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Lack of IRS audits will not shield firms from FATCA consequences, warn officials

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Financial institutions in Asia should not be lulled into a false sense of security over the fact that the U.S. Internal Revenue Service (IRS) will not conduct audits of information provided by firms under the U.S. Foreign Account Tax Compliance Act (2010), said officials. The consequences for responsible officers at Asian firms designated as foreign financial institutions (FFIs) under the act could be severe if they were found to have made false certifications to the IRS, they said, warning that even if the IRS did not conduct audits it had other ways of verifying information.

FATCA was designed to minimise tax evasion by U.S. citizens and permanent residents abroad. It will effectively deputise financial institutions worldwide to report information on U.S. taxpayers to the U.S. Treasury Department. FATCA requires FFIs to enter into special agreements with the IRS by January 1, 2013. Under the act, foreign institutions must provide information about their U.S. owned or controlled accounts, disclose such information to the IRS and withhold U.S. taxes on such accounts if necessary.

"It is correct that the IRS does not intend to audit itself, nor, as a matter of normal business require outside compliance audits," said Stanley Foodman, founder and chief executive of accounting firm Foodman Associates in Miami. He added that proposed regulations clearly indicated that if when receiving information from a FFI, it became apparent to the IRS through its IT programming or other sources of information that an institution was non-compliant, the agency could and would require outside compliance auditing by a firm approved by the IRS.

Karl Egbert, a partner with law firm Dechert in Hong Kong, was similarly unconvinced that the IRS would take no action against overseas institutions — even if there were no audits. "The IRS is going to be getting a vast amount of data on customers and they are going to be cross-referencing that data against data they get from each financial institution," he told Thomson Reuters. He added that if discrepancies appeared, particularly regarding individuals or FFIs that owed U.S. taxes, the IRS had a broad range of powers to go after them.

"So, while I'm not sure that there will be no audits, I don't think the IRS needs a traditional audit to spot problems with FATCA compliance," emphasised Egbert. "Whether they'll have the resources to do so is another question, but they have the tools," he said.

The penalties for non-compliance are a 30 percent withholding tax on net U.S. sourced payments to FFIs — irrespective of the profits or losses they may have incurred. Since late spring, the U.S. Treasury has reached intergovernmental agreements (IGAs) with France, Germany, Italy, Spain, the U.K, and more recently, Switzerland and Japan for taxpayer information exchange. The rules require FFI's clients to certify to their institutions that they are not "American persons" for tax purposes — either through citizenship or permanent residency.

FFIs will likely be required to identify responsible officers (ROs) who will have to certify — under penalty of perjury — that they are compliant with FATCA. Proposed regulations articulate several necessary certifications by ROs. Implementation will probably require supplemental documentation and certifications from others to verify certifications made by ROs. Most worrisome is that the IRS may criminally prosecute false documentation cases under more than one statute.

"I would caution institutions about perceiving that the lack of specific audit requirements within the draft regulations means that the IRS won't establish robust monitoring processes to enable them to identify institutions that are not fully complying with the agreed requirements as specified in the FFI agreement, said Timothy Clough, a partner with PwC in Hong Kong.

Compliance challenges and penalties

Looking ahead, it appears that a great deal of the compliance burden of FATCA for FFIs will fall to ROs.

"Compliance officers [or whomever is identified as the RO required to certify compliance] will need to put in place a robust internal process to obtain subordinate certifications throughout the organisation," said Jim Calvin, a partner with Deloitte in Singapore.

ROs will not be expected to have personal knowledge of compliance throughout the organisation, despite having to certify to it, he told Thomson Reuters. "Thus, they will need to assure themselves that they can obtain and document underlying certifications from other relevant persons within the organization, including those in each line of business, in each jurisdiction and for each entity," said Calvin.

Accordingly, it was understandable that Asian financial institutions chafed against the extraterritorial imposition of a burdensome U.S. law, said Dechert's Egbert. Yet, he added: "Someone at Asian financial institutions is going to have to be the RO — the person who certifies that the FFI has complied with some of FATCA’s core requirements."

The criminal and financial sanctions possible for non-compliance with U.S. tax laws can be steep. If the IRS is able to determine that an FFI has not complied with its agreement under FATCA, the institution becomes a non-participating entity and is subject to a 30 percent withholding penalty on U.S. sourced payments.

"For years, foreign banks did not think they would have to be responsive to the U.S. and that they could act with impunity," said David Makso, an associate with law firm Paul Hastings in New York. "Then UBS pleaded guilty to criminal activity and paid $780 million," he added. The bank subsequently agreed to disclose information regarding its U.S. account holders.

"There is precedent for the U.S. going offshore and enforcing its laws to address tax evasion," stressed Makso.

Long arm of the law

To that end, for compliance officers and in-house counsel, the Internal Revenue Code (IRC) and other U.S. criminal statutes permit the prosecution of foreign individuals through long-arm statutes for conspiracy and other related crimes like aiding and abetting tax crimes, said Foodman. "Furthermore, it is not a big stretch to imagine that an FFI could be declared non-transparent or non-participating, which could end up costing them their correspondent U.S. banking relationships and networks," he warned.

Of concern to ROs is s7206 of the IRC, often referred to as the "false-statement, tax perjury or fraud statute," said Deloitte's Calvin. "It is the one most likely to be invoked and, in fact, it is the most frequently charged criminal tax violation. It applies where a 'return, statement or other document'…contains or is verified by a written declaration that it is made under penalties of perjury," he told Thomson Reuters. Calvin added that civil sanction may — and almost always do — follow criminal investigations.

Under s 7206, any person that willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that is made under the penalties of perjury, and which they do not believe to be true and correct as to every material matter, can face a felony conviction. The penalties are a minimum of three years and fines of no more than $250,000 for individuals and $500,000 for corporations. Both fines, jail-time and prosecutorial costs can be imposed.

Additionally, the U.S. government need not prove any tax deficiency to prevail, said Calvin. "All which must be proved are the elements of the offence," he said.

Therefore, the crux of the rule lies in the willful falsity of a statement.

Yet, from the perspective of both taxpayers and institutions, it was unlikely that both would consistently omit reporting, said Gerald Francese, a partner with law firm DLA Piper in New York. "If there were collusion, severe penalties, including criminal charges, may be imposed," he said.

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