FATCA and the Feedback Loop

Be forewarned: The US Tax Authorities have a built in Feedback Loop

In the US, domestic Financial Institutions provide financial statements to the account holder and to the US Tax Authorities: the Internal Reveue Service or IRS. This allows the IRS to ensure that all income is fully disclosed. For offshore accounts, historically Foreign Financial Institutions (FFI) have only provided information about financal accounts to the individual. The individual is expected to voluntarily report income information to the IRS on their tax forms through a FBAR or 8938 Report.

The Foreign Account Tax Complince Act (FATCA) was created to bridge that gap. By getting Foreign Financial Instututions to report information about US taxpayers with offshore financial accounts, the IRS can compare that information with individual's annual tax forms and determine if they have any undeclared offshore income.

What many Foreign Financial Institutions don't realize is that this can work both ways. Let's take a hypothetical Foreign Financial Institution that has signed up for FATCA and agreed to report US tax payer information. If they fail to file a FATCA report, one of two things can be true: the FFI has no US tax payers or the FFI has US tax payers and simply didn't fulfil its obligations to report. Let's say the FFI has ten US accounts that should have been reported. If even one of the ten US taxpayers voluntarily reports their FFI offshore account, the US IRS knows the FFI is not fulfilling their obligations. In reverse, if the FFI reports all ten of the US tax payers and only one volunteers that information, the IRS can go after the other nine for failing to report.

This introduces a bit of game theory called the Prisoner's Dilemma. In the Prisoner's Dilemma, a policeman catches two suspects at the scene of crime. The policeman arrests them and puts them in separate cells so they cannot communicate. He tells each of them that he has no physical evidence, so if both claim they are innocent, he will be forced to set them free. If either prisoner admits the two suspects did the crime the policeman will ask the judge provide a very light sentence to reward their honesty. However, if one prisoner admits guilt and the other claims innocent, the policeman will ask the judge for the maximum penality to the liar who claimed he was innocent.

In theory, it would be in the best interest of both prisoners to claim innocence and get released. However, since each prisoner doesn't know what the other will do, more often than not rational people will admit guilt and take a light sentence, afraid if they claim innocence the other might admit guilt and they'll get a long prison sentence. This is true of the FFI and US Taxpayers. It would be in both parties best interest to not report the income, however, afraid the other party might, both parties are likely to comply.

Currently, the IRS is running an amnasty program for US tax payers. If a US taxpayer comes forth and declares previously undeclared offshore accounts, they have to pay the back taxes, interest, and a 20% penalty, and then are forgiven. This is better than if the IRS finds the taxpayer first.

If I were the IRS, I would take the next 100 people that ask for amnasty and list the financial products and the Foreign Financial Institutions that hold those products. I'd then pull the FATCA forms for each of these Financial Institutions. Behind every account there was a sales person. This sales person was likely targeting US clients, and somehow, at least one US client got the idea that in the years before FATCA they could maintain the account and likely get away without paying taxes. For each FATCA form, one of two things would happen: There is no FATCA filing, in which case the IRS could hold the FFI to account by formally notifying the FFI or jursidiction of their failure to adhere to their reporting commitments; or a FATCA form is filed. With the FATCA form, I'd pull the tax returns of everyone on the FATCA form, looking for indviduals that didn't voluntarily declare the offshore income.

Like the traffic police, they don't have the manpower to catch everyone. The goal is to get voluntary compliance. Catch enough people that it scares the rest into complying. In addition, although matching declared accounts with those reported on FATCA forms would be a pretty straight forward IT excersie, I'd advise against it on the grounds that it would tip the IRS' hand. If you attempt to match all the accounts, if someone doesn't receive a letter of non-compliance, the IRS would inadvertantly be sending the message that you are "in the clear" and have gotten away with not reporting.

Unlike Anti-Money Laundering, where the chances of being caught with a sanctioned individual or entity in your client base was relatively remote and AML compliance was really determined by the local regulators, with FATCA the IRS has the data to show compliance or the lack thereof. In addition, there are real dollars behind this. Every tax cheat caught means more dollars for a depleated US Treasury. Be forewarned.

About David Olenzak:

David Olenzak is the founder and President of Trans World Compliance, Inc. a provider of the FATCA One line of compliance software for Financial Institutions and Tax Authorities to support US FATCA, UK FATCA, and Common Reporting Standard regulations. David Olenzak is a serial entreprenuer with a background in IT and spent fifteen years in Compliance and RegTech.