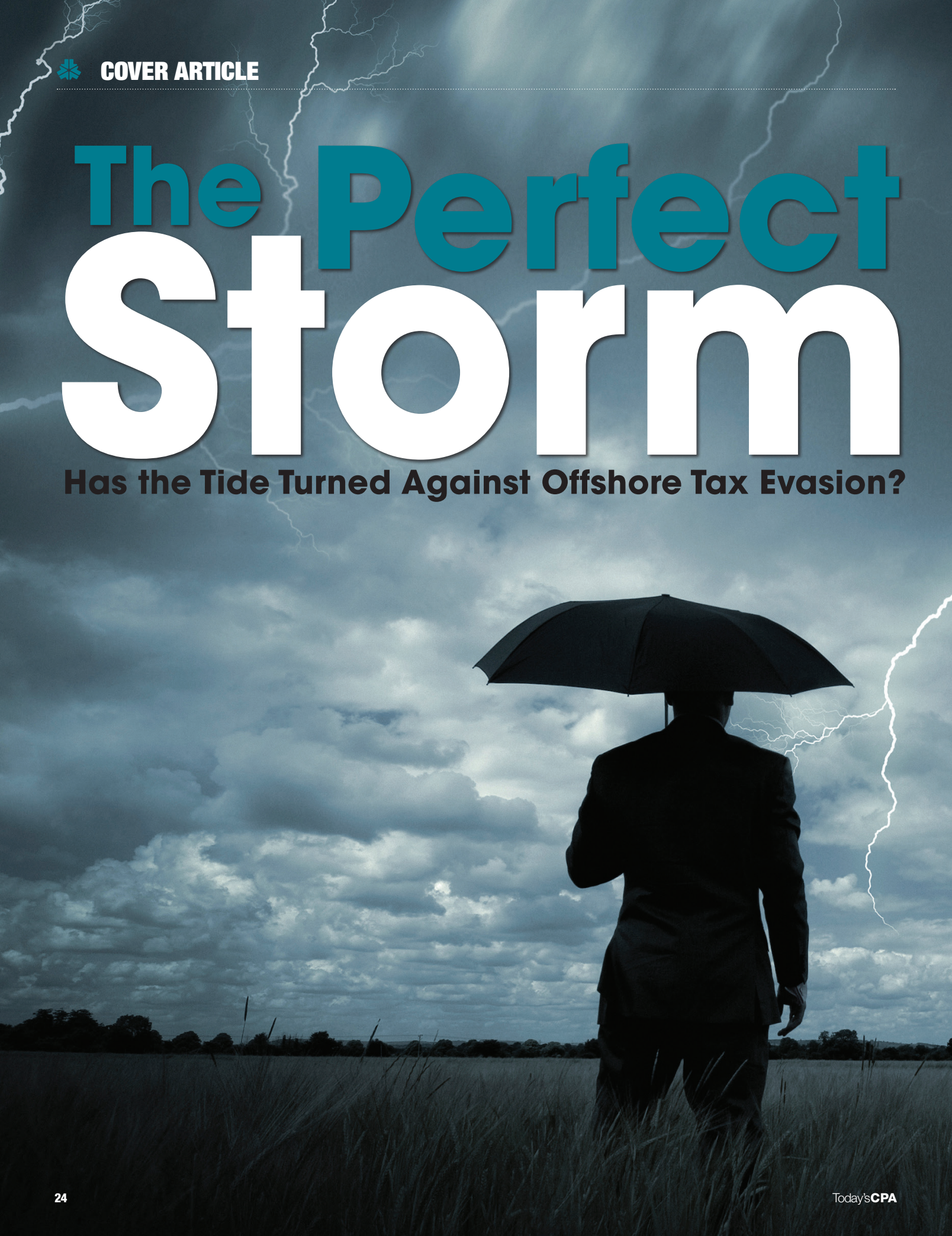
The Perfect Storm

Has the Tide Turned Against Offshore Tax Evasion?



By Jason B. Freeman, JD, CPA

The government is building momentum in its effort to turn the tide against offshore tax evasion. With the fall of Swiss bank secrecy, the rise of the Foreign Account Tax Compliance Act of 2009 (FATCA), and an increasingly global push for cross-border transparency, we are truly entering a new era: an era marked by international cooperation. The government, with its net now cast wider than ever, is poised to haul in a big catch.

The past five years have seen an unprecedented movement towards transparency and international cooperation. A growing number of countries have signed on to information-exchange agreements, such as FATCA. Super-national organizations – such as the Organization for Economic Cooperation and Development (OECD), G20 and the European Union have pushed, with much success, for more effective disclosure agreements. Government prosecution efforts have led to the collapse of Swiss bank secrecy. The capstone on the effort has been the Internal Revenue Service's (IRS's) voluntary disclosure program – a program that has, by most accounts, been wildly successful, bringing forward more than 50,000 Americans and infusing over $6.5 billion in taxes, penalties and interest back into federal coffers over the past five years.

The government, however, is anything but complacent with this success. Congress has put the political spotlight back on hidden offshore accounts. The Senate Permanent Subcommittee on Investigations, in a lengthy and extensive report, took the Department of Justice (DOJ) to task for its "lax" past enforcement efforts and failure to prosecute enough U.S. citizens with undisclosed accounts. It called on the DOJ "to obtain the names of U.S. taxpayers with undeclared accounts at tax haven banks" and to "take legal action against U.S. taxpayers to collect unpaid taxes on billions of dollars in offshore assets."[1] Such pointed criticism and calls to action, coming on the heels of truly unprecedented success, underscores the political will behind the effort to prosecute those who have not yet come forward.

Importantly, that political will is guided by more than high-minded ideals of fairness and tax compliance. There is a much more fundamental driver: the need for tax revenues.[2] The IRS estimates that the annual U.S. tax gap is around $450 billion,[3] and unreported offshore funds account for almost one third of this gap, an estimated $150 billion.[4] Those are big dollars in the face of an annual deficit that exceeds $500 billion.

A Little History

The U.S. government has long been concerned about offshore tax abuses and the role that tax haven banks have played in facilitating tax evasion. Over 30 years ago, the Senate Permanent Subcommittee on Investigations first began conducting investigations into how U.S. taxpayers were using offshore secrecy jurisdictions to hide assets and evade taxes.[5] Attempts to gauge the magnitude of the problem have varied over time, but current estimates indicate that trillions upon trillions of U.S. dollars are held offshore.

Throughout the years, the government has undertaken a number of initiatives to combat offshore tax abuses. One major prong of the attack has been its ongoing effort to establish tax treaties and tax information-exchange agreements with foreign countries. For many years, however, offshore tax havens staunchly resisted entering into such agreements. Bank secrecy jurisdictions, the most prominent of which was Switzerland, successfully created barriers to information exchange. Partly in response to such barriers, the United States also established another key initiative, its Qualified Intermediary Program. In addition to these measures, the government undertook a number of multilateral initiatives, such as the establishment of the Joint International Shelter Information Centre.

These efforts met with relatively modest success in terms of curbing offshore tax evasion. However, they paved the way for new-and-improved intergovernmental approaches like FATCA that will surely usher in a new era in the battle against offshore abuses.

The Rise of FATCA and Intergovernmental Cooperation

At the forefront of the government's attack is FATCA, which was part of the 2010 Hiring Incentives to Restore Employment (HIRE) Act, though its provisions were set for delayed and phased-in implementation. The first wave of disclosure obligations and withholding tax went into effect on July 1, 2014, and the effects will soon be seen.

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FATCA requires foreign financial institutions to either report foreign accounts held by U.S. citizens to the U.S. government or incur a 30 percent withholding tax on investment income received from the United States. As a result, foreign financial intermediaries will soon be reporting many, many more accounts to the IRS.

Because FATCA and its regulations are extremely complex, many countries have opted to enter into streamlined Intergovernmental Agreements (IGAs) with the United States, which offer procedures that simplify compliance and streamline the exchange of information. The IRS now has 45 IGAs in place, and has reached agreements in substance with another 56 countries. [6]

In addition, the United States has a network of tax treaties, tax information exchange agreements (TIEAs), Mutual Legal Assistance Treaties (MLATs) and Agreements (MLAAs). These instruments serve an increasingly important role in tax enforcement. As of 2011, the United States had more than 140 tax treaties, protocols, TIEAs, MLATs or similar tax information exchange agreements with 90 foreign jurisdictions.[7]

International Efforts to Combat Cross-Border Tax Evasion

There is also growing international support to stop tax haven banks from facilitating tax evasion.[8] Two key multilateral organizations, the G8 and G20, have strengthened efforts to combat cross-border tax evasion and have become increasingly vocal in support of their efforts. For 2009, the G20 heads of state issued a joint and unequivocal communique declaring that "the era of bank secrecy is over."

Following UBS and other highly publicized scandals, the G20 intensified its focus on tax haven abuses, including supporting the OECD's efforts to promote the exchange of tax information across borders, the issuance of a list of uncooperative tax havens, and the imposition of sanctions on jurisdictions that impeded tax enforcement.[9] After the enactment of FATCA, G20 and G8 world leaders advocated for automated tax information exchanges as the new international standard, and have called on countries to make automated exchanges effective by the end of 2015.[10]

The OECD has increased the pressure on countries to move towards transparency and to adopt broader information exchange provisions. It has issued influential reports criticizing tax havens that have failed to provide key information, criticizing bank secrecy laws in tax haven jurisdictions, and identifying "uncooperative tax havens."[11] These efforts have directly led a number of previously uncooperative jurisdictions to get on board and commit to exchange information in international tax matters.[12]

In addition, the OECD has developed model information-exchange agreements to support reporting regimes like FATCA[13] and has sought to enable countries to exchange information on an automatic basis.[14] Like the G20 and G8, it has established a goal of enabling automated reporting by 2015.

The Voluntary Disclosure Programs and Key Prosecutions

Another key initiative has been the IRS's Offshore Voluntary Disclosure Program (OVDP). The OVDP allows qualifying taxpayers to disclose unreported foreign accounts in exchange for reduced penalties and an agreement not to refer them for criminal prosecution.

Although the IRS has had a general voluntary disclosure practice for decades, in recent years there has been an explosion in the number of voluntary disclosures of offshore accounts. This has largely been the product of a targeted disclosure program and its promotion through well-publicized prosecutions and settlements that have given taxpayers an extra nudge to enter into the program.

In roughly the past decade, the IRS has implemented four programs specifically targeted at offshore voluntary disclosures – the 2003, 2009, 2011 and 2012 programs.[15] These programs have, by most estimates, been very successful, though they may have only scratched the surface. While the voluntary disclosure programs resulted in over 50,000 Americans coming forward and over $6.5 billion in back taxes, penalties and interest, prior government estimates indicate that there were some 500,000-plus U.S. citizens utilizing abusive offshore schemes to start with.[16]

The 2003 Offshore Voluntary Compliance Initiative was the first voluntary disclosure program specifically targeted at foreign disclosures. In 2003, the IRS estimated that over 500,000 U.S. taxpayers were engaged in abusive offshore schemes.[17] Following an investigation into the identity of offshore credit and debit card holders believed to be hiding taxable income, the Service offered eligible taxpayers an opportunity to come back into compliance, and mitigate their civil penalties and exposure to criminal prosecution. Though the initiative was only open for three months, it resulted in just over 1,300 disclosures and raised approximately $200 million.

For about five years, however, there was not much action on the offshore voluntary disclosure front. But in 2009, the world changed. In February of that year, the U.S. DOJ entered into a deferred prosecution agreement with UBS AG, Switzerland's largest bank. UBS agreed, as part of the deferred prosecution agreement, to a fine of $780 million. As a result of this scandal, UBS ultimately agreed to turn over 4,700 undisclosed accounts owned by U.S. clients.

Shortly after UBS entered into a deferred prosecution agreement, the IRS, leveraging its position of strength, rolled out the 2009 OVDP. The threat that UBS was disclosing names and account information that would link U.S. citizens to undisclosed accounts led many to come forward under the OVDP and greatly increased its success.

The 2009 OVDP was only open for a limited time and provided taxpayers with relief from criminal prosecution, as well as limited civil penalty exposure. To enter into the program, a taxpayer was required to fully disclose their offshore accounts and pay 20 percent of the highest account balance during an eight-year look-back period plus some minor additions. The program, which closed in October 2009, led to about 18,000 taxpayer disclosures and raised $3.4 billion.[18]

In 2011, the IRS offered taxpayers another chance to come forward. However, the 2011 program came with a higher cost, providing a standard penalty equal to 25 percent of the taxpayer's

highest account balance. The higher cost was designed to strike a balance between incentivizing those who had not yet come forward to do so, but also sending a message that the deal would not get sweeter if the account holder waited longer. The 2011 offshore voluntary disclosure initiative offered the same basic benefits as the 2009 program, but it also introduced the possibility of reduced penalties for qualifying taxpayers. The program, which closed in September of 2011, resulted in about 15,000 disclosures and raised just over $1.6 billion.

In 2012, DOJ indicted Wegelin & Co., Switzerland's oldest bank. Months later, Wegelin & Co. pled guilty to conspiracy to defraud the United States and forfeited $32 million in frozen U.S. accounts, paying fines and restitution of another $42 million. The indictment and guilty plea crippled Wegelin beyond repair and it soon folded. The fall of Switzerland's oldest bank was symbolic of the decline and eventual fall of Swiss banking secrecy.

Also in January of 2012, the IRS introduced yet another voluntary disclosure program. Like the 2011 program, the 2012 initiative once again raised the standard penalty, this time to 27.5 percent; however, it also introduced a new "opt-out" procedure, allowing taxpayers to opt-out of the one-size-fits-all penalty structure and make their case for a lower penalty. It also maintained a reduced penalty structure for qualifying taxpayers and introduced, for the first time, a "streamlined" procedure for "low risk" nonresidents.[19] Rather than set a deadline, the IRS left the 2012 program open-ended, reminding taxpayers that it may end the program at any time. And as of July 1, 2014, a date that coincides with phased-in FATCA reporting obligations, the IRS implemented its latest changes to the program and expanded the streamlined procedure – a welcomed development for many U.S. citizens with undisclosed accounts, as it may greatly decrease the applicable penalties under some circumstances.

While the government's efforts against UBS and Wegelin had been successful, in May 2014, the government notched its biggest settlement yet. Credit Suisse entered a plea of guilty to charges of conspiracy to aid and assist in the preparation of filing of false tax returns. As part of that guilty plea, Credit Suisse agreed to pay a total of $2.6 billion to the DOJ, along with $100 million to the Federal Reserve and $715 million to the New York State Department of Financial Services.

All told, in the span of five years, Switzerland saw its oldest, longest-running private bank prosecuted and destroyed, and its two largest banks, UBS and Credit Suisse, agree to massive financial penalties and systemic changes that ended decades, if not centuries, of business practices.

The United States government, aware that it has the upper hand, has not let up. There are currently 13 other Swiss banks under active DOJ investigation. These banks include, among others, Julius Baer, Basler Kantonalbank, Zuercher Kantonalbank, and Swiss arms of Lichtenstein's LLB and the UK's HSBC.[20] The banks on this so-called DOJ "hit-list," having witnessed the fates of UBS, Credit Suisse and Wegelin & Co., are braced for the fallout.

Swiss Non-Prosecution Program

In the midst of all this, the DOJ, in August of 2013, announced a program to enable almost 300 Swiss banks to receive non-prosecution agreements or non-target letters. The DOJ made the program available to all Swiss banks except those under active DOJ investigation,[21] and the Swiss Finance Department urged Swiss banks to participate.

Over 100 Swiss banks have apparently entered into the program. In essence, these banks are agreeing to fully disclose their practices with U.S. customers and pay severe penalties in exchange for the United States government's agreement not to prosecute them. The United States government will be able to utilize the information that it receives to request the identity of U.S. taxpayers under the U.S.-Swiss tax treaty. The fruits of that information will likely set off the next wave and write the next chapter in this saga.

The Impact of the Fall of Swiss Bank Secrecy

These developments set the stage for major changes in the foreign account reporting landscape and led to the fall of Swiss bank secrecy. Switzerland's strategic importance in the battle against offshore evasion cannot be overstated. Switzerland had long been a stronghold for bank secrecy and hidden bank accounts. Even as recently as 2013, it was ranked number one out of 82 jurisdictions on the Tax Justice Network's Financial Secrecy Index.[22] Swiss banks manage about a quarter of the world's total assets,[23] and until recently, the two largest banks – UBS and Credit Suisse – managed about half of those assets.

> **"THE FALL OF SWITZERLAND'S OLDEST BANK WAS SYMBOLIC OF THE DECLINE AND EVENTUAL FALL OF SWISS BANKING SECRECY."**

While the United States has had a tax treaty with Switzerland since 1951, that treaty effectively provided for the exchange of information only in fairly narrow circumstances.[24] These limitations, though addressed to some extent in a 1996 protocol, were unique to the Swiss-United States treaty; they did not exist in any other United States tax treaty.[25]

For years, Switzerland resisted adopting the OECD standards for tax information exchange. However, in March 2009, Switzerland reversed more than a decade of tax policy and announced that it would adopt the OECD standard for tax information exchange.[26]

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By September of that year, Switzerland signed a protocol with the United States amending the countries' tax treaty to incorporate the OECD standard for tax information exchange,[27] a standard that conforms with the U.S. Model Income Tax Convention and U.S. law governing IRS inquiries.[28] Interestingly, though, the United States Senate has yet to vote on ratifying the revised treaty due to a hold on consideration of the treaty that has been in place for more than three years.[29] But that may soon change, as ratification of the revised Swiss tax treaty is one of the top recommendations from the Senate Permanent Subcommittee's 2014 report.[30]

In the meantime, Switzerland has already demonstrated its commitment to change and has entered into several agreements with the United States that open the door to transparency now. Switzerland has not only signed an IGA with the United States, requiring all Swiss financial institutions to comply with FATCA's new disclosures,[31] it also signed the Convention on Mutual Administrative Assistance in Tax Matters, a multilateral agreement that mandates that participating countries cooperate with international tax information exchange requests and tax enforcement efforts.[32]

These developments are a trend. The past several years have seen countries that include well-known tax havens, such as Liechtenstein, Austria, Belgium, Luxembourg and Monaco, pledge that they will cooperate with international tax enforcement efforts and share tax information. More countries will follow.

And with the success in Switzerland, the government has expanded its efforts to target other key countries. For instance, in November 2013 – as part of what the IRS described as the "next phase" of its offshore compliance crackdown – the IRS announced that it would soon be deploying agents from SB/SE's special enforcement program to examine U.S. taxpayers suspected of holding undeclared accounts in Indian banks. Initiatives like this will be interesting to follow and will undoubtedly lead to some high-profile prosecutions.

Other Forces at Work

In addition to the international forces at work, a number of domestic developments have bolstered the government's attack. For instance, the revamped whistleblower program has seen a burgeoning and unprecedented cottage industry of whistleblowers in the offshore account context. Prosecutions for undisclosed offshore accounts are higher than ever. John Doe summonses, which allow the government to obtain information about a class of taxpayers even when it does not know their identities, have increased the information flow and sidestepped traditional legal barriers to gathering information. The development of the so-called required records doctrine has seen an emasculated, if non-existent, Fifth Amendment privilege in the context of undisclosed accounts. These developments bode poorly for those still hesitant to come forward and disclose their offshore accounts.

Unprecedented

We are truly witnessing an unprecedented movement towards global transparency and international cooperation. Those with undisclosed accounts are increasingly at risk, and the stakes are only getting higher. The fall of Swiss banking secrecy, the rise of FATCA, and the growing international coalition calling for cross-border tax transparency is creating a proverbial perfect storm that is lending credence to the claim that the tide is turning against offshore tax evasion. ■

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Footnotes

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