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Scrutiny on the bounty - US IRS Voluntary Disclosure

23 FEBRUARY 2009

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CATEGORY:
ARTICLE

For years, Switzerland has had a reputation for secrecy and chocolates. US and UK authorities are sending a clear message to taxpayers: stick to the sweet stuff.

Swiss bank giant UBS entered into a deferred prosecution agreement last week under which it agreed to pay $780 million in fines and acknowledged that certain bankers assisted US taxpayers in concealing ownership or beneficial interest in accounts. UBS further agreed to the monumental step of turning over the names of 250 to 300 of these individuals who were determined to have committed tax fraud under Swiss rules. Notwithstanding this historic agreement, the very next day the US government filed a new subpoena in Miami federal court seeking full enforcement of its July 2008 UBS 'John Doe' subpoena and increasing the number of alleged US 'undeclared accounts' at UBS to 52,000.

The increased pressure on UBS and other banks comes amid increasing acrimony directed toward offshore financial centres more generally. Immediately following the US – UBS agreement, European governments called for similar information exchange 'courtesies'. Gordon Brown last week called for governments worldwide to combat financial secrecy and pledged to make this a top priority at the G20 summit of leading industrial nations in April. Over the weekend, a pre-G20 meeting of European leaders resulted in statement calling for new sanctions against so-called 'tax havens'; a list of such jurisdictions is to be published by 2 April. Additional fuel is simultaneously be added to the fire with the developing Antigua based Stanford Group scandal. These events follow on the heels of the US presidential election in which Barack Obama took aim at offshore jurisdictions allegedly costing the US $100 billion in annual tax revenues.

The IRS Commissioner has pledged to pursue tax cheats in Switzerland and elsewhere and urged those with unreported assets 'to get right with their government'. The US taxpayers for whom LGT account information was obtained by the IRS in 2007 are currently undergoing IRS audits (in which penalties asserted by IRS can not only wipe out the offshore account balance but also create additional personal exposure), and a Senate committee is investigating the recent disclosure of leaked files of the Cayman branch of Julius Baer, which highlights the perils of secrecy in the digital age.

Individuals looking to 'get right' with the IRS can do so through the Service's voluntary disclosure process. However, this process is not available to individuals who have been identified by the IRS or have already been notified of an audit or investigation. According to IRS Commissioner Doug Shulman, 'having the IRS find you could mean a much heavier price than coming forward on your own'. Penalties for these offences are expected to greatly increase in the near future, as the President and Congress commit their current proposals to written legislative bills.

The remainder of this Stop Press focuses on the application of these developments to US taxpayers, whether they be citizens or green card holders regardless of where they live in the world and non-US persons tax resident in the US.

Voluntary Disclosure

The IRS's voluntary disclosure procedure allows US taxpayers to mitigate the risk of criminal prosecution by filing six years of amended income tax returns and foreign bank account reporting forms ('FBARS'), and paying the associated tax liabilities, penalties and interest on the foregoing amounts. US taxpayers with undeclared foreign accounts who desire more certainty with respect to their criminal exposure can alternatively elect to participate in a different form of voluntary disclosure, in which their attorney negotiates in advance (on an anonymous basis) for an IRS/Department of Justice agreement not to prosecute prior to their filing the amended income tax returns and FBARS.

Importantly, not all failures to file accurate US income tax returns and FBARs result in criminal exposure. Criminal liability depends on whether these failures were 'wilful'; if so, the felonies of 'attempt to evade and defeat' (income tax evasion) and 'fraud and false statements' (filing false tax returns under penalties of perjury) *are complete at the moment the inaccurate returns are filed* (so merely amending these returns without further action does not remove the felony risk). For example, 'wilfulness' exists when the taxpayer knew *or should have known* they were required to include income from the undeclared foreign accounts on filed US income tax returns, and answer truthfully the question on Schedule B of these returns regarding their financial interest in, or signatory authority with respect to, a foreign account. It is becoming increasingly difficult for US taxpayers to argue that their omissions are not wilful, particularly in light of the significant amount of press coverage regarding undeclared foreign accounts over the last two years.

Timing is crucial for those with unreported assets. Once the IRS is alerted to a taxpayer's non-compliance, that individual is no longer eligible for the voluntary disclosure procedure.

Continued assault on offshore centres

Between 2002 and 2007, UBS's cross-border private banking department is alleged to have concealed $18 billion for US clients, depriving the IRS of $300 million a year in taxes. To date, only a fraction of the US clients who allegedly hid assets have been reported to US authorities. UBS and the Swiss government have refused to turn over additional client information, citing strict Swiss secrecy laws that prohibit disclosure of such information unless the individual in question has committed a crime under Swiss law, such as tax fraud. Switzerland does not recognize tax evasion through undisclosed accounts as tax fraud without further fraudulent activity, such as falsifying documents; otherwise, disclosure of client data generally is prohibited. While the 2003 Information Exchange Agreement supplementing the US – Switzerland Income Tax Treaty appears to entitle the US to information even if tax fraud under Swiss law is not present, its exact application to the UBS accounts remains to be determined. The IRS subpoena described herein describes in detail UBS's direction of falsified account, entity and US tax documents, presumably in an attempt to bring this activity within the ambit of the Treaty exchange of information provisions.

US authorities, led by the Department of Justice, have pledged to seek additional client names and have threatened to issue indictments if their demands are not met. It is unclear how this international dispute will be resolved, but cooperation by Swiss authorities would eliminate the opportunity for named taxpayers to negotiate a waiver of criminal prosecution with the IRS.

The Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations has announced a hearing on offshore 'tax havens' for early March, which will focus on obtaining the names of US clients with unreported accounts. This subcommittee is headed by Senator Carl Levin, the primary sponsor of the Stop Tax Haven Abuse Act, which was introduced in 2007 with then-Senator Obama as a co-sponsor but was never enacted.

Senator Levin has promised in recent weeks to reintroduce similar legislation aimed at preventing taxpayers from sheltering taxable assets in offshore jurisdictions. In broad terms, such legislation would force taxpayers to prove that they do not have control over offshore entities with which they contract. US individuals would be presumed to control entities such as trusts and corporations created or domiciled in targeted offshore jurisdictions if the US person directly or indirectly formed, received assets from or is a beneficiary of that entity. The legislation would also heighten penalties and gives the IRS more latitude in investigations.

Foreign account filing requirements

Coming clean with the US government is not limited to filing back income tax returns. For example, US citizens, green card holders, residents and individuals 'in and doing business in' the US who have a financial interest in or signature authority over financial accounts in foreign countries exceeding $10,000 in the aggregate are required to file FBARs by 30 June of each year. Failure to file an FBAR can be a felony offence. Civil penalties (absent a felony) are imposed at the greater of $100,000 or 50 percent of the account balance for each year and each account, and criminal penalties also are possible. Often, US taxpayers are not aware this obligation exists if, for example, someone is appointed under a power of attorney over a foreign account (even if the power is conditional upon some event that has not yet occurred); for US taxpayers that are trust protectors when the trust has a foreign account; and for CFOs (and other corporate signatories) of companies formed or doing business in the US (and certain affiliated subsidiaries) with foreign accounts unless the company itself provides written evidence to the otherwise potentially obligated employee each year that it has satisfied the FBAR filing obligations.

Recent changes to the FBAR form have broadened the scope of accounts that trigger a filing obligation. A "financial interest' in an account exists where one is an agent or nominee, a corporation in which the US individual owns directly or indirectly more than 50 percent of the shares or controls more than 50 percent of the voting power, and a trust if US individuals have a present beneficial interest (direct or indirect) in more than 50 percent of the assets or from which such individuals receive more than 50 percent of the current income.

Conclusion

US authorities are aggressively pursuing information about taxpayers with unreported assets. By engaging a tax professional and coming forward under the voluntary disclosure process, a taxpayer can give himself the best opportunity to negotiate a criminal non-prosecution agreement and minimize civil liabilities. Those US taxpayers with unreported assets should come forward now before the opportunity to avoid criminal prosecution is lost.

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