

Area of
Focus #4

The IRS's Implementation of FATCA Has in Some Cases Imposed Unnecessary Burdens and Failed to Protect the Rights of Affected Taxpayers

TAXPAYER RIGHTS IMPACTED¹

- *The right to pay no more than the correct amount of tax*
- *The right to privacy*
- *The right to a fair and just tax system*

As a response to IRS and congressional concerns that U.S. taxpayers were not fully disclosing the extent of financial assets held abroad, Congress passed the Foreign Account Tax Compliance Act (FATCA) in 2010.² Many U.S. taxpayers, particularly those living abroad, have incurred increased compliance burdens and costs as a result of FATCA's expanded reporting obligations, most of which repeat existing Report of Foreign Bank and Financial Accounts (FBAR) filing requirements.³ These hardships include additional tax preparation fees and the unwillingness of some foreign financial institutions to do business with U.S. expatriates.⁴

FATCA places substantial day-to-day compliance burdens and costs of implementation on financial institutions. For example, a broad range of U.S.-source payments to a foreign financial institution (FFI) are subject to a 30 percent withholding tax, unless the FFI agrees to provide comprehensive information regarding accounts of U.S. taxpayers.⁵ FATCA further charges withholding agents with the responsibility of determining whether they are obliged to undertake FATCA withholding and implementing it when required.⁶

In turn, FFIs who have reached agreements with the IRS to avoid being subject to systematic withholding must impose withholding on any of their own customers defined as "recalcitrant account holders."⁷ Although FFIs have some latitude in identifying recalcitrant account holders, customers are in jeopardy of

1 See IRS, Taxpayer Bill of Rights, available at <http://www.irs.gov/Taxpayer-Bill-of-Rights>.

2 Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat 71 (2010) (adding Internal Revenue Code (IRC) §§ 1471-1474; 6038D). "U.S. taxpayer" is not a specifically defined term within the IRC. But, for purposes of this analysis, it roughly equates to the term "specified United States person" as defined in IRC § 1473(3).

3 The Currency and Foreign Transaction Reporting Act of 1970, (commonly known as The Bank Secrecy Act) requires U.S. citizens and residents to report foreign accounts on the FinCEN Report 114, *Report of Foreign Bank and Financial Accounts* ("FBAR"). See 31 U.S.C. § 5314(a). National Taxpayer Advocate 2013 Annual Report to Congress 235.

4 Sofia Yan, *Banks Lock out Americans Over New Tax Law*, CNNMONEY (Sept. 15, 2013), available at <http://money.cnn.com/2013/09/15/news/banks-americans-lockout/>; Simon Bradley, *U.S. Expats Feel the Burden of FATCA* (May 28, 2013), available at http://www.swissinfo.ch/eng/politics/US_expats_feel_the_burden_of_FATCA.html?cid=35932576; Tom Geoghegan, *Why Are Americans Giving up Their Citizenship?*, BBC NEWS MAG. (Sept. 26, 2013), available at <http://www.bbc.co.uk/news/magazine-24135021>; Katie Holliday, *HSBC Cuts Ties with US Clients Ahead of FATCA*, INVESTMENT WEEK (July 21, 2011), available at <http://www.investmentweek.co.uk/investment-week/news/2095508/hsbc-cuts-ties-clients-ahead-fatca>.

5 IRC § 1471(a); IRC § 1473(1). IRC § 1471(d)(1)(B) exempts from the reporting and withholding requirements those accounts that are held by individuals at the same FFI and have an aggregate value of \$50,000 or less. Note that an FFI can provide information either as a participating FFI or pursuant to an intergovernmental agreement negotiated between the U.S. and the FFI's home country.

6 IRC §§ 1471-1474; Notice 2013-43, 2013-31 I.R.B. 113.

7 IRC § 1471(b)(1)(D)(i).

facing withholding if they do not provide the FFI with either a Form W-9 to certify they are U.S. persons, or a Form W-8BEN to certify they are foreign persons.⁸

When completing a Form W-9, individuals are generally obligated to provide a Social Security number (SSN).⁹ TAS has received reports these SSNs are becoming increasingly difficult to obtain for U.S. persons residing abroad who do not already have them.¹⁰ This difficulty, caused in part by a limited number of locations where required interviews for obtaining an SSN can occur, only enhances the burden of FATCA withholding and increases the challenges to obtaining a credit or refund of the withholding in the future.¹¹

As part of the 2013 Annual Report to Congress, the National Taxpayer Advocate expressed concerns over the broad sweep of FATCA and the compliance burdens it imposed on individuals and financial institutions.¹² In identifying this issue as a Most Serious Problem, the National Taxpayer Advocate urged the IRS to:

- Gather only the information it would actually use;
- Learn from its experiences with the Offshore Voluntary Disclosure (OVD) programs to more effectively preserve the due process rights of taxpayers; and
- Burden impacted parties as little as possible, consistent with the congressional mandate of FATCA.¹³

The Consequences of FATCA Continue to Fall Heavily on Honest Taxpayers

In her 2013 report, the National Taxpayer Advocate also observed that based on analysis of the data then available “... to this point, the IRS is imposing additional reporting burdens and increased potential penalties primarily on a category of taxpayers that, under principles of quality tax administration, should be encouraged, rather than penalized.”¹⁴ Further review of updated and expanded data from FY 2010 through the present continues to demonstrate the weight of FATCA is being felt not by tax evaders, but by U.S. taxpayers who likely would be compliant regardless. U.S. taxpayers under the FATCA umbrella who must file Form 8938, *Statement of Foreign Financial Assets*, are generally at least as compliant as the overall U.S. taxpayer population. This comparison is shown in the following table:

8 IRS Form W-9, *Request for Taxpayer Identification Number and Certification* (Dec. 2014); IRS Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)* (Feb. 2014).

9 IRC § 6109(a)(1) requires taxpayers to use a taxpayer identifying number on tax returns, statements, or other documents required to be filed, when prescribed by regulations, and the regulations specify that this number must be an SSN unless the individual is ineligible for an SSN or is required to use an employer identification number (Treas. Reg. § 301.6109-1(a)(1)(ii)).

10 Patrick W. Martin, *Urgent Need for U.S. Citizens Residing Outside the U.S. to Be Able to Obtain a Taxpayer Identification Number Other Than a Social Security Number*, State Bar of California, Taxation Section, Discussion Paper, meeting with the National Taxpayer Advocate (May 5, 2015). TAS will further explore the severity of this issue during FY 2016.

11 The Social Security regulations require an in-person interview for all applicants age 12 and older (22 C.F.R. § 422.107). The resulting challenges in obtaining a credit or refund of taxes withheld under FATCA exist equally in the case of taxes withheld under Chapter 3 of the IRC, discussed *infra*.

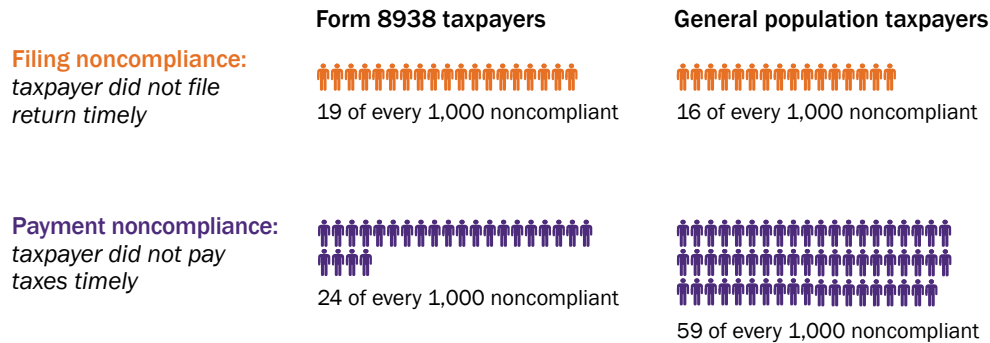
12 See National Taxpayer Advocate 2013 Annual Report to Congress 238-248 (Most Serious Problem: *Reporting Requirements: The Foreign Account Tax Compliance Act Has the Potential to be Burdensome, Overly Broad, and Detrimental to Taxpayer Rights*).

13 *Id.*

14 *Id.* at 241.

FIGURE 3.4.1¹⁵

Noncompliance Rates for Form 8938 Filers vs. General Population Taxpayers



Information reporting can be very useful and influence compliant behavior, provided it is narrowly tailored to accomplish a reasonable result. The National Taxpayer Advocate previously has observed that taxpayers' willingness to meet their reporting and filing obligations is driven more by considerations of personal integrity and perceptions of systemic fairness than by economic deterrence and enforcement measures.¹⁶ To this point, the entire population of FATCA filers have not, to TAS's knowledge, shown themselves to be a group in need of special enforcement procedures. Nevertheless, FATCA starts with the unsubstantiated assumption most taxpayers are bad actors and implements a draconian enforcement regime applied to everyone, even to the vast majority of taxpayers who have been, and likely will continue to be, fully compliant.

As a recommendation to help minimize the burden of FATCA compliance for both individual U.S. taxpayers and businesses, the National Taxpayer Advocate proposed the IRS and Treasury adopt a "same-country exception." This regulatory change would exclude from FATCA coverage financial accounts held in the country in which a U.S. taxpayer is a *bona fide* resident. It would mitigate concerns about the collateral consequences of FATCA raised by U.S. non-residents, reduce reporting burdens faced by FFIs, and allow the IRS to focus enforcement efforts on identifying and addressing willful attempts at tax evasion

15 Data drawn from IRS Compliance Data Warehouse, Individual Return Transaction File (IRTF) Entity and Individual Master File Status History Tables (Mar. 26, 2015). This table uses status code 03 data (Tax Delinquency Investigation) to measure filing compliance and status code 22, 24, and 26 data (Tax Delinquent Account) to measure payment compliance. The analysis covers five tax years from 2009 forward. In addition, FATCA filers appear to have a lower level of reporting noncompliance than the general population because FATCA filers have a lower percentage of high-scoring Discriminant Index Function (DIF) returns in comparison to filers overall. Data drawn April 13, 2015 from IRS Compliance Data Warehouse, IRTF Entity table (Processing Year 2013). High-scoring DIF returns were defined as those with a DIF value that exceeded 80 percent of DIF scores in the general population for a particular Total Positive Income (TPI) class. We calculated a cutoff point for DIF scores at the 80th percentile for each TPI class for Processing Year 2013 and calculated the percentage of FATCA filers in each TPI class that exceeded the DIF cutoff point. Only 16.5 percent of FATCA filers exceeded their respective DIF cutoff points, compared to 20 percent for individual filers in the general population. Thus, FATCA filers showed a lower percentage of "high-scoring" DIF returns than the overall population.

16 National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 134.

through foreign accounts.¹⁷ Nevertheless, to this point, the IRS has not been willing to pursue these recommendations proposed by the National Taxpayer Advocate and supported by other stakeholders.¹⁸

The IRS's Approach to Compliance and Enforcement Is Shifting in Ways That Burden Compliant Non-U.S. Taxpayers

The IRS is developing policies and procedures governing the credit or refund to taxpayers of amounts withheld under FATCA on payments to FFIs or similar institutions (Chapter 4 of the Internal Revenue Code (IRC)). These policies and procedures likewise will apply to amounts withheld on payments of U.S.-source income made directly to non-resident U.S. taxpayers (Chapter 3 of the IRC). As proposed, taxpayers would be entitled to a credit or refund only if they can document that the withholding agent actually deposited the amount withheld with the IRS.¹⁹ Some exceptions to this rule may be available if the amount of the under-deposit of tax is *de minimis*, or if the withholding agent is classified by the IRS as having a demonstrated history of compliance with its deposit requirements. By contrast, the IRS currently accepts creditor-risk in the case of domestic withholding, such as on employment taxes, and taxpayers need only show that the withholding actually occurred to be entitled to a credit or refund from the IRS.²⁰

The IRS argues the shift in enforcement burden now proposed in the international context is necessary as a means of preventing fraud. TAS is unaware of any systematic or rigorous analysis documenting this risk. Moreover, withholding agents, even those active in the international context, are primarily domestic and therefore could be compelled by the IRS to remit the withholding payments they have collected, even where non-resident U.S. taxpayers are involved.²¹ The IRS has far more effective tools and comprehensive resources at its disposal for this type of enforcement than the individual taxpayers to whom this burden would otherwise be allocated. As a result, the National Taxpayer Advocate believes non-resident U.S. taxpayers must still have the right to demonstrate their eligibility for a credit or refund by establishing, to the satisfaction of the IRS, the withholding actually occurred. In addition, TAS is concerned about the IRS's position it would only consider a Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, filed by the withholding agent as valid documentation for verifying the tax has been withheld, and that there are very few – if any – circumstances where a taxpayer can provide alternative documentation.²² TAS will continue advocating, both systemically and through its casework, for the

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17 A workable same country exception would require the development of detailed guidance from the IRS, ideally arrived at in consultation with FFIs and other stakeholders. One potential starting point would be to allow an FFI to accept the self-reporting of its account holders to the extent that this reliance is reasonable under the facts and circumstances known to the FFI.

18 As stated by representatives of organizations of U.S. citizens abroad, accounts opened by U.S. citizens in a foreign country of *bona fide* residence are not “offshore” accounts designed for tax avoidance. These *bona fide* residents have a legitimate need for local banking services in their countries of residence. As a result, only accounts in a country other than one's country of residence should be subject to information reporting. TAS meeting with representatives of the Association of Americans Resident Overseas and the Federation of American Women's Clubs Overseas (Mar. 24, 2014 and Feb. 24, 2015); TAS meeting with Democrats Abroad Task Force on FATCA (Mar. 4, 2014 and Mar. 4, 2015).

19 Notice 2015-10, 2015-20 I.R.B. 965. Whether, in the view of the IRS, the documentation requirement can be met only by providing a properly issued Form 1042-S, or can be satisfied by furnishing other types of evidence, remains unclear.

20 See, e.g., IRC § 31(a).

21 Notice 2015-10, 2015-20 I.R.B. 965.

22 TAS and LB&I Executives teleconference (May 27, 2015).

IRS to consider alternative documentation provided by taxpayers on a case-by-case basis. The IRS should not treat FATCA as the occasion for fundamentally shifting the risk attributable to the improper actions of withholding agents to non-resident U.S. taxpayers, who are least well-positioned to address and remedy such problems.²³

Without persuasive explanation or verifiable justification, the IRS's revised focus under FATCA has transformed Chapter 3 and Chapter 4 tax administration into a system that assumes non-compliance and is dedicated disproportionately to denying unwarranted benefits to the malfeasant few at the cost of the compliant majority who deserve their credits and refunds. In addition to the regulatory changes being contemplated by the IRS, all U.S. taxpayers who file a Form 1040NR requesting a refund of amounts withheld pursuant to FATCA, even those supported by the requisite Form 1042-S, will have the request frozen for up to 168 days, if not longer, while the IRS attempts to match applicable documentation and satisfy itself fraud has not occurred.²⁴ Thus, thousands of compliant U.S. taxpayers will be denied access to their own funds while the IRS tries to marshal its internal resources and detect a relatively few bad actors. The IRS has made provisions to inform U.S. taxpayers who are experiencing "economic harm" as a result of the refund freeze that they can contact TAS for assistance.²⁵ Nevertheless, the IRS has not provided TAS with any specific procedures or protocols that can be followed to assist such U.S. taxpayers and release their funds.

FOCUS FOR FISCAL YEAR 2016

- Update and analyze research and stakeholder concerns regarding the impact and effectiveness of FATCA;
- Encourage the development of mechanisms, such as the "same-country exception," to mitigate the unintended negative consequences of FATCA while perpetuating its broader goals;
- Provide recommendations to the IRS and Treasury regarding the policies and procedures that should govern the credits and refunds of amounts withheld under Chapter 3 and Chapter 4;
- Advocate for U.S. taxpayers experiencing significant hardship as a result of systemic Chapter 3 and Chapter 4 refund freezes and issue Taxpayer Assistance Orders (TAOs) as necessary; and
- Work toward the development of a FATCA regime that gathers only the information actually needed by the IRS, burdens impacted parties as little as possible, and preserves the rights espoused by the IRS in the Taxpayer Bill of Rights, including *the right to pay no more than the correct amount of tax* and *the right to privacy*.

23 The burden of the IRS's contemplated approach with respect to Chapter 3 and Chapter 4 would fall particularly hard on non-residents as the IRS has closed its last overseas offices due to budget cuts, making it more difficult for taxpayers not located in the U.S. to resolve their tax issues. David Kocieniewski, *IRS Will Shut Last Overseas Taxpayer-Assistance Centers*, BLOOMBERG BUSINESS (Jan. 14, 2015), available at <http://www.bloomberg.com/news/articles/2015-01-14/irs-will-shut-last-overseas-taxpayer-assistance-centers>.

24 IRM 21.8.1.11.14.2, *FATCA - Programming Beginning January 2015 Affecting Certain Forms 1040NR (TC 810-3 -E Freeze)* (May 1, 2015). See also IRS SERP Alert 15A0188 (Mar. 23, 2015). The IRS informed taxpayers that those who requested a refund of tax withheld on a Form 1042-S by filing a Form 1040NR will have to wait up to six months from the original due date of the 1040NR return or the date the 1040NR is filed, whichever is later, to receive any refund due. IRS, *What to Expect for Refunds in 2015*, available at <http://www.irs.gov/Refunds/What-to-Expect-for-Refunds-This-Year> (last visited on Apr. 1, 2015). Moreover, as the IRS unilaterally established this systemic refund freeze, taxpayers face the risk that the IRS may seek to extend the refund freeze even further.

25 *Id.* See also IRS SERP Alert 15A0188 (Mar. 23, 2015).