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PRACTITIONERS' CORNER

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William M. Sharp Sr. is with Sharp Kemm PA in Tampa, Fla. Dr. Natalie Peter is with Lenz & Staehelin in Zurich. The authors would like to acknowledge the helpful review comments of Andrea D. de Cortes of Sharp Kemm PA.

Introduction

In the wake of the recently announced settlement of the UBS John Doe summons enforcement case, thousands of U.S. taxpayers holding noncompliant Swiss bank accounts are preparing to submit voluntary disclosure applications before the limited amnesty voluntary disclosure program expires on September 23. Those account holders who do not voluntarily disclose risk being turned in if they are on the list of about 4,450 UBS AG account holders (both current and former account holders) described in the settlement agreement, and they could face criminal penalties, stiffer civil tax penalties, back taxes, and interest.

The more significant impact of this development is that U.S. taxpayers with noncompliant accounts with Swiss banks other than UBS AG, as well as non-Swiss banks, are suddenly coming forward. It also brings into play a substantial community of U.S. taxpayers who have been relatively unknown until now — those U.S. taxpayers who are U.S. citizens (or green card holders) and who also hold Swiss passports and otherwise are long-term residents of Switzerland.

Although no official statistics appear to exist, it is fair to speculate that tens of thousands of such dual passport taxpayers live in Switzerland, if not more than 100,000 of the total Swiss population of approximately 7.4 million inhabitants. It is crucial for those taxpayers to consider the IRS's soon-to-expire limited amnesty voluntary disclosure program.

This article provides an overview of how U.S.-Swiss dual passport holders may use the IRS voluntary disclosure program, an overview of the U.S. tax system, and an overview of the Swiss tax system.

Dual Passport Holders

The Worldwide Tax System

As a general rule, all U.S. persons are subject to U.S. income taxation on a worldwide basis. That ordinarily means all of a U.S. person's taxable income, irrespective of whether it is earned in the United States or abroad, must be reported to the IRS and is subject to U.S. income tax during the year in which it is received or deemed received. Even if a U.S. person is living outside the United States, that person is still subject to U.S. income taxation on a worldwide basis.

The term ''U.S. persons'' is broadly defined to include all U.S. citizens, U.S. residents (that is, a non-U.S. citizen who holds a permanent residency visa, commonly known as a green card, or who alternatively meets the substantial presence test), domestic corporations, domestic partnerships, and domestic trusts and estates. In applying this definitional test, in the case of an individual the holding of a non-U.S. passport is disregarded.

Under U.S. tax law, the term ''gross income'' is defined as all income from whatever source derived, including interest, dividends, and gains from dealings in property. To determine a taxpayer's taxable income and eventually the taxpayer's income tax liability for a given year, it is necessary to first determine gross income. Income that is earned in the United States is commonly known as U.S.-source income, while income earned abroad is typically referred to as foreign-source income. Determining the source of income is important in the context of international tax planning, but both categories of income are generally subject to U.S. income taxation on a worldwide basis.

U.S. persons must annually file a U.S. federal income tax return for each calendar year. The United States also has special regimes addressing foreign trusts and corporations.

U.S. Tax Law Treatment of Foreign Trusts

A foreign trust is ordinarily classified as either a grantor trust or nongrantor trust for U.S. federal tax purposes. A grantor trust is any trust to the extent that the trust corpus is treated as owned by a person other than the trust (such as the person transferring property to the trust). A nongrantor trust is any trust to the extent that the trust assets are not treated as owned by any person other than the trust. The following highlights some of the key foreign trust provisions.

The U.S. grantor trust rules were designed to prevent taxpayers from shifting income from higher-income tax brackets to lower-income tax brackets (or in some cases from deferring taxation) in situations when the grantor retained interests in the trust or had continuing control or influence over the trust. If a foreign trust has any U.S. person as a beneficiary, the grantor trust rules eliminate the ability of a U.S. person/grantor to avoid or defer U.S. income tax by placing assets in a foreign trust.

For nongrantor foreign trusts, a series of special tax rules apply, and they harshly penalize nongrantor foreign trust income accumulations eventually distributed to U.S. persons. In either case, special reporting requirements apply to transfers into and out of a foreign trust; there are also annual reporting requirements.

U.S. Tax Law Treatment of Foreign Corporations

The application of U.S. tax law is equally complicated regarding foreign corporations. Foreign-source income may be deferred from U.S. income tax under limited circumstances. U.S. persons often seek to defer U.S. income taxation of foreign-source income through the use of foreign corporations; Switzerland offers tax-advantaged companies such as a Swiss holding company or a regular Swiss company operating in a low-tax canton.

U.S. tax law generally permits U.S. persons to organize foreign corporations through which active business operations as well as limited amounts of passive investment activities may be conducted in a tax-deferred manner. In some cases the IRS will not tax the foreign-source active business income earned by a foreign corporation until the income is repatriated as a dividend to the U.S. persons who are shareholders in the foreign corporation.

However, U.S. tax law contains many provisions that disallow deferral of income earned by U.S. taxpayers through controlled foreign corporations. The U.S. defines a CFC as a foreign corporation of which more than 50 percent of the stock is owned (by vote or value), or is treated as being owned, by U.S. shareholders. A foreign corporation is a corporation that is not created or organized in the United States or under the laws of the United States or of any state. A U.S. shareholder is a U.S. person who owns, or is treated as owning, at least 10 percent of the voting stock of a foreign corporation.

If a foreign corporation is a CFC, every U.S. shareholder must include in gross income the pro rata share of some types of income earned by the CFC during the year (regardless of whether the income is actually distributed to the U.S. shareholder as a dividend). As a result, a U.S. shareholder may owe U.S. tax on income earned by the CFC, even though the U.S. shareholder did not receive a portion of the income as a dividend. Such tainted income earned by the CFC and taxable to the U.S. shareholders of the CFC is commonly referred to as subpart F income.

Subpart F income includes most types of passive income, such as interest, dividends, capital gains, rents, and royalties. The subpart F income reported by a U.S. shareholder as taxable income for U.S. tax purposes is taxed at ordinary income tax rates, without regard to the character of the underlying income. For example, capital gains that generally may be taxed at the favorable current long-term capital gains tax rate of 15 percent will be subject to U.S. tax as subpart F income at ordinary income tax rates of up to 35 percent.

Another set of antideferral rules apply to a passive foreign investment company. A foreign corporation is a PFIC if either (1) 75 percent or more of its gross income is passive income (the income test), or (2) 50 percent or more of its assets (determined on an average basis) consist of assets that produce passive income or that are held for the production of passive income (the asset test). Passive income generally includes dividends, interest, rents and royalties, and other specific types of income. For purposes of the PFIC asset test, the percentage of passive assets is to be determined by the average of the fair market values of the assets determined as of the end of each quarterly period during the tax year of the corporation.

If a foreign corporation is a PFIC, and assuming it is not a qualified electing fund or a late purging election was not made, any direct or indirect disposition of the foreign corporation stock, or any distribution from the foreign corporation, will be subject to the excess distribution provisions of the PFIC rules. Under the excess distribution regime, any gain realized on the direct or indirect disposition of PFIC shares, or any distribution of assets by the PFIC, will be treated as an excess distribution that must be ratably allocated over the shareholder's holding period. For purposes of calculating tax on the excess distribution, current-year tax is increased by the deferred tax amount. The deferred tax amount represents the amount of excess distribution allocable to each year during the holding period multiplied by the highest rate of tax in effect for the year to which the excess distribution was allocated, plus the accrual of interest on that tax amount.

Reporting Foreign Financial Accounts

Whenever a U.S. taxpayer has a financial interest in, or signature or other authority over, a foreign bank or financial account, disclosure obligations arise. A U.S. person who opens a bank account in a foreign country either directly or indirectly through an offshore corporation, trust, or other entity must report the interest in that foreign bank account.

Under U.S. law, the legal precedent focuses on the beneficial owner of the account. There is no question that under U.S. law, the U.S. taxpayer's obligation to report income earned on the financial account is linked to the beneficial owner of the funds in the account, regardless of which person or entity appears on the name of the account. Part III of Schedule B of Form 1040 contains the following question regarding foreign financial accounts:

> At any time during [the tax year], did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?

If the taxpayer answers yes to the question, Schedule B requires the taxpayer to enter the name of the foreign country where the account is held. The Form 1040 instructions require a taxpayer to check yes to the above question if (1) at any time during the year the taxpayer had an interest in, or signature or other authority over, a financial account in a foreign country, or (2) the taxpayer owns more than 50 percent of the stock in any corporation that owns one or more such accounts. The instructions provide an exception whereby a taxpayer should answer no if the combined value of the foreign accounts was $10,000 or less during the entire year. Failure to properly report foreign bank accounts triggers potential civil and criminal consequences.

The nonwillful civil penalty for failing to report the existence of an account by filing Form TD F 90-22.1 is $10,000. However, the penalty will not be imposed if the violation is due to reasonable cause. Also, if a willful violation is found, the penalty will be increased to the greater of $100,000 or 50 percent of the account balance. There is no reasonable cause exception for a willful violation although defenses may apply to demonstrate an absence of willfulness.

The IRS may assess this civil penalty anytime before the end of the six-year period beginning on the date of the transaction for which the penalty is assessed. The penalty described above may be imposed for each foreign account.

The criminal penalty for willfully violating this reporting requirement is a fine of not more than $250,000, or imprisonment for not more than five years, or both. The penalty may increase to a fine of not more than $500,000, or imprisonment for not more than 10 years, or both, if the violation occurs while violating another law of the United States or as part of any illegal activity involving more than $100,000 in a 12-month period.

Common Tax Traps of U.S.-Swiss Dual Nationals

If a U.S.-Swiss dual national residing in Switzerland has filed all applicable Swiss tax returns and paid Swiss tax thereon but has not filed U.S. income tax returns or alternatively has filed U.S. income tax returns but has failed to fully report all offshore income on those U.S. income tax returns, that taxpayer faces challenges.

First, because that U.S.-Swiss dual national is still obligated to file a U.S. income tax return on a worldwide basis, immediate action should be taken to pursue a voluntary disclosure in order to become compliant with applicable U.S. tax law. Fully complying with Swiss law does not exempt the dual national from fulfilling applicable U.S. tax return filing and payment obligations. Those U.S. taxpayers, even though they have filed full and complete tax returns in Switzerland, still must file all U.S. information reports, including the annual foreign bank account report (FBAR).

In most cases Swiss income taxes paid regarding the Swiss income tax return filing should be creditable to offset the U.S. tax burden, but differences between the two legal systems will limit the credit to only some qualifying taxes.

Failure to become compliant for U.S. income tax purposes means the noncompliant taxpayer faces a range of civil as well as potential criminal penalties, and remedial action should be taken under the voluntary disclosure program before the September 23 deadline.

The Swiss System of Taxation

The Swiss tax system has various taxing jurisdictions. While federal tax is common to all taxpayers, each of the cantons (states) has its own system, which is further subdivided among communes (municipalities). Although the cantonal laws have been harmonized, cantons and communes still have much flexibility regarding tax rates as well as interpretation of tax law.

Income tax is levied on income earned worldwide by individuals who are Swiss residents. Nonresidents are subject to income tax only on specific types of Swiss-source income.

Federal, cantonal, and communal tax rates are progressive. Swiss-resident individuals are normally assessed on the basis of a tax return, which is filed annually. Foreign citizens who come to live in Switzerland for the first time (or after an absence of 10 years) and do not engage in gainful activity in Switzerland will, on request, be taxed on a lump sum basis, which means their worldwide Swiss taxable income will be capped based on a prescribed formula. However, because they are Swiss citizens, dual passport U.S.-Swiss taxpayers may not apply for that lump sum taxation.

Capital gains realized by individuals on the sale of privately held assets are exempt from income tax. Conversely, gains realized on the sale of Swiss immovable property or shares in real estate companies may be subject to a special real estate gains tax.

While there is no Swiss federal wealth tax, all cantons levy a net wealth tax on all worldwide assets owned by the taxpayer except for real estate situated abroad or assets attributable to permanent establishments or enterprises abroad.

Tax Domicile or Tax Residence

Switzerland subjects individuals resident in Swiss territory to personal income tax on worldwide income and to personal net wealth tax on worldwide net wealth. An individual is resident in Switzerland if he has his tax domicile or tax residence in Switzerland. A person has a Swiss tax domicile if he resides in Switzerland and intends to permanently reside there. The Swiss tax authorities seek to establish where an individual has the center of his personal and economic interests through circumstantial evidence such as habitual abode, schools for children, or club memberships. An individual with a foreign domicile who comes to Switzerland for educational or medical purposes is not considered to have a Swiss domicile for tax purposes.

Despite the absence of intent to permanently stay in Switzerland and despite temporary interruptions, a person has a tax residence in Switzerland if he spends at least 30 days on Swiss territory in the tax year and engages in gainful activity. If the person is not engaged in gainful activity, he may stay up to 90 days before having a tax residence in Switzerland triggering unlimited income and net wealth taxation. Unlike the United States, Switzerland does not subject its citizens to income tax if they have neither a tax domicile nor a tax presence in Switzerland. However, for purposes of Swiss taxation of U.S. citizens, it is important to determine whether a U.S. citizen is resident in Switzerland.

For U.S. citizens who reside in Switzerland, the applicable income tax treaty provides that the United States has the right to tax its citizens on their worldwide income as if the treaty had not come into effect. Thus, the treaty is not relevant for determining the U.S. tax exposure of a U.S. citizen residing in Switzerland. Despite the U.S. tax, Switzerland may impose Swiss income tax on the same taxable income amounts.

Filing Status

A taxpayer files his tax return either as single, or as married filing jointly if he is married or divorced but living with children in the same household. Unlike under the U.S. tax system, there is no married filing separately status. All of the spouse's income and net wealth tax are added together and taxed at a higher tax rate than if both spouses filed as single.

Relief From Double Taxation

Most Swiss tax treaties follow the principles of the OECD model treaty — an exclusive right to tax a given type of income is granted to one of the contracting states, and the other contracting state is precluded from taxing that income. Where income that is taxed in the state of residence may be taxed in the state of source, the exemption under the progression method is applied.

The applicable Switzerland-U.S. income tax treaty determines how double taxation may be eliminated when Switzerland is the residence country of the taxpayer. Unlike the United States, Switzerland uses different methods for the elimination of double taxation.

If a U.S. citizen who is resident in Switzerland derives non-U.S.-source income, double taxation arises because the United States uses citizenship as a basis for worldwide taxation. The Switzerland-U.S. income tax treaty does not address this issue. Switzerland will impose a tax on its residents regardless of whether they are liable for tax in the United States because of their U.S. citizenship. Therefore, the relief from double taxation depends on the U.S. law granting relief in the form of either an exemption or a foreign tax credit.

Swiss Tax Amnesty

Unlike the long-standing IRS voluntary disclosure program, the debate for adopting a Swiss tax amnesty has been going on for more than 10 years. Various legislative proposals have been discussed and dismissed. However, the Federal Council recently enacted an amnesty that will apply as of January 1, 2010. Under the new legislation, heirs will no longer be liable for penalties imposed on the deceased for tax evasion committed before the date of death. Also, usually only the last 3 tax years before the death of the deceased, instead of 10 years, will be reassessed.

Taxpayers coming forward under a voluntary disclosure now face penalties of one-fifth of the evaded income tax. As of 2010 each taxpayer will have one opportunity to commence a voluntary disclosure without facing penalties. Unlike for heirs, the last 10 tax years will be subject to reassessment. The tax amnesty does not include late-payment interest. Therefore, late-payment interest will still be applied for the last 3 and 10 years.

Swiss Tax Treatment of Trusts

Switzerland does not have its own trust law. However, with the entry into force of the Hague Convention on the Law applicable to Trusts and their Recognition, the Swiss Tax Conference considered it necessary to issue regulations indicating a number of principles regarding the tax treatment of trusts in Switzerland: (i) the trust itself is never subject to tax due a lack of legal personality; (ii) ownership of the trust's assets and income can not be attributed to a Swiss trustee or protector; (iii) a revocable trust is always treated as transparent, whether it is a fixed interest or discretionary trust, and thus the trust's assets and the income thereof are taxed in the hands of the settlor; (iv) irrevocable trusts can also be treated as transparent if the settlor has any controlling influence over the trust assets; and (v) the trust's assets of an irrevocable fixed interest trust as well as the income thereof are attributed to a beneficiary in analogy to the usufruct and thus taxed in the beneficiary's hands.

Swiss Tax Treatment of Foreign Corporations

Unlike the United States, Swiss tax law does not include a CFC or PFIC regime; however, Swiss law does include an arm's-length pricing system that could impact a Swiss resident taxpayer's dealings with offshore controlled affiliates.

How Dual Passport Holders Can Proceed

IRS Voluntary Disclosure Program

Under the long-standing IRS voluntary disclosure program, U.S. taxpayers, including dual passport holders, may initiate contact with the IRS through legal counsel in order to eliminate the risk of criminal exposure and to resolve all civil tax issues, including all tax deficiencies, penalties, and interest thereon. The voluntary disclosure program is not a blanket amnesty program and, as the IRS has stated on several occasions, creates no substantive legal rights. However, noncompliant taxpayers may effectively end all IRS civil and criminal tax exposure for all open noncompliant years by pursuing this process and eventually entering into a binding and final closing agreement with the IRS.

On March 23, 2009, the IRS announced a penalty framework that tax practitioners commonly refer to as a limited amnesty program. It targets voluntary disclosure cases involving unreported offshore accounts and entities. It also offers greater guidance regarding the substantive and procedural aspects of the voluntary disclosure program, and it is designed to encourage noncompliant taxpayers with offshore financial arrangements to take advantage of it.

To qualify for voluntary disclosure treatment, the disclosure must be truthful, accurate, and complete, and there must be a commitment to cooperate with the IRS in determining the correct tax liabilities for the years at issue as well as to make good-faith arrangements to pay the full amount of tax, interest, and agreed-upon penalties. The disclosing taxpayer must also demonstrate that the income-producing and related activities of the offshore noncompliance, including the source and use of funds, are associated with legal activities.

The disclosure must be made to the IRS before it becomes aware of the taxpayer's potential noncompliance through a civil examination, criminal investigation, or other means. In connection with the UBS AG settlement, the IRS has specified that noncompliant taxpayers still can make a disclosure but that that opportunity will be lost when U.S. account holder data is handed over to the IRS in response to a treaty request or through other means, such as a whistle-blower disclosure or via a random IRS examination.

Under the pending limited amnesty voluntary disclosure program that expires September 23, all applicable taxes and interest will be imposed for the 2003 through 2008 tax years, and the taxpayers must file all required amended or dilatory income tax returns, information returns, and the dreaded FBAR. Also, a special accuracy or delinquency penalty of 20 percent is assessed for the determined tax liability (net of any foreign tax credit due to the payment of qualifying Swiss taxes). Finally, in lieu of all other penalties that might otherwise apply, including the FBAR penalty, a one-time overall offshore penalty amount equal to 20 percent will be imposed for the year with the highest aggregate account value during the prior six-year period. Although a special 5 percent exception exists for this rule, it applies only to some inherited accounts in which the taxpayer has made no deposits or withdrawals and if other conditions are met.

How should a noncompliant dual U.S.-Swiss citizen proceed? The first step is to ensure that all Swiss tax return and tax payment obligations have been fulfilled, because the U.S. voluntary disclosure submission will be based on representations that all tax matters have been properly handled under Swiss tax law. Otherwise, remedial action must be considered under Swiss tax law. The next step is to determine whether the case should qualify for the U.S. voluntary disclosure program; if so, U.S. tax counsel should begin building the voluntary disclosure documents and data file so that the U.S. federal tax results for the 2003 through 2008 tax years can be reconstructed.

Because of the looming September 23 deadline, insufficient time is available to fully perform the due diligence above, but a preliminary assessment may be undertaken and notice of the taxpayer's intent to undergo a voluntary disclosure can be tendered to the IRS. That involves some risk, but most taxpayers in this situation do not want to risk being turned in and missing the September 23 deadline. Accordingly, qualifying noncompliant taxpayers through legal counsel should provide voluntary disclosure notification to the IRS by September 23, and subsequently the case can be developed.

After the pending limited amnesty voluntary disclosure program expires on September 23, all bets are off. The IRS has indicated that the relaxed penalty rules will not apply and that there is no assurance whether any voluntary disclosure program alternatives will be available.

Conclusion

Any dual U.S.-Swiss passport holders who reside in Switzerland should carefully review whether they have been fully compliant not only with Swiss tax law, but also with U.S. tax law. If compliance problems exist under both legal systems, appropriate voluntary disclosure action will need to be taken under both Swiss and U.S. law, with the U.S. voluntary disclosure program typically being initiated before the Swiss program. If the dual passport holder is fully compliant under Swiss law and has filed all required Swiss tax returns and paid the appropriate Swiss tax, but has not filed or reported all offshore matters to the IRS, then filing an IRS voluntary disclosure notification through legal counsel should be immediately considered given the coming September 23 deadline. ◆