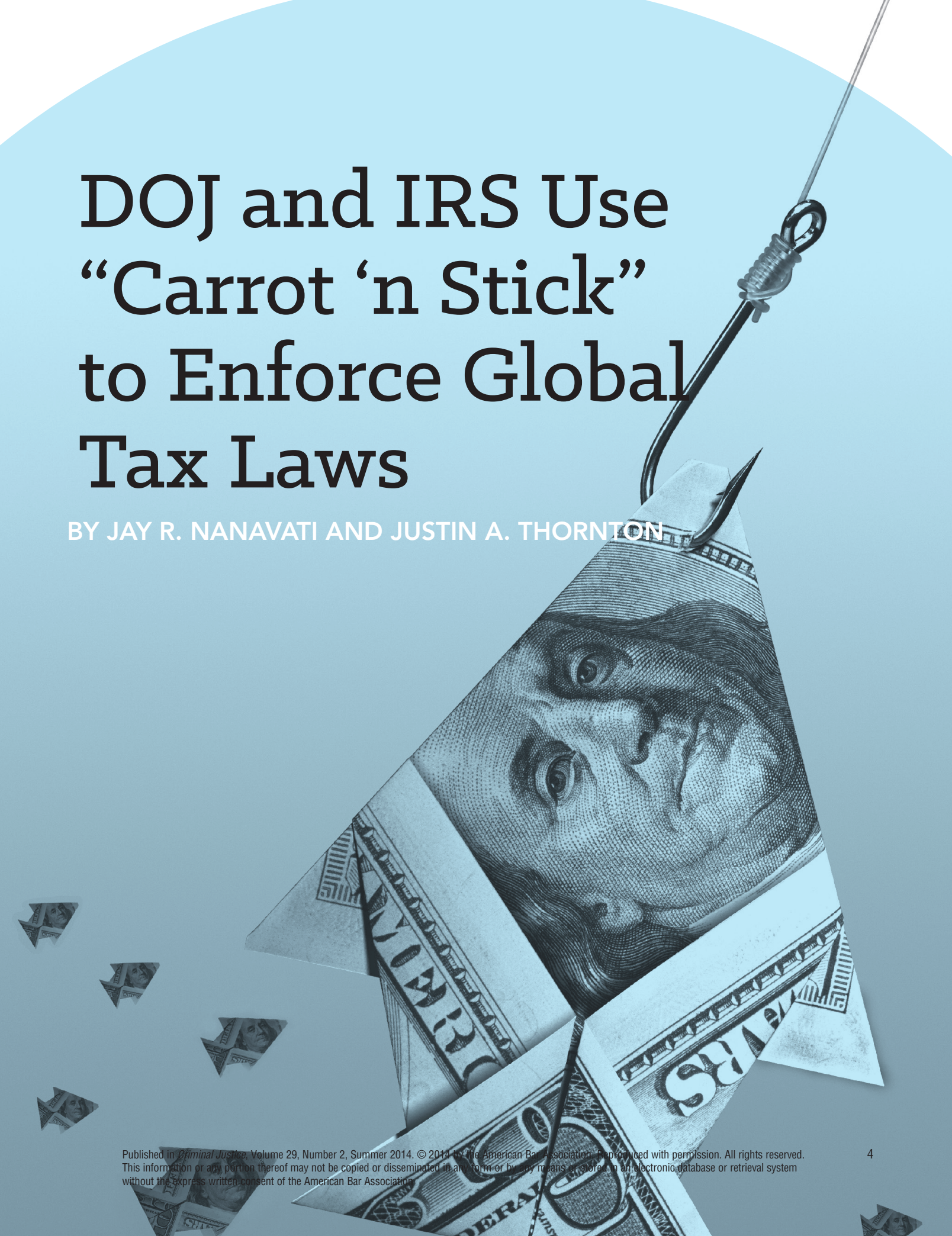
DOJ and IRS Use "Carrot 'n Stick" to Enforce Global Tax Laws

BY JAY R. NANAVATI AND JUSTIN A. THORNTON



The US government continues to hammer away at the use by US taxpayers of foreign secrecy jurisdictions to evade taxes. Beginning with its highly publicized takedown of UBS in 2008 and continuing through the current Offshore Voluntary Disclosure Program (OVDP), the Department of Justice (DOJ) and the Internal Revenue Service (IRS) are using both carrots and sticks to coax taxpayers to bring their money back into the "system." The government's fiscal difficulties of the last five years have only added urgency to the crackdown.

The collection of income taxes in the United States is based on voluntary compliance and self-assessment by taxpayers. The federal government reinforces the integrity of its system of voluntary compliance and self-assessment through vigorous and uniform enforcement of its tax laws, thereby exposing tax cheaters and deterring other potential tax violators.

The IRS Criminal Investigation (IRS-CI) is responsible for investigating tax fraud cases. The DOJ Tax Division in Washington, D.C., ultimately determines which criminal tax cases will be authorized for prosecution. A centralized review process and prosecution oversight by "Main Justice" is intended to ensure nationwide uniformity in the enforcement of the tax laws.

The head of the DOJ Tax Division is Assistant Attorney General Kathryn Keneally. [Note: DOJ recently announced that following her two years of service with the Tax Division, Keneally would step down effective June 5, 2014, and return to private practice.] The chief of IRS-CI is Richard Weber. The two of them are primarily responsible for setting the direction of the federal government's criminal tax enforcement efforts. Through both public pronouncements and recent enforcement actions by their agencies, they have made clear that one of the country's top tax enforcement priorities is putting an end to offshore tax evasion.

Offshore Voluntary Disclosure Program

The OVDP, currently in its third iteration, is the closest thing to a "carrot" that the government has offered taxpayers to induce compliance. The first OVDP was available for a limited time in 2009 and allowed taxpayers with unreported foreign bank accounts to escape criminal prosecution and annual civil penalties of 50 percent of their highest annual account balance. They simply had to fully disclose their accounts and pay, with some minor additions, 20 percent of their highest account balance during an eight-year look-back period. The second OVDP was available in 2011 and provided the same benefits for a higher price—25 percent of the taxpayer's highest account balance. Finally, in 2012 the IRS opened the current OVDP. Although the price increased to 27.5 percent of the taxpayer's highest account balance, the program will remain open indefinitely.

To date, the disclosure programs have induced 43,000 taxpayers to report their foreign bank accounts and to pay taxes, penalties, and interest to the IRS of approximately $6 billion. Taxpayers who enter the program must not only declare their accounts and pay the penalty, but must also frequently submit to detailed questioning regarding the names of the bankers, lawyers, and other professionals who assisted them in opening and maintaining their secret accounts. This, in turn, has led to the prosecution of several bankers and lawyers. The cooperation of the bankers and lawyers with the DOJ has led to the investigation and prosecution of additional banks and taxpayers. This feedback loop has helped the government sustain its momentum for the more than six years since the UBS story first broke. It has also allowed the government to reach into such areas as the Bahamas, Barbados, British Virgin Islands, Cayman Islands, Costa Rica, Guernsey, Hong Kong, India, Israel, Liechtenstein, Malta, and Nevis in search of noncompliant US taxpayers and the banks that assist them. Assistant Attorney General Keneally, discussing Switzerland in September 2013, made the government's broader point forcefully:

> If someone had an account in Switzerland, it is beyond foolish to think that that account is going to remain secret. . . . In the last five years, we've seen a remarkable change in our ability to get information concerning Swiss bank accounts. It's extraordinary. Switzerland is no longer a good place to hide assets for tax reasons.

(David Voreacos, *Secret Swiss Accounts Said No Longer Safe for Tax Dodging*, Bloomberg (Sept. 8, 2013), http://tinyurl.com/m2aztwh.)

John Doe Summonses

In its arsenal, the IRS has a civil means of obtaining information on US taxpayers with unreported foreign bank accounts. It goes by the cloak-and-dagger name "John Doe summons." The IRS typically issues summonses for information pertaining to specified taxpayers. The John Doe summons allows the IRS to seek information on an entire class of taxpayers whose identities it does not know. For example, the IRS might issue a John Doe summons to a bank in which it seeks information on all account holders who provided the bank a US address and whose accounts had more than $50,000 in them at any time in the last three years.

The John Doe summons allows the IRS to overcome the chicken-and-egg problem that it would otherwise face: It needs a summons to discover which taxpayers are hiding funds, but first it must specify the identity of the taxpayers to be able to issue a lawful summons.

Foreign financial institutions present a problem for the IRS, in spite of its ability to issue John Doe summonses.

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The IRS cannot serve a summons outside of the United States. Luckily for the IRS, virtually every major financial institution in the world that has US customers has an Achilles heel: correspondent bank accounts.

American taxpayers who have foreign bank accounts need a convenient way to access their money. Short of having branches in the United States, foreign banks need a way to provide this access. They do this by opening bank accounts at banks in the United States. The foreign bank is then a customer of the US bank. Once the IRS finds out which US bank hosts the foreign bank's correspondent account, the IRS can simply issue the US bank a John Doe summons for information on the account. This account will have documentation of checks written to US taxpayers, wires sent to US taxpayers' accounts at other US banks, and the like.

The Senate's Permanent Subcommittee on Investigations estimates that Americans illegally evade between $40 billion and $70 billion in US taxes each year.

How does the IRS find out which US bank hosts a foreign bank's correspondent account? One likely source is the OVDP's feedback loop. Taxpayers in the OVDP identify their bankers. Bankers who cooperate with the government reveal the location of their banks' correspondent accounts.

On November 12, 2013, the government announced that it had obtained a court order authorizing the IRS to issue John Doe summonses for information on US account holders at the US correspondent banks of Zürcher Kantonalbank (ZKB) in Switzerland and the Bank of N.T. Butterfield & Son Ltd. (Butterfield) in the Bahamas, Barbados, Cayman Islands, Guernsey, Hong Kong, Malta, Switzerland, and the United Kingdom. The US banks that will receive the John Doe summonses are Bank of New York Mellon, Citibank NA, JPMorgan Chase Bank NA, HSBC Bank USA NA, and Bank of America NA. The government appears to have been empowered to seek the John Doe summonses by information that the IRS received from US taxpayers who entered the OVDP. The government announced that as of November 12, 2013, US taxpayers had identified 371 previously undisclosed accounts at ZKB and 81 such accounts at Butterfield. (Press Release, DOJ, Court Authorizes IRS to Issue Summonses for Records Relating to U.S. Taxpayers with Offshore Bank Accounts (Nov. 12, 2013), http://tinyurl.com/pnunqen.)

Criminal Prosecution of Banks and Bankers

Beginning with UBS, the DOJ has typically entered into deferred prosecution agreements (DPAs), and sometimes nonprosecution agreements, with foreign financial institutions instead of indicting them. This is because of the DOJ's post-Arthur Andersen policy of taking into account the collateral harm to innocent employees and shareholders when deciding whether to indict business entities. For example, on July 30, 2013, the DOJ, through the US Attorney's Office for the Southern District of New York, announced that it had reached a nonprosecution agreement with Liechtensteinische Landesbank AG, a bank based in Vaduz, Liechtenstein. The bank forfeited $16,316,000, representing a disgorgement of its earnings from maintaining Americans' undeclared accounts, and paid another $7,525,542 in restitution to the IRS, representing the approximate resulting unpaid taxes. (Press Release, DOJ, Department of Justice Announces Agreement with Liechtenstein Bank to Pay $23.8 Million to Resolve Criminal Tax Investigation (July 30, 2013), http://tinyurl.com/oys5gpv.)

The most recent and noteworthy exception to the DOJ practice of using DPAs was in the case of Credit Suisse. On May 19, 2014, the DOJ announced that Credit Suisse had entered a plea of guilty to the charge of conspiracy to aid and assist in the preparation and filing of false tax returns. According to a statement of facts filed in federal court, Credit Suisse had 22,000 American accounts (both declared and undeclared) worth as much as $10 billion as of 2006. As part of its guilty plea, Credit Suisse will pay a total of $2.6 billion: $1.8 billion to the Department of Justice for the US Treasury (consisting of a fine of over $1.13 billion and nearly $670 million in restitution to the IRS), $100 million to the Federal Reserve, and $715 million to the New York State Department of Financial Services. Although Credit Suisse is now a convicted felon, it will be spared the worst consequence of a felony conviction—being barred from conducting business in the United States. The Federal Reserve, the New York attorney general, and the Securities and Exchange Commission, are all said to have agreed to stand down from barring Credit Suisse from doing business in their bailiwicks. Many have noted that the plea agreement did not require Credit Suisse to turn over the names of its US account holders. This is likely not a significant issue, though, because the agreement requires Credit Suisse to turn over sufficient information about the accounts to enable the US government to make a treaty request for all of the names.

The oldest Swiss private bank, Wegelin & Co., was also an exception to the DOJ preference for such agreements. Citing what the DOJ called its egregious behavior, the US attorney for the Southern District of New York indicted Wegelin on February 2, 2012. Wegelin pleaded guilty to conspiracy to defraud the United States by impairing and impeding the IRS, and on March 4, 2013, Wegelin was sentenced to pay a fine of $58 million and agreed to a civil forfeiture of $16 million. At the same time, Wegelin

announced that it would cease operations permanently. (Bob Van Voris, *Wegelin Must Pay $58 Million in U.S. Tax Prosecution*, Bloomberg (Mar. 4, 2013), http://tinyurl.com/nsuwe3x.)

Some banks, however, have decided to throw in the towel before even being charged. Bank Frey & Co. AG, a Swiss private bank, announced on October 17, 2013, that it would cease operations, further fallout from the United States' enforcement efforts against offshore banks generally and Swiss banks in particular. Bank Frey is the subject of an ongoing DOJ tax evasion investigation. The bank apparently determined that it could not continue operations, even under the terms of a DPA. (John Letzing, *Switzerland's Bank Frey to Cease Operations*, Wall St. J., Oct. 17, 2013.)

Bank Frey was also in the news in April 2013, when its former head of private banking, Stefan Buck, was charged along with Swiss lawyer Edgar Paltzer with conspiracy to help US clients file false tax returns and commit tax evasion. Paltzer pleaded guilty to the charges on August 16, 2013, and Buck remains at large. Additionally, UBS banker Raoul Weil, a fugitive since his indictment in 2009, was arrested on October 19, 2013, in Italy and brought to the United States to face a charge of conspiracy to defraud. He pleaded not guilty on January 7, 2014, in the US District Court for the Southern District of Florida in Ft. Lauderdale. His trial is set for October 14, 2014.

In the run-up to the Credit Suisse guilty plea, the Senate's Permanent Subcommittee on Investigations pushed Swiss banking back into the public eye with hearings on Credit Suisse on February 26, 2014. Senators assailed both Credit Suisse for its role in helping customers evade their US taxes and the DOJ for not moving fast enough to punish Credit Suisse and to extract from the bank the names of US account holders. Senator Carl Levin, a Michigan Democrat and the chairman of the subcommittee, cited estimates that Americans have more than $1 trillion in assets offshore and illegally evade between $40 billion and $70 billion in US taxes each year through the use of offshore tax schemes. He also asserted that US corporations illegally evade another $30 billion in taxes each year through offshore maneuvers. (*Offshore Tax Evasion: The Effort to Collect Unpaid Taxes on Billions in Hidden Offshore Accounts: Hearing Before the Permanent Subcomm. on Investigations*, 113th Cong. (2014).)

Banks outside of Switzerland are presumably also under DOJ criminal investigation. It remains to be seen whether the DOJ will offer them DPAs or will bring indictments against them.

DOJ Program for Swiss Banks

On August 29, 2013, the DOJ Tax Division announced an unprecedented voluntary disclosure program for Swiss banks. Only Swiss banks that are not currently under DOJ criminal investigation are eligible. This excludes the 14 Swiss banks that the DOJ has notified are under criminal investigation, which are referred to as Category 1 banks. The program is quite detailed, but its essence is that banks can seek "nonprosecution" and "nontarget" letters from the DOJ, depending on their culpability, by fully disclosing their practices regarding and information about US customers and by paying stiff penalties. Although the banks need not turn over the names of US customers, they, like Credit Suisse, must turn over sufficient information about the customers' accounts to allow the US government to make a treaty request for the customers' names. The program refers to banks that may have committed offenses as Category 2 banks.

In a September 2013 interview, Assistant Attorney General Keneally explained:

> Those banks must pay 20 percent of the value of accounts not disclosed to the IRS on Aug. 1, 2008; 30 percent for such accounts opened between then and February 2009; and 50 percent for accounts opened after February 2009. Total penalties by banks to avoid prosecution could exceed $1 billion . . . .

(Voreacos, *Secret Swiss Accounts*, *supra*.)

Keneally reasoned that the 50 percent maximum penalty for participating banks was appropriate in spite of the fact that Wegelin had $1.5 billion in undeclared assets and paid only $74 million, or 4.9 percent, to resolve its criminal case. "Wegelin was indicted, Wegelin pled guilty, and Wegelin suffered severe business consequences as a result of all of that . . . . These banks are getting a nonprosecution agreement. That is something of great value, I believe." (*Id.*)

The DOJ announced that 106 of the approximately 300 Swiss banks have chosen to enter the program as Category 2 banks, a number that Assistant Attorney General Keneally confirmed on March 6, 2014, at the American Bar Association's 28th Annual National Institute on White Collar Crime.

Prosecutions of US Taxpayers

Since the UBS investigation and DPA, the DOJ has been aggressively pursuing US taxpayers who have unreported foreign bank accounts. Unfortunately for the government, these taxpayers have only infrequently been sentenced to any incarceration.

On January 14, 2014, Ty Warner, the billionaire creator of Beanie Babies, received a sentence of two years' probation after having pleaded guilty to one count of tax evasion. The US District Court for the Northern District of Illinois in Chicago sentenced Warner to no jail time in spite of his admission that he willfully concealed bank accounts at UBS and ZKB that held as much as $107 million, had $24 million in unreported income, and gave rise to a tax loss to the fisc of $5 million. The US Attorney's Office filed a protective notice of appeal on February 13, 2014, and is seeking permission from the solicitor general to appeal the sentence. (David Voreacos & Andrew Harris, *Beanie Baby Maker Ty Warner Tax Sentence Appealed by U.S.*, Bloomberg (Feb. 13, 2014), http://tinyurl.com/k9cxswt.)

Although the size of Warner's accounts was unusual, the outcome of his guilty plea and sentencing was not. In some ways more surprising than Warner's sentence was that of Wisconsin neurosurgeon Arvind Ahuja. On February 1, 2013, he received a sentence of probation in spite of pleading not guilty and being convicted after a jury trial. The high balance of his accounts at HSBC India and HSBC Jersey was approximately $8.7 million. (David Voreacos, *Doctor Spared Prison for Tax Violations Tied to HSBC Account*, Bloomberg (Feb. 1, 2013), http://tinyurl.com/mms67cy.)

There is no way to know precisely where the IRS will focus its future enforcement efforts, but an official from the IRS Small Business/Self-Employed Division (SB/SE) recently gave a strong indication. On November 9, 2013, an SB/SE official announced that SB/SE's special enforcement program (SEP) will soon begin examining US taxpayers suspected of holding undeclared accounts at Indian banks. The IRS called Indian bank accounts the next phase of the IRS's offshore compliance crackdown. After receiving account information from Indian banks—one source of which was likely the John Doe summons issued to HSBC India—the IRS has about 100 Indian bank account cases that it is sending out for examination across the country, with 30 to 40 of those being in the Bay Area of Northern California. The civil examinations of these taxpayers will in all likelihood lead to criminal investigations and prosecutions. (Kristen A. Parillo, *IRS Will Soon Examine U.S. Taxpayers with Undeclared Indian Bank Accounts*, 2013 Tax Notes 219–14, *available at* http://tinyurl.com/n2gqegy.)

FATCA Developments

Enacted in 2010 in response to the sordid tales of offshore tax evasion that witnesses told Congress, the Foreign Account Tax Compliance Act (FATCA) created a complex new regime under which foreign financial institutions (FFIs) would report their US customers to the IRS. FATCA's core effective date has been delayed several times, but a 30 percent withholding tax will apply to payments of certain US source income to noncompliant FFIs starting July 1, 2014. FFIs must begin reporting their US customers on March 31, 2015. FATCA's hundreds of pages of regulations are devilishly complex, but countries can relieve their FFIs of a great deal of this complexity by entering into intergovernmental agreements (IGAs) with the United States. These agreements simplify compliance and provide alternative reporting arrangements for FFIs in countries whose privacy laws prevent direct reporting of US customers' data to the IRS. To date, the Treasury has entered into IGAs with 33 countries and has reached "agreements in substance" with 35 more.

In 2014, the United States has signed "Model 1" IGAs with Australia, Belgium, Canada, Estonia, Finland, Honduras, Hungary, Italy, Jamaica, Lichtenstein, Luxembourg, and Mexico. In other words, the IGAs will require FFIs in those countries to report tax information about US account holders to their own governments instead of to the IRS. Those governments will then send the information to the IRS. All 12 were reciprocal versions of the Model 1 IGA. Reciprocity requires that the IRS send similar information about those countries' citizens' US accounts to their home governments.

On November 29, 2013, the Cayman Islands and the United States signed a Model 1 IGA that was nonreciprocal. In other words, the Cayman Islands government chose to negotiate an agreement under which the IRS will not report to the Cayman Islands government on Caymanian account holders in the United States. Only Austria, Bermuda, Chile, Japan, and Switzerland have signed Model 2 IGAs, under which FFIs in those countries will report information directly to the IRS. (*FATCA—Archive*, U.S. Dep't of the Treasury, http://tinyurl.com/q6vg7nj (last updated May 5, 2014).)

Conclusion

The US government has clearly come to see tax enforcement as no longer a merely domestic issue. In spite of its name, the IRS has widened its focus to encompass revenue that it is losing externally. The US government's global tax enforcement strategy has come to include the carrots of the OVDP and DOJ program for Swiss banks, the sticks of prosecutions of banks, bankers, and account holders, and joining with foreign countries to root out US taxpayers who would evade paying their share of the tax burden. ■