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Cross-border tax evasion under a unilateral FATCA regime

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ABSTRACT

Cross-border tax evasion has emerged in recent years as a central issue in tax enforcement. Traditionally, the legal regime governing cross-border tax enforcement was based on information exchange upon request. In 2010, the US Congress enacted the Foreign Account Tax Compliance Act (FATCA), which seeks to induce foreign financial institutions (FFIs) to participate in a global regime of automatic information reporting of the income of US residents to the US government. This paper presents a simple theoretical model of cross-border investment that analyzes the consequences of this (unilateral) FATCA regime. The model emphasizes cross-border investors' (heterogeneous) intrinsic motivation to comply with tax law, as well as the impact of information reporting requirements on the cost of providing financial services. In FATCA-compliant equilibria (in which FFIs report information to the US government) FFIs face a higher cost of providing financial services, increasing the fees charged to their accountholders. Consequently, tax-compliant behavior – such as investing via their domestic financial sector – becomes more costly for foreign residents. Under certain conditions, a unilateral FATCA regime causes increased cross-border tax evasion among residents of foreign countries. This result is robust to various extensions.

1. Introduction

Cross-border tax evasion has emerged in recent years as a central issue in international taxation and tax enforcement. Traditionally, the legal regime governing the enforcement of cross-border investors' tax obligations has been based on information exchange upon request. Tax treaties and Tax Information Exchange Agreements (TIEAs) provide for the exchange of information among governments under certain circumstances when one of the governmental parties requests information about the income of one of its residents. It is difficult to evaluate the success of this traditional regime, given the inherent difficulties of measuring tax evasion activity. However, it is widely believed that this regime allows individuals investing through financial institutions based abroad (especially, but not necessarily, in tax haven jurisdictions) to evade taxes owed to their country of residence with only a low probability of detection (e.g. Zucman, 2014).

In 2010, the US Congress enacted the Foreign Account Tax Compliance Act (FATCA) as part of a wider measure known as the Hiring Incentives to Restore Employment (HIRE) Act. The major aim of the FATCA approach is to induce foreign (i.e. non-US) financial institutions (FFIs) to participate in a global regime of automatic information reporting of the income of US residents to the US government. In order to induce FFIs to participate, the FATCA regime threatens to impose a substantial withholding tax on US-source payments to nonparticipating FFIs. Participation in this system entails significant compliance burdens for FFIs (of determining whether the beneficial owner of each account is a US tax resident and of automatic information reporting to the US).[1] As originally envisaged, FATCA is a unilateral system in which automatic information reporting is used to enforce US tax law with respect to US residents' foreign accounts; foreign governments do not receive information on their residents' US (or other offshore) accounts. The FATCA framework has undergone various modifications since its enactment and its implementation has been repeatedly delayed; however, it began operating in 2015.

This paper presents a simple theoretical model that analyzes the consequences of a unilateral FATCA regime for tax compliance and tax revenues. Following prior literature on the "moral costs" of tax evasion (e.g. Gordon, 1989; Luttmer and Singhal, 2014; Langenmayr, 2016; Dwenger et al., 2016), it emphasizes cross-border investors' (heterogeneous) intrinsic motivation to comply with residence country tax law. It also highlights an issue that has not been the focus of primary attention in prior literature - the impact of information reporting requirements on the cost of providing financial services.

The baseline model assumes two countries – the US and a foreign country (F), each with a competitive financial sector. Individuals are assumed to be identical apart from an idiosyncratic utility cost of tax evasion. All financial institutions invest in the same diversified global

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[1] See e.g. Kate Burgess "US legislation: Industry concerned at extraterritorial tax clampdown plan" *Financial Times*, May 8, 2012 (reporting on predictions of billions of dollars of compliance costs for non-US financial institutions).

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portfolio of assets, and are assumed to differ only in their information reporting obligations. US residents can invest via a US financial institution (USFI) or via an FFI. In the former case, tax compliance is automatically induced by domestic information reporting requirements. In the latter case, investors can choose to evade US taxes and thereby incur their idiosyncratic utility cost of evasion, or can comply with US tax law by reporting their income to the US (thereby incurring a fixed "translation cost" of interpreting their FFI income in terms of US tax law). The paper characterizes the equilibrium outcomes in this pre-FATCA regime, in which the fraction of residents evading taxes in each country depends on the distribution of the idiosyncratic evasion cost among that country's population.

The paper then introduces a unilateral FATCA regime. We focus on FATCA-compliant equilibria in which FFIs participate in this regime, as these are most relevant for the analysis. FFIs now face an increased cost of providing financial services, as they must determine whether their accountholders are US residents and must establish an infrastructure for automatic reporting to the US (whether or not any accounts are held by US residents in equilibrium). Thus, they must comply simultaneously with the information reporting requirements of their home government and those of the US. Assuming a competitive financial sector, this raises the fees charged by FFIs to accountholders. Consequently, tax-compliant behavior – such as investing via the domestic financial sector – becomes more costly for F residents. In contrast, USFIs continue to face only one set of information reporting requirements – that of the US – and so their costs are unchanged by the unilateral FATCA system. For F residents, the cost of evading via USFIs is unchanged, while the cost of tax-compliant behavior increases. This leads to a larger fraction of F residents engaging in cross-border evasion in equilibrium.

Thus, under certain conditions a unilateral FATCA regime causes increased cross-border tax evasion among residents of foreign countries. This result is robust to various extensions. It holds in general even in non-FATCA-compliant equilibria (unless enforcement of the FATCA regime is completely ineffective). If the financial sector is assumed to be imperfectly competitive, the impact on evasion is mitigated. However, the welfare of country F is lowered as a result of FATCA by the decline in the economic profits earned by FFIs. The result is robust to a more general formulation of the cost of evasion, in which this cost is an increasing function of the amount of home country tax evaded. The central intuition described above also remains basically operative when a tax haven jurisdiction is added to the model.

Since 2012, the US has significantly changed the original structure of the FATCA regime by signing Inter-Governmental Agreements (IGAs) to overcome legal obstacles to the implementation of FATCA (such as privacy laws in non-US jurisdictions that would be violated by FFIs reporting information to the US). Some (but by no means all) IGAs are formally reciprocal, providing that USFIs report information on non-US accountholders to their home governments. In principle, reciprocity would prevent any increase in evasion among F residents. Indeed, some commentators (e.g. Blank and Mason, 2014) see in this development the potential for the development of a multilateral version of FATCA, with global automatic reporting by all financial institutions to all of the world's governments.[2] However, the compliance costs of such a regime should be taken into account, along with the benefits in terms of increased compliance and tax revenue. This paper highlights the increased costs of financial intermediation that would be entailed by such a regime – in particular, financial institutions would potentially need to report to over 200 different governments and to keep track of the tax laws of each of these countries.

[2] An OECD and G20 initiative - the Global Forum on Transparency and Exchange of Information for Tax Purposes - has sought to encourage governments to collect information from financial institutions and exchange this information on an automatic basis. To this end, a Common Reporting Standard was adopted in 2014. So far, 94 jurisdictions have made commitments to begin the automatic exchange of information in 2017 or 2018; see http://www.oecd.org/tax/transparency/automatic-exchange-of-information/.

This paper proceeds as follows. Section 2 briefly reviews the relevant literature. Section 3 describes the FATCA system and highlights the main features that are most relevant for the paper's analysis. Section 4 presents the model and discusses its implications. Section 5 concludes.

2. Literature review

This paper is related to several strands of literature, including those on the taxation of cross-border portfolio investment and on information exchange among governments in relation to cross-border tax evasion. Bacchetta and Espinosa (1995) analyze information exchange as a strategic choice made by governments. Keen and Ligthart (2006) provide an overview that emphasizes the centrality of information exchange in the design of contemporary international tax policy and tax enforcement. In our model, information exchange is not treated as a strategic choice, in order to focus instead on the impact of an exogenously-imposed FATCA regime of information reporting on the behavior of taxpayers.

The most closely related prior paper is Gérard and Granelli (2013). They develop a unified theoretical framework within which to analyze and compare the European Union (EU) Savings Directive and the FATCA regime, with a particular emphasis on the relative merits of information exchange and withholding taxes as mechanisms to combat cross-border evasion. They characterize a number of tax designs that achieve efficiency, which in their setting involves perfect residence-based taxation. Our model has some similarities to theirs, in particular by assuming highly simplified portfolio choices. However, we do not analyze withholding taxes as an alternative to FATCA-style information exchange, nor do we focus, as Gérard and Granelli (2013) do, on the strategic choice of tax rates by revenue-maximizing governments. Instead, our focus is on how the FATCA regime affects the costs of providing financial services, and on how this regime affects the interaction between pecuniary incentives for evasion and intrinsic motivations for compliance with tax law.

There is also a literature on the taxation of cross-border portfolio investment that is of relevance. For example, Desai and Dharmapala (2011) develop a simple after-tax Capital Asset Pricing Model (CAPM) framework to model investors' cross-border portfolio choices. However, they do not directly model evasion. Their empirical results - using a change in the US tax on foreign-source dividend income from some (but not all) foreign countries as a source of identification - suggest that US portfolio investors are sensitive to US taxes on foreign dividend income. This might not be expected if evasion of US taxes on foreign dividends is commonplace. To be sure, there may also be substantial investment by evaders via FFIs that is not captured in this data. However, the result suggests that significant flows also exist via USFIs (or in other tax-compliant forms), even though the probability of detection of evasion via FFIs is presumably quite low.

It has long been noted that observed levels of tax compliance are difficult to explain using rational choice models in which individuals have purely pecuniary motivations (e.g. Andreoni et al., 1998). A recent literature argues that much of this compliance behavior is attributable to third-party information reporting (Kleven et al., 2011). In addition, a growing literature has emphasized the importance of intrinsic motivation (or "tax morale") in explaining tax compliance (e.g. Gordon, 1989; Luttmer and Singhal, 2014; Langenmayr, 2016; Dwenger et al., 2016). The model in this paper uses intrinsic motivation to generate heterogeneity in compliance behavior among taxpayers who face identical pecuniary incentives for tax evasion.

3. The FATCA regime

The pre-FATCA legal regime governing the enforcement of cross-border investors' tax obligations was based on information exchange upon request. Tax treaties and TIEAs provide for the exchange of information among governments under certain circumstances. Johannesen (2012) interprets the existing empirical evidence as suggesting that