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The Panama Papers Problem: Global Financial Institutions Face Increasing Liability for Clients' Tax Evasion

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Offshore tax havens and nominee entities such as private investment companies (corporate entities often established offshore that act as account holders in lieu of the individuals who beneficially own the assets) pose significant regulatory and compliance risks to international financial institutions. Regulatory authorities around the world, including the U.S. Department of Justice, intensified their investigations into offshore tax havens after the April 3, 2016 publication of names associated with the Panamanian law firm Mossack Fonseca, widely known as the "Panama Papers," and the firestorm of public outcry. While the Panama Papers leak prompted media attention, the swift response by regulatory authorities is just the latest of the steadily increasing initiatives by prosecutors to ramp up their enforcement efforts to identify and root out offshore entities worldwide that may facilitate tax evasion. Though these investigations primarily target individuals evading taxes, statutory regimes such as the U.S. Foreign Account Tax Compliance Act ("FATCA") and retrospective investigative efforts by international enforcement agencies increasingly ensnare financial institutions as unwitting accomplices to account holders' misdeeds. More importantly, the latest enforcement trends shift the burden of proving that account holders are *not* evading taxes onto the financial institutions themselves, lest the institutions face lengthy, costly, and reputation damaging formal investigations.

Tax Avoidance Versus Tax Evasion –– The Conundrum for Financial Institutions

The use of offshore entities to structure investments and wealth management is not, on its own, inappropriate or illegal. In fact, the U.S. tax code itself may encourage the use of offshore entities by excluding certain revenues from tax liability in enumerated circumstances. International financial institutions and their bankers and wealth advisors frequently recommend the use of offshore entities precisely for the tax advantages that such entities offer. But financial advisors must be careful to advise methods that *avoid* taxes, where permitted under applicable tax codes, rather than encourage a client to *evade* taxes that the client otherwise legitimately owes. Clients who structure their assets using offshore entities in order to avoid taxes in accordance with exceptions set forth in the relevant tax codes may face scorn from the general public for taking advantage of such provisions, but the avoidance of taxes through legal means is not inappropriate. However, clients who capitalize on banking secrecy regimes to prevent the disclosure of assets or income held in the name of offshore entities or in offshore accounts to relevant tax authorities—thereby failing to pay taxes they otherwise should and would owe—cross the line into tax evasion.

International financial institutions frequently open accounts in the name of offshore entities. In order to combat the risks of facilitating tax evasion, most financial institutions apply rigorous "Know Your Client" and new client adoption procedures. But even with these processes in place, financial institutions retain limited insight into a client's true intentions. While account opening documentation usually includes language admonishing that the account holder solely is responsible for the tax compliance of the assets held in the account, the trend in international enforcement is to question the sufficiency of such clauses. Regulatory regimes such as the U.S.'s FATCA and the Organisation for Economic Co-operation and Development's ("OECD") Common Reporting Standard require financial institutions to report information on their account holders to tax authorities, essentially coopting the institutions as informants on their clients' holdings. Institutions that fail to implement the reporting schemes carefully and thoroughly face significant automatic withholding of payments from source jurisdictions and potential loss of access to dollar markets.[1]

But, more insidious than the reporting regimes, recent enforcement measures implicate the institutions themselves in the tax evasion activities of their clients. For example, the DOJ implemented a program to resolve allegations of aiding and abetting tax evasion by Swiss banks that netted $1.36 billion in penalties against Swiss banks in exchange for non-prosecution agreements (the "Swiss Bank Program").[2] The Swiss Bank Program likely will serve as a template for future enforcement efforts in other jurisdictions that have strict and protective banking secrecy laws.

DOJ Swiss Bank Program

In August 2013, the DOJ and Swiss government announced a program through which participating Swiss banks could resolve lingering allegations of aiding and abetting tax evasion by U.S. taxpayers who took advantage of Switzerland's rigorous banking secrecy and data privacy laws to shield assets from being declared to U.S. tax authorities. The Swiss Bank Program provided four separate categories for financial institutions: (1) Category 1 banks already were under investigation by the DOJ at the time the program was announced; (2) Category 2 banks were those that had U.S. clients and had "reason to believe [they] may have committed tax-related offenses;" (3) Category 3 banks were those that had U.S. clients, but that had committed no tax-related offenses; and (4) Category 4 banks were those with no U.S. clients.[3] Category 1 banks were not eligible for relief under the Swiss Bank Program, while Category 2 banks were eligible to receive non-prosecution agreements in exchange for a calculated penalty and production of certain data related to U.S. accounts. Banks in categories 3 and 4 were eligible for non-target letters, assuming the DOJ could confirm they met program criteria.

The Swiss Bank Program required participating banks to examine account documentation for any nexus to the United States. The term "U.S. Related Account" meant far more than accounts held by or for U.S. taxpayers, and included accounts with U.S. powers of attorney or signature authority, as well as the numerous indicia of U.S. nexus set forth in FATCA, including such broad elements as a U.S. address on file or standing orders to U.S. banks. The DOJ's expansive definition of U.S. Related Accounts is rooted in its skepticism of nominee entities, which, in the hands of dubious taxpayers, can permit funds to be held in the name of an entity and nominally controlled by the entity's directors, but genuinely owned by an individual holding only a power of attorney over the account. The Swiss Bank Program was retrospective to August 1, 2008, and required participating banks to review account activity for all U.S. Related Accounts from that period forward.

Though Category 2 banks (*i.e.*, those that had reason to believe they had facilitated tax evasion) ultimately had to produce significantly more data and information under the Swiss Bank Program, even Category 3 banks (*i.e.*, those who did not commit any tax-related offenses) had to undertake

significant reviews of their files to ensure they met the requirements of the Swiss Bank Program. The DOJ issued guidance warning participating banks that "changes from [C]ategory 3 to [C]ategory 2" would be approved "only in extraordinary circumstances," and that a Category 3 bank would be liable for any misconduct later discovered.[4] Therefore, it was critical even for banks with little or no reason to suspect involvement in wrongdoing to obtain guidance on the nuances of what constituted violation of U.S. tax laws, and the DOJ's guidance essentially encouraged banks to err on the side of caution and enter the Swiss Bank Program in Category 2 rather than Category 3.

In the framework of the Swiss Bank Program, the DOJ took the view that the Swiss banks themselves could be held liable for aiding and abetting the tax evasion of any account holder who had not declared income associated with their accounts on annual tax returns or who had not submitted annual declarations of the assets held in the Swiss bank accounts through a Foreign Bank Account Report ("FBAR"). The Swiss Bank Program did not require affirmative evidence that a bank had encouraged or assisted the account holder's tax evasion; rather, the DOJ asserted that it could hold the bank liable simply if an account was undeclared. Moreover, the Swiss Bank Program shifted the burden of proof to the banks themselves to demonstrate affirmatively that accounts were declared to tax authorities in order to qualify for non-prosecution agreements or non-target letters. But because the Swiss Bank Program was voluntary, banks faced the dilemma of either accepting the DOJ's expansive view of aiding and abetting and engaging in the program's account review or rejecting the DOJ's broad interpretation of liability and potentially dealing with a far more protracted and expensive defense of a full-scale DOJ investigation. Understandably, most large institutions chose to participate in the Swiss Bank Program. In total, 80 Swiss banks obtained non-prosecution agreements under Category 2,[5] while Category 3 applications for non-target letters remain pending before the DOJ.

While the Swiss Bank Program collected more than $1 billion in penalties from Category 2 banks,[6] the DOJ primarily aimed to obtain account and transaction information to support investigations and prosecutions of tax evaders and the institutions that held their accounts. Though banks participating in the Swiss Bank Program provided much of the information without disclosing the names of specific account holders, transaction data included details such as dates, amounts, and source and destination banks involved. The DOJ can compile the data from all sources and cross reference specific information available to it, especially where U.S. institutions were involved, to develop solid leads and commence targeted investigations of both individuals and financial institutions. As discussed below, the information contained in the Panama Papers leak provides the DOJ with an additional—and likely far more detailed—source of information that will provide prosecutors with further bases for investigations of individuals and institutions.

Expansion of DOJ Investigations to Other Jurisdictions

In October 2015, the DOJ Tax Division's Acting Assistant Attorney General, Caroline Ciraolo, said that the DOJ was "following leads and following the money, wherever that leads us."[7] The DOJ is compiling the transaction and account data provided pursuant to the Swiss Bank Program in order to identify individuals for prosecution as well as to determine the geographic focus of future investigations. Ms. Ciraolo further stated in January 2016 that the DOJ was "looking well beyond Switzerland," to jurisdictions including "Belize, the British Virgin Islands, the Cayman Islands, the Cook Islands, India, Israel, Liechtenstein, Luxembourg, the Marshall Islands and Panama, just to name a few."[8] Press reports frequently cite potential DOJ inquiries into accounts held at institutions based in Hong Kong and Singapore as well.[9] Based on the DOJ's perceived success in implementing the Swiss Bank Program, there is a strong expectation that similar programs may be rolled out to additional jurisdictions based on information obtained by the DOJ through the Swiss Bank Program and other

enforcement actions—or provided to the DOJ through leaks of banking information such as the Panama Papers.

The Panama Papers

The initial publication of the Panama Papers on April 3, 2016, included the names of the individuals identified as being associated with Mossack Fonseca and just 151 of the 11.5 million documents included in the leak.[10] The U.S. Attorney's Office for the Southern District of New York sent an e-mail to the International Consortium of Investigative Journalists (ICIJ), the organization coordinating the release of the Panama Papers, informing them that prosecutors had opened a criminal investigation into the matter.[11] Regulatory authorities in other countries have taken similar steps, including Singapore, Australia, Canada, France, Iceland, India, Mexico, and the United Kingdom, among others.[12] The ICIJ reports that more than 500 banks were involved in the more than 15,000 shell companies established by Mossack Fonseca.[13] Furthermore, the ICIJ intends to disclose a full list of the offshore companies identified in the Panama Papers on May 9, 2016.[14]

This massive leak provides critical information that will enable the DOJ and other regulatory and enforcement authorities to identify individuals who may not have declared their offshore assets and income. But beyond identifying individuals, the Panama Papers will provide prosecutors with a road map to the jurisdictions and institutions in which Mossack Fonseca's clients held accounts and assets. Even if the DOJ does not launch full-scale programs similar to the Swiss Bank Program in every jurisdiction, the DOJ easily could impose a choice upon each financial institution implicated by the Panama Papers: (1) either conduct a rigorous review of accounts for potential tax evaders, or (2) face the prospect of a lengthy investigation for aiding and abetting tax evasion based on the information obtained from the Panama Papers and other sources. Ultimately, the Panama Papers leak has provided the DOJ and other regulatory authorities with a shortcut to obtaining the same type of information they have previously sought through lengthy investigations and efforts such as the Swiss Bank Program.

Staying Ahead of the Curve

Financial institutions no longer can afford simply to relegate responsibility for tax compliance of accounts they hold for their clients. Regulatory regimes like FATCA, the Common Reporting Standard, and investigative initiatives such as the Swiss Bank Program place much of the onus to ensure tax compliance squarely on the institutions themselves. That onus is even greater where regulatory authorities have more granular and detailed information on offshore account activity. Given the scope and sheer volume of the Panama Papers leak, global financial institutions can expect the accounts held by offshore entities—and, by extension, the institution's handling and oversight of those accounts—to come under greater scrutiny. Navigating the murky waters between tax avoidance and tax evasion can be extraordinarily complicated, particularly where offshore entity accounts are concerned. And as seen in the Swiss Bank Program, the DOJ can leverage the threat of reputation damaging formal investigations to extract cooperation and extensive reviews of accounts with some nexus to the United States. Even institutions similar to the Swiss Bank Program Category 3 banks, which have no reason to believe they facilitated tax evasion and have implemented rigorous compliance programs, may need to undertake careful review of accounts with links to the United States or other jurisdictions launching similar enforcement initiatives. Banks and financial institutions that preemptively conduct rigorous risk assessments of offshore entity accounts and implement stricter compliance and oversight measures will be the best prepared to answer when the DOJ or another regulatory authority comes calling.

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[1] *See* IRS, *Summary of Key FATCA Provisions*, https://www.irs.gov/Businesses/Corporations/Summary-of-Key-FATCA-Provisions (last visited April 27, 2016).

[2] *See* Press Release, Justice Department Announces Final Swiss Bank Program Category 2 Resolution, Department of Justice (Jan. 27, 2016), *available at* https://www.justice.gov/opa/pr/justice-department-announces-final-swiss-bank-program-category-2-resolution-hszh-verwaltungs.

[3] For complete language of the Swiss Bank Program, *see* Joint Statement Between the U.S. Department of Justice and the Swiss Federal Department of Finance (Aug. 29, 2013), *available at* https://www.justice.gov/tax/file/631356/download.

[4] The Tax Division's comments about the Program for Non-Prosecution Agreements or Non-Target Letters for Swiss Banks, Department of Justice (Nov. 5, 2013), *available at* https://www.justice.gov/tax/file/631361/download.

[5] *See* Department of Justice, *Swiss Bank Program*, https://www.justice.gov/tax/swiss-bank-program (last visited April 27, 2016).

[6] *See supra* note 2.

[7] David Voreacos & Giles Broom, *U.S. Chases Swiss Bank Secrets to Singapore and Israel*, Bloomberg (Oct. 9, 2015), *available at* http://www.bloomberg.com/news/articles/2015-10-09/swiss-bank-secrets-lead-u-s-to-tax-cases-in-singapore-israel.

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