IRS Response To The PFIC Problem In The UBS Voluntary Disclosure Initiative

Tanya M. Marcum is an assistant professor of law in the Department of Business Administration, Foster College of Business Administration, at Bradley University in Peoria, Illinois. She has taught law for over 12 years and has published 16 scholarly articles on various legal topics. She holds a B.S. degree from Central Michigan University, 1983, and a J.D. from Thomas M. Cooley Law School, 1987. She is licensed to practice law in the State of Michigan. She served as General Counsel for the IRS in the Detroit and Grand Rapids offices for 10 years. She can be reached at tmarcum@bradley.edu.

Sandra J. Perry is a professor of law in the Department of Business Administration, Foster College of Business Administration, at Bradley University in Peoria, Illinois. She has taught law for over 29 years and has published 29 scholarly articles on various legal topics. She holds a B.S. degree from Bradley University, 1976, and a J.D. from Southern Illinois University School of Law, 1979. She is licensed to practice law in the State of Illinois. She can be reached at sjp@bradley.edu.

Tanya M. Marcum and Sandra J. Perry

With a high volume of cases, a lack of information, and harsh penalties, voluntary disclosure of PFIC income presents the perfect storm for taxpayers.

THE RECENT SURGE in enforcement of U.S. tax law by the IRS for non-reporting of foreign income coupled with the complicated tax treatment of passive foreign investment companies (PFICs) threatened to create a perfect storm for the taxpayers, their representatives, and the IRS. Thousands of U.S. taxpayers have come forward to participate in the IRS's voluntary disclosure initiative following the UBS agreement in order to disclose to the U.S. their identities and account information. Much of this previously unreported income is subject to harsh tax treatment requiring detailed financial information about these foreign investments, which is largely unavailable to the taxpayers and the IRS. The volume of cases and lack of information threatened to bottleneck enforcement of the law. This article reviews the background of the high-profile UBS case, the IRS's voluntary disclosure program for these cases, and the tax problems associated with passive foreign investment companies. The current IRS alternative resolution method of dealing with the passive foreign investment company income of the many taxpayers who

have come forward is explained, and some future issues regarding PFIC income are highlighted.

FOREIGN TAX HAVEN CRACKDOWN • The 1990s saw a marked increase in schemes to evade the payment of U.S. taxes through the use of accounts and credit cards in foreign countries. In 1996, the FBI uncovered money laundering in a cable piracy investigation and turned the defendant into an IRS informant on tax evasion in the Cayman Islands banking system. In 1999, John Mathewson pleaded guilty to money laundering and provided what the prosecutor called at the time "the most important cooperation for the Government in the history of tax haven prosecution" (Smothers 1999) (note that all parenthetical references appear in full at the end of this article).

On the heels of that investigation, the IRS announced its Offshore Credit Card Program to combat tax avoidance schemes involving credit cards issued by offshore banks to U.S. citizens (IRS.gov 2003). As part of that program during 2000-2002, the IRS sought and obtained "John Doe" summonses against American Express, VISA, and MasterCard, as well as more than 100 businesses in an effort to identify U.S. taxpayers evading payment of taxes. A "John Doe" summons is any summons where the name of the taxpayer under investigation is unknown and therefore not specifically identified according to I.R.M. §25.5.7.2. In January of 2003, the IRS announced its Offshore Voluntary Compliance Initiative aimed at bringing wayward taxpayers back into compliance with U.S. tax law using offshore credit cards or other offshore arrangements. Those who came forward under this initiative still had to pay back taxes, interest, and penalties, but they did not face civil fraud and information return penalties, and more importantly, criminal penalties. In July 2003, the IRS reported that this initiative had netted more than $75 million in taxes (Offshore Compliance Program Shows Strong Results 2003).

SWISS TAX HAVEN INVESTIGATION • Until recently, Switzerland and its banking system were considered a tax haven for U.S. account holders wishing to keep their income private from the IRS (Todero 2010). Union Bank of Switzerland AG (UBS) provided financial secrecy for its U.S. customers by not disclosing account ownership information to the IRS and/or creating fictitious foreign entities as the owners of the accounts (Lovejoy 2010). Although UBS provided secrecy, U.S. citizens could voluntarily disclose their UBS accounts to the IRS by filing the appropriate forms and reporting the income on their tax returns. However, many chose not to voluntarily disclose income earned on funds in the UBS accounts.

UBS signed an agreement to be part of the U.S. Qualified Intermediary Program in 2001 (*Tax Haven Banks and US Tax Compliance 2008*). The Qualified Intermediary Program allows a financial institution to enter into an agreement with the IRS to "assume certain documentation and withholding responsibilities in exchange for simplified information reporting for its foreign account holders and the ability not to disclose proprietary account holder information to a withholding agent that may be a competitor" (Qualified Intermediary Frequently Asked Questions Q&A-1.). The IRS soon realized that UBS was not reporting account information (Lovejoy, supra). The IRS and the Department of Justice (DOJ) began a criminal investigation of UBS in 2004 (*See* U.S. Senate, Perm. Subcomm. on Investig., *U.S. Tax Shelter Industry: The Role of Accountants, Lawyers and Financial Professionals* (2003, available at http://levin.senate.gov/imo/media/doc/supporting/2003/111803TaxShelterReport.pdf).

In the spring of 2007, the IRS and the U.S. government received a big break in its investigation. Swiss banker Bradley Birkenfeld informed the U.S. government, through his attorneys, of a conspiracy between UBS and its U.S. customers to keep financial account information secret from the IRS (Hil-

zenrath 2010). He hoped to become a whistleblower and provide information to the U.S. which might entitle him to a share of the billions of unreported offshore income hidden by UBS. However, Birkenfeld had engaged in criminal conduct himself and tried to obtain immunity from prosecution from the DOJ as part of the deal. As part of the standard agreement with the government called a proffer, Birkenfeld provided information such as cell phone numbers, email addresses, and the names of American hotels used by UBS salesmen, even though he knew he could still be prosecuted by the U.S. After many back-and-forth discussions with the DOJ, immunity was declined. Birkenfeld then tried to work with the Securities Exchange Commission and continued to offer to help the U.S. in exchange for immunity. Birkenfeld was arrested in 2008 when he returned to the U.S. to attend a high school reunion.

UBS was then the primary target of the DOJ. On July 1, 2008, a federal judge in Miami authorized the IRS to serve a "John Doe" summons on UBS to obtain the names of U.S. taxpayers with hidden accounts at the Swiss bank. Birkenfeld's statements that UBS had about $20 billion in assets of U.S. taxpayers in undeclared accounts and that UBS had assisted them in concealing their identities by creating sham entities and filing false IRS forms provided the basis for issuance of the summons (Press Release #584: *Federal Judge Approves IRS Summons for UBS Swiss Bank Account Records 2008*).

UBS entered into a deferred prosecution agreement with the DOJ in early 2009 (Levine and Vasiliadis 2010). In the agreement, UBS admitted that it participated in a scheme to assist U.S. citizens in hiding accounts from the IRS and agreed to disclose the identities and account information for some of its U.S. customers. Birkenfeld pleaded guilty on August 21, 2009 to a single count of assisting an American billionaire real estate developer evade paying $7.2 million in taxes (IRS News Release: *Offshore Tax-Avoidance and IRS Compliance Efforts* n.d.) and was sentenced to 40 months in prison (DOJ News Release #831: *Former UBS Banker Sentenced to 40 Months for Aiding Billionaire American Evade Taxes 2009*). At Mr. Birkenfeld's sentencing, the U.S. prosecutor admitted that "without Mr. Birkenfeld walking into the door of the DOJ in the summer of 2007, I doubt…that this massive fraud scheme would have been discovered by the United States government" (Hilzenrath 2010).

IRS VOLUNTARY DISCLOSURE INITIATIVE: POST -UBS AGREEMENT • On March 23, 2009, the IRS issued three memoranda regarding the voluntary disclosure of offshore accounts with the following points:

- The IRS's was committed to the challenges of international tax administration in high-risk areas by prioritizing the investigation of abusive offshore transactions designed to evade the payment of U.S. taxes (SBSE Examination Area Directors LMSB Industry Directors 2009);
- The Criminal Investigation Division of the IRS was made responsible for initially screening any taxpayer amended return to determine the actual eligibility of the taxpayer to make a voluntary disclosure of this income to the IRS;
- The amended returns with offshore account disclosures were to be processed for civil penalties through the Philadelphia Offshore Identification Unit;
- The Philadelphia office would attempt to execute agreements with taxpayers to resolve the offshore issues, including: the assessment of all taxes and interest for six years; an accuracy or delinquency penalty for all years; and penalties "equal to 20 percent of the amount in foreign bank accounts/entities in the year with the highest aggregate account/asset value";
- Taxpayers had until October 15, 2009 to make their voluntary disclosures.

THE PFIC PROBLEM • Congress enacted the passive foreign investment company tax rules in 1986. These rules limit tax incentives to invest outside the United States (Staff of Joint Committee on Taxation. *99th Congress General Explanation of the Tax Reform Act of 1986*) and arguably treat passive foreign investments more harshly than passive investments in domestic companies (Crenshaw 2006). Many of the UBS accounts held by U.S. taxpayers involved passive foreign investment companies that would have been subject to this special tax treatment, had the foreign investment been declared by the taxpayer.

A PFIC is any foreign corporation where 75 percent or more of its gross income in a taxable year is passive income, or where the average percentage of assets held by the corporation during a taxable year which produces passive income or which is held for the production of passive income is at least 50 percent according to Internal Revenue Code (I.R.C.) §1297(a). For purposes of PFIC, passive income includes any income such as dividends, interest, royalties, rents, annuities, certain property or commodities transactions, gains from foreign currency, income equivalent to interest, or personal service contracts as described by I.R.C. §§1297(b) and 954(c). A return involving a PFIC must also include a Report of Foreign Bank and Financial Accounts (FBAR) Form TD F 90-22.1 (revised March 2011). There are three taxation alternatives for PFIC. Two of the alternatives require an election by the reporting taxpayer. The third is the default method which is more punitive.

Election To Treat Income As A Qualified Electing Fund

In the first alternative, the taxpayer may elect to treat the income as a Qualified Electing Fund (QEF) if the company complies with such requirements as the secretary may prescribe for purposes of determining the ordinary earnings and net capital gain of the company according to I.R.C. §1295. This means that the company must be able to calculate its ordinary earnings and net capital gains for each year and provide to each investor his or her pro rata share of the same. In addition, a QEF election is only available if the PFIC complies with the IRS information disclosure requirements that enable the IRS to determine the PFICs ordinary earnings and capital gains. Many foreign companies do not provide the necessary financial information to its U.S. customers rendering this election unavailable to most taxpayers. Taxation as QEF treats as ordinary income the shareholder's pro rata share of ordinary earnings for the year and treats as long-term capital gain the shareholder's pro rata share of the net capital gains for the year, whether or not distributions of income are made to the investors in accordance with 26 U.S.C.S. §1293(a). Stock basis is increased for income recognized and decreased for amounts distributed.

Mark-To-Market Election

The second alternative election available to the taxpayer who reports the PFIC income is the mark-to-market election as described in I.R.C. §1296. This election option was added in the Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) because foreign banks often did not provide enough information for taxpayers or the IRS to make the QEF election (IRS Plain Language Regulations, Reg-112306-00 2002, July 31, 2002). The mark-to-market election is available for marketable stock and includes as ordinary income to the taxpayer the excess of the fair market value of stock over the taxpayer's adjusted basis of the stock. A loss deduction is allowed to the lesser of the excess value or unreversed inclusions. Mark-to-market compares the value of the stock at the beginning of the year to its value at the end of the year. If the value of the stock went up, the gain was ordinary income. If the value went down, there was an ordinary loss. This election is considered less favorable than the QEF election for most U.S. taxpayers because the tax is based on the individual