

## TAX LITIGATION ISSUES

BY JOHN J. TIGUE JR. AND JEREMY H. TEMKIN

### *The Internal Revenue Service's Offshore Tax Initiative*

Recent press reports have described the Internal Revenue Service's (IRS) pursuit of an employee of the Swiss bank UBS and certain of the bank's American clients.

Such efforts are hardly new. Rather, for years, the IRS has periodically declared its "increased" focus on abusive tax schemes and overseas tax shelters. In furtherance of these efforts, the IRS has offered initiatives to encourage self-reporting by taxpayers, relied on information obtained pursuant to U.S. law to ferret out possible wrongdoing through use of overseas tax havens, and sought information from financial institutions that execute overseas transactions for their clients.

Beyond the recent press coverage, the government's efforts in this respect may reflect the IRS' increased focus on wealthy individuals in order to close the "tax gap" and bring money into the government's coffers.

#### Methods of Gathering Information

One of the ways in which the IRS is alerted to possible tax evasion is through legislation initially intended to combat money laundering and/or terrorism. The Bank Secrecy Act of 1970 (the BSA) requires U.S. financial institutions to assist the government in detecting and preventing money laundering by: (i) maintaining records of cash purchases of negotiable instruments; (ii) filing reports of daily aggregate cash transactions exceeding \$10,000; and (iii) reporting suspicious activity that might signify criminal activity.<sup>1</sup>

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Section 5314 of the BSA requires persons subject to the jurisdiction of the United States to report transactions with a foreign financial institution. The regulations promulgated under this section require taxpayers to report to the IRS any "financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country."<sup>2</sup> Such information is provided on a Report of Foreign Bank and Financial Accounts or FBAR. The FBAR is not attached to a taxpayer's Form 1040, but is a separate form required under the regulations.<sup>3</sup> FBARs, and all other reports required by the BSA, are kept in two different databases: one maintained by the IRS and another maintained by the Treasury Department's Financial Crimes Enforcement Network (FinCEN), which is used by a variety of federal law enforcement agencies for criminal investigations. The information is used to identify suspicious transactions that might be indicative of other criminal activity or to evaluate the merits of already-pending criminal prosecutions.<sup>4</sup>

The USA Patriot Act, enacted primarily to investigate, deter and punish terrorist acts, also contains provisions that affect financial institutions. Provisions of the USA Patriot Act strengthen the government's ability to seize foreign funds, require U.S. financial institutions to establish anti-money-laundering programs, and expand the requirements for

filing suspicious activity reports to investment companies and individuals registered with the Securities Exchange Commission (SEC).<sup>5</sup> Like the BSA, the USA Patriot Act generates information through which the IRS can identify Americans who may be sheltering income offshore.

The IRS also relies on information gathered through summonses issued to various financial institutions to investigate possible tax evasion. The IRS has the authority to seek broad information from banks and other financial institutions pursuant to 26 U.S.C. §7609(f). This provision allows the government to file an ex parte petition seeking leave to serve a "John Doe" summons, which "does not identify the person with respect to whose liability the summons is issued." Rather, the summons can describe or identify one or more persons or transactions generally. To be successful in its application, the IRS must establish: (i) a relationship between the summons and the investigation of a particular person or ascertainable group or class of persons; (ii) a reasonable basis for believing that the person or group or class of persons may fail or may have failed to comply with any provision of any internal revenue law; and (iii) the unavailability of the information sought (including the identity of the taxpayers involved) from other sources.<sup>6</sup>

#### Government's Focus on These Issues

In many ways, the government's recent focus on Swiss bank accounts is a reprise of earlier efforts. In August 2006, the Senate Subcommittee on Permanent Investigations released a 370-page report criticizing multimillion-dollar tax-avoidance schemes used by wealthy individuals and drawing attention to what it concluded was a "more than \$40 billion-a-year drain on federal

coffers by offshore tax scams.”<sup>7</sup> In its report, the subcommittee noted that offshore tax-avoidance schemes had been the subject of investigations since the early-1980s and that “[t]he evidence is overwhelming that inaction in combating offshore abuses has resulted in their growing more widespread and reaching new levels of sophistication.”<sup>8</sup>

On Aug. 1, 2006, then-Commissioner Mark Everson testified before the Senate subcommittee to detail the IRS’ actions with respect to offshore tax shelters. Commissioner Everson noted that the most significant hurdle for the IRS was the financial privacy laws in foreign jurisdictions. “These jurisdictions deliberately attract foreign business with government policies such as enacting incentives that minimize or mitigate tax, ‘business friendly’ regulatory/supervisory regimes...and secrecy enforced by law.”<sup>9</sup>

Commissioner Everson outlined initiatives the IRS had taken in response to concerns regarding tax evasion through the use of offshore accounts. For example, in 2000, the IRS started summoning information from international credit card companies, including American Express, MasterCard and Visa, regarding transactions in the United States that were billed to bank accounts in Caribbean countries. In upholding the IRS’ right to seek years’ worth of records relating to hundreds of thousands of unspecified (“John Doe”) taxpayers, Judge Adalberto Jordan of the U.S. District Court for the Southern District of Florida found that the IRS had demonstrated a “reasonable basis” that Americans with accounts in the Bahamas, Cayman Islands, and Antigua and Barbuda may be skirting American tax laws and that those countries had a “reputation of being offshore tax havens and financial privacy jurisdictions” suggesting tax avoidance.<sup>10</sup>

This investigatory effort, called the Offshore Credit Card Program, was designed to identify taxpayers who used credit or debit cards issued by banks in secrecy jurisdictions to repatriate unreported income hidden in offshore accounts. Estimating that there could be one to two million U.S. citizens with credit issued by foreign banks, the IRS committed additional resources to investigate potential tax evasion by such individuals.<sup>11</sup> By July 2003, the program had enjoyed modest success: the IRS had assessed more than \$3 million in unreported taxes and referred “dozens” of cases to its criminal investigation unit for possible action.<sup>12</sup>

The IRS also offered a carrot to possible tax violators. In 2002, it initiated the Offshore Voluntary Compliance Initiative (OVCI)

aimed at bringing taxpayers who had used offshore financial arrangements to hide their income back into compliance with the law by offering to waive civil fraud and information return penalties. In its press release announcing the OVCI, the IRS made clear that: “[i]t is not illegal to have an offshore credit card. However, there is a reasonable basis for believing that some people are using offshore credit cards to evade paying U.S. taxes. Credit cards provide easy access to offshore funds and accounts in tax haven countries that allow income to be hidden.”

The OVCI was more lucrative than the IRS’ investigatory efforts. In August 2006, Commissioner Everson reported that the OVCI had resulted in 1,321 applications representing 3,436 returns, identification of 230 tax shelter promoters previously unknown to the IRS, and the collection of over \$270 million in taxes at a cost of approximately \$2 million.<sup>13</sup> Mr. Everson predicted that the revenues would continue to grow as investigators continued to look into “significant incidences of FBARs that are not filed and significant incidences of potential fraud on unreported income.”<sup>14</sup>

In February 2007, the Senate Subcommittee

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on Permanent Investigations proposed legislation aimed at reducing the “\$100 billion a year in tax revenue lost each year because of overseas tax havens.” The bill would impose stringent requirements on U.S. taxpayers using offshore secrecy jurisdictions and give the U.S. Treasury authority to act against a foreign jurisdiction that impedes tax enforcement.<sup>15</sup> In addition, hedge funds would be forced to track their foreign investors.<sup>16</sup> The bill currently is pending before the Senate Committee on Finance and House Subcommittee on Courts, the Internet and Intellectual Policy.

### **Recent Enforcement Efforts**

Experiencing some success with the Offshore Credit Card Program, the IRS is again seeking confidential client information

from financial institutions in order to discover possible tax abuses. In May 2008, a grand jury indicted Bradley Birkenfeld, a UBS employee and U.S. citizen residing in Switzerland, and Mario Staggli, a Liechtenstein citizen and resident who owns and operates a Liechtenstein trust company, New Haven Trust Co. Ltd., for conspiring to defraud the United States by assisting Igor Olenicoff, an American billionaire, evade income taxes on approximately \$200 million of assets hidden in Swiss and Liechtenstein bank accounts.<sup>17</sup>

Specifically, the indictment alleged that the defendants participated in a scheme to defraud the IRS by falsifying Swiss bank documents and required IRS Forms, by failing to prepare IRS Forms W-9, by setting up nominee entities, by failing to issue IRS Forms 1099, and by failing to comply with the terms of a Qualified Intermediary Agreement between UBS and the IRS in order to conceal United States-source income paid into Swiss bank accounts.<sup>18</sup>

Just last month, Mr. Birkenfeld pleaded guilty to helping Mr. Olenicoff evade \$7.2 million in federal income taxes and agreed to cooperate with prosecutors. Mr. Olenicoff also has pleaded guilty to filing a false 2002 tax return. Further, a delegation including members of the Swiss government and individuals from the private sector have traveled to Washington to meet with Justice Department officials to provide “additional information.”<sup>19</sup> At issue is whether UBS employees failed to file certain tax forms as required by law and separate agreements UBS had with the U.S. government.

Media reports suggest that in connection with the growing investigation, UBS is under pressure from government authorities to reveal the names of up to 20,000 of its wealthiest American clients, “a step that would have once been unthinkable to Swiss bankers, whose traditions of secrecy date to the Middle Ages.” As with offshore credit cards, having an offshore bank account is not illegal, but using such an account to hide income from the IRS is, and federal investigators have claimed that U.S. clients may have used UBS accounts to hide approximately \$20 billion in assets from the IRS, resulting in at least \$300 million due and owing in federal taxes.<sup>20</sup>

On June 30, 2008, the government filed an ex parte petition pursuant to §7609(f), asking a federal court to allow them to summon UBS to turn over the names of wealthy clients suspected of evading taxes through secret offshore accounts. The petition to serve John Doe summonses was granted the following day. Although UBS has indicated its intention to

cooperate with the U.S. government in its investigation,<sup>21</sup> it likely will find itself in a bind between that inquiry and its obligations under Swiss law to maintain the privacy of its clients' information. Subject to treaties and MLATs (Mutual Legal Assistance Treaties), it is a crime for bankers to violate the secrecy of their clients under Swiss law. For this reason, banks typically refuse to produce records to foreign tax authorities unless ordered to do so by a Swiss court. To obtain such an order, investigators must show the "probable violation of Swiss law and that there is reason to believe the particular account at issue is involved in that violation." While nonpayment of foreign taxes is not a crime in Switzerland, tax fraud is and it is on this hook that U.S. investigators are likely to hang their hat.<sup>22</sup> Moreover, while the current summons only involves UBS and its clients, IRS Commissioner Doug Shulman has stated that the court's order clears the way for the IRS to "take the next steps" against others with foreign accounts holding unreported income.

## Efforts Likely to Continue

In May 2008, at a conference on cross-border tax issues, Alan Astengo, a foreign residency compliance international team manager with the IRS' Large and Mid-Size Business Division, participated in a panel discussion entitled "International Audits: Current Enforcement Concerns and Common Issues." He noted that the IRS has a number of "vibrant and robust" tools at its disposal to obtain highly specific information about taxpayers' international financial activities, and that the IRS can use "summonses, treaties, tax exchange information agreements, summonses for offshore bank records, and formal document requests" to obtain such information and "is investing more money up front to find offshore tax evasion schemes."<sup>23</sup>

Such investigations are time-consuming. According to data collected by the IRS, the average offshore tax evasion audit takes almost three times as long as other types of audits. For these reasons, in May 2007, the Government Accountability Office recommended that the statute of limitations be extended in cases involving overseas accounts to allow agents to develop and complete investigations involving "highly complex transactions, in small, remote jurisdictions," noting that the U.S. Treasury would benefit in the long run.<sup>24</sup>

A tax practitioner who served on the panel with Mr. Astengo predicted that the IRS'

international focus is likely to continue, saying that with the increase in the U.S. national deficit the IRS is under growing pressure to shrink the tax gap and bring in dollars and has a specific focus on significant unreported international transactions. "The IRS is investing money up front. You're going to see a lot more [overseas investigations]. They think there is significant revenue out there."<sup>25</sup>

## Conclusion

The recent high-profile UBS investigation is evidence that the government is increasing its scrutiny of offshore transactions. In addition, the recent decision allowing the government to serve John Doe summonses on UBS is an example of the courts' willingness to allow the IRS to obtain confidential client information from financial institutions. Coupled with predictions that the government is motivated to heighten its efforts in this area given the gap between expected and realized tax revenues, it is likely that the government's efforts will expand beyond UBS in the coming months.



1. 31 U.S.C. §5311 et seq.
2. 31 CFR 103.24.
3. Secretary of Treasury, "A Report to Congress in Accordance With §361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001," (April 24, 2003).
4. Mark F. Sommer, "Disclosure of Currency Transaction Violations: When, How, and What if You Don't?" 47 Tax Law. 139 (1993).
5. Pub. L. No. 107-56, §§319, 352, 356 (Oct. 26, 2001).
6. L. Richard Fischer, "The Law of Financial Privacy," ¶3.05[2] (2007).
7. Jeffrey H. Birnbaum, "Tax Shelters Saved Billionaires a Bundle," Washington Post (Aug. 1, 2006); David Cay Johnston, "Tax Cheats Called Out of Control," The New York Times (Aug. 1, 2006).
8. Minority & Majority Staff Report, United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, "Tax Haven Abuses: The Enablers, the Tools and Secrecy" at pp. 1-2 (Aug. 1, 2006).
9. Written Testimony of Commissioner of Internal Revenue Mark Everson Before Senate Committee on Homeland Security and Governmental Affairs' Permanent Subcommittee on Investigations Hearing on Offshore Abuses: The Enablers, the Tools and Offshore Secrecy at p. 6 (Aug. 1, 2006) ("Everson testimony").
10. *United States v. Doe*, 2000 WL 34538137 (S.D.Fla. Oct. 30, 2000); see also, *In re Tax Liabilities of John Does*, 2002 WL 32881074 (S.D.Fla. Oct. 31, 2002) (granting the IRS' ex parte petition for leave to file John Does summonses to obtain MasterCard data).
11. Press Release, Internal Revenue Service, "IRS Sets New Audit Priorities" (September 2002).
12. Internal Revenue Service Press Release,

"Offshore Compliance Program Shows Strong Results," (July 30, 2003).

13. Everson testimony at p. 7; see also Internal Revenue Service Press Release, "IRS Unveils Offshore Voluntary Compliance Initiative; Chance for 'Credit-Card Abusers' to Clear Up Their Tax Liabilities," (Jan. 14, 2003).

14. Everson Testimony at p. 8.

15. See, e.g., John J. Tighe Jr. and Jeremy H. Temkin, "The United States' Role in Foreign Tax Evasion Cases," New York Law Journal (March 16, 2006).

16. Senator Carl Levin Press Release, "Levin, Coleman, Obama Introduce Stop Tax Haven Abuse Act" (Feb. 17, 2007); Mark Drajem and Ryan J. Donmoyer, "Senators Set Sights on Overseas Tax Havens," Washington Post (Feb. 18, 2007).

17. Press Release, United States Attorney's Office for the Southern District of Florida, "Foreign Bankers Charged With Aiding American Billionaire Evade Income Tax on \$200 Million" (May 13, 2008).

18. Indictment, *United States v. Birkenfeld*, 08-60099 (filed April 10, 2008).

19. Lynnley Browning, "Ex-Banker Pleads Guilty in Tax Evasion," The New York Times (June 20, 2008).

20. Lynnley Browning, "Wealthy Americans Under Scrutiny in UBS Case," The New York Times (June 6, 2008).

21. Associated Press, "Judge: IRS Can Seek Tax Info From UBS," (July 1, 2008).

22. See Bob Bauman, "Does UBS Have the Guts to Fight?" That's the Way it Looks From Here Blog (July 3, 2008) (available at <http://baumanblog.sovereignsociety.com/2008/07/does-ubs-have-t.html>).

23. The Bureau of National Affairs, "IRS Focusing on Specific Information on Taxpayer Offshore Financial Activities," U.S. Law Week (May 13, 2008).

24. Id.

25. Id.