ARTICLE

Closing the "Shell Bank" Loophole

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The U.S. Senate Committee on Finance has recently published a report on its investigation into the "shell bank" loophole. The report reveals that this loophole was used in the largest individual tax evasion case in U.S. history. This loophole undermines tax enforcement globally because it can be exploited by U.S. and foreign tax evaders. This Article is the first to assess the Finance Committee's findings and policy recommendations.

This Article makes three contributions. First, it argues that the Finance Committee has overlooked the root cause of the "shell bank" loophole. Contrary to the Finance Committee's view that this is a problem of weak enforcement due to inadequate resources, this loophole results from a flawed design of the legal rules in the U.S. Treasury regulations and a problematic interpretation of the relevant intergovernmental agreements.

Second, the Article evaluates the Finance Committee's recommendations for addressing this loophole. It shows that they are neither effective nor feasible. Instead, it proposes to close the loophole by amending the relevant regulations and changing the interpretation of the intergovernmental agreements. Unlike the Finance Committee's recommendations, this solution does not require Congressional action or additional resources.

Third, the Article considers the international challenges created by this loophole. It argues that a similar solution should be applied to the international Common Reporting Standard to eliminate this loophole globally.

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I. INTRODUCTION

In October 2020, the U.S. Department of Justice brought 39 charges against tech executive Robert Brockman in the largest individual tax evasion case in U.S. history.[1] Brockman allegedly evaded hundreds of millions of dollars in tax by concealing $2.7 billion in income.[2] In August 2022, after a year-long investigation, the U.S. Senate Committee on Finance (Finance Committee) released a report on this case.[3]

The fact that tax evasion on such a scale could go undetected until 2020 is a failure of the U.S. tax enforcement apparatus. The U.S. government implements measures that should have detected this tax evasion much earlier. Congress enacted the Foreign Account Tax Compliance Act (FATCA) in 2010 to crack down on U.S. tax evaders' use of overseas financial accounts.[4] The rest of the world followed suit, and a global system of automatic exchange of tax information under the Common Reporting Standard (CRS) was established.[5] According to the OECD, these reforms have facilitated "the largest exchange of tax information in history."[6] Then-Senator Max Baucus, who originally introduced the FATCA legislation, stated that "[t]he days of sending your money offshore to avoid paying US taxes are over."[7] But the extensive reporting under FATCA did not expose Brockman's Swiss bank accounts—co-conspirators and a whistleblower provided information that led to Brockman's indictment.[8] Why did FATCA fail to detect the largest individual tax evasion case in U.S. history?

Every enforcement regime is only as strong as its weakest provision. Under FATCA, foreign financial institutions (FIs) are required to identify U.S. taxpayers among their account holders and report them to the IRS.[9] However, there is a key carve out: FIs are not required to investigate and report accounts held by other FIs.[10] This is because those other FIs are required to report their own account holders. Moreover, it is easy to

1. Press Release, U.S. Dep't of Justice, CEO of Multibillion-dollar Software Company Indicted for Decades-long Tax Evasion and Wire Fraud Schemes (Oct. 15, 2020); S. COMM. ON FINANCE, THE SHELL BANK LOOPHOLE (2022) [hereinafter Report].

2. *See* Report, *supra* note 1, at 3.

3. *See* Report, *supra* note 1.

4. *See* discussion in *infra* Part I.A. The implementation of FATCA started in July 2014.

5. *See* ORG. FOR ECON. COOP. AND DEV. (OECD), STANDARD FOR AUTOMATIC EXCHANGE OF FINANCIAL ACCOUNT INFORMATION IN TAX MATTERS 45 (2nd ed. 2017) [hereinafter CRS].

6. OECD, *Implementation of Tax Transparency Initiative Delivering Concrete and Impressive Results* (June 7, 2019), https://www.oecd.org/tax/exchange-of-tax-information/implementation-of-tax-transparency-initiative-delivering-concrete-and-impressive-results.htm.

7. 155 CONG. REC. S10785 (daily ed. Oct. 27, 2009) (statement of Sen. Max Baucus).

8. *See* Report, *supra* note 1, at 3–4.

9. *See infra* Part I.A. FATCA uses the term Foreign (i.e., non-U.S.) Financial Institution or FFI. CRS uses the term Financial Institution or FI. This Article refers to FFIs as FIs.

10. *See infra* Part I.B.

establish private companies and trusts that would be classified as FIs under the FATCA rules.[11] As a result, tax evaders can hold offshore financial assets through so-called "shell banks"—private, closely held FIs that they own and control. By doing so, they escape the scrutiny of banks and avoid having their information reported to the IRS. While this loophole was already identified and discussed in the tax policy literature in 2018,[12] it has attracted policymakers' attention only recently following the Brockman case.[13]

The Finance Committee's investigation found that Brockman had used "shell banks" to prevent Swiss banks from reporting his financial assets to the IRS.[14] Brockman did that by establishing companies in Bermuda and Nevis and registering them as FIs with the IRS.[15] Upon registering the companies as FIs, they were assigned Global Intermediary Identification Numbers (GIINs), which the IRS automatically issues to registered FIs.[16] The companies then certified that they were FIs to the Swiss banks that maintained their financial accounts. As a result of the companies' FI status, the Swiss banks were not required to report Brockman or his companies. The "shell banks" themselves were required under FATCA to report Brockman. However, as Brockman owned and controlled these companies, such reporting never occurred.[17]

The Finance Committee's report stresses that this loophole may facilitate substantial tax evasion: "There are hundreds of thousands of entities in FATCA partner jurisdictions with IRS-approved GIIN numbers, creating widespread risks for tax evasion and money laundering of the sort allegedly done by Brockman."[18] For example, the report states that there are over 84,000 registered FIs with GIINs in the Cayman Islands alone.[19]

11. *Cf.* Bruce Zagaris, *U.S. Senate Finance Committee Highlights Circumvention of FATCA Reporting Schemes,* 38 INT'L ENF'T L. REP. 348, 350 (2022).

12. *See* Noam Noked, *FATCA, CRS, and the Wrong Choice of Who to Regulate*, 22 FLA. TAX REV. 77 (2018).

13. This Article follows the Finance Committee's use of the term "loophole." Notably, the term "loophole" is frequently used to describe conduct that is legal albeit contrary to the spirit of the law. *See, e.g.*, Leo Katz, *A Theory of Loopholes*, 39 J. L. STUD. 1 (2010). However, the "shell bank" loophole involves a violation of the law—"shell banks" fail to comply with their obligations to report their owners. This "loophole" is described in Noked, *supra* note 12, as a non-compliance opportunity rather than a loophole.

14. *See* Report, *supra* note 1, at 4–5; Noam Noked, *Tax Evasion and Incomplete Tax Transparency*, 7 LAWS 31 (2018). The "shell banks" identified in the Report are not to be confused with the separate concept of shell banks that is derived from the Patriot Act. *See* USA PATRIOT Act, Pub. L. No. 107-56, § 313 (2001); Benjamin Mojuye, *What Banks Need to Know About the Patriot Act*, 124 BANKING L.J. 258 (2007).

15. *See* Report, *supra* note 1, at 5.

16. *See id.* at 4–6.

17. *See id.* at 5 ("This lack of bank reporting heightens the risk that wealthy taxpayers can exploit this loophole to underreport or fail to report offshore income.").

18. *Id.* at 17.

19. *See id.*

Senator Ron Wyden, the Finance Committee Chairman, said, "[i]t doesn't take a rocket scientist to see how this loophole leads to billions in tax evasion[.]"[20] The Finance Committee points to weak enforcement due to insufficient resources for the IRS as the main reason for this loophole.[21]

This Article argues that the Finance Committee has overlooked the root cause of this loophole. As discussed in Part I, this loophole is available because the FATCA rules classify too many entities as FIs. Such entities could be private, unregulated, and closely held tax haven companies—exactly the types of entities that tax evaders would typically use to hide offshore assets.[22] In particular, an entity is generally classified as an FI if it is managed by another FI and most of its gross income is from investing in financial assets.[23] For example, a Cayman Islands company with an investment portfolio managed by a Swiss bank would be classified as an FI under this definition. This entity, as an FI, is supposed to report its U.S. owners, whereas the bank that maintains its financial assets does not need to report anything.[24] However, as noted, such reporting is unlikely to occur if a tax evader owns and manages the company.

This overly broad FI definition is a design choice made by the drafters of the FATCA regulations concerning who should report the owners of private entities that hold financial assets.[25] Such reporting obligations could be imposed on (i) the banks and other FIs that maintain the private entities' financial assets, or (ii) the private entities themselves. The Treasury Department decided to impose reporting obligations on many private entities by classifying them as FIs.[26] This design choice is deeply flawed because it creates the "shell bank" loophole by allowing tax evaders to avoid third-party reporting by banks and other FIs.[27]

How can the "shell bank" loophole be closed? We propose imposing reporting obligations on banks and other FIs that maintain private entities' financial assets.[28] This would replace self-reporting with third-party

20. Press Release, U.S. Senate Comm. on Fin., Wyden Investigation Uncovers Major Loophole In Offshore Account Reporting (Aug. 24, 2022), https://www.finance.senate.gov/chairmans-news/wyden-investigation-uncovers-major-loophole-in-offshore-account-reporting.

21. This finding is highlighted in the Report's cover page: "The Shell Bank Loophole: Billionaire tax evasion scheme exposes how weak enforcement of the Foreign Account Tax Compliance Act enables wealthy tax cheats to hide income offshore." The Report, *supra* note 1, at 3, notes that while FATCA "was intended to crack down on tax evasion by U.S. persons holding accounts and other financial assets offshore, loopholes and limited Internal Revenue Service (IRS) enforcement resources have significantly hindered the law's effectiveness." See *infra* Part II.B.1 for further discussion.

22. *See infra* Part I.B.

23. Treas. Reg. § 1.1471-5(e)(4)(i)(B) (as amended in 2015). See the discussion in *infra* Part I regarding the "managed by" test, which also includes the management of some of the entity's assets.

24. *See infra* Part I.

25. *See* Noked, *supra* note 12, at 93–94.

26. *See id.* at 101.

27. *See id.*

28. *See* discussion *infra* Part III.A.

reporting. We propose two approaches for the Treasury Department to consider: a broad approach and a targeted approach. The broad approach would exclude "shell banks" from the FI definition in all jurisdictions. The targeted approach would focus on addressing this issue in tax havens that are most likely to host "shell banks." It is possible to first implement the targeted approach before proceeding to a wider implementation under the broad approach.

The *broad approach* requires three actions by the U.S. Treasury. First, the U.S. Treasury should publish guidance on the appropriate interpretation of the FI definition in the intergovernmental agreements (IGAs) that facilitate the implementation of FATCA in different countries.[29] As further discussed in Part III, our view is that an amendment of the IGAs is not required. The FI definition in the IGAs can be interpreted as excluding "shell banks," as evident from the interpretations adopted by several countries (Canada, the Netherlands, and Luxembourg). In addition, excluding "shell banks" could be supported by the anti-avoidance requirement to prevent practices intended to circumvent reporting, which is a stated obligation in many IGAs and an implied term in others.[30]

Second, after publishing guidance excluding "shell banks" from the FI definition under the IGAs, the U.S. Treasury can sign a one-page memorandum of understanding (MOU) with its IGA partners. The U.S. Treasury and IGA partners have signed around 40 MOUs which clarify how a particular obligation or definition is understood by the parties.[31] A similar approach could be applied here.

Third, the Treasury Secretary should consider amending the FATCA regulations to exclude unregulated, non-commercial, and closely held entities from the FI definition.[32] This would align the FATCA regulations with their preamble, which states the Treasury's intention to exclude passive, non-commercial investment vehicles.[33] By narrowing the FI definition, private companies like those used by Brockman would no longer be allowed to register as FIs. Banks and other FIs that maintain the financial assets of private entities would be required to identify and report the owners of such entities. The updated FI definition could follow precedents in Canada, the Netherlands, and Luxembourg for excluding unregulated entities (in

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29. For the list of IGAs by jurisdictions and links to these agreements, see *Foreign Account Tax Compliance Act*, U.S. DEP'T OF TREAS., https://home.treasury.gov/policy-issues/tax-policy/foreign-account-tax-compliance-act (last visited Apr. 28, 2023).

30. *See infra* Part III.A.

31. *See* the MOUs linked in *supra* note 29.

32. *See id.*; Noked, *supra* note 12, at 111–12. Alternatively, the Treasury Department may determine that the publication of guidance is sufficient and that it is unnecessary to amend the regulations.

33. *See* text accompanying *infra* notes 126–28.

Canada's case), non-commercial, closely held companies (in the Netherlands' case), or entities that do not meet the FI definition under the international anti-money laundering guidelines (in Luxembourg's case).[34]

Alternatively, the *targeted approach* we propose would focus on several jurisdictions that are most likely to host "shell banks." These jurisdictions include tax havens with low or no income tax, such as the Cayman Islands, the British Virgin Islands, and Bermuda.[35] Under the targeted approach, the U.S. Treasury would not be required to sign an MOU with every IGA partner, only with the jurisdictions that pose a high risk of hosting "shell banks." Also, there would be no need to amend the FATCA regulations.[36]

The Finance Committee proposes different solutions to this loophole.[37] The Finance Committee's recommendations focus on increasing resources for the IRS to expand enforcement efforts.[38] With more resources, the IRS could enhance the scrutiny of applications for FI registration, increase enforcement efforts generally, strengthen the whistleblower program, and conduct more audits of foreign partnerships.[39] The Finance Committee also recommends imposing additional due diligence obligations on FIs that make payments to entities suspected to be "shell banks."[40] Other recommendations include enhancing the reporting of domestic accounts and aligning FATCA with CRS.[41] As discussed in Part III, none of the Finance Committee's recommendations address the root cause of the loophole.[42] As private entities could still be classified as FIs, the measures suggested by the Finance Committee are unlikely to close this loophole effectively. Furthermore, the recommendations call for congressional action, which is far from guaranteed. Thus, it is unclear whether the Finance Committee's proposals would close this loophole or if they could even be adopted in the first place.[43]

The solution proposed in this Article has several advantages over the Finance Committee's recommendations. First, the Treasury Department can implement this solution without congressional action. The relevant rule that classifies many private entities as FIs is in the FATCA regulations and

34. *See infra* Part III.A.3.

35. It would make little sense for a tax evader to set up a "shell bank" in a country where his investment income would be subject to high taxes.

36. As noted in Part III.A, if the FATCA regulations are not amended, the MOUs should state that FIs cannot rely on the "investment entity" definition in the FATCA regulations because this would frustrate the purposes of the IGA.

37. *See* Report, *supra* note 1, at 7–8.

38. *See id.* at 7.

39. *See id.* at 7–8.

40. *See id.* at 7.

41. *See id.* at 8.

42. *See infra* Part III.B.

43. *See id.*

IGAs (as currently interpreted), not the Internal Revenue Code.[44] The Treasury Secretary is authorized to change the FATCA regulations and exclude "shell banks" from the FI definition.[45] Signing MOUs with IGA partners and amending the IGAs (if needed) does not require Senate ratification.[46] Second, our proposed solution would eliminate this loophole effectively because it addresses the root cause of the problem by imposing reporting obligations on third parties—the banks and other FIs that maintain the financial accounts of private entities. As noted, the Finance Committee's recommended measures would be less effective because they retain the existing framework under which private entities should report their owners. Third, this solution would resolve this problem at a substantially lower cost than additional enforcement actions and compliance obligations. It does not require additional resources.[47] Finally, this solution would considerably reduce the number of FIs worldwide, making it easier for the IRS and foreign governments to ensure compliance among the remaining FIs.[48] Overall, adopting this Article's solution would free up enforcement resources that the IRS could use elsewhere. It is important to note that some of the Finance Committee's recommendations may be desirable on grounds unrelated to this loophole.

The "shell bank" loophole is a global problem. While the Finance Committee's report focuses only on the risks to the United States, other countries are likely harmed by the same loophole.[49] This is because CRS, the international automatic information exchange standard implemented by more than 110 jurisdictions, was modeled after the FATCA Model 1 IGA.[50] The same loophole can be used to avoid reporting under CRS.[51] To close this loophole under CRS, the OECD can either amend the FI definition or publish guidance on the appropriate interpretation of the FI definition such that "shell banks" are explicitly excluded.[52]

In an interesting development, the OECD recently published a new framework for the reporting of crypto assets, which addresses this loophole but only with respect to crypto assets.[53] This Article calls on the OECD to close the loophole for all types of financial assets. The best approach would

44. *See infra* Part III.A.

45. *See* text accompanying *infra* note 234.

46. *See* Allison Christians, *The Dubious Legal Pedigree of IGAs (and Why It Matters)*, 69 TAX NOTES INT'L 565, 565–66 (Feb. 11, 2013); Susan Morse, *Why FATCA Intergovernmental Agreements Bind the U.S. Government*, 70 TAX NOTES INT'L 245, 246 (Apr. 15, 2013).

47. *See infra* Part III.C.

48. *See id.*

49. *See infra* Part I.B.2.

50. *See* CRS, *supra* note 5, at 10.

51. *See infra* Part I.B.2.

52. *See infra* Part III.A.6.

53. *See infra* text accompanying note 248.

be for the U.S. Treasury and the OECD to cooperate on excluding "shell banks" from the FI definition under both FATCA and CRS. A coordinated solution to the "shell bank" loophole is more likely to gain broad international support and would reduce compliance costs for FIs.

This Article is organized as follows: Part I discusses how tax evaders can use the "shell bank" loophole to avoid reporting by exploiting weaknesses under the relevant rules of FATCA and CRS. Part II examines the Finance Committee's investigation into the Brockman case and its findings. Part III explores proposals for how to close the "shell bank" loophole and evaluates the Finance Committee's recommendations.

II. THE "SHELL BANK" LOOPHOLE

A. Brief Background of FATCA and CRS

Congress enacted FATCA to combat offshore tax evasion by U.S. taxpayers.[54] The law sought to make it difficult for U.S. taxpayers to conceal financial assets overseas by requiring that FIs report information on their U.S. clients to the IRS.[55] The FATCA legislation was passed as

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54. For further background on FATCA, see WILLIAM H. BYRNES, LEXISNEXIS® GUIDE TO FATCA AND CRS COMPLIANCE (Matthew Bender & Co., Inc. 2023); Niels Johannesen et al., *Taxing Hidden Wealth: The Consequences of US Enforcement Initiatives on Evasive Foreign Accounts*, 12 AM. ECON. J.: ECON. POL'Y 312 (2020); Thomas F. Commito, *An Overview of the Foreign Account Tax Compliance Act*, 71 J. FIN. SERV. PROS. 11 (2017); Yi-Hsin Wu, *Unwise Integration of the Foreign Account Tax Compliance Act into the Common Reporting Standard – Taking Taiwan as an Example*, 1 INT'L COMPAR., POL'Y & ETHICS L. REV. 565 (2017); Dean Smith, *The* Foreign Account Tax Compliance Act *(FATCA): An Introduction to the Potential Impact on Canadian Trusts and Estates*, 36 ESTS., TRS. & PENSIONS J. 1 (2016); Taylor Denson, *Goodbye, Uncle Sam? How the Foreign Account Tax Compliance Act is Causing a Drastic Increase in the Number of Americans Renouncing Their Citizenship*, 52 HOUS. L. REV. 967 (2015); Bruce W. Bean & Abbey L. Wright, *The U.S. Foreign Account Tax Compliance Act: American Legal Imperialism?*, 21 ILSA J. INT'L & COMPAR. L. 333 (2015); Adrian Sawyer, *The Implications of the Multilateral Convention and the Foreign Account Tax Compliance Act: An Australasian Perspective*, 44 AUSTL. TAX REV. 1 (2015); Sunita Ahlawat & Howard Telson, *The Foreign Account Tax Compliance Act's Unintended Consequences*, 2 BANKING & FIN. REV. 137 (2015); Sean Deneault, *Foreign Account Tax Compliance Act: A Step in the Wrong Direction*, 24 IND. INT'L & COMPAR. L. REV. 729 (2014); Adrian Sawyer, *Comparing the Swiss and United Kingdom Cooperation Agreements with Their Respective Agreements Under the Foreign Account Tax Compliance Act*, 12 ELEC. J. TAX RSCH. 285 (2014); Richard Eccleston & Felicity Gray, *Foreign Accounts Tax Compliance Act and American Leadership in the Campaign against International Tax Evasion: Revolution or False Dawn?*, 5 GLOB. POL'Y 321 (2014); Charles S. Bowen, Jr., *There are Many Ways to Catch FATCAts: What Impact Will the Foreign Account Tax Compliance Act (FATCA) Have on Caribbean Nations' Privacy Law and Costs Associated with Non-Compliance*, 1 INDON. J. INT'L & COMPAR. L. 968 (2014); Kenneth E. Werner, *Foreign Account Tax Compliance Act (FATCA) Issues for Fund Managers*, 4 GEO. MASON J. INT'L & COMPAR. L. 359 (2012); Alberto Gil Soriano, *Toward an Automatic but Asymmetric Exchange of Tax Information: The US Foreign Account Tax Compliance Act (FATCA) as Inflection Point*, 40 INTERTAX 540 (2012); Peter Nelson, *Conflicts of Interest: Resolving Legal Barriers to the Implementation of the Foreign Account Tax Compliance Act*, 32 VA. TAX REV. 387 (2012); Dean Marsan, *FATCA: The Global Financial System Must Now Implement a New U.S. Reporting and Withholding System for Foreign Account Tax Compliance, Which Will Create Significant New Exposures – Managing this Risk (Part III)*, 88 TAX MAG. 21 (2010).

55. *See* sources cited in *supra* note 54.

part of the Hiring Incentives to Restore Employment (HIRE) Act of 2010, and its implementation started in July 2014.[56] Under FATCA, FIs are required to carry out specific due diligence procedures to identify who among their account holders are U.S. persons.[57] The FIs must then report these U.S. account holders' personal information, account balances, and income to the IRS.[58] FIs are also required to register with the IRS and receive GIINs.[59] The IRS website provides a list of all the FIs registered by the IRS, their jurisdictions, and their GIINs.[60] As of June 2023, around 440,000 FIs have registered with the IRS.[61] FIs that fail to meet these requirements are subject to 30% withholding on certain payments made to them.[62]

Around the time FATCA's implementation started, many foreign governments entered into IGAs with the U.S. government to facilitate the implementation of FATCA by FIs in their territory.[63] By eliciting the cooperation of foreign governments, IGAs clarify the reporting process for FIs, ensure that their reporting is consistent with domestic law, and reduce the risk of withholding penalties.[64] FATCA IGAs come in two forms: Model 1 and Model 2.[65] These two models differ primarily in how information is transmitted from the FIs to the IRS. In a Model 1 IGA, FIs report the information to their home governments, which then send it to the IRS.[66] In a Model 2 IGA, FIs report the information directly to the IRS.[67] The

56. Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, §§ 501-35, 124 Stat. 71, 97-115 (2010); I.R.C. §§ 1471–74.

57. Treas. Reg. § 1.1471-4 (2013); Rev. Proc. 2017-16, 2017-3 I.R.B. 501.

58. *See* sources cited in *supra* note 57.

59. Treas. Reg. § 1.1471-1(b)(57) (2013). Alternatively, FIs can be "sponsored" by other entities that have registered with the IRS and obtained their own special "sponsor" GIINs. Treas. Reg. § 1.1471-4(d)(2)(ii)(C) (2013).

60. IRS, *FATCA Foreign Financial Institution (FFI) List Search and Download Tool*, https://apps.irs.gov/app/fatcaFfiList/flu.jsf (last visited Feb. 17, 2023).

61. *See id.* for the FFI List. The exact figure as of June 24, 2023 was 440,882 registered FIs.

62. I.R.C. §§ 1471(a), 1472(a); Treas. Reg. §§ 1.1471-2(a)(1), 1.1472-1(a), (b)(2013).

63. *See Foreign Account Tax Compliance Act*, U.S. DEP'T OF TREAS., https://home.treasury.gov/policy-issues/tax-policy/foreign-account-tax-compliance-act (last visited Jan. 19, 2023). For further discussion on IGAs, see Christians, *supra* note 46; Morse, *supra* note 46; Leopoldo Parada, *Intergovernmental Agreements and the Implementation of FATCA in Europe*, 7 WORLD TAX J. 1 (2015); John S. Wisiackas, *Foreign Account Tax Compliance Act: What it Could Mean for the Future of Financial Privacy and International Law*, 31 EMORY INT'L L. REV. 583 (2017).

64. *See* Noked, *supra* note 12, at 86.

65. *See* U.S. DEP'T OF TREAS., *supra* note 63.

66. The U.S. Treasury provides a general version of each type of IGA. For Model 1, see U.S. DEP'T OF TREAS., MODEL 1A IGA RECIPROCAL, PREEXISTING TIEA OR DTC (2014) [hereinafter MODEL 1 IGA].

67. For a general version of Model 2, see U.S. DEP'T OF TREAS., MODEL 2 IGA, PREEXISTING TIEA OR DTC (2014) [hereinafter MODEL 2 IGA].

majority of FATCA IGAs in use are Model 1.[68] The obligations for FIs under IGAs are largely similar to those under the FATCA regulations.[69]

After the United States adopted FATCA, other countries became interested in adopting a similar reporting regime.[70] The OECD led the development of CRS as a multilateral standard for automatic exchange of information.[71] CRS was introduced in 2014, and its implementation started in 2016.[72] The number of countries that implement CRS has been growing

68. *See* U.S. DEP'T OF TREAS., *supra* note 63.

69. *See* Noked, *supra* note 12, at 86.

70. *See* CRS, *supra* note 5, at 9–10.

71. *See id.* for more background on CRS; *see* Eschrat Rahimi-Laridjani & Erika Hauser, *The New Global FATCA: An Overview of the OECD's Common Reporting Standard in Relation to FATCA*, 42 INT'L TAX J. 31 (2016); Noked, *supra* note 12; Noam Noked, *Should the United States Adopt CRS?*, MICH. L. REV. ONLINE 118 (2019); Andres Knobel, *Penguins Hold Millions in Australian Banks: Revealing Trends from Australian and German Banking Statistics*, TAX JUST. NETWORK (Dec. 14, 2021), https://taxjustice.net/2021/12/14/penguins-hold-millions-in-australian-banks-revealing-trends-from-australian-and-german-banking-statistics/; Hannes Arnold & Sophie Herdina, *Implications of Common Reporting Standard for Liechtenstein Foundations and Trusts–Taking Stock*, 25 TRS. & TRS. 682 (2019); Andres Knobel, *Statistics on Automatic Exchange of Banking Information and the Right to Hold Authorities (and Banks) to Account*, TAX JUST. NETWORK (June 21, 2019), https://taxjustice.net/2019/06/21/statistics-on-automatic-exchange-of-banking-information-and-the-right-to-hold-authorities-and-banks-to-account/; Andres Knobel, *The Use of Banking Information to Tackle Corruption and Money Laundering: A Low-hanging Fruit the OECD Refuses to Harvest*, TAX JUST. NETWORK (Apr. 30, 2019), https://taxjustice.net/2019/04/30/the-use-of-banking-information-to-tackle-corruption-and-money-laundering-a-low-hanging-fruit-the-oecd-refuses-to-harvest/; Xavier Oberson, INTERNATIONAL EXCHANGE OF INFORMATION IN TAX MATTERS: TOWARDS GLOBAL TRANSPARENCY (2nd ed. 2018); David Russell AM QC, *Trusts and Foundations: Implications of Common Reporting Standard and Anti-money Laundering Legislation*, 24 TRS. & TRS. 493 (2018); ANDRES KNOBEL & FREDERIK HEITMÜLLER, CITIZENSHIP AND RESIDENCY BY INVESTMENT SCHEMES: POTENTIAL TO AVOID THE COMMON REPORTING STANDARD FOR AUTOMATIC EXCHANGE OF INFORMATION (Tax Justice Network eds., 2018); Daniel Ho, *Common Reporting Standard: An Unprecedented Time for Improving Tax Transparency in Hong Kong*, 44 INT'L TAX J. 63 (2018); Filippo Noseda, *EU National Challenges the Common Reporting Standard*, 24 TRS. & TRS. 985 (2018); ANDRES KNOBEL, REPORTING TAXATION: ANALYSING LOOPHOLES IN THE EU'S AUTOMATIC EXCHANGE OF INFORMATION AND HOW TO CLOSE THEM (The Greens/EFA Group eds., 2018); Andres Knobel, *It's Time for Countries to Start Publishing the Data They're Collecting Under OECD's Common Reporting Standard*, TAX JUST. NETWORK (July 11, 2018), https://taxjustice.net/2018/07/11/its-time-for-countries-to-start-publishing-the-data-theyre-collecting-under-oecds-common-reporting-standard/; Andres Knobel, *OECD Rules vs CRS Avoidance Strategies: Not Bad, but Short of Teeth and Too Dependent on Good Faith*, TAX JUST. NETWORK (Mar. 27, 2018), https://taxjustice.net/2018/03/27/oecd-rules-vs-crs-avoidance-strategies-not-bad-but-short-of-teeth-and-too-dependent-on-good-faith/; Filippo Noseda, *Common Reporting Standard and EU Beneficial Ownership Registers: Inadequate Protection of Privacy and Data Protection*, 23 TRS. & TRS. 404 (2017); Fred Law & Anthony Siouclis, *Automatic Exchange of Information and the Common Reporting Standard*, 20 TAX SPECIALIST 187 (2017); Andres Knobel, *Faking Residency: OECD's Common Reporting Standard Leaves the Door Wide Open for Fraud*, TAX JUST. NETWORK (May 23, 2017), https://taxjustice.net/2017/05/23/faking-residency-how/; David Russell & Toby Graham, *The EU Commission's Finding that Irish Tax Rulings in Relation to Apple Amounted to Illegal State Aid; Reflections on This and the Legislative Underpinning of Common Reporting Standard*, 22 TRS. & TRS. 1039 (2016); ANDRES KNOBEL & MARKUS MEINZER, "THE END OF BANK SECRECY?" BRIDGING THE GAP TO EFFECTIVE AUTOMATIC INFORMATION EXCHANGE: AN EVALUATION OF THE OECD'S COMMON REPORTING STANDARD (CRS) AND ITS ALTERNATIVES (Tax Justice Network eds., 2014); ANDRES KNOBEL & MARKUS MEINZER, AUTOMATIC EXCHANGE OF INFORMATION: OPPORTUNITY FOR DEVELOPING COUNTRIES TO TACKLE TAX EVASION AND CORRUPTION (Tax Just. Network, eds., 2014).

72. 49 jurisdictions started implementation in 2016 and conducted their first information

every year.[73] As of June 2023, 110 jurisdictions have already exchanged information under CRS, and 13 more have committed to do so by 2026.[74] The United States is the only large economy and financial center that does not implement CRS.[75] CRS is modeled after the FATCA Model 1 IGA,[76] with many CRS definitions and obligations similar to those under FATCA.[77] However, unlike CRS, FATCA is not fully reciprocal: U.S. FIs are not subject to similar obligations to identify and report foreign account holders.[78] Also, unlike FATCA's withholding tax on FIs that fail to meet the FATCA obligations, CRS does not have an enforcement mechanism against FIs in countries that do not implement CRS.[79]

B. FATCA, CRS, and the "Shell Bank" Loophole

While FATCA and CRS are powerful tools in the global fight against tax evasion, tax evaders may elude detection under both regimes.[80] The "shell bank" loophole, as evident from the Finance Committee's

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exchanges in 2017. 51 jurisdictions started implementation in 2017 and conducted their information exchanges in 2018. *See* OECD, *Automatic Exchange of Information (AEOI): Status of Commitments* (June 9, 2023), https://www.oecd.org/tax/transparency/AEOI-commitments.pdf.

73. *See id.*

74. *See id.*

75. *See* Noam Noked & Zachary Marcone, *International Response to the U.S. Tax Haven*, 48 YALE J. INT'L L. 177 (2023). For more on how non-participation enables tax evaders globally, see Niels Johannesen & Gabriel Zucman, *The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown*, 6 AM. ECON. J.: ECON. POL'Y 65 (2014); Carmela D'Avino, *Counteracting Offshore Tax Evasion: Evidence from the Foreign Account Tax Compliance Act,* 73 INT'L REV. L. & ECON. 1 (2023); Rachel E. Brinson, *Is the United States Becoming the "New Switzerland"?: Why the United States' Failure to Adopt the OECD's Common Reporting Standard is Helping it Become a Tax Haven*, 23 N.C. BANKING INST. 231 (2019); ANDRES KNOBEL, THE ROLE OF THE U.S. AS A TAX HAVEN, IMPLICATIONS FOR EUROPE (Catherine Olier et al. eds., 2016); Nick Shaxson, *Panama Papers Help the World Wake Up to Tax Haven USA*, TAX JUST. NETWORK (Apr. 7, 2016), https://taxjustice.net/2016/04/07/tax-haven-usa-the-world-is-waking-up/.

76. *See* CRS, *supra* note 5, at 9–10 ("The Common Reporting Standard, with a view to maximising efficiency and reducing cost for financial institutions, draws extensively on the intergovernmental approach to implementing FATCA.").

77. OECD, STANDARD FOR AUTOMATIC EXCHANGE OF FINANCIAL INFORMATION IN TAX MATTERS: IMPLEMENTATION HANDBOOK 22 (1st ed. 2015).

78. *See* Noked, *supra* note 12, at 98; Noked & Marcone, *supra* note 75, at 191; Peter A. Cotorceanu, *Hiding in Plain Sight: How Non-US Persons Can* Legally *Avoid Reporting Under Both FATCA and GATCA*, 21 TRS. & TRS. 1050, 1050–55 (2015).

79. *See* sources cited in *supra* note 78; Prepared Testimony of Ryan Gurule, Policy Director, FACT Coalition, before European Parliament Subcommittee on Tax Matters Regarding the Exchange of Information with Jurisdictions Appearing Prominently in the Pandora Papers (such as Crown Dependencies, British Overseas Territories and some US States) (Mar. 28, 2022).

80. *See* Noked, *supra* note 14; Lisa De Simone et al., *Transparency and Tax Evasion: Evidence from the Foreign Account Tax Compliance Act (FATCA)*, 58 J. ACCT. RSCH. 105 (2020); Elisa Casi et al., *Cross-Border Tax Evasion After the Common Reporting Standard: Game Over?*, 190 J. PUB. ECON. 1, 11 (2020); Mark Morris, *The 26 OECD Common Reporting Standard Loopholes*, ETUDES FISCALES INTERNATIONALES (May 6, 2017), https://www.etudes-fiscales-internationales.com/media/00/02/3141295366.pdf.

investigation, is a glaring example of a loophole that undermines the effectiveness of these reporting regimes.[81] The following sections explain how the relevant rules under FATCA and CRS create this loophole.

1. *"Shell Banks" Under FATCA*

It is common practice for individuals to hold financial assets indirectly through private entities.[82] This is often done for asset protection, privacy reasons, succession planning, as a response to specific regulations, or for legitimate business or tax purposes.[83] As seen in the Brockman case, tax evaders may also use entities to hold offshore financial assets.[84]

Who should report the owners of an entity that holds offshore financial assets? This depends on the classification of the entity. In general, FATCA classifies entities as either FIs or Non-Financial Entities (NFEs).[85] NFEs are classified as either active or passive. Active NFEs include several categories of entities, such as publicly-traded companies, active businesses that meet certain requirements, non-profit organizations, governmental bodies, and others.[86] Passive NFEs are all those NFEs that do not meet the criteria for an Active NFE.[87]

Where the entity is an Active NFE, there is no need to identify and report its owners.[88] The rationale for this is that Active NFEs pose a lower risk of being used by tax evaders to hide offshore financial assets.[89] However, where the entity is a Passive NFE, the FIs that maintain the accounts of that entity must identify and report any "controlling persons" who are U.S. persons.[90] Controlling persons are the natural persons who

81. *See* Report, *supra* note 1, at 3.

82. *See* Noked, *supra* note 12, at 87.

83. *See id.*

84. *See* Report, *supra* note 1, at 9–10.

85. FATCA uses the term Non-Financial Foreign Entity or NFFE. CRS uses the term Non-Financial Entity or NFE. This Article refers to NFFEs as NFEs. I.R.C. §§ 1471(d)(5) (defining FIs), 1472(d) (defining NFEs as "any foreign entity which is not a financial institution").

86. U.S. DEP'T OF TREAS., MODEL 1 IGA ANNEX I § VI(B)(4) (2014) [hereinafter MODEL 1 IGA ANNEX I]; Treas. Reg. § 1.1472-1(c)(1) (2013).

87. MODEL 1 IGA ANNEX I § VI(B)(3).

88. Treas. Reg. § 1.1471-4(d) (2013).

89. This rationale is problematic because an entity might falsely certify that it is an Active NFE. While some FIs might be able to determine that such a self-certification is incorrect and reject it, many FIs might not be able to know that the entity's self-reported Active NFE classification is false. Practitioners report that banks are vigilant in challenging Active NFE classifications and almost always require proof that a private entity is an Active NFE. The authors believe that private and closely held Active NFEs and Passive NFEs should be treated similarly. This issue is outside the scope of this Article.

90. This information is collected through a FATCA self-certification form. The appropriate forms are IRS Forms W-8, W-9, or any permissible substitute. The name, address, and tax identification number (TIN) for each controlling person who is a U.S. person must be provided in this form. Under the FATCA regulations (which apply in the absence of an applicable IGA), FIs must report the "substantial U.S. owners" of Passive NFEs, which are generally defined as any specified

exercise control over an entity.[91] In the case of a Passive NFE trust, the controlling persons are the trustee, the settlor, the protector, the beneficiaries, and any other natural person that has ultimate effective control over the trust.[92] In the case of a Passive NFE company, controlling persons typically include any natural person who owns, either directly or indirectly, more than 25% of that company.[93]

In contrast, where the entity is classified as an FI, the reporting requirements are imposed on the entity itself, not the FIs that maintain its financial assets. As noted, FATCA requires FIs to register with the IRS, obtain a GIIN, implement due diligence procedures, and report all accounts held by U.S. persons.[94] An FI does not need to identify and report the account holders of another FI. Therefore, the entity (if it is classified as an FI) would be required to report its own account holders. The account holders of an "investment entity" FI are its equity and debt interest holders.[95]

When an entity opens an account with a bank, how does the bank know if the entity is an FI, Active NFE, or Passive NFE? Banks and other FIs generally rely on self-certifications provided by their account holders. However, they must confirm the reasonableness of these self-certifications using information collected for other purposes, such as anti-money laundering (AML) know-your-customer (KYC) procedures.[96] Also, FIs cannot rely on a self-certification and other documentary evidence if they

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U.S. person that owns directly or indirectly more than 10% in the stock of a corporation classified as a Passive NFE. Treas. Reg. § 1.1473-1(b). All references to "controlling persons" in this Article also refer to substantial U.S. owners where the relevant FIs are in jurisdictions that do not have IGAs with the United States.

91. MODEL 1 IGA, *supra* note 66, art. 1 § 1(mm); MODEL 2 IGA, *supra* note 67, art. 1 § 1(ee).

92. *See* sources cited in *supra* note 91.

93. For the 25% threshold which is used in many jurisdictions, see for example Int'l Tax Auth., 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). However, countries may use lower thresholds.

94. *See supra* Part I.A.

95. *See* Treas. Reg. § 1.1471-5(b)(1)(iii) (2013). There is no 25% ownership threshold for the reporting of equity and debt interest holders of an "investment entity" FI. For example, a U.S. shareholder of an "investment entity" FI should be reported even if the shareholder owns 1% of the shares.

96. MODEL 1 IGA ANNEX I, *supra* note 86, § III(B); Noked, *supra* note 12, at 89. This requirement is referred to as the "reasonableness test." For information about AML/KYC procedures including the requirement for FIs to identify beneficial owners, see Financial Action Task Force, *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation: The FATF Recommendations* (Feb. 2023) (hereinafter *FATF Recommendations*). For a list of participating countries, see FINANCIAL ACTION TASK FORCE (FATF), https://www.fatf-gafi.org/ (last visited Aug. 8, 2023).

know or have reason to know that such certification or evidence is incorrect or unreliable.[97]

The "shell bank" loophole is available because companies that are private, non-commercial, and closely held can be classified as FIs. If such entities were classified as Passive NFEs, there would be *third-party* reporting of the entities' controlling persons by the banks and other FIs that maintain the entities' accounts.[98] In contrast, if such entities are classified as FIs, there would be, in essence, *self-reporting* because the controlling persons control the entities.[99] While third-party reporting is widely considered more reliable and accurate, self-reporting is vulnerable to abuse and tax evasion.[100]

This problem arises from the FI definition in the FATCA regulations and IGAs. This definition generally includes depository institutions, custodial institutions, specified insurance companies, and investment entities.[101] The "investment entity" category is most susceptible to abuse.[102] Under one of the sub-categories of the "investment entity" category in the FATCA regulations, an entity is classified as an FI if it meets the following two requirements:[103]

1. The entity is managed by another FI. This test is commonly referred to as the "managed by" test and is generally met if the entity's investment activities are managed by another FI.[104] This

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97. *See* MODEL 1 IGA ANNEX I, *supra* note 86, § VI(A).

98. *See* Noked, *supra* note 12, at 82, 104–05.

99. *See id.*

100. There is extensive literature on the advantages of third-party reporting over self-reporting. *See, e.g.*, Bibek Adhikari, James Alm & Timothy F. Harris, *Information Reporting and Tax Compliance*, 110 AEA PAPERS & PROC. 162 (2020); Paul Carrillo, Dina Pomeranz & Monica Singhal, *Dodging the Taxman: Firm Misreporting and Limits to Tax Enforcement*, 9 AM. ECON. J.: APPLIED ECON. 144, 144–145 (2017); Henrik Jacobsen Kleven, Claus Thustrup Kreiner & Emmanuel Saez, *Why Can Modern Governments Tax So Much? An Agency Model of Firms as Fiscal Intermediaries*, 83 ECONOMICA 219 (2016); Dina Pomeranz, *No Taxation Without Information: Deterrence and Self-Enforcement in the Value Added Tax*, 105 AM. ECON. REV. 2539 (2015); Mark D. Phillips, *Individual Income Tax Compliance and Information Reporting: What do the U.S. Data Show?*, 67 NAT'L TAX J. 531 (2014); James Alm, *Measuring, Explaining, and Controlling Tax Evasion: Lessons from Theory, Experiments, and Field Studies* (Tul. Econ. Working Paper No. 1213, 2012); Henrik Jacobsen Kleven et al., *Unwilling or Unable to Cheat? Evidence from a Tax Audit Experiment in Denmark*, 79 ECONOMETRICA 651 (2011); Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733, 1738–39 (2010); Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695 (2007); James Alm, John A. Deskins & Michael McKee, *Third-Party Income Reporting and Income Tax Compliance* (Andrew Young Sch. Pol'y Stud. Rsch. Paper Series, Working Paper No. 06-35, 2006); Danshera Cords, *Tax Protestors and Penalties: Ensuring Perceived Fairness and Mitigating Systemic Costs*, 2005 BYU L. REV. 1515, 1542–43 (2005).

101. MODEL 1 IGA, *supra* note 66, art. 1, § 1(g); MODEL 2 IGA, *supra* note 67, art. 1, § 1(g); Treas. Reg. § 1.1471-5(e).

102. *See* Noked, *supra* note 12, at 93–94.

103. Treas. Reg. § 1.1471-5(e)(4) (as amended in 2019).

104. *Id.* Under the FATCA regulations, the managing FI should be either a depository institution, a custodial institution, a specified insurance company, or an investment entity that primarily conducts as a business certain financial activities for or on behalf of its customers.

test can also be satisfied where the other FI manages some of the entity's financial assets. For example, the test is satisfied when an entity owns an investment portfolio managed by another FI.[105]

2. Fifty percent or more of the entity's gross income is attributable to investing, reinvesting, or trading in financial assets. This test is commonly referred to as the "gross income" test.[106]

This category of the FI definition captures a wide range of private entities that are not considered "financial institutions" under any other law.[107] This includes the types of entities tax evaders typically use to hide offshore assets: unregulated, non-commercial, and closely held companies organized in tax havens such as the Cayman Islands or the British Virgin Islands. They could also include family trusts.[108] Unlike these private companies and trusts, most FIs under other categories of the FI definition—such as banks and insurance companies—are subject to financial regulation, audits, and other legal and compliance requirements.[109] By exploiting this broad FI definition, tax evaders can easily establish and hold offshore assets without FATCA reporting.[110]

The FATCA regulations provide limited guidance on when an entity should be considered as "managed by" another entity. Under one example in the FATCA regulations, the "managed by" test is satisfied where a fund is managed by a fund manager and an investment advisor (both are FIs).[111] Under another example, a fund satisfies the "managed by" test where an investment manager (a U.S. entity that meets the "investment entity" definition) "is authorized to facilitate purchases and sales of financial assets held by Fund A in accordance with Fund A's investment strategy."[112] Other examples provide that a trust does not satisfy the "managed by" test where

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105. *See* Noked, *supra* note 12, at 93–94.

106. Treas. Reg. § 1.1471-5(e)(4)(iv)(A) (as amended in 2019). This Article refers to entities classified as FIs under this category as "managed" investment entities.

107. *See* Noked, *supra* note 12, at 95. The problem of classifying too many entities as FIs was noted by tax experts when FATCA was still in its early stages. *See* Peter A. Cotorceanu, *FATCA and Underlying Companies: Pin the Tail on the Elephant*, 142 TAX NOTES 957, 968 (2014) ("However, should those top-tier [underlying companies] really be classified as holding company FFIs, given that they are not the sorts of structures that category was aimed at and that classifying them as holding company FFIs will preclude otherwise available compliance paths if the top-tier [underlying companies] are also investment entities, which they often will be?").

108. For a detailed discussion on the application of FATCA to trusts, see Peter A. Cotorceanu, *FATCA and Offshore Trusts: The First Nibble*, 139 TAX NOTES 409 (2013); Peter A. Cotorceanu, *FATCA and Offshore Trusts: A Second Bite of the Elephant*, 72 TAX NOTES 1007, 1017–24 (2013).

109. *See generally* STEPHEN LUMPKIN, OECD, SUPERVISION OF FINANCIAL SERVICES IN THE OECD AREA (2002), https://www.oecd.org/finance/insurance/2089622.pdf.

110. *See* Report, *supra* note 1, at 4.

111. Treas. Reg. § 1.1471-5(e)(4)(v)(example 2) (as amended in 2019).

112. Treas. Reg. § 1.1471-5(e)(4)(v)(example 3) (as amended in 2019).

it is managed by an individual trustee,[113] but the test is satisfied where the trustee is an FI.[114]

These examples cover some situations but not others. These examples indicate that the following entities generally satisfy the "managed by" test: (i) funds with fund managers and investment managers that are FIs; (ii) trusts with FI trustees with the power to manage and administer the trusts' assets. However, these examples do not cover common situations where the relevant entity is a private, non-commercial, closely held company with a portfolio managed by an FI.

The "investment entity" definition in the IGAs is somewhat different from the one in the FATCA regulations. Under the IGA definition, an "investment entity" is any entity that conducts as a business (or is managed by an entity that conducts as a business) financial investment activities for or on behalf of a customer.[115] This definition omits the "gross income" test for "managed" investment entities, which may make it easier for such entities to qualify as FIs under the IGA definition. Also, the IGAs do not define or provide guidance on when an entity should be considered as "managed by" another entity. Notably, IGAs generally allow countries to use the definitions in the FATCA regulations instead of the definitions in the IGA provided that it would not frustrate the purposes of the IGAs.[116]

The IGAs state that the paragraph that includes the "investment entity" definition "shall be interpreted in a manner consistent with similar language set forth in the definition of "financial institution" in the Financial Action Task Force Recommendations."[117] There is no U.S. guidance on what interpretation would be consistent with the "investment entity" definition in the FATF Recommendations and whether this requirement applies to "managed" entities.

Even if a private entity does not meet the FI definition, it may falsely certify that it is an FI under the "investment entity" category, register as such with the IRS, and obtain a GIIN.[118] As noted in the Finance Committee's report, the IRS accepts entities' registration as FIs "without meaningful investigation or due diligence from IRS personnel."[119] If the IRS tried to investigate, the sheer number of FIs that correctly classify as FIs under this category would make it hard to identify false claims of FI status. Moreover,

113. Treas. Reg. § 1.1471-5(e)(4)(v)(example 5) (as amended in 2019).

114. Treas. Reg. § 1.1471-5(e)(4)(v)(example 6) (as amended in 2019).

115. *See* MODEL 1 IGA, *supra* note 66, art. 1, § 1(j); MODEL 2 IGA, *supra* note 67, art. 1, § 1(k).

116. MODEL 1 IGA, *supra* note 66, art. 4, § 7; MODEL 2 IGA, *supra* note 67, art. 3, § 6.

117. MODEL 1 IGA, *supra* note 66, art. 1, § 1(j); MODEL 2 IGA, *supra* note 67, art. 1, § 1(k). Notably, this reference to the FATF Recommendations does not appear in the FATCA Regulations.

118. *See* Noked, *supra* note 12, at 96–97.

119. Report, *supra* note 1, at 6.

if the IRS started examining such applications more closely, tax evaders could ensure that their private entities meet the FI definition.[120]

In addition, banks and other FIs that maintain the financial assets of an entity that certifies that it is an FI and provides a GIIN are unlikely to reject this classification. This is because they would typically have no reason to know that the entity's self-reported FI classification is false. Banks and other FIs only need to act if they know or have a reason to know that the entity's self-certification is incorrect or unreliable.[121] The Finance Committee's report noted that "[t]hese knowledge standards are vague and hard to prescribe."[122] Banks and other FIs are not required to conduct an independent investigation into the entity's self-reported FATCA classification if it appears to be reasonable.[123]

This broad FI definition is problematic for several reasons. In addition to creating the "shell bank" loophole, it harms compliant taxpayers.[124] Classifying private companies and family trusts as FIs increases the compliance costs for compliant taxpayers. It would be more cost-efficient to impose the reporting obligations on banks and other regulated FIs that maintain the financial accounts of such private entities. As these FIs already implement FATCA for their other clients, they benefit from economies of scale. Also, imposing the reporting obligations on banks and other regulated FIs would likely result in fewer distortions of the behavior of tax-compliant beneficial owners of private entities.[125]

It is possible that the Treasury Department never intended to allow the classification of passive, non-commercial investment vehicles as FIs. The preamble to the FATCA regulations states 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."[126] The preamble also notes that the FATCA regulations generally incorporated the IGAs' "investment entity" definition.[127] These statements in the preamble indicate that the Treasury Department intended to exclude private, non-commercial

120. For example, a private entity can open an account with portfolio investments under discretionary management of an FI. By doing so, it would meet the "managed by" test. If this entity only holds stocks or other financial assets, it would also meet the "gross income" test.

121. *See* MODEL 1 IGA ANNEX I, *supra* note 86, § VI(A).

122. Report, *supra* note 1, at 14.

123. *See* Noked, *supra* note 12, at 96–97.

124. *See id.* at 102–04.

125. *See id.* for a discussion of such potential distortions.

126. Treas. Reg. §§ 1.1471-1.1474 ¶ VI.E.3.

127. *See id.* ("Taking into consideration comments that the provisions of the final regulations should conform as closely as possible to the provisions of the IGAs, the final regulations generally incorporate the definition of investment entity contained in the IGAs[.]").

entities from the FI definition. Nonetheless, the "managed" investment entity definition (which applies to many passive, non-commercial entities) does not follow this stated intention. There is no evidence indicating that the drafters of the FATCA regulations considered the implications of classifying such "managed" investment entities as FIs.[128]

It is possible that the overly broad FI definition is a result of a mistaken expectation that classifying more entities as FIs would generate more reporting.[129] However, classifying private investment entities as either FIs or Passive NFEs should result in similar reporting in most cases.[130] As evident from the Brockman case, classifying private entities as FIs would likely result in less reporting because these entities are unlikely to report their owners if they are tax evaders.[131] Another possible explanation for the overly broad FI definition is that the Treasury Department paid little attention to private entities and failed to recognize the risks created by classifying such entities as FIs.[132]

2. *"Shell Banks" Under CRS*

CRS's adoption of FATCA's overly broad FI definition means that the "shell bank" loophole may also enable tax abuse globally. Like FATCA, CRS classifies any entity that meets the "managed by" test and the "gross income" test as an FI.[133] As a result of the similarity between the definitions under FATCA and CRS, a private entity classified as an "investment entity" FI under FATCA would usually also be classified as such under CRS, and vice versa.

Under the CRS guidance published by the OECD, the "managed by" and "gross income" tests are easy to satisfy. The "managed by" test is satisfied if its assets are managed "in whole or part" by an FI.[134] This means

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128. *See* Noked, *supra* note 12, at 107–08.

129. *See id.* at 107.

130. The reporting may be different if there are debt and equity interest holders that are not considered as "controlling persons." Such persons would be reported if the relevant entity is an FI but not reported if it is a Passive NFE. However, where the relevant entity is closely held like in the Brockman case, there should be little difference in the reporting. *See supra* note 95.

131. *See* Noked, *supra* note 12, at 107.

132. *See id.* at 107–08 (noting that "[t]he main focus of FATCA and CRS is the banking industry," not private investment entities).

133. CRS, *supra* note 5, at 44–45 ("[T]he gross income of which is primarily attributable to investing, reinvesting, or trading in Financial Assets, if the Entity is managed by another Entity that is a Depository Institution, a Custodial Institution, a Specified Insurance Company, or an Investment Entity . . . ."). Similar to the FATCA IGAs, CRS states that the paragraph that includes the "investment entity" definition "shall be interpreted in a manner consistent with similar language set forth in the definition of 'financial institution' in the Financial Action Task Force Recommendations." *Id.* at 45.

134 *See* OECD, *CRS-Related Frequently Asked Questions*, FAQ Section VIII (A)(6) (Feb. 2019) ("In the context of Section VIII (A)(6)(b), does the notion of 'managed by' also include cases where an Entity has discretionary authority to manage the assets (in whole or part) of another Entity, but does not manage the second Entity itself? Yes, the concept of 'managed by' under Section VIII (A)(6)(b)

that an entity is "managed by" an FI even if the FI only manages a fraction of the entity's assets. An entity is considered to be "managed by" an FI where it is managed by a mix of FIs and non-FIs.[135] The guidance on the "gross income" test provides that this test only considers the income from assets directly held by the entity.[136] An entity that holds a non-financial asset through a holding company is considered as investing in the shares (i.e., financial assets) of that holding company.[137] As a result, the "gross income" test is always satisfied where an entity holds the shares of a holding company, even if the assets held by that company are non-financial.[138]

While the FATCA regulations and IGAs do not provide clear guidance on these issues, entities usually adopt the same classification for both FATCA and CRS purposes unless specific rules dictate a different outcome.[139] The Treasury Department and the IRS have not published any guidance or clarification requiring that the "managed by" and "gross income" tests for FATCA purposes be construed more narrowly. The result of the CRS guidance (and the lack of contrary guidance under FATCA) is that even more private entities are classified as FIs for FATCA and CRS purposes.

Unlike the United States, countries that implement CRS do not maintain a publicly available, searchable list of their FIs. Consequently, other FIs cannot independently verify that entities that self-report as FIs are registered as such with their jurisdictions. Under CRS, an FI may be required to register as an FI with the domestic tax authority where it is resident or organized.[140]

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also covers cases where an Entity has discretionary authority to manage the assets (in whole or part) of another Entity, but does not manage the second Entity itself."). The CRS Commentaries' statements on this issue are less clear than the statement in the FAQs; CRS, *supra* note 5, at 162 ("An Entity is 'managed by' another Entity if the managing Entity performs, either directly or through another service provider, any of the activities or operations described in subparagraph A(6)(a) on behalf of the managed Entity. However, an Entity does not manage another Entity if it does not have discretionary authority to manage the Entity's assets (in whole or part).").

135. CRS, *supra* note 5, at 162 ("Where an Entity is managed by a mix of Financial Institutions, NFEs or individuals, the Entity is considered to be managed by another Entity that is a Depository Institution, a Custodial Institution, a Specified Insurance Company, or an Investment Entity described in subparagraph A(6)(a), if any of the managing Entities is such another Entity.").

136. *See* OECD, *supra* note 134, FAQ Section VIII (A)(5). This issue is not addressed in CRS or the Commentaries.

137. *See id.*

138. *See id.*; Noked, *supra* note 12, at 99–101. Notably, some jurisdictions consider the nature of the underlying sources of income (e.g., Virgin Is., *supra* note 93, § 6.4.1). However, this approach does not appear consistent with the FAQs issued by the OECD.

139. As the definitions under FATCA and CRS are similar, it would generally be difficult to justify classifying the same entity differently for the two regimes. From a practical perspective, entities that self-report that they have different classifications under FATCA and CRS may have difficulties opening financial accounts with FIs that would likely question this divergence.

140. In general, under CRS, the FI is subject to the rules of the jurisdiction where it is resident for tax purposes. If the FI does not have a jurisdiction of tax residence, then it should follow the rules of the jurisdiction where it is organized, where it has its place of management, or where it is subject to

For example, Cayman Islands FIs must register with the Cayman authorities.[141] However, these FIs are not assigned a registration number that could be verified against a public list of all Cayman Islands FIs. Moreover, not all jurisdictions require such registration. Hong Kong, for example, only requires FIs with at least one reportable account to register.[142] This means that when a private entity certifies to a bank that it is an FI in the Cayman Islands, Hong Kong, or elsewhere, the bank that maintains the account of such entity cannot independently verify that the entity is registered as an FI in the relevant jurisdiction. As a result, an entity can falsely certify that it is an FI in a particular jurisdiction without being registered in that jurisdiction. Even if the entity is registered as an FI, this does not mean it complies with the applicable reporting obligations.[143]

While an entity used to circumvent CRS reporting may avoid registering in its jurisdiction of residence or incorporation, it would likely register as an FI with the IRS and obtain a GIIN. This would be the case even if the entity has no U.S. owner or nexus. This is because the entity would wish to certify to banks and other FIs that it is an FI for FATCA and CRS purposes. As the entity is required to provide its GIIN in such self-certification, it would need to register with the IRS.[144] The IRS would have no interest in investigating such an entity because it has no U.S. owner or nexus. However, foreign tax authorities could potentially examine whether entities registered with the IRS as FIs are also registered as FIs with them.[145] While such cross-checking would be easy to carry out, we are unaware of any tax authority implementing this simple compliance check.

As an example of using the "shell bank" loophole to circumvent CRS reporting, assume that a French tax evader is the sole owner and director of a Cayman Islands company whose only asset is a bank account in Singapore. The company may or may not register as an FI in the Cayman Islands. The company would register with the IRS and obtain a GIIN. The company would certify to the bank that it is an FI for FATCA and CRS purposes. The bank would not be able to independently verify if the company is

financial supervision. *See* CRS, *supra* note 5, at 158–59.

141. Tax Information Authority, *Cayman Islands: The Common Reporting Standard for Automatic Exchange of Financial Account Information in Tax Matters Version 3.0 Guidance Notes* 7 (Mar. 15, 2018).

142. *See* Hong Kong Inland Revenue Ordinance, Cap. 112, § 50D(2)(a).

143. As demonstrated in the Brockman case, entities may be registered as FIs yet fail to comply with their reporting obligations.

144. FIs are required to enter their GIIN in the IRS self-certification form for entities: IRS Form W-8BEN-E, line 9a. The instructions for this form state, "If you are a participating FFI, registered deemed-compliant FFI (including a sponsored FFI described in the Treasury regulations), reporting Model 1 FFI, reporting Model 2 FFI . . ., you are required to enter your GIIN (with regard to your country of residence) on line 9a." *See* I.R.S. Instructions for Form W-8BEN-E (Oct. 2021), https://www.irs.gov/pub/irs-pdf/iw8bene.pdf.

145. The IRS list of FIs, which is published on the IRS website, includes their jurisdictions.

registered as an FI in the Cayman Islands.[146] Even if the company is registered as an FI in the Cayman Islands, the likelihood that the Cayman authorities would initiate an audit and expose the company's failure to report its owner is low. The company would then fail to report its owner despite its CRS obligations in the Cayman Islands. At the same time, the bank in Singapore is not required under CRS to identify and report the French owner.

C. How to Turn Your Company into a "Shell Bank"

The Finance Committee's report included a so-called "Cheat Sheet" on "[h]ow to turn your shell company into an IRS approved 'shell bank:'"[147]

> The key steps:
> 1. Establish a shell company in a FATCA partner jurisdiction (even those in well-known tax haven jurisdictions such as Bermuda or the British Virgin Islands).
> 2. Fill out form 8957 with the IRS to register the shell company as a foreign financial institution and obtain a GIIN number.
> 3. Open account at a bank in Switzerland or other FATCA partner jurisdiction in the name of the shell company now registered as a financial institution. Use an attorney or other intermediary as the signatory of the account.[148]
> 4. Invest in private equity firms or other investment vehicles and direct the fund manager to wire proceeds from investment activities in U.S. to the shell company's account in Switzerland or elsewhere."[149]

The report states that the steps above would achieve the following results:

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146. As noted, while there is a registration requirement in the Cayman Islands, the government of the Cayman Islands does not publish a list of registered FIs.

147. *See* Report, *supra* note 1, at 18.

148. Regarding step #3, it is not necessary to "[u]se an attorney or other intermediary as the signatory of the account" in order to circumvent FATCA reporting using the "shell bank" loophole. The bank would not be required to report the U.S. owner of a company classified as an FI even if the bank knows that the company's owner is a U.S. person or if that U.S. person is the signatory of the account. Also, even if another person is acting as a signatory, the bank would still be required to identify the U.S. owner as the beneficial owner following the applicable AML/KYC due diligence procedures. Some tax evaders might avoid using other parties as signatories because this might increase the risk of detection. For example, such parties may become whistleblowers or witnesses, as demonstrated in the Brockman case.

149. Step #4 can be described more broadly: The account held by the "shell bank" can receive, hold, and transfer any asset without FATCA and CRS reporting by the bank.

- The Swiss bank is no longer required to report that the account is held by U.S. persons because the account is held in the name of an entity with a valid GIIN number. The Swiss bank is also no longer required to conduct due diligence to determine whether the account has a U.S. nexus.
- The shell company is now operating as a "shell bank" and can self-certify reporting offshore accounts to IRS for FATCA purposes.
- In the absence of an audit or other federal investigation, is it highly unlikely the IRS will detect whether these accounts are concealing or underreporting assets held by U.S. persons.[150]

While the report does not cover CRS, the steps required to circumvent CRS reporting are generally similar:[151]

1. Establish a shell company in a CRS partner jurisdiction (even those in well-known tax haven jurisdictions such as Bermuda or the British Virgin Islands).[152]
2. Fill out form 8957 with the IRS to register the shell company as an FI and obtain a GIIN.[153]
3. You may register the shell company as an FI in its jurisdiction. However, even if this registration is not done, it is unlikely that this will be detected without an investigation by the relevant jurisdiction.
4. Open an account at a bank in Switzerland or another CRS partner jurisdiction in the name of the shell company now registered as an FI.
5. Use the account held by the "shell bank" to receive, hold and transfer any financial assets without CRS reporting by the bank.

III. THE FINANCE COMMITTEE'S FINDINGS

The Finance Committee describes its investigation into Brockman's tax evasion as a "case study" showing how "wealthy taxpayers continue to use schemes involving offshore entities and secret bank accounts to successfully

150. *See* Report, *supra* note 1, at 18.

151. *See supra* Part I.B.2 for a discussion of "shell banks" under CRS.

152. For the CRS exchange relationships, see OECD, *Activated Exchange Relationships for CRS Information* (Oct. 2022), https://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/exchange-relationships/.

153. As noted in *supra* Part I.B.2, the company would likely certify that it is an FI for both FATCA and CRS purposes. Therefore, it would need to register as an FI with the IRS and obtain a GIIN.

hide billions in income from the IRS."[154] It notes that Brockman might not have been detected without evidence provided by a whistleblower and co-conspirators.[155] Thus, this case study exposes FATCA's failure to detect tax evasion and "widespread risks for offshore tax evasion and money laundering."[156] Subpart A summarizes the Finance Committee's finding on how Brockman exploited the "shell bank" loophole to circumvent FATCA reporting. Subpart B discusses the Finance Committee's findings on the reasons for this loophole.

A. Brockman's "Shell Banks"

According to the Finance Committee's report and court filings by the Department of Justice, Robert Brockman created several "shell banks" to conceal income from the IRS.[157] To effectuate this scheme, Brockman followed the steps described below. Brockman used "shell banks" to funnel money from the United States to banks in Switzerland and Bermuda.[158] Altogether, these "shell banks" allowed Brockman to hide $2.7 billion in income from the U.S. government.[159]

Brockman formed companies in several jurisdictions, including Belize, Bermuda, the Cayman Islands, Malta, Nevis, Switzerland, Singapore, Guernsey, and the British Virgin Islands.[160] The most important of these companies were Point Investments Ltd., Edge Capital Investments, Cabot Global Investments, and Framfield Assets Ltd.[161] Point Investments Ltd. was formed in Bermuda, and the other three companies were formed in Nevis.[162] Point Investments Ltd. alone was allegedly responsible for $2.3 billion in hidden income.[163]

When FATCA's implementation started, Brockman registered these companies as FIs with the IRS.[164] The registration was approved, and the IRS issued GIINs to the companies.[165] Point Investments Ltd. and the other companies could then certify to the banks that held their financial accounts that they were FIs.

154. Report, *supra* note 1, at 3.
155. *See id.* at 3–4.
156. *Id.* at 21.
157. *Id.* at 9.
158. *Id.*
159. *Id.* at 3.
160. *Id.* at 9.
161. *Id.* at 9, 12.
162. *Id.*
163. *Id.* at 9.
164. *Id.* at 5.
165. *Id.* at 12.

Brockman used his "shell banks" to hold offshore financial accounts with foreign banks such as the Bermuda Commercial Bank and the Swiss bank Mirabaud and Cie ("Mirabaud").[166] Evatt Tamine, Brockman's attorney, and other associates served as signatories.[167] Normally, the banks would be required to conduct due diligence procedures to determine if the companies were owned by U.S. persons.[168] However, because these companies were classified as FIs with valid GIINs, the foreign banks concluded that they were not required under FATCA to identify and report the companies' owners.[169]

The Finance Committee's report notes that "[a]s a result of this loophole, the banks in Switzerland were able to accept massive wire transfers from the United States without being required to ask questions as to whether the funds belonged to U.S. persons or report the accounts to the IRS."[170]

B. The Causes of the Loophole According to the Finance Committee Weak Enforcement

The Finance Committee identifies weak enforcement as the main reason wealthy taxpayers can exploit the "shell bank" loophole. This finding is highlighted in the report's cover page: "The Shell Bank Loophole: Billionaire tax evasion scheme exposes how weak enforcement of the Foreign Account Tax Compliance Act enables wealthy tax cheats to hide income offshore."[171]After noting that "[t]here are hundreds of thousands of possible shell banks in countries widely considered tax haven jurisdictions," the Finance Committee states that "[d]ue to persistent budget cuts and decade-long campaign to gut the IRS, the agency does not have the personnel or the capabilities to adequately monitor whether these offshore entities are properly reporting accounts belonging to U.S. persons."[172]

The Finance Committee describes the process of registering as an FI and obtaining a GIIN as "shockingly easy" because such applications are "almost always approved without significant investigations from IRS personnel."[173] This is also explained by insufficient resources: "The IRS

166. *Id.* at 9.
167. *Id.* at 12.
168. *See supra* Part I.B.
169. *See* Report, *supra* note 1, at 5 ("Because the account holders of these accounts in Switzerland were Bermudan and Nevisian entities with IRS issued GIIN numbers, the Swiss banks determined that they were not required by FATCA to independently investigate whether these accounts were held by U.S. persons.").
170. *Id.* at 13.
171. *Id.* at 1.
172. *Id.* at 21.
173. *Id.* at 6, 16–17.

indicated that resource issues at the agency, as well as the sheer volume of financial institutions makes it extraordinarily difficult to do meaningful due diligence with regard to entities who are seeking or have obtained GIIN number approvals."[174]

The Finance Committee also finds that IRS audits of foreign partnerships are insufficient because the "IRS simply does not have enough qualified personnel to conduct complex audits of sophisticated partnership structures used by wealthy taxpayers to conceal billions of dollars in undeclared income."[175] The report does not clearly explain the connection between audits of foreign partnerships and the "shell bank" loophole.[176]

In summary, the Finance Committee identifies the "shell bank" loophole as a problem enabled by weak enforcement of FATCA due to inadequate resources. With more resources, the IRS would be able to better monitor whether hundreds of thousands of offshore entities "are properly reporting accounts belonging to U.S. persons," scrutinize GIIN applications more rigorously, and increase audits of foreign partnerships.[177]

1. *Ineffective Monitoring by Banks and Other FIs*

While weak enforcement is featured in the report as the main problem, the Finance Committee also considered the role played by Swiss banks and whether they should have reported Brockman. Under FATCA, an FI must "not rely on a self-certification or documentary evidence if [it] knows or has reason to know that the self-certification or documentary evidence is incorrect or unreliable."[178] The report notes that "the size of the accounts involved in the Brockman case raises important questions as to whether Mirabaud and [another Swiss bank] could have had reason to know the accounts were linked to Brockman and suspect that they were not being properly disclosed to the IRS."[179]

The report also notes that "[i]f the bank had reason to know that the accounts were owned by a U.S. person, it would have been required to report the account to U.S. tax authorities."[180] This statement is incorrect. Under FATCA, the bank is generally not required to report a U.S. owner of another FI.[181] This means that even if Mirabaud knew that the companies (registered as FIs) that held the bank accounts were owned by a U.S. person,

174. *Id.* at 17.
175. *Id.* at 20.
176. *See infra* Part III.B.
177. Report, *supra* note 1, at 21.
178. *See* MODEL 1 IGA ANNEX I, *supra* note 86, § VI(A).
179. Report, *supra* note 1, at 14.
180. *Id.* at 5.
181. *See supra* Part I.B.

it would generally not be required to report him to the IRS under FATCA. Reporting would only be needed in two situations: First, if the bank knows or has reason to know that the relevant entity should be classified as a Passive NFE, not as an FI, then the bank must report the entity's controlling persons. Second, the bank must report the entity itself as a "nonparticipating FI" (i.e., non-compliant FI) if the bank knows or has a reason to know that the entity does not comply with its obligations as an FI. However, these situations are likely uncommon. As discussed in Part I, many private entities should be classified as FIs under the overly broad FI definition, so banks typically have no reason to question this classification. Also, as noted, banks are not required to monitor the compliance of other FIs with their obligations.

The Finance Committee acknowledges that "it is unclear in what kinds of circumstances a Swiss bank is expected to know that a large account is owned and controlled by a U.S. person and the account holder has fulfilled their reporting obligations with the IRS."[182] The report also cites an IRS official's statement that the knowledge standards and the reason to know provisions are "'hard to prescribe' and subjective."[183]

The Finance Committee recently published its report on its investigation into Credit Suisse's role in U.S. tax evasion schemes.[184] This report recommended the following concerning the "reason to know" requirement under FATCA:

> The IRS should send updated guidance to Swiss banks regarding the "reason to know" provisions of the U.S.–Switzerland FATCA agreement. A provision in the U.S.–Switzerland FATCA intergovernmental agreement requires Swiss banks to identify and report U.S. accounts to the IRS when they have "reason to know" that the "self-certification or other documentation with an account is incorrect or unreliable." The IRS has previously indicated that these knowledge standards are vague and hard to enforce as currently written. The IRS should act quickly to issue situational guidance to Swiss banks clarifying the instances in which Swiss banks are expected to detect and report accounts held by U.S. persons, particularly situations involving high-net worth clients.[185]

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182. Report, *supra* note 1, at 17.

183. *Id.*

184. *See* U.S. SENATE COMMITTEE ON FINANCE, CREDIT SUISSE'S ROLE IN U.S. TAX EVASION SCHEMES, A DEMOCRATIC STAFF INVESTIGATION (Mar. 29, 2023).

185. *Id.* at 38 (citations omitted). The report states that the Finance Committee "believes [that] Credit Suisse had 'reason to know' that the bank's electronic records may have been incorrect or unreliable." Also, the report states that "Credit Suisse confirmed to the Committee that its own employees had raised concerns about the U.S. citizenship of the Family, and recommended to the Family that they enter into a voluntary disclosure program with the IRS, providing clear evidence that Credit Suisse was aware the account holders were not in compliance with U.S. tax laws." *Id.* at 25 n.68.

2. *Discussion*

The Finance Committee attributes the exploitation of the "shell bank" loophole to a lack of IRS resources and the agency's consequent inability to effectively identify non-compliance among hundreds of thousands of FIs.[186] It fails to ask a key question: Why are there hundreds of thousands of FIs in the first place?

This Article contends that the root cause of the "shell bank" loophole is the overly broad FI definition that allows the classification of unregulated, non-commercial, and closely held entities as FIs.[187] As discussed in Part I, tax evaders like Brockman can exploit the FI definition to form entities that qualify as FIs.[188] By holding financial assets through private entities classified as FIs, tax evaders can avoid third-party reporting by banks and other FIs. This is contrary to the policy aims of FATCA and CRS, which were intended to introduce third-party reporting for offshore financial assets.[189] Thus, insufficient IRS enforcement is not the primary cause of the "shell bank" loophole. Instead, the primary cause is the legal rule that classifies "shell banks" as FIs. As discussed in the next part, additional resources alone would not resolve the loophole effectively.

In addition, the fact that there are hundreds of thousands of registered FIs is a direct result of the overly broad FI definition. As discussed in the next Part, if the FI definition is interpreted as excluding unregulated, non-commercial, and closely held entities, the number of FIs worldwide would likely drop considerably. This would make it easier and less costly for the IRS to ensure compliance among the remaining FIs. Also, if only regulated entities (such as banks, insurance companies, and regulated funds) were allowed to register as FIs, it would be harder for an entity that does not meet these requirements to falsely certify that it is an FI.[190]

The other factor considered by the Finance Committee—limited monitoring by banks and other FIs—is also a result of the overly broad FI definition that allows classifying "shell banks" as FIs. If Brockman's companies had been classified as Passive NFEs, the Swiss banks would have been required to identify Brockman as the companies' controlling person and report him to the IRS. However, as a result of the companies' FI status, the Swiss banks were not required to be involved in the companies' FATCA

186. Report, *supra* note 1, at 17.

187. See the discussion in *supra* Part I.B regarding the FI classification rules under FATCA and CRS.

188. As noted, tax evaders can also register entities that do not meet the FI definition as FIs. However, this option is unnecessary because it is easy to meet the FI definition as discussed in *supra* Part I.B.

189. *See* Noked, *supra* note 12, at 105.

190. *See infra* Part III.A.

compliance. Therefore, the limited monitoring by banks and other FIs is not the primary factor that enables the "shell bank" loophole; it is the legal rule that classifies such "shell banks" as FIs, thereby shifting the FATCA compliance obligations from real banks to sham ones.

IV. HOW TO CLOSE THE "SHELL BANK" LOOPHOLE

The policy response to the "shell bank" loophole should be tailored to address the problem that enables it. As shown in the previous parts, the Finance Committee and the authors of this Article identify different problems at the heart of this loophole. While we contend that this loophole is enabled by a flawed design of the legal rules, the Finance Committee finds that it is mainly a problem of weak enforcement.[191] This difference leads to different recommendations regarding the appropriate policy response. Subpart A presents our proposed solution. Subpart B discusses and evaluates the Finance Committee's recommendations. Subpart C compares potential policy responses.

A. Proposed Solution

We propose that the loophole should be eliminated by correcting the flaw in the design of the legal rules providing who should report the owners of private entities that hold financial assets.[192] As noted, such reporting obligations can be imposed on (i) the FIs that maintain the private entities' financial assets, or (ii) the private entities themselves.[193] As discussed in Part I, the drafters of the FATCA regulations and CRS decided to impose reporting obligations on many private entities by classifying them as FIs.[194] This design choice is deeply flawed because it creates the "shell bank" loophole.[195]

Closing this loophole would require imposing reporting obligations on the FIs that maintain the financial assets of private entities. This can be achieved by interpreting the FI definitions in the FATCA IGAs and CRS as excluding entities that could be used as "shell banks," i.e., unregulated, non-commercial, and closely held entities.[196] The FATCA regulations should be amended to achieve a similar result. Excluding such entities from the FI definition would shift the FATCA reporting obligations to the banks and

191. *See supra* Part II.B.1.
192. *See* Noked, *supra* note 12, at 111–12.
193. *See id.* at 84.
194. *See id.* at 81.
195. *See id.* at 105–06.
196. *See id.* at 111–12.

other FIs that maintain these entities' financial assets.[197] For example, in the Brockman case, if his companies had not been classified as FIs, they would likely have been classified as Passive NFEs. The Swiss banks that maintain the companies' accounts would have been required to identify Brockman as the companies' controlling person and report him to the IRS. Attempts by such companies to falsely certify that they are FIs would likely fail, as discussed below.[198]

1. *Broad Approach vs. Targeted Approach*

We propose two approaches for the Treasury Department to consider: a broad approach and a targeted approach. The broad approach would exclude "shell banks" from the FI definition in all jurisdictions. The targeted approach would focus on addressing this issue in tax havens that are most likely to host "shell banks." It is possible to first implement the targeted approach before proceeding to a wider implementation under the broad approach.

The *broad approach* requires three actions by the U.S. Treasury. First, the U.S. Treasury should publish guidance on the appropriate interpretation of the FI definition under the IGAs as excluding "shell banks." Second, the U.S. Treasury can sign a one-page MOU with each IGA partner to indicate that they agree with the updated guidance. Third, the Treasury Secretary should consider amending the FATCA regulations to exclude unregulated, non-commercial, and closely held entities from the FI definition. These actions are described in more detail in the sections below.

Alternatively, the *targeted approach* would focus on several jurisdictions that are most likely to host "shell banks." These are tax havens with low or no income tax, such as the Cayman Islands, the British Virgin Islands, and Bermuda. These jurisdictions have entered into IGAs with the U.S. government.[199] Under the targeted approach, the U.S. Treasury would not be required to sign MOUs with all the IGA partners, only with the jurisdictions that pose a high risk of hosting "shell banks." Also, there would be no need to amend the FATCA regulations.[200]

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197. This conclusion assumes that these entities would be classified as Passive NFEs if they are not FIs.

198. *See infra* Part III.B.2.

199. *See* U.S. DEP'T OF TREAS., *supra* note 63.

200. As noted in Part III.A.2, if the FATCA regulations are not amended, the MOUs should state that FIs cannot rely on the "investment entity" definition in the FATCA regulations because this would frustrate the purposes of the IGA.

2. *IGAs*

As noted in Part I, many jurisdictions, including tax havens and financial centers, have entered into IGAs with the U.S. government for the implementation of FATCA by the FIs in their territory. IGA jurisdictions include, for example, Bermuda, British Virgin Islands, Cayman Islands, Hong Kong, Mauritius, Panama, Seychelles, Singapore, St. Kitts and Nevis, Switzerland, United Arab Emirates, the United Kingdom, all EU member states, and other jurisdictions. This means that IGAs cover most (if not virtually all) jurisdictions where "shell banks" are likely to be formed.

To close the "shell bank" loophole in IGA jurisdictions, the Treasury Department could ensure that "shell banks" are excluded from the FI definition under the IGAs by publishing guidance on the appropriate interpretation of the IGAs and signing one-page MOUs with the IGA partners. There is no need to renegotiate and amend the IGAs.

i. Guidance on the FI Definition under the IGAs

Under the IGAs, as noted in Part I, an "investment entity" is any entity that conducts as a business (or is managed by an entity that conducts as a business) financial investment activities for or on behalf of a customer.[201] The IGAs require that the paragraph that includes the "investment entity" definition be interpreted in a manner consistent with similar language set forth in the FI definition in the FATF Recommendations.

The IGAs do not define or provide guidance on when an entity should be considered as "managed by" another entity. The U.S. Treasury could publish guidance providing that in order to be considered as "managed by" another entity, the managing FI must be responsible for the overall management of the entity or act in a capacity similar to that of an investment manager of a fund or a trustee. There is no reason to prefer a broad interpretation under which the "managed by" test is satisfied where an FI manages the investment portfolio of a non-commercial, closely held company. As the broad interpretation of the "managed by" test frustrates the purposes of the IGAs by enabling the "shell bank" loophole, the purpose of this guidance would be to clarify the existing FI definition in a manner consistent with the purposes of the IGAs.

Canada, the Netherlands, and Luxembourg—countries that have IGAs with the United States—adopted domestic laws and regulations that exclude unregulated entities (in Canada's case), non-commercial, closely held entities (in the Netherlands' case), and "managed" investment entities that do not meet the FI definition under the FATF Recommendations (in Luxembourg's case) from the FI definition. The U.S. government has not

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201. *See* MODEL 1 IGA, *supra* note 66, art. 1, § 1(j); MODEL 2 IGA, *supra* note 67, art. 1, § 1(k).

challenged these laws and regulations. Thus, these precedents reflect possible interpretations of the existing "investment entity" definition in the IGAs under which "shell banks" are excluded from the FI definition. These precedents are further discussed below.

Moreover, an interpretation that excludes "shell banks" from the FI definition would also be consistent with the IGAs' anti-avoidance provision. Many IGAs include a clause titled "Prevention of Avoidance" which states, "[t]he Parties shall implement as necessary requirements to prevent Financial Institutions from adopting practices intended to circumvent the reporting required under this Agreement."[202] Some IGAs do not include this anti-avoidance provision.[203] Yet this does not mean that circumventing reporting is allowed under such IGAs. The U.S. government would likely take the position that even if the IGA does not include an anti-avoidance provision, there is an implied term that the IGA jurisdictions must not allow practices intended to circumvent the required reporting. IGA jurisdictions should prevent a practice intended to circumvent the FATCA reporting by excluding "shell banks" from the FI definition.

ii. MOUs with IGA Partners

Following the issuance of updated guidance, the U.S. Treasury can reach out to the IGA jurisdictions and request that they sign MOUs to record the understanding that the IGAs' FI definition excludes "shell banks." If the *targeted approach* we propose is followed, then the U.S. Treasury should prioritize signing MOUs with tax havens and offshore financial centers where "shell banks" are likely to be organized. If the *broad approach* is followed, the U.S. Treasury should aim to sign MOUs with all IGA partner jurisdictions.

Around 40 similar understandings with different jurisdictions have been reached with respect to various terms and obligations under the IGAs.[204] The typical length of an understanding is one to two pages.[205] As the IGAs

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202. *See* MODEL 1 IGA, *supra* note 66, art. 5, § 4.

203. For example, the IGA with Hong Kong does not include this clause. However, the IGAs with many offshore financial centers and tax havens such as the British Virgin Islands and Cayman Islands include this clause. *See* Agreement Between the Government of the United States of America and the Government of the Hong Kong Special Administrative Region of the People's Republic of China for Cooperation to Facilitate the Implementation of FATCA, H.K.-U.S., Mar. 25, 2014, U.S. Dep't of Treasury; Agreement Between the Government of the United States of America and the Government of the British Virgin Islands to Improve Tax Compliance and to Implement FATCA, U.S.-Virgin Is., June 30, 2014, U.S. Dep't of Treasury; Agreement Between the Government of the United States of America and the Government of the Cayman Islands to Improve International Tax Compliance and to Implement FATCA, Cayman Is.-U.S., Nov. 29, 2013, U.S. Dep't of Treasury.

204. *See* U.S. DEP'T OF TREAS., *supra* note 63 (providing a list of understandings under FATCA).

205. For example, the U.S. Treasury's MOU with Hong Kong is less than two pages in length with the body of the MOU consisting of only three paragraphs. *See* Memorandum of Understanding

lack guidance on which entities should be considered as "managed" investment entities, the understanding concerning the appropriate interpretation could be recorded in an MOU.

IGA partner jurisdictions may need to update their domestic laws and regulations to conform to the updated interpretation of the FI definition. Alternatively, IGA partner jurisdictions could disregard the U.S. guidance and reject a request to sign an MOU. However, the U.S. government could then terminate the IGA. If an IGA is terminated, FIs in the relevant country would need to comply with the obligations under the FATCA regulations (which are generally considered to be more onerous than the IGAs) or face withholding taxes.[206] Thus, IGA partner jurisdictions have little to gain by refusing to follow the U.S. government's requirements concerning the IGAs.

The IGAs also allow jurisdictions to adopt the definitions in the FATCA regulations in lieu of the IGA definitions if this does not frustrate the purpose of the IGAs.[207] If the FATCA regulations are amended in a manner consistent with the new guidance on the appropriate interpretation of the IGAs, then using the FI definition in the FATCA regulations would be non-problematic because "shell banks" would still be excluded. However, without a concurrent similar amendment of the FATCA regulations, the MOUs should also state that it is not permitted to use a definition in the FATCA regulations that allows classifying "shell banks" as FIs because this would frustrate the purposes of the IGAs.

Although amending the IGAs is likely unnecessary, doing so would not require ratification or any other action by Congress.[208] These agreements have been negotiated and concluded by the U.S. Treasury and foreign governments.[209] However, negotiating and amending a few dozen bilateral IGAs would require time and resources. Also, IGA partners may require that the U.S. government act on its commitment for reciprocal information exchange, which the U.S. Treasury cannot provide without new legislation.[210] Therefore, a solution that does not require amending IGAs would likely be preferred. Publishing guidance and signing MOUs appears to be the most practical approach.

As discussed later, if the FI definition under CRS is interpreted in a similar manner, there should be a global consensus on the updated

Regarding the Agreement between the Government of the United States of America and the Government of the Hong Kong Special Administrative Region of the People's Republic of China for Cooperation to Facilitate the Implementation of FATCA, H.K.-U.S., Nov. 13, 2014, U.S. Dep't of Treasury.

206. *See supra* Part I.A.

207. *See* text accompanying *supra* note 116.

208. *See* text accompanying *supra* note 46.

209. *See id.*

210. *See* Noked & Marcone, *supra* note 75.

definition. Compliant FIs and entities would generally prefer that the same definitions be implemented for both FATCA and CRS purposes. Therefore, if the U.S. Treasury and the OECD adopt a coordinated approach and interpret the FI definition as excluding "shell banks," IGA partners would likely support that change.

3. Precedents in Canada, the Netherlands, and Luxembourg

As noted, Canada, the Netherlands, and Luxembourg provide precedents for excluding unregulated, non-commercial, and closely held entities from the FI definition under the respective IGAs.

i. Canada

Canada restricts the FI definition to regulated entities. Under Canada's Income Tax Act, an FI must fall within one of thirteen types of "listed financial institutions," which are different categories of regulated entities.[211] The Canadian guidance on this issue states that a trust that is not represented or promoted to the public is a Passive NFE because it is not a "listed financial institution" and thus cannot be classified as an FI.[212] Similarly, unregulated private entities that are not represented or promoted to the public, such as Brockman's companies, are not included in the list and therefore cannot be classified as FIs under Canadian law.[213]

FATCA already includes several definitions requiring the relevant entities to be regulated in the countries where they are organized or registered. One of the FI definition categories is a "specified insurance company,"[214] which must be "regulated as an insurance business under the laws, regulations, or practices of any jurisdiction in which the company does business[.]"[215] The definitions of several types of Registered Deemed-

211. *See* Income Tax Act, R.S.C. 1985, c 1 s. 263(1) (Can.); *Guidance on the Canada-U.S. Enhanced Tax Information Exchange Agreement: Part XVIII of the Income Tax Act*, CAN. REVENUE AGENCY ¶ 3.29 (Aug. 23, 2023) ("Two conditions must be met for an entity to be a Canadian financial institution—the entity must be a Canadian financial institution under the Agreement and it must be a 'listed financial institution'. . . ."); 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).

212. *See Guidance on the Canada-U.S. Enhanced Tax Information Exchange Agreement*, *supra* note 211, ¶ 3.41 ("Example C: Peter establishes a Canadian resident trust as a vehicle to hold financial assets for family estate planning purposes in Canada. The trust is settled with capital provided by Peter and it is not represented or promoted to the public. The trust is not a 'listed financial institution' and is not a Canadian financial institution with due diligence and reporting obligations under Part XVIII. As such, the trust cannot represent itself as a financial institution to any financial institution at which it holds an account. Instead, it must classify itself as a passive or active NFFE in accordance with the circumstances.").

213. *Id.*

214. Treas. Reg. § 1.1471-5(e)(1)(iv) (as amended in 2019).

215. Treas. Reg. § 1.1471-1(b)(65)(i) (as amended in 2019).

Compliant FIs, which are exempt from FATCA obligations, include similar requirements. For example, a "local bank" must be "licensed and regulated as a financial institution under the laws of its country of incorporation or organization[.]"[216] Similarly, a "collective investment vehicle" must be "regulated as an investment fund either in its country of incorporation or organization or in all of the countries in which it is registered and all of the countries in which it operates."[217] A "restricted fund" is subject to a similar requirement.[218] "Broad participation retirement funds" and "narrow participation retirement funds" must also be subject to government regulation.[219] However, as discussed in Part I, unregulated entities could fall within the "investment entity" category of the FI definition in the FATCA regulations. Following the Canadian approach, it is possible to provide that only entities subject to government regulation would be classified as FIs.[220]

ii. The Netherlands

The Netherlands previously excluded non-commercial, closely held entities from the FI definition. Before an amendment in 2020, the Dutch definition of a Passive NFE included private investment entities which (i) are owned by a small group of shareholders or by participants that are all from one family; (ii) do not represent themselves on the market as an investment fund; and (iii) have not raised and will not raise capital from the market.[221] This definition of a Passive NFE covered many private investment entities that may have been classified as FIs otherwise.[222] For example, Brockman's companies would be classified as Passive NFEs under this definition. The U.S. tax system implements special rules for closely held

216. Treas. Reg. § 1.1471-5(f)(1)(i)(A)(1) (as amended in 2019).

217. Treas. Reg. § 1.1471-5(f)(1)(i)(C)(1) (as amended in 2019).

218. Treas. Reg. § 1.1471-5(f)(1)(i)(D) (as amended in 2019).

219. Treas. Reg. §§ 1.1471-6(f)(2)(ii); 1.1471-6(f)(3) (as amended in 2019).

220. There should be guidance specifying what type of regulation is required. As this is the "investment entity" category of the FI definition, entities regulated as investment vehicles such as funds should meet this requirement. Also, it is possible that certain investment vehicles should be classified as FIs even if they are not subject to regulation. For example, a commercial investment vehicle that raises capital from the market should generally be classified as an FI even if not regulated in any jurisdiction.

221. *See* Ministry of Finance, *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); Noked, *supra* note 12, at 97.

222. In 2020, the Netherlands updated its guidance on FATCA and CRS and reverted to the standard definition for Passive NFE. This was following OECD guidance that the Passive NFE definition should be brought in line with CRS. *See* PWC, *Amendments to the Dutch FATCA and Common Reporting Standard Guidance (Leidraad)* (Oct. 16, 2020). While standardizing the implementation of CRS globally is generally recommended in order to reduce compliance costs and ensure the adoption of best practices, occasionally such standardization can have negative consequences, as in the Dutch case. For more on how CRS is implemented differently across countries and jurisdictions, see Elisa Casi et al., *A Call to Action: From Evolution to Revolution on the Common Reporting Standard*, 2 BRIT. TAX REV. 166 (2019).

entities in other contexts. For example, specific tax rules address tax avoidance by a "personal holding company" where five or fewer individuals own more than 50% of a company directly or indirectly.[223] However, as discussed in Part I, an entity can be classified as an FI even if it is closely held.[224]

It is possible to consider a *combination* of the Canadian and Dutch models: the "investment entity" category of the FI definition would only apply to an entity that is (i) subject to government regulation, (ii) commercial,[225] and (iii) not closely held.[226] Combining both requirements would reduce the risk of tax evaders finding new and creative ways to establish "shell banks." For example, if only the Canadian model is followed, a tax evader may be able to form a closely held fund that is subject to lax regulation in a tax haven jurisdiction. The combined approach would allow governments and FIs to identify fraud more effectively, as discussed in the following sections.

iii. Luxembourg

Under the rules in Luxembourg, "managed" investment entities qualify as FIs for CRS purposes only if they meet the FI definition under the FATF Recommendations.[227] This ensures consistency between the interpretation of the "investment entity" definition under CRS and the FATF Recommendations. This also excludes "shell banks" from the FI definition.

The FATF Recommendations state:

> *[f]inancial institutions* means any natural or legal person who conducts as a business one or more of the following activities or operations for or on behalf of a customer: 1. Acceptance of deposits and other repayable funds from the public. 2. Lending. 3. Financial leasing. 4. Money or value transfer services. 5. Issuing and managing means of payment (e.g. credit and debit cards, cheques, traveller's cheques, money orders and bankers' drafts, electronic money). 6. Financial guarantees and commitments. 7. Trading in: (a) money market

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223. I.R.C. § 542(a)(2).

224. *See* text accompanying *supra* note 107.

225. This requirement could follow the Dutch model under which an entity is not an investment entity FI if it does not represent itself on the market as an investment vehicle and it has not raised and will not raise capital from the market.

226. A "closely held entity" could be defined in reference to a stock ownership requirement for a "personal holding company" as defined in I.R.C. § 542(a)(2).

227. *See* Le Gouvernement du Grand-Duché de Luxembourg: Administration des contributions directes, *Circulaire du directeur des contributions ECHA – no. 2 du 31 juillet 2015* (July 31, 2015); PwC, *Luxembourg Tax Authorities Publish CRS Guidance* (Apr. 26, 2016); LE GOUVERNEMENT DU GRAND-DUCHÉ DE LUXEMBOURG: ADMINISTRATION DES CONTRIBUTIONS DIRECTES, *Foire aux questions (FAQ) – Norme commune de declaration (NCD)* (Apr. 4, 2022).

> instruments (cheques, bills, certificates of deposit, derivatives etc.); (b) foreign exchange; (c) exchange, interest rate and index instruments; (d) transferable securities; (e) commodity futures trading. 8. Participation in securities issues and the provision of financial services related to such issues. 9. Individual and collective portfolio management. 10. Safekeeping and administration of cash or liquid securities on behalf of other persons. 11. Otherwise investing, administering or managing funds or money on behalf of other persons. 12. Underwriting and placement of life insurance and other investment related insurance. 13. Money and currency changing.[228]

The FI definition in the FATF Recommendations focuses on the activities of the relevant entity, not on who manages it. There is no category of entities that qualify as FIs because they are "managed by" another FI. Private, non-commercial, and closely held entities—such as the companies held by Brockman—do not appear to fall within any of the categories under the FI definition of the FATF Recommendations. While such entities may trade financial assets, invest funds, and conduct other financial activities, they do not do it as a business for or on behalf of a customer: these non-commercial entities trade their own funds. Therefore, "shell banks" should generally be excluded from the FI definition in the FATF Recommendations and under the rules adopted in Luxembourg.

As noted in Part I, the FATCA IGAs and CRS require that the paragraph that includes the "investment entity" definition be interpreted in a manner consistent with similar language set forth in the FI definition in the FATF Recommendations.[229] Arguably, the approach adopted by Luxembourg ensures consistency with the FI definition in the FATCA Recommendations.

iv. Other Options

In addition to the precedents discussed above, it is possible to exclude many "shell banks" from the FI definition by interpreting the "managed by" test more narrowly. As noted, this test can require that the managing FI must be responsible for the overall management of the entity. Also, the test can provide that an entity is managed by another entity only if the managing entity acts as a fund manager, investment manager of a fund, a trustee, or an equivalent role with respect to the managed entity.[230]

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228. *See FATF Recommendations*, *supra* note 96, at 126–27 (citations omitted).

229. MODEL 1 IGA, *supra* note 66, art. 1, § 1(j); MODEL 2 IGA, *supra* note 67, art. 1, § 1(k); CRS, *supra* note 5, at 44–45.

230. These requirements would exclude situations where the managed entity has a securities account managed by an FI broker.

4. *FATCA Regulations*

Congress does not need to enact legislation in order to exclude "shell banks" from the FI definition. The statutory "financial institution" in the Internal Revenue Code is as follows:

> Except as otherwise provided by the Secretary, the term "financial institution" means any entity that—
> (A) accepts deposits in the ordinary course of a banking or similar business,
> (B) as a substantial portion of its business, holds financial assets for the account of others, or
> (C) 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.[231]

It is unclear why unregulated, non-commercial, and closely held entities that passively hold financial assets should be considered as FIs under the statutory FI definition. Such entities do not fall under categories (A) and (B).[232] To fall under category (C), an entity should be engaged primarily in the business of investing in financial assets. It is unclear why an entity used by its owner to hold financial assets should be considered as engaging in a "business" under general principles of U.S. tax law.[233] The statutory definition does not identify entities that are "managed by" other FIs as FIs themselves. Therefore, the statutory FI definition may be interpreted as excluding "shell banks."

Moreover, even if "shell banks" should be classified as FIs under the appropriate interpretation of the statutory FI definition, the Treasury Secretary has the authority to exclude such entities. By stating that the entities described in the definition are FIs "[e]xcept as otherwise provided by the Secretary," Congress granted the Treasury Secretary the authority to exclude entities from this definition.[234] Also, the FATCA legislation

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231. I.R.C. § 1471(d)(5).

232. Category (A) is irrelevant because a "shell bank" does not conduct a banking business. Category (B) is irrelevant because a "shell bank" does not hold financial assets for others in exchange for a fee, which is generally how this category is interpreted in the FATCA regulations. Treas. Reg. § 1.1471-5(e)(3) (as amended in 2019).

233. For example, a foreign company is considered as engaging in a U.S. trade or business if its activities in the United States are "considerable, continuous, and regular." BORIS I. BITTKER & JAMES EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS ¶ 15.02[2][a] (1999) ; Rev. Rul. 88-3, 1988-1 C.B. 268. A company may not be considered as engaging in a trade or business if its sole activity is to passively hold financial assets.

234. I.R.C. § 1471(d)(5).

provides the Treasury Secretary with broad authority to issue regulations or other guidance to carry out the purposes of FATCA and prevent its avoidance.[235] Thus, the Treasury Secretary is authorized to exclude "shell banks" from the FI definition.

As discussed in Part I, the classification of "managed" investment entities as FIs is a creation of the FATCA regulations and the IGAs. The FATCA regulations provide the "managed by" and the "gross income" tests to classify entities as FIs. The Treasury Secretary can amend these regulations without any need for Congressional action.

As noted, the preamble to the FATCA regulations reflects an intention to clarify that the FI definition does not include private, non-commercial investment vehicles.[236] The Treasury Secretary should consider amending the FATCA regulations to exclude "shell banks" from the FI definition. Alternatively, the Treasury Department may determine that the publication of guidance is sufficient and that it is unnecessary to amend the regulations. By amending the regulations (or publishing guidance if amending the regulations is not required), the Treasury Department can ensure that the rules and guidance follow this stated intention.

Amending the FATCA regulations would likely be required if the *broad approach* we propose is to be followed. This would ensure that "shell banks" are excluded in jurisdictions without an IGA with the U.S. government. The amended regulations should be consistent with the guidance on the interpretation of the FI definition in the IGAs.

In contrast, if the *targeted approach* we propose is followed, then there is no need to amend the FATCA regulations. MOUs with relevant tax havens and offshore financial centers could state that it is understood that entities in these IGA jurisdictions cannot use the FI definition under the FATCA regulations to the extent that it allows the classification of "shell banks" as FIs given that this would frustrate the purposes of the IGAs.

5. Preventing Fraud

If our proposal to exclude "shell banks" from the FI definition is adopted, would tax evaders still be able to use the "shell bank" loophole by falsely certifying that an entity is an FI? For example, assume that after the FI definition excludes "shell banks" as proposed here, a tax evader tries to register his wholly-owned, unregulated Bermudan company as an FI with the IRS despite not meeting the FI definition. He then attempts to open an

235. I.R.C. § 1474(f) ("The Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the purposes of, and prevent the avoidance of, this chapter.").

236. *See* the discussion accompanying *supra* notes 126–128. Treas. Reg. §§ 1.1471–1.1474 ¶ VI.E.3. (as amended in 2019).

account for the company with a Swiss bank while falsely certifying that the company is an FI.

This type of fraud is unlikely to be successful. As noted, banks and other FIs must confirm the reasonableness of self-certifications.[237] They are required to reject any self-certification if it is incorrect or unreliable. Through the banks' AML/KYC procedures, they must identify entities' beneficial owners. This means that the Swiss bank in this example should identify that the company is wholly owned by one beneficial owner. If closely held entities cannot be classified as FIs, the bank would be required to reject the company's self-certification that it is an FI even if it is registered as such with the IRS. Moreover, if all FIs must be regulated entities, the bank could require documentary evidence showing that the company is subject to regulation.[238] Thus, FIs should be able to detect and prevent attempts to pass an entity as an FI fraudulently where the relevant entity is closely held and cannot provide documentary evidence showing that it is regulated.

Moreover, the IRS and foreign tax authorities could implement simple measures to counter such fraud. If only regulated entities can be classified as FIs, the IRS can request that other governments periodically confirm that entities registered as FIs with the IRS are indeed regulated in the relevant jurisdictions. Also, the FI registration process could require uploading documentary evidence showing that the relevant entity is regulated. Even without investigating applications for FI registration rigorously, this requirement may have some deterrent effect because tax evaders who want to register unregulated companies as FIs would need to forge documents and submit them to the IRS in order to meet this requirement. Adopting and implementing measures to counter fraud would require some resources for FATCA enforcement. As noted, adopting this Article's proposed solution would reduce the number of FIs globally, making it easier to detect fraud.

6. *CRS*

The "shell bank" loophole has become a global problem because CRS adopts FATCA's FI definition.[239] To resolve this issue globally, the OECD should work with the U.S. Treasury to adopt an appropriate solution that would apply consistently under FATCA and CRS. A coordinated solution would also reduce compliance costs for FIs.

237. *See* text accompanying *supra* note 96.
238. This requirement could be added to the prescribed due diligence procedures for FIs.
239. *See* text accompanying *supra* note 133.

Notably, CRS also includes an anti-avoidance provision under which jurisdictions must ensure effective implementation and compliance. Jurisdictions must adopt "rules to prevent any Financial Institutions, persons or intermediaries from adopting practices intended to circumvent the reporting and due diligence procedures[.]"[240] Excluding "shell banks" from the FI definition would prevent CRS avoidance.

If the agreed solution requires that the FI definition under CRS be amended, the OECD will need to reach a consensus on this amendment among CRS-implementing countries. The amendment would then be adopted by these countries into their domestic laws and regulations. This would be similar to other amendments that have already been made to CRS, such as the amendments recently approved by the OECD.[241] If the EU supports this amendment, CRS-implementing countries would likely adopt it because they could otherwise face EU blacklisting.[242]

If the preferred approach is to adopt a narrower interpretation of the existing "investment entity" definition without amending it, the OECD could publish guidance (possibly in the form of FAQs or an update to the CRS Commentaries) on the appropriate interpretation of the "investment entity" definition. After publishing the updated guidance, the OECD should ensure that CRS-implementing countries—especially tax havens where "shell banks" are more likely to be organized—follow it.

The OECD has been aware of the "shell bank" loophole since 2018, if not earlier.[243] However, it has taken no action to address it. Instead, the OECD has been attempting to close other weaknesses in the existing reporting framework. It recently approved important changes to international tax transparency standards, which are divided into two parts.[244]

240. *See* CRS, *supra* note 5, § IX(A)(1).

241. *See* OECD, *infra* note 244.

242. For more on the EU's use of blacklisting as a means to pressure countries to adopt and implement certain tax standards, see COUNCIL OF THE EUROPEAN UNION, *Taxation: EU List of Non-cooperative Jurisdictions*, https://www.consilium.europa.eu/en/policies/eu-list-of-non-cooperative-jurisdictions/ (last visited Jan. 27, 2023); Katrin Eggenberger, *When is Blacklisting Effective? Stigma, Sanctions and Legitimacy: The Reputational and Financial Costs of Being Blacklisted,* 25 REV. INT'L POLIT. ECON. 483 (2018); Giuseppe Melis & Alessio Persiani, *The EU Blacklist: A Step Forward but Still Much to Do*, 28 EC TAX REV. 253 (2019); Aija Rusina, *Name and Shame? Evidence from the European Union Tax Haven Blacklist*, 27 INT'L TAX & PUB. FIN. 1364 (2020); Naomi Fowler, *Will the EU Really Blacklist the United States?*, TAX JUST. NETWORK (June 11, 2018); Andres Knobel, *The US Can be Blacklisted Under the OECD's New Rules due to a Forgotten Commitment*, TAX JUST. NETWORK (Dec. 12, 2018); Andres Knobel, *Blacklist, Whitewashed: How the OECD Bent its Rules to Help Tax Haven USA*, TAX JUST. NETWORK (July 27, 2018); Shu-Yi Oei, *World Tax Policy in the World Tax Polity? An Event History Analysis of OECD/G20 BEPS Inclusive Framework Membership*, 47 YALE J. INT'L L. 199 (2022).

243. *See* Noked, *supra* note 12. The author of that publication identified this loophole and submitted the publication to the OECD Secretariat in 2018.

244. OECD, INTERNATIONAL STANDARDS FOR AUTOMATIC EXCHANGE OF INFORMATION IN TAX MATTERS: CRYPTO-ASSET REPORTING FRAMEWORK AND 2023 UPDATE TO THE COMMON REPORTING STANDARD (2023), https://www.oecd-ilibrary.org/taxation/international-standards-for-automatic-exchange-of-information-in-taxmatters_896d79d1-en.

The first part is the Crypto-Asset Reporting Framework, which imposes due diligence and reporting obligations on Crypto-Asset Service Providers.[245] The second part includes several changes that aim to close loopholes and address problems in CRS.[246] None of the changes in the second part address the "shell bank" loophole.[247]

Interestingly, the Crypto-Asset Reporting Framework addresses the "shell bank" loophole, but only for crypto assets. Under this new framework, Crypto-Asset Service Providers must identify and report the controlling persons of entities that are not "excluded persons."[248] The "excluded person" definition provides that a "managed" investment entity is not an excluded person.[249] All other types of FIs are included in the "excluded person" definition. The result is that Crypto-Asset Service Providers must treat "managed" investment entities like Passive NFEs and report their controlling persons, although they are generally classified as FIs under CRS.

Therefore, the OECD is moving to eliminate the "shell bank" loophole, but only for crypto assets. This indicates that the OECD acknowledges that "managed" investment entities could be used to facilitate tax evasion. It is unclear why the OECD has decided to close the "shell bank" loophole only for crypto assets while keeping this loophole wide open for all other types of financial assets.

7. *Transition*

If this proposal is adopted, jurisdictions implementing FATCA and CRS should be given a start date on which they must exclude "shell banks" from the FI definition. This start date could be prospective or retroactive. A prospective start date would allow more time for preparation and

245. *Id.* at 8–61.

246. *Id.* at 62–102; Menusch Khadjavi & Marjolein Vertelman, *Closing Pandora's Box: How to Improve the Common Reporting Standard* (Kiel Inst. World Econ., Working Paper No. 2223, May 2022).

247. *See* Noam Noked, *Response to the OECD Public Consultation Document: Crypto-Asset Reporting Framework and Amendments to the Common Reporting Standard* (Apr. 29, 2022) (proposing that the "shell bank" loophole be closed and other weaknesses addressed in response to the public consultation on these changes).

248. *See* OECD, *supra* note 244, at 15, 21–22.

249. *See id.* at 21–22 ("The term 'Excluded Person' means (a) an Entity the stock of which is regularly traded on one or more established securities markets; (b) any Entity that is a Related Entity of an Entity described in clause (a); (c) a Governmental Entity; (d) an International Organisation; (e) a Central Bank; or (f) a Financial Institution other than an Investment Entity described in Section IV E(5)(b)."). Section IV E(5)(b) described "managed" investment entities ("the gross income of which is primarily attributable to investing, reinvesting, or trading in Financial Assets or Relevant Crypto-Assets, if the Entity is managed by another Entity that is a Depository Institution, a Custodial Institution, a Specified Insurance Company, or an Investment Entity described in subparagraph E(5)(a).").

implementation by banks and other FIs, but it would enable tax evaders to terminate or empty their accounts in "shell banks" to avoid reporting of their undeclared funds.

The U.S. Treasury and the OECD could consider providing guidance on the transition. Such guidance could provide that banks and other FIs that maintain the accounts of "shell banks" opened prior to the applicable start date would need to treat these accounts as pre-existing accounts, subject to the due diligence obligations for pre-existing accounts.[250]

This transition is not expected to be complicated or costly. The banks and other FIs that maintain the accounts of the relevant "shell banks" would need to follow the standard due diligence and reporting obligations that they generally implement. While this would result in more work by such banks and other FIs because they would have additional accounts to review, the "shell banks" themselves would no longer be required to comply with these obligations which would reduce costs for compliant "managed" investment entities. Thus, it is unlikely that the transition to the updated FI definition would result in substantial difficulties or compliance challenges.

8. Other Solutions

While construing the FI definition more narrowly is the most direct and cost-effective solution to the "shell bank" loophole, other solutions could be considered. For example, FATCA and CRS could require parallel reporting by "shell banks" and the FIs that maintain their financial assets.[251] This means that the FIs would treat "shell banks" as Passive NFEs and report their controlling persons. At the same time, the "shell banks" would still be required to satisfy their obligations as FIs to identify and report their equity and debt interest holders. This would ensure that any reports made by private entities could be cross-checked with the information submitted by banks and other FIs.[252] While this would close the "shell bank" loophole by adding third-party reporting, this solution would be costlier because of the duplicate compliance obligations.

Parallel reporting may be appropriate in the context of FI trusts with professional trustees. In general, discretionary beneficiaries of FI trusts should only be reported if they receive a distribution during the calendar year.[253] Banks and other FIs that maintain financial assets of trusts may not

250. *See* MODEL 1 IGA ANNEX I, *supra* note 86, § IV; CRS, *supra* note 5, at 16.

251. It may be possible to add parallel reporting to CRS as part of the Model Mandatory Disclosure Rules. For more on these rules, see OECD, MODEL MANDATORY DISCLOSURE RULES FOR CRS AVOIDANCE AND OPAQUE OFFSHORE STRUCTURES (2018).

252. Under this proposal, the third-party FI would submit to the IRS all of the information it would have normally been required to report if the entity had been classified as a passive NFE as opposed to an FI. *See* Noked, *supra* note 12, at 113.

253. Treas. Reg. § 1.1471-5(b)(3)(iii)(B)(3) (as amended in 2019).

know whether discretionary beneficiaries receive distributions. The trustees of FI trusts would likely be in a better position to identify when reporting of discretionary beneficiaries is required. However, there is a risk that family trusts could be used as "shell banks" to avoid reporting. Thus, we recommend imposing parallel reporting both on the trusts and the FIs that maintain their financial assets.

In addition to parallel reporting, there are other ways to introduce third-party monitoring. For example, auditing procedures could require that all FIs must be audited by accounting firms to ensure compliance with FATCA.[254] Alternatively, mandatory disclosure rules (MDRs) could be considered.[255] MDRs require intermediaries such as accountants, tax advisers, and FIs to report on arrangements that meet certain characteristics or hallmarks.[256] These hallmarks are generally designed to expose tax evasion and avoidance.[257] MDRs are important tax transparency tools used in many countries around the globe, including the United States, the United Kingdom, and the European Union.[258] A recent proposal calls for the adoption of MDRs on a global, multilateral basis.[259] MDRs could require the reporting of "shell banks" by intermediaries that know or have reason to know that such entities are used to circumvent reporting. However, this solution might not address the "shell bank" loophole effectively because intermediaries may not be able to know or suspect that a private entity is used to facilitate tax evasion.

B. *The Finance Committee's Recommendations*

The Finance Committee's report outlines several recommendations that "would help crack down on this kind of abuse."[260] We discuss these recommendations in the order they appear in the report.

254. Noked, *supra* note 12, at 113.

255. *See* Elisa Casi, Mohammed Mardan & Rohit Reddy Muddasani, *So Close and Yet So Far: The Ability of Mandatory Disclosure Rules to Crack Down on Offshore Tax Evasion* 2 (TRR 266 Accounting for Transparency Working Paper Series, No. 104, 2022) ("In this study, we investigate the effect of an innovative reporting standard, called mandatory disclosure rules (MDRs) which has the power to prevent individuals from exploiting tax evasion schemes such as the 'shell bank' loophole.").

256. *See* Noam Noked, Zachary Marcone & Alison Tsang, *The Expansion and Internationalization of Mandatory Disclosure Rules*, 13 COLUM. J. TAX L. 122 (2022); OECD, MANDATORY DISCLOSURE RULES, ACTION 12: 2015 FINAL REPORT (2015) (providing more background on MDRs).

257. *See* OECD, *supra* note 256, at 39–49 (providing more information on hallmarks under MDRs).

258. *See* Noked et al., *supra* note 256 (giving an overview of the current and historic geographic distribution of MDRs); Casi et al., *supra* note 255, at 1.

259. Noam Noked & Zachary Marcone, *Targeting Tax Avoidance Enablers*, 13 UC IRVINE L. REV. (forthcoming 2023).

260. Report, *supra* note 1, at 21.

1. Imposing Additional Due Diligence Requirements

The Finance Committee calls on Congress and the Treasury Department to "consider imposing additional due-diligence requirements on transfers between foreign financial institutions (FFIs) in situations involving large transfers of funds into relatively-small, closely held FFIs that pose an increased risk of tax evasion."[261] This recommendation aims to address the Finance Committee's finding concerning the weak monitoring of Brockman's companies by the Swiss banks that held their accounts.[262]

This recommendation does not specify what these increased due diligence requirements should be. Noting that this recommendation is addressed to both Congress and the Treasury Department, it is unclear whether Congress would need to amend the FATCA legislation to impose additional due diligence requirements. This would depend on the scope of these due diligence obligations, which is unclear from the recommendation.[263]

In addition, it is unclear why this recommendation only concerns fund transfers and not the maintenance of the financial assets of small, closely held FIs.[264] For this recommendation to be effective, FIs should regularly identify and report the owners of entity account holders where these entities are unregulated, non-commercial, and closely held. This is the solution proposed in this Article. Absent adopting this solution, it is unclear how additional due diligence requirements can address the "shell bank" loophole.

Finally, the Finance Committee's recommendation for the IRS to publish updated guidance to Swiss banks regarding the "reason to know" requirement under the applicable IGA is unlikely to address the "shell bank" loophole effectively. As noted, a bank is generally not required to report a U.S. owner of another FI even if the bank knows or has reason to know the U.S. tax status of that FI's owner.[265] While this recommendation would not close the "shell bank" loophole, it is still important to ensure that banks and other FIs comply with the "reason to know" requirement. For example, assume that the "shell bank" is eliminated as proposed in this Article and all "shell banks" are classified as Passive NFEs. These Passive NFEs and their controlling persons might provide false self-certifications and information concerning the controlling persons' tax residence. Banks and other FIs must act on their employees' actual knowledge as required under FATCA to

261. *Id.* at 7.

262. *Supra* Part II.B.

263. Report, *supra* note 1, at 7.

264. While there are FATCA withholding obligations on payments from participating FIs to nonparticipating FIs, the FATCA due diligence and reporting obligations generally apply to financial accounts maintained by the relevant FI. *See supra* Part I.A.

265. *See* text accompanying *supra* notes 180–181.

report such controlling persons if they know or have reason to know that they are U.S. persons.

2. *More Rigorous Screening of GIIN Applications*

The Finance Committee calls on Congress and the Treasury Department to implement more rigorous screening of GIIN applications.[266] This recommendation aims to change the "shockingly easy" process of registering an FI with the IRS and obtaining a GIIN.[267]

However, even if the IRS's resources were increased to screen each application for FI registration rigorously, it is unclear how this would resolve the "shell bank" loophole. As discussed in Part I, tax evaders can easily establish an entity that meets the FI definition.[268] The main concern is not fraud at the FI registration stage; it is the subsequent failure of the private entity to report its owners. More scrutiny at the FI registration stage would not detect this later non-compliance.

It is possible that the Finance Committee intended to suggest that the IRS should also investigate whether entities that wish to register as FIs have U.S. owners. But this investigation would be resource intensive. An entity owned by a U.S. person may conceal this fact from the IRS, which might not be able to detect it easily. In light of the high number of FIs that register with the IRS, rigorous vetting of applications might not be cost-effective.[269] Also, there may be ways to circumvent IRS scrutiny at the registration stage. For example, a U.S. person may avoid detection by becoming the entity's owner after registering it as an FI with the IRS. Notably, this approach is markedly different than the general design of FATCA, under which FIs must identify and report U.S. persons to the IRS. The recommendation that the IRS should identify whether entities that wish to register as FIs have U.S. owners means that it would be the IRS, not the FIs, that would need to investigate these entities' beneficial ownership.

3. *Strengthening the IRS Whistleblower Office*

The Finance Committee recommends that Congress and the Treasury Department expand the IRS whistleblower program.[270] It notes that the

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266. Report, *supra* note 1, at 7.

267. *Id.* at 6; *supra* Part II.B.

268. *Supra* Part I.B.

269. Also, if this measure only applies to new applications, it would not address entities that are already registered with the IRS. Investigating the latter entities' registrations would increase the required costs.

270. Report, *supra* note 1, at 7. For more on the IRS whistleblower program, see IRS, *Whistleblower Office*, https://www.irs.gov/compliance/whistleblower-office (last visited Jan. 27, 2023).

number of tax investigations stemming from whistleblower claims has been in sharp decline in recent years.[271] Historically, the U.S. whistleblower program has been important for tax enforcement.[272] A whistleblower also played a key role in reporting Brockman to the IRS. While Brockman was eventually caught, it was not FATCA reporting that exposed him. The Finance Committee states, "it appears Brockman's scheme may have gone undetected by the IRS and federal prosecutors were it not for evidence provided by a whistleblower and the cooperation of several co-conspirators."[273]

While strengthening the IRS whistleblower program would generally enhance tax enforcement and may occasionally detect tax evaders using a "shell bank" such as Brockman, this measure does not specifically address the "shell bank" loophole. Also, it is possible that many tax evaders using this loophole are not at risk of being reported by a whistleblower. This is because this loophole does not require the involvement of multiple parties with incriminating knowledge. While the tax evader may seek the assistance of service providers to set up an offshore company, handle its registration as an FI, and open a foreign bank account, these service providers may have no reason to know that this company facilitates tax evasion. The illegal conduct—the company's failure to report its owner—might not be known to anyone other than the tax evader who owns and manages the company. Thus, while this recommendation would enhance tax enforcement generally, it is unlikely to close this loophole effectively.[274]

4. *Increasing Enforcement Resources*

The Finance Committee calls on Congress to "increase IRS enforcement resources to ensure it has the manpower and infrastructure sufficient to audit complex financial structures involving high-net worth individuals, including undeclared offshore accounts."[275] It notes that the

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271. *See* Report, *supra* note 1, at 7.

272. *See, e.g.*, David Masclet, Claude Montmarquette & Nathalie Viennot-Briot, *Can Whistleblower Programs Reduce Tax Evasion? Experimental Evidence*, 83 J. BEHAV. EXPERIMENTAL ECON. 1, 10 (2019); Jaron H. Wilde, *The Deterrent Effect of Employee Whistleblowing on Firms' Financial Misreporting and Tax Aggressiveness*, 92 ACCT. REV. 247, 247 (2017); Alon Faiman, *"No One Likes a Tattle Tale," or Do They? Why the Implementation of Broad Definition of "Collected Proceeds" Under the Tax Whistleblower Program is a Major Win for Whistleblowers and Taxpayers*, 12 CHARLESTON L. REV. 173 (2018).

273. Report, *supra* note 1, at 3–4.

274. Brockman, as discussed in *supra* Part II.A, conducted his tax evasion scheme with the assistance of other persons, such as his attorney Evatt Tamine, who served as signatories. *See* Report, *supra* note 1, at 12–14. While some tax evaders may involve more parties in their schemes, there is no inherent or practical need for any parties other than the tax evaders to know about the non-reporting of the "shell bank" owners. As noted in the text accompanying *supra* note 82, many people hold financial accounts through private entities for legitimate reasons.

275. *See* Report, *supra* note 1, at 7. This proposal was made in response to a forty-percent reduction in IRS revenue agents since 2011 as measured in a report by the Government Accountability

IRS, at the time of the report, employed 40% fewer revenue agents than it had in 2011.[276] This additional funding could resolve the current state in which the "IRS [] does not have the personnel or capabilities to adequately monitor whether these offshore entities are properly identifying and reporting accounts belonging to U.S. persons."[277]

Similar to the previous recommendation, while increasing enforcement resources would expand the IRS's personnel and enforcement capabilities, this measure is not specific to the "shell bank" loophole. It is unclear whether any additional funding to the IRS would be used to detect tax evaders using this loophole. Most importantly, such resource-intensive enforcement efforts would not be the most cost-effective policy response because it is possible to close the "shell bank" loophole more effectively and at a lower cost following the solution proposed in this Article.[278] Instead of allocating resources to investigate hundreds of thousands of tax haven entities registered as FIs, our proposed solution would prevent these entities from operating as "shell banks" at a substantially lower cost.[279] Adopting this Article's solution would free up enforcement resources that the IRS could use elsewhere.

5. *Increasing Audits of Foreign Partnerships*

The Finance Committee calls for additional funding for audits of foreign partnerships.[280] It notes that "[t]he steep decline in IRS audits of partnerships, combined with the sharp increase in the number of partnerships and weak FATCA enforcement have created a permissive

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Office (GAO). *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-22-104960, TRENDS OF IRS AUDIT RATES AND RESULTS FOR INDIVIDUAL TAXPAYERS BY INCOME 28–29 (May 2022).

276. Report, *supra* note 1, at 7.

277. *Id.* at 17.

278. In general, cost-effectiveness analysis involves comparing a set of regulatory actions with the same desired outcome. *See* OFF. OF MGMT. & BUDGET, CIRCULAR A-4, 11 (Sept. 17, 2003) ("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).").

279. The relevant costs would include those for the banks and other FIs that would need to implement the FATCA due diligence and reporting obligations with respect to private entities currently registered as FIs. However, as discussed in *supra* Part III.A, these costs are unlikely to be high because such banks and FIs already implement FATCA and CRS, and they are required to identify the controlling persons of the private entities under AML laws. The IRS and foreign governments would still need to dedicate some resources for FATCA and CRS enforcement, as discussed *supra* in Part III.A in the context of preventing fraud, but such resources would be substantially lower than those needed to monitor and investigate hundreds of thousands of FIs as recommended by the Finance Committee.

280. *See* Report, *supra* note 1, at 8.

environment which allows the wealthy to conceal investment income using these entities."[281] It also notes that Brockman used foreign partnerships as part of his tax evasion scheme.[282]

The report does not explain the connection between the "shell bank" loophole and non-compliance involving foreign partnerships. The "shell bank" loophole could be used by tax evaders without any interest in foreign partnerships. For example, a "shell bank" could hold cash, portfolio investments, and other financial assets. While increasing audits of foreign partnerships may occasionally detect a "shell bank," this enforcement measure does not specifically target this loophole. This is not to say that increasing audits of foreign partnerships is not desirable on other grounds. However, it is not the most cost-effective policy response if the goal is to eliminate this loophole.

6. *Increasing Domestic Account Disclosures and International Coordination*

The Finance Committee's final recommendation has two parts. The first is a recommendation for Congress to increase the disclosure of domestic high-value financial accounts.[283] The second is a recommendation for Congress to "explore opportunities to increase information sharing and coordination between partner jurisdictions and more closely align reporting regimes" with the OECD's CRS.[284]

It is unclear how increasing the disclosure of domestic high-value financial accounts would address the "shell bank" loophole. This loophole enables U.S. persons to use foreign entities to hold offshore financial assets without being reported under FATCA. Domestic tax evasion, including round-tripping that involves a U.S. person making domestic investments through foreign entities while disguising the indirect U.S. ownership, is a different problem. Also, if round-tripping using "shell banks" was monitored more closely, tax evaders may reduce detection risk by investing in foreign assets. Similar to audits of foreign partnerships, increasing domestic disclosure requirements may occasionally expose a "shell bank," but this measure is unlikely to address this loophole effectively.

The Finance Committee's recommendation regarding international information sharing and cooperation appears to suggest that the United States should either join CRS or adopt a fully reciprocal FATCA information exchange. This would undoubtedly improve global tax transparency and roll back some of the features that make the United States

281. *Id.* at 8.
282. *See id.*
283. *See id.*
284. *Id.*

an attractive tax haven for non-U.S. persons.[285] However, as FATCA and CRS use similar FI definitions, the United States' participation in CRS would not close this loophole.

C. *Comparing Policy Responses*

The discussion above shows that the solution proposed in this Article has several advantages over the Finance Committee's recommendations in addressing the "shell bank" loophole. First, this solution does not require any Congressional action. The Treasury Department can publish guidance on the interpretation of the IGAs' FI definition as excluding "shell banks" and sign MOUs with IGA partners. Amendments to IGAs are likely unnecessary, and even if they are needed, they do not require Senate ratification.[286] The Treasury Secretary can amend the FATCA regulations and exclude "shell banks" from the FI definition.[287] In contrast, the Finance Committee's recommendations to Congress necessitate Congressional action, which is far from guaranteed.[288]

Second, this Article's proposed solution would effectively eliminate this loophole because it would address the problem at its root by imposing reporting obligations on third parties—the banks and other FIs that maintain private entities' financial accounts. The Finance Committee's recommendations would be less effective because they retain the existing framework under which private entities report their own owners. As noted, most of these recommendations do not specifically address this loophole.[289]

Third, this Article's proposed solution would resolve this problem at a substantially lower cost than additional enforcement actions and due diligence obligations. This solution does not require additional resources.[290] Therefore, this solution would be more cost-effective than the Finance Committee's recommended policy responses.[291]

Finally, narrowing the FI definition would considerably reduce the number of FIs worldwide. Reducing the number of FIs would have benefits

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285. *See* Noked & Marcone, *supra* note 75, at 184–97.

286. For an in-depth discussion on the legal status of IGAs, see Christians, *supra* note 46; Morse, *supra* note 46.

287. *See* text accompanying *supra* note 234.

288. This is especially true in a divided Congress, which is the state of affairs at the time of this Article.

289. As discussed in *supra* Part III.B, the recommendations to strengthen the whistleblower program, increase enforcement efforts generally, conduct more audits of foreign partnership, enhance reporting of domestic accounts, and align FATCA with CRS do not specifically address the "shell bank" loophole.

290. *See supra* Part III.A.

291. *See generally* OFF. OF MGMT. & BUDGET, *supra* note 278.

beyond eliminating the "shell bank" loophole. As there would be fewer FIs to monitor and audit, it would be easier for the IRS and foreign governments to ensure compliance among these FIs. Concentrating enforcement efforts on fewer FIs would likely result in a general improvement in the compliance of these FIs.[292]

It is important to note that some of the Finance Committee's recommendations may be desirable on grounds unrelated to this loophole. This Article analyzes these recommendations in the specific context of the "shell bank" loophole because the Finance Committee proposes them as policy responses aiming to "crack down on this type of abuse."[293] As noted, adopting this Article's solution would free up enforcement resources that the IRS could use elsewhere.

If the "shell bank" loophole is eliminated, some tax evaders might still escape detection by exploiting other weaknesses and loopholes in the tax system. Instead of holding reportable financial assets, they may hold assets that are not within the scope of FATCA and CRS, such as real estate, precious metals, or artwork.[294] Tax evaders may also exploit other loopholes in FATCA and CRS to circumvent reporting.[295] The Treasury Secretary recently noted that "[a]bsent our new investment in the IRS, the tax gap—the gap between taxes owed and those actually paid—was estimated at around $7 trillion over the next decade. Much of this was because the IRS lacked the resources to effectively audit wealthy taxpayers and complex businesses."[296] Even after closing the "shell bank" loophole, more enforcement efforts would be required to further curb tax evasion and noncompliance.

V. CONCLUSION

The Finance Committee's finding that the "shell bank" loophole creates widespread risks for offshore tax evasion threatens the fairness of the tax system. "Those who game the tax system by hiding their money in offshore accounts, . . . unfairly shift the tax burden to honest taxpayers who comply with their tax obligations," noted Senator Baucus when he first introduced the FATCA legislation.[297] FATCA was intended to put an end

292. *See generally* Leigh Osofsky, *Concentrated Enforcement*, 16 FLA. TAX REV. 325 (2014).
293. *See* Report, *supra* note 1, at 21.
294. *See* Noked, *supra* note 14, at 4–5. The OECD recently proposed to enhance international tax transparency on foreign-owned real estate. *See* OECD, ENHANCING INTERNATIONAL TAX TRANSPARENCY ON REAL ESTATE (July 2023).
295. *See* Noked, *supra* note 14, for further discussion on these loopholes.
296. *See* Janet L. Yellen, U.S. Sec'y of Treas., Remarks at the Swearing-In Ceremony for IRS Commissioner Danny Werfel (Apr. 4, 2023).
297. 155 CONG. REC. S10785 (Oct. 27, 2009) (statement of Sen. Baucus).

to offshore tax evasion.[298] However, as the Brockman case shows, FATCA falls short of these expectations.

This Article makes three contributions. First, it argues that the Finance Committee has overlooked the root cause of the "shell bank" loophole. Contrary to the Committee's view that this loophole is enabled by weak enforcement, the Article shows that this loophole results from a flawed design of the legal rules in the U.S. Treasury regulations and an overly broad interpretation of the "investment entity" definition in the IGAs. Under the overly broad FI definition, tax evaders can avoid reporting by holding financial assets through private entities classified as FIs. Second, the Article proposes a solution different from the Finance Committee's recommended policy responses. Excluding unregulated, non-commercial, and closely held entities from the FI definition would address the underlying problem enabling this loophole. Unlike the Finance Committee's recommendations, this solution does not require Congressional action or additional resources. Third, the Article considers the international challenges created by this loophole. It suggests that a similar solution should be applied to CRS to eliminate this loophole globally.

The Finance Committee's investigation into the "shell bank" loophole is an important step towards addressing serious problems in the tax system. As noted in the report, "[U]rgent steps need to be taken to ensure that the wealthy taxpayers are not abusing this 'shell bank' loophole and other weaknesses with FATCA enforcement to hide their assets offshore and evade paying their fair share."[299] Policymakers, regulators, academics, and tax law professionals should continue this work by identifying these weaknesses and promoting effective solutions.

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298. *See id.*
299. *See* Report, *supra* note 1, at 21.