhaps best described by the theory of collective action, which posits that individuals will behave like rational wealth maximizers.²²⁶ Those individuals will rarely find it justifiable to contribute resources to attaining collective goods, but instead will free-ride on the contributions that others make.²²⁷ As a result,

217. See generally U.K. FATCA Agreement, *supra* note 46.

218. The IRS estimates that 83 percent of domestic income taxes are collected. Eric Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1784 (2000).

219. *Topic 306 - Penalty for Underpayment of Estimated Tax*, INTERNAL REVENUE SERV., <http://www.irs.gov/taxtopics/tc306.html> (last updated Jan. 22, 2014, archived at <http://perma.cc/FPY2-MAHS>).

220. *Tax Withholding*, *supra* note 5.

221. See INTERNAL REVENUE SERV., FISCAL YEAR 2011 ENFORCEMENT AND STATISTICS (2011), archived at <http://perma.cc/Y65A-3A4E>.

222. Posner, *supra* note 218, at 1783.

223. Posner, *supra* note 218, at 1784.

224. Most major political parties in the United States recognize taxes as a necessary part of the federal government, and it has become acceptable to some degree. *But see* LIBERTARIAN PARTY, LIBERTARIAN PARTY PLATFORM para. 2.4 (2012), archived at <http://perma.cc/6MRX-RKRR> (The libertarian party vehemently opposes the income tax and calls for it to be repealed.).

225. While all benefit from the protection and infrastructure provided by government, it is often hard to see and is not as tactile as the individual having more of his or her funds.

226. OLSON, *supra* note 2, at 2.

227. OLSON, *supra* note 2, at 21.

the group will be harmed because too few individuals will contribute.²²⁸ According to the father of collective action theory,²²⁹ Mancur Olson, the only way to overcome this problem is to provide external influences, either in the form of subsidies or penalties, to herd individuals into compliance for the benefit of the community.²³⁰ In the domestic tax sphere, the US government has circumvented this problem entirely through the employer withholding system, and is attempting to do the same in the international realm with FATCA.²³¹

So what occurs when the decision is left to the individual? When an individual examines whether or not to comply with the external influences in the tax system, i.e. audit risk and underpayment penalties, he or she can be understood to be engaging in a modified prisoner's dilemma.²³² One element of the decision is the theory of "signaling" posited by Eric Posner.²³³ Signaling is based on an assumption that society consists of a great deal of cooperative relationships, each of which has the structure of a repeated prisoner's dilemma.²³⁴ Based on the existence of this web of repeated prisoner's dilemmas, an individual has the choice in each one whether to cooperate or cheat, and "players may refrain from cheating in the hope that they will develop a reputation for not cheating—both within

228. OLSON, *supra* note 2, at 35.

229. Because he wrote the book *THE LOGIC OF COLLECTIVE ACTION*, Olson is the person most associated with the development of Collective Action logic. See *THE ECONOMIST*, OBITUARY: MANCUR OLSON, Mar. 5, 1998, archived at <http://perma.cc/N6VY-RKMW>.

230. Posner, *supra* note 218, at 1791.

231. 26 U.S.C. §1471(a).

232. Professor Eskridge explains that the classic prisoner's dilemma consists of two prisoners, each of whom is offered a deal: If you betray your colleague and he is loyal to you, you will get a benefit of eight (say a good plea bargain). And if one prisoner is loyal and his colleague betrays him, he will get no benefit (the other prisoner gets the benefit). Each prisoner also knows that if he is loyal and his colleague is also loyal, they each get a benefit of five. However, if both prisoners betray one another, they both get a benefit of only two. . . . The best strategy would be for both prisoners to be loyal. Yet under the circumstances of the prisoner's dilemma game, each prisoner acting separately will tend to betray the other.

William N. Eskridge, Jr., *The Judicial Review Game*, 88 NW. U.L. REV. 382, 389-90 (1993) (alteration added). Professor Eskridge further explains: "Acting rationally but not knowing what B will do, A faces possible benefits of two or eight if he betrays, but only zero or five, respectively, if he does not betray. Given such a choice, A will betray. B will also betray under the same reasoning." *Id.* at 390, n.29. Public goods games can be conceived of as prisoner's dilemma games because each player's rational move is not to contribute, but total welfare is maximized if all players contribute. See also Steven Kuhn, *Prisoner's Dilemma*, STANFORD ENCYCLOPEDIA OF PHILOSOPHY (Oct. 22, 2007), <http://plato.stanford.edu/entries/prisoner-dilemma/>, archived at <http://perma.cc/B7SU-5K9E>; Posner, *supra* note 218, at 1786.

233. Posner, *supra* note 218, at 1787.

234. Posner, *supra* note 218, at 1786.

an existing relationship and generally amongst others in society.”²³⁵

The key to understanding the prior conflict of the offshore bank account problem is that those individuals were not located within the community envisioned by Olson and Posner. Their choice to place assets outside of the detection and reach of the withholding system is a loophole that allows the individual to maximize wealth potential while avoiding the negative “signaling” associated with individual-motivated actions.²³⁶ The FATCA regime tries to extend the domestic taxation system, forcing individuals into a withholding system²³⁷ with the risk of receiving negative signaling consequences.²³⁸ The success of the domestic tax collection system, which FATCA is attempting to replicate in the international realm, is predicated on the successful application of withholding to those offshore tax evaders.²³⁹

VI. ANALYSIS

A. International Relation Implications

Even with the recent focus by the United States on intergovernmental agreements with other countries to implement the reporting requirements, FATCA is still a stark departure from previous international law precedent.²⁴⁰ Most of the treaties and agreements that constitute international law have relied upon non-binding, vague language to effectuate broader policy goals.²⁴¹ Whether through multinational organizations, or bilateral treaties, the power of a given agreement is limited to the power an individual sovereign nation is willing to give up.²⁴²

235. Posner, *supra* note 218, at 1786.

236. Posner, *supra* note 218, at 1786.

237. 26 U.S.C. § 1471 (2010).

238. Posner, *supra* note 218, at 1816.

239. Through the broad definitions, FATCA seeks to come as close as practically possible to the domestic system’s universal application of withholding, although it will inevitably fall short because the definitions are predicated on the foreign entities caring about doing business within the United States. 26 U.S.C. § 1471.

240. *See supra* Part II for a discussion of the reliance on ineffective bilateral and multinational treaties.

241. For example, see the language used in the OECD commitment letter for the Cayman Islands, where the Government of the Cayman Islands “commits to refrain from...introducing any new regime that would constitute a harmful tax practice....strengthening or extending the scope of any existing measures that currently constitute a harmful tax practice.” Commitment Letter, *supra* note 117. These commitments basically amount to promises not to expand an already thriving tax haven, and as such are vague and lack true reform.

242. U.N. Charter art. 2, June 26, 1945, *archived at* <http://perma.cc/XAH3-H4WM>; for an example of such a limiting agreement see Rome Statute of the International Criminal Court, July 17, 1998, 2187 U.N.T.S. 90.

In the realm of international relations, the fear of surrendering too much sovereignty often has to be balanced with pressures from other countries. The quintessential example of international pressure comes from the Cold War exploits of the United States and the USSR, where both countries sought influence across the globe.²⁴³ There is a fine line in international relations between preserving sovereignty on the one hand and keeping up good international relations on the other. As a result of the tightrope that must be walked between the two, it is only logical that most countries do not appreciate another that asks too frequently for sovereignty concessions and for too much advantage through international agreements. Understandably, the international community does not appreciate an actor who unilaterally imposes its will onto other countries to effectuate domestic policies. This unilateral imposition is a complete disregard for the sovereignty of the foreign nation and thus a disregard for international relations as a whole.

In the past decade, the United States has found out the hard way that unilateral imposition on another nation's sovereignty, even for a beneficial reason, damages a country's international reputation if the proper protocols are not followed.²⁴⁴ In order for international law and order to work, it has to apply uniformly to all parties involved, and all states must respect the sovereignty of other states. While the old, pre-WWII system of international relations would allow unilateral impositions upon another state's sovereignty,²⁴⁵ the multinational system of cooperation in today's world requires something different.

In this system of international relations, FATCA sticks out like a sore thumb and a relic of old. The very concept of FATCA is for a unilateral imposition of US domestic policy onto entities located in foreign sovereign states.²⁴⁶ While the trend towards intergovernmental agreements reduces the brazenness of this move, the agreements are still the same exact implementation of US domestic law.²⁴⁷ As a country coming to the negotiating table with the United States, you have three options. First, you could enter into an agreement with the United States;²⁴⁸ second, you could not enter into an agreement and have the United States implement its laws onto your financial institutions anyway;²⁴⁹ or third, you could inform your

243. See generally Burton Kaufman, *The Cold War: U.S.S.R. and the United States*, THE HISTORY PROFESSOR, <http://thehistoryprofessor.us/bin/histprof/misc/coldwar.html> (last visited Feb. 9, 2013, archived at <http://perma.cc/3PMV-6AGL>).

244. See Joint Declaration by Russia, Germany and France on Iraq, Feb. 10, 2003, archived at <http://perma.cc/JG3S-GQTL>.

245. This was due to a lack of an effective multinational legal system.

246. See *infra* Part III.

247. 26 C.F.R. §§1.1471-1.474.

248. The FFI Agreement is outlined in 26 U.S.C. § 1471(b)(1) (2010).

249. The withholding mechanisms are set out in 26 U.S.C. § 1471(b)(1)(D).

institutions not to do business in the United States or with an entity that would bring them under the FATCA requirements.²⁵⁰

The United States is the largest and most “technologically powerful” economy in the world, with the second highest GDP, behind only the European Union.²⁵¹ The United States also has the highest market value of shares of publicly traded corporations, almost double that of any other country.²⁵² The New York Stock Exchange and NASDAQ are the two largest stock exchanges in the world.²⁵³ With how interconnected the financial world is today,²⁵⁴ telling a financial institution to not conduct its business in the United States can severely affect that entity’s profitability because of the size of the US capital markets.²⁵⁵ And when the passthru payment provisions are implemented, it will be nearly impossible for reputable financial institutions to not fall under the 30 percent withholding of FATCA.²⁵⁶ So even when the United States comes to negotiate an intergovernmental agreement, it is merely a veiled unilateral imposition of its domestic law.

While the United States may still carry a great deal of weight and enjoy a level of respect from other countries who view it as the predominant hegemon, good will and hegemonic status can only go so far. By implementing FATCA, the United States is continuing to stray from the path of multinational agreements and the frameworks of international law that have been developing for the past seventy years. By continuing down the unilateral “my way or the highway” approach, the United States is subverting the international institutions that it helped found²⁵⁷ in favor of an

250. This third solution will become more difficult once the “passthru payment” provisions of FATCA are enacted. *See* O’Donnell, et. al, *supra* note 186, at 27.

251. *CIA World Factbook: The United States*, CENTRAL INTELLIGENCE AGENCY, <https://www.cia.gov/library/publications/the-world-factbook/geos/us.html> (last updated Nov. 12, 2013, archived at <http://perma.cc/5XZV-U8C8>).

252. *Id.*

253. *Ten Largest Stock Exchanges in the World by Market Capitalization, 2011*, WORLD STOCK EXCHANGES, <http://www.world-stock-exchanges.net/top10.html> (last visited Feb. 26, 2014, archived at <http://perma.cc/W9X7-F3M2>); *Annual Statistics Reports*, WORLD FED’N OF EXCHANGES, <http://www.world-exchanges.org/statistics/annual> (last visited Feb. 9, 2013, archived at <http://perma.cc/8PGQ-WERN>).

254. Marina Primorac, *The Global Village: Connected World Drives Economic Shift*, INT’L MONETARY FUND SURVEY MAG. (Aug. 30, 2012), <http://www.imf.org/external/pubs/ft/survey/so/2012/new083012a.htm>, archived at <http://perma.cc/EKR4-Z33C>.

255. The United States contains the two largest trading markets and second highest GDP. *CIA World Factbook: The United States*, *supra* note 251.

256. *See supra* Part III.

257. The recent wars in Afghanistan and Iraq, and America’s inability to join the International Criminal Court have led to a great deal of negative criticism of America’s international policy in recent years. *See generally* Marlise Simons, *U.S. Grows More Helpful to International Criminal Court, a Body it First Scorned*, NY TIMES, Apr. 2, 2013, archived

outdated and unsustainable method of international relations.²⁵⁸ While the United States may still enjoy hegemonic status for now, there will come a day when other countries have the spotlight and the tables may turn. And even if that eventuality is a long way off, there is no denying that advances in technology have made our world interconnected to the point where the old unilateral method of international relations is no longer a viable option.²⁵⁹

B. Negative Effect upon US Capital Market

The United States is just beginning to recover from the effects of the worst economic recession since the Great Depression.²⁶⁰ With the largest financial economy in the world,²⁶¹ implementing rules that could cost an estimated thirty to forty US dollars per customer to implement²⁶² appears to be a strong disincentive to doing business within the United States. By placing such a large cost upon the businesses, the United States will require foreign businesses to seriously consider choosing an alternate route before investing in any US company.

While “Wall Street” and large companies may not be the most popular groups in America,²⁶³ they comprise a very important part of the economy.²⁶⁴ Publicly traded corporations rely upon investors to provide them with money that they can then use for purposes such as hiring employees or developing new technology.²⁶⁵ Foreign investment in the United States amounts to \$21 trillion, and \$10.5 trillion of that is invested in

at <http://perma.cc/E7V3-37E5>.

258. The unilateral method of international relations that was prevalent before World War Two has been sharply criticized as ineffective in the modern world. See *Capsule Reviews: Unilateralism and U.S. Foreign Policy: International Perspectives*, FOREIGN AFFAIRS (May/June 2003), <http://www.foreignaffairs.com/articles/58894/g-john-ikenberry/unilateralism-and-us-foreign-policy-international-perspectives>, archived at <http://perma.cc/EVT9-AB62>.

259. This is due to the interconnectivity of the various first-world countries whose economies entirely depend upon one another. Primorac, *supra* note 254.

260. *Three Economists Agree 2009 Worst Financial Crisis since Great Depression; Risks Increase if Right Steps Are Not Taken*, REUTERS (Feb. 27, 2009), <http://www.reuters.com/article/2009/02/27/idUS193520+27-Feb-2009+BW20090227>, archived at <http://perma.cc/SEJ2-NHZE>.

261. *Annual Statistics Reports*, *supra* note 253.

262. Porritt, *supra* note 26.

263. See, e.g., Erik Eckholm & Timothy Williams, *Anti-Wall Street Protests Spreading to Cities Large and Small*, N.Y. TIMES (Oct. 3, 2011), <http://www.nytimes.com/2011/10/04/us/anti-wall-street-protests-spread-to-other-cities.html>, archived at <http://perma.cc/6K2W-8AGP>.

264. Daniel Indiviglio, *Why You Shouldn't Hate Wall Street*, ATLANTIC (Oct. 6, 2011), <http://www.theatlantic.com/business/archive/2011/10/why-you-shouldnt-hate-wall-street/246282/>, archived at <http://perma.cc/WE99-KKBY>.

265. *Id.*

US securities.²⁶⁶ A KPMG survey indicated that only 36 percent of financial institutions polled are definitely planning to remain in the US and comply with FATCA.²⁶⁷ For a bank such as UBS, the estimated thirty to forty dollars in customer compliance costs²⁶⁸ is a large burden, and while they and other large financial institutions could bear the cost or pass it on to their customers, the question becomes whether or not investment in the United States is worth that price.

Another problem affecting the US capital market comes from the smaller financial institutions which will likely be unable to sustain the added costs of FATCA compliance and will be required to change business drastically or close entirely.²⁶⁹ While the overall decrease in investment in the US capital markets is hard to determine, even if a small percent of the \$234 billion per year²⁷⁰ exits, it would be a major hit to the US economy.

C. Effect upon US Citizens Living Abroad

The Bureau of Consular Affairs within the US Department of State estimates that there are approximately 6.8 million Americans living abroad.²⁷¹ Currently, United States taxpayers living abroad must file two tax returns, one for the country in which they reside, and the other with the IRS.²⁷² While almost 82 percent of all Americans living abroad who filed their returns with the IRS owed no US taxes, there is still the possibility that they can face double taxation.²⁷³

Under the FATCA regulations, this group of US citizens, who are not

266. *Why FATCA is Bad for America - Update*, AMERICAN CITIZENS ABROAD, <http://americansabroad.org/issues/fatca/fatca-bad-america-why-it-should-be-repealed/> (last updated Aug. 9, 2013, archived at <http://perma.cc/T3KU-F7NW>).

267. FATCA AND THE FUNDS INDUSTRY: DEFINING THE PATH, KPMG 6 (June 2011), archived at <http://perma.cc/8GL6-C9DL>.

268. Porritt, *supra* note 26.

269. Jolly & Knowlton, *supra* note 178.

270. The U.S. attracted \$234 billion in foreign direct investment in 2011. Neil Shah, *Foreign Investment Surges*, WALL STREET JOURNAL, (June 15, 2012), <http://online.wsj.com/news/articles/SB10001424052702303410404577466692621011900>, archived at <http://perma.cc/6JX9-RLUB>. While not all foreign direct investment will be subjected to FATCA, this figure shows the vast sums of money that foreign individuals and companies contribute to the United States, and with the volatility of the marketplace, the imposition of strict and complicated rules could damper investment even if such investment has no relation to the rules.

271. *Who We Are and What We Do: Consular Affairs by the Numbers*, BUREAU OF CONSULAR AFFAIRS, U.S. DEPARTMENT OF STATE (May 2013), http://travel.state.gov/pdf/ca_fact_sheet.pdf, archived at <http://perma.cc/Q4G6-NCY6>.

272. See American Citizens Abroad et al., *Residence-Based Taxation: A Necessary and Urgent Tax Reform* 4 (Overseas Americans Week, Working Paper, 2013), archived at <http://perma.cc/7RDC-3DJH>.

273. *Id.*

the target of the statute,²⁷⁴ will fall under its grasp and be subject to it.²⁷⁵ It is entirely possible that some of these US citizens will be forced to leave their foreign bank if that entity decides to not accept US citizens as clients. Because of the stringent reporting requirements²⁷⁶ and the large unforgiving penalty structure in place with violating those requirements,²⁷⁷ it is very possible that these innocent-intentioned people could find themselves in a great deal of trouble for a very small mistake. FATCA was set up to reign in US citizens' usage of offshore bank accounts to avoid taxation,²⁷⁸ not to force a citizen living abroad from using a local bank out of convenience. This area of overlap within the regulations is concerning, as unknowing US citizens living abroad could be subjected to the effects of FATCA.

VII. RECOMMENDATION TO RE-THINK WHETHER PENALIZING TAX AVOIDERS IS IN THE BEST INTERESTS OF THE COUNTRY

A. FATCA's Logical End

When trying to influence a person's decision, you can entice her or threaten her to achieve a desired result. Commonly known as the "carrot or the stick," this behavioral dilemma at its very essence is based on the idea that in order to get a person to do what you need her to do, there has to be motivation compelling her to do so, and depending on the situation, a varying degree of carrot or stick is needed. FATCA is all stick and no carrot.

While there is some credence to using a strict law with stiff penalties,²⁷⁹ the purpose of FATCA is to reign in those who keep funds in offshore accounts by motivating their compliance with the US tax code by cutting off their offshore resources.²⁸⁰ By mandating the reporting requirements, FATCA is forcing the facilitators of these tax evaders to become agents of the US government. This gives the tax evaders a choice: give in and report their information and pay taxes, or continue to evade by moving to another offshore bank that does not face the same motivation to be compelled into FATCA.

A cursory glance at economic studies will support the generality that

274. Treas. Reg. § 9022-01 (2012).

275. See American Citizens Abroad, *supra* note 272.

276. See *supra* Part III.

277. See *supra* Part III.

278. Treas. Reg. § 9022-01.

279. See generally Agnar Sandmo, *The Theory of Tax Evasion: A Retrospective View*, (Nordic Workshop on Tax Policy and Public Economics, Discussion Paper 31/04, 2004), archived at <http://perma.cc/N55T-YPWP>.

280. Using the reporting or withholding system of 26 U.S.C. § 1471, FATCA tilts the scale for foreign financial institutions, making it very disadvantageous to continue harboring tax evaders.

there is always a market where there is demand.²⁸¹ There are an estimated \$1 trillion in assets held by Americans in offshore accounts.²⁸² Those assets, if discovered by the US government, will be subjected to the requisite tax due, and could be subject to additional taxes, substantial penalties, interest, fines, and could even lead to imprisonment for the individual.²⁸³ The stiff penalties in place provide a very strong demand for an “offshore banking haven” that can protect US citizens from these penalties.²⁸⁴ It is unrealistic to believe that the demand for favorable tax treatment and protection from the stiff penalties will just disappear.²⁸⁵

Currently, the IRS is entering into its third “amnesty” period.²⁸⁶ During this period, an offshore tax evader can amend their tax returns to reflect foreign assets if they pay a hefty 27.5 percent penalty.²⁸⁷ As of June 2012, there have been approximately 33,000 US citizens who have taken advantage of these amnesty periods from which the government has collected over \$5 billion.²⁸⁸ While the efforts of the IRS and its success in collecting more than \$5 billion is laudable, its insistence to continue using the threat of FATCA against the evaders who remain is troubling. After three amnesty periods²⁸⁹ and a great deal of news regarding offshore tax shelters,²⁹⁰ it is unrealistic to believe that funds are located offshore due to ignorance. This leaves one possible reason why people still retain these accounts: because it makes financial sense.

These accounts are often very sophisticated and are designed primarily to maximize return on capital by avoiding the demanding taxes of the United States.²⁹¹ The people left with these accounts have now had three opportunities to bring their offshore accounts into compliance.²⁹² They have

281. Reem Heakal, *Economics Basics: Supply and Demand*, INVESTOPEDIA, <http://www.investopedia.com/university/economics/economics3.asp#axzz2KTIIfkso4> (last visited Feb. 9 2013, archived at <http://perma.cc/PS82-38HN>).

282. *Abusive Tax Schemes*, *supra* note 7.

283. *Income from Abroad is Taxable*, INTERNAL REVENUE SERV., <http://www.irs.gov/Businesses/Income-from-Abroad-is-Taxable> (last updated Sept. 3, 2013, archived at <http://perma.cc/U2ZR-DW4W>).

284. Sandmo, *supra* note 279.

285. Sandmo, *supra* note 279.

286. Press Release, IRS Offshore Programs Produce \$4.4 Billion to Date for Nation's Taxpayers; Offshore Voluntary Disclosure Program Reopens (Jan. 9, 2012), archived at <http://perma.cc/D5AE-RR4B>.

287. *Id.*

288. Press Release, IRS Says Offshore Effort Tops \$5 Billion, Announces New Details on the Voluntary Disclosure Program and Closing of Offshore Loophole (June 26, 2012), archived at <http://perma.cc/9KRQ-AEZP>.

289. *See, e.g., id.*

290. *See, e.g., Levin, supra* note 19.

291. *See supra* Part I-A-1 (describing how banks utilize the strong privacy laws of their country to attract customers who require discretion and privacy).

292. Press Release, IRS Offshore Programs Produce \$4.4 Billion to Date for Nation's

examined their situations and determined that the best decision for them is to keep their money offshore and accept the risk that the United States may find them. FATCA attempts to rein these ardent avoiders in by taking away their banks. And although FATCA has a broad reach, its problem is that it is not universal.

When there is a demand for a service such as international tax avoidance, the only way to combat it effectively is make it as close to universally illegal as possible. By increasing the breadth and scope of international tax law to the point where tax avoiders cannot hide their money by staying one step ahead of the United States and switching banks, the government will be in the best position to control the market and lessen the demand.²⁹³ FATCA, however, is not so broad,²⁹⁴ and thus instead of eliminating the market for offshore “havens,” it will merely push it elsewhere.

Historically the demand for offshore “havens” have been mostly filled by medium to large sized reputable banks located in countries with strong privacy laws such as Switzerland, Luxembourg, the Cayman Islands, the Bahamas, and the like.²⁹⁵ Most of these banks have become the choice of many US citizens because their size affords a convenience—the banks usually deal heavily within the United States and often have offices in the country.²⁹⁶ FATCA is designed to target these larger banks directly,²⁹⁷ and other banks within developed nations are “compelled” to enter into intergovernmental agreements to implement FATCA themselves.²⁹⁸

By taking away the larger, reputable banks in well-developed countries, FATCA pushes the markets into areas where the financial institutions do not regularly deal in US “source income” and are not overly persuaded to give up domestic sovereignty if the United States flexes its muscle.²⁹⁹ These are the locations where FATCA cannot reach, and where the money will find its way.

The implications of this shift are troubling. The countries in the world that do not routinely do business with the United States or do not care about its influence are those which are often the most dangerous countries. The problem with trying to avoid the watching eye of the US government for tax purposes is that it pushes tax evasion to the same places that terrorists, drug cartels, and other black market individuals also must go.

Taxpayers; Offshore Voluntary Disclosure Program Reopens, *supra* note 286.

293. Sandmo, *supra* note 279.

294. As discussed in Part III, FATCA only applies to companies that do business within the United States.

295. US SENATE SUBCOMM. ON INVESTIGATIONS, COMM. ON HOMELAND SEC. AND GOV'T AFF., *supra* note 122.

296. Levin, *supra* note 19.

297. 26 U.S.C. § 1471 (2010).

298. 26 C.F.R. §§ 1.1471-1.1474.

299. This includes countries in Africa and the Middle East where the United States does not carry as much weight.

Perhaps the most concerning country that this market could move to is China. As of October 2012, China owned \$1.2 trillion in US Treasury bonds, or 10 percent of the US national debt,³⁰⁰ and has become a very important trading partner.³⁰¹ If China wanted to use its political sway to take advantage of creating a market for international tax avoiders, it is unlikely that anyone would be able to stop it.

Because the tax avoiders left in the offshore arena are there for their own financial reasons, it is unlikely that FATCA will force compliance. So while FATCA is recognized by some as a success,³⁰² that success is only short-term, as a result of capturing the funds of the non-ardent avoiders. When taken to its logical end, FATCA will push funds into the hands of dangerous people and unreliable institutions in dangerous countries.³⁰³

B. What Should Be Done?

While the philosophical discussion over which motivational tool works better—the stick or the carrot—has been a well-documented contest,³⁰⁴ the determination is predominantly dependent on the facts of a given scenario. Due to the surrounding facts or background information, some situations call for more stick than carrot or vice versa. The background information of the person involved sets the scene for how they can be expected to perceive and react to the motivation. By examining the facts of a given situation, the motivator must then decide which of the very different techniques he should use to achieve his goals.

The principal benefit of using a stick to motivate an individual is deterrence.³⁰⁵ By imposing strict and daunting penalties, and using those penalties to threaten individuals into action, they are motivated not to be

300. *China's Holdings of U.S. Debt*, WASHINGTON POST (Oct. 16, 2012), http://www.washingtonpost.com/business/economy/chinas-holdings-of-us-debt/2012/10/16/075f71c0-17ee-11e2-9855-71f2b202721b_graphic.html, archived at <http://perma.cc/F92-AEXL>.

301. Dan Ikenson, *Soured U.S.-China Relationship Approaches Inflection Point*, FORBES (Jan. 1, 2013), <http://www.forbes.com/sites/danikenson/2013/01/29/reading-the-tea-leaves-on-u-s-china-economic-relations/>, archived at <http://perma.cc/V8B-YEND>.

302. Robert Wood, *FATCA Fuels IRS Amnesty, but Advocate Calls it Harsh*, FORBES (Feb. 2, 2014), <http://www.forbes.com/sites/robertwood/2014/02/02/fatca-fuels-irs-amnesty-but-advocate-calls-it-harsh/>, archived at <http://perma.cc/DMS2-GF2D>.

303. Bashar Malkawi, *Bank Secrecy in Arab Countries: A Comparative Study*, 123 BANKING L.J. 894, 894 (2006); Bruce Zagaris, *International Enforcement Law Trends for 2010 and Beyond: Can the Cops Keep up with the Criminals?*, 34 SUFFOLK TRANSNAT'L L. REV. 1 (2011); Daryl Shetterly, *Starving the Terrorists of Funding: How the United States Treasury is Fighting the War on Terror*, 18 REGENT U. L. REV. 327, 328-29 (2006).

304. See generally Andy Henion & Karen Sedatole, *Carrots, Not Sticks, Motivate Workers*, MICH. STATE UNIV. (June 20, 2012), <http://msutoday.msu.edu/news/2012/carrots-not-sticks-motivate-workers/>, archived at <http://perma.cc/7SPJ-GK6S>.

305. See *id.*

harmed.³⁰⁶ In order for this type of motivation to be effective, the individual must both fear the penalties and believe that the motivator will carry out the punishment. For the deterrence effect to work as motivation, the individual must believe that his failure to act in a desirable way will result in the penalties. An important variation on how effective a specific deterrent can be is how likely an individual will be found to be in violation of the rule.³⁰⁷ The penalties can be extremely strict and strike fear into the heart of the individual who believes that the motivator will carry out the action but still decides to not act in the desired manner because there is a very small chance that the variance will be discovered.

The carrot on the other hand relies on a beneficial reward for the desired performance. Also relying upon the individual's belief that the motivator will carry through with his promise, this dynamic relies upon how "shiny" the reward is.³⁰⁸ Conversely from the deterrence motivation, the higher the reward available to an individual, the less likely the chance of receiving that reward has to be in order for the individual to perform as desired.³⁰⁹

The individuals with offshore bank accounts have determined that keeping their funds overseas is in their best interest, and that it is worth the risk of severe penalties³¹⁰ if the US government should find them. These individuals have already evaluated the "stick" of US government penalties prior to FATCA and have now been afforded three opportunities to re-evaluate their positions after taking into account FATCA's more strenuous rules that increase the chances that they will be discovered, and yet they still maintain their offshore accounts. FATCA is not designed to adequately address these individuals. All FATCA can do in regard to these individuals is push them further away from large reputable banks located in friendly countries to those that are less desirable.³¹¹

The FATCA "stick" is not the right tool for achieving the goal of increased revenue and compliance with US tax laws with respect to the ardent tax avoiders left with assets overseas. While the government is focused merely on getting these individuals to report their information and collect tax on those offshore funds,³¹² the better solution is to entice these

306. *See id.*

307. This claim relies on the basic assumption that an individual uses a probability of a negative effect happening when evaluating whether or not to commit an action. This is especially true in the financial world where decisions about monetary assets have a concrete effect on those assets, and many individuals go through systematic cost benefit analysis.

308. Margaret Christ et al., *Sticks and Carrots: The Effect of Contract Frame on Effort in Incomplete Contracts*, 87 ACCOUNTING REV. 1913, 1917 (2012).

309. This is a furthering of the logic from the logical assumption that risk of a negative effect and size of the payout are linked. *See generally id.*

310. *Income from Abroad is Taxable*, *supra* note 283.

311. *See supra* Part IV.

312. 26 C.F.R. §§ 1.1471- 1.1474.

avoiders to bring their assets back onto US soil. By bringing the \$1 trillion in assets³¹³ back onto US soil there are potentials not only for tax collection, but many more economic benefits, such as creating jobs and freeing up capital for investment.

The problem with using the “carrot” to attract avoiders back onto US soil is that public opinion would most likely not favor leniency.³¹⁴ The last few years have seen a growing groundswell of opposition against wealthy individuals who appear able to manipulate the laws at the expense of other taxpayers in order to improve their bottom line.³¹⁵ Although on a purely economic side, allowing offshore tax avoiders to bring their money back into the country would be beneficial, it would be a “third rail”³¹⁶ in terms of public policy.

The solution to this barrier of public opinion is to compromise by giving enough of an enticement to compel the avoiders to bring their assets back onto US soil, while giving enough of an appearance of punishment to satisfy the public. One possible solution could be to create a large fund in which all returning offshore assets must be kept for a certain period of time, such as three or five years. The fund could be used to fund federal or state projects and give the tax avoiders a reasonable rate of return for borrowing the money which could then be used to benefit the public at large. While this is just one idea, it shows how, if both sides of the table (or both prisoners) decide to accept the compromised deal, both will be better off because of it.

VIII. CONCLUSION

FATCA constitutes a departure from previous tax collection methods, and has caused a great deal of concern in the accounting and financial worlds.³¹⁷ The possibility of a negative effect on US capital markets, the strain on the United States’ waning international influence, the dim prospects of collecting revenue, and other issues make FATCA a troubling piece of legislation. Even with the Treasury Department’s focus on using intergovernmental agreements to effectuate the implementation of FATCA, it is still only a veiled unilateral imposition of US domestic law on the international community. Perhaps most troubling is the fact that FATCA is

313. Levin, *supra* note 19.

314. See, e.g., Eckholm & Williams, *supra* note 263.

315. See e.g., Eckholm & Williams, *supra* note 263.

316. “Third Rail” is a metaphor for any political issue so controversial that it is “charged” and “untouchable” and will bring negative effects to any politician who attempts to tackle it. See generally *Third Rail Politics*, CHI. TRIB. (Sept. 27, 2010), http://articles.chicagotribune.com/2010-09-27/news/ct-edit-tenth-20100927_1_dold-and-seals-private-accounts-social-security, archived at <http://perma.cc/G44J-ATUZ>.

317. Jolly & Knowlton, *supra* note 178; Porritt, *supra* note 26.

so broad as to cause a great disturbance in the financial industry, but not broad enough to reach the ardent tax avoiders that it seeks to cover.³¹⁸

FATCA only pushes the market for offshore tax evasion deeper into the darkness and further from reputable institutions. The best solution to increase the revenue of the IRS and decrease the amount of individuals avoiding taxes is to entice those individuals to move their assets back onto US soil with favorable treatment. Although public opinion will most likely prevent this from occurring, a compromise must be struck. The American public and the tax avoiders are locked in a prisoner's dilemma and they must work together to find the best solution for all parties involved.

318. *See supra* Part IV.