New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
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An ALM Publication
VOLUME 243—NO. 9
THURSDAY, JANUARY 14, 2010

TAX LITIGATION ISSUES

Expert Analysis

Offshore Banking: the End Of the World as We Know It?

By **Jeremy H. Temkin**

In 2007, the Internal Revenue Service's efforts to clamp down on offshore tax-avoidance schemes received a boost (and holders of undisclosed offshore accounts received a shock) when Bradley Birkenfeld, a UBS banker, agreed to cooperate with the government. The Birkenfeld disclosures breathed new life into the government's pursuit of offshore accounts, which reportedly result in a "more than $40 billion-a-year drain on federal coffers."[1]

In addition to pursuing criminal charges against offshore accountholders whose names have been disclosed, on March 23, 2009, the IRS sought to encourage accountholders to "come clean" by announcing a reduced penalty structure for taxpayers who availed themselves of its longstanding voluntary disclosure practice.

This special voluntary disclosure program ended on Oct. 15, but the government's efforts in this arena are still in high gear. Not only has the government extracted a commitment from UBS to disclose the names of approximately 4,450 U.S. taxpayers who held previously undisclosed accounts, but the IRS has indicated that it will be pursuing other foreign banks for information regarding their U.S. clients. These efforts have been supported by the Obama administration, which has stated that it intends to raise revenues by "crack[ing] down on 'illegal overseas tax evasion.'"[2] And Congress has gotten into the act, proposing legislation to enhance the IRS's ability to combat offshore tax abuses.

Given the government's continuing pursuit of offshore tax-avoidance schemes, it appears that taxpayers will continue to seek advice from lawyers and accountants regarding the implications of their previously undisclosed offshore accounts.

The IRS Initiative

The background of the IRS's recent focus on offshore accounts is well documented.[3] In 2007, Mr. Birkenfeld agreed to cooperate with an investigation of tax evasion by his U.S. clients.[4] This led to the issuance of a "John Doe summons" to UBS seeking information about U.S. taxpayers who may be using Swiss bank accounts to evade their federal income taxes.

The publicity surrounding the IRS's investigation and the John Doe summons caused many nervous accountholders to seek advice from criminal defense lawyers. While the IRS's existing Voluntary Disclosure Practice was one way for taxpayers to bring themselves into compliance with their obligations while obtaining a substantial measure of comfort that they would not be prosecuted criminally,[5] potentially devastating civil penalties made the financial risk associated with voluntary disclosure intolerable for many taxpayers. To alleviate the uncertainty, on March 23, 2009, the IRS provided guidance to offshore accountholders regarding the somewhat reduced penalties that would be imposed if they were accepted into the voluntary disclosure program.

On Nov. 17, 2009, Commissioner of Internal Revenue, Douglas Shulman, announced that approximately 14,700 taxpayers had come forward by the program's Oct. 15 deadline, generating billions of dollars in taxes, interest and penalties.[6] While the participation was nearly double Mr. Shulman's estimate in the middle of October, and more than 10 times the response to a previous IRS initiative aimed at Americans who evaded taxes through the use of offshore credit cards,[7] given reports that there were 52,000 previously undisclosed accounts at UBS alone, it is hard to view the program as an unqualified success.

> The government's aggressive pursuit of all avenues used to conceal U.S. income offshore is clearly continuing.

Additional Names on the Way

One factor that increased participation in the voluntary disclosure program was the August 2009 announcement that UBS and the Swiss and United States governments had reached an agreement resolving litigation over the John Doe summons. Under that agreement, UBS will provide information regarding approximately 4,450 U.S. investors with UBS accounts.[8]

In November, IRS Commissioner Shulman unveiled the criteria that UBS would use to identify the investors whose names would be turned over to the IRS pursuant to the agreement. Under the criteria, UBS will provide the names of taxpayers (1) "for which a reasonable suspicion of 'tax fraud or the like' can be demonstrated" and (2) who are (a) U.S. domiciled clients of UBS who directly held and beneficially owned "undisclosed (non-W-9) custody accounts" and "banking deposit accounts" with more than one million Swiss francs at any point from 2001 through 2008; or (b) U.S. persons who beneficially owned "offshore company accounts" from 2001 through 2008.

Moreover, accounts with as little as 250,000 Swiss francs will be disclosed if there is evidence the accountholder concealed assets and underreported income through a "scheme of lies." Similarly, accounts that generated an average of 100,000 Swiss francs in revenue over a three-year period will be disclosed if the taxpayer failed to provide a Form W-9.

While Mr. Shulman asserted that the 4,450 investors to be disclosed were those most suspected of committing "acts of continued serious violations of tax law" and "most likely to have been involved in U.S. tax evasion,"[9] the criteria set forth in the August 2009 agreement is not without its critics. Senator Carl Levin (D-Mich), chairman of the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, has asserted that "the tortured wording and the many limitations in [the agreement] shows the Swiss government trying to preserve as much bank secrecy as it can for the future, while pushing to conceal the names of tens of thousands of suspected U.S. tax cheats. It is disappointing that the U.S. government went along."[10]

Further Enforcement Efforts

Given the pro-enforcement climate (combined with the need to increase revenues without taking the politically unpopular step of raising taxes), it is clear that investigation of offshore accountholders will not be limited to the 4,450 names to be provided by UBS. According to Mr. Shulman, the IRS plans to scour the data gathered through the voluntary disclosure program to identify patterns of abuse at financial institutions and among advisers. Of course, UBS was not the only foreign bank at which U.S. taxpayers had undisclosed accounts, and the IRS has indicated that it will continue to pursue information from other banks.[11] The IRS's ability to identify and pursue offshore accountholders will be enhanced by a $400 million increase in tax enforcement funding in the 2010 federal budget.[12]

Recognizing the political benefits in being perceived as cracking down on tax cheats, on Oct. 27, 2009, several senior senators and congressmen introduced the Foreign Account Tax Compliance Act of 2009. The bill, which was the product of consultation with

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the Treasury Department, is intended to provide "a comprehensive proposal to clamp down on tax evasion and improve taxpayer compliance by giving the IRS new administrative tools to detect, deter and discourage offshore tax abuses."[13]

The bill imposes substantial withholding and reporting obligations on non-U.S. private investment funds and other "foreign financial institutions," greatly expanding the traditional definition to include "any entity that is in the business of holding, investing, reinvesting, or trading investment type assets." Additionally, the bill will increase the statute of limitations for the imposition of tax, interest and penalties from three years to six years for taxpayers who omit more than $5,000 of income attributable to one or more foreign assets. The proposal would also require electronic filing of information reports about withholding on transfers to foreign accounts to enable the IRS to better match reports to tax returns.[14]

Predicament

In addition to increased enforcement efforts and a longer statute of limitations, taxpayers who did not participate in the voluntary disclosure program in response to the March 23 guidance will soon be preparing their 2009 tax returns. These returns will again require the taxpayers to report income generated from their offshore accounts and to disclose the existence of those accounts both on Schedule B of their tax returns and on the required Report of Foreign Bank and Financial Accounts (FBAR) form.[15] Accordingly, even those who missed the Oct. 15 deadline should consider the benefits of making a voluntary disclosure.

As an initial matter, practitioners advising these clients must assess whether the disclosure will be timely, which means it must be made before the IRS has initiated an audit or otherwise obtains information about the taxpayer's non-compliance. Since last September, in notifying its current and former clients that their accounts might be among those disclosed, UBS has explicitly told accountholders that they are still eligible to make a voluntary disclosure. Indeed, it appears that even those taxpayers who have been informed that their accounts are among the 4,450 to be disclosed may qualify for the voluntary disclosure program until such time as their names are actually turned over to the IRS.

Despite the substantial comfort that a successful voluntary disclosure will provide to taxpayers regarding potential criminal sanctions,[16] taxpayers who now seek to enter the voluntary disclosure program are ineligible for the reduced penalty provisions offered under the March 23, 2009, guidance. Thus, in addition to paying back taxes and interest on all previously unreported income, the taxpayer can be liable for a fraud penalty of up to 75 percent of the previously unpaid taxes and FBAR penalties of up to 50 percent of the balance of the offshore account for each year an FBAR was not filed. Thus, these taxpayers face a great deal of uncertainty regarding the extent of the penalties they will have to pay.

While it is doubtful that late-comers will receive more favorable penalty treatment than was set forth under the March 23, 2009, guidance, one of the complaints regarding the voluntary disclosure program was that its "one size fits all" penalty approach ignored the wide range of purposes served by offshore accounts. For instance, a taxpayer who had an account in a foreign country where he or she resided (and paid all applicable taxes in that country) was treated the same as a taxpayer who put undeclared income into an offshore account specifically for the purpose of concealing both the initial income and subsequent interest and dividends. Under the March 23 pronouncement, both taxpayers were subject to the same penalties, a result that can be perceived as unfair to the former taxpayer and a windfall to the latter.

The practitioner retained by a taxpayer with a previously undisclosed account should also consider making a "quiet disclosure," by which the client files amended tax returns together with the additional taxes and interest owed, without making a formal disclosure to the IRS. Although taxpayers making such a "quiet disclosure" do not pay penalties in the first instance, the IRS previously made clear that taxpayers who made quiet disclosures before Oct. 15, 2009, would only receive the benefit of the favorable penalty structure under the March 23 pronouncement if they availed themselves of the targeted overseas voluntary disclosure program.[17] Assumedly, the IRS will continue to treat taxpayers who make "quiet disclosures" less favorably than those who make formal voluntary disclosures.

Finally, there are several taxpayers whose efforts to participate in the voluntary disclosure program were rejected because they were among the 225 names that UBS disclosed in February 2009, when it entered into a deferred prosecution agreement with the government. At the time, several practitioners complained that UBS had deprived these taxpayers of the opportunity to participate in the voluntary disclosure program even though the facts and circumstances surrounding their accounts were no more egregious than those of taxpayers whose accounts were not disclosed.

> The Foreign Account Tax Compliance Act of 2009 is intended to provide 'a comprehensive proposal to clamp down on tax evasion and improve taxpayer compliance by giving the IRS new administrative tools to detect, deter and discourage offshore tax abuses.'

On Jan. 7, 2010, the Federal Administrative Court in Bern ruled that the Swiss Financial Market Supervisory Authority exceeded its authority when it ordered UBS to release the names to avoid criminal prosecution or possible insolvency.[18] It is, however, unclear whether the U.S. government will give consideration to these taxpayers, whose ineligibility for voluntary disclosure was predicated on UBS's violation of Swiss law.

Conclusion

The government's aggressive pursuit of all avenues used to conceal United States income offshore is clearly continuing. The IRS's most recent tax initiative has resulted in a large number of voluntary disclosures by taxpayers holding previously undisclosed offshore accounts. Many of these disclosures were attributable to the government's continuing pursuit of UBS, which many believe may serve as a "template for how the IRS obtains account information from other Swiss banks."[19]

Describing proposed legislation, Deputy Attorney General David W. Ogden has said that "[t]he message to American taxpayers is clear: the era of bank secrecy and hidden assets is over. We will continue to work closely with the IRS and our international partners to ensure that our tax laws are enforced fully and fairly, and that the rule of law is vindicated."[20] Whether this will hold true remains to be seen.

1. 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).
2. John D. McKinnon, "White House Leans Towards Tighter Enforcement of Taxes," Wall Street Journal (March 26, 2009).
3. Prior articles in this column have documented the government's ongoing battle against secret offshore tax havens. See Jeremy H. Temkin, "One Last Chance for Offshore Account Holders," NYLJ (May 14, 2009); John J. Tigue and Jeremy H. Temkin, "The Internal Revenue Service's Offshore Tax Initiative," NYLJ (July 17, 2008); John J. Tigue and Jeremy H. Temkin, "The 'New' IRS Voluntary Disclosure Policy," NYLJ (Jan. 16, 2003); John J. Tigue and Jeremy H. Temkin, "IRS Struggles to Equalize Enforcement Efforts," NYLJ (May 16, 2002); John J. Tigue and Jeremy H. Temkin, "IRS Crackdown on Abusive Trust Scams," NYLJ (Jan. 18, 2001).
4. In 2008, Mr. Birkenfeld pled guilty to conspiring to defraud the United States by assisting an American billionaire evade income taxes on assets hidden in Swiss bank accounts. Lynnley Browning, "Ex-Banker Pleads Guilty in Tax Evasion," The New York Times (June 20, 2008).
5. I.R.M. 9.5.11.9(1) (Sept. 9, 2004).
6. Alison Bennett, "Shulman Says About 14,700 Taxpayers Voluntarily Disclosed Offshore Assets," BNA Daily Report for Executives, 220 DER GG-2 (Nov. 18, 2009).
7. Lynnley Browning, "14,700 Disclosed Offshore Accounts," The New York Times (Nov. 18, 2009).
8. Lynnley Browning, "U.S. Reports Agreement With UBS in Tax Case," New York Times (Aug. 13, 2009); Carrick Mollenkamp, Evan Perez and Stephen Fidler, "Switzerland, UBS Settle U.S. Tax Case," The Wall Street Journal (Aug. 13, 2009); Alison Bennet, "IRS Unveils Criteria Used to Identify U.S. Investors With Accounts at UBS AG," BNA Daily Report for Executives (Nov. 18, 2009).
9. Department of Justice, Press Release, "Justice Department & IRS Announce Results of UBS Settlement & Unprecedented Response in Voluntary Tax Disclosure Program" (Nov. 17, 2009).
10. "Shulman Says About 14,700 Taxpayers Voluntarily Disclosed Offshore Assets."
11. Indeed, just last month, the IRS sought permission from the U.S. District Court for the Northern District of Texas to serve a John Doe summons on Stanford Group Inc. seeking the names of American clients with assets abroad. Kim Dixon, "U.S. Seeks Names of Stanford's American Clients," Reuters (Dec. 2, 2009).
12. Office of Management and Budget, "A New Era of Responsibility: Renewing America's Promise," (Feb. 26, 2009) (available at http://www.whitehouse.gov/omb/budget/Overview/).
13. House Committee on Ways and Means, Press Release, "Rangel, Baucus, Neal, Kerry Improve Plan to Tackle Offshore Tax Abuse Through Increased Transparency, Enhanced Reporting and Stronger Penalties: House-Senate Proposal Detects, Deters, Discourages Overseas Tax Evasion" (Oct. 27, 2009).
14. The bill also increases penalty amounts with regard to foreign trusts and clarifies that U.S. dividend payments received by foreign persons are treated as dividends even when couched as another type of distribution in an effort to avoid U.S. taxes. A copy of the bill's text is available at http://waysandmeans.house.gov/media/pdf/111/RANGEL_071_xml.pdf. In addition, a technical explanation of the Foreign Account Tax Compliance Act of 2009 from the Joint Committee on Taxation (JCT) is available on their Web site here: http://jct.gov/.
15. One issue that may arise with respect to offshore accounts is whether a client properly can assert his Fifth Amendment privilege against self-incrimination. See Jeremy H. Temkin, "Privilege Against Self Incrimination and Tax Filings," NYLJ (July 16, 2009).
16. While making a voluntary disclosure does not preclude criminal prosecution, the Internal Revenue Manual provides that a voluntary disclosure is one factor to be considered in determining whether criminal prosecution will be recommended.
17. Internal Revenue Service, "Voluntary Disclosure: Questions and Answers," Q10 (last reviewed or updated Jan. 8, 2010) (available at http://www.irs.gov/newsroom/article/0,,id=210027,00.html).
18. Elena Logutenkova and Joseph Heaven, "Swiss Regulator Broke Law on UBS Client Disclosure," Bloomberg.com (Jan. 8, 2010).
19. Mollenkamp, Perez and Fidler, "Switzerland, UBS Settle U.S. Tax Case," Wall Street Journal (Aug. 13, 2009).
20. Id.

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