

**SELECTED ISSUES RELATING TO TAX COMPLIANCE WITH
RESPECT TO OFFSHORE ACCOUNTS AND ENTITIES**

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
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Prepared by the Staff
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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing for July 24, 2008 on The Cayman Islands and Offshore Tax Issues. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides information on recent reports and investigations of tax evasion involving financial institutions and entities located in foreign jurisdictions, the self-reporting requirements applicable under present law with respect to interests in foreign trusts and foreign financial accounts, the third-party reporting requirements that apply to foreign financial institutions, including through the Qualified Intermediary (“QI”) program, and potential modifications to those self-reporting and third-party reporting rules.

¹ This document may be cited as follows: Joint Committee on Taxation, *Selected Issues Relating to Tax Compliance With Respect to Offshore Accounts and Entities* (JCX-65-08), July 23, 2008. This document can be found at www.jct.gov.

I. RECENT REPORTS AND INVESTIGATIONS RELATING TO TAX EVASION INVOLVING OFFSHORE ENTITIES AND FINANCIAL INSTITUTIONS

This section describes several recent reports and investigations by the Internal Revenue Service (the “IRS”) and the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the U.S. Senate (the “PSI”) relating to tax evasion by U.S. citizens under circumstances involving offshore entities and financial institutions. At a recent hearing of the PSI, Internal Revenue Service Commissioner Douglas H. Shulman testified that the IRS does not have sufficient data to quantify the level of tax evasion through the use of offshore entities and accounts.² Nonetheless, there is widespread agreement that such evasion presents a significant enforcement challenge.

A. Offshore Credit Card Program and Voluntary Compliance Initiative

In 2000, the IRS initiated the Offshore Credit Card Program (“OCCP”) to identify taxpayers who hide unreported income in offshore bank accounts and access the funds through credits cards issued by those banks. Between 2000 and 2002, the IRS issued a series of summonses to a variety of financial and commercial businesses to obtain information and records relating to U.S. residents who held credit, debit, or other payment cards issued by offshore banks. The IRS used the information and records obtained through those efforts to trace the identities of people using the payment cards.³ As of July 31, 2003, the OCCP had resulted in approximately 2,800 tax returns being selected for audit, a number of which had been referred to the Criminal Investigation Division for possible action.⁴

In January 2003, the IRS announced the Offshore Voluntary Compliance Initiative (“OVCI”) to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements similar to those targeted by the OCCP. Under this program, the IRS waived the civil fraud penalty and certain penalties relating to failure to file information and other returns, including the Report of Foreign Bank and Financial Accounts (“FBAR”),⁵ but taxpayers remained liable for

² Written Testimony of Douglas H. Shulman, Commissioner, Internal Revenue Service, Hearing on Tax Haven Banks and U.S. Tax Compliance Before the Permanent Subcommittee on Investigations, S. Comm. on Homeland Sec. and Governmental Affairs, 110th Cong., July 17, 2008 [hereafter, “Shulman Testimony”].

³ News Release, Internal Revenue Service, IR-2003-95 (July 31, 2003); General Accounting Office, *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Schemes*, GAO-04-50, at 10-11 (Nov. 19, 2003) [hereafter GAO, *Challenges Remain*].

⁴ News Release, Internal Revenue Service, IR-2003-95 (July 31, 2003).

⁵ News Release, Internal Revenue Service, IR-2003-48 (April 10, 2003). Taxpayers wishing to participate in the OVCI program were required to apply before April 15, 2003. The FBAR reporting requirements are discussed in Section II of this document.

back taxes, interest, and certain accuracy-related and delinquency penalties.⁶ The IRS reported that, as of July 31, 2003, it had received OVCI applications from 1,299 taxpayers who paid over \$75 million in taxes and identified over 400 offshore promoters of abusive credit card or other financial arrangements.⁷

⁶ Rev. Proc. 2003-11, 2003-1 C.B. 311; News Release, Internal Revenue Service, IR-2003-5 (Jan. 14, 2003); GAO, *Challenges Remain, supra*, at 12; General Accounting Office, *Testimony of Michael Brostek Before the Committee on Finance, U.S. Senate: Taxpayer Information: Data Sharing and Analysis May Enhance Tax Compliance and Improve Immigration Eligibility Decisions*, GAO-04-972T (Nov. 19, 2003).

⁷ News Release, Internal Revenue Service, IR-2003-95 (July 31, 2003).

B. 2006 Report of the Permanent Subcommittee on Investigations Regarding Tax Haven Abuses

On August 1, 2006, the PSI issued a report (prepared in connection with a hearing held that day) entitled *Tax Haven Abuses: the Enablers, the Tools and Secrecy* (the “2006 PSI Report”).⁸ The report summarized an investigation by the PSI into the roles of offshore and U.S. financial service providers in facilitating the evasion of U.S. tax, securities and anti-money laundering laws by U.S. citizens through arrangements involving offshore entities and accounts.

The report presents a series of case studies illustrating the involvement of certain service providers in establishing foreign corporations and trusts to hide the assets of U.S. taxpayers in tax haven jurisdictions with strict corporate and financial secrecy laws. These entities were managed by trustees, directors, and officers who served as agents of their U.S. clients. For example, in the case of trusts, the report described the use of individuals known as “trust protectors” who, while assigned to monitor the actions of the trustees and ensure that the grantors’ wishes were respected, would in certain cases merely serve as conduits for a client to instruct the trustees, permitting substantial client control of the offshore trust while maintaining an appearance of trustee independence.

In the cases examined by the report, accounts were opened for these offshore entities with offshore financial institutions that used correspondent accounts with U.S. financial institutions to obtain wire transfer services, financing, and brokerage services. Often, the U.S. financial institution was unaware of the identity of the beneficial owner of the funds held by the offshore financial institution. In some cases, however, U.S. financial institutions accepted IRS Forms W-8BEN representing that the offshore entities beneficially owned the account assets (for purposes of claiming an exemption from or reduced rate of U.S. withholding tax), even when the U.S. financial institutions knew that the offshore entities were being directed by, or were closely associated with, U.S. taxpayers. Funds were typically transferred from the offshore accounts to the U.S. clients through the use of ATM cards or credit cards issued by the offshore financial institution, through the use of sham loans to or from the U.S. taxpayer to their offshore entities, or by billing for fictional services. Income received by the U.S. individuals involved in these arrangements was not reported by either the U.S. financial institutions involved or the offshore financial institutions, and the individuals themselves did not report their beneficial interests in the offshore entities and accounts to the IRS.

⁸ S. Hrg. 109-797, 109th Cong., 2d Sess. (August 1, 2006).

C. 2008 Report and Hearing of the Permanent Subcommittee on Investigations

On July 17, 2008, the PSI released a report (prepared in connection with a hearing held that day) entitled *Tax Haven Banks and U.S. Tax Compliance* (the “2008 PSI Report”). The report focuses primarily on two case histories: the business practices of the Liechtenstein Global Trust Group (“LGT”) in Liechtenstein and UBS AG (“UBS”) in Switzerland, both of which are alleged to have facilitated tax evasion by U.S. clients of those institutions.

Liechtenstein Global Trust Group

The report describes practices employed by LGT, a leading Liechtenstein financial institution that is alleged to have assisted U.S. clients in hiding assets offshore during the period from 1998 to 2007. According to the report, those practices included maintaining U.S. client accounts that were not disclosed to U.S. tax authorities; advising U.S. clients to open accounts in the name of Liechtenstein foundations to hide their beneficial ownership of the account assets; advising clients on the use of complex offshore structures to hide ownership of assets outside of Liechtenstein; and establishing “transfer corporations” to disguise asset transfers to and from LGT accounts. According to the report, LGT also advised clients on how to structure their investments to avoid disclosure to the IRS under the QI program.⁹

The LGT inquiry originated with an investigation by German authorities into the role of LGT in facilitating the evasion of German tax.¹⁰ On February 25, 2008, the German authorities announced that they would share the information they had obtained in regard to LGT with authorities in other countries whose residents had utilized Liechtenstein to engage in tax evasion.¹¹ On February 26, the IRS issued a news release stating that it was initiating enforcement actions involving more than 100 U.S. taxpayers to ensure that they properly reported income, and paid taxes, in connection with accounts in Liechtenstein.¹² The news release also stated that the tax authorities in Australia, Canada, France, Italy, New Zealand, Sweden, the United Kingdom, and the United States were working together to address the use of Liechtenstein accounts for tax evasion purposes.

⁹ The QI program is discussed in detail in Section IV of this document.

¹⁰ For additional background on this investigation, see Nicholas Kulish & Carter Dougherty, *Deutsche Post Chief Under Tax Inquiry*, N.Y. Times, Feb. 15, 2008, at C4; Randall Jackson, *The Mouse that Roared: Liechtenstein’s Tax Mess*, 49 Tax Notes Int’l 707 (2008) [hereafter Jackson, *The Mouse that Roared*]; Mark Landler, *Liechtenstein Seeks Man Suspected of Selling Information that Led to Tax Scandal*, N.Y. Times, Mar. 13, 2008, at C3.

¹¹ Jackson, *The Mouse that Roared*, *supra*.

¹² News Release, Internal Revenue Service, IRS and Tax Treaty Partners Target Liechtenstein Accounts, IR-2008-26 (Feb. 26, 2008).

Both the 2008 PSI Report and news accounts of the IRS and other investigations into the conduct of LGT suggest that Liechtenstein's favorable treatment of foundations, together with its bank secrecy laws, was important to LGT's ability to shield client assets from discovery by U.S. and other tax authorities.¹³ In Liechtenstein, according to these accounts, foundations are effectively taxed at a very low rate,¹⁴ are permitted to benefit their founders and their founders' families,¹⁵ and are permitted to open bank accounts in their own names outside Liechtenstein (which provides foundation owners with ready access to cash outside Liechtenstein). Efforts to trace the owners or activities of nonpublic foundations are typically precluded by Liechtenstein's bank secrecy laws. Although these foundations function effectively as foreign trusts, the U.S. clients of LGT who established these foundations apparently did not file Forms 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Foreign Gifts) or 3520-A (Annual Information Return of Foreign Trust with a U.S. Owner), and LGT did not disclose the existence of bank accounts opened by these foundations (whether at LGT or other financial institutions) to the IRS. The U.S. clients also apparently did not file the FBAR form to disclose the existence of these accounts to the Treasury Department.¹⁶

UBS AG

The report also summarizes the PSI staff's findings regarding the practices employed by UBS, based in Switzerland and one of the world's largest financial institutions, to facilitate tax evasion by U.S. clients and avoidance of reporting requirements under the QI program.¹⁷ According to the report, these practices included maintaining "undeclared" accounts in Switzerland for an estimated 19,000 U.S. clients with billions of dollars in undisclosed assets.¹⁸

¹³ See 2008 PSI Report at 36-37; Jackson, *The Mouse that Roared*, *supra*.

¹⁴ Foundations are generally exempt from income taxes in Liechtenstein. However, they are subject to an annual capital tax, which is generally equal to the greater of 0.1 percent of the foundation's capital or CHF 1,000 (approximately U.S. \$980). Other taxes may apply, including a stamp duty on formation (equal to no more than 1.0 percent of taxable capital) and a tax on the transfer of securities (equal to 0.15 percent for Liechtenstein securities and 0.30 percent for foreign securities).

¹⁵ Liechtenstein does not tax distributions to beneficiaries residing outside Liechtenstein.

¹⁶ The Form 3520, Form 3520-A, and FBAR filing requirements are discussed in Section II of this document.

¹⁷ For additional background on the U.S. government's investigation of UBS, see Lynnley Browning, *Ex-Banker from UBS Is Indicted in Tax Case*, N.Y. Times, May 14, 2008, at C3; Press Release, U.S. Department of Justice, Banker Pleads Guilty to Helping American Real Estate Developer Evade Income Tax on \$200 Million, 08-550 (June 19, 2008).

¹⁸ In response to PSI inquiries, UBS estimated that it has about 20,000 accounts in Switzerland for U.S. clients, of which roughly 1,000 are declared accounts and 19,000 are undeclared accounts that had not been disclosed to the IRS. UBS also estimated that those accounts contained assets with a combined value of about \$17.9 billion. However, UBS was unable to specify the breakdown in assets

UBS had voluntarily entered into a QI agreement with the IRS, effective January 1, 2001, under which UBS agreed to identify and document any customers who held U.S. investments or received U.S.-source income in accounts maintained with UBS. Alternatively, if a U.S. customer refused to be identified under the QI agreement, UBS was required to withhold U.S. tax at a 28-percent rate on payments made to the customer, and to bar the customer from holding U.S. investments. The reporting or 28-percent withholding requirements also applied to income from certain non-U.S. investments made as a result of contact with the U.S. client in the United States.

According to the report, many of UBS's U.S. clients refused to be identified, to have taxes withheld, or to sell their U.S. assets as required under the QI agreement. To retain these customers, UBS bankers assisted the customers in concealing their ownership of the assets held in offshore accounts by helping to create nominee and sham entities. These entities were set up in various jurisdictions, including Switzerland, Liechtenstein, Panama, the British Virgin Islands, and Hong Kong. The UBS bankers and their U.S. customers then claimed that the offshore accounts were owned by these nominee and sham entities and were not subject to the reporting requirements imposed by the QI agreement.

On July 1, 2008, a Federal district court in Florida granted the IRS permission to issue a John Doe summons to UBS seeking the names of as many as 20,000 U.S. citizens who were UBS customers for which reporting or withholding obligations may not have been met.

At the 2008 PSI hearing, Mark Branson, Chief Financial Officer, UBS Global Wealth Management and Business Banking, acknowledged in his testimony that compliance failures may have occurred and stated that UBS would take actions to ensure that the types of activities identified in the 2008 PSI Report would not recur. As part of that effort, UBS will no longer provide offshore banking services to U.S. customers; instead, such customers will be provided services only through companies licensed in the United States. Moreover, UBS will no longer permit advisors based in Switzerland to travel to the United States to meet with U.S. customers. Finally, Mr. Branson indicated that UBS would comply with the John Doe summons as it relates to the UBS accounts held by U.S. residents.

between the undeclared and declared accounts, except to note that the amount of assets in the undeclared accounts was much greater than the amount in the declared accounts. 2008 PSI Report at 9.

II. REPORTING REQUIREMENTS FOR INDIVIDUALS WITH AN INTEREST IN OFFSHORE BANK ACCOUNTS AND OFFSHORE TRUSTS

There are two categories of reporting requirements designed to curtail the use of accounts with foreign financial institutions and foreign trust arrangements to facilitate tax evasion by U.S. taxpayers. The first is a series of self-reporting requirements under which U.S. taxpayers are required to disclose to the IRS any beneficial ownership interest in a foreign bank account or foreign trust. Both the Internal Revenue Code¹⁹ and title 31 of the United States Code (the “Bank Secrecy Act”) include provisions that require disclosure by U.S. persons who transfer assets to, and hold interests in, foreign bank accounts and foreign trusts. Those rules are discussed in this section. The second category of reporting requirements, those imposed on financial institutions and other third parties, is discussed in Sections III and IV below.

A. Present Law

Foreign bank accounts

A citizen, resident, or person doing business in the United States is required to keep records and file reports, as specified by the Secretary of the Treasury (the “Secretary”), when that person enters into a transaction or maintains an account with a foreign financial entity.²⁰ In general, individuals must fulfill this requirement by answering a question regarding foreign bank accounts that is contained in Part III of Schedule B of IRS Form 1040. The exact wording of the question on the 2007 Form 1040, Schedule B is: “At any time during 2007, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?” The instructions to Schedule B provide certain exceptions, including for accounts whose combined value was \$10,000 or less during the entire year.

An individual who answers “yes” in response to the question asking whether the individual has an interest in or signature authority over a foreign account(s) exceeding \$10,000 must then file Treasury Department Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (“FBAR”).²¹ This form must be filed by June 30 of the year following the year when the \$10,000 threshold is met.²² The form is mailed to the Department of the Treasury in Detroit and is received and processed by the IRS. The form is not included as part of the income tax return that the individual files with the IRS and is not filed in the same office as the return.

¹⁹ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

²⁰ 31 U.S.C. sec. 5314.

²¹ 31 C.F.R. sec. 103.24.

²² 31 C.F.R. sec. 103.27(c).

The FBAR requires disclosure of any account in which the filer has a financial interest or as to which the filer has signature authority (in which case the filer must identify the owner of the account). Under the instructions to the FBAR, the term “financial interest” includes an account held by an entity where the owner of record or holder of legal title is (1) a corporation in which the U.S. person owns directly or indirectly more than 50 percent of the total value of shares of stock, (2) a partnership in which the U.S. person owns an interest in more than 50 percent of the profits, or (3) a trust in which the U.S. person either has a present beneficial interest in more than 50 percent of the assets or receives more than 50 percent of the current income.²³

Penalties may apply if the FBAR is not timely filed or the information supplied is inaccurate or incomplete. These penalties are imposed under title 31 of the United States Code, rather than the Internal Revenue Code. An individual who willfully fails to file an FBAR may be subject to civil penalties under title 31 equal to the greater of \$100,000 or 50 percent of the amount in the account at the time of the violation.²⁴ An individual who fails to file, but is not willful, may be subject to civil penalties under title 31 equal to \$10,000 for each negligent violation.²⁵ In addition, criminal violations are subject to both monetary penalties and imprisonment.

In April 2003, the Financial Crimes and Enforcement Network (“FinCEN”), an agency of the Department of the Treasury, delegated civil enforcement authority over these penalties to the IRS.²⁶ The delegated authority includes the authority to assess and collect civil penalties.²⁷

²³ According to the instructions to the FBAR, a “financial interest” in a bank, securities, or other financial account in a foreign country means “an interest described in either of the following two paragraphs: (1) A United States person has a financial interest in each account for which such person is the owner of record or has legal title, whether the account is maintained for his or her own benefit or for the benefit of others including non-United States persons. If an account is maintained in the name of two persons jointly, or if several persons each own a partial interest in an account, each of those United States persons has a financial interest in that account. (2) A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is: (a) a person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person; (b) a corporation in which the United States person owns directly or indirectly more than 50 percent of the total value of shares of stock; (c) a partnership in which the United States person owns an interest in more than 50 percent of the profits (distributive share of income); or (d) a trust in which the United States person either has a present beneficial interest in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income.”

²⁴ 31 U.S.C. sec. 5321(a)(5)(C).

²⁵ 31 U.S.C. sec. 5321(a)(5)(B)(i). The penalty may be waived if there is a reasonable cause for the failure to report and if any income from the transaction was properly reported. 31 U.S.C. sec. 5321(a)(5)(B)(ii).

²⁶ 31 C.F.R. sec. 103.56(g). Memorandum of Agreement and Delegation of Authority for Enforcement of FBAR Requirements (April 2, 2003); News Release, Internal Revenue Service, IR-2003-48 (April 10, 2003). Consequently, the IRS now processes the FBARs.

However, the IRS is not authorized to use the procedural or collection rules of the Code. In addition, if the penalty is delinquent for a period of 180 days, the law requires that the debt be transferred to the Secretary, where the Financial Management Service is responsible for such non-tax collections.²⁸

Foreign trusts

In 1996, Congress substantially expanded the Code's information reporting requirements with respect to U.S. persons transferring assets to and receiving distributions from a foreign trust.²⁹ Under the present requirements, taxpayers also must answer a question regarding distributions from, and transfers to, foreign trusts on Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" to this question³⁰ must file Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. A foreign grantor trust with a U.S. owner files a Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner. Generally, the appropriate form is required if the taxpayer received a distribution from a foreign trust or the taxpayer was the grantor or transferor to a foreign trust.³¹ The form must be filed by the 15th day of the third month after the end of the trust's taxable year.

Penalties may apply if the Form 3520 or 3520-A is not timely filed or the information supplied is inaccurate or incomplete.³² The penalties are imposed by the IRS under the Code. Generally, the penalty is 35 percent of the gross value of the property transferred to the foreign trust for failure by the U.S. transferor to report the transfer,³³ 35 percent of the gross value of the property distributed by the foreign trust to the U.S. beneficiary for failure to report receipt of the

²⁷ A penalty may be assessed before the end of the six-year period beginning on the date of the transaction with respect to which the penalty is assessed. 31 U.S.C. sec. 5321(b)(1). A civil action for collection may be commenced within two years of the later of the date of assessment and the date a judgment becomes final in any a related criminal action. 31 U.S.C. sec. 5321(b)(2).

²⁸ 31 U.S.C. sec. 3711(g).

²⁹ The Small Business Job Protection Act of 1996 (Pub. L. No. 104-188) made substantial changes to the tax law governing foreign trusts in response to concerns of taxpayer abuse. The Act expanded information reporting requirements for U.S. persons making transfers to foreign trusts (and for U.S. owners of foreign trusts), added new reporting requirements for U.S. beneficiaries of foreign trusts, revised the civil penalties for failure to file information with respect to foreign trusts, and added civil penalties for failure to report certain transfers to foreign entities.

³⁰ The exact wording of the question on 2007 Form 1040, Schedule B is: "During 2007, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust?"

³¹ Sec. 6048.

³² Secs. 6677 and 6039F.

³³ Secs. 6048(a) and 6677(a).

distribution,³⁴ or five percent of the amount of certain foreign gifts for each month for which the failure to report continues (not to exceed a total of 25 percent).³⁵

³⁴ Secs. 6048(c) and 6677(a).

³⁵ Sec. 6039F. In the case of persons required to file Form 3520, the penalty is equal to 35 percent of the “gross reportable amount.” In the case of a U.S. owner of a foreign grantor trust under sections 671 through 679, the penalty is equal to five percent of the “gross reportable amount.” Secs. 6048(b) and 6677(b). In general, the gross reportable amount is the gross value of property transferred to the trust, the gross value of the portion of the trust’s assets at the close of the year that is treated as owned by a U.S. person, or the gross amount of distributions received from the trust. In the case of any failure to report that continues for more than 90 days after the IRS mails notice of such failure, an additional penalty of \$10,000 applies for each 30-day period (or fraction thereof) during which the failure continues. The total penalties with respect to any failure may not exceed the gross reportable amount. The penalties may be waived if due to reasonable cause and not willful neglect. Secs. 6677(d) and 6039F(c)(2).

B. Discussion

On April 26, 2002, the Secretary submitted “A Report to Congress in Accordance with § 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act).” In its report, the Secretary noted that FBAR filings increased by almost 52 percent from 1991 to 2001 (116,600 FBAR filings in 1991 and 177,151 FBAR filings in 2001). However, the Secretary also estimated that there may have been as many as one million U.S. taxpayers in 2002 who had signature authority or control over a foreign bank account and were required to file FBARs. As a result, the Secretary estimated that the compliance rate with respect to FBAR filing requirements might have been less than 20 percent based on the available information.³⁶

Since 2001, the number of FBAR filings has increased by almost 82 percent (322,414 FBAR filings in 2007).³⁷ As a result, the number of U.S. persons with an interest in foreign bank accounts is substantial and appears to have grown significantly in recent years.³⁸

The IRS currently is providing education outreach as a result of the April 2003, delegation of authority for civil enforcement from FinCEN. In addition, the IRS has issued Publication 4261, entitled “Do You Have a Foreign Bank Account?” in order to remind foreign account holders of the reporting requirements. The publication is available on the IRS website and is provided to tax practitioners, brokers and banks.

There appear to be three categories of U.S. individuals who currently are not filing the FBAR and Form 3520s as required by law. The first category consists of those taxpayers who fail to file because of a lack of knowledge or confusion about the filing requirements. It has been suggested that improving the instructions to the forms and imposing a due diligence requirement on return preparers could help to alleviate much of the lack of knowledge and confusion.

The second category of taxpayers who fail to file consists of those who are concealing income or possibly engaged in some kind of criminal activity. For these taxpayers, neither changes to the instructions of the FBAR (or Form 3520), nor imposing a due diligence requirement on return preparers, is likely to have a meaningful effect on increasing the compliance rate as to FBAR filings and Form 3520 filings. The Secretary has noted that, for this

³⁶ The Secretary has acknowledged that this is only a rough approximation of the compliance rate because of the difficulty in determining whether the amounts held in the offshore accounts exceed the \$10,000 threshold. Secretary of the Treasury, “A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)” (April 8, 2005).

³⁷ News Release, Internal Revenue Service, IR-2008-79 (June 17, 2008).

³⁸ Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, at 378; see also Statement of Eileen J. O'Connor, Assistant Attorney General, Tax Division, Before the Committee on Finance, United States Senate, Concerning “Corporate and Partnership Enforcement Issues” (June 13, 2006).

category of non-compliant taxpayers, “achiev[ing] deterrence . . . will require a series of highly publicized criminal actions against intentional violators in order to raise the cost of being an FBAR scofflaw.” Recently, Congress, as part of the American Jobs Creation Act of 2004,³⁹ enacted an additional penalty regime with respect to FBAR filings in an attempt to increase compliance. The new regime applies a monetary penalty without regard to willfulness. It is too soon to determine whether compliance has increased as a result of the new penalty regime.

The third category of taxpayers who fail to file consists of those who structure transactions, usually with advice from lawyers or accountants, in a manner that is intended to avoid the filing requirements. Generally, these transactions violate the intent of the filing requirements while arguably falling outside the literal filing requirements.

For example, assume a U.S. citizen organizes a Cayman Island company that has a bank account in its name over which the U.S. citizen has signature authority. Assume further that the bank account is set up in Miami at the international division of a U.S.-based bank, and the funds in the account are accessed through the Cayman Islands branch of the same U.S.-based bank. In this circumstance, the U.S. citizen may take the legal position that the bank account is not a “financial account in a foreign country” because the account is located in the United States and not in a foreign country. The U.S. citizen, therefore, may take the position that he is not required to file an FBAR for the account.

The proposals described below would expand the number of transactions subject to the filing requirements by adding accounts and interests in accounts held “directly or indirectly” by taxpayers and thus should include a greater number of transactions within the foreign bank and foreign trust reporting requirements.

As stated above, one of the most significant recent developments in increasing compliance for FBAR filings is the April 2, 2003, delegation of civil enforcement authority from FinCEN to the IRS. Prior to that delegation, the Secretary had delegated examination authority for FBAR compliance to the IRS but had delegated to FinCEN the authority to assess civil penalties for violation of the FBAR filing requirements. As a result, if a taxpayer refused to pay the penalty, FinCEN referred the matter to the Department of Justice, which instituted an action against the taxpayer in which the liability and the amount of the penalty were litigated. In a memorandum dated April 2, 2003, FinCEN delegated all of its civil enforcement authority with respect to FBAR filings to the IRS.⁴⁰ As a result, the IRS can “create interpretive education outreach materials for the FBAR, revise the form and instructions, examine individuals and other entities, and assess civil penalties for violations.”⁴¹ It is too early to determine whether the

³⁹ Pub. L. No. 108-357 (2004).

⁴⁰ Memorandum of Agreement and Delegation of Authority for Enforcement of FBAR Requirements (April 2, 2003).

⁴¹ Secretary of the Treasury, “A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)” (April 8, 2005).

delegation of authority from FinCEN to the IRS with respect to civil enforcement authority has increased compliance with FBAR filing requirements.

C. Proposals to Enhance Foreign Bank Account and Foreign Trust Reporting

Joint Committee on Taxation Staff Proposal

On August 3, 2006, the staff of the Joint Committee on Taxation prepared a report for then-Chairman Grassley and Ranking Member Baucus of the Senate Finance Committee, entitled “*Additional Options to Improve Tax Compliance.*”⁴² The report contains a proposal intended to enhance FBAR compliance (the “JCT proposal”). There are two parts to the proposal. The first is a legislative change relating to income tax return preparers, and the second involves recommendations for administrative changes relating to the FBAR. The Secretary appears to have the power currently to implement these administrative changes. The proposal directs the Secretary to implement them as promptly as possible.

Legislative changes

Under the JCT proposal, income tax return preparers would be subject to a statutory due diligence requirement, similar to that in section 6695(g) of present law, relating to the earned income credit,⁴³ in determining whether the preparer’s client is required to file an FBAR or Form 3520. As a result, the return preparer would be required to explain to the client the reporting requirements pursuant to the FBAR and Form 3520, the meaning of the various terms (such as “financial interest” and “signature authority”) that are used in determining whether the forms are required to be filed, and the applicable penalties, civil and criminal, if the client negligently or willfully fails to file the forms when required to do so. In addition, the return preparer would be required to document the client’s responses and retain the documentation for possible use in any audit with respect to the client’s income tax return for the year.

The detailed due diligence requirements would be specified in Treasury regulations. It might also be appropriate to consider a minimum income threshold, so that the preparer due diligence requirements would not be applicable with respect to taxpayers who have adjusted gross income below a certain threshold or, perhaps, with respect to those taxpayers eligible to file Form 1040EZ (or Form 1040A). The amount of the preparer’s penalty for failure to follow the due diligence rules would be specified in the statute, but should be substantially greater than the \$100 penalty for failures with respect to the earned income credit.

⁴² The report was released on the Senate Finance Committee website on October 19, 2006.

⁴³ In 1997, Congress enacted section 6695(g), which imposes a due diligence requirement on income tax return preparers with respect to the earned income credit. Under that section, the preparer is subject to a \$100 penalty for each failure if the preparer fails to comply with the due diligence requirements imposed by the Secretary by regulations with respect to determining the eligibility and the amount of the earned income credit.

Recommended administrative changes

The Treasury Department and the IRS have indicated that they intend to revise the reporting requirements with respect to U.S. persons holding an interest in a foreign bank account, but those revisions have not yet been made.⁴⁴ The JCT proposal would require the FBAR form and its accompanying instructions to be updated so that the form itself is not an obstacle to compliance. Specifically, the form would be required to use updated terminology and to clarify how the filing requirement applies to new types of financial transactions. In addition, the form would be revised in a manner to encompass transactions that should be reported but may arguably fall outside the literal language of the instructions.

For example, under the instructions, the term “financial interest” includes an account held by an entity where the owner of record or holder of legal title is (1) a corporation in which the U.S. person owns directly or indirectly more than 50 percent of the total value of shares of stock, (2) a partnership in which the U.S. person owns an interest in more than 50 percent of the profits, or (3) a trust in which the U.S. person either has a present beneficial interest in more than 50 percent of the assets or receives more than 50 percent of the current income. Under the proposal, the definition of “financial interest” in the instructions would be expanded to include an account held by a corporation in which a U.S. person owned, directly or indirectly, more than 50 percent of the value “or the voting power” of the corporation. A financial interest would also include a partnership in which the U.S. person owns an interest, “either directly or indirectly,” in more than 50 percent of the profits “or capital of the partnership.” The revised instructions would also address the situation in which a partnership that permits special allocations could be used to allocate more than 50 percent of the income from the account to a partner who has a 50 percent or less interest in the partnership (by profits or capital). In addition, the definition of “financial interest” would be expanded to include an account held by the trustee (for the benefit of the trust) or by a U.S. person who has a beneficial interest, “either directly or indirectly,” in more than 50 percent of the trust’s assets.

The JCT proposal would also require that the FBAR instructions be expanded to cover foreign trusts established by U.S. persons for which a trust protector, usually a foreign person, is appointed. Under the JCT proposal, the duties and powers of the trust protector would be attributed to the U.S. person for FBAR reporting purposes. A trust protector is a third party who is responsible for monitoring the trustee’s activities and can replace the trustee under certain specified conditions. A trust protector sometimes is used to prevent the U.S. person from having (or appearing to have) signature or other authority, as presently defined for FBAR reporting purposes.⁴⁵

⁴⁴ Treasury Department Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, was last revised in July 2000. On March 16, 2006, the Department of the Treasury and the IRS issued a request for comments on proposed changes to the form and instructions. 71 Fed. Reg. 13674. The proposed changes include additional information regarding joint accounts, the elimination of certain duplicate information, and a clarification of the term “United States person.”

⁴⁵ According to the instructions to the FBAR, a person has “signature authority” over an account “if such person can control the disposition of money or other property in it by delivery of a document

Administration Proposal

As part of its Fiscal Year 2009 Budget, the Bush Administration proposed that the Code provisions imposing a penalty for failure to file Form 3520 be amended to impose an initial penalty equal to the greater of \$10,000 or 35 percent of the gross reportable amount (if the gross reportable amount is known). The additional \$10,000 penalty for continued failure to report would remain unchanged. Thus, even if the gross reportable amount is not known, the IRS would be able to impose a \$10,000 penalty on a person who fails to report timely or correctly as required and would be able to impose a \$10,000 penalty for each 30-day period (or fraction thereof) that the failure to report continues. If a person provided enough information for the IRS to determine the gross reportable amount, the total penalties would be capped at the gross reportable amount as under current law and any excess penalty already paid would be refunded.

In some cases, a third-party may provide the IRS with information that certain persons are not complying with the foreign trust reporting requirements. In such cases, although the IRS may be aware of noncompliance by a particular person, the IRS may not have sufficient information to determine the gross reportable amount and calculate the appropriate penalties. This makes imposition of the penalties problematic and impedes the ability of the IRS to enforce the reporting requirements and related trust provisions.⁴⁶ By ensuring that the IRS can assess penalties, notwithstanding a gap in its available information, the proposal would assist the IRS in its enforcement of the reporting requirements and related foreign trust provisions. More generally, by increasing the expected cost of failing to comply with the foreign trust reporting requirements, the proposal may increase compliance by those persons who are required to report, but who choose not to based on the belief that detection is unlikely. The proposal is unlikely to affect the behavior of those who successfully structure a transaction to avoid the reporting requirements or those engaging in criminal activity.

Other Proposals

In addition to the proposals discussed above, several other proposals have been advanced to facilitate IRS enforcement of FBAR requirements. For example, taxpayers could be required to file FBAR forms with their Form 1040 or 1120 tax returns.⁴⁷ The statute of limitations for payment of taxes with respect to any event or period to which FBAR information relates could be extended to a date that is three years after the date on which the taxpayer furnishes such

containing his or her signature (or his or her signature and that of one or more other persons) to the bank or other person with whom the account is maintained.”

“Other authority” exists in a person “who can exercise comparable power over an account by direct communication to the bank or other person with whom the account is maintained, either orally or by some other means.”

⁴⁶ See sec. 7491(c) (providing that Secretary has the burden of production in any court proceeding with respect to the liability of any individual for any penalty).

⁴⁷ Cf. sec. 6038 (relating to Form 5471).

information.⁴⁸ Some or all of the title 31 FBAR provisions could be duplicated in the Code, in order to provide that the IRS may collect penalties using the legal means specified in the Code.⁴⁹

⁴⁸ Cf. sec. 6501(c)(8). The Government Accountability Office has suggested that the IRS may need additional time to complete offshore examinations. Government Accountability Office, *Tax Administration: Additional Time Needed to Complete Offshore Tax Evasion Examinations*, GAO-07-237 (Mar. 30, 2007).

⁴⁹ See chapter 68, subchapter B of the Code (providing that the IRS may assess and collect certain specified penalties upon notice and demand, in the same manner as taxes); chapter 64 of the Code (providing for collection of taxes).

III. FINANCIAL INSTITUTION REPORTING ISSUES

To promote compliance, the U.S. tax rules include broad third-party information reporting requirements. In general, under these requirements persons who make payments to other persons as part of a trade or business must report those payments to the IRS. This section provides an overview of certain U.S. information reporting rules, particularly as those rules apply to payments of investment income by foreign financial institutions to U.S. customers.

A. Background

Every person engaged in a trade or business must file with the IRS an information return on Form 1099 (or, for wages or other compensation, on Form W-2) for payments of certain amounts totaling at least \$600 that it makes to another person in the course of its trade or business.⁵⁰ Detailed rules are provided for the reporting of various types of investment income, including interest, dividends, and gross proceeds from brokered transactions (such as a sale of stock).⁵¹ In general, the requirement to file Form 1099 applies with respect to amounts paid to U.S. persons and is linked to the backup withholding rules of Section 3406. Thus, a payor of interest, dividends, or gross proceeds generally must request that a U.S. payee (other than certain exempt recipients) furnish a Form W-9 providing that person's name and taxpayer identification number.⁵² That information is then used to complete the Form 1099.

If a Form W-9 is not provided, the payor is required to "backup withhold" tax at a rate of 28 percent of the gross amount of the payment.⁵³ The backup withholding tax may be credited by the payee against regular income tax liability, i.e., it is effectively an advance payment of tax, similar to the withholding of tax from wages. This combination of reporting and backup withholding is designed to ensure that U.S. persons pay an appropriate amount of tax with respect to investment income, either by providing the IRS with the information that it needs to audit payment of the tax or, in the absence of such information, requiring collection of the tax on payment.

Amounts paid to foreign persons are generally exempt from information reporting on Form 1099, because they are subject to a separate information reporting requirement linked to the nonresident withholding provisions of chapter 3 of the Code. Under those rules, amounts of U.S. source "fixed and determinable annual or periodic" income, including interest, dividends, and similar types of investment income, that are paid to foreign persons are subject to withholding at a 30 percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding (for example, the portfolio

⁵⁰ Sec. 6041; Treas. Reg. secs. 1.6041-1, 1.6041-2.

⁵¹ Secs. 6042 (dividends), 6045 (broker reporting), and 6049 (interest) and the Treasury regulations thereunder.

⁵² See Treas. Reg. sec. 31.3406(h)-3.

⁵³ Sec. 3406(a)(1).

interest exemption) or a reduced rate of withholding under an income tax treaty.⁵⁴ Typically a foreign person must provide an IRS Form W-8BEN, W-8ECI, W-8EXP or W-8IMY⁵⁵ to a withholding agent in order to establish foreign status and eligibility for an exemption or reduced rate. Provision of this form also establishes an exemption from information reporting on Form 1099 and backup withholding.⁵⁶ A withholding agent that makes payments of U.S. source amounts to a foreign person is required to report those payments, including any amounts of U.S. tax withheld, to the IRS on Forms 1042 and 1042-S.⁵⁷

In the case of U.S. source investment income, the information reporting, backup withholding and nonresident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.⁵⁸ As a practical matter, however, these reporting and withholding requirements are difficult to enforce with respect to foreign financial institutions, unless they have some connection to the United States, e.g., a foreign subsidiary of a U.S. financial institution, or a foreign financial institution that is doing business in the United States. Moreover, to the extent that these rules apply to foreign financial institutions, the rules may also be modified by QI agreements between the institutions and the IRS.⁵⁹ In the case of foreign source investment income, special rules apply as described below.

⁵⁴ See Treas. Reg. sec. 1.1441-1(b).

⁵⁵ The Form W-8BEN is filed by a beneficial owner of U.S. source non-effectively-connected income. The Form W-8ECI is filed by a beneficial owner of U.S. source effectively-connected income. The Form W-8EXP is filed by a beneficial owner of U.S. source income that is an exempt organization or foreign government. The Form W-8IMY is filed by a payee that is receiving a payment of U.S. source income as an intermediary for the beneficial owner. The Form W-8IMY must be accompanied by a Form W-8BEN, W-8EXP, or W-8ECI, as applicable, furnished by the beneficial owner, unless the intermediary is a qualified intermediary. The rules applicable to qualified intermediaries are discussed in Section IV below.

⁵⁶ See Treas. Reg. sec. 1.1441-1(b)(5).

⁵⁷ Treas. Reg. sec. 1.1461-1(b), (c).

⁵⁸ See Treas. Reg. secs. 1.1441-7(a) (definition of withholding agent includes foreign persons), 31.3406(a)-2 (payor for backup withholding persons means the person (the payor) required to file information returns for payments of interest, dividends, and gross proceeds (and other amounts), 1.6049-4(a)(2) (definition of payor for interest reporting purposes does not exclude foreign persons), 1.6042-3(b)(2) (payor for dividend reporting purposes has the same meaning as for interest reporting purposes), and 1.6045-1(a)(1) (brokers required to report include foreign persons).

⁵⁹ The QI program is described in Section IV.

B. Reporting Requirements Under Present Law

Reporting of foreign-source amounts generally

Special reporting rules apply when payments are made by non-U.S. persons and when amounts potentially subject to reporting are foreign source. Under these rules, information returns generally are not required for payments of amounts otherwise subject to reporting under section 6041 (which provides the basic reporting rules for payments of \$600 or more other than interest, dividends, and other amounts subject to special reporting rules) when the payments are of foreign-source amounts and are made by a non-U.S. payor or non-U.S. middleman outside the United States.⁶⁰ A person is a non-U.S. payor or a non-U.S. middleman if the person is not a U.S. citizen or resident or a domestic corporation, partnership, trust, or estate; is not the U.S. government or a State or local government; is not a controlled foreign corporation; is not a foreign partnership that is more than 50-percent owned by U.S. persons or that is engaged in a U.S. trade or business; is not a foreign person half or more of the gross income of which (over a three-year period) is effectively connected with the conduct of a U.S. trade or business; and is not a U.S. branch of a foreign bank or insurance company.⁶¹ An amount is considered to be paid outside the United States if the acts necessary to effect payment are completed outside the United States.⁶² This rule is described in more detail immediately below.

Interest reporting

In general, every person who makes payments of interest totaling \$10 or more to any other person in a calendar year must file a Form 1099 with the IRS reporting the amount of the payments and the name and address of the person to whom the interest is paid.⁶³ This general requirement is subject to various exceptions, including an exception when the interest is from sources outside the United States and is paid outside the United States by a non-U.S. payor or a non-U.S. middleman.⁶⁴ The definitions of non-U.S. payor and non-U.S. middleman are the same as those described above, as is the general rule for whether an amount is considered to be paid outside the United States.

Detailed rules for whether amounts are considered to be paid outside the United States apply when the amounts are paid with respect to deposits or accounts with banks and other financial institutions. Generally, an amount paid by a bank or other financial institution in

⁶⁰ Treas. Reg. sec. 1.6041-4(a)(2).

⁶¹ Sec. 6049-5(c)(5)(i). For the definitions of payor and middleman, see Treas. Reg. sec. 1.6049-4(a)(2), (f)(4)(i). In general, a middleman is a person who makes a payment or collects an amount (interest, for example) on behalf of another person.

⁶² Treas. Reg. sec. 1.6049-5(e)(1).

⁶³ Sec. 6049(a); Treas. Reg. sec. 1.6049-1(a)(1).

⁶⁴ Sec. 6049(b)(2)(B)(ii), (b)(5)(B)(i); Treas. Reg. sec. 1.6049-5(b)(6).

respect of a deposit or in respect of an account with the institution is considered to be paid at the branch or office at which the amount is credited.⁶⁵ An amount is not, however, considered to be paid at the branch or office at which the amount is credited unless the branch or office is a permanent place of business that is regularly maintained, occupied, and used to carry on a banking or similar financial business; the business is conducted by at least one employee of the branch or office who is regularly in attendance at that place of business during normal business hours; and the branch or office receives deposits and conducts one or more of the other activities listed in Treas. Reg. section 1.864-4(c)(5)(i) (requirements for being considered to be engaged in the active conduct of a banking, financing, or similar business).⁶⁶ An amount paid by a bank or other financial institution also is not considered to be paid at a branch or office outside the United States if the customer has transmitted instructions to an agent, branch, or office of the institution by mail, telephone, electronic transmission, or otherwise concerning the deposit or account – unless the transmission from the United States has occurred only in isolated and infrequent circumstances.⁶⁷

The regulations governing when interest is considered to be paid in the United States are illustrated by several examples. One example concerns the isolated and infrequent transmission rule just described:

Individual C deposits funds in an account with FB, a foreign country X branch of DB, a U.S. corporation engaged in the commercial banking business. FB maintains an office and employees in foreign country X, accepts deposits, and conducts one or more of the other activities listed in §1.864-4(c)(5)(i). The terms of C's deposit provide that it will be payable in six months with accrued interest. On the day that the interest is credited to C's account with FB, C telephones DB from inside the United States and asks DB to direct FB to transfer the funds in his account with FB to an account C maintains in the United States with DB. Transmissions from the United States concerning this account have taken place in isolated and infrequent circumstances. Under paragraph (e)(2) of this section, FB is considered to have paid the interest on C's deposit outside the United States.⁶⁸

By contrast, interest would be considered to be paid in the United States if C's deposit were placed with FB for an indefinite period of time, interest were credited to C's account daily, and C instructed FB to wire the interest every 90 days to C's account with DB within the United States. In that case, the regular crediting of C's account would disqualify the transmission from being isolated or infrequent.⁶⁹

⁶⁵ Treas. Reg. sec. 1.6049-5(e)(2).

⁶⁶ Id.

⁶⁷ Id.

⁶⁸ Treas. Reg. sec. 1.6049-5(e)(4), Example (5).

⁶⁹ Id., Example (6).

Interest also is treated as paid within the United States in the following situation, presumably because all operations of a foreign branch of a U.S. bank are carried out in the United States and the interest in question is credited by employees of the U.S. bank:

FB is recognized by both foreign country X and by the Federal Reserve Bank as a foreign country X branch of DC, a U.S. corporation engaged in the commercial banking business. A local foreign country X bank serves as FB's resident agent in country X. FB maintains no physical office or employees in foreign country X. All the records, accounts, and transactions of FB are handled at the United States office of DC. E deposits funds in an amount maintained with FB. Interest earned on the deposit is periodically credited to E's account with FB by employees of DC.⁷⁰

Dividend reporting

In general, every person who pays to any other person during a calendar year dividends totaling \$10 or more or who receives as a nominee and pays to another person dividends totaling \$10 or more must file a Form 1099 with the IRS showing the aggregate amount of the payments and the name and address of the person to whom the dividends are paid.⁷¹

There are several exceptions to the general requirement to report dividend payments. One exception applies to dividends paid by a foreign corporation.⁷² Distributions or payments from non-U.S. sources paid outside the United States by a non-U.S. payor or a non-U.S. middleman generally are not considered dividends required to be reported.⁷³ The rules for determining whether amounts are considered paid outside the United States are the same as those described previously.

Capital gains

In general, a broker that effects sales of securities or other property for customers is required to report to the IRS the gross proceeds from sale transactions.⁷⁴ The term "broker" is defined broadly to include both U.S. and foreign persons.⁷⁵ There are, however, certain exceptions from the definition of a broker. In particular, for a sale effected at an office outside the United States, a broker includes only a U.S. payor or U.S. middleman. A sale of stock

⁷⁰ Id., Example (8).

⁷¹ Sec. 6042(a)(1); Treas. Reg. sec. 1.6042-1(a)(1).

⁷² Sec. 6042(b)(2)(A)(i).

⁷³ Sec. 1.6042-3(b)(1)(iv). Dividends paid by foreign corporations generally are considered foreign-source. See secs. 861(a)(2), 862(a)(2).

⁷⁴ Sec. 6045(a); Treas. Reg. sec. 1.6045-1(c).

⁷⁵ Treas. Reg. sec. 1.6045-1(a)(1).

carried out by a foreign broker entirely outside the United States therefore generally is not subject to gross proceeds reporting.

C. Discussion

While the information reporting regime under present law is broad in the strictly domestic context, it is significantly narrower in the case of transactions involving foreign financial institutions and foreign-source income. In particular, if, for example, a U.S. person is paid interest by a non-U.S. bank outside the United States (and other requirements, such as that the office at which the interest is credited regularly carries on a banking business, are satisfied), the bank generally is not required to report the interest payment unless the U.S. person has transmitted instructions to the bank in more than isolated and infrequent circumstances. In light of the experiences with offshore accounts that led to the Offshore Credit Card Program and the Offshore Voluntary Compliance Initiative, as well as the abusive transactions documented in the 2006 PSI Report, Congress may wish to consider whether it would be appropriate to expand the information reporting rules so that they cover this transaction or other classes of transactions that involve U.S. customers and foreign financial institutions but that are not subject to present-law reporting requirements.

In considering whether the information reporting regime should be expanded in the foreign context, Congress should consider the extent to which any rules present problems of enforcement. Under present law, it may currently be difficult to enforce the requirement to report when, for instance, the only connection a foreign bank has to the United States is that it serves a U.S. customer and receives instructions from that customer. For several reasons, this difficulty could be heightened if a foreign bank were required to report, for example, all payments to U.S. customers or all payments made to a U.S. address. First, a foreign bank with no connection to the United States other than a customer base might simply refuse to comply with reporting rules, and it would be difficult for the IRS to discover the arrangement if a U.S. customer did not self-report payments it received from the foreign bank. Second, even if a bank made a good faith effort to comply with reporting requirements, a U.S. customer might arrange to hold an account through a foreign entity or might arrange to have any communications sent to a non-U.S. address. Particularly in an age when the Internet facilitates transacting significant business online, it may be difficult for the IRS to establish a U.S. connection. Third, if the IRS were able to enforce broadened requirements to report payments to U.S. customers, the requirements might be avoided if U.S. individuals were willing to hold accounts that generated no payments – non-interest bearing accounts, for example. A U.S. individual who has received unreported income – cash payments from the operation of a business, for instance – and is determined to evade U.S. tax on that income, might be willing to forgo interest payments if doing so would make it easier to hide the arrangement from the IRS.

Congress may wish to consider several general approaches to addressing enforcement challenges. First, to address the enforcement problems created when U.S. individuals hold accounts with foreign financial institutions through foreign entities, Congress may wish to examine whether rules requiring financial institutions to inquire into and report U.S. beneficial ownership might appropriately be broadened. Second, to address the enforcement problems created if U.S. individuals hold non-interest bearing foreign accounts, Congress might consider whether requiring asset-based reporting in some circumstances might be justified. Third, and more broadly, Congress might ask whether effective enforcement of existing or expanded information reporting rules could be enhanced by the use of non-tax rules and non-tax law enforcement strategies. A non-tax approach could include possible changes to domestic non-tax

laws and also joint undertakings with foreign governments in areas such as securities law and money laundering.

In considering changes to reporting rules and enforcement strategies in the foreign context, Congress should examine whether changes could have harmful or unintended consequences. Expanding reporting rules may increase costs for financial institutions and other businesses, and increased costs could be borne by individual customers of those institutions or by taxpayers more broadly. Moreover, Congress may wish to consider whether expanding foreign-based reporting rules might deter legitimate financial arrangements. In particular, it should be asked whether rules intended to prevent U.S. individuals from avoiding or evading tax might discourage non-U.S. individuals from investing in the United States.

IV. QUALIFIED INTERMEDIARY PROGRAM

A. Background

In addition to the general information reporting and withholding rules described in Section III above with respect to foreign financial institutions, Treasury regulations provide special rules for QIs.⁷⁶ A QI is defined as a foreign financial institution or a foreign clearing organization, other than a U.S. branch or U.S. office of such institution or organization, which has entered into a withholding and reporting agreement (a “QI agreement”) with the IRS.⁷⁷ In exchange for entering into a QI agreement, the QI is able to shield the identities of its customers from the IRS and other intermediaries (for example, other financial institutions in the chain of payment that may be business competitors of the QI) in certain circumstances and is subject to reduced information reporting duties compared to those that would be imposed in absence of the agreement. In particular, a foreign financial institution that becomes a QI is not required to forward beneficial ownership information with respect to its customers to a U.S. financial institution or other payor of U.S.-source investment-type income to establish their eligibility for an exemption from, or reduced rate of, U.S. withholding tax.⁷⁸ Instead, the QI is permitted to establish for itself the eligibility of its customers for an exemption or reduced rate, based on information as to residence obtained under the “know-your-customer” rules imposed by the banking laws to which the QI is subject in its home jurisdiction. The QI then certifies as to eligibility on behalf of its customers and provides information to the U.S. withholding agent as to the portion of each payment that qualifies for an exemption or reduced rate of withholding. As described below, a QI may also assume responsibility for both nonresident withholding and, in the case of U.S. customers, backup withholding. A QI is required to disclose to the IRS the identity of any U.S. customer and to report any payments of U.S.-source income to U.S. customers on Form 1099.

The IRS has published the model QI agreement that financial institutions wishing to become QIs are expected to sign.⁷⁹ A prospective QI must submit an application to the IRS

⁷⁶ Treas. Reg. sec. 1.1441-1(e)(5).

⁷⁷ The definition also includes: a foreign branch or office of a U.S. financial institution or U.S. clearing organization; a foreign corporation for purposes of presenting income tax treaty claims on behalf of its shareholders; and any other person acceptable to the Internal Revenue Service. Treas. Reg. sec. 1.1441-1(e)(5)(ii).

⁷⁸ A foreign financial institution that is not a QI must furnish a Form W-8IMY to a U.S. withholding agent and attach Forms W-8BEN completed by each of its foreign customers to establish their eligibility for an exemption from, or reduced rate of, U.S. withholding tax.

⁷⁹ Rev. Proc. 2000-12, 2000-1 C.B. 387, *supplemented by* Announcement 2000-50, 2000-1 C.B. 998, and *modified by* Rev. Proc. 2003-64, 2003-2 C.B. 306, and Rev. Proc. 2005-77, 2005-2 C.B. 1176. The QI agreement applies only to foreign financial institutions, foreign clearing organizations, and foreign branches or offices of U.S. financial institutions or U.S. clearing organizations. However, the principles of the QI agreement may be used to conclude agreements with other persons defined as QIs.

providing certain specified information, and any additional information and documentation requested by the IRS. The application must establish to the IRS's satisfaction that the applicant has adequate resources and procedures to comply with the terms of the QI agreement.

Before entering into a QI agreement that provides for the use of documentary evidence obtained under a country's know-your-customer rules, the IRS must receive (1) that country's know-your-customer practices and procedures for opening accounts and (2) responses to 18 related items. If the IRS has already received this information, a particular prospective QI need not submit it. The IRS web site (www.irs.gov) lists more than 50 countries for which it has received such information and for which the know-your-customer rules are acceptable.

B. The QI Agreement

Withholding and reporting

The QI agreement is quite broad in scope and covers numerous points intended to simplify withholding and reporting obligations. As a technical matter, all QIs are withholding agents for purposes of the nonresident withholding and reporting provisions of chapter 3 of the Code, which require a withholding agent to withhold U.S. tax at a 30-percent rate from payments of U.S.-source interest, dividends, and similar amounts made to account holders who are foreign persons, unless the withholding agent can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a U.S. person or as made to a foreign person entitled to a reduced rate of withholding. However, a QI is not required to withhold on such payments if it does not accept primary responsibility for withholding under the QI agreement, and it has provided appropriate withholding documentation to a withholding agent from which it receives those amounts. Nevertheless, the QI must still report such amounts.

Similarly, as a technical matter, all QIs are payors for backup withholding purposes. However, a QI is not required to backup withhold on an amount that is subject to nonresident withholding, is U.S.-source deposit interest, or is U.S.-source interest or original interest discount paid on the redemption of short-term obligations (collectively, a “reportable amount”) in certain circumstances. Specifically, a QI is not required to backup withhold on such amounts if the QI does not assume primary Form 1099 reporting and backup withholding responsibility, and it provides to a payor from which it receives a reportable amount the Forms W-9 of U.S. non-exempt recipient account holders (i.e., account holders that are U.S. persons not generally exempt from Form 1099 reporting and backup withholding), together with certain additional information about the withholding rate pools attributable to such account holders. A withholding rate pool aggregates payments of a single type of income (e.g., interest or dividends) that is subject to a single rate of withholding.

A QI may elect to assume primary Form 1099 reporting responsibility under chapter 61 of the Code, primary backup withholding responsibility under section 3406, or both, with respect to reportable amounts. A QI that assumes such responsibility is subject to all of the obligations imposed by chapter 61 or section 3406.

Regardless of whether a QI assumes primary Form 1099 reporting and backup withholding responsibility for amounts that are potentially subject to nonresident withholding, the QI is responsible for Form 1099 reporting and backup withholding on other amounts that are not subject to nonresident withholding but that constitute “reportable payments.” The definition of reportable payments depends upon whether the QI is a U.S. payor or a non-U.S. payor. U.S. payors include U.S. persons, the government of the United States (or any State or political subdivision thereof), controlled foreign corporations, certain foreign partnerships that are more than 50-percent owned by U.S. persons or engaged in a U.S. trade or business, certain foreign persons for whom at least 50 percent of their income is effectively connected with a U.S. trade or business, and U.S. branches of certain foreign banks or foreign insurance companies. A non-U.S. payor is a payor other than a U.S. payor.

If the QI is a U.S. payor, then a reportable payment includes any reportable payment as defined in section 3406(b) (which includes certain interest, dividends, and royalties), including any broker proceeds from the sale of assets beneficially owned by a U.S. non-exempt recipient account holder that produce, or could produce, reportable payments if the identity and account information of that account holder is prohibited by law (including by contract) from disclosure. A U.S. non-exempt recipient is a U.S. person that is not an exempt recipient. A U.S. exempt recipient is a U.S. person generally exempt from Form 1099 reporting and backup withholding. Whether a person is an exempt recipient varies depending on the type of income, but may include a corporation or a financial institution.

If the QI is a non-U.S. payor, then a reportable payment includes: any reportable amount; any broker proceeds from the sale of assets that produce, or could produce, reportable amounts if the sale is effected at an office inside the United States; any broker proceeds from the sale of an asset that produces, or could produce, reportable amounts that are beneficially owned by a U.S. non-exempt recipient whose identity and account information is prohibited by law (including by contract) from disclosure; any foreign-source fixed and determinable income (including interest, dividends, rents, and royalties) paid in the United States or to an account maintained in the United States; and any other amount presumed paid to a U.S. non-exempt recipient under certain rules.

Documentation

To obtain the benefits available to QIs, a QI must generally be able to reliably associate reportable amounts or payments with valid documentation from account holders. QIs agree to review and maintain documentation in accordance with the terms of their QI agreement and, in the case of documentary evidence obtained from direct account holders, in accordance with “know-your-customer” rules applicable under the banking laws and regulations of the jurisdiction in which the QI is located.

A QI may treat an account holder as a foreign beneficial owner of an amount if the account holder provides a valid Form W-8 (other than a Form W-8IMY) or valid documentary evidence that supports the account holder’s status as a foreign person. With such documentation, a QI generally may treat an account holder as entitled to a reduced rate of withholding if all the requirements for the reduced rate are met and the documentation supports entitlement to a reduced rate. A QI may not reduce the rate of withholding if the QI knows that the account holder is not the beneficial owner of a reportable amount or payment. If a direct foreign account holder is the beneficial owner of a payment, then a QI may shield the account holder’s identity from U.S. custodians and the IRS.

If a foreign account holder is not the beneficial owner of a payment, the account holder must provide the QI with a Form W-8IMY for itself along with specific information about each beneficial owner to which the payment relates. A QI that receives this information may shield the account holder’s identity from a U.S. custodian, but not from the IRS.

In general, if an account holder is a U.S. person, the account holder must provide the QI with a Form W-9 or appropriate documentary evidence that supports the account holder’s status

as a U.S. person. Under the QI agreement, there are two types of U.S. persons—U.S. exempt recipients and U.S. non-exempt recipients.

In cases in which a QI cannot reliably associate a payment with valid documentation from an account holder to determine whether the payment is made to a U.S. or foreign person, the QI must apply certain presumption rules detailed in the QI agreement; the rules may not be used to grant a reduced rate of withholding. The presumption rules depend on the type of payment, and fall into four categories.

First, an amount subject to nonresident withholding that is paid outside the United States to an account maintained outside the United States is presumed made to an undocumented foreign account holder. A QI must treat such an amount as subject to withholding at a 30-percent rate and report the payment to an unknown account holder on Form 1042-S.

Second, an amount of U.S.-source deposit interest (other than an amount that is part of the purchase price of a certificate of deposit sold in a transaction other than a redemption) or an amount of U.S.-source interest or original issue discount on the redemption of a short-term obligation that is paid outside the United States to an offshore account is presumed made to an undocumented U.S. non-exempt recipient account holder. A QI that receives from another payor such an amount of U.S.-source interest or original issue discount must backup withhold at a 28-percent rate and report such amount on Form 1099 unless it has provided sufficient information for that other payor to backup withhold and report the payment and the QI does not know that the other payor has failed to backup withhold or report.

Third, a QI shall presume that the following payments are made to an exempt recipient provided that such amounts are paid outside the United States to an account maintained outside the United States: foreign-source income; broker proceeds; original issue discount paid in a sale other than a redemption; interest paid as part of the purchase price of an obligation when the instrument is sold between interest payment dates; amounts held on deposit with banks or other financial institutions for two weeks or less; amounts of original issue discount arising from a sale and repurchase transaction that is completed within two weeks or less; and certain other amounts described in Treasury regulations. These amounts are not subject to withholding or reporting.

Finally, any other payment not described above is presumed made to a U.S. non-exempt recipient and should therefore generally be subject to Form 1099 reporting and backup withholding.

Withholding agent-related requirements

In general, a QI must provide a withholding certificate and a withholding statement to each withholding agent from which the QI receives a reportable amount as a QI. Typically, the withholding certificate is a Form W-8IMY that certifies that the QI is acting as a QI and provides certain other required information. The withholding statement has no prescribed form, and may be provided in whatever manner the QI and withholding agent mutually agree. However, the withholding statement must provide sufficient additional information for a withholding agent to apply the correct rate of withholding on payments from the accounts identified on the statement and to properly report such payments on Forms 1042-S and Forms 1099, as applicable. In

addition, the withholding statement must designate those accounts for which the QI acts as intermediary; designate those accounts for which the QI assumes primary responsibility for nonresident withholding and/or primary Form 1099 reporting and backup withholding responsibility; and provide information regarding withholding rate pools, if necessary. If a QI does not assume primary Form 1099 reporting and backup withholding responsibility, the withholding statement must establish a separate withholding rate pool for each U.S. non-exempt recipient account holder that the QI has disclosed to the withholding agent.

In general, a QI is not required to disclose on either the withholding certificate or the withholding statement the identity of an account holder that is a foreign person or a U.S. exempt recipient that is a direct account holder. To the extent a QI has not assumed primary Form 1099 reporting and backup withholding responsibility, the QI must provide to a withholding agent the Forms W-9 obtained from each U.S. non-exempt recipient account holder on whose behalf the QI received a reportable amount. If a U.S. non-exempt recipient that must be disclosed has not provided a Form W-9, the QI must disclose the name, address, and taxpayer identification number (if available) to the withholding agent. However, no such disclosure is necessary if the QI is, under local law, prohibited from making the disclosure and the QI has followed certain procedural requirements.

QI tax and information return requirements

A QI must file a Form 1042 by March 15 of the year following any calendar year in which the QI acts as a QI. In addition to other information, the QI should include as an attachment to that Form a statement setting forth the aggregate amounts of reportable payments paid to U.S. non-exempt recipient account holders, and the number of such account holders, whose identity is prohibited by foreign law (including by contract) from disclosure. QIs must separately report each type of reportable payment and the number of undisclosed account holders receiving such payments.

A QI must also file a Form 945 by January 31 of the year following any calendar year in which the QI backup withheld any amount under section 3406.

A QI must file a Form 1042-S for each direct account holder by March 15 of the year following the calendar year in which the payment reported on the form was made, to report the pools of income paid to the account holder. In general, account holder identities need not be reported on the form. However, recipient-specific reporting is required for several types of account holders. In particular, a QI must file separate Forms 1042-S for amounts paid to each of the following types of account holders: (1) a QI or withholding foreign partnership account holder that receives an amount subject to withholding under chapter 3 of the Code from the QI, or from a private arrangement intermediary of the QI (without regard to whether such account holder is a direct or indirect account holder); (2) a foreign account holder of a nonqualified intermediary foreign interest holder of a flow-through entity receiving an amount subject to withholding under chapter 3 of the Code (without regard to whether the nonqualified intermediary or flow-through entity is a direct or indirect account holder), to the extent the QI can reliably associate such amounts with valid documentation from an account holder that is not itself a nonqualified intermediary or flow-through entity; (3) a foreign account holder of a nonqualified intermediary or foreign interest holder of a flow-through entity that is an account

holder of a private arrangement intermediary of the QI (without regard to whether the nonqualified intermediary or flow-through entity is a direct or indirect account holder of the private arrangement intermediary), to the extent the QI can reliably associate such amounts with valid documentation from an account holder that is not itself a nonqualified intermediary or flow-through entity; (4) an unknown recipient for amounts subject to withholding paid to a nonqualified intermediary or a flow-through entity (without regard to whether the nonqualified intermediary or flow-through entity is a direct or indirect account holder), to the extent the QI cannot reliably associate such amounts with valid documentation from the account holders of the nonqualified intermediary or the interest holders of the flow-through entity; and (5) an unknown recipient for amounts subject to withholding paid to a nonqualified intermediary or a flow-through entity that is a direct or indirect account holder of a private arrangement intermediary of the QI, to the extent the QI cannot reliably associate such amounts with valid documentation from the account holders of the nonqualified intermediary or the interest holders of the flow-through entity.

A QI generally must file Forms 1099 for reportable payments made to certain specified persons. Those persons are: (1) an unknown owner of a reportable amount and/or payment who is a U.S. non-exempt recipient whose identity is prohibited by law from being disclosed; (2) a U.S. non-exempt recipient account holder whose identity is not prohibited by law from being disclosed but who has not provided a Form W-9 or identity to a withholding agent; (3) an account holder that is (or is presumed to be) a U.S. non-exempt recipient of a reportable payment whose identity and account information are not prohibited by law from being disclosed; (4) an account holder that is (or is presumed to be) a U.S. non-exempt recipient that receives reportable amounts for which the QI has assumed primary Form 1099 reporting and backup withholding responsibility; and (5) an account holder that is a U.S. person if the QI has made a reportable payment to which it applied backup withholding and that was not otherwise reported on a Form 1099.

Foreign law prohibition of disclosure

The QI agreement includes procedures to address situations in which foreign law (including by contract) prohibits the QI from disclosing the identities of U.S. non-exempt recipients. Separate procedures are provided for accounts established with a QI prior to January 1, 2001, and for accounts established on or after January 1, 2001.

Established prior to January 1, 2001

For accounts established prior to January 1, 2001, if the QI knows that the account holder is a U.S. non-exempt recipient, the QI agrees (1) to request from the account holder the authority to disclose its name, address, taxpayer identification number (if available), and reportable amounts; (2) to request from the account holder the authority to sell any assets that generate, or could generate, reportable payments; or (3) to request that the account holder disclose itself by mandating the QI to provide a Form W-9 completed by the account holder. The QI must make these requests at least two times during each calendar year and in a manner consistent with the QI's normal communications with the account holder (or at the time and in the manner that the QI is authorized to communicate with the account holder). Until the QI receives a waiver on all prohibitions against disclosure, authorization to sell all assets that generate, or could generate,

reportable payments, or a mandate from the account holder to provide a Form W-9, the QI shall backup withhold on all reportable payments paid to the account holder and report those payments on Form 1099 or, in the case of reportable amounts and designated proceeds, provide another withholding agent with all of the information required for that withholding agent to backup withhold and report the payments on Form 1099.

If the QI's records indicate that the account holder of an account established prior to January 1, 2001, is a foreign person, but the QI discovers that the account holder is a U.S. non-exempt recipient, then the QI shall follow the procedures applicable to accounts of U.S. non-exempt recipients established prior to January 1, 2001. However, if the QI may legally dispose of the account holder's assets that generate, or could generate, reportable payments without authorization, then the QI must dispose of all such assets within 365 days after the QI learns that the account holder is a U.S. non-exempt recipient.

Established on or after January 1, 2001

For any account established by a U.S. non-exempt recipient on or after January 1, 2001, the QI agrees (1) to request from the account holder the authority to disclose its name, address, taxpayer identification number (if available), and reportable amounts; (2) to request from the account holder, prior to opening the account, the authority to exclude from the account holder's account any assets that generate, or could generate, reportable payments; or (3) to request that the account holder disclose itself by mandating the QI to transfer a Form W-9 completed by the account holder.

If a QI is authorized to disclose the account holder's name, address, taxpayer identification number, and reportable amounts, it must obtain a valid Form W-9 from the account holder, and, to the extent the QI does not have primary Form 1099 and backup withholding responsibility, provide the Form W-9 to the appropriate withholding agent promptly after obtaining the form. If a Form W-9 is not obtained, the QI must provide the account holder's name, address, and taxpayer identification number (if available) to the withholding agents from whom the QI receives reportable amounts on behalf of the account holder, together with appropriate withholding rate pool information relating to the account holder. If a QI is not authorized to disclose an account holder's name, address, taxpayer identification number (if available), and reportable amounts, but is authorized to exclude from the account holder's account any assets that generate, or could generate, reportable payments, the QI must follow procedures designed to ensure that it will not hold any assets that generate, or could generate, reportable payments in the account holder's account.

If a QI discovers, after opening the account, that any account holder in an account established on or after January 1, 2001, is a U.S. non-exempt person, the QI is required immediately to correct the withholding statement information provided to the withholding agent, if necessary. In addition, the QI must obtain a Form W-9 within 60 days of discovering that the account holder is a U.S. non-exempt recipient, and, if the QI has not assumed primary Form 1099 reporting and backup withholding responsibility, provide the Form W-9 to the appropriate withholding agents together with appropriate withholding pool information promptly after obtaining the Form W-9. Alternatively, if the QI is not authorized to disclose account holder information, the QI must sell all of the account holder's assets that generate or could generate

reportable payments within 60 calendar days from the day that the QI discovers the account holder is a U.S. non-exempt recipient. The QI must backup withhold, or instruct a withholding agent to backup withhold, on any reportable payments made after the time the QI discovers the account holder's U.S. non-exempt recipient status and before obtaining a valid Form W-9 from the account holder.

External audit procedures

The IRS generally will not audit a QI with respect to withholding and reporting obligations covered by a QI agreement if an approved external auditor conducts an audit of the QI. An external audit must be performed of the second and fifth full calendar years in which the QI agreement is in effect. In general, the IRS must receive the external auditor's report by June 30 of the year following the year being audited.

Certain requirements for the external audit are provided in the QI agreement. In general, however, the QI must permit the external auditor to have access to all relevant records of the QI, including information regarding specific account holders. In addition, the QI must permit the IRS to communicate directly with the external auditor, review the audit procedures followed by the external auditor, and examine the external auditor's work papers and reports.

Term of a QI agreement

A QI agreement expires on December 31 of the fifth full calendar year after the year in which the QI agreement first takes effect, although it may be renewed. Either the IRS or the QI may terminate the QI agreement prior to its expiration by delivering a notice of termination to the other party. However, the IRS will not terminate a QI agreement unless there is a significant change in circumstances or an event of default occurs, and the IRS determines that the change in circumstance or event of default warrants termination. In the event that an event of default occurs, a QI is given an opportunity to cure it within a specified time.

C. Discussion

Since the adoption of the QI regime in 2001, 7,007 QI agreements have been signed. There are currently 5,660 active QI agreements involving financial institutions in 60 countries.⁸⁰ The QI program provides a significant benefit to foreign financial institutions—in particular, the ability to obtain a reduced rate or exemption from U.S. withholding tax for their non-U.S. customers without disclosing the identities of those customers to the IRS or competing financial institutions. At the same time, however, the contractual nature of the QI program provides the IRS with an important mechanism to enforce compliance with U.S. reporting and withholding rules. For example, a foreign financial institution that is a QI is contractually required to disclose the identity of its U.S. customers to the IRS, report the payment of certain amounts to those customers and, in some circumstances, apply backup withholding. These contractual requirements extend beyond the scope of the reporting and withholding that would otherwise be required under applicable Treasury regulations. Moreover, the fact that so many of the world’s major financial institutions have entered into QI agreements places a non-QI financial institution at a competitive disadvantage and creates a significant incentive for existing QIs to maintain their QI status. The IRS’s ability to terminate a QI agreement in the event of noncompliance, thereby placing a financial institution at such a disadvantage, is a powerful tool for enforcing compliance and ensuring cooperation by a QI when instances of noncompliance are discovered.

Recently, however, a number of recommendations have been made by the Government Accountability Office (the “GAO”) and the PSI for improvement of the QI program. Those recommendations, and certain changes currently being considered by the IRS, are described below.

2007 GAO Report

In December 2007, the GAO prepared a report on the QI program.⁸¹ In general, the report concludes that the QI program provides the IRS some assurance that tax on U.S.-source income sent offshore is properly withheld and reported. However, the report also found that a low percentage of U.S.-source income sent offshore flows through QIs (approximately 12.5 percent in 2003), while the rest flows through U.S. withholding agents. The report states that this distinction is of significance because QIs are required to verify account owners’ identities while U.S. withholding agents may rely on account owners’ self-certification of their identity.

The report also found that the QI program’s external audit requirement helps provide assurance that taxes are properly withheld. However, external auditors are not required to follow up on indications of fraud or illegal acts. In addition, although the IRS obtains considerable data

⁸⁰ See Shulman Testimony, *supra*. The difference between signed agreements and active agreements is due to mergers, acquisitions, and terminations. The IRS has issued 600 default letters and has terminated 100 QI agreements.

⁸¹ Government Accountability Office, *Tax Compliance: Qualified Intermediary Program Provides Some Assurance that Taxes on Foreign Investors Are Withheld and Reported, but Can Be Improved*, GAO-08-99 (Dec. 19, 2007).

from information returns, it does not make effective use of it to ensure proper withholding and reporting.

The report offers four recommendations for the IRS to further improve the QI program. Specifically, the report recommends that IRS: (1) measure U.S. withholding agents' reliance on self-certified documentation and use that data in its compliance efforts; (2) determine why some funds are reported to unknown jurisdictions and to unidentified recipients and take appropriate steps to recover withholding taxes that should have been paid and to better ensure that U.S. taxes are withheld;⁸² (3) work to enhance external reviews by requiring the external auditor to report any indications of fraud or illegal acts; and (4) require electronic filing of forms in QI agreements whenever possible.

2008 PSI Report

The 2008 PSI Report includes several recommendations for strengthening the QI program, based primarily on its investigation of the LGT and UBS matters. First, the report recommends that QIs should be required to file Forms 1099 for all U.S. persons who are clients (whether or not the client has U.S. securities or receives U.S.-source income) and for all accounts beneficially owned by U.S. persons, even if the accounts are held in the name of a foreign corporation, trust, foundation, or other entity.

The report also recommends that the IRS close what the report describes as a gap in the QI program by expressly requiring QIs to apply to their QI reporting obligations all information obtained through their know-your-customer procedures to identify the beneficial owners of accounts. The 2008 PSI Report states that the rules of the QI program are distinct from the know-your-customer rules that apply for due diligence purposes under the internal laws of the country in which the QI is located, although a QI must apply such know-your-customer rules as a prerequisite for entering into the QI program. As a result, the 2008 PSI Report concludes, some QIs, including LGT and UBS, have apparently taken the position that information the QI acquires about a particular customer as a result of satisfying the QI's requirements under applicable know-your-customer rules does not necessarily affect the determination of that customer's status for purposes of the QI program. Thus, for example, the report states that such a QI may take the position that it can rely on a certification of non-U.S. status (technically a Form W-8BEN) proffered by a foreign nominee owner (e.g., a Liechtenstein foundation) to establish that the nominee in fact is the beneficial owner of an account for withholding and reporting purposes under the QI program, even if the QI knows, as a result of satisfying the

⁸² The GAO's examination of data for tax year 2003 showed that \$19 billion of U.S.-source income was reported (by QIs and U.S. withholding agents) from transactions with undisclosed jurisdictions and \$7 billion of U.S.-source income was reported (by QIs and U.S. withholding agents) from transactions with unknown recipients. Approximately \$500 million was withheld from the transactions with undisclosed jurisdictions and \$233 million on the transactions with unknown recipients. These numbers represent a 2.7-percent withholding rate and a 3.4-percent withholding rate, respectively, instead of the 30-percent withholding rate that generally applies under U.S. tax law in the absence of any documentation as to the recipients' nationality, residency, and type of investment. The IRS was unable to explain the reduced rates of withholding on these transactions.

applicable know-your-customer rules, that a U.S. person is the actual beneficial owner of the account.

It can forcefully be argued that the gap identified by the 2008 PSI Report does not in fact exist, although admittedly the model QI agreement might be revised to make the point more explicitly. Very simply, a QI is a “withholding agent” for all U.S. tax purposes. The QI agreement expands the obligations of withholding agents under the relevant Treasury regulations,⁸³ but does not override them. Under the regulations (and, indeed, under the model QI agreement itself⁸⁴), a withholding agent may not accept a certification of non-U.S. status (a Form W-8BEN) if the withholding agent has *actual knowledge* that the beneficial owner of the relevant income (the taxpayer) is a U.S. person. There is no obvious basis for concluding that information obtained through know-your-customer rules is irrelevant for this purpose. Moreover, the relevant Treasury regulations also provide that a withholding agent effectively must compare a Form W-8BEN that it receives with other account information in its possession, and reject the Form W-8BEN if it is inconsistent with that information.⁸⁵

As a result, a straightforward reading of the model QI agreement, in the context of the Treasury regulations under which the QI program exists, is that a foreign QI cannot accept a Form W-8BEN certification of non-U.S. status where it has actual knowledge (whether obtained through know-your-customer rules or otherwise) that the beneficial owner of the income in question is a U.S. person or where the certification is inconsistent with other account information. The gap, to the extent one exists, is with the consistent treatment of foreign corporations, in particular, as entities separate from their owners for both know-your-customer and withholding tax purposes, but this is a different (and larger) issue.

Like the 2007 GAO report, the PSI report also recommends that the IRS broaden QI audits to require external auditors to report evidence of fraudulent or illegal activity. The report also recommends that the Treasury Department penalize banks located in tax haven jurisdictions that impede U.S. tax enforcement or fail to disclose accounts held directly or indirectly by U.S. clients by terminating their QI status. The report further recommends that Congress amend section 311 of the Patriot Act to allow the Treasury Department to bar such banks from doing business with U.S. financial institutions.

Potential modifications under IRS consideration

In light of these recommendations, the IRS has recently indicated that it may make several modifications to the QI program intended to further improve its effectiveness in enhancing compliance.⁸⁶ In particular, the IRS has indicated that it may require foreign banks to

⁸³ Principally, Treasury Regulation sections 1.1441-1 and 1.1441-7.

⁸⁴ See Section 5.10 of the model QI agreement, as set forth in Rev. Proc. 2000-12, 2000-1 C.B. 387.

⁸⁵ Treasury Regulation section 1.1441-7(b)(4).

⁸⁶ See Shulman Testimony, *supra*.

determine whether their customers are actually U.S. persons using trusts and other offshore shell entities to hide their identities and claim the benefit of reduced withholding tax rates.

In addition, as recommended by the 2007 GAO report and the 2008 PSI Report, the IRS may require external auditors that conduct the audits required under the QI agreements to identify fraud or illegal acts and report them to the IRS. The IRS is also engaged in discussions with the major accounting firms that perform QI audits to identify ways to enhance the detection and reporting of violations of the QI agreement.

Third, as recommended by the 2008 PSI Report, the IRS is considering whether to require foreign banks that become QIs to report to the IRS with respect to foreign-source income, as well as U.S.-source income, received by U.S. customers who are not otherwise exempt from information reporting and backup withholding.