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In this article, Bruce explains the need for a same-country exemption

to the Foreign Account Tax Compliance Act, which he says could mitigate the “lockout” problem faced by Americans living abroad who are being denied financial services by banks in their country of residence.

The views expressed in this article are those of the author alone and do not necessarily represent the views of any other person or group.

In recently published final and temporary regulations (T.D. 9809) concerning the Foreign Account Tax Compliance Act, released December 30, 2016, Treasury stated that it had rejected the request by commentators for an exemption from the FATCA rules for specific accounts of individuals who reside in the foreign jurisdiction where their account with a foreign financial institution is located. The idea of the exemption was to mitigate the “lockout” problem faced by Americans living abroad who have difficulty accessing banking services by foreign banks for use in the ordinary, everyday conduct of their lives. The regulations ignore the problem and focus only on the risk — neither quantified nor weighted — that some overseas-resident U.S. taxpayers holding an account in a local FFI might try to avoid U.S. taxes.

What Do the Regulations Provide?

The regulations describe Treasury’s decision to reject the same-country exemption (or SCE):

Comments requested that the definition of a U.S. account exclude accounts held by U.S. individuals resident in the same jurisdiction as the FFI with which the account is held. This comment is not adopted. The U.S. federal income tax system largely relies on voluntary compliance, and third party information reporting of the financial accounts of U.S. taxpayers is used to encourage voluntary compliance. For this reason, U.S. financial institutions are generally required to report under chapter 61 U.S. and foreign source investment income paid to account holders that are U.S. individuals. However, before FATCA, FFIs (in particular, non-U.S. payors) generally were not required to report foreign source payments made to U.S. taxpayers. The information reporting required by FATCA is intended to address the use of foreign accounts to facilitate tax evasion, and also to strengthen the integrity of the voluntary compliance system by placing U.S. taxpayers with accounts held with FFIs in a comparable position to U.S. taxpayers with accounts held with U.S. financial institutions. This is the case even for U.S. taxpayers resident abroad, since U.S. citizens and U.S. resident aliens are subject to U.S. income tax on their worldwide income regardless of where they reside and regardless of whether their accounts are maintained by U.S. financial institutions or FFIs. The Treasury Department and the IRS have also decided that the risk of U.S. tax avoidance by a U.S. taxpayer holding an account with an FFI exists regardless of whether the U.S. taxpayer holds an account in his or her

foreign country of residence or another foreign country.¹

What's Going On?

A lockout problem has arisen in the wake of FATCA. Americans abroad are being denied financial services — including retail banking — by foreign banks. To some difficult-to-quantify degree, this is a result of the imposition of FATCA rules. For over two years, members of Congress, groups representing Americans abroad, and others have worked to add a same-country exemption to those rules. Proponents of the exemption have met with and otherwise communicated with Treasury staff on several occasions. It was believed that progress had been made and that Treasury was just inches away from solving the problem. More specifically, it was thought that Treasury would insert the same-country exemption in the final FATCA regulations.

There is little doubt that the lockout problem exists. There are hundreds, if not thousands, of testimonials by Americans abroad to that effect. Those testimonials have been assembled and presented by groups such as American Citizens Abroad Inc. Moreover, Treasury has not said that it disputes the existence of the problem.

Treasury previously raised the issue of whether FFIs would react to a same-country exemption by loosening up — that is, increase their provision of financial services to U.S. taxpayers living in their jurisdictions. An investigation revealed that the effects would be positive.²

Do individuals residing abroad really want a same-country exemption? According to a survey conducted in 2015, the answer is yes. Eighty-six percent of respondents said that FATCA needs to be reworked to allow Americans overseas better access to banking services and to include a same-country exemption.³

The same-country exemption is also supported by groups such as American Citizens Abroad, the Federation of American Women's Clubs Overseas Inc., and the Association of Americans Resident Overseas, as well as by members of Congress (including the Congressional Americans Abroad Caucus), the National

Taxpayer Advocate, Democrats Abroad, and the Republican Party. In fact, no one has spoken against the proposal.⁴

Could an SCE Be Added to the Regulations?

Yes. In fact, it would be remarkably easy to achieve. Similar language already exists in the regulations and in intergovernmental agreements. Individuals would need to be able to make an election to use the exemption, but that could be accomplished with a one-page form.

Would FFIs Face Additional Work?

No. Participation by FFIs would be voluntary. If an FFI did not want to treat individuals qualifying for the exemption as outside FATCA, that would be its prerogative. But if it wanted to have American customers and not have to wrestle with FATCA, it could do that instead. Most FFIs have said they would be delighted to have American customers if they could be inoculated against FATCA. (Participation by individual taxpayers would also be voluntary. Individuals who do not want to make the election would not be required to do so. Their accounts would remain subject to FATCA rules.)

Potential Benefits to Treasury and the IRS

If Treasury and the IRS stepped back and took a broader view, they would see that individuals who wish to use the exemption would need to file an election with their regular federal income tax return and give a copy of the election to the FFI. This means that non-compliant individuals could not simply hide quietly in the woodwork. (Would that be an invitation for individuals to cheat by filing an election with the FFI but not sending a copy as required to the IRS? No. By spot-checking with FFIs and requesting their list of U.S. taxpayers who had made the election, the IRS could match data and thus easily identify that type of tax cheat.)

Would SCE Increase the Risk of Cheating?

No. The exemption would reduce cheating. Individuals would have to come clean by filing tax returns and attaching a same-country exemption election. The lockout problem tempts people to cheat by avoiding FFIs or giving FFIs wrong or incomplete know-your-customer documentation, or otherwise. The same-country exemption in reality shines a light on those issues.

¹T.D. 9809, at 47-48. The reference to “or another foreign country” seems misplaced because the same-country exemption, as proposed by commentators, would not touch accounts other than those in the country where the individual lives.

²See Letter from American Citizens Abroad to Robert B. Stack, then-Treasury Deputy Assistant Secretary (International Tax Affairs), dated Aug. 10, 2016.

³University of Nevada, Reno, and American Citizens Abroad Global Foundation, “A Study of the Consequences of the Foreign Account Tax Compliance Act on Americans Living Overseas: Survey Results and Interpretations” (Jan. 2016).

⁴*Supra* note 2.

Treasury Missed the Point

We know that there is a risk that Americans overseas will not report information concerning their foreign bank accounts, and we know that that risk exists regardless of whether the account is located in the country where the individual resides. But we also know that Americans abroad face a lockout effect denying them access to local banks. And we know that there are perfectly honest, legitimate reasons for individuals to have local bank accounts. In fact, as a practical matter, Americans living abroad are normally very reliant on their local banks to make routine payments. In many foreign countries, paying by check is simply not standard practice. Exempting same-country accounts would have given a sensible measure of relief without doing great damage to anything.

Where Are We Now?

Here are some possible solutions to solve the lockout problem:

- The next deputy assistant secretary for international tax affairs can simply insert a same-country exemption into the regulations. As everyone has acknowledged and as has been shown by the handling of the final FATCA regulations, there is no need for legislation. A form could be published that would allow affected Americans abroad to make the election. That election process could be explained in a notice to FFIs. Groups representing Americans abroad would gladly assist in disseminating that news to individual taxpayers and to FFIs.
- Congress could enact a same-country exemption. In fact, it is no secret that members of Congress — even before the late-stage work on the final FATCA regulations — have taken steps to do this. But what a shame that everyone should be put to that trouble.

- Congress could repeal FATCA. That might be considered the “nuclear” option, but there are a number of problems with FATCA beyond the need for a same-country exemption, and repeal would solve those problems as well. There would, of course, be resistance to that path.

Congress could enact residency-based taxation to replace the existing regime of citizenship-based taxation. That is probably the best solution of all. Everyone to the author’s knowledge who supports the same-country exemption also supports residency-based taxation. In saying no to the same-country exemption, Treasury put its finger on how residency-based taxation could solve the problem. It indicated that the need for rules to prevent cheating arises because “U.S. citizens and U.S. resident aliens are subject to U.S. income tax on their worldwide income regardless of where they reside and regardless of whether their accounts are maintained by U.S. financial institutions or FFIs.”

Too Bad

The problem of lockout for Americans abroad could have easily been solved, or at least largely solved, by inserting a same-country exemption in the regulations, saving everyone a lot of angst. Congress could have taken this off its To Do List. Taxpayers and Treasury both would have benefitted. It’s hard to fathom why Treasury did not throw its arms around the proposal. Officials responsible for the system’s administration should create exemptions when there is a widely acknowledged problem and the exemptions would give some relief and not create any new harm.

On the one hand, administrators must maintain regulatory structures like FATCA, but in our voluntary compliance system — a decidedly two-handed world — administrators must also not make people believe that the system, for no good reason, is unbending. ◆