

# Federal Attempts to Close Offshore Tax ‘Loopholes’

## Necessity or Nuisance?

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The federal government is attempting to close perceived loopholes in the U.S. tax laws that it believes allow taxpayers to hide income offshore. Investment advisors need to stay apprised of these developments, which could affect the ability of U.S. investors to diversify investments in offshore vehicles as well as impose stringent reporting requirements on advisors. The two competing versions of proposed legislation are discussed below.

The Stop Tax Haven Abuse Act, introduced unsuccessfully in 2007, reappeared late last year when co-sponsor Sen. Carl Levin, D-MI, announced that it would become law in 2009. Sen. Levin reintroduced the bill (S. 506) on March 2, 2009, and it was referred to the Senate Finance Committee. The following day, Rep. Lloyd Doggett, D-TX, introduced the same legislation in the House of Representatives (H.R. 1265) and on March 16, 2009, it was referred to the House Subcommittee on Courts and Competition Policy.

The proposed legislation’s stated purpose is to “restrict the use of offshore tax havens and abusive tax shelters to inappropriately avoid Federal taxation.” It would impose a requirement for financial institutions to report clients’ dealings with “offshore secrecy jurisdictions” and it would add another category to the existing definition of “financial institution” for this purpose as “persons involved in forming new corporations, limited liability companies, partnerships, trusts, or other legal entities.” This means that lawyers, CPAs, or other advisors could be considered “financial institutions” required

to report private clients’ activities to the U.S. government.

On March 12, 2009, Sen. Max Baucus, D-MT, chairman of the Senate Finance Committee, began circulating a draft of competing legislation that seeks to “detect, deter, and discourage tax evasion offshore.” On March 17, 2009, Sen. Baucus commented to the Senate Finance Committee that he was considering various ideas and would discuss them with committee members shortly. At the end of April, Sen. Baucus conferred with the Obama administration, and Baucus’ aides stated that he would introduce the bill in the coming weeks. As of press time, however, the Baucus bill was not introduced.<sup>1</sup>

The discussion draft of the Baucus bill is more concise than Levin’s (15 pages versus 69 pages) and takes better aim at actual abuses by targeting individual abuses via a three-pronged approach, rather than creating a blacklist of “secrecy jurisdictions.” For example, the Baucus bill would extend the statute of limitations from three years to six years, thereby doubling the time the Internal Revenue Service (IRS) has to scrutinize tax returns that reported, or should have reported, certain international transactions. The Baucus bill would require taxpayers to include the Foreign Bank Account Reports (FBAR) form with their income tax returns in addition to the current requirements that they file the FBAR with the Treasury Department’s Financial Crimes Enforcement Network and preparers would be required to ask certain “due diligence” questions to determine if filing an FBAR would be required. Each bill would change

the definition of trust distributions by qualifying the use of real estate, artwork, and jewelry as a distribution. Lastly, the Baucus bill would double fines and penalties for underpayment of taxes on certain offshore transactions.

Below is a summary of the salient points of each proposal.

### The Levin Bill

- Would create a blacklist of 34 offshore secrecy jurisdictions (OSJs) that includes the Channel Islands, the Isle of Man, Switzerland, the Cayman Islands, the British Virgin Islands, Bermuda, the Bahamas, Costa Rica, Belize, Hong Kong, and Singapore.
- Would create the following rebuttable presumptions against U.S. taxpayers who deal with OSJs:
  - » A U.S. taxpayer who formed, funded, or benefited from an entity in an OSJ would be in control of that entity.
  - » Funds received from an OSJ entity would be fully taxable and funds transferred to an OSJ would not yet have been taxed.
- Taxpayers would be able to rebut the above presumptions only by showing “clear and convincing evidence” that the presumptions are factually inaccurate, i.e., present the foreign witness (offshore banker, corporate officer, or trust administrator) for cross-examination in the U.S. proceeding to establish the facts as inaccurate or to authenticate foreign-based documents.
  - » An affidavit from an offshore resident who refused to submit to



- cross examination in the United States would be insufficient.
- Would allow Treasury to impose sanctions and penalties under the Patriot Act on foreign jurisdictions or financial institutions that are “impeding U.S. tax enforcement.”

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- Would extend the statute of limitations from three years to six years for tax returns that reported, or should have reported, transactions involving an OSJ.
- Would require any U.S. financial institution that directly or indirectly establishes a non-U.S. account or entity for a U.S. taxpayer to report that transaction to the IRS.
  - » Would add another category to the existing definition of “financial institution” for this purpose as “persons involved in forming new corporations, limited liability companies, partnerships, trusts, or other legal entities.”
- Would treat any U.S. person who benefits from a foreign trust (including future or contingent beneficiaries) as a current trust beneficiary, even if such person is not named as a beneficiary in the trust document.
- Would expand the types of property considered to be a distribution, such as loans of trust assets and property, including real estate, artwork, and jewelry, making such distributions potentially taxable.
- Would attribute certain protector and protector-like powers to the grantor, which in some circumstances would result in taxable trust

- income and gains to the grantor.
- Would replace the “more likely than not” standard (greater than 50 percent) for relying on legal opinions relating to penalties with a “should” level of confidence (at least 70 percent to 75 percent).

#### The Baucus Bill

- Would treat all U.S. corporate dividend-based payments to non-U.S. persons as taxable income subject to withholding.
- Would increase disclosure obligations in connection with passive foreign investment companies (PFICs) by requiring reporting from any U.S. person who directly or indirectly causes a PFIC to be formed or who transferred assets to or received assets from a PFIC.
- Would require entities transferring funds offshore, other than on behalf of publicly traded companies, to report to the IRS the amount and destination of funds transferred.
- Would extend the statute of limitations from three years to six years for tax returns that reported, or should have reported, certain international transactions.
- Would require the FBAR form (T.D. F 90-22.1) to be filed with the income tax return.
- Would enhance the foreign-trust “failure to file” penalty by establishing a \$10,000 minimum penalty.
- Would expand the types of property considered to be a distribution, such as real estate, artwork, and jewelry.

- Would double applicable fines and penalties on tax underpayments attributable to certain offshore transactions. 

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#### Endnote

<sup>1</sup> In May 2009, the U.S. Department of the Treasury published its “Green Book” containing Treasury’s supposition about what the future rules will be. While this is a supposition, it can be helpful in analyzing what the future legislation ultimately may be. The May 2009 Green Book is available online at <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>.

