SHEARMAN & STERLING LLP

Practice Group Newsletter

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Editor's Note

Dear Readers,

This issue features articles discussing the IRS's recently released FAQs for its 2012 Offshore Voluntary Disclosure Program, Treasury's publication of two versions of a model bilateral intergovernmental agreement for the implementation of FATCA, and the Fourth Circuit's recent decision implicating the willfulness standard in FBAR penalty cases.

If you have comments or suggestions for future publications, you may contact Lawrence M. Hill at lawrence.hill@shearman.com. They are very much appreciated.

IN THIS ISSUE

IRS Voluntary Disclosure Update

On June 26 the Internal Revenue Service ("IRS") released guidance to frequently asked questions related to the latest Offshore Voluntary Disclosure Program ("OVDP").[1] The guidance issued by the IRS responds to numerous inquiries submitted by practitioners and taxpayers, tightens eligibility for taxpayers, and provides assistance to help U.S. citizens living abroad meet their income tax return filing obligations. The IRS also disclosed that the OVDP programs have brought in more than $5 billion in tax revenue to the United States.

Many of the provisions of the 2009 and 2011 OVDP programs are included in the 2012 program. However, one area of recent concern raised by tax practitioners involves the taxpayer's eligibility to make a voluntary disclosure once the IRS has served a summons or made a treaty request seeking information from a financial institution. The timing of disclosure has become a particular concern to taxpayers because the IRS has increased the number of investigations into foreign institutions within the last two years. FAQ 21 now makes clear that the mere fact that the IRS has sent a John Doe summons, or made a treaty request, does not make every member of the John Doe class or group ineligible to participate in OVDP. However, a taxpayer will be ineligible for OVDP once the IRS or the Department of Justice obtains information under a summons, treaty request, or other similar action that provides evidence of a specific taxpayer's noncompliance with the tax laws. This is code by the IRS to act now or forever be barred from OVDP.

The FAQ also provides two other ways in which a taxpayer may become ineligible. First, if a taxpayer appeals a foreign tax administration's decision authorizing the release of account information to the IRS and fails to provide the U.S. notice as required by 18 U.S.C. 3506. Second, the IRS may announce that certain taxpayer groups that have or had accounts at specific financial institutions will be ineligible due to U.S. government actions in connection with the specific financial institutions. The new FAQ provides some clarity and certainty but may eliminate eligibility for some taxpayers who have waited too long to voluntarily disclose.

The IRS also clarified eligibility by requiring that within 90 days of the date of the letter from IRS Criminal Investigation, the taxpayer must provide the completed voluntary disclosure, which includes filing complete and accurate amended federal income tax returns for all tax years covered by the voluntary disclosure. This is consistent with the first and second offshore disclosure programs. Under FAQ 25.1, a taxpayer can apply for a 90-day extension provided the request is made in writing and provides a detailed statement of those items that are missing and the reasons why the extension is necessary.

The IRS also announced a proposed new procedure for U.S. citizens living abroad and dual citizens with low compliance risks who did not file U.S. income tax and informational returns to become current on their income tax return filing obligations. The IRS's guidance is intended to provide "common sense steps to help U.S. citizens abroad get current with their tax obligations."[2]

The new procedures require affected taxpayers to file delinquent tax returns with related information returns for the past three years and to file delinquent Reports of Foreign Bank and Financial Accounts ("FBARs") for the past six years. All submissions will be reviewed by the IRS with varying degrees of intensity. For taxpayers considered by the IRS to be low compliance risk, the IRS will expedite the review, and penalties will not be asserted – this is a substantial concession by the IRS. However, taxpayers who present a greater compliance risk may be subject to a more exhaustive audit that can be expanded beyond the three years. In both instances, the payment of tax and interest must accompany the submission and 2011 tax returns that have yet to be filed would need to be filed under the procedure.

[1] *See* Internal Revenue Service, "Offshore Voluntary Disclosure Frequently Asked Questions and Answers," June 26, 2012, *available at* http://www.irs.gov/businesses/small/international/article/0,,id=256774,00.html.

[2] IR 2012-65 (June 26, 2012).

The level of compliance risk will be based on return information, as well as certain additional information that will be required as part of the submission. Generally, the IRS will consider greater risk as income and assets of the taxpayer rise. In addition, evidence of sophisticated tax planning, prior non-compliance or potential avoidance, or even material economic activity in the United States may indicate greater risk. Tax returns that show less than $1,500 in tax due in each of the tax years will be treated as low risk. The new procedures will go into effect on September 1, 2012.

– R. Nessler

Model Bilateral Intergovernmental FATCA Agreement Released

On July 26 the Treasury Department published two versions of a model bilateral intergovernmental agreement for the implementation of the Foreign Account Tax Compliance Act ("FATCA").[3] One version is a reciprocal agreement providing for the bilateral exchange of tax information between the U.S. and the foreign country (called a "partner country" by the model), while the nonreciprocal version provides that the partner country would gather information about the accounts of certain U.S. persons and entities controlled by such U.S. persons ("U.S. Reportable Accounts") and transmit that information to the IRS, but the U.S. would not be obligated to reciprocate. Each version of the model agreement reflects the approach described in a February 2012 joint statement by France, Germany, Italy, Spain, the United Kingdom, and the U.S. These governments issued a joint communiqué on July 26 stating that they had collaborated in the development of the model agreement and that they "look forward to a speedy conclusion of bilateral agreements based on this Model, including by other jurisdictions."[4] However, it should be noted that both versions of the model agreement require that a tax treaty or tax information exchange agreement ("TIEA") between the U.S. and the foreign country is in place pursuant to which the automatic exchange occurs.

Model Agreement Provisions

Under each version of the model agreement, foreign financial institutions ("FFIs") will be required to report U.S. Reportable Accounts to their home tax authority, rather than the IRS, and information about these accounts will be automatically transferred every year to the IRS under an existing tax treaty or TIEA.[5] The reciprocal version of the agreement provides for the IRS to send the partner country information on accounts of the partner country's residents that are held with U.S. financial institutions. The model agreement obligates the foreign country's government to legally compel FFIs in the partner country to report information on U.S. Reportable Accounts required by FATCA. FFIs in the foreign country generally will be treated as complying with FATCA ("participating FFIs"), i.e., U.S. source payments to and certain gross proceeds derived by these FFIs will not be subject to FATCA withholding. If the U.S. competent authority notifies the partner country of significant non-compliance by an FFI in the partner country, the partner country must address the non-compliance, and if the FFI's non-compliance is not resolved within 18 months, the U.S. will treat the FFI as a nonparticipating FFI subject to FATCA withholding.[6] Any FFI in the partner country will be treated as a participating FFI even if affiliates and branches of the FFI in other jurisdictions are prohibited by law from fully complying with FATCA reporting obligations. However, in order to maintain its participating FFI status, the FFI must ensure that the non-compliant affiliate or branch

[3] U.S. DEPT. OF THE TREASURY, Model Intergovernmental Agreement to Improve Tax Compliance and to Implement FATCA [Reciprocal Version], July 26, 2012; U.S. DEPT. OF THE TREASURY, Model Intergovernmental Agreement to Improve Tax Compliance and to Implement FATCA [Nonreciprocal Version], July 26, 2012.

[4] JOINT COMMUNIQUE BY FRANCE, GERMANY, ITALY, SPAIN, THE UNITED KINGDOM AND THE UNITED STATES ON THE OCCASION OF THE PUBLICATION OF THE "MODEL INTERGOVERNMENTAL AGREEMENT TO IMPROVE TAX COMPLIANCE AND TO IMPLEMENT FATCA," July 26, 2012.

[5] Model Intergovernmental Agreement to Improve Tax Compliance and to Implement FATCA, *supra* note 3, arts. 2 & 3.

[6] *Id.*, art. 5, para. 2.

complies with FATCA to the extent permitted by law, identifies itself to withholding agents as non-compliant, and refrains from "specifically soliciting" certain accounts that would be held by persons not resident in its jurisdiction.[7]

The model agreement specifies, in considerable detail, due diligence obligations of FFIs in the partner country for identifying and reporting U.S. Reportable Accounts, which differ in part from those in the proposed regulations under FATCA.[8] The model agreement generally postpones until January 1, 2014 the effective date of FFI due diligence requirements with respect to the opening of new accounts and treats all accounts opened in 2013 (or earlier) as "preexisting accounts."[9] This extends the deadline for full due diligence by one year as compared to the proposed regulations under FATCA. However, significant due diligence will be required in 2013 and after for these preexisting accounts.[10]

Under the model agreement, an FFI in the partner country will not be required to withhold on payments to or, to terminate an account of, a "recalcitrant" accountholder, i.e., an accountholder that does not provide information required to be furnished under the due diligence procedure. The U.S. and the partner country further commit to developing a practical and effective approach to foreign pass-thru payments, which are payments by the FFI attributable to payments received by the FFI that, absent the FFI's qualification as a participating FFI, would be subject to FATCA withholding.

Forthcoming Alternative Model Agreement

A Treasury employee recently stated that another model agreement will be released in the near future reflecting the alternative approach described in the bilateral June 2012 Treasury statements with Japan and Switzerland (the "Model II approach").[11] The Model II approach will require direct information reporting by FFIs to the IRS and will require the foreign government, at the request of the U.S. competent authority, to provide information regarding accounts that are identified as held or controlled by recalcitrant accountholders. It is not yet known whether the Model II approach will also require that a tax treaty or TIEA is already in place.

– *A. Simon, D. Kershaw*

Fourth Circuit Reverses Lower Court on "Willfulness" in FBAR Case

The U.S. Court of Appeals for the Fourth Circuit, in an unpublished opinion, reversed the decision of the U.S. District Court for the Eastern District of Virginia,[12] which had held in favor of J. Bryan Williams in an action seeking to enforce penalties for failure to file an FBAR. The only issue before the Fourth Circuit was whether Williams "willfully" failed to file a timely FBAR. The trial court found that Williams's violation was not willful, but in a 2-1 decision, the appellate court concluded that the trial court clearly erred in so finding.

Background

Between 1993 and 2000, Williams deposited more than $7,000,000 into two Swiss bank accounts that together earned more than $800,000 in income on deposits. Government officials became aware of the Swiss accounts in 2000, and Swiss authorities soon thereafter froze the accounts. In January 2001, Williams completed a "tax organizer" that his accountant had given him. A question in the organizer asked whether he had an interest in a foreign financial account, to which Williams responded, "No." He also answered "No" to a similar question on the 2000 Form 1040, Schedule B. Although he eventually disclosed the accounts to the IRS, he was charged with

[7] *Id.*, art. 4, para. 5.
[8] *Id.*, Annex I.
[9] *Id.*, art. 1, para. 1(aa).
[10] *Id.*, Annex I.

[11] Kristen A. Parillo, "No Further Extensions of FATCA Deadlines Likely," *Tax Notes Today*, July 25, 2012.
[12] *United States v. Williams*, No. 10-2230 (4th Cir. 2012); *United States v. Williams*, No. 1:09-cv-00437 (E.D. Va. 2010).

and pled guilty to superseding criminal information, which charged him with conspiracy to defraud the IRS and criminal tax evasion. In connection with his plea bargain, Williams allocuted to all the elements of both crimes and admitted that he knew that he had an obligation to report the Swiss accounts but chose not to in order to evade taxes. Subsequently, the IRS assessed FBAR penalties against him.

Bank Secrecy Act

The Bank Secrecy Act requires a taxpayer annually to report financial interests in any bank, securities, or other financial institutions in a foreign country and authorizes the Secretary of the Treasury to impose a civil money penalty on any person who fails to file a timely FBAR.[13] The Secretary may impose an increased maximum penalty of up to $100,000 or 50 percent of the balance in the account at the time of the violation in cases where a person "willfully" fails to file an FBAR.[14]

Majority and Dissenting Opinions

The majority pointed to Williams's signature on the return as *prima facie* evidence that he knew the contents of the return and the directions to Schedule B as inquiry notice to Williams of the FBAR requirement. His false answers on the tax organizer and the federal return, according to the majority, were "'meant to conceal or mislead sources of income or other financial information.'" According to the majority, "[t]his conduct constitutes willful blindness to the FBAR requirement." The majority also cited Williams's allocution as "confirm[ing] that his violation of § 5314 was willful."

Judge Agee in dissent accused the majority of disregarding, at least in practice, the clear error standard. The dissent acknowledged that there was "evidence supporting a finding of a willful violation, especially if a 'willful violation' can include 'willful blindness to the FBAR requirement' or 'intentional ignorance.' [Citation omitted.] That evidence could have led a reasonable factfinder to conclude that the violation was willful, as the majority believes." In support of the district court's finding, however, the dissent referred to Williams's testimony that he was unaware of the filing requirement and the district court's reasoning that Williams had no motive to continue to conceal the Swiss accounts in June 2001 because he knew that the government already knew about the accounts. The dissent also took issue with the majority's reliance on Williams's allocution: "pleading guilty to hiding the existence of the two accounts for income tax purposes does not necessarily establish that Williams willfully failed to file a FBAR for 2000."

Conclusion

The *Williams* decision raises a number of questions about the meaning of "willfulness" in the context of the FBAR penalty. Neither the majority nor the dissent provides a clear definition of the term, and the majority's holding has caught the attention of a number of tax practitioners who are concerned that courts may look to it in analyzing the FBAR penalty in other cases even though it is non-precedential.[15]

– E. McGee

[13] 31 U.S.C. § § 5314, 5321(a)(5)(A).
[14] 31 U.S.C. § 5321(a)(5)(C).

[15] *See* Jeremiah Coder, "FBAR Penalty Case Reversal Raises Questions About Civil Willfulness Standard," *Tax Notes Today*, July 24, 2012; Jack Townsend, "Fourth Circuit Reverses *Williams* on Willfulness," July 20, 2012, *available at* http://federaltaxcrimes.blogspot.com/2012/07/fourth-circuit-reverses-williams-on.html?utm_source=BP_recent.

U.S. Supreme Court Declines to Hear Challenge to Foreign Bank Account Subpoena

On June 25 the United States Supreme Court denied a petition for a writ of certiorari in *M.H. v. U.S.*[16] The Court chose not to review a Ninth Circuit decision that upheld a finding of contempt against a man who failed to comply with a grand jury subpoena ordering the production of records related to foreign bank accounts. The man, identified by the initials M.H., was the subject of an investigation into the use of Swiss bank accounts to evade federal income taxes.[17] The government began the investigation of M.H. after the Swiss bank UBS AG gave account information to the Department of Justice in 2009 pursuant to a deferred-prosecution agreement.

District Court Decision

In 2010, a grand jury investigating M.H. issued a subpoena demanding the production of his foreign account records, which are required to be kept under the Bank Secrecy Act of 1970 and related regulations.[18] The requested information is the same as that already subject to mandatory reporting to the IRS on FBAR. M.H. initially refused to produce the records or confirm that they did not exist on Fifth Amendment grounds. He argued that if he produced the documents, he might incriminate himself because the information could conflict with his previous reports to the IRS, and, alternatively, that if he denied possessing the records, he might risk incriminating himself because failure to keep the required records is a felony. The district court issued M.H. a contempt citation, leading to appeals to the Ninth Circuit and Supreme Court.

[16] Patrice Gray, "Supreme Court Denies Review to Individual Challenging Contempt Order in Tax Evasion Investigation," *Tax Notes Today*, July 26, 2012 (citing and discussing *M.H. v. U.S.*, Sup. Ct. Dkt. No. 11-1026 (2012), 648 F.3d 1067 (9th Cir. 2011)).
[17] *In re Grand Jury Investigation M.H., M.H. v. U.S.*, 648 F.3d 1067 (9th Cir. 2011).
[18] *Id.*

Ninth Circuit Decision

The Ninth Circuit affirmed the district court's determination that the Fifth Amendment privilege did not apply and upheld the order of contempt for failing to produce the records.[19] Both courts found the Fifth Amendment inapplicable because of the Required Records Doctrine, which eliminates the privilege when certain circumstances are met and the record is required to be maintained by law. The Ninth Circuit noted that this rule may apply when records are required to be kept because of an individual's voluntary participation in a regulated activity. The court further explained that the Fifth Amendment privilege is inapplicable under the Required Records Doctrine if: "(1) the purpose of the government's inquiry is regulatory, not criminal; (2) the information requested is contained in documents of a kind the regulated party customarily keeps; and (3) the records have public aspects."[20] The court found that the purpose of the Bank Secrecy Act's record-keeping requirement is regulatory rather than criminal because the existence of a foreign account is not inherently illegal. Secondly, the court found the records to be of a type customarily maintained because they consisted of basic account information that a customer would keep to either access an account or report it to the government as required by law. Third, the court found the requested information to have public aspects, in part because it is required to be kept pursuant to a valid regulatory scheme that applies as a result of the accountholder's voluntary participation in a publicly regulated activity. Therefore, the Ninth Circuit found that the Fifth Amendment did not bar compelled disclosure because of the Required Records Doctrine.

Cert Petition in the Supreme Court

In his petition for a writ of certiorari, M.H. asked the Supreme Court to review the Ninth Circuit's decision to clarify an issue of national importance and resolve splits

[19] *Id.*
[20] *Id.* (citing and quoting *In re Grand Jury Proceedings* (*Doe M.D.*), 801 F.2d 1164 (9th Cir. 1986)).

of authority that have developed in lower courts with respect to similar Fifth Amendment claims and the Required Records Doctrine.[21] M.H. challenged the holdings of the district court and Ninth Circuit, including their interpretation of the Required Records Doctrine. His petition suggested that "[i]f the act of producing documents is incriminating, it is not less incriminating because the records were required to be kept." The Department of Justice argued that the Fifth Amendment was inapplicable and urged the Supreme Court to reject M.H.'s appeal.[22] The government noted that by the time the Supreme Court considered the petition, M.H. had already produced the requested documents to avoid incarceration for contempt, thus rendering the issue moot until the government charges him with a crime. The Supreme Court's denial of M.H.'s petition will leave the Ninth Circuit's decision undisturbed and may lead to further development of these issues in future cases.

– D. Smith

Draft Guidelines Say India's Anti-Avoidance Rule Will Not Apply Retrospectively

On June 28 in a move apparently intended to ease foreign investors' worries, India's Ministry of Finance issued new draft guidelines on the general anti-avoidance rule (GAAR), which was introduced in Indian Finance Bill 2012. The draft guidelines clarify that GAAR will not apply retrospectively and state that the burden of proving tax liability lies with the Indian tax authority. The potential for retroactive tax has been of particular concern to foreign investors.[23]

The proposed draft guidelines will be finalized after feedback has been received and considered. Although the publication of the draft guidelines is generally seen as a positive step, some commentators have noted that there are a number of ambiguities which will require further clarification.[24]

– N. Beekman

[21] Petition For Writ of Certiorari and Appendix Vol. 1, *M.H. v. U.S.*, Sup. Ct. Dkt. No. 11-1026 (2012).
[22] Bob Drummond, "Top Court Rejects Appeal on Foreign Bank Account Subpoena," *Bloomberg Businessweek*, June 25, 2012, *available at* http://www.businessweek.com/news/2012-06-25/top-court-rejects-appeal-on-foreign-bank-account-subpoena.
[23] For previous coverage, please refer to D. Jones, "Indian Government Identifies Vodafone as Potentially Subject To Retroactive Tax," *Focus on Tax Controversy and Litigation*, June 2012, at 13.
[24] Stephanie Johnston, "India Says Antiavoidance Rule Won't Be Retroactive," *Tax Notes International*, July 9, 2012.

Shearman & Sterling's Tax Controversy Practice

Shearman & Sterling's Tax Controversy and Litigation practice is centered on large-case tax controversy examinations, tax litigation matters, and government investigations. Our prominent team of nationally recognized trial lawyers represents taxpayers at the audit and appeals stages before the Internal Revenue Service and litigates on behalf of taxpayers in the federal courts, from the U.S. Tax Court to the Supreme Court of the United States. Shearman & Sterling's tax lawyers also represent clients in obtaining rulings from tax authorities and in competent authority proceedings and work with clients to obtain advance pricing agreements.

In addition, our tax lawyers are active members of the American Bar Association Section of Taxation ("ABA Tax Section"), the New York State Bar Association Tax Section ("NYSBA Tax Section"), the Wall Street Tax Institute, and the Institute of International Bankers. One partner recently served as chair of the NYSBA Tax Section; another recently ended his term as Chair of the ABA Tax Section's Court Practice and Procedure Committee. Our tax controversy lawyers frequently participate in panels at tax law conferences and publish articles regarding significant tax controversy and litigation developments.

If you wish to receive more information about or discuss Shearman & Sterling's tax controversy practice, you may contact Lawrence M. Hill at lawrence.hill@shearman.com or (212) 848-4002 or your Shearman & Sterling relationship partner.

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This newsletter is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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