International Tax Review

May 2008 -

Voluntary disclosure becomes a necessity

Scott Michel of tax boutique Caplin & Drysdale argues that companies and tax professionals should seriously consider the Internal Revenue Service's voluntary disclosure programme

The tax enforcement pendulum is swinging again. In recent weeks, businesses, professional firms, financial institutions and wealthy individuals have seen the authorities aim at undeclared assets and income stashed in secret offshore accounts in tax haven countries. At the same time, with revenue-hungry governments focusing on what they call the tax gap, tax agencies are cracking down on allegedly abusive business structures centred in offshore and other tax-friendly environments. Around the world, there is evidence of aggressive and enhanced efforts to investigate, prosecute and collect tax from businesses, professionals and other individuals thought to have engaged in abusive transactions or outright tax evasion.

The burgeoning regulatory focus on hidden assets and tax haven jurisdictions is exemplified by recent news involving LGT, the largest bank in Liechtenstein. Some time ago, a bank employee unlawfully removed customer account data containing information, which he sold to tax authorities in Germany and other countries, including, apparently, the US.

In early 2008, Germany conducted a number of raids. It arrested prominent executives, including the head of Deutsche Post, charging tax evasion arising from undisclosed accounts at LGT. Tax officials in the UK, France, Greece, Sweden, Spain, Italy, Canada, Australia and New Zealand are now exploring similar cases.

The US Internal Revenue Service also disclosed that it was beginning unspecified enforcement action against about 100 US persons whose names were on a list of LGT account holders. This followed an announcement by US Senator Carl Levin that he intends to have his Permanent Subcommittee on Investigations (PSI) look into hidden offshore accounts maintained by US taxpayers. The PSI conducted the first enquiry into whether persons at the big-four firm KPMG had engaged in the mass marketing of abusive tax shelters, which led to an investigation that has resulted in criminal indictments and prosecutions.

Offshore business structures

Offshore business structures are also attracting increased attention. On February 29 2008, another US Senator, Max Baucus, who chairs the powerful Senate Finance Committee, announced that congressional investigators were heading to the Cayman Islands to examine whether US businesses are evading tax through the use of offshore entities. This follows other IRS announcements and efforts focused on the use of offshore business structures to defer or avoid tax improperly.

Also joining in this effort are the IRS Criminal Investigation Division and specialist prosecutors at the tax division of the US Department of Justice. They are pursuing criminal conspiracy and tax evasion charges against business entities and individuals, including legal and accounting professionals, arising from what are alleged to be schemes involving sham offshore structures, International Business Companies, or foreign trusts. Numerous criminal convictions have occurred, both through guilty plea and after trial. Criminal actions across the country are pending, in which lawyers or accountants are included as co-conspirators in connection with alleged tax scams involving offshore entities.

Increased information exchange

At the same time, tax practitioners are seeing many countries, especially the US and those in the EU, making greater use of tax treaties and tax information exchange agreements, and engaging in more spontaneous disclosures of data from one taxing authority to another. A decade ago many experts viewed tax information exchange provisions as cumbersome and subject to legal interruption and delay. Now, with the post 9/11 focus on terrorism and money laundering, and the increasing consensus that tax and fiscal crimes are just as serious as other offences, countries are exchanging tax information more freely.

Exemplifying this trend, the US, Canada, the UK, Japan and Australia have established the Joint International Tax Shelter Information Centre (JITSIC), aimed at sharing information on tax shelters and on the professionals and financial institutions that plan and promote them. JITSIC's charter is to enable tax authorities in these five nations to exchange details on complex tax avoidance structures, and to enable more rapid and coordinated enforcement

responses.

Meanwhile, bank secrecy in tax haven jurisdictions is becoming an increasingly flimsy reed of protection. Even such formerly secret locales as Switzerland, the Isle of Man and the Jersey Isles are responding to properly-framed requests from other countries under applicable information exchange provisions, unimpeded by legal challenges from the businesses and individuals affected. As an outgrowth of the LGT matter, moreover, the EU and OECD have increased pressure on countries like Liechtenstein, Monaco and Andorra to become more transparent. Recently this pressure has extended even to Singapore, as the drumbeat for greater tax transparency grows worldwide.

These matters are not confined to a few rogue individuals who may have engaged in garden-variety tax evasion by maintaining a secret bank account in a tax haven. The heightened attention on the usage of allegedly sham or improper entities in tax haven jurisdictions could ripple through the suites of large corporations, which have set up global business structures aimed at reducing the worldwide tax rate. The focus will probably be broad, ranging from the personal actions of senior executives, the use of arguably abusive corporate and IBC structures for sheltering income, and the payment of wages or bonuses to employees by means of hidden offshore accounts.

Also likely to be swept into the investigations are financial institutions and tax professionals. They are watching the developments with concern. Many offshore structures and complex transactions routed through low tax or haven countries are facilitated by cooperating banks. They are created, implemented, and blessed by tax intermediaries, often by means of detailed opinion letters. These opinions frequently advise clients that a given tax structure is more likely than not acceptable under particular legal provisions. While there has been an enhanced focus on practitioner ethics, especially in the US and UK, these new investigations may extend beyond professional sanction, raising issues of criminal tax evasion and the potential of criminal prosecution and substantial civil penalties for anyone found to have wilfully violated tax laws.

Tax enforcement officials are well aware of the deterrent effect gained by prosecuting a few selected lawyers or accountants for participating in abusive schemes – witness the indictments of former professionals from KPMG, Ernst & Young and Sidley, Austin, Brown & Wood. And it is common knowledge that some of the largest banks in the world remain involved in a number of continuing criminal tax shelter investigations. The authorities can be expected to apply the same template to enquiries into allegedly abusive offshore structures.

Voluntary disclosures

In spite of all this, there is time for fast-acting professionals and affected companies and persons to insulate themselves from criminal prosecution. Nearly every tax authority worldwide has a voluntary disclosure policy of one kind or another. The terms and approaches of such policies differ from country to country. Most such policies, though, promise leniency, if not outright amnesty, for businesses and individuals that come forward voluntarily and in good faith to correct prior tax misdeeds.

In the US, a taxpayer is under no legal obligation to correct prior wrongful filings. Nor are tax practitioners ethically obligated to insist that a client undertake such action. However, US tax practitioners often advise clients to take advantage of a longstanding IRS Voluntary Disclosure Policy, under which the IRS generally will not seek criminal prosecution of anyone – company, individual or professional – who comes forward and satisfies the policy's criteria. While the IRS often points out, and the policy itself specifies, that it does not provide full immunity, the IRS historically has welcomed voluntary disclosures, and there is no reported case of a true voluntary disclosure blowing up into a criminal prosecution. In practical terms, the policy presents an opportunity for anyone concerned about a potential US tax investigation to eliminate the risk of a future criminal proceeding.

In the US, an effective voluntary disclosure has five components:

- Legal Source: Irrespective of any other factor, the voluntary disclosure policy does not apply to funds derived from unlawful activity, including fraud or money laundering. The assets and income at issue must be from a legal source.
- Timeliness: To be recognised as conducting an effective voluntary disclosure, taxpayers must come forward before the IRS has begun a civil or criminal investigation of their tax affairs (whether the taxpayer is aware of such investigation), or before the IRS is in possession of information from a third party that would directly lead to those taxpayers. (Thus, for those persons whom the IRS now knows had undisclosed accounts at LGT, it may be too late to qualify, technically, for a voluntary disclosure.)
- Completeness: People making a voluntary disclosure must file truthful and accurate amended (or delinquent) tax returns. They cannot selectively correct prior tax filings to fix some errors but not others.
- Payment: An effective voluntary disclosure requires payment of the tax at issue, plus interest, or at least good faith efforts on the part of the individual to make payment.

- Cooperation: Most voluntary disclosures do not result in a full audit, but if one ensues, the taxpayer must cooperate with the examination in all respects or the protection of the voluntary disclosure is lost.

Legal and tactical issues

Every taxpayer's case is different, and a number of issues often arise in each case. One such issue is how many years the taxpayer must correct. In many cases, practitioners recommend going back six years, as that is the statute of limitations for criminal tax prosecutions in the US. In other cases, for a variety of reasons, a taxpayer may correct filings for fewer years.

A second issue is the manner of the disclosure itself. Depending on the facts of the case, taxpayers might make an effective voluntary disclosure by filing amended (or delinquent) returns accompanied by payment, or they could surface overtly with IRS officials to provide relevant facts to obtain their view that the Voluntary Disclosure Policy would apply. While many tax practitioners recommend a strategy of simply filing the appropriate returns, in more complicated cases or those involving substantial amounts, a practitioner might suggest making affirmative contact with the IRS. Such a contact might first be on a hypothetical basis to sound out IRS representatives on the repercussions of a significant disclosure. But the IRS will not grant voluntary disclosure status unless the names of the relevant taxpayers are eventually provided.

Third, complex tax reporting and accounting issues often arise from the nature and structure of the assets and income at issue. The presence of foreign corporations, foreign trusts, IBCs, foundations or stiftungs, personal estates, or non-profit entities can complicate the analysis of how a taxpayer might correct returns and filings in earlier years. If the conduct involves wages or withholding issues, additional complexities arise. The exact nature of the assets and even technicalities such as currency exchange calculations will require accounting analysis.

Fourth, there are often questions regarding the separate US Treasury form (Form 90-22.1, the FBAR), an annual information return required of US persons that control or have interests in foreign financial accounts. There are separate rules on the filing of this form for individuals and for businesses. A complete voluntary disclosure will require analysis of these matters as well.

Lastly, the IRS policy does not protect against civil penalties. These penalties can be significant in cases where information returns on foreign corporations, estates, trusts or foundations may be involved. Having said this, the IRS is often more lenient in voluntary disclosures because the taxpayer has shown good faith in coming forward and making a complete and truthful disclosure.

Complications aside, given the increasing US enforcement focus on offshore accounts and business structures, the IRS's Voluntary Disclosure Policy provides an opportunity for companies to make their peace at what is often (relatively speaking) a reasonable price, especially when the benefits include avoiding a criminal inquiry. Policies in other countries afford the same chance to clean up matters before trouble arises.

It would behove businesses worldwide, and the professionals that advise them and their personnel, to review their tax-related structures, accounts and holdings, to ascertain whether it would make sense to consider a voluntary disclosure. This is especially the case for valued company management who may have undeclared assets in tax haven countries, and for legal and accounting professionals or financial institutions that may have advised businesses, families, or individuals about secret accounts or offshore business structures, which may be perceived as abusive. Prudent action now could pre-empt potentially serious legal trouble down the road.

All material subject to strictly enforced copyright laws. © 2008 Euromoney Institutional Investor PLC.