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Turning Up the Heat On Offshore Account Holders

New tax act increases the risk of maintaining these funds.

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THE RISK versus reward analysis for offshore account holders changes drastically with the implementation of the Foreign Account Tax Compliance Act (FATCA). As a result of FATCA, offshore, undisclosed account holders will be faced with a dilemma: a continuous potential 30 percent withholding on select payments to the account or a one-time payment of 27.5 percent of their highest account value and other penalties and taxes under the current voluntary disclosure program.

The current voluntary disclosure program of the Internal Revenue Service (IRS) allows the offshore account holder to control disclosure, but FATCA could change that. FATCA requires each foreign financial institution that enters into an agreement with the IRS (a participating foreign financial institution) to identify and report their U.S. accounts beginning in 2014.

The Department of Justice (DOJ) and the IRS have been waging a successful battle against offshore tax evasion and FATCA will become one of the strongest tools in their arsenal. Over the past three years, the DOJ and IRS have successfully increased their efforts to combat offshore tax evasion, without the benefit of the added disclosure required by FATCA. Their results have included:

- A deferred prosecution agreement with UBS for maintaining undisclosed offshore accounts and for facilitating tax evasion schemes;
- Criminal convictions of 33 offshore account holders;
- Criminal charges against 13 bankers and two attorneys as facilitators of offshore tax fraud and a conviction of one advisor and one banker; and

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• Investigations against numerous offshore banks¹ (the media has reported that HSBC and Credit Suisse are two of the financial institutions under investigation for facilitating tax evasion).

IRS Commissioner Doug Shulman confirmed this trend will continue, stating that “we are in the middle of an unprecedented period for our global international tax enforcement efforts...[w]e have pierced international bank secrecy laws, and we are making a serious dent in offshore tax evasion.”²

Overview of FATCA

FATCA, which will go into effect in 2013, generally mandates that a participating foreign financial institution identifies and reports on its U.S. accounts—individual and entity—to the IRS or suffer a 30 percent withholding on withholdable payments and passthru payments. Withhold-

able payments include interest and dividends from U.S. sources and gross proceeds from the sale of certain assets,³ and a passthru payment is defined by FATCA as “[a]ny withholdable payment or other payment to the extent attributable to a withholdable payment.”⁴ The proverbial stick, the 30 percent withholding, and FATCA’s self-enforcing mechanism loom so large that many foreign financial institutions and account holders will comply with FATCA and give the IRS a treasure trove of information concerning U.S. accounts.

The Basics. On March 18, 2010, FATCA was signed into law as part of the Hiring Incentives to Restore Employment Act (the HIRE Act). FATCA generally goes into effect on July 1, 2013 and provides the IRS and U.S. Department of the Treasury (Treasury Department) with oversight responsibility. Proposed regulations were issued on Feb. 8, 2012.

FATCA mandates that foreign financial institutions report select information on their U.S. accounts to the IRS. To achieve this goal FATCA requires foreign financial institutions to put processes in place to identify and report their U.S. accounts to the IRS or suffer a 30 percent withholding tax. In addition to analyzing individual accounts, foreign financial institutions will also have to “look-through” certain foreign entity account holders to identify U.S. owners.

As a result of FATCA, the IRS will be receiving information from foreign financial institutions located around the world. Between 2014 and 2015, foreign financial institutions complying with FATCA will be required to report:

- The name, address and U.S. taxpayer identification number of each U.S. person account holder, or, for foreign entity account holders, the name, address and U.S. taxpayer identification number of each U.S. person that owns more than 10 percent of the entity account holder;
- The account balance as of Dec. 31, 2013 (and in future years the prior year-end account balance) or the balance of the account immediately prior to closure if the account was closed; and

- The account number.⁵

This will provide the IRS with more information about offshore accounts, which can contain both legal and illegal sourced income, than ever before. Also, to assist in ensuring the identification of U.S. accounts is done appropriately, the IRS will require participating foreign financial institutions to put in place a strong control: The chief compliance officer or equivalent level person of the participating foreign financial institution must certify to the IRS that the analysis to identify U.S. accounts was done appropriately.

FATCA Forces Foreign Financial Institutions to Comply. Many of the world's largest financial institutions are already working on building their FATCA compliance programs. International financial institutions, especially those with a U.S. nexus, want to ensure other institutions will continue to do business with them and remit the full value of payments. Foreign financial institutions that participate in the FATCA reporting and withholding regime will have an obligation to withhold on certain payments made to non-participating foreign financial institutions. Many foreign financial institutions are not willing to have 30 percent of a payment withheld because of non-compliance with a U.S. based law.

Passthru Payments: Extending the Reach of Withholding. Non-participating foreign financial institutions will not be able to maintain accounts at participating foreign financial institutions to avoid withholding. Withholding will occur not only on U.S.-sourced income payments, but also on payments "attributable to" withholdable payments from one participating foreign financial institution to a non-participating foreign financial institution. This notion is referred to as a passthru payment by FATCA. The U.S. government is still working out the details of how foreign financial institutions will withhold on passthru payments, but it is clear that one goal of the passthru payment concept is to not allow one financial institution to bank with another participating foreign financial institution and avoid withholding.

The Fall of Global Bank Secrecy Picks Up Steam. While there has been much publicity regarding the downfall of bank secrecy in Switzerland because of the deferred prosecution agreement with UBS and subsequent cases, FATCA will expedite this downfall as it will affect each country's bank secrecy and data protection laws. This impact of FATCA has not gone unnoticed. Financial institutions, trade organizations and foreign governments have lodged comments to the IRS and Treasury regarding the effect FATCA will have on local bank secrecy and data protection laws.⁶ The IRS and Treasury Department seem determined to work around these concerns. According to recent guidance, participating foreign financial institutions will ask for waivers from account holders of applicable restrictions, if any, on reporting of the account holder's information to the IRS. The account holder will suffer the same 30 percent withholding on certain pay-

ments to the accounts if she does not waive the privacy requirements of the local laws that are in conflict with FATCA.

Voluntary Disclosure Programs

The IRS' voluntary disclosure programs from 2009 to the present have been a success. Approximately 33,000 voluntary disclosures have been filed and \$4.4 billion collected thus far. The third and most recent program, announced by the IRS on Jan. 9, 2012, is similar to the last voluntary disclosure program except the highest penalty category is 27.5 percent, up from 25 percent of the highest aggregate balance or value offshore during the eight tax years preceding the disclosure. Like previous voluntary disclosure programs, offshore account holders also have to pay back taxes and interest for the eight previous tax years in addition to accuracy-related and/or delinquency penalties. Furthermore, there is no set deadline to apply and the terms of the open voluntary disclosure program could change. The IRS can increase penalties in the program or end the program entirely at any point.⁷ Indeed, account holders are not eligible for the voluntary disclosure program if a criminal investigation or civil audit has already been initiated by the IRS.

The Odds Increase in the IRS' Favor

Account holders who have not disclosed their offshore account to the IRS are playing the odds regarding the initiation of a civil audit or criminal tax fraud investigation. "As we've said all along, people need to come in and get right with us before we find you," Shulman said. "We are following more leads and the risk for people who do not come in continues to increase."⁸

The IRS will be able to use the annually reported information by foreign financial institutions on its account holders as a check and balance against information provided by the account holders on their individual tax returns. The IRS could look to see if the account holder identified by the foreign financial institution

(1) filed a voluntary disclosure relating to the offshore account,

(2) identified the offshore account on Form 1040 Schedule B, which asks if the individual taxpayer had a financial interest in or signature authority over an offshore financial account, and

(3) examine other documentation that requests individuals identify their offshore accounts to the U.S. government, such as Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts.

Conclusion

Now more than ever there is greater incentive to voluntarily disclose the existence of an offshore account. The risk versus reward analysis changes drastically because of FATCA, which not only increases the risk of being identified as an offshore account holder, but also decreases the reward due to FATCA's withholding of 30 percent in perpetuity of select payments if the account holder does not provide the required documentation to the participating foreign financial institution. As of today, much of the control regarding

a disclosure is still in the hands of the offshore account holder, but that changes in 2014 when FATCA reporting begins.

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1. Offshore Compliance Initiative, Tax Division, The U.S. DOJ, http://www.justice.gov/tax/offshore_compliance_initiative.htm.

2. IRS, "IRS Shows Continued Progress on International Tax Evasion," IR-2011-94, Sept. 15, 2011, <http://www.irs.gov/newsroom/article/0,,id=245768,00.html>.

3. A withholdable payment is (a) any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical (FDAP) gains, profits, and income, if such payment is from sources within the United States, and (b) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States. Internal Revenue Code (IRC) §1473(1)(A).

4. IRC §1471(d)(7). Passthru payments are discussed in more detail below.

5. IRS, Part III Administrative, Procedural and Miscellaneous, Chapter 4 Implementation Notice, Notice 2011-53, p.6.

6. See Comment Letter by the Association of British Insurers, "ABI Response on Notice 2010-60 Regarding the Foreign Account Tax Compliance Act (FATCA) Provision Incorporated Into the Hiring Incentives to Restore Employment Act" (Nov. 10, 2010), which states:

Article 25(1) of Directive 95/46/EC prevents the transfer of the personal data to a country or territory outside the European Economic Area unless that country or territory ensures an adequate level of protection for the rights and freedoms of data subjects in relation to the processing of personal data. The EU Commission has provided an official list of those countries that it considers offers an adequate level of protection but does not include the US.

7. "IRS Offshore Programs Produce \$4.4 Billion to Date for Nation's Taxpayers; Offshore Voluntary Disclosure Program Reopens," IR-2012-5, Jan. 9, 2012, <http://www.irs.gov/newsroom/article/0,,id=252162,00.html>.

8. Id.