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FATCA, CRS, and the Wrong Choice of Who to Regulate

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FLORIDA TAX REVIEW

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FATCA, CRS, and the Wrong Choice of Who to Regulate

by

*Noam Noked**

Abstract

FATCA and CRS have a major flaw that enables tax evaders to avoid reporting of their offshore financial assets. This noncompliance opportunity stems from the fact that many private entities are classified under FATCA and CRS as "financial institutions" ("FIs"), and as such these entities are required to report their beneficial owners. Where a tax evader holds financial assets through a private entity that he or she owns and manages, it is unlikely that this entity will report its owner to the tax authorities. At the same time, banks and other FIs that maintain the financial accounts of such entities are not required to report these entities' beneficial owners. Therefore, to avoid reporting, tax evaders can simply hold financial assets through private entities that are classified as FIs.

This noncompliance opportunity is a result of a wrong choice of who to regulate. The drafters of FATCA and CRS decided to impose obligations on many private entities to report their beneficial owners, instead of imposing these obligations on banks and other FIs that maintain the financial assets of such entities. This policy also results in higher compliance costs for compliant taxpayers, and larger distortions and deadweight loss. Thus, it benefits tax evaders and harms compliant taxpayers. This Article proposes solutions that the U.S. Treasury and the OECD should consider.

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Building on this analysis, this Article explores a general question of regulatory design: how to choose which group of agents should be required to satisfy a regulatory obligation where that obligation can be imposed on one of two or more alternative groups of agents. When making this decision, the designers of the regulation should consider the cost-effectiveness of compliance, the potential distortions, and the likelihood of noncompliance for each of the alternative groups.

Introduction 79
I. FATCA, CRS, and the Reporting of Beneficial Owners 84
  A. FATCA 84
    1. Background 84
    2. How to Report Beneficial Owners of Accounts Held Through Entities 87
      a. Reporting Beneficial Owners of Passive NFEs 88
      b. Reporting Beneficial Owners of FIs 90
    3. FATCA's Choice of Who to Regulate 93
  B. CRS 98
    1. Background 98
    2. CRS's Choice of Who to Regulate 99
  C. Analysis of the Choice of Who to Regulate 101
    1. Compliance Costs 102
    2. Effectiveness of Compliance 102
    3. Distortions 103
    4. Noncompliance Opportunities and Loopholes 104
  D. Why Did FATCA and CRS Get It Wrong? 106
  E. Model Mandatory Disclosure Rules 108
  F. Potential Solutions 111
    1. Changing the FI Definition 111
    2. Parallel Reporting 112
    3. Third Party Verification 113
II. Considerations When Choosing Who to Regulate 113
III. Concluding Remarks 119

Introduction

FATCA[1] and CRS[2] are two of the most costly and onerous pieces of tax regulation in recent history.[3] Some analysts argue that despite the large implementation costs, FATCA has generated only a modest increase in tax revenues,[4] which calls into question the cost-effectiveness of FATCA and possibly CRS.[5] A possible reason for this limited effectiveness is that tax evaders use noncompliance opportunities and loopholes to avoid FATCA and CRS reporting.[6]

Law enforcement agencies and the courts try to counter such noncompliance. On February 6, 2017, the U.S. District Court for the Eastern District of New York imposed prison sentences on the defendants in *United States v. Bandfield*,[7] which was the first federal prosecution for a conspiracy to avoid FATCA reporting.[8] In that case, Bandfield and his business partner admitted that they had engaged in schemes that

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1. FATCA (the Foreign Account Tax Compliance Act) is discussed in Part I.A. In general, FATCA is U.S. legislation that facilitates the reporting to the IRS of offshore financial assets held by U.S. citizens and tax residents.

2. CRS (the Common Reporting Standard) is discussed in Part I.B. In general, CRS is a global version of FATCA, adopted by over 100 countries to facilitate reporting of offshore financial assets held by foreign tax residents to the account holders' countries of tax residence. *See CRS by Jurisdiction*, OECD, http://www.oecd.org/tax/automatic-exchange/crs-implementation-and-assistance/crs-by-jurisdiction/ (last visited Nov. 3, 2018). It was developed by the Organisation for Economic Co-operation and Development (OECD). *See What Is the CRS?*, OECD, http://www.oecd.org/tax/automatic-exchange/common-reporting-standard/ (last visited Nov. 3, 2018).

3. *See* William H. Byrnes & Robert J. Munro, LexisNexis Guide to FATCA & CRS Compliance chs. 1, 18B (Matthew Bender 2018).

4. *See id.* § 1.01. There is no available information on the revenues generated from CRS because the implementation is in its early stages.

5. *See, e.g.,* Robert W. Wood, *FATCA Carries Fat Price Tag*, Forbes (Nov. 30, 2011, 6:12 AM), https://www.forbes.com/sites/robertwood/2011/11/30/fatca-carries-fat-price-tag/#526f36fe4ae9.

6. *See* Noam Noked, *Tax Evasion and Incomplete Tax Transparency*, 7 Laws, no. 3, Aug. 2018, https://www.mdpi.com/2075-471X/7/3/31.

7. *United States v. Bandfield*, No. 1:14-CR-00476-ILG, 2017 WL 924789 (E.D.N.Y. Feb. 10, 2017).

8. *See* Miriam L. Fisher & Brian C. McManus, *Latham & Watkins Discusses US Law Enforcement Efforts to Combat Offshore Fraud*, CLS Blue

provided their clients—U.S. tax evaders—with ways to illegally circumvent FATCA reporting of their offshore financial assets by concealing them through shell companies and nominees.[9]

The OECD attempts to identify and dismantle schemes that are used to circumvent CRS reporting. On March 8, 2018, the OECD approved model mandatory disclosure rules ("Model Mandatory Disclosure Rules") that require promoters and intermediaries (such as lawyers, accountants, financial advisors, banks, and other service providers) to inform tax authorities of the schemes they put in place in order for their clients to circumvent CRS reporting or to prevent the identification of the beneficial owners of entities or trusts.[10] Although countries are not obligated to follow these rules, it is likely that these rules will become the international norm and be adopted by the countries that implement CRS.

If such efforts continue, will FATCA and CRS succeed in their war on offshore tax evasion? This Article shows that the noncompliance and enforcement challenges of FATCA and CRS are substantial and go well beyond schemes such as those offered by Bandfield or those targeted by the OECD under the Model Mandatory Disclosure Rules.

As discussed in Part I of this Article, tax evaders can avoid FATCA and CRS reporting without the assistance of any intermediaries or enablers and without using complicated offshore structures. All they need to do is to hold their offshore financial assets through a private entity controlled by them that certifies that it meets the definition of a "Financial Institution" ("FI"). This can be done rather easily because many private investment entities are classified as FIs under FATCA and

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Sky Blog (Sept. 24, 2014), http://clsbluesky.law.columbia.edu/2014/09/24/latham-watkins-discusses-fatca-violation-underlying-latest-us-tax-and-securities-fraud-charges/.

9. Press Release, U.S. Attorney's Office, E. Dist. N.Y., Architect of Offshore Fraud Haven and Orchestrator of More Than 40 Pump and Dump Schemes Sentenced to 6 and 12 Years in Prison, Respectively, for Executing a $250 Million Money Laundering Scheme (Feb. 6, 2017), https://www.justice.gov/usao-edny/pr/architect-offshore-fraud-haven-and-orchestrator-more-40-pump-and-dump-schemes-sentenced.

10. OECD, *Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures* 3 (2018), http://www.oecd.org/tax/exchange-of-tax-information/model-mandatory-disclosure-rules-for-crs-avoidance-arrangements-and-opaque-offshore-structures.pdf [hereinafter *Model Mandatory Disclosure Rules*].

CRS. Such entities are required to report their beneficial owners. However, in reality, where a tax evader holds unreported financial assets through a private entity that he or she owns and manages, it is unlikely that this entity will report its owner to the tax authorities. In addition, CRS reporting is not required where the investment entity FI and its owner are resident in the same jurisdiction. At the same time, banks and other FIs that maintain the financial accounts of such entities are not required to report the beneficial owners of these entities. The result is that FATCA and CRS are completely ineffective in catching these tax evaders.

This Article shows that this noncompliance opportunity is a result of a decision by the drafters of FATCA and CRS regarding who should report the beneficial owners of private investment entities that hold offshore financial assets. In general, under FATCA and CRS, FIs must identify and report certain account holders who are tax residents of the U.S. or other reportable jurisdictions.[11] Many people hold financial accounts and assets, not directly under their names, but through closely-held private companies and family trusts (this Article refers to these entities collectively as "private investment entities"[12]). Thus, the drafters of FATCA and CRS needed to choose who should be required to identify and report these beneficial owners. Two groups of agents could have been chosen for that purpose: (1) the financial institutions that maintain the financial assets of these private investment entities,[13] or (2) the private investment entities themselves. The drafters of FATCA and CRS chose to impose the reporting requirements on many of the private investment entities by classifying them as FIs.[14]

This policy is deeply flawed. First, it creates vast opportunities for noncompliance as mentioned above. Where the beneficial owners

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11. For example, where a British tax resident holds a bank account in a bank in Hong Kong, the bank will annually report information about the account and the account holder to the Hong Kong tax authority, which will exchange this information with the British tax authority.

12. As this Article focuses on closely-held entities, the private investment entities discussed here do not include private (i.e., not publicly traded) collective investment vehicles, such as private equity funds and hedge funds.

13. For example, banks that maintain bank accounts of such entities.

14. If these private investment entities were not classified as FIs, the reporting of the beneficial owners of these entities would have been done by the FIs that maintain the financial assets of the private investment entities. *See* Part I.

control and manage these closely-held private investment entities, imposing reporting obligations on these entities is in substance similar to requiring *self-reporting* of the beneficial owners.[15] If the reporting obligations are imposed on the FIs that maintain such entities' financial accounts, then this is *third-party reporting*, which significantly increases the likelihood of compliance and detection of noncompliance.[16] Under the current policy, tax evaders can transfer financial assets that are not currently held through private investment entities into such entities. They might remove third parties, such as professional trustees and directors, to ensure that the private investment entities' failure to comply with the reporting obligations goes undetected.

Second, this policy results in higher costs for compliant taxpayers. It would be more cost-effective to impose the reporting obligations on the FIs that maintain the private entities' financial assets because these FIs already implement FATCA and CRS with respect to other accounts they maintain; they are typically larger and more sophisticated, equipped with legal and compliance teams that can handle these obligations at a lower cost because of the economies of scale, and they are already required to identify the beneficial owners under anti-money laundering rules.

Third, imposing reporting obligations on certain private investment entities might distort the behavior of tax-compliant beneficial owners because they could make certain changes in the holding structure, asset management style, and asset location to avoid holding entities that need to comply with costly and complicated regulatory obligations. Imposing the reporting obligations on the FIs that maintain the financial accounts of private investment entities would likely result in fewer distortions and lower deadweight loss.

The result is that tax evaders love this policy because they can exploit it to avoid FATCA and CRS reporting and keep their unreported

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15. For a discussion of the impact of self-reporting and third-party reporting on compliance, see Henrik Jacobsen Kleven et al., *Unwilling or Unable to Cheat? Evidence from a Tax Audit Experiment in Denmark*, 79 Econometrica 651 (2011) [hereinafter Kleven et al., *Unwilling or Unable to Cheat?*]; Henrik Jacobsen Kleven et al., *Why Can Modern Governments Tax So Much? An Agency Model of Firms as Fiscal Intermediaries*, 83 Economica 219 (2016) [hereinafter Kleven et al., *Why Can Modern Governments Tax So Much?*].

16. Kleven et al., *Why Can Modern Governments Tax So Much?*, *supra* note 15, at 219.

offshore financial assets at a low detection risk. Compliant beneficial owners hate this policy because it imposes large compliance costs on them and distorts their behavior. This could have been avoided if the reporting obligations had been imposed on the FIs that maintain these private investment entities' financial assets instead of on the private investment entities. As FATCA and CRS are in their early years of implementation, it is important to identify and fix the problems this policy has created. This Article proposes possible solutions that the U.S. Treasury and the OECD should consider.

This Article builds on the analysis of FATCA and CRS to explore an important general question of regulatory design: how to choose which group of agents should be required to satisfy a regulatory obligation where that obligation can be imposed on one of two or more alternative groups of agents. Choices of who to regulate arise in various regulatory regimes, such as financial, tax, environmental, and product safety regulation. As shown in the context of FATCA and CRS, these choices may have significant implications on the costs and the effectiveness of the regulation. In general, as discussed in Part II, choosing who to regulate requires a cost-effectiveness analysis of imposing the regulatory obligations on each of the alternative groups.[17] This analysis should consider the cost-effectiveness of compliance, the distortions created by imposing the regulatory obligations, and the likelihood of noncompliance, as these factors may be different for different groups of agents. After analyzing these factors, we should compare the aggregated societal benefits and costs of imposing regulatory obligations on each of the alternative groups.

The structure of this Article is as follows: Part I discusses the decision made by the drafters of FATCA and CRS regarding who should report the beneficial owners of private investment entities, and the substantial implications of this decision. Part II explores the general question of regulatory design: how to choose who to regulate. Part III concludes.

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17. This analysis should be part of more comprehensive cost-benefit and cost-effectiveness analyses of the regulation. *See* Matthew D. Adler & Eric A. Posner, New Foundations of Cost-Benefit Analysis 6 (2006); *infra* note 109.

I. FATCA, CRS, and the Reporting of Beneficial Owners

FATCA and CRS revolutionized the way countries collaborate on fighting offshore tax evasion. Under these regimes, FIs are required to identify account holders who are foreign tax residents and report their information to the local tax authority.[18] The local tax authority then transfers this information to the tax authority of the account holders' jurisdiction of tax residence.

As many people hold financial accounts not directly under their names but through closely-held private investment entities, the drafters of FATCA and CRS needed to decide who should be required to identify and report reportable beneficial owners. One approach would have been to impose the due diligence and reporting obligations on the FIs that maintain the financial accounts of the private investment entities. Another approach would have been to impose the due diligence and reporting obligations on the private investment entities themselves so that they would be required to report their beneficial owners.

Sections A and B below discuss the decision made by the drafters of FATCA and CRS regarding who should report the beneficial owners of financial accounts held by private investment entities. Section C analyzes this choice following the approach suggested in this Article and then explains why the choice made by the drafters of FATCA and CRS is deeply flawed. Section D discusses possible explanations for the approach adopted by the drafters of FATCA and CRS. Section E shows that the OECD's Model Mandatory Disclosure Rules do not solve the problems identified in this Article. Section F discusses possible solutions.

A. FATCA

1. Background

Sections 1471 through 1474 of the Internal Revenue Code, which provide the statutory basis for FATCA, were enacted by the U.S. Congress and signed into law in 2010 as the revenue-raising portion of the

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18. This is the approach of CRS and FATCA Model 1 IGA (which is the most common FATCA arrangement). Other FATCA arrangements (i.e., the FATCA legislation and regulations, and Model 2 IGA) are discussed later. *See infra* Part I.A.1.

Hiring Incentives to Restore Employment (HIRE) Act of 2010.[19] The purpose of FATCA was to force non-U.S. financial institutions to report to the IRS information about their clients who are U.S. persons.[20] Under FATCA, in general, FIs[21] are required to register with the IRS to obtain a Global Intermediary Identification Number ("GIIN")[22] and comply with the terms of the standard agreement with the IRS ("FFI Agreement"). Under the FFI Agreement, the FIs commit to conducting certain due diligence procedures to identify U.S. persons who are account holders or controlling persons of account holders and reporting these U.S. persons' personal information and account balance and income to the IRS.[23] Under the U.S. legislation and regulations, if an FI does not comply with FATCA, withholding of 30% is imposed on certain payments made to that FI.[24]

These obligations came into force on July 1, 2014. In the months before that date, the U.S. government and the governments of many other countries agreed to enter into bilateral intergovernmental agreements ("IGAs") for the implementation of FATCA by FIs of these countries. The U.S. Treasury developed two types of IGAs: Model 1 IGA and Model 2 IGA.[25] The main difference is that Model 1 IGA requires FIs to report the required information to the tax authority in the relevant jurisdiction, which will then transfer the information to the IRS, whereas

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19. Pub. L. No. 111-147, §§ 501–35, 124 Stat. 71, 97–115 (2010). For more background about FATCA, see BYRNES & MUNRO, *supra* note 3, ch. 1.

20. Reportable U.S. persons (defined as "specified U.S. persons" under FATCA) generally include U.S. citizens, permanent residents ("green card" holders), alien residents, and U.S. entities such as U.S. corporations (with certain exceptions) and U.S. trusts. *See* Reg. § 1.1473–1(c).

21. FATCA uses the term foreign (i.e., non-U.S.) financial institution or "FFI." CRS uses the term financial institution or "FI." For consistency, this Article refers to FFIs as FIs. The FATCA definition of FI is discussed later.

22. *See* Reg. § 1.1471–1(b)(57).

23. *See* Reg. § 1.1471–4(c); Rev. Proc. 2017–16, 2017–3 I.R.B. 501. As discussed below, the obligation to comply with the terms of the FFI Agreement does not apply to FIs in Model 1 IGA jurisdictions.

24. I.R.C. § 1472(a).

25. *Resource Center*, *Foreign Account Tax Compliance Act (FATCA)*, U.S. TREAS. DEP'T, https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx (last updated Apr. 11, 2018) [hereinafter *FATCA Resource Center*].

Model 2 IGA requires that FIs report the information directly to the IRS. Most countries that signed onto the IGAs adopted Model 1 IGA.[26]

There are a few reasons for the popularity of Model 1 IGA. Governments that signed Model 1 IGA can issue more flexible local guidance, and they can act as an intermediary between the IRS and the local financial industry. In addition, many countries have laws that prohibit reporting personal data by financial institutions unless this reporting is required under domestic law and the reporting is to governmental authorities (and not to foreign governments). These countries could overcome this legal hurdle by signing Model 1 IGA and enacting domestic legislation and regulations that require reporting to the relevant governments, which then transfer the information to the IRS under the Model 1 IGA. Both Model 1 IGA and Model 2 IGA provide some advantages to the FIs of the jurisdictions that signed onto these IGAs.[27] Most importantly, the IGAs reduce the risk that compliant FIs in these jurisdictions would be subject to withholding or be required to impose withholding.[28]

The obligations that FATCA regulations and the IGAs impose on FIs are generally similar, although the IGAs offer a somewhat more simplified approach than the U.S. regulations. Many countries that adopted IGAs issued detailed regulations and guidance notes that provide practical guidance to the FIs of the relevant jurisdictions. As most of the world's significant economies, financial centers, and offshore jurisdictions have adopted IGAs, FATCA is now based mostly on these bilateral IGAs and much less on the unilateral U.S. FATCA legislation and regulations.

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26. As of April 11, 2018, 89 jurisdictions have signed Model 1 IGA. Ten other jurisdictions have agreed in substance to adopt a Model 1 IGA, but the agreements have not been finalized. Eleven jurisdictions signed Model 2 IGA, and three jurisdictions have agreed in substance to adopt Model 2 IGA, but the agreements have not been finalized. *FATCA Resource Center*, *supra* note 25.

27. This explains why the financial industry in many countries lobbied and pressured governments to enter into IGAs with the United States.

28. *See* Model 1 IGA art. 4 § 1; Model 2 IGA art. 3 § 1. Under the U.S. regulations and Model 2 IGA, FIs are required to comply with the terms of the FFI Agreement that requires withholding on certain payments made to non-compliant FIs, although this withholding is rarely seen in practice. *See* Rev. Proc. 2017–16, 2017–3 I.R.B. 501. Also, the U.S. regulations keep postponing imposing withholding on "passthru payments," which have not been defined yet. *See* Notice 2015–66, 2015–41 I.R.B. 541.

2. How to Report Beneficial Owners of Accounts Held Through Entities

As many people hold financial assets not directly under their name, but through other entities, the drafters of FATCA needed to decide who should be required to identify and report U.S. beneficial owners to the IRS. There are different reasons why people choose to not hold assets directly under their names but through private investment entities, such as a company, a trust, or a holding structure with several entities. These reasons may include asset protection,[29] privacy considerations,[30] tax considerations,[31] succession planning,[32] regulatory requirements of certain jurisdictions,[33] and so on.

One approach would be to impose the obligation to identify and report the beneficial owners on the FIs that maintain the financial accounts of the private investment entities. As explained below, this approach could be implemented by classifying these private investment entities as Passive Non-Financial Entities ("Passive NFEs"). Another approach would be to impose this obligation on the private investment entities, which will be required to report their beneficial owners. As explained below, this approach could be implemented by classifying these private investment entities as FIs.

If a private investment entity is classified as a Passive NFE, its beneficial owners will generally be classified as "controlling persons," and the FI that maintains the entity's financial account will be required to identify and report these controlling persons if they are U.S. persons. If a private investment entity is classified as an FI, then its beneficial

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29. For example, creditors would find it harder to access assets held in companies or irrevocable trusts.

30. Privacy issues are connected to personal safety in certain jurisdictions, particularly when high-net-worth individuals and their relatives are at risk of kidnapping.

31. For example, if a non-U.S. person dies while directly holding U.S. real estate or shares of U.S. companies, an estate tax of 40% would apply to any amount exceeding U.S. $60,000. I.R.C. § 6018(a)(2). This supports holding U.S. situs assets through foreign companies.

32. For example, trusts are very commonly used as a succession planning tool.

33. Some jurisdictions impose restrictions on who can purchase assets in those jurisdictions, and, in some cases, it is advantageous to incorporate a local entity instead of holding assets under the name of a foreigner.

owners will generally be considered as "account holders," and the private investment entity will be required to report them to the tax authority if they are U.S. persons. In the vast majority of cases, these entity classifications will result in similar reporting of the beneficial owners; the main difference would be who is required to identify and report the beneficial owners. The following discussion elaborates on how beneficial owners will be reported under these entity classifications.

a. Reporting Beneficial Owners of Passive NFEs

In general, FATCA classifies entities as FIs and Non-Financial Entities. Non-Financial Entities ("NFEs") include Active NFEs and Passive NFEs. Active NFEs include a few types of NFEs, which are typically not used for holding unreported financial accounts: publicly listed NFEs, NFEs that conduct an active business,[34] nonprofit NFEs, NFEs that serve as holding companies or treasury centers of nonfinancial businesses, and government entities.[35] All other NFEs are Passive NFEs. Most private investment entities that are used for tax evasion are passive in nature,[36] so the relevant classifications for them are Passive NFE or FI.[37]

Passive NFEs must provide information about their "controlling persons" who are U.S. persons to the FIs that maintain their accounts when the FIs request this information. This information is generally provided in a self-certification form for FATCA purposes.[38] These FIs will report this information to the domestic government (under Model 1 IGA) or to the IRS directly (under Model 2 IGA and the U.S. law and regulations). Active NFEs are not required to disclose information about their controlling persons.

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34. This means that more than 50% of the NFE's gross income is active income and more than 50% of the NFE's assets produce or are held for the production of active income.

35. Model 1 IGA Annex I § VI(B)(4).

36. This is because such entities are typically used for holding financial assets (such as cash and investments) or properties.

37. The question of when an entity would be classified as an FI or a Passive NFE is discussed later in this Article.

38. The FATCA self-certification form could be a Form W-8BEN-E or a valid substitute form.

The term “controlling persons” is defined as the natural persons who exercise control over an entity.[39] The controlling persons of a Passive NFE trust are the settlor, the trustees, the protector, the beneficiaries, and any other natural person that has ultimate effective control over the trust.[40] Many jurisdictions classify a controlling person as any natural person who holds 25% or more, directly or indirectly, in a Passive NFE.[41]

FIs must review and determine whether the information they receive from account holders is incorrect, unreliable, or otherwise unreasonable. When an FI receives a self-certification, it must assess the reasonableness of it.[42] If the self-certification is found to be unreasonable, the FI cannot accept it. The reasonableness is assessed “based on the information obtained by the Reporting [FATCA Partner] Financial Institution in connection with the opening of the account,” including any documentation collected pursuant to the applicable customer due diligence under the anti-money laundering (“AML”) and “know your customer” (“KYC”) procedures[43]—a different regulatory regime that generally applies to financial institutions.[44] As the FI is required to conduct due diligence to identify the entity’s beneficial owners under the

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39. Model 1 IGA art. 1 § 1; Model 2 IGA art. 1 § 1.

40. In the case of a legal arrangement other than a trust, such term means persons in equivalent or similar positions.

41. *See, e.g.*, Int’l Tax Authority, British Virgin Is., Guidance Notes on the International Tax Compliance Requirements of the Legislation Implementing the Intergovernmental Agreements Between the British Virgin Islands and the United States of America and the United Kingdom to Improve International Tax Compliance § 9.7 (Mar. 20, 2015) [hereinafter BVI Guidance Notes]. Instead of using the “controlling person” definition, as included in the IGA, the U.S. regulations use the term “substantial U.S. owner” with a threshold of 10%. Reg. § 1.1473–1(b). However, under the IGAs (which govern most of the worldwide implementation of FATCA), FIs are required to report controlling persons and not substantial U.S. owners.

42. Model 1 IGA Annex I § II(B).

43. *Id.*

44. Many countries have adopted legislation implementing such procedures. *See* Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation: The FATF Recommendations 7–9 (Feb. 2012; updated Oct. 2016), http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf.

AML/KYC procedures, the FI should be able to identify inconsistencies and discrepancies between the information obtained for AML/KYC purposes and the self-certification.[45] Also, if the FI employees have actual knowledge or reason to believe that a person is reportable as a controlling person and is a U.S. person, the FI must report that person.[46]

b. Reporting Beneficial Owners of FIs

If a private investment entity is an FI, then it will be required to register with the IRS and obtain a GIIN,[47] conduct certain due diligence procedures, and report its "account holders" who are U.S. persons. In general, account holders of an investment entity FI are its debt and equity holders.[48] All equity interest holders of an investment entity FI who are U.S. persons are reportable, even if they hold less than 25% (there is no threshold of 25% or more unlike the definition of a controlling person of a Passive NFE). In addition, in most jurisdictions, persons that would be considered as controlling persons of a Passive NFE trust would

45. Some beneficial owners may succeed in avoiding disclosing their identity under both AML/KYC procedures and FATCA. However, many beneficial owners provided FIs with their information (e.g., copies of their U.S. passports) before FATCA was enacted, and it would be harder for them to argue that they are not reportable controlling persons if the private investment entity is classified as a Passive NFE. The FATCA requirement that FIs must act on the actual knowledge of their employees makes it harder for reportable beneficial owners to avoid being identified and reported.

46. FATCA instructs that FIs must inquire of relationship managers whether they have actual knowledge that any of the account holders of the preexisting high value individual accounts is a reportable person. In addition, FIs cannot rely on a self-certification or any other documentary evidence if they know or have reason to know that it is incorrect or unreliable. *See* Model 1 IGA Annex I § II(D)(4) ("Relationship Manager Inquiry for Actual Knowledge"), § VI(A) ("Reliance on Self-Certification and Documentary Evidence").

47. FIs resident in Model 2 IGA jurisdictions will also need to comply with the terms of the FFI Agreement on the IRS website. *See FATCA Information for Foreign Financial Institutions and Entities*, IRS.gov, https://www.irs.gov/businesses/corporations/information-for-foreign-financial-institutions (last updated Mar. 30, 2018).

48. All equity interest holders of an investment entity FI who are U.S. persons are reportable; there is no threshold of 25% or more like in the definition of controlling persons.

generally be considered as having an equity interest in the trust.[49] These persons include the settlor, beneficiaries who are entitled to mandatory distributions, discretionary beneficiaries who received distributions in the calendar year, and any other person that exercises ultimate effective control over the trust.[50]

Although not identical, the identity of the account holders of investment entity FIs and the controlling persons of Passive NFEs overlap in most practical cases. The main difference is that owners of less than 25% of equity interest would be considered as account holders of an FI and not as controlling persons of Passive NFEs. In most cases, this would not result in different reporting because it is likely that most private investment entities used for holding unreported offshore financial assets are closely held.[51]

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49. There is no ownership threshold requirement with respect to the account holders of an FI trust. *See, e.g.*, BVI Guidance Notes, *supra* note 41, § 6.7; Tax Info. Auth., Cayman Isl., Guidance Notes on the International Tax Compliance Requirements of the Intergovernmental Agreements Between the Cayman Islands and the United States of America and the United Kingdom § 6.7 (July 1, 2015); HM Rev. & Customs, U.K., Guidance Notes: Implementation of the International Tax Compliance (United States of America) Regulations 2014, at 63 (Aug. 28, 2014).

50. See the definition of "Equity Interest" in Model 1 IGA art. 1 § 1(v). The term "Equity Interest" is not defined in Model 2 IGA. The U.S. regulations provide a different definition for the people who are considered as holding equity interest in an FI trust, which include a person who is an owner of the trust under U.S. tax law (typically the settlor of a grantor trust), a beneficiary who is entitled to a mandatory distribution from the trust, and a discretionary beneficiary that received a distribution in the relevant calendar year. *See* Reg. § 1.1471–5(b)(3)(iii)(B).

51. From cases in practice, it appears that many offshore entities that hold unreported offshore accounts are owned by an individual or by a couple. People can bundle assets into one company or transfer shares so that each person's holdings will be below 25%, although this would involve high costs (giving up control and transferring assets) and risks (the likelihood of detection might be higher where there is collusion between multiple people). As mentioned in note 41 of this Article, the U.S. regulations impose the requirement to identify and report a "substantial U.S. owner" (with a threshold of 10%) of a Passive NFE. Reg. § 1.1473–1(b). As the ownership threshold under the U.S. regulations is lower, there is more overlap between the reporting of beneficial owners under the different entity classifications. However, the U.S.

Table 1:

	Passive NFE	**FI (Investment Entity)**
Who reports?	The FI that maintains the financial account of the entity	The entity itself
Who is reportable?	Controlling person (generally there is ownership threshold of 25% or more for a controlling person) who is a U.S. person	Account holder (any debt and equity holder without any threshold) who is a U.S. person
What information is reported?	Personal information (name, address, tax identification number); account information on the financial account maintained by the reporting FI	The same personal information; account information concerning interest of the beneficial owner in the private investment entity

The personal information that will be reported concerning U.S. persons who are account holders of an FI and controlling persons of a Passive NFE is identical. This personal information includes the account holder's or the controlling person's name, tax identification number (for individuals it would be their U.S. Social Security number), and address. However, the reported financial account information would be different. In general, this information includes the account number, balance or value, and income paid to the account. If the private investment entity is a Passive NFE, the FI that maintains the entity's financial account will report both the balance or value of that account and the income paid to that account. If the private investment entity is an FI, then it will be required to report the whole value beneficially owned by the beneficial owner of that entity.[52]

In most cases, the differences in the reportable account information would have limited practical importance. Where the entity's main assets are held in financial accounts and the entity does not have

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regulations do not apply to jurisdictions that enter into IGAs, which follow the "controlling persons" definition.

52. An entity's value is calculated as the value of its assets (including nonfinancial assets) minus liabilities.

debt, the FIs that maintain these accounts will report them to the IRS, so the IRS will receive similar information, although it would be received from different sources. Moreover, the main purpose of FATCA is to expose unreported financial accounts. Assuming compliance with the reporting requirements, the IRS would obtain this information under either entity classification.

Table 1 summarizes the FATCA treatment of the beneficial owners of private investment entities if these entities are Passive NFEs or FIs.

3. FATCA's Choice of Who to Regulate

FATCA's choice of who should identify and report the beneficial owners of private investment entities is reflected in the entity classification rules, which classify these private investment entities as FIs or Passive NFEs. As discussed below, under the FATCA entity classification rules, many private investment entities are classified as FIs. In addition, it is rather easy for a private investment entity to adopt certain features that would result in that entity being classified as an FI.

Under FATCA, the term FI means a custodial institution, a depository institution, an investment entity, or a specified insurance company.[53] The U.S. regulations define three types of FI "investment entities."[54] One of these types is an entity that meets the following requirements:

1) The entity is managed by another FI. This Article refers to this requirement as the *"managed by" test*. "An entity is managed by another entity if the managing entity performs, either directly or through another third-party

53. Model 1 IGA art. 1 § 1(g). Similar definitions appear in Model 2 IGA art. 1 § 1(g), and Reg. § 1.1471–5(e).

54. Reg. § 1.1471–5(e)(4). The investment activities include the following: (1) trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign exchange; exchange, interest rate, and index instruments; transferable securities; or commodity futures trading; (2) individual and collective portfolio management; or (3) otherwise investing, administering, or managing funds or money on behalf of other persons. *See* Model 1 IGA art. 1 § 1(j). A similar definition appears in Reg. § 1.1471–5(e)(4)(i)(A) and Model 2 IGA art. 1 § 1(k).

service provider," any of the investment activities on behalf of the managed entity.[55]

2) The entity's gross income is primarily attributable (i.e., more than 50%)[56] to investing, reinvesting, or trading in financial assets. This Article refers to this requirement as the *"gross income" test.*

Any entity that satisfies these requirements is classified as an FI under this type of the "investment entity" FI category (this Article refers to this type as *"managed" investment entity*). Interestingly, the U.S. FATCA legislation does not include any reference to this type of investment entity.[57] The drafters of the U.S. regulations created this definition, which was later adopted by the IGAs and the CRS.

The IGAs adopted a somewhat different definition of the term "investment entity." Under the IGAs, an investment entity is any entity that conducts itself as a business (or is *managed by* an entity that conducts as a business) where one or more of the financial investment activities or operations is for or on behalf of a customer.[58] The definition in the IGA does not include the "gross income" test, so any entity "managed by" an investment entity FI would be classified as an FI under this definition. However, the IGAs generally permit adopting relevant U.S. regulations instead of a corresponding definition in the IGA, as long as the application would not frustrate the purposes of the IGA.[59] Following this approach, FIs in many IGA jurisdictions can generally choose to adopt the FI definition in the regulations.[60]

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55. Reg. § 1.1471–5(e)(4)(i)(B).

56. Income is "primarily attributable" to investing, reinvesting, or trading in financial assets if more than 50% in the shorter of the three-year period ending on December 31 of the preceding year or the period during which the entity has been in existence. Reg. § 1.1471–5(e)(4)(iv)(A).

57. I.R.C. § 1471(d)(5)(C) ("Except as otherwise provided by the Secretary, the term 'financial institution' means any entity that . . . is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities . . . , partnership interests, commodities . . . , or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities.").

58. Model 1 IGA art. 1 § 1; Model 2 IGA art. 1 § 1.

59. *See* Model 1 IGA art. 4 § 7. A similar provision appears in Model 2 IGA art 3 § 6.

60. *See, e.g.*, BVI Guidance Notes, *supra* note 41, § 1.4.

The definition of "managed" investment entity applies to many private investment entities, such as private family trusts and private closely-held investment companies, which satisfy the "managed by" test and the "gross income" test.[61] These private investment entities are typically not subject to financial regulation, unlike other FI categories, such as banks, insurance companies, and funds, which are usually under other forms of regulation as financial institutions.

Shortly after the U.S. regulations and IGAs were published, professional advisers and wealth managers raised concerns that the guidance on the "managed by" test and the "gross income" test was lacking.[62] Some governments have provided additional guidance, yet some important practical questions remain unanswered.[63]

In light of the limited guidance, different people take different approaches concerning the appropriate FATCA classification of certain

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61. A trust that would be classified as an FI if it were managed by a trust company (which is an FI) and the gross income of the trust was from investing in financial assets. *See* Reg. § 1.1471–5(e)(4)(v), Ex. 6. The same result would apply to any entity managed by an FI if the entity's gross income was attributable to investing in financial assets. A trust managed by an individual trustee will not be an FI because it does not satisfy the "managed by" test, unless the trust has assets that are under discretionary management of an FI. The same result would apply to any entity that is managed by an FI if the entity's gross income was attributable to investing in financial assets.

62. See, for example, the questions raised in Peter A. Cotorceanu, *FATCA and Offshore Trusts: A Second Bite of the Elephant*, 72 TAX NOTES INT'L 265, 274–81 (Oct. 21, 2013).

63. Here are some of these questions:

> 1) Is an entity considered as "managed by" an FI if a small part of its assets is subject to the discretionary management of a professional investment company? The investment company is an FI, and it performs investment activities on behalf of the other entity. However, the other entity may have individual directors as managers, and the managed assets may be a small part of the overall assets. The IGAs and the U.S. regulations do not provide clear guidance on these issues.
>
> 2) Is a trust "managed by" a trustee of a discretionary trust if the power of investment is reserved by the settlor? Arguably, the trustee does not perform investment activities for the trust, although the trustee still administers funds in the sense that the trustee decides whether to keep assets invested in the trust or make distributions.

entities. Some beneficial owners and directors of private investment entities did not want these entities to be classified as FIs, the main reason being the cost of compliance with the obligations imposed on FIs. FATCA provides sponsoring arrangements, under which another FI undertakes to satisfy the sponsored entity's FATCA obligations.[64] However, the sponsoring entities typically charge fees for their services as sponsors, so these private investment entities have been required to carry the additional cost of compliance. Some beneficial owners and directors of private investment entities without any U.S. ties had privacy concerns due to the requirement of registering these entities with the IRS to obtain a GIIN, which is generally required if an entity is an unsponsored FI.

Some FIs put pressure on private investment entities to classify themselves as FIs. Where an entity certifies that it is a Passive NFE, and the FI that maintains that entity's financial account holds the view that this entity is an FI, it may refuse to accept the self-certification. Nonetheless, it is less likely that an FI would reject a self-certification of an entity certifying that it is an FI. This is because many FIs and professional advisers view classifying an entity as an FI as adopting a more conservative approach—an FI classification is perceived as involving more

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3) Does the "gross income" test apply to the underlying income, or does it apply to the trust's income from the intermediate holding company? Many trusts and private investment companies hold assets through intermediate holding companies. Some jurisdictions adopted the approach to look at the underlying sources of income (e.g., BVI Guidance Notes, *supra* note 41, § 6.4.1) while many jurisdictions do not provide guidance on this issue.

64. Relevant sponsoring arrangements include "Sponsored Investment Entity" and "Sponsored, Closely Held Investment Vehicle." Another arrangement, available only for trusts, is a "Trustee-Documented Trust," in which an FI trustee undertakes to satisfy the FI trust's FATCA obligations. Model 1 IGA Annex II § IV. Similar arrangements are available under Model 2 IGA Annex II § IV. The U.S. regulations include fewer sponsoring arrangements, and some of the requirements for sponsoring arrangements are stricter. Some early IGAs do not include sponsoring arrangements, and FIs in the relevant jurisdictions can only rely on the sponsoring arrangements under the U.S. regulations.

compliance obligations and more reporting.[65] The result is that if an entity that does not meet the FI definition falsely certifies that it is an investment entity FI, the likelihood that other FIs would reject this classification is rather low.

Unlike other countries that generally follow these entity classification rules, Canada and the Netherlands adopted different approaches with respect to the classification of private investment entities. The Canadian definition of "listed financial institution" includes 13 types of regulated entities, and it does not include unregulated private trusts and private investment companies.[66] The Netherlands' guidance dictates that an entity should be classified as a Passive NFE if (i) it is owned by a very limited group of shareholders or if the participants are part of the same family; (ii) it does not present itself as an investment fund in the market; and (iii) it has neither raised nor will raise capital in the market.[67]

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65. As discussed in sections C and D below, this perception is false, and it is wrong to assume that classifying an entity as an FI would result in more reporting.

66. See the definition of "listed financial institution" in the Canadian Income Tax Act, R.S.C. 1985, c 1 s. 263(1) (Can.). For further discussion, see Roy A. Berg & Paul M. Barba, *FATCA in Canada: The Restriction on the Class of Entities Subject to FATCA*, 6 Can. Tax J. 587 (2014). Canada applies the same approach also for CRS.

67. Ministry of Fin., Guidance with Technical Explanatory Notes to the Agreement Between the Kingdom of the Netherlands and the United States of America to Improve International Tax Compliance and to Implement FATCA, concluded on 18 December 2013 (Jan. 12, 2015) ("Entities that have assets that consist of cash or investments—or a holding company thereof—with a (very) limited group of direct and indirect shareholders or participants who are members of one family, who do not present themselves as an investment entity and who have neither raised nor will raise capital in the market are not investment entities in the sense of Article 1, first paragraph, under j, of the NL IGA, including the situation in which the assets are managed by an FI. An entity of this nature—or a holding company thereof—is deemed to be a passive NFFE."). The Netherlands applies a similar approach for CRS. *See CRS Newsbrief, The Netherlands Issues Dutch Guidance on the Common Reporting Standard*, PWC 3 (Feb. 9, 2016), https://www.pwc.nl/nl/assets/documents/crs-newsbrief-the-netherlands-issued-dutch-guidance-on-the-common-reporting-standards.pdf.

B. CRS

1. Background

After the United States enacted FATCA, other countries expressed interest in adopting an automatic exchange of information ("AEOI") regime that would provide governments with information about their tax residents' offshore financial accounts.[68] Supported by the G20, the OECD developed the CRS, which was adopted in 2014. More than 100 jurisdictions, including all major economies (excluding the United States[69]), have committed to implementing AEOI under the CRS. These jurisdictions have already or are in the process of enacting legislation that incorporates the CRS into their domestic law. Forty-nine jurisdictions started exchanging information in 2017; fifty-one started in 2018; and eight are expected to start by 2020.[70]

CRS is modeled after FATCA Model 1 IGA. FIs of a particular country are required under that country's domestic law to identify account holders (and controlling persons of Passive NFE account holders) who are foreign tax residents of reportable jurisdictions and report their information to the local tax authority. The local tax authority will exchange this information with the account holder's jurisdiction of tax residence.

CRS adopted, with some changes, much of FATCA's definitions, due diligence, and reporting obligations of FIs. There are a few notable

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68. For an overview of the history of CRS, see OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters* 9–10 (2d ed. 2017), http://www.oecd.org/publications/standard-for-automatic-exchange-of-financial-account-information-in-tax-matters-second-edition-9789264267992-en.htm.

69. The United States has announced that it will fulfill its information reporting obligations under the FATCA IGAs; some of them are reciprocal and should provide some reporting from the United States to the IGA jurisdictions. However, this reporting is much less comprehensive than the required reporting under CRS. For further information and analysis, see Peter A. Cotorceanu, *Hiding in Plain Sight: How Non-U.S. Persons Can Legally Avoid Reporting Under Both FATCA and GATCA*, 21 Trusts & Trustees 1050, 1050–51 (2015).

70. This is the status of commitments as of November 2018. *AEOI: Status of Commitments*, OECD, https://www.oecd.org/tax/transparency/AEOI-commitments.pdf (last updated Nov. 2018).

differences between FATCA and CRS. First, FATCA was initially implemented unilaterally as a U.S. law, whereas CRS is a multilateral reporting framework. Second, FATCA focuses on identifying and reporting U.S. persons only, whereas CRS focuses on the identification and reporting of tax residents of reportable jurisdictions.[71] Third, unlike FATCA, CRS does not involve the risk of withholding; instead, countries adopt sanctions in their domestic laws to penalize noncompliance. Fourth, unlike FATCA, CRS does not provide a de minimis exemption for individual accounts. And finally, CRS does not allow the sponsoring arrangements that are available under FATCA.[72]

2. CRS's Choice of Who to Regulate

CRS adopted the U.S. Regulations' definition of "managed" investment entity as any entity that meets the "managed by" test and the "gross income" test. The OECD's Commentaries on the Common Reporting Standard ("CRS Commentaries") and the CRS-related Frequently Asked Questions ("CRS FAQs") issued by the OECD provide additional guidance on these tests.[73] In general, it is easier to satisfy the "managed by" test and the "gross income" test under CRS than under FATCA. Therefore, some entities that could be classified as Passive NFEs under FATCA would be classified as FIs under CRS.

Concerning the "managed by" test, under the CRS Commentaries, when an entity is managed by a mix of FIs, NFEs, or individuals, the entity is considered to be managed by an FI if any of the managing

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71. This difference has some implications for the applicable due diligence obligations. For example, FATCA includes in its list of indicia an unambiguous indication of the U.S. as a place of birth; CRS does not contain such indicium.

72. The only "sponsoring" arrangement included in CRS is Trustee-Documented Trust. CRS allows the use of service providers to fulfill the reporting and due diligence obligations, but these obligations remain the responsibility of the FI. *See* OECD, *Standard for Automatic Exchange*, *supra* note 68, at 31 (*Common Reporting Standard* § II.D).

73. For the OECD guidance materials, including the CRS Commentaries, see *Automatic Exchange Portal*, OECD, http://www.oecd.org/tax/automatic-exchange/ (last visited Nov. 4, 2018). Some uncertainties remain, and some governments have adopted different approaches to how to implement these tests.

entities is an FI.[74] The CRS Commentaries also imply that an entity is "managed by" another entity if the managing entity has discretionary authority to manage the entity's assets *in whole or part*.[75] Under this approach, an entity is considered to be "managed by" an FI where there is an FI investment manager who has discretionary authority to manage some of the entity's assets, even if the managed assets are only a small part of the entity's overall assets, and even if the FI does not manage the entity itself.[76] If the FI investment manager has only an advisory role, then the entity is not considered to be "managed by" the FI investment manager. Some jurisdictions have taken different approaches with respect to the management of trusts. Switzerland, in its CRS guidance, provided that any trust managed by an FI professional trustee would be considered as "managed by" an FI irrespective of the specific powers of that trustee.[77] Singapore has adopted a different approach according to which the "managed by" test may not be satisfied where the settlor reserves the power of investment and the trustee neither performs any investment activities directly or indirectly nor has discretionary authority to manage the trust's assets.[78]

Concerning the "gross income" test, the CRS FAQs provide that we should not look at the underlying assets and income of an entity or a trust, but instead should only look at the assets directly held by that trust/entity. Therefore, if a trust holds real estate through a holding company, the income of the trust would be attributable to investing in the stock of the holding company, which is a financial asset, and the "gross

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74. OECD, *Standard for Automatic Exchange*, *supra* note 68, at 161–64 (CRS Commentaries regarding term "Investment Entity").

75. *Id.*at 162 ("[A]n Entity does not manage another Entity if it does not have discretionary authority to manage the Entity's assets (in whole or part).").

76. *CRS-Related Frequently Asked Questions*, OECD § VIII.A Q&A 6 (June 2018), https://www.oecd.org/tax/exchange-of-tax-information/CRS-related-FAQs.pdf [hereinafter CRS FAQs].

77. *See* Département fédéral des finances, Confédération suisse, Directive: Norme d'échange automatique de renseignements relatifs aux comptes financiers: Norme commune de déclaration § 2.1.3 (Jan. 2017) (Switz.).

78. *See* Inland Rev. Auth. of Sing., *FAQs on the Common Reporting Standard*, Q&A B.5 (July 18, 2017), https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/Quick_Links/International_Tax/IRAS%20FAQs%20on%20the%20Common%20Reporting%20Standard%20(Jan%202018).pdf.

income" test would be satisfied.[79] Some jurisdictions have adopted a different approach that looks at the nature of the underlying income and assets. Switzerland has taken a different approach under which investing either directly *or indirectly* in nonfinancial assets does not satisfy the "gross income" test. Other countries appear to follow the OECD's approach.[80] The general trend is that under the CRS rules more private investment entities are classified as FIs.

Furthermore, an FI is not required to report account holders where the FI and the account holders are resident, for tax purposes, in the same jurisdiction.[81] For example, if an investment entity FI is resident only in Hong Kong, and all the account holders of this FI are Hong Kong tax residents, then no CRS reporting is required by this (or any other) FI with respect to this FI's domestic and offshore financial accounts.

C. Analysis of the Choice of Who to Regulate

FATCA and CRS impose obligations to identify and report beneficial owners of private investment entities on these entities themselves if they meet the "managed by" and the "gross income" tests discussed above. Many private investment entities satisfy these tests under FATCA and even more entities meet these tests under CRS. This Part discusses whether the decision to impose these obligations on these entities is optimal.

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79. CRS FAQs, *supra* note 76, § VIII.A Q&A 5.

80. *See, e.g.*, Inland Rev. Dep't, Hong Kong, CRS Guidance for Financial Institutions ch. 3 ¶ 42 (Sept. 4, 2017), which follows the approach reflected in the CRS FAQs.

81. It is possible that an entity organized in one jurisdiction would be considered as a resident of another jurisdiction. For example, a British Virgin Islands company that is normally managed or controlled in Hong Kong should be subject to the CRS legislation in Hong Kong. If such entity is classified as a Hong Kong FI, then it is not required to report its account holders who are Hong Kong tax residents. *See* Mark Morris, *The 26 OECD Reporting Standard Loopholes*, Planning for the CRS 8 (May 6, 2017), http://www.the-best-of-both-worlds.com/support-files/oecd-crs-loopholes-report.pdf. If an entity account holder certifies that it is a tax resident of one jurisdiction although it is organized in another jurisdiction, the FI that maintains a financial asset of such entity may require documentary evidence (such as a certificate of residence from the jurisdiction of tax residence) to support such self-certification.

1. Compliance Costs

Imposing reporting obligations on the FIs that maintain financial accounts of private investment entities would result in lower compliance costs because of economies of scale. FIs that maintain financial accounts of private investment entities typically include regulated financial institutions such as banks, insurance companies, and funds. These FIs are required to satisfy the obligations under FATCA and CRS concerning all of their account holders, which typically include multiple clients. In contrast, private investment entities have a small number of account holders. In addition, the FIs that maintain the private entities' financial accounts should obtain the information of the beneficial owners of these private entities under AML/KYC rules, which require conducting thorough customer due diligence procedures.[82] The additional cost of identifying the beneficial owners for FATCA and CRS purposes should be very low for an FI that already identifies these beneficial owners for AML/KYC purposes.

Higher costs are incurred by compliant private investment entities that are classified as FIs. As mentioned above, FATCA allowed certain sponsoring arrangements under which another FI could undertake the FATCA obligations of the sponsored entity. This can reduce the FATCA implementation costs for private investment entities because they can retain sponsors that can satisfy the FATCA obligations for a lower cost. However, the CRS does not permit any sponsoring arrangements other than a Trustee-Documented Trust, although FIs can use service providers to fulfill the CRS reporting and due diligence obligations. It is questionable whether appointing sponsors for FATCA and service providers for CRS results in a significant cost saving.

2. Effectiveness of Compliance

The implementation of FATCA and CRS by private investment entities is likely to be less effective even if these entities try to be compliant. The FIs that maintain the financial accounts of private investment entities typically have legal and compliance teams that handle the compliance with CRS, FATCA, AML/KYC, and other regulatory requirements. Many of these FIs are advised by professional lawyers and accountants to ensure accurate implementation of FATCA, CRS and other matters.

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82. *See supra* note 44 and accompanying text.

Private investment entities, in contrast, are less likely to have legal and compliance teams and to have ongoing relationships with professional advisers. Due to this lack of expertise, a private investment entity that intends to comply with its FATCA and CRS obligations without engaging professional advisers is more likely to make errors in the implementation of the relevant obligations. There may not be sufficient deterrence to ensure effective compliance by these private entities because the penalties that apply to unintentional mistakes are typically low[83] and enforcement actions against unintentional failures of these entities might not be a high enforcement priority.

In addition, large regulated FIs (such as banks, insurance companies, and certain funds) that maintain financial accounts of private investment entities might have stronger incentives to comply with the regulation and adopt higher-than-minimal compliance standards to reduce the risk of being found non-compliant. This is because large regulated FIs are exposed to higher costs and penalties for a failure to meet the required compliance standard, such as reputational costs, regulatory penalties, and the potential revocation of their licenses.

3. Distortions

Imposing reporting obligations on certain types of private investment entities might distort the beneficial owners' behavior even where they are not tax evaders. Many owners of offshore private entities that are classified as FIs may avoid this classification by taking certain steps that eliminate the FI status. Here are a few examples:

1) An owner of an offshore private investment entity FI can liquidate that entity and hold the assets directly or through a domestic entity.

2) Some people own their active businesses and their financial assets in separate entities. If a person owns an Active NFE (that holds the active business) and a private investment

83. For example, the penalty in Hong Kong for an unintentional but negligent failure to comply with a CRS obligation is a fine of up to HK$50,000 (around U.S. $6,250). The penalty for an intentional failure to comply is imprisonment for up to three years. *See* Inland Revenue Ordinance (1989) Cap. 112, § 80B (H.K.).

entity FI (that holds the financial assets), then that person can transfer the financial assets into the Active NFE and eliminate the investment entity FI.

3) An owner of an investment entity FI can change his investments to hold more non-financial assets (for example, real property) so that the entity would fail the "financial assets" test.

4) An owner of an entity that has an investment portfolio under the discretionary management of the portfolio manager FI can change the management style to advisory management, or manage the investment himself so that the entity would fail the "managed by" test.

5) A settlor of an offshore trust with a professional trust company acting as the trustee may (if the settlor has the relevant powers) revoke the trust and revest the assets in himself, or change the trustee to an individual trustee so that the trust would fail the "managed by" test.

The main reason compliant taxpayers may take such actions is to avoid the onerous compliance obligations that apply to FIs and the associated costs. These reactions reflect distortions of people's preferences for investments, holding structure, asset management style, and location of assets. Therefore, imposing FATCA and CRS compliance obligations on these private investment entities results in a greater deadweight loss because of the distortion of the preferences of compliant taxpayers who take steps to avoid FI classification.

If the FIs that maintain the financial accounts of private investment entities are required to report these entities' beneficial owners (which would be the result of classifying these private investment entities as Passive NFEs), then there would be fewer distortions in the behavior of these beneficial owners. This is because the private investment entities would not be classified as FIs and, therefore, there would be no need to change the investments, the holding structure, the asset management style, or the location of assets.

4. Noncompliance Opportunities and Loopholes

Where the beneficial owners control the private investment entities, imposing the reporting obligations on these entities is, in substance,

requiring *self-reporting* of the beneficial owners.[84] If the beneficial owners hold unreported financial accounts, there is no reason to believe that imposing reporting obligations on the entities they control would result in reporting. Instead, where the tax evaders control and manage the private investment entities, these entities will not comply with the reporting obligations and the tax evasion will go undetected. If the reporting obligations are imposed on the FIs that maintain such entities' financial accounts, this is in essence *third-party reporting*, which significantly increases the likelihood of compliance and detection of noncompliance.[85] As noted above, FIs are required to obtain information about the beneficial owners under AML laws, and in many cases, relationship managers know where the beneficial owners reside.[86] Although there is a possibility of collusion between the employees of the FIs and the beneficial owners, the likelihood of this appears to be low in the current environment of the financial industry.[87] Therefore, imposing the reporting obligations on private investment entities is likely to result in significantly more incidences of noncompliance.

In addition, no CRS reporting is required when the FI and the account holders are resident in the same jurisdiction. This is a loophole that can be used to avoid CRS reporting by holding assets through a domestic private investment entity that certifies it is an investment entity FI. This entity must comply with the tax and reporting obligations that apply to resident taxpayers, but when such an entity is owned and controlled by tax evaders, it is unlikely that these obligations will be satisfied.

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84. *See* Kleven et al., *Unwilling or Unable to Cheat?*, *supra* note 15, at 651–652.

85. *Id*.

86. Both FATCA and CRS instruct that FIs must inquire relationship managers about whether they have actual knowledge that any of their clients is a reportable person.

87. Since the UBS scandal in 2008, the U.S. Department of Justice has investigated and penalized many banks and financial institutions that assisted clients to evade tax. This has impacted the financial industry, and FIs today are much less likely to help clients hide assets and income from tax authorities. Moreover, most countries that adopted CRS impose criminal sanctions on FIs and employees of FIs for willful noncompliance. For an overview of U.S. enforcement efforts, see Shu-Yi Oei, *The Offshore Tax Enforcement Dragnet*, 67 Emory L.J. 655, 655 (2018).

Tax evaders can take advantage of this policy in many situations. They can transfer assets that are not currently held through private investment entities into such entities to avoid reporting. They can ensure that their private investment entities are classified as FIs under the entity classification rules.[88] Even without making any changes in the management, activities, or income of an entity, if an entity reports on its self-certification that it is an FI, then there is a very low likelihood the FIs that maintain this entity's financial accounts will challenge this classification. Tax evaders may also remove third parties, such as professional trustees and directors, so that the noncompliance of the entity that fails to satisfy its reporting obligations will go undetected.[89] The FIs that maintain these entities' financial assets would not report the beneficial owners because it is the entities' responsibility to report. This opportunity for noncompliance would not be available if the reporting obligations were imposed on the FIs that maintain these entities' financial assets.

These considerations support imposing the obligation to identify and disclose reportable beneficial owners of private investment entities on the FIs that maintain the financial accounts of such entities. This would be the result if private investment entities were always classified as Passive NFEs. This would result in lower compliance costs, more effective compliance, and fewer distortions and incidences of noncompliance.

D. Why Did FATCA and CRS Get It Wrong?

It is unclear why the drafters of FATCA and CRS chose to impose on many private investment entities the obligation to identify and report these entities' beneficial owners. We do not know what the considerations were of the drafters of the U.S. regulations who first made this

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88. As discussed above, the "gross income" test and the "managed by" tests are easy to satisfy. For example, it is possible to satisfy the "managed by" test by engaging a portfolio manager FI with discretionary management over some of the entity's assets.

89. For example, professional trustees are more likely to ensure compliance with FATCA and CRS. However, many settlors reserve the power to remove and appoint trustees, so they can remove the professional trustee and appoint another person (e.g., the settlor's spouse) as trustee who may not insist on reporting.

decision.[90] When drafting the CRS, the OECD could have adopted a different approach, such as the Canadian approach of not classifying unregulated private entities as FIs. The OECD's CRS-related publications do not explain why this approach has been taken. We can suggest possible explanations for the approach adopted by the drafters of FATCA and CRS.

One explanation would be that the drafters had a false perception that classifying more entities as FIs would result in more reporting. The definition of "managed" investment entity can be viewed as a "catch-all" definition that tries to impose reporting obligations on more entities that hold financial assets. As discussed above, the reporting under both classifications as FI and Passive NFE would have resulted in similar information being reported in the majority of cases. Thus, classifying more entities as FIs does not necessarily mean more reporting. Taking into account the increased likelihood of noncompliance, classifying private investment entities as FIs likely results in less reporting. In addition, there will be no CRS reporting where the investment entity FI and its account holders are resident in the same jurisdiction.

Another possible explanation is that the drafters of FATCA and CRS did not pay much attention to private investment entities because this was not the focus of these reporting regimes. The main focus of FATCA and CRS is the banking industry, because many banks maintained unreported accounts of noncompliant taxpayers. This may explain

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90. The drafters of the U.S. regulations considered the large compliance costs borne by small "managed" investment entity FIs (Notice 2010–60, 2010–37 IRB 329), and they provided certain sponsorship arrangements that could potentially reduce compliance costs (*see supra* note 64). In addition, the preamble of the U.S. regulations notes the following: "Comments requested that the definition of 'financial institution' be clarified and more narrowly defined to exclude passive, non-commercial investment vehicles, including trusts. The IGAs adopt this approach by requiring an investment entity to undertake activity on behalf of customers." T.D. 9610, 2013–15 I.R.B. 765. This statement that the IGAs adopted this approach appears to be inconsistent with the broad definition the IGAs adopted for "managed" investment entities. It is possible that the drafters of the U.S. regulations did not expect that the definition of "managed" investment entity would result in many passive, non-commercial investment vehicles, including trusts, being classified as FIs. There is no evidence showing that the drafters of the U.S. regulations analyzed whether "managed" investment entities should be classified as FIs or Passive NFEs.

why the drafters of FATCA and CRS did not conduct a careful analysis of the expected impacts of the FATCA and CRS rules on private investment entities. This explanation is supported by the incomplete guidance of FATCA and to a lesser extent CRS on questions related to private investment entities. The drafters of FATCA and CRS likely did not expect that the noncompliance opportunities created by classifying private investment entities as FIs could undermine the effectiveness of these reporting regimes.

E. Model Mandatory Disclosure Rules

The OECD's Model Mandatory Disclosure Rules do not address the noncompliance opportunities discussed in this Article. These rules impose reporting requirements with respect to CRS Avoidance Arrangements[91] and Opaque Offshore Structures.[92] Holding financial assets through a

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91. *See Model Mandatory Disclosure Rules*, *supra* note 10, Rule 1.1 (A "CRS Avoidance Arrangement' is any Arrangement for which it is reasonable to conclude that it is designed to circumvent or is marketed as, or has the effect of, circumventing CRS Legislation or exploiting an absence thereof . . . where it is reasonable to conclude that such Arrangement is designed to circumvent or is marketed as, or has the effect of, circumventing CRS Legislation or exploiting an absence thereof."). Sections (a) to (g) of Rule 1.1 list several situations that are covered under this definition.

92. *See id*. Rule 1.2 ("(a) An 'Opaque Offshore Structure' means a Passive Offshore Vehicle that is held through an Opaque Structure. (b) Subject to paragraph (c) below, a 'Passive Offshore Vehicle' means a Legal Person or Legal Arrangement that does not carry on a substantive economic activity supported by adequate staff, equipment, assets and premises in the jurisdiction where it is established or is tax resident. (c) A Passive Offshore Vehicle does not include a Legal Person or Legal Arrangement (i) that is an Institutional Investor or that is wholly-owned by one or more Institutional Investors or (ii) where all Beneficial Owners of that Legal Person or Legal Arrangement are only resident for tax purposes in the jurisdiction of incorporation, residence, management, control and establishment (as applicable) of the Legal Person or Legal Arrangement. (d) An Opaque Structure is a Structure for which it is reasonable to conclude that it is designed to have, marketed as having, or has the effect of allowing, a natural person to be a Beneficial Owner of a Passive Offshore Vehicle while not allowing the accurate determination of such person's Beneficial Ownership or creating the appearance that such person is not a Beneficial Owner . . . where it is reasonable to conclude that the Structure is designed to have, marketed as having, or has the effect of allowing a natural

closely-held investment entity FI that is not resident in the same jurisdiction as its account holders, but in a participating jurisdiction with a broad AEOI network,[93] is unlikely to be considered as a CRS Avoidance Arrangement. Such arrangement does not meet the specific categories identified in the definition of the CRS Avoidance Arrangement.[94] Under such an arrangement, the investment entity FI is subject to CRS reporting obligations,[95] and the FIs that maintain the financial assets of such an entity are unlikely to know if such entity fails to satisfy its CRS reporting obligations. The Commentary on Rule 1.1(e)(i), states that "a share broker that maintains a share trading account for an offshore entity can be expected to require that entity to provide information on its shareholders or other evidence that the entity is a Financial Institution or Active NFE."[96] However, as discussed above in Part I.B.2, it is fairly easy for private investment entities to qualify as "managed" investment entity FIs and provide evidence supporting such a classification.

Holding financial assets through a closely-held investment entity FI is also unlikely to be considered as an Opaque Offshore Structure. Such an entity may be considered a "Passive Offshore Vehicle" if it "does not carry on a substantive economic activity supported by adequate staff, equipment, assets and premises in the jurisdiction where it is established or is tax resident."[97] However, holding financial assets through an investment entity FI that is organized in a jurisdiction with legislation that follows the latest Financial Action Task Force Recommendations is unlikely to involve any "Opaque Structure."[98] This is because it would be possible to accurately determine the entity's beneficial owners. The

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person to be a Beneficial Owner of a Passive Offshore Vehicle while not allowing the accurate determination of such person's Beneficial Ownership or creating the appearance that such person is not a Beneficial Owner.").

93. This assumes that the entity is a reporting FI under the laws of the relevant jurisdiction of the investment entity, and AEOI network of that jurisdiction includes the jurisdictions of the relevant account holders. Otherwise, Rules 1.1(b) and 1.1(d) may apply.

94. *See id.* Rule 1.1(a)–(g).

95. This is why Rule 1.1(f)(ii) does not apply.

96. *Id.* at 27.

97. *Id.* Rule 1.2(b).

98. *Id.* Rule 1.2(d) (defining "Opaque Structure" as a "[s]tructure for which it is reasonable to conclude that it is designed to have, marketed as having, or has the effect of allowing, a natural person to be a Beneficial Owner of a Passive Offshore Vehicle while not allowing the accurate determination

result is that the FIs that maintain the financial assets of such entity would not reasonably conclude that this arrangement has the effect of allowing a natural person to be a beneficial owner of a Passive Offshore Vehicle while not being identified as such.[99]

Where the investment entity FI is resident in the same jurisdiction as its account holders, CRS reporting is not required, and, therefore, this arrangement might potentially be considered as a CRS Avoidance Arrangement.[100] If the banks and other FIs that maintain such an entity's financial assets know that the entity is not required to report its account holders, then these banks and other FIs may be able to reasonably conclude that this arrangement has the effect of exploiting an absence of CRS reporting. However, this conclusion requires that the FIs maintaining such an entity's financial assets determine the tax residence of these entity's account holders. Under CRS, if an FI maintains financial assets of another FI, then the first FI is not required to ascertain the tax residence of the second FI's account holders. Thus, FIs may not be able to identify such arrangements as CRS Avoidance Arrangements.

These disclosure requirements apply to "Intermediaries," who are the persons responsible for the design or marketing of CRS avoidance arrangements and opaque offshore structures, and to those persons that provide assistance or advice with respect to the design, marketing, implementation, or organization of such arrangements/structures where such persons could reasonably be expected to know that the arrangements/structures are CRS Avoidance Arrangements or Opaque Offshore Structures.[101] The discussion above shows that the FIs that maintain the financial assets of private investment entities are unlikely to report them as CRS Avoidance Arrangements or Opaque Offshore Structures. It is important to note that tax evaders who use these noncompliance opportunities do not need any other intermediaries. These tax evaders only need to buy or organize entities through which they will hold their offshore financial assets and maintain these entities. Tax evaders may use corporate service providers for setting up such entities or providing some

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of such person's Beneficial Ownership or creating the appearance that such person is not a Beneficial Owner[.]").

99. *See id.* Rule 1.2.

100. This arrangement may fall within the category of "allowing, or purporting to allow . . . an investment to be made through an Entity without triggering a reporting obligation under the CRS Legislation[.]" *Id.* Rule 1.1(f)(ii).

101. For the definition of "Intermediaries," see *id.* Rule 1.3.

services that are not related to CRS. However, these service providers may not have any reason to know or suspect that such entities are used to circumvent CRS reporting.

F. Potential Solutions

FATCA and CRS are in their early years of implementation. FATCA's first reporting was in 2015. Some countries started CRS reporting in 2017, and others started CRS reporting in 2018. It is important to identify ways to improve these new reporting regimes and close loopholes and noncompliance opportunities as quickly as possible.

The solutions discussed below would be fully effective only if they were adopted by all countries that implement FATCA and CRS. Otherwise, tax evaders would be able to exploit the noncompliance opportunity discussed above by transferring their unreported financial assets to jurisdictions that classify private investment entities as FIs. Partial effectiveness will be achieved if the chosen solution is adopted by the jurisdictions that serve as financial centers, especially offshore and mid-shore jurisdictions.

Adopting any change in FATCA or CRS rules would require legislative amendments in dozens of countries. The fixing process should start with the U.S. Treasury (concerning FATCA) and the OECD (concerning CRS). After the U.S. Treasury decides to adopt a solution to this problem, it will need to negotiate new IGAs with all the jurisdictions that entered into IGAs with the United States. Many of these jurisdictions have enacted domestic laws for the implementation of FATCA, and they will need to change these laws to incorporate the required changes. CRS has been adopted, or is in the process of being adopted, in more than 100 countries' domestic legislation.[102] If the OECD accepts a change in the entity classification rules or one of the alternative solutions proposed below, effecting it would require legislative amendments in the countries that implement CRS.

1. Changing the FI Definition

As the problems discussed above are a result of a wrong decision of who to regulate, changing this decision by imposing the relevant obligations on the alternative group of agents would be the most straightforward

102. *See supra* note 2.

and efficient solution. This requires changing the entity classification rules so that "managed" private investment entities are always classified as Passive NFEs. The FIs that maintain these entities' financial accounts will report these entities' beneficial owners if they are reportable persons.

This can be achieved by following the approach adopted by Canada, which only includes certain types of regulated entities in the definition of FI and does not include unregulated private investment entities.[103] Alternatively, it is possible to entirely remove the category of "managed" investment entities from the FI definition or narrow it significantly, following the Dutch approach, so that it does not apply to closely-held private investment entities.[104] Under the approach adopted by the Netherlands, a private investment entity should be classified as a Passive NFE if (i) it is owned by a very limited group of shareholders or participants that are part of the same family; (ii) it does not present itself as an investment fund on the market; and (iii) it has neither raised nor will raise capital in the market.[105] The fact that the United States and the OECD did not challenge Canada and the Netherlands on adopting these approaches may suggest that the United States and the OECD are open to these approaches and that other countries can follow these routes.

2. Parallel Reporting

Another solution would be to require parallel reporting of the beneficial owners by "managed" investment entities and by the FIs that maintain such entities' financial accounts.[106] Parallel reporting would increase compliance costs because more agents would be required to satisfy due diligence and reporting obligations, but it would eliminate the noncompliance opportunity discussed above by providing third-party

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103. See the definition of "listed financial institution" in the Canadian Income Tax Act, R.S.C. 1985, c 1 s. 263(1), and the discussion in Part I.A.3, *supra*.

104. There may be rationales supporting classifying certain subsidiaries of funds as FIs, so the definition of "managed" investment entity could be tailored to apply only to such entities.

105. See *CRS Newsbrief*, *supra* note 67, at 3, and the discussion above in Part I.A.3.

106. The most common parallel reporting in the tax system is of employment income, which is reported by both the employer and the employee.

reporting. As the private entities' financial assets are held by FIs, and these FIs obtain the information about the entities' beneficial owners through the applicable AML/KYC procedures, the additional costs of parallel reporting may not be very high.

It is possible to expand the Model Mandatory Disclosure Rules so that the FIs maintaining financial assets of closely-held private investment entities, which are classified as FIs, will be required to report such entities under these rules. This would be parallel reporting where such entities are subject to CRS reporting obligations. However, it is questionable whether imposing such reporting requirement (which concerns many private investment entities that are not used for CRS avoidance) should be done through the Model Mandatory Disclosure Rules and not the CRS itself.

3. Third Party Verification

The risk of noncompliance can also be mitigated, at least partially, if "managed" investment entities are required to be audited by an accountant or another third party who reviews the accuracy of the reporting made by the "managed" investment entities.[107] However, requiring a third-party audit would increase the overall compliance costs.

II. Considerations When Choosing Who to Regulate

Building on the analysis of FATCA's and CRS's choice of who to regulate, this Part explores a general regulatory design question: how to choose which group of agents should be required to satisfy a regulatory obligation where that obligation can be imposed on one of two or more alternative groups of agents. Choices of who to regulate arise in various regulatory regimes, such as financial, tax, environmental, and product safety regulation.

The following are a few examples of regulatory obligations that can be imposed on alternative groups of agents. In the context of *tax regulation*, the requirement to report a transaction and pay or withhold

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107. The FIs that maintain the financial assets of the private investment entities may not be able to reliably verify the reporting of the private investment entities that are classified as FIs, unless they are provided with access to the AEOI returns filed by such entities, and can verify such returns' authenticity and accuracy.

the applicable tax can be imposed on the buyers or the sellers. In the context of *environmental regulation*, the regulation implementing carbon emission standards can be imposed on car manufacturers and importers, or car owners, or both. In the context of *product safety regulation*, regulatory obligations can be imposed on manufacturers, importers, wholesalers, retailers, or consumers. In the context of *financial regulation* of initial public offerings, there is a need to define the responsibilities and the obligations imposed on the to-be-listed company, the underwriter, the external legal and financial advisers, the auditor, and different functions and officials within the company, such as the board members and senior management officers. Some regulatory obligations can only be applied to one group of agents, while other regulatory requirements could be imposed on one of two or more alternative groups of agents. In some cases, it is possible to impose similar obligations on the different groups (for example, parallel reporting of employment income to the tax authority by the employer and employee).

Assume that the government has decided to achieve a certain outcome through imposing a regulatory obligation.[108] When choosing who to regulate, as a first step, designers of the regulations should identify the relevant agents and determine whether the obligation can be imposed on one of two or more alternative groups of agents. After identifying the relevant alternative groups, the designers should analyze what would be the optimal choice. In general, choosing who to regulate requires a cost-effectiveness comparison of imposing the regulatory obligations on either one of the alternative groups.

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108. There is extensive law and economics literature on the conditions where regulation is superior or inferior to liability and corrective taxation. *See, e.g.*, Richard A. Posner, *Regulation (Agencies) Versus Litigation (Courts): An Analytical Framework*, *in* Regulation Versus Litigation: Perspectives from Economics and Law 11 (Daniel P. Kessler ed., 2011); Steven Shavell, *A Fundamental Enforcement Cost Advantage of the Negligence Rule over Regulation*, 42 J. Legal Stud. 275 (2013); Steven Shavell, *Liability for Harm Versus Regulation of Safety*, 13 J. Legal Stud. 357 (1984); Steven Shavell, *A Model of the Optimal Use of Liability and Safety Regulation*, 15 RAND J. Econ. 271 (1984); Andrei Shleifer, *Efficient Regulation*, *in* Regulation Versus Litigation, *supra*, at 27. This discussion is outside the scope of this Article because it is assumed that regulation is the preferred approach.

The question of how to use cost-benefit analysis to evaluate regulatory policies has been discussed extensively in the literature.[109] According to Sunstein, a cost-benefit analysis involves "an effort (1) to quantify the anticipated consequences of regulatory action and (2) to monetize those consequences in terms of benefits and costs, subject to (3) a feasibility constraint, meant to acknowledge that some consequences may be hard or impossible either to quantify or monetize."[110] The term "cost-effectiveness analysis" is sometimes distinguished from the general concept of cost-benefit analysis. Generally, cost-effectiveness analysis involves comparing a set of regulatory actions with the same desired outcome.[111] The choice of who to regulate should be made as

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109. For the recent discussions and debates on how cost-benefit analyses should be used to shape regulation, see ADLER & POSNER, *supra* note 17; John Bronsteen et al., *Well-Being Analysis vs. Cost-Benefit Analysis*, 62 DUKE L.J. 1603 (2013); John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882 (2015); Eric A. Posner & E. Glen Weyl, *Benefit-Cost Analysis for Financial Regulation*, 103 AM. ECON. REV. (ESSAYS & PROC.) 393 (2013); Jonathan S. Masur & Eric. A. Posner, *Unquantified Benefits and the Problem of Regulation Under Uncertainty*, 102 CORNELL L. REV. 87 (2016); Richard Revesz, *Cost-Benefit Analysis and the Structure of the Administrative State: The Case of Financial Services Regulation*, 34 YALE J. ON REG. 545 (2017); Cass R. Sunstein, *Cost-Benefit Analysis, Who's Your Daddy?*, 7 J. BENEFIT-COST ANALYSIS 107 (2016); Cass R. Sunstein, *The Real World of Cost-Benefit Analysis: Thirty-Six Questions (and Almost as Many Answers)*, 114 COLUM. L. REV. 167 (2014). Cost-benefit analysis has been adopted by the U.S. government as a method to assess regulation, see Exec. Order No. 13,563, 76 Fed. Reg. 3821, 3821 (Jan. 18, 2011) ("Our regulatory system . . . must take into account benefits and costs, both quantitative and qualitative . . . It must measure, and seek to improve, the actual results of regulatory requirements.").

110. Cass R. Sunstein, *Financial Regulation and Cost-Benefit Analysis*, 124 YALE L.J. F. 263, 264 (2015).

111. For a detailed discussion, see Office of Mgmt. & Budget, Circular A-4, 11 (Sept. 17, 2003) [hereinafter OMB Circular A-4] ("Cost-effectiveness analysis can provide a rigorous way to identify options that achieve the most effective use of the resources available without requiring monetization of all of relevant benefits or costs. Generally, cost-effectiveness analysis is designed to compare a set of regulatory actions with the same primary outcome (e.g., an increase in the acres of wetlands protected) or multiple outcomes that can be integrated into a single numerical index (e.g., units of health improvement).").

part of the analysis of the alternative regulatory approaches.[112] The following discussion identifies general factors that should be considered when choosing who to regulate, although the relevant factors and considerations may vary across different regulatory contexts.

Cost of compliance: For each of the groups, what would be the overall compliance costs incurred by agents? There are a few possible reasons why different agents would incur higher or lower compliance costs. First, the economy of scale may make the overall cost lower if compliance is imposed on fewer agents that handle more matters under the same regulation. Second, a synergy between regulatory regimes may lower costs if a group of agents is already under other regulatory obligations that would make compliance with the new regulation less costly.[113] Third, if agents of one group are typically larger and tend to have legal and compliance staff, the additional compliance cost of introducing a new regulatory obligation may be lower than the cost incurred by agents with no legal and compliance staff.[114]

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112. *See id.* at 7 ("Once you have determined that Federal regulatory action is appropriate, you will need to consider alternative regulatory approaches. Ordinarily, you will be able to eliminate some alternatives through a preliminary analysis, leaving a manageable number of alternatives to be evaluated according to the formal principles of the Executive Order. The number and choice of alternatives selected for detailed analysis is a matter of judgment. There must be some balance between thoroughness and the practical limits on your analytical capacity. With this qualification in mind, you should nevertheless explore modifications of some or all of a regulation's attributes or provisions to identify appropriate alternatives.").

113. For example, different financial and tax regulations may have synergies where they address similar matters or collect similar information.

114. *See* OMB Circular A-4, *supra* note 111, at 8 ("Different Requirements for Different Sized Firms: You should consider setting different requirements for large and small firms, basing the requirements on estimated differences in the expected costs of compliance or in the expected benefits. The balance of benefits and costs can shift depending on the size of the firms being regulated. Small firms may find it more costly to comply with regulation, especially if there are large fixed costs required for regulatory compliance. On the other hand, it is not efficient to place a heavier burden on one segment of a regulated industry solely because it can better afford the higher cost. This has the potential to load costs on the most productive firms, costs that are disproportionate to the damages they create.").

Effectiveness of compliance: How effectively would each group implement the regulation? In many cases, one group of agents is clearly more effective than other groups in achieving the regulatory goals.[115] Different agents may vary in their understanding of the regulation, their access to information, and their ability to satisfy the regulatory obligations. Some agents may have stronger incentives to comply, which could be the result of higher costs and penalties from a failure to comply.[116] Imposing complex regulatory obligations on larger and more sophisticated agents may result in more effective compliance as the whole group would likely meet a higher standard of implementation.[117] Regulators may require a similarly high standard from less sophisticated agents. Likewise, they may impose penalties for failing to meet the required standard, although changing the behavior of unsophisticated agents might be harder and would involve greater enforcement efforts. In addition, as discussed below, the effectiveness of enforcement depends on the ability of the regulator to detect and prevent noncompliance.

Distortions: What would be the behavioral distortions and deadweight loss resulting from imposing the proposed regulation on each of the groups? Different groups of agents may have different reactions to regulation. Some agents may be more likely to change their behavior as a result of the regulatory obligations being imposed on them. For example, certain agents may avoid engaging in a particular activity if they need to comply with regulatory obligations, whereas they would engage

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115. For example, the current regulation of driving imposes obligations on drivers to follow road rules because they are considered the most effective group of agents who can achieve the desired outcome of safe traffic. Certain related obligations could have been imposed on car manufacturers today (e.g., the speed of the car could be limited to avoid speeding). In the future, it is likely that the obligations to follow road rules and drive safely will be imposed on car manufacturers because self-driving cars can achieve the desired outcome more effectively than human drivers.

116. For example, these costs could be reputational costs or costs from losing a license to conduct a certain business (e.g., banking).

117. Similarly, people with special expertise are generally required to meet a higher standard of behavior under tort laws of many countries. In addition, entities and professionals that conduct certain businesses are frequently subject to a higher standard of care than laymen that act in similar capacities (e.g., professional trustees are typically subject to more regulation and a higher standard of care than non-professional trustees).

in this activity if someone else bore the responsibility of complying with these regulatory obligations. Different reactions and avoidance patterns can be explained by frictions that limit the ability of certain agents to change their behavior to avoid complying with certain regulatory requirements legally.[118]

Noncompliance and loopholes: What would be the likelihood of noncompliance, and what would be the required enforcement efforts to address noncompliance? What are the possible loopholes, and how can they be eliminated? The expected level of noncompliance and the ability to exploit loopholes may differ for the various groups of agents. First, some agents may face a higher cost if noncompliance is detected. Second, different agents may have different benefits from noncompliance.[119] Third, some agents may have better opportunities for noncompliance with low detection risk. The literature on tax evasion shows that third-party reporting significantly increases the likelihood of compliance and detection of noncompliance in comparison to self-reporting.[120] When noncompliance can only be achieved through the collusion of multiple people, the likelihood of detection is higher.[121] The decision of who to regulate may also impact governmental enforcement costs, which may be different depending on the likelihood of noncompliance, the cost of detecting noncompliance, and implementing enforcement measures.

After considering these factors, we should compare the aggregated societal benefits and costs (including costs of compliance, distortions, enforcement, and the harm of undetected noncompliance) of imposing a regulatory obligation on each of the alternative groups.

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118. *See* David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 Colum. L. Rev. 1312 (2001).

119. For example, the tax evader's benefit is the tax saved, whereas the accountant that prepares the tax return may receive a lower benefit from noncompliance.

120. For a discussion of the impact of third-party reporting on compliance, see Kleven et al., *Why Can Modern Governments Tax So Much?*, *supra* note 15, at 220.

121. Where more people are involved in noncompliance, there is a higher risk of information leakage (e.g., whistleblower) that would result in regulators detecting the scheme. *See id.*

III. Concluding Remarks

This Article shows how a wrong choice of who to regulate can substantially impact the costs and the effectiveness of a regulatory regime. FATCA's and CRS's decision to impose reporting obligations on private investment entities provides tax evaders with a simple yet effective way to avoid reporting of their offshore financial assets. While benefiting tax evaders, this policy harms compliant taxpayers as it imposes higher compliance costs and creates larger distortions and deadweight loss. This Article provides possible solutions that should be considered by the U.S. Treasury and the OECD.

Although choices of who to regulate have a substantial impact on the costs and the effectiveness of regulatory regimes, they have attracted little attention in the literature on regulatory design. Building on the analysis of FATCA and CRS, this Article identifies considerations that should be included in a general framework for choosing who to regulate. This framework could be further developed and applied to choices of who to regulate in other contexts.

It is important that the designers of regulatory regimes follow the approach proposed in this Article for identifying and analyzing choices of who to regulate as an integral part of the process of regulatory design. As evident from the experience with FATCA and CRS, changing this choice after the regulation has been enacted might be challenging.