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Why the U.S. and the Worldwide Tax Systems Have Run Amok

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The ever-growing complexity and reach of the U.S. tax system impinges on the ability of U.S. taxpayers to live abroad, work abroad, open bank accounts abroad, or conduct business abroad. The difficulties caused by extraterritorial taxation are exacerbated by similar moves by other nations, often implemented as a response to aggressive policies by the United States. These developments create a challenging environment, with taxpayers being subject to onerous – and sometimes conflicting – requirements. The complex array of obligations put taxpayers in legal jeopardy as governments threaten to impose sanctions on investors and businesses – or even on other governments. Meanwhile, many of the disputes in international tax matters emanate from the overbroad extraterritorial reach of tax authorities.

The United States

A unique aspect of the U.S. tax system is that it requires citizens, permanent residents, and tax residents to report and pay taxes on their worldwide income even if they live overseas and their income is earned in other nations. To enforce this approach, the U.S. has imposed a plethora of byzantine overlapping reporting requirements and has levied heavy penalties for persons who run afoul of the regime. Moreover, IRS resources are now more focused on dealing with the metastasizing complexity of domestic provisions of the tax code. As a result, the IRS has reduced its workforce dedicated to overseas issues, thereby depriving U.S. taxpayers overseas of their ability to obtain advice from the IRS. For the common taxpayer, speaking to the right tax official who can provide practical answers has become almost impossible at a time when the U.S. tax system becomes increasingly complex and inscrutable.

The U.S. has even proactively prosecuted individuals and companies for cross-border tax activities that do not violate American laws. In 2005, in the *Pasquantino* case the U.S. Supreme Court affirmed the conviction of two individuals for helping violate the liquor excise tax in Canada. The U.S. has prosecuted foreign banks, asset managers, lawyers, and other professionals for helping U.S. taxpayers violate U.S. tax law with respect to their foreign assets and income.

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The paperwork and reporting requirements for cross-border economic activity are extensive.

- Since 1970, pursuant to the Bank Secrecy Act, U.S. taxpayers must file Foreign Bank Account Reports (FBARs), now known as FinCEN 114 reports, if they have a financial interest in, or signature or other authority over, foreign financial accounts in which the aggregate value of these financial accounts exceeds $10,000 at any time during the calendar year. A willful failure to file can incur a civil penalty of as much as 50% of the value of the foreign account, with no cap for each violation, per year.[1] U.S. taxpayers must file a report when they send or receive more than $10,000 in monetary instruments, including currency, into or out of the U.S.[2]
- If a U.S. transferor of property to a foreign trust, or a U.S. recipient of a distribution of more than $100,000 from a Non-Resident Alien (NRA) or a foreign estate or from such a trust, fails timely to file a Form 3520 to report these transactions, the IRS may impose a penalty equal to 35% of the gross value of the property transferred to or received from the trust.
- Certain U.S. citizens and residents who are officers, directors, or 10% shareholders in certain foreign corporations must file Form 5471 and its schedules to fulfill the reporting requirements of IRS, sections 6038 and 6046, and the related regulations. Additional reporting requirements require filings in connection with owning interests in foreign partnerships (Form 8865).

FATCA

The icing on the cake of intrusiveness and costly compliance is the Foreign Account Tax Compliance Act.

In March 2010, the U.S. Congress enacted FATCA, responding to U.S. tax non-compliance by providing enhanced transparency with respect to assets and investments held by U.S. persons outside the U.S. Its purpose is to guarantee that U.S. persons with financial assets outside the U.S. declare their income and assets. The law is very complex and important for financial institutions and other foreign businesses and individuals. The IRS has issued over 500 pages of technical guidance with over 100 technical terms that require an enormous investment of time to understand its concept and operation.

FATCA requires “foreign financial institutions” (FFIs) and other foreign entities receiving payments from U.S. sources to develop due diligence programs to identify U.S. account holders and report information with respect to their accounts annually to the IRS. To facilitate compliance, FATCA requires U.S. Withholding Agents to withhold 30% on U.S. sourced

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[1] 31 U.S.C. § 5321.

[2] 31 U.S. C. § 5316 requires filing FinCEN Form 105: A Report of International Transportation of Currency or Monetary Instruments (CMIR).

payments and payments subject to Pass Through Withholding to foreign institutions/entities that do not comply.

Many countries have complained that complying with FATCA would violate their fundamental laws. To overcome this problem, the U.S. has concluded International Governmental Agreements (IGAs) with other countries. These IGAs are mini-tax information exchange agreements. However, the U.S. has not fully reciprocated with the IGAs, as U.S. law does not authorize the exchange of certain information that the U.S. nonetheless requires other countries and FFI to exchange.

A recent study by the European Parliament PETI Committee states that FATCA amounts to the unilateral exercise of extraterritorial legislative jurisdiction in most cases not based on reciprocity, triggering systemic conflicts with the General Data Protection Regulation (GDPR) and undermining the multilateral systems of automatic exchange of information to which the U.S., the EU, and the international community undertook at the time the U.S. government proposed the Intergovernmental Agreements (IGAs) with other countries. On May 15, 2018, Valere Moutarlier, the EU's head of direct taxation, told a new European Parliament tax investigative committee that if the U.S. does not conform FATCA to the Common Reporting Standard by June 2019, the EU should put the U.S. on its tax blacklist.

FATCA has amended IRC, §6038D(d) and requires certain U.S. taxpayers holding "specified foreign financial assets" (SFFAs) to report those assets on IRS Form 8938 and file the form with the taxpayer's annual return if the aggregate value of interest in SFFAs exceeds applicable thresholds ($50,000). Failure to file Form 8938 will suspend the statute of limitations for the taxpayer's entire return. Civil penalties for failure to report this information are $10,000. Additional $10,000 penalties apply to a maximum of $50,000 after the IRS gives notice. The filing of FinCEN 114 and IRS 8938 are overlapping and confuse taxpayers.

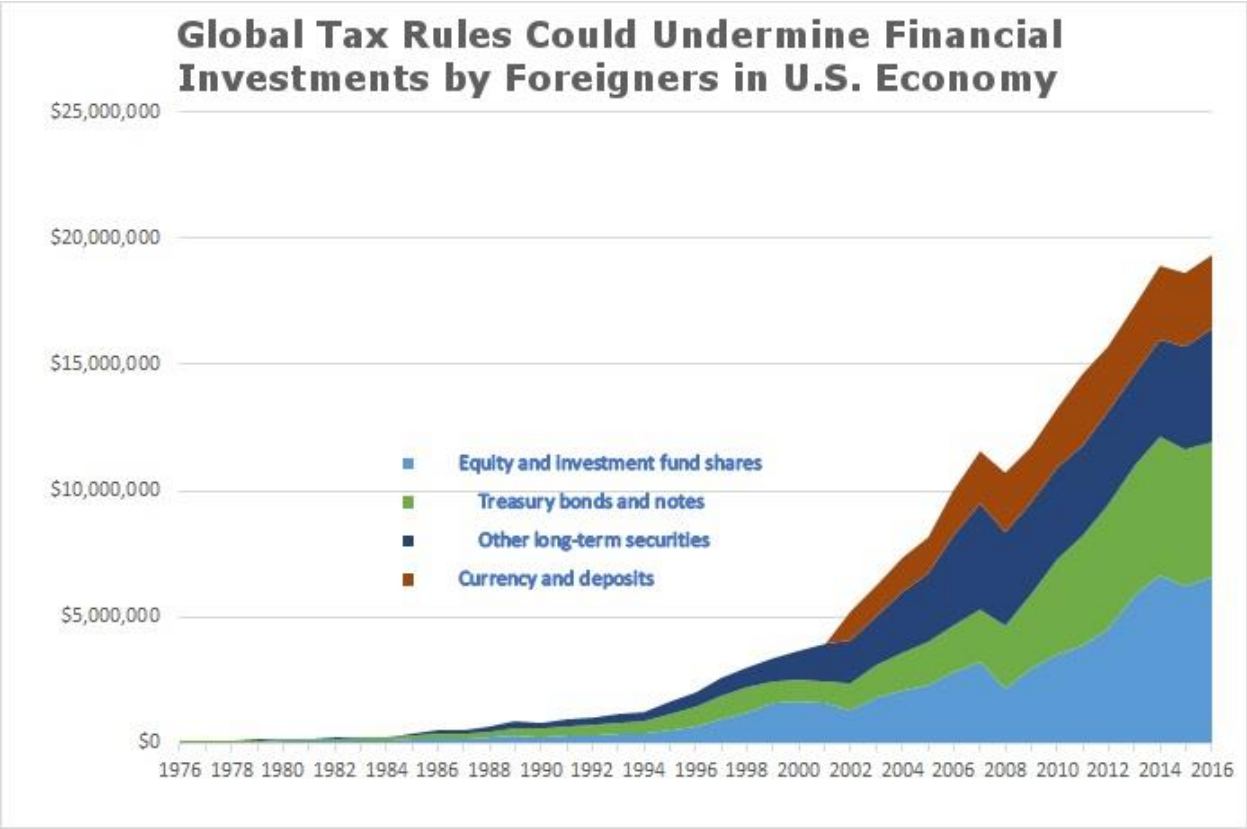
An important U.S. tax policy issue is that many states in the U.S. impose tax on and/or require reporting on a worldwide basis. On the one hand, many of them confer tax, secrecy, and other incentives to attract diverse financial services, such as asset protection and other trusts, captive insurance, and bank accounts. On the other hand, they issue tax haven blacklists and impose countermeasures on entities doing business in so-called tax havens. When foreign governments have complained to the U.S. Treasury about the illegality of state tax haven countermeasures, the U.S. Treasury has responded that the states are sovereign in their ability to take tax decisions.

International Tax Issues

Extraterritorial tax enforcement by the United States has encouraged similar behavior by other nations.

As a result of FATCA, the Organization for Economic Cooperation and Development has issued in July 2014 the Common Reporting Standard (CRS), which is a multilateral version of FATCA. It comes with over 500 pages of its own technical regulations. While it uses concepts similar to

FATCA, the CRS has different substantive (it is based on the residence rather than citizenship of the taxpayer) and procedural features, requiring financial institutions and professionals to master these technical terms and impose still another framework on their clients.



In connection with the CRS, the OECD has developed compliance and enforcement initiatives. The OECD has issued mandatory disclosure rules to combat CRS avoidance and offshore structures. They bring a new layer of reporting that increase the burdens on intermediaries. Criticisms are that the rules are vague insofar as they require intermediaries to "reasonably be expected to know of a CRS Avoidance Arrangement or an Offshore Structure" and can be interpreted differently in different jurisdictions.

The consultation was released right before the Christmas holiday and gave only thirty days for comment. An industry criticism concerns the undesirability of imposing on citizens a legally enforceable duty to inform on one another. The new rules apply retrospectively, thereby challenging the rule of law. The consultation endangers the entitlement of citizens to obtain confidential independent professional advance rulings about the application of law to their particular circumstances. In addition, the OECD has issued consultation documents on preventing abuse of residence by investment schemes to circumvent the CRS. The OECD is considering imposing additional requirements on all stakeholders involved, including the jurisdictions offering these schemes, the tax administrations of jurisdictions participating in the

CRS, financial institutions subject to CRS reporting, the intermediaries promoting the schemes, and taxpayers.

BEPS

Many of the above laws and regulations target investors, entrepreneurs, and small businesses. But extraterritorial tax rules also are impinging on corporations. In response to the G-20 identification in 2012 of so-called base erosion and profit shifting by multinational enterprises as a major threat to fiscal stability, the OECD produced a "BEPS Action Plan" in a specially created working group. In 2013, the G-20 endorsed that action plan and mandated that the OECD act on the 15 issues identified in the Action Plan.

The OECD claims that its 15 Action Plans, produced in a compressed period of two years, strengthens the coherence of international corporate income tax law, mainly by combating "double non-taxation"; in part insisting that a deduction in one country of a transnational, intra-company transaction should equal a taxable inclusion on the other side. The Plans also realign taxation and "substance" by requiring that MNCs recognize income in the territories where value is created; and providing improved transparency and a more stable compliance environment for all stakeholders.

Many commentators characterize the BEPS Action Plan as an ad hoc response to a laundry list of issues that were raised by various sovereigns but left unaddressed by the OECD over the last few decades.

The OECD is attempting to implement the Action Plans through peer reviews. Until now, the peer reviews have been effective mainly against small countries. Their use against large countries or international organizations, such as the EU, which continues to apply its own rules, such as through the state aid mechanisms, remains to be seen.

Meanwhile, many tax authorities are using the BEPS process to proactively impose new tax rules against MNCs. The United Kingdom's and Australia's Diverted Profits tax (DPT) laws impose a penalty tax (40 per cent) in circumstances such as in Australia where the amount of Australian tax paid is reduced by diverting profits offshore through related-party arrangements. The DPT is extremely broad (for example, both financing and non-financing arrangements are in scope), and will apply to a significant number of multinational groups and will create uncertainty to affected entities. The DPT is likely to trigger a proliferation of disputes and litigation.

In addition, The Multinational Anti-Avoidance Law (MAAL) amended Australia's anti-avoidance rules by introducing a targeted anti-avoidance law that applies to multinationals that supply goods or services to Australian customers and record the revenue from those sales overseas. The law will apply where an Australian related entity of the foreign seller performs activities connected with the sales (such as marketing services), and it would be concluded that the arrangement was entered into with a principal purpose of avoiding tax in Australia or reducing their foreign tax liability. Where the MAAL applies, the foreign entity will be taxed as

if it had made the sales through a deemed Australian permanent establishment (PE) and will be subject to Australian income tax on the notional profits attributable to the deemed PE. More withholding taxes may be imposed. Penalties will apply on top of these taxes, generally at a rate of 100 per cent.

The European Union

The EU has taken a series of aggressive steps to impose tax on cross-border transactions. Since June 2013, the EU has started investigations of individual tax rulings and challenged other tax arrangements of Member States under EU state aid rules. In particular, the EU found that Luxembourg, the Netherlands, and Ireland had granted selective tax advantages to a number of multinationals. In January 2016, the Commission concluded that selective tax advantages granted by Belgium to at least 35 multinational groups under Belgium's "excess profit" tax scheme were illegal under EU state aid rules.

State aid rules arguably are not suited to deal with the use of mismatches by multinational entities between national tax laws to lower their tax burdens. State aid is a mechanism to address cases where a member state has made an exception to its own rules and given a specific company an advantage. To know whether that is the case, one has to understand how corporate taxation works.

International corporate tax principles require that companies pay taxes where value is created. In the modern world, companies create value through design, marketing and intellectual creativity. The situs of those activities is where the profits really originate. Hence, companies should pay tax where they undertake research and development and produce intellectual property and not primarily where the products are made or sold.

The tax laws of different countries permit multinational corporations to allocate much of their income in low-tax or no-tax jurisdictions, and many of their expenses in high-tax jurisdictions, thereby significantly reducing their tax liabilities.

EU member states have a sovereign right to determine their own tax laws. State aid cannot be used to rewrite those rules. However, the state aid investigations into national tax rulings constitute a radical new approach to so-called transfer-pricing rules that determine where profits shall be allocated.

On December 5, 2017, the EU issued its conclusions on the EU list of non-cooperative jurisdictions for tax purposes. The conclusions also set forth the criteria and proposed sanctions for the countries blacklisted.

The purpose of the program and list of non-cooperative jurisdictions for tax purposes is to combat tax evasion and avoidance and enable the EU to more robustly combat external threats to EU Members' tax bases and third countries that "consistently refuse to play fair on tax matters." Until now, a patchwork approach has had limited impact.

During the debate, MEPs deplored the lack of transparency surrounding the compilation of the list and especially the lack of information about the criteria for removal of a country from the blacklist.

During a February 29 hearing of the European Parliament, outside experts and EP members criticized the weak and opaque criteria in the process. One of the important criteria is "fair tax competition: the country should not have harmful tax regimes, which violate the principles of the EU's Code of Conduct or OECD's Forum on Harmful Tax Practices." The ones that choose to have no or zero-rate corporate taxation should ensure that this does not encourage artificial structures without real economic activity. Some of the jurisdictions on the grey list for lack of real economic activity are now in the process of holding discussions with the OECD.

In February 2018, the European Parliament decided to review the extent to which the EU and its member states have implemented the recommendations of the previous special committees on LuxLeaks and the Committee of Inquiry on the Panama Papers. Parliament will investigate tax privileges for new residents or foreign income such as citizenship programs or non-dom regimes. Such distorting privileges are offered by Portugal, Italy, Malta, the United Kingdom and Cyprus. In the context of Brexit, the committee will give particular attention to "the British Crown Dependencies and Overseas Territories." However, the EU member states are not subject to the investigation, reflecting a discriminatory conception and application of the recommendations.

Conclusion

Overly aggressive tax compliance and enforcement initiatives erode globalization, impede the ability of normal commerce and the movement of people, capital, and goods, and threaten privacy. The proliferation of overlapping taxes and reporting requirements mean that individuals are faced with aggressive reports from sometimes three levels of government (e.g., federal, state, and local). Governments, meanwhile, spend inordinate amounts of time preparing for evaluations from multilateral organizations. In turn, governments impose more reporting requirements and penalties on intermediaries and taxpayers. The confidential affairs of taxpayers are increasingly exposed and increasingly find their way onto WikiLeaks or the media.

These legal concerns are augmented by economic worries. Most of the policies reviewed above are only necessary because governments not only tax income, but also impose extra layers of tax on income that is saved an invested, exacerbated by decisions to impose such tax laws on income earned outside national borders. In a neutral, territorial tax system that taxes economic activity only one time, such as the Hall-Rabushka flat tax, almost all international tax conflicts disappear.

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