BakerHostetler

Brief

Global Tax Enforcement in 2016: What You Need to Know

The investigation and prosecution of tax evasion has, in the last decade, grown from a specialized subcategory of law enforcement into a first-tier policy concern for the global community. Starting with the U.S. government's crackdown on Swiss bank UBS in 2008, there has been a steady drumbeat of news about prosecutions of financial institutions, bankers, and taxpayers. This drumbeat has coincided with the public's frustration with the slow growth of most of the world's economies over the last decade and the related problem of governments' budgetary troubles. Cracking down on offshore tax evasion is a relatively uncontroversial source of new revenue.

What You Need to Know

Financial institutions, bankers, professional advisers, and taxpayers need to understand that stepped-up global tax enforcement has made the financial world smaller and more transparent. To deal with this new environment, actors must prepare themselves before enforcement authorities arrive at their doorsteps. With worldwide financial institutions having begun to report U.S. account information to the IRS in March 2015, the time to seek professional advice and to take action is now.

> "Global tax enforcement has made the financial world smaller and more transparent."

Banks in the Crosshairs

The U.S. government's pursuit of financial institutions continues, with no signs of abating. Financial institutions need to prepare themselves for U.S. enforcement activity by evaluating their policies and procedures, bringing them up to current standards, and drawing a clear temporal line between present compliance and any possibly inappropriate past practices.

The current era of tax enforcement against banks began when the U.S. government's investigation of UBS became public in 2008. In February 2009, UBS entered into a deferred prosecution agreement with the U.S. Department of Justice (DOJ) and agreed to cease its U.S. cross-border business and pay a fine of $780 million. While this ended UBS's troubles with the U.S. authorities over assisting U.S. taxpayers in evading taxes (leaving aside the widely reported 2015 tax evasion investigation of UBS over bearer securities), it signaled the beginning of the U.S. government's attack on financial institutions that may have assisted their clients in violating U.S. tax laws.

After UBS, the U.S. government turned its attention to Wegelin & Co., Pictet & Cie, Neue Zuercher Bank, Credit Suisse Group AG, Basler Kantonalbank, Bank Julius Baer, Bank Frey, Bank Hapoalim, Bank Leumi, Bank Mizrahi-Tefahot, Liechtensteinische Landesbank AG, swisspartners, CIBC FirstCaribbean, HSBC India, and Bank of Butterfield.

Of these banks, Wegelin pleaded guilty to a felony, paid a fine of $58 million, agreed to a civil forfeiture of $16 million, and ceased operations in 2013. Before even being charged, Bank Frey announced in 2013 that it would cease operations. Credit Suisse was convicted in federal court in 2014 of a felony and paid a fine of $2.6 billion, dwarfing UBS's then-astonishing $780 million fine.

Instead of seeking felony convictions, the DOJ has typically entered into deferred prosecution agreements, and rarely non-prosecution agreements, with foreign financial institutions that it has prosecuted criminally. Since the demise of Arthur Andersen after the Enron scandal, the DOJ's policy has been to take into account the collateral harm to innocent employees and shareholders when deciding whether to indict business entities. The DOJ made exceptions for Wegelin and Credit Suisse on the ground that their behavior was especially culpable.

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In a twist on the DOJ's use of deferred prosecution and non-prosecution agreements, on August 29, 2013, the DOJ Tax Division announced a voluntary disclosure program for Swiss banks. The Program for Swiss Banks, as it is called, was the product of an agreement between the U.S. and Swiss governments to encourage all Swiss banks to admit their role in U.S. tax evasion. In exchange, the participating banks would receive non-prosecution agreements and pay substantial monetary penalties. Only Swiss banks that were not then under DOJ criminal investigation were eligible. To participate, Swiss banks had to fully disclose their cross-border activities; provide detailed information on U.S. taxpayers' accounts; and pay a penalty of 20, 30, or 50 percent of the maximum value of all non-disclosed U.S. accounts that were held by the banks, depending on when the accounts were opened. According to the DOJ, 106 of the approximately 300 Swiss banks chose to enter the program. As of the end of 2015, approximately half of the banks have reached non-prosecution agreements with the DOJ. Many speculate that the DOJ will try to replicate this program's success in other countries, resulting in large numbers of banks outside of Switzerland turning over detailed information on U.S. taxpayers' accounts.

Our position on the front lines of the crackdown on financial institutions has taught us that banks that began to change their behavior immediately after the UBS deferred prosecution agreement stand in better stead with the authorities than banks that continued to conduct business as usual. The later in time that our client financial institutions changed their policies and practices, the stiffer the penalties they faced. The lesson here is clear: Either be prepared to defend your actions as legal or get out ahead of the authorities by making the necessary changes immediately.

Prosecution of Bankers, Lawyers, and Financial Advisors

Since 2008, the DOJ has publicly charged a few dozen bankers, lawyers, and financial advisors. As of the end of 2015, more than half of them remain fugitives. Being a fugitive means being unable to travel to or through any countries that extradite to the U.S. for tax crimes. For the majority of the fugitives, this means essentially being confined to Switzerland indefinitely. The banks, lawyers, and financial advisors that have answered their charges in the U.S. have either pleaded guilty and cooperated with the U.S. authorities or been convicted at trial, with two exceptions: One Swiss banker and one Israeli banker have been acquitted at trial.

The acquitted Swiss banker was UBS's Raoul Weil. He was a fugitive in Switzerland from the time of his indictment in 2009 until he was arrested in 2013, when he made the mistake of going to Italy on vacation. In a major surprise to the U.S. government, a Florida jury found Weil not guilty on November 3, 2014.

Charging and prosecuting bankers, lawyers, and financial advisors allows the U.S. government to hold individuals responsible for assisting tax evasion. This, in turn, allows the government to satisfy an angry public by putting people in prison. Deferred prosecution agreements of corporate entities do not afford the same measure of retributive satisfaction. Recognizing the public's growing discomfort with corporate prosecutions resulting in no one spending time in prison, Deputy Attorney General Sally Yates issued a memorandum to DOJ prosecutors on September 9, 2015. In the so-called Yates Memo, she emphasized the DOJ's strong interest in holding individuals accountable for corporate crime, calling on the DOJ to "fully leverage its resources to identify culpable individuals at all levels in corporate cases."

Experience teaches that any banker or adviser who is not prepared to risk indictment and trial should seriously consider approaching the authorities about a cooperation agreement. The U.S. government prosecutes individuals without the policy restrictions that cause it to spare financial institutions the full consequences of criminal convictions. The only bankers and advisers who have avoided prosecution have done so by offering full cooperation to the authorities. This is not to say that the government is invulnerable to attack in these cases. When an individual is willing to put the government to its proof at trial, legal counsel with experience in this area can make a conviction far from a foregone conclusion.

Prosecutions of U.S. Taxpayers

The U.S. government's push to end offshore tax evasion has included numerous prosecutions of U.S. taxpayers. These taxpayers have held accounts at banks in Switzerland, Israel, and India, among other countries. The courts have imposed sentences that the government would view as lenient, but a felony conviction for an otherwise-law-abiding individual is devastating.

The government has appealed at least one sentence in an offshore bank account prosecution. On January 14, 2014, Ty Warner, the billionaire creator of Beanie Babies, received a sentence of two years' probation after having pleaded guilty to one count of tax evasion. The U.S. District Court for the Northern District of Illinois in Chicago sentenced Warner to no jail time in spite of his admission that he willfully concealed bank accounts at UBS and Zürcher Kantonalbank of Switzerland that held as much as $107 million, generated $24 million in unreported income, and created a tax loss to the government of $5 million. The government appealed the sentence as unreasonably low, but on July 10, 2015, the Seventh Circuit Court of Appeals affirmed the sentence.

The IRS is unlikely to announce which taxpayers it will target next, but an official from the IRS Small Business/Self-Employed Division (SB/SE) announced on November 9, 2013, that the IRS's Special Enforcement Program (SEP) would focus its resources on examining U.S. taxpayers suspected of holding undeclared accounts at Indian banks. The IRS has called Indian bank accounts the next phase of its offshore compliance crackdown.

Individuals with unreported foreign bank or financial accounts are in serious and potentially immediate jeopardy of criminal investigation and prosecution. They should seek counsel to evaluate their options.

John Doe Summonses

In the last decade, the IRS has greatly increased its use of the so-called John Doe summons. The IRS routinely uses traditional summonses in tax investigations to develop evidence. Traditional summonses are of limited use in identifying unknown taxpayers with offshore bank accounts. This is because a traditional summons must identify the taxpayer whose conduct is at issue.

> "Any account holder who receives notice from his or her bank that it has received a John Doe summons should prepare to face civil or criminal enforcement."

The John Doe summons is perfectly tailored to the IRS's effort to identify account holders. It allows the IRS to seek information on an entire class of taxpayers whose identities are unknown. In exchange for not having to identify the subject taxpayers, the law requires that a federal district judge authorize the issuance of the summons.

The IRS issued John Doe summonses to UBS in 2008 and 2011. Because UBS has operations in the U.S., the IRS was able to serve the summonses on UBS directly. The IRS has also issued John Doe summonses for information held by banks that have no presence in the U.S. The key to serving a summons on a bank that operates wholly outside the U.S. is the correspondent bank. Any bank in the world that wishes to allow its customers to hold U.S.-dollar-denominated accounts and conduct transactions in U.S. dollars must have access to the U.S. banking system. This requires foreign banks to open accounts at banks in the U.S., known as correspondent banks. The IRS then simply serves its John Doe summonses on the correspondent banks. The foreign banks' U.S. correspondent accounts will have records of checks, drafts, and wires sent to U.S. taxpayers or their accounts at other U.S. banks.

For example, on December 19, 2014, the U.S. District Court for the Central District of California authorized the IRS to issue John Doe summonses to HSBC USA, the Federal Reserve Bank of New York, FedEx, DHL, UPS, and Western Union. These summonses require the recipients to produce information about U.S. taxpayers who may be evading taxes by using the services of Sovereign Management & Legal Ltd. The IRS and the DOJ alleged that Sovereign is “a multi-jurisdictional offshore services provider that offers clients, among other things, the formation and administration of anonymous corporations and foundations in Panama as well as offshore entities. Related services provided by Sovereign include the maintenance and operation of offshore structures, mail forwarding, the availability of virtual offices, re-invoicing, and the provision of professional managers who appoint themselves directors of the client’s entity while the client maintains ultimate control over the assets.” The IRS and the DOJ alleged that Sovereign used FedEx, DHL, and UPS to correspond with its U.S. clients and used Western Union to transmit funds to them. According to the IRS and the DOJ, HSBC USA and the Federal Reserve Bank of New York were likely to have records of Sovereign’s transactions.

On November 12, 2013, the IRS issued John Doe summonses for information on U.S. taxpayers at the U.S. correspondent banks of Zürcher Kantonalbank in Switzerland and the Bank of N.T. Butterfield & Son Ltd. in the Bahamas, Barbados, Cayman Islands, Guernsey, Hong Kong, Malta, Switzerland, and the United Kingdom. The U.S. correspondent banks were Bank of New York Mellon, Citibank NA, JPMorgan Chase Bank NA, HSBC Bank USA NA, and Bank of America NA. The government supported its application for the John Doe summonses with evidence that the IRS received from U.S. taxpayers who entered the Offshore Voluntary Disclosure Program (“OVDP”).

On April 29, 2013, the government issued a John Doe summons to the Canadian Imperial Bank of Commerce FirstCaribbean International Bank (“FCIB”). The government again based its application for the John Doe summons on information submitted by FCIB customers who participated in the OVDP.

The U.S. government also used a John Doe summons to pursue U.S. taxpayers in India. On April 7, 2011, a federal court granted the IRS’s and DOJ’s request for a John Doe summons to require HSBC India to turn over information on U.S. taxpayers “who at any time during the years ended December 31, 2002 through December 31, 2010, directly or indirectly had interests in or signature or other authority” over “financial accounts maintained at, monitored by, or managed through The Hongkong and Shanghai Banking Corporation Limited in India (HSBC India).”

In its application for the summons, the DOJ asserted that there were 9,000 U.S. residents of Indian origin who had at least a $100,000 balance in their accounts at HSBC India. In contrast, for calendar year 2009, the most recent year for which information was available, there were only 1,391 FBARs (“Reports of Foreign Bank Accounts”) filed, disclosing 1,921 accounts at HSBC India.

In the last decade, we have seen the IRS, the DOJ, and the courts become far more willing to use these tools. We believe that the use of John Doe summonses is likely to continue and even increase. Courts have been seemingly eager to authorize their issuance, and they are highly effective at producing evidence for use in civil and criminal tax investigations and prosecutions. Any financial institution that receives a John Doe summons should immediately consult with qualified counsel. Similarly, any account holder who receives notice from his or her bank that it has received a John Doe summons should prepare to face civil or criminal enforcement.

FATCA

Angered by the brazen offshore tax evasion that the UBS scandal brought to light, Congress enacted FATCA in 2010 as part of the Hiring Incentives to Reduce Unemployment Act “HIRE Act”. Its purpose was to force foreign financial institutions (“FFIs”) to report their U.S. customers to the IRS or face 30% withholding on any payments that they received from a U.S. source.

Foreign financial institutions had to be FATCA compliant by July 1, 2014, or they would face 30% withholding. To relieve some of the compliance burden, the U.S. government allowed FATCA partner countries to enter into intergovernmental agreements (“IGAs”) with the United States. These agreements simplify compliance and provide alternative reporting arrangements for FFIs in countries whose privacy laws prevent direct reporting of U.S. customers’ data to the IRS. As of the end of 2015, the Treasury has entered into IGAs with 79 countries and has reached “agreements in substance” with 28 more.

So-called Model 1 IGAs require FFIs in partner countries to report tax information about U.S. account holders to their own governments instead of to the IRS. Those governments then send the information to the IRS. The vast majority of the Model 1 IGAs to date have been reciprocal. Reciprocity requires that the IRS send similar information about partner countries’ citizens’ U.S. accounts to their home governments. Reporting by FFIs in Model 1 IGA countries began on September 30, 2015.

Only a handful of countries have entered into Model 2 IGAs. Foreign financial institutions in Model 2 IGA partner countries report information on U.S. account holders directly to the IRS. Reporting to the IRS began on March 31, 2015, for FFIs in Model 2 IGA countries and non-IGA countries.

Organization for Economic Cooperation and Development’s Common Reporting Standard

While some have called FATCA an example of U.S. government overreach, the OECD has taken inspiration from FATCA and proposed an even more sweeping regime called the Standard for Automatic Exchange of Financial Account Information, commonly known as the Common Reporting Standard. Like FATCA, the Common Reporting Standard calls for automatic, rather than on-request, exchange of account information. Its reach is far greater than FATCA’s though, as 93 countries have so far committed to exchange information about their citizens’ financial accounts. Due to the need for legislation, the U.S. is not one of those countries and will engage in information exchange via the FATCA IGA route.

Reporting will function similarly to FATCA Model 1 IGA reporting. Financial institutions will report account information to their own countries’ authorities, which will then automatically exchange the information with partner countries. Some “early adopter” jurisdictions will begin collecting account information on January 1, 2016. Exchange of information will begin in 2017 or 2018, depending on the jurisdiction.

FATCA and the Common Reporting Standard will require financial institutions worldwide to undertake major operational and technological changes. Although the law-enforcement focus of FATCA and the Common Reporting Standard is on account holders, our financial institution clients have faced the greatest enforcement risk from information that those very account holders have provided to the authorities. The unhappy account holders whose information the banks provide to the authorities will not hesitate to blame their tax noncompliance on their banks and professional advisers. It would be naïve to think otherwise. FATCA and the Common Reporting Standard therefore present not only logistical issues for financial institutions, but also potential exposure to criminal enforcement actions.

Offshore Voluntary Disclosure Program and Streamlined Alternative

> “. . . ‘non-willful’ taxpayers [can] pay either 0% or 5% of their account balance as a penalty, depending on their U.S. residency status.”

The IRS’s Offshore Voluntary Disclosure Program (“OVDP”) is currently in its third incarnation. The first OVDP was available for a limited time in 2009 and allowed taxpayers with unreported foreign bank accounts to escape criminal prosecution and annual civil penalties of 50 percent of their highest annual account balance. They simply had to fully disclose their accounts and pay, with some minor additions, 20 percent of their highest account balance during an eight-year look-back period. The second OVDP was available in 2011 and provided the same benefits in exchange for 25 percent of the taxpayer’s highest account balance. Finally, in 2012 the IRS opened the current OVDP, increasing the cost to 27.5 percent of the taxpayer’s highest account balance. More recently, the IRS increased the penalty to 50% for taxpayers whose accounts are at banks that the IRS has publicly identified as being under investigation.

In 2014, the IRS introduced an alternative to the OVDP called the Streamlined Filing Compliance Procedures. This allows certain "non-willful" taxpayers to pay either 0% or 5% of their account balance as a penalty, depending on their U.S. residency status. The OVDP and the Streamlined procedures have attracted tens of thousands of taxpayers and have resulted in billions of dollars in payments to the IRS.

Taxpayers who enter the OVDP must not only declare their accounts and pay a penalty, but they must also frequently submit to detailed questioning regarding the names of the bankers, lawyers, and other professionals who assisted them in opening and maintaining their secret accounts. The IRS and DOJ have used this information to procure John Doe summonses and indictments. Many indicted persons have in turn cooperated with the DOJ, leading to the investigation and prosecution of additional banks, bankers, lawyers, and taxpayers.

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How to Protect Yourself

Our experience defending banks, financial and legal advisors, and U.S. taxpayers in global and domestic criminal tax matters has shown us that the U.S. government and foreign governments will not back down anytime soon. It is essential to partner with dedicated criminal tax counsel who can assess the exposure and determine how to address noncompliance problems when there is an investigation.

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