U.S. Response to Unreported Offshore Income and Assets of U.S. Taxpayers

*Carol P. Tello**


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Since the G-20 meeting on April 2, 2009, there has been a worldwide emphasis on the elimination of bank secrecy through the implementation of tax information exchange agreements ("TIEA") with countries or jurisdictions that traditionally have been thought of as "tax havens." In addition to negotiating new TIEAs, the United States has instituted a number of new legislative and administrative measures to ensure compliance with U.S. tax laws. This article will briefly discuss those measures.

FBAR reporting on offshore accounts

Prior to the enhanced compliance efforts undertaken by the U.S. government following that April 2, 2009 G-20 meeting, U.S. persons with foreign financial accounts already were required to report the amount of assets held in those accounts. Under the Bank Secrecy Act (Title 31 of the U.S. Code), a Form TDF 90-22.1 (colloquially known as the "FBAR") is required to be filed each June 30 for individuals and entities that have a financial interest in a foreign financial account or who have signature or other authority over such an account. The Internal Revenue Service ("IRS") had developed a public awareness campaign in which it suggested that no penalties would be imposed if delinquent FBAR reports were filed with a "reasonable cause" statement.

It is important to note that the FBAR requirement is not imposed under the Internal Revenue Code,[1] although the IRS has been delegated FBAR enforcement authority by the U.S. Treasury Department Financial Crimes Enforcement Network ("FINCEN"), which is charged with responsibility for the Bank Secrecy Act.

* Carol P. Tello, Partner, Sutherland Asbill & Brennan LLP, Washington, D.C.

Penalties for failing to file the FBAR, which include both civil and criminal penalties, can be onerous. Civil penalties for a failure that is not wilful are not to exceed $10,000, while a wilful failure can result in a maximum penalty of $100,000 or 50% of the amount of the transaction or the balance in the account at the time of the violation. A reasonable cause exception is available for a non-wilful failure to file, but not for a wilful failure. Criminal penalties include monetary penalties of up to $500,000, imprisonment for not more than five years, or both.

U.S. Legal actions with respect to UBS

The most aggressive measures were taken by the U.S. Department of Justice ("DOJ"), which initiated a lawsuit against Union Bank of Switzerland ("UBS") for conspiracy to defraud the United States by impeding IRS investigations.[2] Ultimately, the DOJ and UBS entered into a voluntary agreement under which UBS was required to report the income and other relevant information about the UBS accounts held by U.S. persons.[3] Under that disclosure program, reports were provided to the IRS on approximately 4000 taxpayers with additional names expected to be released before the process is concluded.

In addition to the legal action taken against UBS, DOJ has successfully prosecuted a number of former UBS U.S. clients for various criminal offences.

Negotiation of new exchange of information provision in U.S. - Switzerland treaty

A new Protocol to the U.S.-Switzerland treaty was signed on September 23, 2009. To date, the Protocol has not been considered by the United States Senate and is not in force. Furthermore, the text of the Protocol has not been released.

Currently, Article 26(1) of the U.S. – Switzerland treaty limits the exchange of information to such information that is necessary to carry out the provisions of the Treaty or to prevent "tax fraud or the like." Article 26(3) prevents the imposition of an obligation to carry out administrative practices that vary with the regulations and practice of either country or that would be contrary to a country's sovereignty, security or public policy. In addition, information not procurable under a country's laws is not required to be made available to the other country.

Notwithstanding the current provision, UBS was able to disclose the names of U.S. clients under the August 19, 2009 agreement with the DOJ, which was given the legal status of a Protocol to the treaty in order for Swiss law to permit the disclosure.

It is believed that the September 23, 2009 Protocol will conform the existing Exchange of Information Article (Article 26) to the Exchange of Information provision contained in the OECD Model Treaty. Significantly, the OECD Model Treaty provision provides that Article 26(3) cannot be construed to permit another country to decline to supply information because the information is held by a financial institution or a person acting in a nominee or fiduciary capacity or because the information relates to the ownership interests of a person. Article 26(3) of the OECD Model Treaty limits the obligation to provide information when to do so would be at variance with the laws and administrative practice of the other country.

2009 offshore voluntary disclosure

Following the announcement of the lawsuit filed against UBS, on March 23, 2009, the IRS announced a Voluntary Disclosure program for U.S. persons that had not filed FBAR reports nor reported income earned in offshore accounts. A taxpayer that had already been contacted by the IRS did not qualify for the program.

To apply for the program, a taxpayer was required to disclose the unreported offshore accounts to the IRS Criminal Division, which determined whether to pursue criminal sanctions. If the Criminal Division did not pursue criminal sanctions, the taxpayer was admitted to the Voluntary Disclosure program. The Voluntary Disclosure program ended on October 15, 2009 and ultimately resulted in approximately 15,000 voluntary disclosures by U.S. persons.[4]

The program substituted a "miscellaneous" civil penalty of 20 percent in lieu of the numerous penalties that could otherwise be assessed. The 20-percent penalty was imposed on the highest aggregate account balance for the six-year period ending with the 2009 taxable year. All delinquent FBAR reports and amended U.S. income tax returns for that same six-year period were required to be filed as well.

New statutory reporting provisions

In addition to the Voluntary Disclosure program described above, new legislation commonly referred to as "FATCA" was enacted in 2010 that requires reporting by foreign financial institutions on offshore accounts of U.S. persons effective as of January 1, 2013. More limited reporting is required for non-financial foreign entities, including any U.S. owners.

Under the FATCA provisions, an acronym for Foreign Account Tax Compliance Act, if a foreign financial institution does not enter into an agreement with the IRS to report account information about its U.S. account holders, withholding tax of 30 percent will be imposed on U.S. source income other than gains (so-called fixed, determinable annual or periodic income or "FDAP") and on gains realized from the sale of an asset that produces FDAP income.[5]

In addition to the FATCA provisions, U.S. taxpayers are required to report on offshore accounts under new section 6038D, effective beginning for 2011 taxable years. This new reporting requirement is in addition to the FBAR filing requirement, although both reports will collect similar information. A $10,000 penalty may be imposed for a failure to report under section 6038D, which may be increased if the failure continues following notice by the IRS.

Two other reporting provisions also were enacted in 2010. One provision requires annual reporting of an interest in a foreign passive investment company under section 1298(f) and the other provision requires reporting on interests in a foreign trust under section 6048(b)(1).

New offshore voluntary compliance program

The IRS on Feb. 8, 2011 announced the second Special Voluntary Disclosure Initiative, which will end on Aug. 31, 2011. See IR-2011-14. The IRS will refer to this initiative s the 2011 Offshore Voluntary Disclosure Initiative (OVDI). The overall penalty is 25% of the highest aggregate account balance covering the 2003 to 2010 time period, with some taxpayers eligible for 5% or 12.5% penalties. Back taxes and interest plus accuracy related and or delinquency penalties will also be required to be paid. The 12.5% penalty is applicable to taxpayers whose offshore accounts or assets are not greater than $75,000 in any calendar year. Along with the announcement of the 2011 OVDI is a new set of Q&As.

Summary

The U.S. government has undertaken serious measures to ensure compliance with U.S. tax laws. To date, a large number of U.S. taxpayers have disclosed their unreported offshore assets and more taxpayers are expected to do so as the new voluntary compliance program is initiated. Moreover, the IRS and DOJ continue to investigate foreign banks that may have encouraged or facilitated non compliance, which may well result in further disclosure of unreported accounts of U.S. taxpayers. The controversial WikiLeaks organization also is said to be preparing to release information about offshore accounts of U.S. persons. Finally, new reporting requirements imposed on foreign financial institutions and U.S. taxpayers should result in increased future compliance.

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1. Except as otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the "Code.")
2. U.S. v. UBS AG, No. 09-20423-CIV (S.D. Fla, Miami Div.), filed Feb. 19, 2009.
3. IR-2009-75 (Aug. 19, 2009).
4. IR-2009-16.
5. For a more detailed discussion of the FATCA provisions, see Tello, "U.S. Withholding and Reporting Regimes—One Old, One New, 3 International Taxation 185 (Oct. 2010)."
6. The possibility of a second voluntary disclosure program was initially raised by IRS Commissioner Douglas Shulman in December 2010, which was confirmed by Steven Miller, IRS Deputy Commissioner for Services and Enforcement on January 21, 2011.