Perspective of Foreign Accounting Tax Compliance Act as a Future Substitute of Foreign Bank Account Report

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Summary:

In this paper, we discuss FATCA (Foreign Account Tax Compliance Act) and whether it could successfully operate in collaboration with the existing FBAR (Foreign Bank Account Report). In order to provide such discussion, we define these two regulations, their initial premise for creation, and means of achieving their objectives. We note that these two regulations were created with the same premise of improving tax compliance but with different outcomes. Further, we argue that IRS created FATCA in order to improve compliance of the ineffective FBAR. In fact we contend that even though these two regulations are separate from each other, the reasoning for the creation of FATCA was the inability of IRS to properly administer and control FBAR. However, with the creation of FATCA, we argue that IRS is now better equipped to ensure compliance.

Key words: FATCA, FBAR, resident alien

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1. Introduction

In this paper we discuss today's forefront of the IRS's agenda - FATCA (Foreign Account Tax Compliance Act) and whether it could substitute or successfully operate in collaboration with the existing FBAR (Foreign Bank Account Report). We note that these two regulations, though overlapping, were created with the same premise of improving tax compliance. This is achieved by requiring individuals/ entities to report specifically defined foreign assets above a certain threshold. By requiring such disclosure, IRS has the right on their discretion to evaluate the origin of such assets to determine whether taxes have been paid on the resources used to generate these assets. In order to provide such discussion we first define these two regulations, their initial premise for creation, and means of achieving their objectives. Furthermore, we argue that IRS created FATCA in order to improve compliance of FBAR. That is, we contend that even though these two regulations are separate from each other, the reasoning for the creation of FATCA was the inability of IRS to properly administer and control FBAR. However, with the creation of

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FATCA, we argue that IRS is now better equipped to ensure compliance. After such discussion is furnished, we proceed with evaluating some of the benefits and costs of these two statutory requirements.

2. Definitions and creation premise/ means for FBAR and FATCA

As a starting point we note that the US tax system is unique as it taxes individuals (residents) on their world-wide income, in particular the income generated within and outside the United States. It is therefore critical to review the definition of US resident per tax code. Per IRS Publication 519 (2013), a person is considered resident if he or she is a US Citizen or "meets either the green card test or the substantial presence test for calendar year" (IRS Publication 519, 2013). There is some ambiguity in the definition of "US Citizen" and therefore, it would not be discussed in this paper. In the following paragraphs, we would briefly list these two tests (green card and substantive presence tests) as per IRS Publication 519 (2013):

Green card test

Person is a resident for tax purposes if he/she is a lawful permanent resident of the United States at any time during calendar year…A person is a lawful permanent resident of the United States at any time if he/she has been given the privilege, according to the immigration laws, of residing permanently in the United States as an immigrant. He/she generally has this status if the U.S. Citizenship and Immigration Services (USCIS) (or its predecessor organization) has issued an alien registration card, also known as a "green card." The person continues to have resident status under this test unless the status is taken away or is administratively or judicially determined to have been abandoned.

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Substantive presence test

Person will be considered a U.S. resident for tax purposes if he/she meets the substantial presence test for calendar year. To meet this test, a person must be physically present in the United States on at least:

1. *31 days during calendar year, and*
2. *183 days during the 3-year period that includes current calendar year and the previous 2, based on IRS provided formula*

Further, IRS Section 25.2501-1(b) (1983) provides that "a resident of the United States is an individual who has his domicile in the United States". The code (Section 25.2501-1(b), 1983) further states:

A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of moving therefrom. Residence without the requisite intention to remain indefinitely will not constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

The above section (25.25.01-1(b)) (1983) of the code is a little bit misleading and it should not be taken as a stand-alone rule of residence. It is the means of initiating the "substantive presence test" to determine if a person should be treated as resident or nonresident. That is, if a person has established residence in the United States, we need to then figure out whether such a person meets the established secondary tests (green card and substantive presence). As we have defined residents, we note that

FATCA and FBAR regulations apply directly to them. The main premise for the creation of FBAR and FATCA was to ensure that such residents properly report their income generated from financial assets located outside of the United States.

As the US system taxes residents on their worldwide income, IRS has indirectly expressed concern that residents have the ability to hide some of their foreign income by opening offshore bank account and not reporting it to the US government (United States. Congress. Senate. Committee on Governmental Affairs. Permanent Subcommittee on Investigations, 2003). These types of activities remain hidden from the IRS and therefore result in non-compliance as the tax system is made so that residents are to be taxed on their worldwide income. In such situations it is almost impossible for the US government to track down on an aggregate basis the compliance of individuals on the reporting of their income. This is the main reasoning for the creation of FBAR and later on the FATCA. The first regulation requires completion of the annual disclosure report for by "US persons" with an interest in, or signatory authority over a foreign financial account, and the aggregate value of those "accounts exceeds $10,000 at any time during the calendar year" (FBAR, 2013). However, in order to achieve compliance, IRS established severe penalties for the failure to report the assets on these accounts when they should have been reported. That is, it created an indirect incentive to residents to self-report and if they did not and they were found to be not in compliance and they face stagnant penalties. However, IRS was still struggling with creating a meaningful mechanism to combat non-compliant individuals. One approach created and executed was to develop voluntary disclosure (such as FBAR disclosure programs) programs with the main premise of learning more about the behavior of individuals (Miller and Faris, 2012). However, even this learning activity did not bring full compliance and the authorities may need "to devote more enforcement resources in order to deal with it amenability" (Miller and Faris, 2012). After many years of learning, IRS came up with its greatest weapon yet – the establishment of FATCA. This new regulation goes a step further by requiring banks that deal with US residents to provide annual information about their account holders. That is, IRS would now be able to compare bank provided information with the resident and if there is a discrepancy, pursue further action. However, once discrepancy is established the question arises of whether penalties for previous noncompliance would trigger the draconian FBAR penalties or more lenient FATCA penalties. In the following paragraphs, we would provide a brief summary of both regulations in respect to individuals reporting requirements.

FBAR

The FBAR reporting requirements are grounded in the Bank Secrecy Act of 1970 (Bank Secrecy Act, 2004). Per this act (which was later amended), it authorizes the Secretary of the Treasury to require residents to keep records and/ or file reports concerning transactions with any foreign agency (Bank Secrecy Act, 2004). The provisions of the Act resulted from Congressional concern that "foreign financial institutions located in jurisdictions having laws of secrecy with respect to bank activity were being extensively used to violate or evade domestic criminal tax and regulatory requirements" (Bank Secrecy Act, 2004). Specifically, here is a key summary of the act, with respect to individuals, per the IRS code (IRS Comparison of Form 8938 and FBAR Requirements, 2013):

Who must File:

Specified individuals, which include US citizens, resident aliens, and certain non-resident aliens that have an interest in specified foreign financial assets and meet the reporting threshold.

Reporting Threshold (Total Value of Assets) 10,000 at any time during the calendar year.

When do you have an interest in an account or asset?

Financial interest: you are the owner of record or holder of legal title; the owner of record or holder of legal title is your agent or representative; you have a sufficient interest in the entity that is the owner of record or holder of legal title.

Signature authority: you have authority to control the disposition of the assets in the account by direct communication with the financial institution maintaining the account.

What is Reported?

Maximum value of financial accounts maintained by a financial institution physically located in a foreign country

How are maximum account or asset values determined and reported?

Use periodic account statements to determine the maximum value in the currency of the account.

Convert to US dollars using the end of the calendar year exchange rate and report in US dollars.

Penalties

Up to $10,000 for failure to disclose and an additional $10,000 for each 30 days of non-filing after IRS notice of a failure to disclose, for a potential maximum penalty of $60,000; criminal penalties may also apply

As noted above, FBAR placed the responsibilities for reporting on the individuals (FBAR, 2013). Specifically, US residents are required to self-report their foreign bank accounts annually on their income tax return. As there are a limited ways for the IRS to ensure that individuals properly report their bank accounts, including "obvious locations such as Switzerland, the Cayman Islands, British Virgin Islands," which creates an inefficient and ineffective system (Wood, 2013). That is, the US government does not have the ability to check whether all US residents are properly reporting their foreign bank accounts. As such, this creates a "catch me if you can" type of a game where, the US government does not have the proper tools to ensure compliance of this regulation. In order to for such program to work, the US government needed to have information furnished by the foreign financial institutions and use this information to match with the US residents self-returns. This is accomplished with the establishment of FATCA.

FATCA

To summarize the Foreign Account Tax Compliance Act (FATCA) is a tax law that has come into effect year end of 2013 with a critical requirement for Americans who have assets located outside of the United States (FATCA Publication 5118, 2013). To ensure that they are disclosing this information with the U.S. and are taking care of their tax liabilities. It requires financial institutions outside the United States to provide information to the US tax authorities regarding accounts held by US nationals. Financial institutions who do not agree to provide this information will suffer a 30% withholding tax on payments of US source income (IRS Publication 515, 2013). Specifically, here is a key summary of the act, with respect to individuals, per the IRS code (IRS Publication 515, 2013) (IRS Comparison of Form 8938 and FBAR Requirements, 2013):

Who must file:

U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities that have an interest in foreign financial accounts and meet the reporting threshold

Reporting Threshold (Total Value of Assets)

50,000 on the last day of the tax year or $75,000 at any time during the tax year (higher threshold amounts apply to married individuals filing jointly and individuals living abroad)

When do you have an interest in an account or asset?

If any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the account or asset are or would be required to be reported, included, or otherwise reflected on your income tax return

What is Reported?

Maximum value of specified foreign financial assets, which include financial accounts with foreign financial institutions and certain other foreign non-account investment assets

How are maximum account or asset values determined and reported?

Fair market value in U.S. dollars in accord with the Form 8938 instructions for each account and asset reported

Convert to US dollars using the end of the taxable year exchange rate and report in US dollars.

Penalties

If non-willful, up to $10,000; if willful, up to the greater of $100,000 or 50 percent of account balances; criminal penalties may also apply

With the establishment of this new regulation, IRS has now the ability to match the residents' self-reporting of financial assets with the foreign institutions. This would ensure that the previously ineffective and inefficient FBAR could operate as desired. That is, if there is no match between what is reported by the individual and foreign financial institution, would be a trigger for further IRS investigation.

3. Analysis

There has been a lot of controversy over tax havens and offshore bank accounts being used by US residents for tax evasion. In an attempt to expose this negative behavior, the United States created the Foreign Account Tax Compliance Act (FATCA) in 2010. As FATCA currently is at its implementation stage, it has become clear that this law will put an unfair burden on certain US residents. In this section we analyze some of the aspects of FATCA.

FATCA will provide critical information to the IRS about US account holders and their foreign financial assets. As a result of the establishment of this regulation, it is expected that it would diminish some of the bank secrecy for US residents with financial assets outside of the United States. This is accomplished by requiring foreign financial institutions to provide IRS with information about foreign accounts of their US customers. Some authorities, especially foreign institutions, are concerned over the unfair financial and regulatory burden this places on them in comparison to their other non-US customers. As previously noted, in order for FATCA to work, many countries need to ratify agreements with the IRS to operate within the constraints of new rules. Some countries are agreeing to do this because they cannot afford to have their current relationship with the United States hit a sour note. Others would just terminate their relationships with US customers (that is close their accounts) and continue to operate as before. However, in either case, there would be a cost incurred by the foreign financial institution, which is either the cost of implementing the new rules or the cost of losing US customers. Each financial institution needs to evaluate the benefits and costs of these before making a determination.

Another cause of concern is whether complying with FATCA would be a starting point for FBAR investigations and penalties. As previously noted, these two regulations are overlapping and it could be argued that once an individual files his/hers FATCA disclosure form, IRS could use this information for its FBAR investigations. In such a scenario, if a person is found to be in non-compliance, the IRS could invoke both FBAR and FATCA penalties. Considering this, we argue that in the near future, depending on the success of the FATCA, IRS would probably eliminate the FBAR altogether and require that individuals comply with only one regulation. This would ensure proper compliance and no further duplications of efforts which is a primary sign of inefficiencies.

Conclusion

In this paper we discussed FATCA (Foreign Account Tax Compliance Act) and we argued that it could successfully operate in collaboration with the existing FBAR (Foreign Bank Account Report). We provided a brief discussion of the two regulations and exclusively noted that they were created with the same premise of improving tax compliance. Furthermore, we contended that even though these two regulations are separate from each other, the reasoning for the creation of FATCA was the inability of IRS to properly administer and control FBAR. However, we argue that with the creation of FATCA IRS is now better equipped to ensure compliance. We also noted that the establishment of such regulations appears justifiable under the current scheme of tax incompliance.

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