The IRS and Panama Papers: *Lessons Learned*

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LORMAN EDUCATION SERVICES

July 2016

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The IRS & Panama Papers: Lessons Learned

In a 7/7/16 Hearing before the House Oversight/Government Reform Committee, James B. Comey, FBI Director said: "We don't want to put people in jail unless we prove that they knew they were doing something they shouldn't do".

In 2016, the "Panama Papers" named hundreds of thousands of wealthy international investors with offshore accounts (set up by Mossack Fonseca) hidden behind a maze of anonymous companies set up in the tax havens (BVI the major destination) to conceal the true ownership of the companies. These companies may be implicated in international tax evasion and money laundering.

For the nearly 3000 US taxpayers named to date, they are now under a "spotlight" and face IRS and US Dept. of Justice investigation into their activities thru these companies. To the extent these companies invested in US assets (e.g. real estate, stocks and bonds) they may face IRS audit (for tax evasion) and US DOJ investigation into multiple felonies for money laundering, wire fraud and mail fraud (each of which have 20 year prison sentences as maximum criminal penalties).

For US taxpayers in this predicament the best approach is to immediately address these matters and not wait for an IRS tax audit. If these US taxpayers amend tax returns, declare income and pay tax as long as they were not criminal in their intent (i.e. they were not willful), and either had a mistaken good faith belief that the income was not subject to tax reporting or they were so advised by tax professionals (and they are not tax professionals) they may be safe from criminal prosecution for tax crimes and other related felonies.

The lessons learned from the Panama Papers include the following:

1) For the estimated up to 10m US taxpayers with offshore accounts, they must report annually to the IRS their worldwide income (both within the US and outside the US i.e. offshore).

2) Offshore accounts offer limited privacy since they may forced to be disclosed in the event of IRS tax audits, US DOJ criminal prosecution and US litigation (especially for divorcing spouses).

3) In a divorce action, both spouses must disclose under penalty of perjury all of their worldwide assets.4) In a divorce action, disclosure of US financial accounts may reveal prior transfers of assets to offshore entities. These assets may then be subject to either community property claims or equitable distribution laws.

5) In California, community property assets that are not distributed in a divorce remain community property and are subject to division as community property under a "Henn action".

California certainly requires spouses in a divorce to make written disclosure to each other of all assets and debts, worldwide, whether community property or separate property. Other states may or may not have the same requirement.

A fraudulent failure to disclose a known asset in a California divorce allows the judge to award up to 100% of the undisclosed asset to the defrauded spouse. See Marriage of Rossi (2001) 90 Cal App 4th 34. In that case wife failed to disclose winning lottery ticket. When (now ex) husband found out the judge awarded him 100% of the lottery winnings. Known as the "how to win the lottery without buying a ticket" case. Same principles would apply to fraudulent non-disclosure of offshore bank accounts. The IRS would take a bite, as would the defrauded spouse.

After the Henn case California passed Family Code Section 2556, which said the divorce court can divide "omitted assets" without the need for a new lawsuit.

6) If a US taxpayer is in bankruptcy, US Bankruptcy Courts (as federal courts) have jurisdiction over their worldwide assets. The bankruptcy court my issue a "turn-over" article relating to offshore assets and has the authority to hold a debtor in contempt, subject to jail if the debtor does not comply with the court order.

7) US taxpayers are taxed on their world-wide income. Non-resident aliens are only taxed in the US on US source income unless they receive a green card or are in the US for 183 days in one year or 122 days per year over 3 years, at which time they are taxed on their world-wide income.

8) US taxpayers must disclose offshore accounts over $10k (in which they own or have control e.g. signatory authority) on the annual FBAR filing (Foreign Bank and Account Report; Fin Cen Form 114) due 6/30 each year. FBAR filings are due for all US individuals, and US LLCs, Corporations, Estates & Trusts.

9) US taxpayers must disclose all foreign financial assets over $50k (FATCA filing form 8938, attached to Form 1040 for Individual taxpayers). Foreign bank accounts over $50k require both Fincen Form 114 filing and Form 8938 filing.

10) US taxpayers who invest in offshore corporations are subject to tax compliance filings for Controlled Foreign Corporations (IRS Form 5471) or Passive Foreign Investment Companies (Form 8621).

The tax rules for CFC/PFIC are anti-tax deferral rules, which minimize the tax deferral of certain types of income from foreign sources. The CFC rules impose tax annually on certain types of "tainted income" known as Subpart F income. The PFIC rules impose tax on passive income. These tax rules were enacted by Congress to eliminate unlimited deferral of US income tax on a foreign corporation's undistributed income for the types of income covered by Subpart F and PFIC rules (generally passive investment income and income from certain transactions between a foreign corporation and a related party).

The CFC Subpart F rules only apply if more than 50% of the voting power of the foreign corporation's stock is owned collectively by US shareholders owning 10% or more of the voting power of the foreign corporation (i.e. 5 or fewer US shareholders). The PFIC rules apply to any US person owning shares in a foreign corporation if that corporation's passive income or passive assets exceed certain thresholds (i.e. at least 75 % of the income of which is passive or at least 50% of the assets of which produce passive income or are held of the production of passive income).

Both the CFC/Subpart F rules and the PFIC rules impose US income tax on US persons owning shares in a foreign corporation with passive income (e.g. interest, dividends, rents, royalties and gain on sale of assets which produce passive income), the Subpart F rules (but not the PFIC rules) also impose tax on US shareholders if the CFC has certain types of income from sales or services between the CFC and certain related persons.

11) US multi-national foreign corporations with more than 5 US shareholders (defined as a "10% owner") can take advantage of annual tax deferral by forming subsidiary companies in the foreign countries where they do business. Foreign subsidiaries of US corporations are not considered US corporations for US income tax purposes and their overseas profits are not subject to current US taxes. In this case, US tax applies when the offshore profits are repatriated to the US (e.g. issuance of a dividend to the US parent, who may be eligible for a tax credit for foreign taxes paid by the foreign subsidiary).

12) The US has Income Tax Treaties with a number of countries which contain tax planning opportunities for certain types of income (e.g. dividends, interest) and to reconcile tax rate disparities between countries.

Tax practitioners, both Attorneys and CPAs, who have tax clients who have committed tax crimes (e.g. Tax felonies: willful evasion of tax, obstruction of tax collection et al) may not have an attorney-client privilege for taxpayer communications to them. Since the attorney-client privilege belongs to the client, the client's intent determines whether the exception applies. For those tax practitioners, who continue representing non-tax compliant taxpayers (who remain non-tax compliant despite being informed of their legal obligations by the tax practitioner) they may subject themselves to IRS/CID investigation and US Dept. of Justice criminal prosecution for two separate felonies: conspiracy to evade taxes (18 USC 371), and misprision of a felony (18 USC 4).