FEATURED PERSPECTIVE

Coexistence Between FATCA and MCAA — Potential Conflicts

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Implementation of both the OECD's multilateral competent authority agreement and the U.S. Foreign Account Tax Compliance Act may lead to situations in which there are two different tax authorities that will be automatically receiving the same information on Swiss bank accounts held by U.S. persons. This double reporting may lead to double taxation.

Recently, the mayor of London, Boris Johnson, issued a call for a crusade against the U.S. Foreign Account Tax Compliance Act, which became effective as of July 1, 2014. In this context, the representative of a large expatriate advisory firm stated the following:

> I welcome the Mayor of London joining the growing army of voices on this issue. Boris Johnson's noble and brave stance against the fatally flawed, imperialistic and economically dangerous law, means he is legally in the wrong, yet morally he is right.[1]

On October 29, 2014, 51 countries signed the multilateral competent authority agreement (MCAA) proposed by the OECD to the Berlin G-20 summit. The United States did not sign the MCAA, because its tax system is based on citizenship instead of residence. Rather than having a single system, there will be two widely overlapping systems, both dealing with the automatic exchange of information. As the MCAA allows for an exemption regarding EU law, the EU Economic and Financial Affairs Council in October 2014 decided to launch EU-FATCA, that is, to opt for a significantly enlarged cooperation and mutual assistance directive and to give up the tax savings directive instead. Therefore, there will (in the near future) be three different but overlapping multilateral systems, all of them dealing with the issue of automatic exchange of information.

U.S. Taxation of Citizens

Today, the United States is the only major economy that imposes income taxes based on citizenship. With some exceptions, the United States taxes the worldwide income of its citizens regardless of whether the citizens live in the United States or abroad. For the United States to change to a residence-based system would be much more than just a simple change of its tax laws; it would be an entirely different tax system. The United States is unlikely to impose this radical change in the near future and will continue to tax based on citizenship.

There is little doubt that taxation based on citizenship is deeply rooted in the U.S. system. Its origins go back to the Civil War; Congress enacted the first U.S. income tax in 1861 shortly after the war broke out. At that time, nonresident citizens were only taxed on their U.S.-source income rather than on their worldwide income. These early statutes reflect an attempt to ensure that citizens living abroad paid their fair share of U.S. taxes under roughly defined equity principles. In 1864 Congress revised the tax laws to apply to income of ''every person in the United States or of any citizen of the United States residing abroad, regardless of where the income arose in the United States or elsewhere.''

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[1] *See* https://www.devere-group.com/news/London-Mayor-Boris-Johnson-right-American-taxes-FATCA.aspx.

This was the birth of the worldwide income principle, as it is applied in the United States.[2]

The U.S. system as it stands today was finalized in 1913. Because the United States taxed the worldwide income of its citizens and residents, the potential for double taxation existed (if a U.S. taxpayer earned income abroad and the foreign country imposes its own tax). In 1918 Congress enacted a credit for foreign taxes paid by U.S. taxpayers (citizens as well as U.S. corporations). The foreign tax credit system remains a fundamental part of the U.S. income tax law today, although in significantly altered form.[3]

To avoid double taxation of U.S. taxpayers abroad, the foreign tax credit is not enough and therefore the foreign-earned income exclusion plays an important role. To keep U.S. business abroad competitive, Congress provided a generous relief in the Revenue Act of 1926. A U.S. citizen was allowed to exclude all foreign-earned income received from sources outside the United States, provided that the taxpayer in question was a bona fide nonresident of the foreign country in which he lived. This system was finally abandoned in 1981, when Congress enacted a limited foreign-earned income exclusion. This limitation, which originally amounted to $75,000, has increased to $97,600 for 2013.

To claim the foreign-earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, the U.S. citizen living abroad must have foreign-earned income, his tax home must be in a foreign country, and he must be one of the following:

- a U.S. citizen who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year;
- a U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect and who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year; or
- a U.S. citizen or a U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.

As the term indicates, the foreign-earned income exclusion only applies to ''earned'' income, not to any passive income. If the U.S. citizen in question maintained a bank account abroad on which he would earn income, that income could not be reduced by virtue of the foreign-earned income exclusion.

Conflicting tax interests between the foreign country and the U.S. authorities are regulated by the savings clause. All U.S. tax treaties include a savings clause, which simply preserves or ''saves'' the right of each country to tax its own residents as if no tax treaty existed. For U.S.-source income, this clause means that both the United States and the foreign country of residence may impose their tax on a particular item of income.

If the U.S. citizen becomes a foreign resident, he may be subject to (juridical) double taxation. The United States will generally grant a tax credit for income taxes imposed by the country of residence. This tax credit will, however, be limited, as the U.S. tax system does not allow a foreign country's income taxes to reduce U.S. income taxes on U.S.-source income.[4]

The typical triangular situation remains unclear. These are the cases in which a U.S. person that is residing abroad receives income that is neither sourced in the United States nor in the country of residence in question, but instead stems from a third country. What happens to the third-country-sourced income if the country of residence will not exempt that income from its worldwide income taxation, even though the United States has asserted a primary right of taxation?

Potential for Conflicts

While for purposes of an income tax treaty it was possible to find a common denominator covering the divergent aspects of a territorial system based on residence and of a system based on citizenship, under FATCA any such ''compromise'' seems far less evident. This is particularly true in a triangular situation in which the taxable income stems from a third country.

In ''Automatic Exchange of Financial Account Information — Background Information Brief, Updated: 29 October 2014,'' the OECD outlines the difference existing between the MCAA and FATCA. Admittedly, the intergovernmental agreement Model 1 developed by the United States to alleviate foreign countries' approach to FATCA served as a template for the model used by the OECD. Looking at the differences that exist between the two systems, the OECD argues:

> The OECD standard consists of a fully reciprocal automatic exchange system from which the US specificities have been removed. For instance it is based on residence and unlike FATCA does not refer to citizenship.

From this short statement, it is clear that FATCA and the MCAA will never become one system, but will continue as two different and fundamentally incompatible exchange of information systems. While in a treaty

[2]Michael S. Kirsch, ''Taxing Citizens in a Global Economy,'' *NYU Law Rev.*, Vol. 82 (2007), 443; originally Notre Dame Legal Studies Paper 06-33.

[3]*Id.* at 455.

[4]Richard L. Doernberg, *International Taxation in a Nutshell*, 9th ed. (West Publishing, 2012), p. 214.

context it looks as if the MCAA will be replacing article 26 of the OECD model treaty, it is likely that the United States may go in a different direction. Regarding the savings clause, the United States may find an easy solution for FATCA. Despite residence country laws or regulations, U.S. citizens will remain subject to FATCA (and either IGA Model 1 or IGA Model 2 will apply). As far as the exchange of information of nonresident aliens is concerned, it may be that the United States may provide for some reciprocity and thus consider the MCAA (or at least parts of it).

Will there be a friendly coexistence between the MCAA and FATCA, or is there the potential for conflicts or even double taxation? For individuals, mismatches may occur because the United States applies an extensively designed system, which is based on their citizenship taxation. From a U.S. point of view, U.S. citizens and green card holders enjoy special privileges and are therefore obliged to pay U.S. taxes, even though they are not residing in the United States.

The coexistence of the MCAA and FATCA may lead to double reporting regarding the same property owned by U.S. citizens residing outside the United States. Double reporting means that two different tax authorities receive the same or similar information about the same property item, such as, for example, a Swiss bank account.

Consider a triangular situation in which there is a U.S. citizen, who is a bona fide resident of, for example, Belgium, and who maintains a Swiss bank account on which he realizes income (for example, by holding bonds that were issued by a German resident debtor). Further assume that both FATCA and the MCAA are in full force and effect.

According to FATCA (and the IGA Model 2), Switzerland (that is, the Swiss-based foreign financial institution) will be reporting directly to the IRS and under the MCAA, it will also convey the same (or similar) information to Belgium. Assuming that the U.S. citizen in question has consented so that his name and other identifying details of his Swiss bank account can be transmitted to the IRS, under both systems there will be an automatic exchange of information.

Any income received in the third-country-based bank account is undoubtedly passive income, which is, therefore, outside the scope of the foreign-earned income exclusion.

Because both countries tax individuals on a worldwide income basis, there is the potential for (juridical) double taxation regarding the income derived on the Swiss bank account. Under regular circumstances, the income earned on the Swiss account would be third-country income subject to article 21 of the OECD model treaty (that is, to the corresponding provision contained in an income tax treaty).

However, the Belgium-U.S. treaty (as well as all other U.S. treaties) contains a savings clause, which allows the United States to tax the Swiss-source income, even though the U.S. person is a Belgian resident and according to the OECD model tax convention, the Swiss-source income would be subject to Belgian income tax only.

Keeping in mind the triangular situation, in which the income generated on the Swiss bank account neither stems from U.S. nor Belgian sources, it will be appropriate to qualify this passive income as ''other income'' under article 20 of the Belgium-U.S. treaty (which is based on article 21 of the OECD model tax convention). To the extent that Belgium retains the right to also impose tax on such income and to the extent that the United States does not grant a full tax credit for the Belgian tax paid on that income, there will inevitably be double taxation.

Resolving the Conflict

How can this conflict be resolved?

The first question will be determining which is the proper treaty to apply. This question may be resolved by assuming that the U.S. citizen residing in Belgium is not a Swiss resident and therefore Swiss treaties are not applicable. The conflicting issue arises between the United States and Belgium, and hence only the Belgium-U.S. treaty will apply.

The elimination of double taxation is addressed in article 23 A (exemption method) and article 23 B (credit method) of the OECD model tax convention. Triangular situations are dealt with in the context of permanent establishments situated in a third country. Assuming that a simple bank account is not a PE, the OECD model treaty offers no guidance on this specific issue.

Article 23(3)(a) of the 1970 Belgium-U.S. treaty stated:

> (c) Where a resident of Belgium receives income to which the provisions of Article 22 (Income Not Expressly Mentioned) apply and which has been taxed by the United States, the amount of Belgian tax proportionately attributable to such income shall not exceed the amount which would be imposed in accordance with Belgian law, if such income were taxed as earned income derived from sources outside Belgium and subject to foreign tax.

Comparing that with the present 2007 treaty, one notices that the applicable language has been modified.

Article 22(4) of the 2007 Belgium-U.S. treaty states:

> Where a resident of Belgium is also a citizen of the United States . . . the following shall apply:
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>> a) taxation by the United States of the income of such persons shall not affect the taxation in Belgium of income from sources arising in third countries, as determined under the laws of Belgium, and received by a resident of Belgium.

Comparing the 1970 treaty with the 2007 Belgium-U.S. treaty, the situation of the U.S. citizen who is a resident of Belgium who receives third-country-source income has further deteriorated. Under the 1970 treaty, his overall tax burden was limited to the higher amount of Belgian tax on the income. The 2007 treaty does not impose any limitation; thus, both countries are free to levy their tax regardless of what the other country is doing. The triangular situation involving, for example, a Swiss bank account is apparently outside the scope of the 2007 Belgium-U.S. treaty. By adding the U.S. tax rate of 35 percent to the Belgian tax rate of 50 percent, there could be an overall tax burden in excess of 80 percent.

Would it make any difference if the U.S. citizen was residing in Switzerland rather than in Belgium? Yes, because there would not be any double reporting. Moreover, the income will not be sourced in a third country but in the ''other'' treaty country. Although Switzerland would have the right to tax such Swiss-source income, the United States would grant a (limited) tax credit for the Swiss taxes paid on the Swiss-source income. If, however, the U.S. citizen was a Swiss resident deriving passive income that arises in a third country, he may not be better off.

In a case involving third-country-sourced passive income, both Switzerland and the United States asserted a primary right to tax.[5] The U.S. citizen in question appealed this case, arguing that Switzerland should exempt this third-country-source income from Swiss taxation. The verdict on this appeal is still pending.

Is there an easy solution to the double reporting problem? Since the MCAA is not yet in effect, Swiss banks may be using the short time left before the MCAA becomes law to carefully consider the issue of triangular situations (involving U.S. citizens living outside the United States or Switzerland) and the related double reporting questions.

Otherwise, there will only be one effective solution: If you are a U.S. citizen residing outside the United States (or Switzerland) and in a country regarding which Switzerland will be applying the MCAA (it appears that the list of countries with which Switzerland will exchange information under the MCAA requires parliamentary approval), it would be advisable to close your Swiss bank account and transfer the funds to either a bank situated in your country of residence or to a bank located in the United States. ◆

[5]The case concerns a client of the author, and it has not as yet been published.