Alerts and Updates

# CRITERIA FOR DISCLOSURE OF SWISS ACCOUNTS ANNOUNCED: NOW THAT THE OFFSHORE IRS VOLUNTARY DISCLOSURE PROGRAM HAS ENDED, WHAT'S A TAXPAYER TO DO?

November 24, 2009

The U.S. Department of Justice recently revealed the criteria for disclosure of account information made in the August 19, 2009, U.S.-Swiss Treaty Request, under the U.S.-Swiss tax treaty. This disclosure comes on the heels of the passage of the deadline for applying for the U.S. Internal Revenue Service's ("IRS") Offshore Voluntary Disclosure Program ("OVDP"), for offshore financial accounts. For those who timely applied for the OVDP, much remains to be done to complete the voluntary disclosure process. Securing bank records, preparing amended tax returns and Reports of Foreign Bank and Financial Accounts ("FBARs") are only part of the process to complete the voluntary disclosure. For those who missed the deadline, opportunities are still available to avoid criminal prosecution and resolve civil liabilities for offshore and domestic tax compliance issues under the long-standing IRS voluntary disclosure practice.

## Application for Offshore Voluntary Disclosure Ended on October 15, 2009

After extending the OVDP application deadline from September 23, 2009, to October 15, 2009, the IRS announced that at least 14,000 taxpayers had applied for the program. Issues remain for some groups of taxpayers regarding availability for admission to the program. For instance, certain non-English-speaking taxpayer communities have asserted that the program was not adequately communicated to them in a timely fashion. There is some discussion of admitting such applicants beyond the deadline. Some have speculated that a supplemental program with stiffer penalties may be announced, but no official announcement has been made. For the moment, October 15 was the last opportunity to take advantage of the reduced-penalty framework offered by the OVDP.

## Notice of Preliminary Acceptance

Many taxpayers made last-minute timely application for the OVDP by notifying the IRS that they desired to participate in the program. Those last-minute filers as well as all other applicants will be required to submit the optional format disclosure letter to the assigned Criminal Investigation ("CI") special agent. That letter provides summary information regarding the formation of the account, the persons with access to it, the identity of the taxpayer's advisors, and the account's balances and unreported income for the years 2003 through 2008.

After the special agent has determined whether the taxpayer is disqualified from participation in the OVDP (an untimely disclosure being the most-typical disqualifying factor) and secured any additional information deemed necessary, the agent, in most cases, will issue the taxpayer's representative a letter stating that the taxpayer has been "preliminarily accepted" into the OVDP. However, this is not a uniform practice and, in some instances, the CI field offices are not issuing the "preliminarily acceptance" letter and the taxpayer is left wondering what happened to his or her application. What is likely to be the only way to resolve the issue is to contact the assigned CI special agent to ascertain the status of the OVDP application. In most instances, the agent is likely to advise that the matter has been forwarded for civil review.

## The Civil Examination

Once the taxpayer's OVDP application has been preliminarily accepted, the file is transferred for civil review. The IRS has trained more than 500 agents to review the taxpayer's voluntary disclosure. The review will involve the analysis of amended income-tax returns, FBARs and other information returns (Forms 3520, 5471, etc.), as applicable. The process starts with a request for information, typically in the form of an Information Document Request ("IDR"). The standard IDR for the OVDP is three pages of single-spaced requests for everything from copies of originally filed returns, amended returns, FBARs and bank records, to the names of the persons who provided the taxpayer advice relative to the offshore financial arrangement—including attorneys, accountants and financial advisors.

As the civil aspect of the OVDP matures, the scope of the information requested is becoming more refined. The IRS has started placing taxpayers in three categories for purposes of document production. The categories appear to be based on the dollar value of the foreign account. The higher the category, the greater the scrutiny and extent of document production. The highest level of document production is category 3. Taxpayers at this level will be required to produce extensive documentation regarding not only their foreign accounts but also their domestic accounts.

A determination of the appropriate penalties will be made during the civil phase. Originally, the IRS implied that the penalty structure announced in March 2009 was to be applied without exception.[1] Now the IRS has asserted that "Under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes."[2]

Taxpayers not satisfied with the penalties proposed by the revenue agent have the ability to opt out of the OVDP.[3] It is unlikely that this would result in a referral of the matter for criminal investigation. Taxpayers reaching this stage of the

process would have made a timely, voluntary disclosure, and would not have engaged in any other disqualifying conduct (*e.g.*, an illegal source of funds). The Voluntary Disclosure Program does require cooperation with the IRS. but this cannot be construed to require the taxpayer to accept a proposed penalty that is not warranted by the applicable statute.

Taxpayers opting out of the OVDP are likely to face an examination—which, depending upon the circumstances, may lead to a penalty less than that suggested by the OVDP penalty structure. The decision to opt out can be made only after the taxpayer and legal counsel have performed an exhaustive analysis of the risks an exam presents, in comparison to the penalty proposed by the revenue agent under the OVDP.

## Criteria

On August 19, 2009, when the treaty request for bank records was made by the United States to Switzerland under the U.S.-Swiss tax treaty ("U.S.-Swiss Treaty Request"), the criteria for the disclosure of the records were not made public. The presumptive rationale for not disclosing the criteria before the expiration of the deadline for applying for the OVDP was that U.S. taxpayers whose accounts were not included in the criteria would not apply for the OVDP. Now that the deadline for OVDP application has passed, disclosure of the criteria has been made.

Account information for U.S. persons whose accounts meet either of the following criteria will be disclosed:

- U.S.-domiciled clients of UBS who directly held and beneficially owned "undisclosed (non–W-9) custody accounts" and "banking deposit accounts" in excess of one million CHF Swiss francs [approximately 990,000 U.S. dollars ("USD")], at any point in time during the period from 2001 through 2008) with UBS and for which a reasonable suspicion of "tax fraud or the like" can be demonstrated; or
- U.S. persons (irrespective of domicile) who beneficially owned "offshore company accounts" that have been established or maintained during the period from 2001 through 2008 and for which a reasonable suspicion of "tax fraud or the like" can be demonstrated.

### *The Criteria for Determining "Tax Fraud or the Like"for Undisclosed (Non–W-9) Custody Accounts and Banking Deposit Accounts*

For "undisclosed (non–W-9) custody accounts" and "banking deposit accounts," "tax fraud and the like" is established where there is a reasonable suspicion that the U.S.-domiciled taxpayers engaged in either of the following:

1. Activities presumed to be fraudulent conduct[4]—including such activities that led to a concealment of assets and an underreporting of income based on a "scheme of lies" or submission of incorrect and false documents. Where such conduct has been established, persons with accounts of less than 1 million CHF [approximately 99,000 USD] in assets (except those accounts holding assets below 250,000 CHF [approximately 248,000 USD]) during the relevant period would also be included in the group of U.S. persons subject to this request. Such a "scheme of lies" may exist where, based on the bank's records, beneficial owners:
    - used false documents;
    - engaged in a fact pattern that has been set out in the "hypothetical case studies" in the appendix to the Mutual Agreement concerning Article 26 of the Tax Treaty (for example, by using related entities or persons as conduits or nominees to repatriate or otherwise transfer funds in the offshore accounts); or
    - used calling cards to disguise the source of trading.

    These examples are not exhaustive and, depending on the applicable facts and circumstances, certain further activities may be considered by the Swiss Federal Tax Administration ("SFTA") as a "scheme of lies."

2. Acts of continued and serious tax offense for which the Swiss Confederation may obtain information under its laws and practices,[5] including cases where: (i) the U.S.-domiciled taxpayer has failed to provide a Form W-92 for a period of at least three years (including at least one year covered by the request) and (ii) the UBS account generated revenues of more than 100,000 CHF [approximately 99,000 USD] on average per annum for any three-year period that includes at least one year covered by the request. For the purpose of this analysis, revenues are defined as gross income (interest and dividends) and capital gains (which for the purpose of assessing the merits of this administrative information request are calculated as 50 percent of the gross sales proceeds generated by the accounts during the relevant period).

    For "banking deposit accounts," a reasonable suspicion for such tax offense would be met if the U.S. persons failed to prove upon notification by the SFTA that they have met their statutory tax-reporting requirements for their interests in such accounts (*i.e.*, by providing consent to the SFTA to request copies of the taxpayer's FBAR returns from the IRS for the relevant years).

### *Offshore Company Accounts*

For "offshore company accounts," a reasonable suspicion of "tax fraud and the like" exists where there is a reasonable suspicion that the U.S. beneficial owners engaged in either of the following:

1. Activities presumed to be fraudulent conduct,[6] including such activities that led to a concealment of assets and an underreporting of income based on a "scheme of lies" or submission of incorrect or false documents, other than U.S. beneficial owners of offshore company accounts holding assets below 250,000 CHF [approximately 248,000 USD] during the relevant period. Such a "scheme of lies" may exist where the bank's records show that beneficial owners continued to direct and control, in full or in part, the management and disposition of the assets held in the offshore company account, or otherwise disregarded the formalities or substance of the purported corporate ownership (*i.e.*, the offshore corporation functioned as a nominee, sham entity or alter ego of the U.S. beneficial owner) by:
    - making investment decisions contrary to the representations made in the account documentation or in respect to the tax forms submitted to the IRS and the bank;
    - using calling cards / special mobile phones to disguise the source of trading;
    - using debit or credit cards to enable them to deceptively repatriate or otherwise transfer funds for the payment of personal expenses or for making routine payments of credit card invoices for personal expenses using assets in the offshore company account;
    - conducting wire-transfer activity or other payments from the offshore company's account to accounts in the United States or elsewhere held or controlled by the U.S. beneficial owner or a related party with a view to disguising the true source of the person originating such wire-transfer payments;
    - using related entities or persons as conduits or nominees to repatriate or otherwise transfer funds in the offshore company's account; or
    - obtaining "loans" to the U.S. beneficial owner or a related party directly from, secured by, or paid by assets in the offshore company's account.

    These examples are not exhaustive, and depending on the applicable facts and circumstances, certain further activities may be considered by the SFTA as a "scheme of lies."

2. Acts of continued and serious tax offense, for which the Swiss Confederation may obtain information under its laws and practices,[7] including cases where the U.S. person failed to prove, upon notification by the SFTA, that the statutory tax-reporting requirements for their interests in such offshore-company accounts had been met (*i.e.*, by providing consent to the SFTA to request copies of the taxpayer's FBAR returns from the IRS for the relevant years). Absent such confirmation, the SFTA would grant information exchange where (i) the offshore company account has been in existence over a prolonged period of time (*i.e.*, at least three years, including one year covered by the request) and (ii) generated revenues of more than 100,000 CHF [approximately 99,000 USD] on average per annum for any three-year period that includes at least one year covered by the request. For the purpose of this analysis, revenues are defined as gross income (interest and dividends) and capital gains (which for the purpose of assessing the merits of this administrative information request are calculated as 50 percent of the gross sales proceeds generated by the accounts during the relevant period).

## Disclosure of Account Information in Response to the U.S. Treaty Request to Switzerland

As early as September 14, 2009, many foreign account holders received notices that their accounts were among those meeting the criteria for disclosure under the U.S.-Swiss Treaty Request. The notice presented account holders a number of options for responding, including:

- appointment of an agent in Switzerland to receive official notices from the SFTA
- consent to UBS sending information directly to the IRS
- consent to the SFTA sending information directly to the IRS
- participation in the OVDP

Those taxpayers who timely applied for the OVDP should consider responding to this notice by consenting to disclosure of the account records and requesting a copy of the records produced to the IRS. One of the requirements of the OVDP is full cooperation with the IRS. Failure to consent to the disclosure of the account records subject to the treaty request may be construed as a failure to cooperate. Consent to disclosure is likely to ensure a cooperative stance with the IRS. Furthermore, securing a copy of the produced records will ensure that the taxpayer has the same records the IRS is reviewing in determining the accuracy of amended returns and FBARs. Those same records may also play a role in determining whether the taxpayer will be subject to the standard OVDP penalty structure or some lesser penalty.

## Voluntary Disclosure After the Deadline Has Passed

Although the deadline for the OVDP has now passed, taxpayers with undisclosed foreign accounts still have an opportunity to avoid criminal prosecution and secure reduced penalties for their compliance shortcomings.

Any taxpayer who has failed to file a return or has filed a false return may be able to take advantage of the long-standing IRS voluntary disclosure practice. Although the OVDP has changed some long-standing procedures in the world of voluntary disclosures, the fundamentals of the practice set forth in the *Internal Revenue Manual* ("IRM") at section 9.5.11.9 remain unchanged.

A voluntary disclosure occurs when the taxpayer's communication to the IRS regarding the taxpayer's compliance failures is truthful, timely and complete, and when the taxpayer:

- cooperates with the IRS in determining his/her correct tax liability; and
- makes good-faith arrangements with the IRS to pay in full, the tax, interest and penalties determined by the IRS.

One of the issues in voluntary disclosure is the "timeliness" of the disclosure. The *IRM*, in essence, provides that a disclosure is "timely" if it is received before:

1. The IRS *has initiated* a civil examination or criminal investigation of the taxpayer, or *has notified* the taxpayer that it intends to initiate such an examination or investigation.
2. The IRS has received information from a third party alerting the IRS to the *specific taxpayer's* noncompliance.
3. The IRS has initiated a civil examination or criminal investigation that is *directly related to the specific liability* of the taxpayer.
4. The IRS has acquired information directly related to the *specific liability* of the taxpayer from a criminal enforcement action, such as a search warrant or grand jury subpoena.

How can these restrictions on "timeliness" of a disclosure impact taxpayers with offshore accounts in the current environment? This question may present concerns in the context of the U.S.-Swiss Treaty Request. The request is directed at U.S. account holders, and in some cases account records have already been produced to the the SFTA for a determination on whether the account information should be produced in response to the Treaty Request. Some customers

have been notified that their accounts appear to be within the scope of the Treaty Request. If a taxpayer receives this notification, is it too late to make a voluntary disclosure?

The IRS has provided no formal guidance on this issue. However, it appears that a disclosure after the receipt of the notice would be timely. The taxpayer recipient of the notice is not under examination or investigation; the IRS has not yet received any information on the taxpayer from the SFTA, the bank or any criminal enforcement agency; and there is no examination or investigation directly related to the specific taxpayer's noncompliance.[8] Voluntary-disclosure coordinators have advised some practitioners that receipt of the notice does not make the disclosure untimely.

Therefore, voluntary disclosure is still available, but not under the same conditions as the OVDP. The primary benefit of "no referral for criminal prosecution" is still present. However, differences exist in the "traditional" disclosure and the now-expired OVDP disclosure:

- The days of "silent" or "stealth" voluntary disclosure appear to be over. Given the protocol for making a disclosure under the OVDP (*i.e.*, direct contact with and disclosure to the IRS) taxpayers will be unable to find comfort in simply filing an amended return and paying the bill—as was frequently the practice before the OVDP was announced.
- The scope of the civil penalties that will be imposed under traditional voluntary disclosure are stiffer than those imposed by the OVDP. Traditional-disclosure taxpayers face civil-fraud penalties of as much as 75 percent of the additional tax liability versus 20 percent under the OVDP. FBAR penalties can also amount to as much as 50 percent of the account value for multiple years, as opposed to 20 percent of the highest value of the account for a single year. Experience shows however that negotiation of these penalties may still be possible.

## What Can Be Done Now

Taxpayers who wait until their account records are produced to the IRS will be untimely in making disclosure and may face criminal prosecution. Those making disclosures before their records are produced will not have the same benefits as those who submitted before October 15, but they are likely to fare much better than the accountholders who merely hope their accounts will not be discovered.

## For Further Information

If you would like more information about voluntary disclosure for offshore accounts, please contact Thomas W. Ostrander, the author of this *Alert*, Hope P. Krebs or Stanley A. Barg in Philadelphia, Jon Grouf in New York, Anthony D. Martin in Boston, any member of the International Practice Group, Michael A. Gillen of the Tax Accounting Group or the attorney in the firm with whom you are regularly in contact.

*As required by United States Treasury Regulations, the reader should be aware that this communication is not intended by the sender to be used, and it cannot be used, for the purpose of avoiding penalties under United States federal tax laws.*

## Notes

1. See *LMSB Memorandum Authorization to Apply Penalty Framework*, dated March 23, 2009.
2. FAQ #35.
3. FAQ #28 and FAQ #34.
4. As described in paragraph 10, subparagraph 2, first sentence of the Protocol, "Fraudulent conduct is assumed in situations when a taxpayer uses, or has the intention to use, a forged or falsified document such as a double set of books, a false invoice, an incorrect balance sheet or profit and loss statement, or a fictitious order or, in general, a false piece of documentary evidence, and in situations where the taxpayer uses, or has the intention to use a scheme of lies ("Lügengebäude") to deceive the tax authority."
5. As described in paragraph 10, subparagraph 2, third sentence of the Protocol.
6. As described in paragraph 10, subparagraph 2, first sentence of the Protocol.
7. As described in paragraph 10, subparagraph 2, first sentence of the Protocol.
8. See *IRM* 9.5.11.9 (6) for examples of timely disclosure.