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Reporting Rule Might Deflect Some Criticism of U.S. as Tax Haven

By

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Although the United States has been accused of hypocrisy for forcing foreign banks to turn over the financial information of U.S. account holders while the U.S. withholds details about the ultimate foreign beneficiaries of U.S. bank accounts, a recent requirement to report the underlying buyers of real estate in New York and Miami could be a foot in the door for expanded international cooperation.

Some critics have called the United States a tax haven for its alleged failure to require disclosure of the beneficial owners of entities and trusts. In the United States, the registration of those vehicles is done according to state law, with Delaware the jurisdiction of choice for many large companies and wealthy individuals, especially those with international connections. Delaware imposes strict confidentiality limitations on registering and disclosing the names of the owners of entities registered in the state. There has been criticism that the anonymity offered by states such as Delaware allows foreign tax cheats and money launderers to squirrel away their funds without fear that the United States will expose them to their home governments.

"The U.S. has always been the number one tax haven in the world," said Kenneth Rubinstein of Rubinstein & Rubinstein. "If you look at U.S. policy, it's always been to discourage capital flow out and encourage flow in. That's the underlying motivation for" the Foreign Account Tax Compliance Act.

FATCA, enacted in 2010, requires U.S. persons to report their offshore financial accounts to the federal government. The law also mandates that foreign financial institutions search their records for suspected U.S. persons and report the assets and identities of those account holders to the Treasury Department. Any U.S. financial institution or other U.S. withholding agent making a payment to a foreign entity without documenting its FATCA status must withhold 30 percent of the amount paid and remit those funds to the IRS. U.S. financial institutions must also report information about certain nonfinancial foreign entities.

A number of European countries picked up on the United States' cue and worked with the OECD to put together a common reporting standard (CRS). While FATCA requires automatic reporting to the United States and allows the IRS to provide information in the other direction on request, the CRS calls for both automatic and reciprocal exchange of information from the source country to the residence country on an annual basis. "The U.S. has FATCA and therefore saw no need to sign up to CRS," said Richard Cassell of Withers LLP. "It believes it is effectively participating through its bilateral information exchange under FATCA intergovernment agreements. The OECD does not agree, and so the U.S. is classified as a nonparticipating country."

Cassell said classification as a nonparticipating country will likely lead to more intrusive investigations by an entity, such as a brokerage, in a CRS jurisdiction to determine the beneficial ownership and "controlling persons" of a client that is a U.S. trust.

Cassell challenged the claim that the United States doesn't have information to share about the foreign owners of U.S. entities. He pointed to a requirement that entities that are treated as partnerships under the Internal Revenue Code must provide the IRS with information about their owners. U.S. corporations paying dividends must also report details about their shareholders, he said. "The IRS has been active in exchanging information, particularly with EU countries, through intergovernment agreements," Cassell said. "But it isn't clear exactly what information is being exchanged."

J. Richard Harvey of Villanova University said that by implementing FATCA, the United States paved the way for more international reporting of financial assets, such as through the CRS. "Thus, it is somewhat ironic and disappointing that the U.S. has failed to fully participate in CRS," Harvey said. "Such failure could make it more difficult for the U.S. to successfully implement FATCA to the extent [that] other countries decide to not provide certain information with the U.S."

"By not participating in the effective exchange of information process, in particular exchanging information with others which can be found in U.S. records, it does leave a big hole in the attempt to limit the ability of money launderers, tax evaders, and the criminal fraternity from being closed," said Andrew McKenna of Smith & Williamson in Manchester, England.

Although the CRS provides for the automatic exchange of information of some beneficial owners of financial accounts, the requirement is not absolute. The name of the beneficial owner (known as the controlling person) of an entity must be disclosed only if it is considered a passive nonfinancial entity and is the registered holder of the financial account. Equity holders of an investment entity such as a trust with a financial account are subject to information exchange if the entity is considered a financial institution and has a financial account in a signatory country.

Andres Knobel of the Tax Justice Network said that while more than 70 jurisdictions have signed the multilateral competent authority agreement on the automatic exchange of financial account information under the CRS, a number of requirements regarding underlying treaties, national legislation, and confidentiality must also be met before the transfer of information can begin. Knobel likened the process to the Tinder online dating service. Automatic exchange of information "will take place only among jurisdictions that meet all the requirements . . . and that choose each other," he said.

Follow the Cash

Even with its limitations, the CRS provides for the exchange of far more information about the ultimate owners or beneficiaries of financial accounts than is easily available to foreign governments from the United States. A small crack in that largely impervious wall might have been opened on January 13, when the Treasury Department announced that title insurance companies must identify and report the natural persons behind companies paying cash for high-end residential properties in Manhattan and Miami. The requirement, which will be in effect for 180 days from March 1, is intended to address money laundering vulnerabilities and applies to

cash transactions in excess of $1 million in Miami and $3 million in Manhattan.
The *New York Times* reported in 2015 that almost half the homes in the United States purchased for at least $5 million were bought in the name of shell companies. The *Times* said there were 1,045 residential sales in excess of $3 million in Manhattan during the second half of 2015. The newspaper also reported that its review of property records for a number of condominiums in Manhattan revealed several hidden owners who had been subjects of government investigations.

"We are seeking to understand the risk that corrupt foreign officials, or transnational criminals, may be using premium U.S. real estate to secretly invest millions in dirty money," Jennifer Shasky Calvery, director of Treasury's Financial Crimes Enforcement Network, said in a statement.

"This is a great way to launder money," said Milan Patel of Anaford AG. "Some of these guys live in Russia or somewhere else and aren't U.S. citizens. There's no U.S. tax evasion. Who's going to stop the deal? The real estate brokers, title companies, and lawyers all want the deal to go through."

Patel said that once real estate bought in those cash transactions is ultimately sold, the proceeds take on a cloak of legitimacy. "They'll launder money that's gone untaxed, but when they sell, they'll have a legitimate source," he said.

FinCEN said the information received from title insurance companies will be made available to law enforcement investigators. The agency did not respond by press time to the question whether the information would also be accessible by foreign governments as part of their tax evasion investigations.

Thierry Boitelle of Bonnard Lawson in Geneva said "this rather limited reporting" will be available to foreign governments by way of the information exchange provisions of tax and judicial assistance agreements. "Most likely it will be upon request, although there are good arguments for saying that contracting states have a fiduciary duty toward each other to exchange information spontaneously in case of suspicion of money laundering or tax evasion," Boitelle said. "I would hope this is actually a best practice being applied, but maybe I am dreaming or being naive about it."

Boitelle said that under article 26 of the OECD model tax convention, contracting states agree to exchange information "that is foreseeably relevant" for the application of the treaty or for the enforcement of domestic tax laws in the other contracting state. Robert Stack, Treasury deputy assistant secretary (international tax affairs), told a Senate committee in October 2015 that the "foreseeably relevant" standard for information exchange has been accepted by the United States since 1996, and is used in all but one of the country's 57 tax treaties. The lone exception is the treaty with Switzerland, which provides for information exchange only in cases of tax fraud. (Prior coverage.)

Even the CRS, which applies only to financial accounts, does not require direct reporting of the beneficial owners of entities involved in residential real estate transactions. "But it does get details of any other amount credited to an account in the year, which may be the proceeds of a property sale, etc., but that would not be identified as such," McKenna said.

Kevin Packman of Holland & Knight LLP said the temporary reporting requirement is not foolproof because it focuses only on cash transactions. "If the purchaser has a mortgage, then the rules do not apply," he said. "I suspect the belief is that, if there is a mortgage in place, the lender's due diligence [requirement] kicks in and they can determine if the funds are from legitimate means. Notwithstanding, . . . if this works, I do believe we can expect FinCEN to kick in greater rules in other areas."

Knobel referred to the move as a "tiny first step, more symbolic than real," because it is prospective in effect. "What is the use of publicly announcing to tax dodgers and money launderers about the future?" Knobel said. "What tax dodger or money launderer will now buy any real estate in New York or Miami between March and August?"

Knobel said the Tax Justice Network leveled similar criticism at the OECD for saying in 2014 that there would be no reporting of preexisting financial accounts up through the end of December 2015 if the account was held in the name of an entity and its value was below $250,000.

Harvey said the temporary reporting requirement for cash transactions might not prove effective for long. He said he is "not sure what vehicles [or] strategies will still be available, but if there is any ability to continue to shield identities, they will be pursued."

Washington's Big Stick

There is broad agreement that the United States was successful with FATCA because Washington brandished a big stick in the form of the 30 percent withholding requirement. "Just about every foreign bank holds its excess cash in U.S. foreign notes," Rubinstein said. "The threat is a very serious one. That's why every institution has agreed. Foreign governments don't have the same leverage over us."

Boitelle agreed. The situation "may be different if the European Union made trade or financial services agreements dependent on reciprocity and if exchange of information agreements did the same," he said. "But with FATCA already in place, the position of other countries is not very strong. The U.S. will get the information it wants in any case."

Daniel Blum of the University of Vienna said the EU could have similar leverage if it wanted to. "In theory, it could speak in one voice," he said. "But there are deviating national interests."

Knobel said the Tax Justice Network will soon publish a paper calling on the EU to impose FATCA-style withholding requirements on the United States and other noncooperating countries. "Ideally, [it would work] unilaterally, via an EU directive, against all financial centers that refuse to send as much information as the CRS requires, either to the EU or to developing countries," Knobel said. He added that his organization fears that the EU would rather renegotiate existing intergovernmental agreements with the United States than impose a withholding requirement via an EU directive.

Touting U.S. as CRS Refuge

Cassell said he has heard from trust companies promoting the use of their U.S. affiliates as

vehicles to avoid CRS reporting, but he declined to identify them. Tax Analysts conducted an informal poll of 15 tax and financial professionals to see if any were aware of financial institutions touting the United States as a haven for their financial accounts, safe from CRS information exchange requirements. While two other respondents said they had also heard of attempts, neither was able to provide tangible evidence of the activity.
Other financial professionals were less sure. "They might do this, but we are not aware of any U.S. financial institutions using this as a marketing tool to attract new account holders," said Michael Molenaars of Stibbe in Amsterdam.

McKenna said smaller, private banks might consider such an approach worthwhile. "There is anecdotal evidence that some banks . . . would use such ploys to attract business, but it would not be done in a marketed or public way," he said. "It may be marketable [just as] the unwillingness of many European banks to deal with U.S. customers post-FATCA became an opportunity to some European-based banks who saw this as an opportunity to expand their customer base to take on these unwanted U.S. clients."

Boitelle said a similar approach was taken in the past by U.S. banks out of Miami trying to win the business of high-net-worth individuals in Latin America. "But I can't imagine a reputable U.S. financial institution using such arguments in today's transparent world," he said. "Even if it would still be true today, we have learned that things can quickly change and the U.S. banks may even commit a crime if they could be seen as aiding and abetting foreign tax evasion."