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INTERGOVERNMENTAL AGREEMENTS (IGAS): Amend Internal Revenue Code § 1474 to Allow a Period of Notice and Comment on New Intergovernmental Agreements (IGAs) and to Require That the IRS Notify Taxpayers Before Their Data Is Transferred to a Foreign Jurisdiction Pursuant to These IGAs, Unless Unique and Compelling Circumstances Exist

TAXPAYER RIGHTS IMPACTED¹

- *The Right to Be Informed*
- *The Right to Privacy*
- *The Right to Confidentiality*

PROBLEM

The Foreign Account Tax Compliance Act (FATCA) generally requires foreign financial institutions (FFIs) to provide the U.S. with information regarding foreign accounts held by U.S. taxpayers.² Typically, this information exchange occurs via intergovernmental agreements (IGAs), under which FFIs furnish the information to their local tax authority, which in turn transfers it to the U.S.³ These IGAs also generally incorporate reciprocity, pursuant to which the U.S. agrees to provide the foreign jurisdiction with information regarding its citizens or residents maintaining accounts in the U.S.⁴

As previously cautioned by the National Taxpayer Advocate, the information sharing contemplated by FATCA and similar programs can be extremely helpful in identifying and preventing tax evasion through the use of offshore accounts, but it also presents enormous risks to taxpayer rights.⁵ Recognizing the importance of taxpayers' *right to privacy* and *right to confidentiality*, Congress has enacted significant taxpayer protections relating to disclosure and use of taxpayer information.⁶ Moreover, the National Institute of Standards and Technology (NIST) has developed detailed

1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3).

2 Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, Title V, Subtitle A, 124 Stat. 71, 97 (2010) (adding IRC §§ 1471-1474; 6038D). "U.S. taxpayer" is not a specifically defined term within the IRC. But, for purposes of this analysis, it roughly equates to the term "specified United States person" as defined in IRC § 1473(3).

3 U.S. Department of Treasury, *Foreign Account Tax Compliance Act (FATCA)* (Apr. 11, 2018), <https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx>.

4 *Id.*

5 National Taxpayer Advocate 2013 Annual Report to Congress 244; Nina E. Olson, *An Analysis of Tax Settlement Programs as Amnesties - When Should the Government Offer Them and How Should They Be Structured? (Part 1 of 3)*, NTA Blog, (Mar. 14, 2018), <https://taxpayeradvocate.irs.gov/news/nta-blog-analysis-of-tax-settlement-programs-as-amnesties-part-1>; Nina E. Olson, *An Analysis of Tax Settlement Programs as Amnesties - Why IRS's Offshore Voluntary Disclosure Settlement Programs Posed Risks to Voluntary Compliance (Part 2 of 3)*, NTA Blog, (Mar. 21, 2018), <https://taxpayeradvocate.irs.gov/news/nta-blog-an-analysis-of-tax-settlement-programs-as-amnesties-why-irs-s-offshore-voluntary-disclosure-settlement-programs-posed-risks-to-voluntary-compliance-part-2-of-3>; Nina E. Olson, *An Analysis of Tax Settlement Programs as Amnesties: A Discussion of Belated Alternatives to the Offshore Voluntary Disclosure Program and Recommendations for Further Improvements (Part 3 of 3)*, NTA Blog, (Mar. 30, 2018), <https://taxpayeradvocate.irs.gov/news/an-analysis-of-tax-settlement-programs-as-amnesties-a-discussion-of-belated-alternatives-to-the-offshore-voluntary-disclosure-program-and-recommendations-for-further-improvements-part-3-of-3>.

6 See, e.g., IRC § 7213, 6103. See also IRC §§ 7803(a)(3)(G), (H).

cybersecurity guidelines, to which all federal agencies, including the IRS, must conform.⁷ Nevertheless, the IRS is exchanging U.S. taxpayer information under circumstances where the data transfers to foreign recipients do not conform to NIST guidelines, and where the IRS cannot ensure that the data is used properly by IGA partners.⁸

The IRS has identified the risks inherent in this approach, but has determined that these risks are acceptable.⁹ The data being disclosed and potentially breached, however, relates to taxpayers, not to the IRS. Taxpayers, rather than the IRS, are exposed to the consequences of data theft or misuse potentially arising during or after information transfers to foreign partners pursuant to IGAs. Currently, however, taxpayers have no voice in these IGAs and receive no notification that their personal information is being transferred outside of U.S. jurisdiction.¹⁰

EXAMPLE

Taxpayer is a citizen of the U.S. but is currently a resident of a foreign country. The U.S. and the foreign country enter into an IGA, which contemplates the reciprocal sharing of taxpayer information. Once the IGA is in force and the U.S. has done as much as it can to confirm that the cybersecurity measures of the foreign country are satisfactory, the reciprocal exchange of information begins. As part of that exchange, Taxpayer's personal information is provided to the foreign country without Taxpayer's specific knowledge. Once the information arrives in the foreign country and is beyond the continuing oversight of the IRS, a data breach occurs. As a result, Taxpayer's personal information is exposed and Taxpayer becomes the victim of identity theft. Unlike in the U.S., the foreign country does not follow the practice of alerting taxpayers when data breaches occur. Thus, the identity theft results in substantial economic damage to Taxpayer in part because Taxpayer remains unaware of the data breach until unauthorized account activity begins to appear. Moreover, Taxpayer's risk for subsequent damage has effectively been doubled by the circumstance that Taxpayer's personal information now is maintained in two different jurisdictions, thereby increasing exposure to unauthorized disclosure or improper use of that information.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress amend Internal Revenue Code (IRC) § 1474 to add:

- IRC § 1474(g)(1), requiring the public announcement of IGAs for notice and comment by taxpayers;
- IRC § 1474(g)(2), requiring that, as part of this announcement, the IRS specify the extent to which the proposed IGA partner jurisdiction complies with the cybersecurity standards to which U.S. federal agencies are held and the taxpayer privacy standards which govern the IRS; and

7 National Institute of Standards and Technology (NIST) Special Publication (SP) 800-63-2 (Aug. 2013), superseded by NIST SP 800-63-3 (June 2017), <https://doi.org/10.6028/NIST.SP.800-63-3>.

8 IRS, Form 14675, *Risk Assessment Tool and Form, Foreign Account Tax Compliance Act (FATCA) International Data Exchange System (IDES) Identity Proofing Requirements* (Jul. 18, 2017) (on file with TAS).

9 *Id.*

10 Most jurisdictions have yet to adopt transparent procedures for notifying taxpayers regarding international information exchanges; however, France and Kazakhstan do routinely notify affected taxpayers. Further, Australia has made significant strides toward the adoption of procedures to ensure transparency under most circumstances. See Ali Noroozi, *Taxpayer Rights: Privacy and Transparency*, 87 *TAX NOTES INT'L* 2 141-145 (July 10, 2017). See also Inspector-General for Taxation, *Review into the Taxpayers' Charter and Taxpayer Protections* 117-128 (Dec. 2016).

- IRC § 1474(g)(3), requiring that, barring unique and compelling circumstances, taxpayers be informed prior to the transfer of their individual information pursuant to the terms of an IGA.

PRESENT LAW

In 2010, Congress enacted FATCA to address concerns that U.S. taxpayers were not fully disclosing the extent of financial assets held abroad.¹¹ Subject to various thresholds and exceptions, FATCA requires FFIs to report to the IRS information about financial accounts held by U.S. taxpayers, or by certain foreign entities in which U.S. taxpayers hold a substantial ownership interest.¹² Failure to do so can result in a 30 percent U.S. withholding tax on a broad range of payments.¹³ In order to avoid this withholding, an FFI must report directly to the IRS on accountholders, or undertake reporting pursuant to IGAs that have been negotiated between the U.S. and the FFI's country of residence or organization.

Under a Model 1 IGA, FFIs provide accountholder information to their country's tax authority, which in turn transfers it to the IRS.¹⁴ By contrast, under a Model 2 IGA, FFIs report directly to the IRS based on protocols negotiated between the U.S. and the FFI's country of residence.¹⁵ To date, the U.S. has negotiated over 100 IGAs with foreign jurisdictions.¹⁶

Many Model 1 IGAs, specifically those that are "in force," also include reciprocity, in which the IRS provides information to a given foreign jurisdiction regarding accounts held in the U.S. by residents or citizens of the foreign country. When negotiating reciprocal IGAs with a reciprocal partner, the U.S. includes certain provisions specifically addressing data security.¹⁷ These protections include safeguards aimed at ensuring that the data remains confidential and is used solely for tax purposes.¹⁸ Further, reciprocal IGAs typically require the existence of an infrastructure facilitating timely, accurate, and confidential information exchanges.¹⁹ Only after the U.S. is satisfied that the reciprocal partner has appropriate protections in place does the data transfer take place.²⁰

Further, the IRS has taken several steps to mitigate the risk of data breaches resulting from reciprocal agreements, including:

- Establishing long-term relationships with partner countries' points-of-contact;

11 Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, Title V, Subtitle A, 124 Stat. 71, 97 (2010) (adding IRC §§ 1471-1474; 6038D).

12 U.S. Department of Treasury, *Foreign Account Tax Compliance Act (FATCA)* (Apr. 11, 2018), <https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx>.

13 IRC § 1471(a).

14 IRS, *FATCA Information for Governments* (Feb. 17, 2018), <https://www.irs.gov/businesses/corporations/fatca-governments>.

15 *Id.*

16 U.S. Department of Treasury, *Foreign Account Tax Compliance Act (FATCA)* (Apr. 11, 2018), <https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx>. Specifically, there are over 100 intergovernmental agreements (IGAs) that are either "in force" or "treated as in effect." An IGA is "in force" when the jurisdiction has enacted implementing legislation for its foreign financial institutions (FFIs) to document and report under the IGA.

17 Department of Treasury, *Model 1A IGA Reciprocal, Preexisting TIEA or DTC* (Nov. 30, 2014), Article 3.7-9.

18 *Id.* See, for example, paragraph 8, which in relevant part, states, "Following entry into force of this Agreement, each Competent Authority shall provide written notification to the other Competent Authority when it is satisfied that the jurisdiction of the other Competent Authority has in place (i) appropriate safeguards to ensure that the information received pursuant to this Agreement shall remain confidential and be used solely for tax purposes, and (ii) the infrastructure for an effective exchange relationship..."

19 Department of Treasury, *Model 1A IGA Reciprocal, Preexisting TIEA or DTC* (Nov. 30, 2014), Article 3.7-9.

20 *Id.*

- Encrypting outbound data files using encryption standards common across all sensitive government uses;²¹
- Providing partner countries with unique private keys to open data transmissions; and
- Undertaking on-site reviews of partner countries to ensure that their safeguards are sufficient and will be in place to protect the incoming data.²²

Within the U.S., federal agencies, including the IRS, are required to conform to cybersecurity guidelines set forth by NIST.²³ Likewise, Congress enacted a variety of statutes protecting the confidentiality and use of taxpayer data, both inside and outside of the IRS.²⁴

REASONS FOR CHANGE

Notwithstanding significant efforts to ensure the confidentiality and appropriate use of taxpayer data in implementing IGAs, the IRS is unable to comply with NIST standards when transferring that information to reciprocal partners. Likewise, it cannot control what a country does with taxpayer data once the information transfer is complete. These exposures, particularly noncompliance with NIST guidelines, prompted the IRS to undertake an assessment regarding identity proofing and e-authentication with respect to foreign users.²⁵ Where outbound data transfers to partner countries are concerned, the IRS concluded that the impact of a data breach would be “high,” but that the likelihood of such a breach actually occurring was “very low.”²⁶ Therefore, the IRS assessed the overall risk stemming from this deficiency as “low.”²⁷

That being said, the exposure to the IRS in the event of data theft or misuse occurring either in transfer or after receipt by the foreign jurisdiction is primarily reputational. On the other hand, the true impact of such a data breach would be experienced by the taxpayers whose information is compromised. They could, among other things, be the victims of identity theft or the targets of persecution within foreign jurisdictions. The consequences could range from substantial inconvenience to serious economic damage to harassment and even physical danger.

Nevertheless, taxpayers who are citizens or residents of a foreign jurisdiction have no voice in the U.S.’s decision to pursue an IGA with a foreign jurisdiction, or in the terms that are ultimately negotiated. Likewise, once such an IGA is put into place, these taxpayers may not even know that their account

21 Specifically, the IRS uses Advanced Encryption Standard (AES) encryption, which is the standard recommended by National Institute of Standards and Technology (NIST) for use by all government agencies, including for the protection of top-secret data by the National Security Agency. See NIST, *Cryptographic Standards and Guidelines* (Oct. 10, 2018), <https://csrc.nist.gov/projects/cryptographic-standards-and-guidelines/archived-crypto-projects/aes-development>.

22 IRS, Form 14675, *Risk Assessment Tool and Form, Foreign Account Tax Compliance Act (FATCA) International Data Exchange System (IDES) Identity Proofing Requirements* (July 18, 2017) (on file with TAS).

23 NIST SP 800-63-2 (Aug. 2013), superseded by NIST SP 800-63-3 (June 2017), <https://doi.org/10.6028/NIST.SP.800-63-3>.

24 See, e.g., IRC § 7213, 6103.

25 IRS, Form 14675, *Risk Assessment Tool and Form, Foreign Account Tax Compliance Act (FATCA) Qualified Intermediaries (QI) and Financial Institution Registration* (July 18, 2017) (on file with TAS); IRS, Form 14675, *Risk Assessment Tool and Form, Foreign Account Tax Compliance Act (FATCA) International Data Exchange System (IDES) Identity Proofing Requirements* (July 18, 2017) (on file with TAS).

26 IRS, Form 14675, *Risk Assessment Tool and Form, Foreign Account Tax Compliance Act (FATCA) International Data Exchange System (IDES) Identity Proofing Requirements* (July 18, 2017) (on file with TAS).

27 *Id.*

information is the subject of a data transfer.²⁸ If impacted taxpayers were allowed to comment on potential IGAs, they could make the U.S. aware of circumstances that perhaps were unknown or undervalued by those participating in the negotiations. Moreover, once informed that data transfers to a foreign jurisdiction were under consideration, taxpayers would have an opportunity to minimize risks to their property and physical safety. This public notice would also give affected taxpayers the chance to address any erroneous information or noncompliance that should be remedied. Further, it would provide them with the opportunity to mitigate the potential impact flowing from misinterpretation or improper re-disclosure of the information by the foreign jurisdiction.

The public notice should explain the safety measures that have been taken to ensure that taxpayer data will be transferred securely and used properly. This explanation will likely provide taxpayers with some reassurance. Nevertheless, the negative consequences of a data breach ultimately fall on the taxpayer, and the risk of damage increases exponentially with every additional country receiving the taxpayer's information.

Of course, unique circumstances may occasionally arise in which individual notification could jeopardize ongoing criminal investigations in either the U.S. or the foreign jurisdiction. In order to address such situations, procedures should be developed to govern the evaluation of this risk and the determination of when nondisclosure to specific individuals is warranted.

EXPLANATION OF RECOMMENDATION

Congress should amend IRC § 1474 to require announcement of IGAs for notice and comment by taxpayers; specification of the extent to which the proposed IGA partner jurisdiction conforms with the cybersecurity standards to which U.S. federal agencies are held and the taxpayer privacy standards which govern the IRS; and, barring unique and compelling circumstances, notification to taxpayers prior to the transfer of their individual information pursuant to the terms of an IGA. By doing so, Congress would give taxpayers the opportunity to voice specific concerns to be considered prior to implementation of an IGA and would allow taxpayers to undertake steps to mitigate the potential risk flowing from the theft or misuse of data during or after electronic transfer of that data to foreign jurisdictions.

28 The possibility that data may be provided under a Model 1 IGA is disclosed in various places, including on the face of the current Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)*, and in the current instructions to Form W-8BEN-E, *Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)*. Nevertheless, these generalized statements function more as broad caveats than as targeted notifications.