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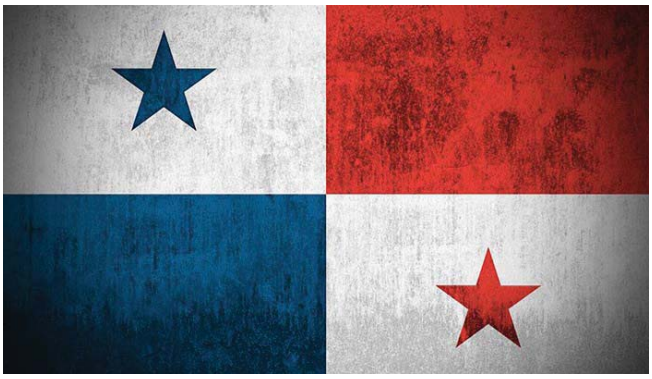
The Panama Papers And The Voluntary Disclosure Conundrum



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On June 26, 2016, a widened Panama Canal will open for business after a ten-year, USD5.3bn expansion project is completed. The new locks will allow bigger ships to pass through the 102-year-old waterway. The canal has been a source of great pride to America, who built the canal, and Panama, who possesses and operates the great locks. But the recently leaked 11.5 million documents from the Panama-based law firm Mossack Fonseca & Co., known as the "Panama Papers," shows another, darker side of our Pan-American relationship, which has been largely ignored until now.

The Panama Papers present the US government with a vast amount of highly confidential information on the secretive world of tax havens, offshore accounts, their underlying beneficial owners and possible tax evasion, which will take years to investigate and unravel. Already, in response to the release of the Panama Papers, the US Attorney's Office for the Southern District of New York has opened a formal criminal investigation into potentially widespread tax evasion and other criminal activity, and the New York State Department of Financial Services has asked 13 foreign banks to turn over information about their respective New York branches' contact with the Mossack Fonseca law firm. The United States is not alone. Similar inquires have been launched in the

UK, Germany, France, Austria, Sweden, the Netherlands and elsewhere. The person who leaked the information to the International Consortium of Investigative Journalists ("ICIJ") remains anonymous, but he issued a manifesto on May 6, describing his reasons for exposing what he called "massive, pervasive corruption." In response, Panama has stated that it is "fully and immediately" committed to providing an exchange of tax information. It is a certainty that the IRS and US Department of Justice will soon issue a treaty request to Panama that seeks additional account information.[1]

Having a foreign account in the name of an offshore company is not *per se* illegal (although see below for a caveat to this) and may be accompanied by full compliance with the tax laws. There are no restrictions in the United States against having a bank or securities account in a foreign jurisdiction. Many Americans maintain foreign accounts for legitimate reasons. Thus, the fact that a name may appear on a client list of the Panamanian law firm, Mossack Fonseca, does not mean tax evasion has been committed. However, it is a tax crime to willfully conceal foreign accounts and income, and to use offshore structures to hide such accounts and evade US taxes.

US citizens are taxed annually on their world-wide income and are required to report income from all offshore accounts. A US citizen must disclose on their annual income tax returns any financial interest in or signatory authority over a financial account located in a foreign country and report all income from the offshore account. This must be done regardless of the account balance or whether income was earned from the foreign account. US citizens are also required to file a Report of Foreign Bank and Financial Account (FBAR) to reveal all foreign accounts if more than USD10,000 is held in their offshore accounts in total.

The FBAR is an informational return and does not require the payment of any tax. The annual FBAR must be filed with the IRS whenever a taxpayer has an interest in, or signature authority over, a foreign financial account with a value over USD10,000 at any time during the calendar year. It makes no difference if the average amount in the account during the year is less than USD10,000 or if all of the money is withdrawn by the end of the year. If the account held more than USD10,000 at any time during the year, the FBAR must be filed. The USD10,000 threshold is based on the cumulative balance of all your foreign accounts. You are also required to file the FBAR if a foreign account has non-monetary assets of more than USD10,000. For example, the cash surrender value of a life insurance policy is such a nonmonetary asset. In addition to the annual FBAR, the US taxpayer must also report the income earned from each foreign account on schedule B, Form 1040, as well as complete the IRS Form 8938, *Statement of Specified Foreign Financial Assets*.

The FBAR must contain the name and address of each financial institution in which you hold an account, the account number and the maximum amount in the account during the year. The FBAR is not filed with your income tax return. Instead, it must be separately filed with the Department of the Treasury by June 30 each year – in this case, filed means received by the Department of the Treasury, not placed in the mail.

Obtaining an extension to file your federal income tax return does not extend the due date for filing your FBAR. You may not request an extension for filing the FBAR. If you do not have all the information you need to file the FBAR by June 30, you should file as complete a return as you can and later amend the FBAR when the additional or new information becomes available.

The civil penalties for failing to file FBARs are severe, some say draconian. There is a minimum USD10,000 penalty per bank account if your failure to file was inadvertent. However, if you willfully fail to file the FBAR, the minimum fine is USD100,000 or half the value of the account, whichever is greater. The civil penalty applies to each account annually. Possible criminal charges for failure to file an FBAR and failure to report income from a foreign account may subject a person to a prison term of up to ten years and a criminal penalty of up to USD500,000.

In January 2012, the IRS announced that it reopened the offshore voluntary disclosure program (OVDP) by which taxpayers could voluntarily disclose unreported offshore accounts to the US government in exchange for reduced civil penalties (first implemented in 2009), rather than face possible criminal prosecution if detected. Taxpayers who participate in the OVDP must file all delinquent FBARs, original amended income tax returns and pay back taxes and interest as well as a related penalty on the unreported income and late filing penalties for up to eight years. The written submission must also provide information to the IRS explaining how the taxpayer evaded their US tax obligation and the role of any intermediary and foreign financial institution.

Under the 2012 OVDP, individuals were required to pay a civil penalty of 27.5 percent of the highest aggregate balance in their foreign bank accounts during the eight full tax years prior to the disclosure. So, for example, if the foreign account had a high balance of USD1m dollars during any of the eight years, even if just for an instant, the IRS would impose a failure to file FBAR penalty of USD275,000, exclusive of any tax, interest and other penalties associated with the unreported interest income in the account. Taxpayers, in limited situations, whose offshore accounts or assets did not exceed USD75,000 in any year covered by the disclosure program qualified for a reduced 12.5 percent FBAR penalty. And some taxpayers only faced a 5 percent penalty.[2] Under

the OVDP, if the taxpayer truthfully, timely, and completely complied with all provisions of the voluntary disclosure practice, the OVDP enables noncompliant taxpayers to resolve their tax liabilities and minimize their chance of criminal prosecution.

In June 2012, effective September 1, 2012 the IRS announced a streamlined program ("Streamlined Program"), limited to US taxpayers living abroad with foreign accounts. Eligibility was limited to non-resident non filer US taxpayers who could demonstrate a low level of compliance risk and who did not owe more than USD1,500 of tax for each of the three years covered by the Streamlined Program.[3] Resident US taxpayers were not eligible for the Streamlined Program. Non-resident US taxpayers who utilized the Streamlined Program were required to file delinquent tax returns for the past three years and to file delinquent FBARs for the past six years. On June 18, 2014, the IRS announced an expansion of the Streamlined Program to permit resident US taxpayers to participate in the program. Resident US taxpayers who filed under OVDP prior to June 30, 2014 who met certain eligibility requirements for the expanded Streamlined Program could elect to proceed under the Streamlined Program and benefit from a more favorable penalty structure.

The expanded Streamlined Program eliminated the cap on outstanding taxes owed (formerly USD1,500 each year), did away with the risk questionnaire, but now requires the taxpayer to submit a written statement signed under penalty of perjury certifying their non-willfulness with respect to all foreign activities, and specifically describe the reasons for the failure to report all income and file timely FBARs. According to the IRS's transition rule, the taxpayer bears the burden of proving that their actions were not willful, not an insubstantial hurdle. Upon IRS acceptance into the Streamlined Program, US resident taxpayers, who formerly participated in the OVDP, will not be required to pay the 27.5 percent offshore penalty at the OVDP rate, but will instead be subject to the streamlined penalty rate of 5 percent. However, the Streamlined Program does not provide protection from criminal prosecution if the IRS and the DOJ determine that the taxpayer's particular circumstances warrant such prosecution.

According to the IRS, returns submitted under the Streamlined Program will not automatically be subject to IRS audit, but may be selected for audit under existing audit selection applicable to any US tax return, and may be subject to verification procedures against information received from banks and other sources. The IRS has not provided a list of factors to demonstrate willful behavior, but prior actions brought by the IRS asserting willful conduct include: (i) opening foreign accounts in an entity or foundation name; (ii) providing false information to taxpayer's tax accountant, or

(iii) knowing at the time of filing the tax return that the taxpayer should have reported both the existence of the account and the income earned from it.[4] A taxpayer could be subject to criminal liability and/or substantial monetary penalties if a taxpayer's behavior was willful.

Taxpayers who did not enter the OVDP by June 30, 2014 must decide whether to submit to the OVDP or the expanded Streamlined Program. Once a taxpayer makes a submission under the Streamlined Program, the taxpayer may not participate in the OVDP. Similarly, a taxpayer who submits an OVDP voluntary disclosure letter on or after July 1, 2014 is not eligible to participate in the streamlined procedures. However, taxpayers who file directly into the Streamlined Program who had not previously entered the OVDP are presumed to be non-willful and need only to correct their tax return filings for three years and foreign bank account report filings for six years. But taxpayers who use the streamlined procedures do not enter into a closing agreement and do not get criminal investigation protection. Taxpayers who go into the OVDP do enter into closing agreements.

The 2014 OVDP also modified the offshore penalty. Because of the expansion of the Streamlined Program, the IRS eliminated the 12.5 percent and 5 percent offshore penalties. After July 1, 2014, the offshore penalty under the OVDP is either 27.5 percent, or 50 percent of the highest year's aggregate value during the period covered by the voluntary disclosure. The new 50 percent offshore penalty applies if either: (i) a foreign financial institution at which the taxpayer has or had an account, or (ii) a facilitator who assisted the taxpayer to establish or maintain an offshore account, has been identified as being under investigation by the IRS or DOJ or as cooperating with a US government investigation. Examples of public disclosure include, without limitation: a public filing in a judicial proceeding or public disclosure by the DOJ regarding a Deferred Prosecution Agreement or Non-Prosecution Agreement with a financial institution or facilitator. It remains to be seen whether the disclosure of Mossack Fonseca will be considered a public disclosure of a facilitator, triggering the 50 percent offshore penalty. Once the 50 percent offshore penalty applies to any of the taxpayer's accounts or assets, the 50 percent penalty will apply to all of the taxpayer's undisclosed foreign accounts, including accounts held at another institution or established through another facilitator.

The Streamlined Program will continue to be offered to US taxpayers residing outside the United States. For non-resident US taxpayers, the IRS has eliminated the cap on outstanding taxes and no longer requires the risk questionnaire. To qualify as a nonresident, the taxpayer must not have a US abode and the individual must be physically present outside the United States for at least

330 full days. Non-resident taxpayers eligible for the streamlined foreign offshore procedures will not be subject to failure to file and failure to pay penalties, accuracy related penalties, information return penalties, or FBAR penalties.

As of October 2015, according to IRS figures, more than 54,000 taxpayers had participated in the OVDP since 2009 and more than 30,000 US taxpayers had used the streamlined procedures. In addition, the IRS has conducted thousands of offshore-related civil audits that have produced tens of millions of dollars in taxes and penalties, and has pursued criminal charges leading to billions in criminal fines. The DOJ and the IRS have obtained valuable information regarding account holders as well as detailed information regarding the offshore banks and professionals who assisted in the cross-border activities. Additionally, information obtained through the OVDP, as well as information provided by whistleblowers, led to criminal investigations of a number of well-known Swiss banks.

The US government and Swiss officials eventually agreed to a Program for Non-Prosecution Agreements or Non-Target Letters from Swiss banks (commonly known as the Swiss Program), which led the DOJ entering into 78 Non-Prosecuting Agreements with Swiss banks, and collecting more than USD1.3bn in penalties from the banks. The Swiss Program has provided the US government with significant information about cross-border activities, and information regarding other banks that transferred funds into undeclared accounts, or that accepted funds from undeclared accounts. The Panama Papers will add to the US government's treasure trove of information. The ICIJ has published details on over 200,000 offshore entities set up in 21 jurisdictions, including the United States, Hong Kong, Singapore and New Zealand. It is likely just a matter of time before the United States obtains the identity of those taxpayers behind these entities.

In recent years, the Tax Division working closely with the United States Attorneys' office has opened numerous criminal investigations into US citizens with offshore accounts and has indicted dozens of banking professionals and nearly 100 account holders, resulting in convictions after trial and numerous guilty pleas. A number of the individuals we and who others have represented have had accounts in Switzerland, as well in India, Israel and the Cayman Islands. The US government is aggressively working to uncover and prosecute those who hide their unreported income and assets from the United States. Recently, the IRS issued a "Bank of Nova Scotia" [5] summons to UBS's branch in Miami seeking foreign bank records from a Singapore account purportedly owned by a US taxpayer who may have held undeclared offshore accounts in Singapore. In addition, a federal court in Miami has authorized the IRS to serve a "John Doe" summons seeking

information about US taxpayers who may hold offshore accounts at Belize Bank International or Belize Bank Limited.[6]

Despite the success of the OVDP, the US government believes that there remains tens of thousands of undeclared foreign accounts held by US citizens. The IRS and DOJ have acknowledged that they have begun to target accounts in other countries, which include Hong Kong, Panama, Singapore, Belize, Guernsey, Cayman Islands, Luxembourg, Channel Islands, and the British Virgin Islands.

Closing a foreign account and moving money to a different account to evade detection is a dangerous and potentially criminal exit strategy. As part of the Swiss Program, in order for a Swiss Bank to be eligible for a non-prosecution agreement, the Bank was required to provide to the DOJ a "Leaver List," which details information regarding other banks that transferred funds into undisclosed accounts, or that accepted funds when undeclared accounts were closed. In addition, the recently enacted FATCA rules will mandate greater disclosure of foreign account information to the IRS.[7] FATCA requires foreign banks to report to the IRS all names and account information of US beneficial owners of foreign accounts. Indeed, to satisfy their compliance under FATCA, many foreign banks have sent letters to their US customers requiring execution of an IRS W-9 disclosure form to be filed with the bank. Failure to establish that an account holder is US tax complaint may result in closure of the account.

American citizens with foreign accounts must properly report their foreign accounts to the US government and pay taxes on income earned on their foreign accounts. Under FATCA, foreign banks will undoubtedly cooperate with the US and will begin disclosing accounts held by US owners to the DOJ, which may lead to severe civil fines and possible criminal prosecution for Americans who are not tax compliant. Both the OVDP and the Streamlined Program permit US taxpayers to correct prior omissions and become complaint with their federal tax obligations while mitigating potential criminal penalties. The OVDP and Streamlined Program remain open, and US taxpayers with undisclosed offshore accounts should strongly consider using existing voluntary disclosure procedures and become fully compliant before the US government becomes aware of the undisclosed accounts.

The US government's interest in the Panama Papers together with FATCA implementation should raise serious concerns to non-compliant taxpayers that the window for making a voluntary disclosure may be slamming on them. It is apparent that the DOJ and IRS remain aggressively

committed to thwarting offshore tax evasion wherever it occurs. US taxpayers home or abroad should consult with experienced tax counsel and act promptly to mitigate civil tax exposure and to avoid criminal exposure and a tax nightmare.

Endnotes

1 On May 9, 2016, the International Consortium of Investigative Journalists unveiled a searchable database containing information from the Panama Papers. The ICIJ database is located at http://offshoreleaks.icij.org

2 See FAQ 52: https://www.irs.gov/individuals/international-taxpayers/offshore-voluntary-disclosure-program-frequently-asked-questions-and-answers

3 To be eligible, the non-resident US taxpayer must have resided outside the US since January 1, 2009, and who did not file a US tax return during the same period, and who presented a low level of compliance risk. Low risk was predicated on simple returns with little or no US tax due. The IRS considered risk to be high if, in part, (i) the taxpayer demonstrated material activity in the United States; (ii) the taxpayer was under audit or investigation by the IRS, or (iii) if the taxpayer had US source income or any indication of sophisticated tax planning or avoidance.

4 *See United States v. McBride*, 908 F.Supp 2d 1186 (D. Utah 2012).

5 *See In Re Grand Jury Proceedings (Bank of Nova Scotia)*, 740 F.2d 817 (11th Cir. 1994). By federal court order the summons compels the US branch of a non-US branch to produce banking records even though disclosure would violate bank secrecy laws which govern the non-US branch.

6 *See In the Matter of Tax Liability of John Does* (Index No. 1;15-mc-23475) (September 16, 2015). The "John Doe" summons is a summons that does not identify the person with respect to whose liability the summons is issued. The IRS uses the "John Doe" summons to obtain information about possible violations of internal revenue laws by individuals or groups or classes of persons whose identities are unknown.

7 The Foreign Account Tax Compliance Act ("FATCA") is a 2010 federal law to enforce disclosure of foreign accounts held by US persons. FATCA requires reporting by foreign financial institutions about financial accounts held by US persons. FATCA is intended to promote cross-border tax compliance by implementing an international standard for the automatic exchange of information related to US taxpayers. FATCA imposes tax withholding where the applicable documentation and reporting requirements are not met.