Practice

By *Charles P. Rettig and Kathryn Keneally*

Liechtenstein Accounts, German Spies and Now the IRS?

Charles P. Rettig is a Principal with the firm of Hochman, Salkin, Rettig, Toscher & Perez, P.C., in Beverly Hills, California. Mr. Rettig is a Member of the IRS Advisory Council (IRSAC - SB/SE Subgroup) and the Advisory Board for the California Franchise Tax Board.

Kathryn Keneally is a Partner at Fulbright & Jaworski, LLP, in New York, New York. Ms. Keneally is the immediate past chair of the ABA Section of Taxation Civil and Criminal Tax Penalties Committee and is a member of the U.S. Sentencing Commission Practitioner's Advisory Group.

Wealthy tax evaders stashing funds in hidden foreign accounts are not typically sympathetic figures. For various tax and non-tax reasons, some wealthy Americans maintain interests in supposedly secret foreign financial accounts believing claims that bank secrecy in tax haven countries such as Liechtenstein was "impenetrable." Many felt such secrecy could be further enhanced through layers of trusts and corporations designed to conceal the actual ownership and control of the foreign accounts. Without secrecy, tax havens have little purpose.

IRS Commissioner Doug Shulman recently stated "Combating offshore tax avoidance and evasion are high priorities for the IRS. Recent events show there is no safe hiding place for the proceeds of tax avoidance and evasion. Anyone with hidden income and gains would be well-advised to make a prompt and complete disclosure to the IRS." Offshore tax havens are countries that allow corporations, trusts and other businesses to be established within their territory on the condition that any business they conduct is only with persons who are "offshore," meaning persons who are not citizens or domestic businesses operating inside the country. Tax havens charge significant fees for establishing and maintaining an offshore business, though they often charge little-to-no taxes.

The offshore businesses operating in tax havens are often shell operations established by attorneys, trust companies or banks within the tax haven jurisdiction operating under corporate secrecy laws that make it difficult to identify the actual owner. They frequently open accounts at banks licensed by the tax haven and conduct financial transactions under bank secrecy laws making it difficult to trace transactions or identify bank account owners. Money deposited in these banks is usually held in correspondent accounts that the banks have opened at larger banks in the United States or other countries.

A long tradition of bank secrecy in Liechtenstein is now at the center of a widening global tax evasion investigation as a result of stolen customer data being sold to the German spy service. Liechtenstein, roughly the size of Washington, D.C., lies across the Rhine River from Switzerland, another country with a long tradition of banking secrecy. The House of Liechtenstein has ruled the territory since it was created as a principality within the Holy Roman Empire in 1719. Liechtenstein is the sixth-smallest independent nation in the world, by land area (only the Vatican City, Monaco, Nauru, Tuvalu, and San Marino are smaller). Liechtenstein is one of only two doubly landlocked countries in the world—being a landlocked country wholly surrounded by other landlocked countries—the other is Uzbekistan. It has no army and is the only country with a predominantly German-speaking population that does not share a border with the Federal Republic of Germany.

The tax evasion investigation, which began in Germany but has spread to the United States and at least 12 other countries, was ignited by the alleged theft of confidential client data in 2002 by a former employee of LGT Treuhand AG in Vaduz. LGT Treuhand AG, which set up foundations for many of its clients, is a subsidiary of the LGT Group (LGT)—the principality's largest bank having almost 100 billion francs under management (according to the LGT's Web site). LGT, the wealth and asset management group of the Princely House of Liechtenstein, has about 1,500 employees in 29 locations in Europe, Asia, the Middle East, and the Americas.

LGT has described the stolen data as including approximately 1,400 "client relationships" (most held through various foundations or trusts) which was taken by "a convicted data thief" who then allegedly sold the information to Germany for between Ⓤ4 million and Ⓤ5 million (about $6 million to $7.4 million). German authorities have confirmed they (allegedly the BND, the German foreign intelligence service) paid an informant for Liechtenstein banking data now being used to pursue approximately 600-suspected tax evaders identified in Germany. Germany would have been legally prohibited from using such evidence in criminal prosecutions if it received assistance from law-enforcement authorities in Liechtenstein, where tax evasion is treated as a civil rather than a criminal offense.

LGT apparently believed that the matter had previously been resolved. According to the LGT Web site, four DVDs containing the stolen client data had supposedly been returned in 2003 by the former employee to LGT Treuhand, which later destroyed them. However, the former employee apparently had extra copies which were recently sold to the German spy service. Liechtenstein has issued an international arrest warrant for the man suspected of selling the stolen banking data to the German authorities. Some have asserted that the Germans provided their informant with a new identity and that he may now be living in Australia. Hollywood must be salivating at the prospects for the book and movie rights in this global tax scandal!

Upon receipt of the LGT information, Germany initially targeted about 150 suspects and focused on 120 separate cases. Many have apparently pled to tax evasion and voluntarily surrendered to German authorities admitting that they failed to declare income from Liechtenstein trust assets. Germany received at least Ⓤ27.8 million ($41.2 million) in delinquent taxes during the initial phase of the investigation. That amount will surely increase as additional Germans declare previously unreported income.

The German investigation has been expanded to include another Liechtenstein-based bank and more possibly stolen information. Evidence apparently surfaced during searches in Germany revealing some were using more than one bank for services Germany believes were designed to evade taxes. It has been alleged that this second bank - Liechtensteinische Landesbank AG, (LLB), the principality's second largest - may have made significant payments to those in possession of its stolen data in a futile effort to prevent disclosure of their clients confidential information. In both cases, bank employees culled sensitive client information electronically and then endeavored to sell it to prospective buyers.

How Does the IRS Get Information About Foreign Source Income and Foreign Transactions?

The IRS recently announced that it is initiating enforcement actions involving more than 100 U.S. taxpayers to ensure proper income reporting and tax payment in connection with suspect accounts in Liechtenstein.[1] While the IRS does not have the same level of information reporting on foreign source income as it does for U.S. source income, they do have the ability to secure information on foreign source income and transactions. The U.S. has over 60 bilateral tax treaties with other countries, and over 20 Tax Information Exchange Agreements (TIEA) in effect with various countries and jurisdictions where a bilateral tax treaty is not in place. These treaties and agreements facilitate the exchange of information, and generally allow for mutual assistance for both civil and criminal investigations. The tax treaties allow for information exchange by specific request, and in most cases, through spontaneous and automatic exchanges as well.

Specific requests allow treaty partners to request and exchange information relative to a specific tax investigation or tax administration matter. A spontaneous exchange allows a country to spontaneously share information relative to tax administration that might be of interest to its treaty partner, even when a request has not been made. And the automatic exchange program allows treaties partners to routinely share information they maintain about income sourced in one country and paid to a resident of the other treaty partner country.

As part of the IRS Servicewide Approach to International Tax Administration, there is a concerted effort to make better use of these information exchange tools and to coordinate with treaty partners to share information about international tax compliance issues. Specially trained IRS examiners focus on aggressive international tax planning, including the abusive use of entities and structures established in foreign jurisdictions.

OECD Transparency

The Paris-based Organization for Economic Cooperation and Development (OECD) maintains standards of transparency and exchange of information for tax purposes requiring members to adopt effective exchange of information for tax purposes. The national tax administrations of Australia, Canada, France, Italy, New Zealand, Sweden, United Kingdom, and the United States, all member countries of the OECD's Forum on Tax Administration (FTA), are working closely together following revelations of the Liechtenstein account information possibly being used for unlawful tax avoidance and evasion.

Liechtenstein, Andorra and Monaco are the only countries on the OECD list of "uncooperative tax havens." Such lack of cooperation—referred to as "wealth management"—has allowed Liechtenstein and its 35,000 residents (of which 34 percent are foreigners (mainly Swiss, Austrians, Italians and Germans) to enjoy one of Europe's highest standards of living. Countries such as Switzerland and Austria also have banking secrecy laws but cooperate with other governments on tax related issues. Liechtenstein's banks no longer allow intermediaries such as accountants and lawyers to open anonymous accounts for their clients and have increased identity checks to fight fraud and money laundering.

The Egmont Group–FIUs and Information Exchange

The Egmont Group is the coordinating body for the international group of financial intelligence units formed in 1995 to promote and enhance international cooperation in anti-money laundering and counter-terrorist financing. The fight against money laundering has been an essential part of the overall struggle to combat illegal narcotics trafficking, the activities of organized crime, and since September 11 the financing of terrorist activity. It became apparent over the years that banks and other financial institutions were an important source for information about money laundering and other financial crimes being investigated by law enforcement.

Specialized governmental agencies were created as countries around the world developed systems to respond to issues involving money laundering. These entities, referred to as "financial intelligence units" or "FIUs," offer global law enforcement agencies an important avenue for information exchange. Recognizing the benefits inherent in the development of a FIU network, in 1995, a group of FIUs at the Egmont Arenberg Palace in Brussels decided to establish an informal group for the stimulation of international cooperation. These FIUs meet regularly to find ways to cooperate, especially in the areas of information exchange, training and the sharing of expertise.

The Egmont Group created a global network by promoting international cooperation between FIUs. There are currently 106 countries with recognized operational FIU units, with others in various stages of development. FIUs receive, analyze, and disclose information by financial institutions to competent authorities of suspicious or unusual financial activities. Although FIUs operate under different guidelines, most FIUs can exchange information with foreign counterpart FIUs. In addition, many FIUs also provide other government administrative data and public record information to their counterparts. The ongoing development and establishment of FIUs exemplify how countries around the world continue to intensify their efforts to focus on research, analysis and information exchange in order to combat money laundering, terrorist financing and other financial crimes.

Whistleblowers

The U.S. has not announced how the IRS obtained information regarding more than 100 U.S. taxpayers possibly having some connection to suspect accounts in Liechtenstein. However, authorities throughout the world pay informants for valuable information. These tactics may not be pretty, but they are both legal and effective allowing surgical strikes while preserving limited enforcement resources. The German investment in the Liechtenstein data has already reaped significant economic returns over their reported investment. U.K. authorities reportedly paid about £100,000 (approximately $197,000) for information linking U.K. citizens to suspect Liechtenstein accounts. Why would a U.S. tax-person assume that financial data located in a foreign country would not find its way to the taxing authorities in exchange for a significant cash reward?

The IRS is authorized to pay whistleblowers up to 30 percent of the recovered tax, interest and penalties. Section 7623(a) of the Internal Revenue Code (IRC) authorizes the Secretary of Treasury to pay a reward in "such sum as he deems necessary for (1) detecting underpayments of tax, or (2) detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same...." Code Sec. 7623(b) entitles an informant to receive as a reward of at least 15 percent (but no more than 30 percent) of the collected proceeds, including penalties, interest, additions to tax, and additional amounts, resulting from any administrative or judicial action or from any settlement thereof for specific information that caused the investigation and resulted in the recovery. IRS Notice 2008-4 provides guidance on how to file claims under Code Sec. 7623.

If the taxes, penalties, interest and other amounts in dispute exceed $2 million, and a few other qualifications set forth in Code Sec. 7623(b) are satisfied, the IRS will pay 15 percent to 30 percent of the amount collected. If the taxpayer is an individual, his or her annual gross income must be more than $200,000. If the whistle-blower disagrees with the outcome of the claim, he or she can appeal to the Tax Court.

There is an award program under Code Sec. 7623(a) for other whistleblowers—generally those who do not meet the dollar thresholds of $2 million in dispute or cases involving individual taxpayers with gross income of more than $200,000. The awards through this program are less, with a maximum award of 15 percent up to $10 million. In addition, the awards are discretionary and the informant cannot dispute the outcome of the claim in Tax Court. Submissions that do not qualify under Code Sec. 7623(b) can be processed under Code Sec. 7623(a).

The statutory threshold for individual taxpayers reflects a balance reached by the Congress intended to help IRS avoid spending limited resources on an avalanche of informant claims that have little revenue potential. The IRS is looking for solid information, not an "educated guess" or unsupported speculation. IRS is looking for a significant Federal tax issue - this is not a program for resolving personal problems or disputes about a business relationship.

Who Must File U.S. Tax Returns?

As globalization continues to grow, international noncompliance is a significant area of concern and focus for the IRS. The ease of utilizing complex international structures and cross border transactions results in constantly evolving compliance issues. To address these challenges, the IRS has developed a Service-wide Approach to International Tax Administration to improve voluntary compliance with the international tax provisions and to reduce the tax gap.

U.S. citizens and residents are taxed on their worldwide income. This applies whether a person lives inside or outside the United States. Foreign income must be reported on a U.S. tax return whether or not the person receives a Form W-2, Wage and Tax Statement, a Form 1099 (information return) or the foreign equivalent of those forms. Foreign source income includes but is not limited to earned and unearned income, such as wages and tips, interest, dividends, capital gains, pensions, rents, and royalties.

Nonresident aliens are generally subject to U.S. income tax only on their U.S. source income. They are subject to two different tax rates, one for effectively connected income, and one for fixed or determinable, annual, or periodic (FDAP) income. Effectively connected income (ECI) is earned in the U.S. from the operation of a business in the U.S. or is personal service income earned in the U.S. (such as wages or self-employment income). It is taxed for a nonresident at the same graduated rates as for a U.S. person. FDAP income is passive income such as interest, dividends, rents or royalties. This type of income is taxed at a flat 30-percent rate, unless a tax treaty specifies a lower rate.

Generally, a foreign corporation must file a U.S. tax return if it is engaged in a trade or business in the United States, whether or not it had income from that trade or business. It must also file if it had income, gains, or losses treated as if they were effectively connected with a U.S. trade or business, and if it had income from any U.S. source (even if its income is tax exempt under an income tax treaty or code section).

In addition to reporting worldwide income, U.S. taxpayers must also report on their U.S. tax return whether they have any foreign bank or investment accounts. The Bank Secrecy Act requires the filing of Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), if: (1) a person has a financial interest in, signature authority, or other authority over one or more accounts in a foreign country, and (2) the aggregate value of all foreign financial accounts exceeds $10,000 at any time during the calendar year. More information on foreign financial account reporting requirements is in News Release FS-2007-15, Foreign Financial Accounts Reporting Requirements and Publication 4261, Do You have a Foreign Financial Account? The failure to disclose a foreign bank account on a tax return can be a criminal offense.

Summary

Why do so many people risk so much by maintaining an undisclosed foreign account? Few actually enjoy the benefits from their foreign accounts. Many are concerned about when the government will locate their foreign account and the possible ramifications. All risk significant civil penalties and criminal sanctions. Counsel should advise clients with an undisclosed foreign account to appropriately clean it up either through amending returns or pursuing the informal IRS voluntary disclosure process. Doing nothing is not a viable option.

The IRS has been diligently pursuing information regarding foreign financial activities. Various U.S. Senators have begun inquiries about methods to strengthen the tools available to the IRS to root out such information. The U.S. receives information from many sources and maintains a strong network of bilateral tax treaties and tax information exchange agreements with foreign nations to enhance transparency and cooperation in addressing potential tax avoidance and evasion. These information exchange provisions help the IRS rise to the challenges of ever-increasing flows of capital, people, and transactions across borders.

As long as there are tax havens that refuse to cooperate in the bilateral exchange of tax information and that fail to meet international transparency standards, residents of high tax countries will continue to be tempted to continue to evade their reporting obligations. However, strong bank secrecy rules and a complete refusal to exchange information regarding foreign activities are quickly becoming relics of a distant time.

Although Liechtenstein related investigations have gathered significant media coverage, it would be a mistake to assume that the IRS has limited its offshore focus to information obtained from Liechtenstein. The ability to reward informants located throughout the world coupled with information sharing agreements in the electronic age greatly increase the risk of detection within bank secrecy countries. Secret perhaps, but impenetrable...definitely not!

Endnotes

1 IR-2008-26 (Feb. 26, 2008).