

MSP
#16**FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA): The IRS's Approach to International Tax Administration Unnecessarily Burdens Impacted Parties, Wastes Resources, and Fails to Protect Taxpayer Rights****RESPONSIBLE OFFICIALS**

Douglas W. O'Donnell, Commissioner, Large Business and International Division
Mary Beth Murphy, Commissioner, Small Business/Self-Employed Division

TAXPAYER RIGHTS IMPACTED¹

- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

DEFINITION OF PROBLEM

The Foreign Account Tax Compliance Act (FATCA) was passed in 2010 in response to IRS and congressional concerns that U.S. taxpayers were not fully disclosing the extent of financial assets held abroad.² In passing FATCA, Congress hoped to reign in “tax cheats” and to collect substantial amounts of previously inaccessible revenue.³ Although the concerns giving rise to FATCA are understandable, the IRS's approach to FATCA implementation has created significant compliance burdens and risk exposures to a variety of impacted parties including non-resident aliens, U.S. citizens living abroad, and foreign financial institutions (FFIs).⁴

- 1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).
- 2 Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat 71 (2010) (adding Chapter 4 of IRC §§ 1471-1474; 6038D), collectively referred to as the Foreign Account Tax Compliance Act (FATCA).
- 3 See e.g., J. Comm. on Tax'n (JCT), “*Estimated Revenue Effects of the Revenue Provisions Contained In Senate Amendment 3310, the “Hiring Incentives to Restore Employment Act,” Under Consideration by the Senate,*” JCX-5-10 (Feb. 23, 2010), Doc 2010-3977, 2010 TNT 36-20; Brian Kindle, *FATCA may identify tax cheats, but its dragnet for financial criminals may produce an even bigger yield*, Association of Certified Financial Crime Specialists (Mar. 1, 2012), <http://www.acfcs.org/fatca-may-identify-tax-cheats-but-its-drag-net-for-financial-criminals-may-produce-an-even-bigger-yield/>.
- 4 See e.g., SIFMA, *Comments on the Final FATCA Regulations* (June 21, 2013), 2, <http://www.sifma.org/comment-letters/2013/sifma-submits-comments-to-the-us-department-of-treasury-and-the-irs-on-final-fatca-regulations/>; Treas. Reg. § 1.1474-1(f); Letter from American Citizens Abroad to Jacob Lew, Sec'y, Treasury, and John Koskinen, Cmm'r, IRS (Sept. 15, 2015), <https://www.americansabroad.org/media/files/files/f74d1b79/same-country-exemption-letter.pdf>. The hardships experienced by non-resident aliens often occur under Chapter 3 of the IRC (IRC §§ 1441-1443), which is not part of FATCA. Nevertheless, as it went about implementing FATCA, the IRS determined that it would begin treating Chapter 3 refund claims synonymously with its treatment of Chapter 4 refunds. See Notice 2015-10, 2015-20 I.R.B. 965. As a result, the issues experienced by non-resident aliens when filing Forms 1040NR, U.S. Nonresident Alien Income Tax Return, seeking amounts shown as withheld on Forms 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, are discussed in this Most Serious Problem as being related to FATCA.

The IRS has adopted an enforcement-oriented regime with respect to international taxpayers.⁵ Its operative assumption appears to be that all such taxpayers should be suspected of fraudulent activity, unless proven otherwise. This assumption results in the IRS ignoring stakeholders, dismissing useful comments and suggestions, and misallocating resources.⁶ At various points, this perspective has resulted in the IRS freezing over 102,000 refund claims from non-resident aliens, creating and then suspending use of a semi-automated matching tool, and implementing a regime that places unnecessary burdens on both taxpayers and businesses.⁷

The IRS has taken this approach despite a lack of comprehensive statistical data establishing the existence of widespread noncompliance or fraud on the part of Form 1040NR filers seeking Form 1042-S refunds, and despite TAS analysis indicating that the vast majority of these taxpayers actually appear to be substantially more compliant than a comparable portion of the overall U.S. taxpayer population.⁸ Instead, the IRS should pursue a service- and assistance-oriented strategy for the vast majority of international taxpayers, coupled with a data-driven, narrowly targeted enforcement program. This approach would no longer disadvantage the compliant majority in an effort to prevent potential fraud by a few bad actors. In the meantime, the National Taxpayer Advocate remains concerned that:

- IRS processes for reviewing and validating Chapter 3 and Chapter 4 refund requests continue to unnecessarily burden taxpayers;
- Contemplated Chapter 3 and Chapter 4 regulations would explicitly make the availability of credits and refunds to covered taxpayers contingent on the actions of withholding agents;
- U.S. expatriates are particularly vulnerable to FATCA-related hardships;
- Passport revocations and denials could cause substantial problems for both U.S. expatriates and residents; and
- FFIs face regulatory uncertainty, reputational risk, and ongoing expenditures regarding FATCA and related information reporting obligations.

5 National Taxpayer Advocate FY 2017 Objectives Report to Congress 80-84.

6 See National Taxpayer Advocate FY 2017 Objectives Report to Congress 80-84; National Taxpayer Advocate 2015 Annual Report to Congress 346-52; National Taxpayer Advocate 2013 Annual Report to Congress 238-48.

7 Compliance Data Warehouse (CDW), Individual Master File (IMF) and Individual Returns Transaction File (IRTF) Extract Cycle as of 201634 (Aug. 2016); IRS, *IRS Takes Steps to Help Students; Outlines Interim Process for Obtaining Refunds of Withholding Tax Reported on Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding* (June 6, 2016), <https://www.irs.gov/uac/irs-takes-steps-to-help-students-and-others-outlines-interim-process-for-obtaining-refunds-of-withholding-tax-reported-on-form-1042s-foreign-persons-us-source-income-subject-to-withholding>.

8 TAS bases this determination on an analysis of data relating to reporting compliance. For example, since 2008 the “no change” rate for cases involving audits of Form 1040NR filers who also filed a Form 1042-S has generally exceeded the audit “no change” rate for all Form 1040NR filers as well for as all Form 1040 filers. Data drawn July 12, 2016 from IRS CDW, IRTF, IRMF, and Audit Information Management System (AIMS). Further, Form 1040NR taxpayers claiming Form 1042-S refunds have a lower percentage of high-scoring Discriminant Index Function (DIF) returns in comparison to filers overall — see particularly Total Positive Income (TPI) Class 72, which encompassed most taxpayers in this group. Data drawn March 25, 2016 for tax year (TY) 2014 from IRS CDW, IRTF and IMF.

ANALYSIS OF PROBLEM

IRS Processes for Reviewing and Validating Chapter 3 and Chapter 4 Refund Requests Continue to Unnecessarily Burden Taxpayers

The FATCA Program has generated a number of technology-based data management systems. These systems, on which over \$100 million have been spent, are designed to:⁹

- Allow FFIs to establish online accounts with the IRS and participate in a standardized worldwide residence-based information reporting regime;
- Facilitate financial institution reporting to the IRS and the exchange of information between the IRS and foreign tax authorities under intergovernmental agreements; and
- Compile FATCA-related data filed by taxpayers, such as via Form 8938, *Statement of Specified Foreign Financial Assets*, and Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, and match those against related compliance data coming from FFIs and withholding agents.

Many of these systems, however, are not fully functional and are not yet adequate to process the various data streams being collected from other governments, FFIs, and withholding agents under FATCA. Large amounts of data are being collected, but the ability to effectively match that data as part of the tax compliance process has not been fully developed. For example, although the IRS spent \$15 million developing and implementing an automated matching tool with respect to Chapter 3 and Chapter 4 withholding and refunds, that tool has not produced the intended business results, and the IRS does not have a timetable for when it will be remedied and brought online.¹⁰

In the interim, the IRS pursued its systemic matching program through the use of a newly developed semi-automated matching tool supplemented by high-level manual review.¹¹ This program generated widespread disallowances of Form 1042-S refunds claimed by non-residents on their Forms 1040NR.¹² This policy fell especially hard on international students, who, as a category, generally seek small-dollar refunds and represent a particularly low-risk taxpayer group.¹³ Many of these disallowances occurred for reasons that often were beyond taxpayers' control, such as transcription errors within the IRS and poor data quality.¹⁴

The National Taxpayer Advocate and various stakeholders raised concerns about the matching program and the problems it caused for non-residents.¹⁵ These cautions, however, were repeatedly dismissed by

9 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2016-20-077, 2-3 (Aug. 31, 2016). See the TIGTA report for a more detailed discussion of the FATCA Program systems deployment and the actual or contemplated functionalities associated with each release.

10 TIGTA, Ref. No. 2016-20-077, 4, 8 (Aug. 31, 2016).

11 Internal Revenue Manual (IRM) 21.8.1.11.14.2, *FATCA - Programming Beginning January 2015 Affecting Certain Forms 1040NR* (Aug. 1, 2016). (See Servicewide Electronic Research Program: <http://serp.enterprise.irs.gov/databases/irm.dr/current/21.dr/21.8.dr/21.8.1.dr/21.8.1.11.14.2.htm>).

12 IRS, *IRS Takes Steps to Help Students; Outlines Interim Process for Obtaining Refunds of Withholding Tax Reported on Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding* (June 6, 2016), <https://www.irs.gov/uac/irs-takes-steps-to-help-students-and-others-outlines-interim-process-for-obtaining-refunds-of-withholding-tax-reported-on-form-1042s-foreign-persons-us-source-income-subject-to-withholding>.

13 *Id.*; National Taxpayer Advocate 2017 Objectives Report to Congress 123-30.

14 Notes from TAS conference call with Large Business and International (LB&I) (Apr. 29, 2016) (on file in TAS archives).

15 TAS General Project 34152; Briefing paper, NACUBO, *Widespread Tax Problems for International Students* (Apr. 21, 2016) (on file in TAS archives); Letter from Donna Kopley, President, Arctic International LLC, to Nina Olson, National Taxpayer Advocate (Apr. 18, 2016) (on file in TAS archives).

the IRS officials charged with operating the program.¹⁶ Only when congressional inquiries were received did the IRS take the problems seriously.¹⁷ Ultimately, an investigation of the process determined that IRS transcription errors and rigid processes were primarily responsible for the excessive number of false positives generated by the systemic matching program.¹⁸

... the IRS should pursue a service- and assistance-oriented strategy for the vast majority of international taxpayers, coupled with a data-driven, narrowly targeted enforcement program.

The IRS announced that it would lift the freezes placed on refunds of withholding tax reported on Forms 1042-S and that it would discontinue its policy of instituting future freezes until it redesigned the process for examining such claims.¹⁹ This redesign, which is currently ongoing, appears to be primarily focused on ways of alleviating the most obvious and egregious inequities to which taxpayers were subject under the prior program. Rather than retaining the prior concepts, which derive from the incorrect assumption that international transactions are more likely to be fraudulent, the process redesign should center around improving and then adapting the already-developed policies, procedures, and systems applied in the domestic context to the majority of international taxpayers.²⁰ Such an approach would effectively utilize IRS resources and fairly apply the U.S. tax laws to international taxpayers. In order for this effort to be successful, however, the IRS must abandon its enforcement-only bias against international taxpayers, become less insular in its approach, better coordinate among its own Operating Divisions, and listen to the observations and recommendations of the National Taxpayer Advocate and stakeholders who have valuable perspectives to contribute.

The IRS should treat domestic and international taxpayers similarly unless and until comprehensive statistical data indicates significantly different compliance patterns for specific groups of taxpayers. To the extent those patterns are established, the IRS would have a basis for treating certain categories of taxpayers differently and would also have a means of implementing effective and proportionate compliance initiatives (including enforcement) against those groups most likely to be noncompliant. Until such time,

¹⁶ TAS General Project 34152.

¹⁷ Letter from Rep. Lloyd Doggett to John Koskinen, Comm'r, IRS (Apr. 22, 2016) (on file in TAS archives); Letter from John Koskinen, Comm'r, IRS to Rep. Lloyd Doggett (June 6, 2016) (on file in TAS archives).

¹⁸ IRM 21.8.1.11.14.2, *FATCA - Programming Beginning January 2015 Affecting Certain Forms 1040NR* (Aug. 1, 2016). (See SERP: <http://serp.enterprise.irs.gov/databases/irm.dr/current/21.dr/21.8.dr/21.8.1.dr/21.8.1.11.14.2.htm>); IRS, *IRS Takes Steps to Help Students; Outlines Interim Process for Obtaining Refunds of Withholding Tax Reported on Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding*, (June 6, 2016), <https://www.irs.gov/uac/irs-takes-steps-to-help-students-and-others-outlines-interim-process-for-obtaining-refunds-of-withholding-tax-reported-on-form-1042s-foreign-persons-us-source-income-subject-to-withholding>.

¹⁹ IRS, *IRS Takes Steps to Help Students; Outlines Interim Process for Obtaining Refunds of Withholding Tax Reported on Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding* (June 6, 2016), <https://www.irs.gov/uac/irs-takes-steps-to-help-students-and-others-outlines-interim-process-for-obtaining-refunds-of-withholding-tax-reported-on-form-1042s-foreign-persons-us-source-income-subject-to-withholding>.

²⁰ In the Return Integrity & Compliance Services (RICS) Integrity & Verification Operation (IVO) employed domestically, the IRS freezes potentially questionable claims while seeking to validate the withholding through its own systems and directly with the employer. IRM 25.25.1.1 (Feb. 19, 2015). See also National Taxpayer Advocate 2015 Annual Report to Congress 47 Fig. 1.4.1. This program itself is in need of substantial improvements in order to achieve an acceptable target rate of false positives.

the IRS's enforcement-oriented approach with respect to international taxpayers likely will continue to be unsystematic, unjustified, and unsuccessful.²¹

Contemplated Chapter 3 and Chapter 4 Regulations Would Explicitly Make the Availability of Credits and Refunds to Covered Taxpayers Contingent on the Actions of Withholding Agents

As previously discussed by the National Taxpayer Advocate, this new international enforcement regime under which the burdens and risks are disproportionately shifted to largely compliant taxpayers takes troubling shape in Chapter 3 and Chapter 4 withholding regulations currently under development by the IRS and Treasury.²² Specifically, these regulations would allow full credits or refunds only after a taxpayer files a tax return accompanied by the requisite Form 1042-S if the IRS can confirm that the withholding agent remitted the full amount of the aggregate liabilities for which the withholding agent is responsible.²³ In the event that a withholding agent has only partially satisfied its deposit requirements with the IRS, the regulations would provide for a *pro rata* allocation of the amount deposited among taxpayers seeking to claim credits or refunds for the withholding in question.²⁴

Some exceptions may be developed for certain scenarios, such as in cases where the under deposit of tax is *de minimis*, or in cases where the withholding agent in question has a demonstrated history of compliance with its deposit requirements.²⁵ These proposed exceptions, however, would not always address circumstances where proper amounts were *actually withheld* from taxpayers' accounts. Thus, good-faith taxpayers, for reasons completely beyond their control, could be denied a credit or refund of amounts withheld pursuant to U.S. tax law. This shift in creditor risk from the IRS, which is best positioned to enforce and collect withholding liabilities, to individual taxpayers, who are often powerless to remedy such failures, jeopardizes taxpayers' *right to a fair and just tax system* and *right to pay no more than the correct amount of tax*.²⁶ Such a regime undermines the fundamental perceptions of equity on which the voluntary tax compliance system depends.²⁷

As in the domestic context, the IRS should accept responsibility for bringing its enforcement resources to bear against noncompliant withholding agents, rather than innocent taxpayers.²⁸ This approach is feasible as withholding agents, even those active in the international arena, are overwhelmingly domestic (approximately 86 percent) and, to the extent they engage in noncompliant behavior, can be compelled by the IRS to remit the withholding payments they have collected, even where non-resident taxpayers are involved.²⁹

21 IRC § 6611(e)(4) provides that no overpayment interest will accrue on Chapter 3 and Chapter 4 refunds paid within 180 days of when the tax return is due or filed, whichever is later. Nevertheless, this statutory authority to avoid paying interest on such refunds should not be construed as a mandate for perpetually delaying those refunds in the absence of a reasonable basis for doing so and without an effective system for reviewing the claims. Simply because the IRS *can* freeze Chapter 3 and Chapter 4 refunds without quickly incurring interest charges, does not mean that the IRS *should* freeze these refunds at all or for the full 180 days.

22 National Taxpayer Advocate 2015 Annual Report to Congress, 346-52. See also Notice 2015-10, 2015-20 I.R.B. 965.

23 Notice 2015-10, III.A., 2015-20, I.R.B. 965.

24 *Id.*

25 *Id.*

26 See TBOR, www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

27 Marjorie E. Kornhauser, *A Tax Morale Approach to Compliance: Recommendations for the IRS*, 8 Fla. Tax Rev. 599 (2007); John Hasseldine and Peggy Hite, *Key Determinants of Compliance and Non-Compliance*, 2007 TNT 205-40, 379 (2007).

28 National Taxpayer Advocate 2015 Annual Report to Congress, 346-52.

29 LB&I response to TAS information request (Sep. 6, 2016). Treas. Reg. § 1.1461-1T(c). See also IRC §§ 6601, 6651(a)(2), and 6656.

U.S. Expatriates Are Particularly Vulnerable to Foreign Account Tax Compliance Act (FATCA)-Related Hardships

The IRS's enforcement-based orientation regarding offshore issues can also be especially problematic for U.S. expatriates. Some American citizens residing abroad have reported experiencing banking “lock-out” by FFIs that have chosen to eliminate their U.S. client base in order to minimize their exposure to FATCA reporting requirements and potential penalties.³⁰ As a recommendation to help solve this problem and minimize the burden of FATCA compliance for both individual U.S. taxpayers and FFIs, the National Taxpayer Advocate previously proposed that the IRS and Treasury adopt a “same country exception.”³¹ This exception would exclude from FATCA coverage financial accounts held in the country in which a U.S. taxpayer is a *bona fide* resident, would mitigate concerns about the collateral consequences of FATCA raised by U.S. non-residents, and would reduce reporting burdens faced by FFIs.

No action has been taken by the IRS or Treasury with respect to this recommendation. This idea of a same country safe harbor has also been placed before Congress by the National Taxpayer Advocate, American Citizens Abroad, and Democrats Abroad.³² The National Taxpayer Advocate reiterates her recommendation that the FATCA regime incorporate a same country exception.

In a recent survey of U.S. expatriates conducted by Americans Abroad Global Foundation and the University of Nevada-Reno, 91 percent of respondents indicated that FATCA compliance placed them at a disadvantage compared with ordinary citizens from their country of residence.³³ Further, 86 percent articulated the belief that the law should be revised to reduce some of the associated burdens by adopting a “Same Country Exception.”³⁴ The survey report concludes, “There appears to be a consensus among many respondents that their government does not recognize how the FATCA legislation is negatively affecting them and limiting their ability to maintain banking and financial relationships. Most feel that their government is not doing enough to try and address their concerns and problems.”³⁵

Perhaps because of the perceptions expressed in the University of Nevada study, along with other reasons including banking lock-out and the additional compliance burdens imposed by FATCA and related information reporting regimes, the number of expatriates renouncing their U.S. citizenship has continued to rise.³⁶ In calendar year 2015, a record 4,279 individuals renounced their U.S. citizenship or long-term residency — a 25 percent increase over 2014, which likewise had been a record-breaking year.³⁷ As

30 See Letter from American Citizens Abroad to Jacob Lew, Sec'y, Treasury, and John Koskinen, Cmm'r, IRS (Sept. 15, 2015), <https://www.americansabroad.org/media/files/files/f74d1b79/same-country-exemption-letter.pdf> (last visited Oct. 21, 2016).

31 *National Taxpayer Advocate Seeks End to Duplicative FATCA Reporting*, 2015 TNT 71-16 (Apr. 14, 2015).

32 Letter from American Citizens Abroad to Jacob Lew, Sec'y, Treasury, and John Koskinen, Cmm'r, IRS (Sept. 15, 2015), <https://www.americansabroad.org/media/files/files/f74d1b79/same-country-exemption-letter.pdf>; Democrats Abroad, *FATCA Update: October - December 2015*, http://www.democratsabroad.org/fatca_update_oct_december_2015 (last visited Feb. 12, 2016). See also National Taxpayer Advocate 2015 Annual Report to Congress 353-62.

33 *A Study of the Consequences of the Foreign Account Tax Compliance Act on Americans Living Overseas: Survey Results and Interpretations*, University of Nevada, 10, Table 1. <http://www.unr.edu/Documents/business/accounting/FATCASurveyReportFinalDraftDecember2015.pdf>.

34 *Id.* at 13.

35 *Id.* at 14.

36 81 Fed. Reg. 6598-02, 2016-02312.

37 International Tax Blog, *New Expatriate Record for 2015 – Nearly 4,300 Expatriations* (Feb. 5, 2016) http://intltax.typepad.com/intltax_blog/2016/02/new-expatriate-record-2015-nearly-4300-expatriations.html; Russell Newlove, *Why Expat Americans are Giving up their Passports*, BBC News (Feb. 12, 2016), <http://www.bbc.com/news/35383435>. See also 81 Fed. Reg. 6598-02, 2016-02312.

explained by one expatriate, “If it weren’t for FATCA and the decision by the bank [lock-out], I’d never be doing this.”³⁸

Passport Revocations and Denials Could Cause Substantial Problems for Both U.S. Expatriates and Residents

Another enforcement provision that exacerbates the disproportionate burden on expatriates is the recently enacted law allowing for the revocation or denial of passports for taxpayers who owe the IRS more than \$50,000.³⁹ For U.S. residents, the lack of a passport typically would constitute an irritation; for expatriates, however, it could represent a crisis: “Americans abroad need their passports for many routine activities of daily life, such as banking, registering in a hotel, or registering a child for school, and mistakes could be disastrous.”⁴⁰ Additionally, concern has been expressed regarding potentially dangerous in-country events or circumstances to which expatriates might sometimes be exposed because of passport revocation.⁴¹

The IRS is currently developing processes and procedures relating to the implementation of this additional tax enforcement mechanism. In this process, the IRS should learn from its experiences with Chapter 3 and Chapter 4 refunds and carefully coordinate and collaborate within its own Operating Divisions and within the Department of State. Moreover, the IRS should protect the rights of taxpayers by, among other things:

- Broadly interpreting hardship and other discretionary exclusions;
- Providing an administrative appeal before certifying a “seriously delinquent tax debt” to the Department of State;
- Encouraging the Department of State to adopt expansive definitions of humanitarian and emergency exceptions; and
- Informing the taxpayer of the availability of TAS assistance before passport revocation or denial occurs.⁴²

Great care should be taken in the implementation of this law to ensure that its application is reasonable and proportionate with respect to both U.S. citizens residing abroad and in the United States.

Foreign Financial Institutions (FFIs) Face Regulatory Uncertainty, Reputational Risk, and Ongoing Expenditures Regarding the Foreign Account Tax Compliance Act (FATCA) and Related Information Reporting Obligations

The IRS’s shift to enforcement-based international tax administration places significant compliance burdens and costs of implementation on FFIs as well as taxpayers. For example, a broad range of U.S.-source payments to FFIs are subject to a 30 percent withholding tax, unless the FFIs agree to provide

38 Russell Newlove, *Why Expat Americans are Giving up their Passports*, BCC NEWS (Feb. 12, 2016), <http://www.bbc.com/news/35383435>.

39 Fixing America’s Surface Transportation Act (FAST), Pub. L. No. 114-94, Title XXXII, Subtitle A, § 32101 (Dec. 4, 2015), adding IRC § 7345. See also Chris Matthews, *Pay Your Taxes or Lose Your Passport*, FORTUNE MAGAZINE (Nov. 20, 2015), <http://fortune.com/2015/11/20/irs-taxes-passport/>.

40 Chris Matthews, *Pay Your Taxes or Lose Your Passport*, FORTUNE MAGAZINE (Nov. 20, 2015), <http://fortune.com/2015/11/20/irs-taxes-passport/>.

41 Alexander Lewis, *New Law Will Revoke Passports for Delinquent Tax Debts*, 2015 TNT 234-6 (Dec. 7, 2015). See also Fixing America’s Surface Transportation Act (FAST), Pub. L. No. 114-94, Title XXXII, Subtitle A, § 32101 (Dec. 4, 2015).

42 See Fixing America’s Surface Transportation Act (FAST), Pub. L. No. 114-94, Title XXXII, Subtitle A, § 32101 (Dec. 4, 2015), adding IRC § 7345.

comprehensive information regarding accounts of U.S. taxpayers.⁴³ Additionally, FATCA charges withholding agents with the responsibility of determining whether they are obliged to undertake FATCA withholding and implementing it when required.⁴⁴

In turn, FFIs who have reached agreements with the IRS to avoid being subject to systematic withholding must impose withholding on any of their own customers defined as “recalcitrant account holders.”⁴⁵ Although FFIs have some latitude in identifying recalcitrant account holders, customers are in jeopardy of facing withholding if they are unable to provide the FFI with either a Form W-9 to certify they are U.S. persons, or a Form W-8BEN to certify they are foreign persons.⁴⁶ When in doubt, FFIs are incentivized to over-withhold, as failure to do so can result in liability for the uncollected withholding and exposure to penalties.⁴⁷

FATCA implementation has been characterized by a change from information gathering to withholding and enforcement.⁴⁸ This heavy-handed approach, especially when combined with the complexity surrounding IRS requirements, has negative consequences, both for FFIs and the IRS. For example, the IRS has made a number of changes to Form 8966, *Foreign Account Tax Compliance Act (FATCA) Report*, which is used to collect information for identifying noncompliance, without providing helpful instructions or adequately coordinating with foreign tax authorities.⁴⁹ As explained by industry stakeholders in a 2015 IRS FATCA roundtable:

Complexity is a big issue under FATCA. Regional/community banks that do not have the resources to make all of the changes needed to respond to the complexity are struggling with clarity and lack of understanding of what the rules are. As a result, FFIs run the risk of IRS sanctions if they mistakenly use incorrect codes for reporting or misinterpret the rules in validating W-8s.⁵⁰

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

44 IRC §§ 1471 – 1474; Notice 2016-08, 2016-06 I.R.B. 304.

45 IRC § 1471(b)(1)(D)(i).

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

47 IRS, *IRS FATCA Roundtable: Industry Concerns and Suggestions*, 5 (Nov. 16, 2015). See also Notice 2016-08, 2016-06 I.R.B. 304

48 *Id.* at 3.

49 *Id.*

50 *Id.* at 2-3.

The IRS could reduce compliance burdens on FFIs and ultimately achieve more effective results if it adopted a collaborative model of tax administration with respect to FFIs. A significant step in this regard would be to simplify and clarify the definition of “good faith efforts” under IRS published guidance.⁵¹ As things stand now, “... over-reporting, over-withholding, and misinformation could make it difficult for the IRS to use the information it is receiving as intended, and may lead to false-positives.”⁵² The IRS should “distinguish between FFIs that are colluding with their local authorities to avoid FATCA and FFIs that are making genuine, ‘good faith’ efforts to comply, but are unable to because of the complexity of the law.”⁵³

The IRS should acknowledge the colossal efforts undertaken by FFIs to comply with FATCA rules. At the same time, it should begin working cooperatively with them to maintain and improve reporting rather than simply penalizing them for noncompliance. Instead of threatening penalties, the IRS should encourage correction of erroneous reporting and focus its efforts on giving FFIs the clarity and consistent guidance needed for reasonable, cost-effective compliance with FATCA.

CONCLUSION

The IRS has gradually shifted to an enforcement-based regime with respect to international taxpayers.⁵⁴ The underlying assumption is that all such taxpayers should be suspected of fraudulent activity until they can prove otherwise, an outlook that causes the IRS to mistrust stakeholders, dismiss useful comments and suggestions, and misallocate resources.⁵⁵

One manifestation of this perspective has been the development and implementation of processes for reviewing and validating Chapter 3 and Chapter 4 refund requests that continue to unnecessarily burden taxpayers. Contemplated Chapter 3 and Chapter 4 regulations would exacerbate these problems by making the availability of credits and refunds to covered taxpayers contingent on the actions of withholding agents, over whom taxpayers have little, if any, control. Further, U.S. expatriates are particularly vulnerable to FATCA-related hardships such as banking lock-out and other conceptually similar legislation, such as IRC § 7345, which allows for potential passport revocation and denial.

FFIs likewise face regulatory uncertainty, reputational risk, and ongoing expenditures regarding FATCA and related information reporting obligations. The IRS could achieve better results and reduce burdens placed on taxpayers and FFIs if it followed a collaborative model of taxation that sought to identify and focus on the relatively few bad actors while at the same time recognizing the good faith efforts of the compliant majority.

51 IRS, *IRS FATCA Roundtable: Industry Concerns and Suggestions*, 3 (Nov. 16, 2015).

52 *Id.* at 7.

53 *Id.* at 7.

54 National Taxpayer Advocate FY 2017 Objectives Report to Congress 80-84.

55 See *id.* National Taxpayer Advocate 2015 Annual Report to Congress 346-52; National Taxpayer Advocate 2013 Annual Report to Congress 238-48.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Implement policies and procedures for reviewing and issuing Chapter 3 and Chapter 4 refund claims that mirror those processes currently in place with respect to domestic taxpayers under IRC § 31 and related regulations.
2. Adopt a same country exception that excludes from FATCA coverage financial accounts held in the country in which a U.S. taxpayer is a *bona fide* resident.
3. Protect the rights of taxpayers potentially impacted by the new law regarding revocations and denials of passports by broadly interpreting hardship and other discretionary exclusions; providing an administrative appeal before certifying a “seriously delinquent tax debt” to the Department of State; working with the Department of State to encourage it to adopt expansive definitions of humanitarian and emergency exceptions; and informing taxpayers of the availability of TAS assistance before passport revocation or denial occurs.
4. Reduce burdens on FFIs by adopting a collaborative model of tax administration that encourages FFIs to correct erroneous reporting and focuses on providing the clarity and consistent guidance needed for reasonable, cost-effective compliance with FATCA.