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THE IRS vs. UBS: IMPLICATIONS FOR CANADIANS

David H. Sohmer and Pierre-Paul Persico

Shortly after the U.S. Department of Justice and UBS agreed to settle criminal proceedings, the IRS instituted civil proceedings demanding that UBS disclose the names of 52,000 U.S. persons who had secret accounts with it. The highly publicized slugfest was recently settled leaving UBS less wounded and Swiss banking secrecy less vulnerable than many had anticipated. In an *amicus curiae* brief filed by Switzerland, the Swiss threatened to seize the information demanded by the IRS so that the issue would be elevated to a dispute with a sovereign state. The intervention of American and Swiss diplomats resulted in a face-saving settlement for both parties. UBS agreed to disclose the names of approximately 4,450 U.S. persons whose activities could be characterized as tax fraud under Swiss law. Tax fraud occurs if tax evasion is committed by using false documents for deceptive purposes. Tax evasion is the failure to report taxable income. The U.S.-Switzerland tax treaty provides for the exchange of information with respect to tax fraud, so the disclosure would be consistent with Swiss domestic law and with its treaty obligations. While there is no doubt that the settlement will require Switzerland to expand the concept of "tax fraud" and limit procedural protection beyond its comfort

level, the terms of the settlement do confirm that "fishing expeditions" are not permitted.¹

The IRS wisely coupled its attack on UBS with a temporary partial amnesty. The program has been so successful that the IRS introduced an expedited procedure. Persons disclosing under the program must pay tax and interest on six years of income, an accuracy penalty of 20 to 25 percent of the tax owing and an additional penalty of 20 percent of the highest amount in the account over the six-year period. This is in stark contrast to the current voluntary disclosure program ("VDP") of the CRA which only allows relief with respect to civil and criminal penalties.² The dramatic difference in approaches is illustrated by the example on p. 138.³

- 1 A decision by the Swiss "Tribunal administratif fédéral" on March 5, 2009 held that in the case of tax fraud, the mere failure to provide names and personal information is insufficient to characterize a request for assistance as a "fishing expedition".
- 2 Information Circular 00-1R2 - Voluntary Disclosures Program, October 22, 2007, paragraph 8. Note that partial relief may be granted with respect to interest for periods preceding the three most recent years of returns required to be filed.
- 3 The example is based on the example contained in IRS "Voluntary Disclosure: Questions and Answers", posted May 6, 2009, (Q and A 12). New York State tax and interest calculations and U.S. federal interest calculations were provided by Richard B. Halperin of McLaughlin & Stern, LLP, New York (rhalperin@mccloughlinstern.com).

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There are compelling reasons for the CRA to follow the lead of the IRS and provide for a temporary partial amnesty.

1. There are an estimated (\$US) 10 trillion in secret accounts worldwide including a reported (\$US) 5.6 billion being held for Canadians by UBS. The magnitude of the sums involved indicate that even a modestly successful amnesty program could result in a material reduction of government deficits. The taxes collected on repatriation of the funds and the economic stimulus resulting from the investment and spending of the untaxed portion of such funds should be sufficient to counter arguments that an amnesty would compromise the integrity of the system.
2. The Canadian parents of the baby boom generation have accumulated substantial wealth and are willing to pay a price to put their affairs in order. There is no doubt that the IRS and the G20 attacks on banking secrecy have increased the price that they are willing to pay. CRA statistics however indicate that they have not been availing themselves of the voluntary disclosure program and it is doubtful that they will in the absence of an amnesty.⁴ The resolutions to the IRS and G20 attacks on banking secrecy

4 According to the Canadian Press, an October 2005 draft CRA review of the VDP indicates that in 2003-2004, the main clients

	AMOUNT ON DEPOSIT	INTEREST	ACCOUNT BALANCE	CANADA FED & PROV TAX @ 45%	U.S. FED TAX @ 35%	NY STATE TAX @ 6.85%
1999	800,000	50,000	850,000	382,500		
2000		50,000	900,000	22,500		
2001		50,000	950,000	22,500		
2002		50,000	1,000,000	22,500		
2003		50,000	1,050,000	22,500	17,500	
2004		50,000	1,100,000	22,500	17,500	
2005		50,000	1,150,000	22,500	17,500	3,425
2006		50,000	1,200,000	22,500	17,500	3,425
2007		50,000	1,250,000	22,500	17,500	3,425
2008		50,000	1,300,000	22,500	17,500	3,425
				585,000	105,000	13,700
U.S. 20% accuracy penalty					21,000	
U.S. additional 20% penalty on highest amount					260,000	
				585,000	386,000	
Canada interest @ assumed rate of 4%				197,529		
U.S. actual interest					21,500	
NY actual interest						2,161
				<u>782,529</u>	<u>407,500</u>	<u>15,861</u>
Percentage of current account balance				60%	31%	1%

confirm that "fishing expeditions" will not be permitted so that detection of accounts where there has been little or no activity for many years is unlikely.⁵ If offshore funds are bequeathed to children who have emigrated, the "revenue rule" will deny Canada access to foreign courts to collect tax due by their parents.⁶ Article XXVI A of the Canada-U.S. tax treaty provides an exception to the revenue rule but it is doubtful whether amounts that may be due under section 160 ITA constitute a tax covered by the provision.⁷

3. The legal foundation for the U.S. attack on UBS was based to a large degree on UBS circumventing its obligations under the qualified intermediary agreement which it entered into with the IRS. The qualified intermediary program requires foreign financial intermediaries to ensure that U.S. persons execute W-9 forms and that non-U.S. persons execute W-8BEN forms. Canada has no qualified intermediary program and does not have the economic muscle to introduce an effective one. It is arguable that the CRA can only obtain foreign-based information in accordance with section 231.6 ITA which does not extend to information relating to unnamed persons.⁸ Its attack on banking secrecy will accordingly be limited to action taken by it as part of the G20 or OECD.
4. In her 2004 report to Parliament, the Auditor General observed that determining how much of unreported income should be assessed "means finding the balance between what the taxpayer owes and what the taxpayer is willing to pay to become compliant, taking into account that the

were men whose average age was 49. The baby-boom generation was born between 1946 and 1964 so that their average age in 2003-2004 was 49. In the same period, \$459 million in income tax and GST were assessed but this was unusually high due to two large disclosures. (Assessments in 2000-2001 were about \$140 million.) These disclosures were made in accordance with flexible guidelines which were in effect prior to January 1, 2005. The guidelines permitted the waiver of tax on unreported income for years prior to the six years preceding the year of disclosure.

5. On March 13, 2009, in response to a threat from the G20 countries to include it on a black list, the Swiss "Conseil fédéral" announced that it would adopt Article 26 of the OECD Model Tax Convention in its tax treaties. Article 26 creates an obligation to exchange tax information but does not permit "fishing expeditions" or a "request for information that is unlikely to be relevant to the tax affairs of a given taxpayer" (OECD Centre for Tax Policy and Administration).
6. The revenue rule prohibits the courts of one country from enforcing a tax judgment from another country.
7. Section 160 ITA provides that the transferee and transferor are jointly and severally liable to pay a part of the transferor's tax where property is transferred for consideration which is less than fair market value.

result also has to be fair to taxpayers who have been compliant". The current policy of the CRA is that the appropriate balance is achieved if all unreported income is taxed without penalty or prosecution. The concern is that the VDP must not be a vehicle for taxpayers to intentionally avoid their obligations under the Acts administered by the CRA. A temporary partial amnesty need not be inconsistent with this policy.

5. It is less costly if taxpayers and their representatives do all the work through disclosures rather than officers having to carry out prolonged audits.
6. Other members of the G20 have adopted partial amnesty programs. The August 11, 2009 issue of ft.com reported that the U.K. has offered easy terms to about 5,000 British investors with an estimated £2bn to £3bn in secret Liechtenstein bank accounts. They will be asked to settle unpaid tax going back 10 years and pay interest and a penalty of 10 percent of the tax. The report states that the generosity of the terms reflects the paucity of information that the U.K. tax authorities have about the secret accounts.

The CRA maintains that the legislative authority for the VDP is subsection 220(3.1) ITA which permits the Minister to waive all or a portion of penalties and interest. It is however arguable that the program (including a partial amnesty) can also be based on subsection 152(4) ITA which provides that the Minister *may* at any time make a reassessment if the taxpayer has made any misrepresentation that is attributable to neglect, carelessness or wilful default or has committed any fraud in filing a return or supplying any information under the ITA. Given the current political climate in Canada, it may be unrealistic to expect the Agency to use this discretion to introduce a partial amnesty.⁹ The response of the Agency to the terms of the disclosure by ex-Prime Minister Mulroney indicates that the Agency is not prepared to risk being attacked without a broad-based political consensus. Hopefully such a consensus will develop.

8 See David H. Sohmer, "The IRS and CRA vs. UBS: Will Disclosures Be Voluntary", *The Canadian Taxpayer*, Vol. XXXI, issue # 1, page 1.

9 A partial amnesty was implicitly rejected in a letter dated July 17, 2009 to David Sohmer and Aaron Rodgers by Terrance McAuley, Deputy Assistant Commissioner, Compliance Program Branch. The letter was in response to a submission to William Baker, Commissioner of the CRA, proposing a partial amnesty.

Foregoing billions of dollars in tax revenue is too high a price to pay for political gamesmanship.

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HORGAN TAKES OVER FINANCE

You might be forgiven for not having noticed that during the last couple of months, during a broad-based economic crisis, the Department of Finance has been without a deputy minister.

That situation has now been rectified.

Michael Horgan, currently Executive Director for the Canadian, Irish and Caribbean constituency at the International Monetary Fund (IMF), becomes Deputy Minister of Finance, effective September 8, 2009.

Horgan's appointment as the new Deputy Minister of Finance has been welcomed in many circles including those who know him and have worked with him. He'll have a big challenge as Finance has not been performing particularly well in recent years, though many believe that is a function of the political, not bureaucratic leadership.

He was rumoured to be the top contender for the job for months, even before his predecessor, Rob Wright, retired on July 8. The Prime Minister took the opportunity to congratulate Robert Wright on his retirement after a very successful career spanning 35 years in the public service. As Finance Deputy Minister, he will be in charge of the relatively small, but central and uniquely influential policy-oriented department, with a staff of about 765 people.

Those who know him say he is up to the task; those who don't say they hope he is, because what is ahead is challenging and the Finance DM will need be a strong deputy and have a good working relationship with the Minister of Finance to rebuild the credibility of his department. There is little doubt he has a challenge on his hands because, rightly or not, Finance has been under fire for the pitiful finan-

cial projections starting a year ago and its credibility with the observing public has plunged.

Horgan has a solid reputation, having handled difficult files at key times. He served as Deputy Minister of Indian Affairs and Northern Development in 2003-2006, when it was a high priority of the Paul Martin government, including the negotiation of the Kelowna Accord in 2005. Shortly after the Conservative government came to power in January, 2006, he was moved to Environment and was there as the DM until August of last year.

Prior to Environment Canada, Horgan was also the president of the Atlantic Canada Opportunities Agency. He has extensive experience inside Finance, starting in 1978, with his first public service job. He climbed all the way up to senior Finance ADM in 2001-2003. He also holds a master's degree in economics from Princeton University.

SCC PENSION PLAN DECISION

It says something about how long it can take to come to a final legal determination and how at least some aspects of the issue can be viewed in current terms as an economic anomaly.

The Supreme Court of Canada's August 7 ruling in *Nolan v. Kerry (Canada) Inc.*¹ upheld a 2007 Ontario Court of Appeal decision permitting administrators of pension plans to take "contribution holidays" as long as the plan's surplus still allows it to meet its obligations. The majority ruled the plan did not have specific language preventing the company from taking a contribution break.

Of course, by 2008/09 with the problems so many pension plans are having, the notion of there being an actuarial surplus in a plan seems a long-gone vision. The case was somewhat more complex than the aforesaid summary suggests as there were at the time two plans in play, a defined benefit plan and a defined contribution plan and there were issues of inter-plan transfers and the use of plan funds to pay expenses.

¹ 2009 SCC 39, 2009 CarswellOnt 4494, affirming 2007 ONCA 416, 2007 CarswellOnt 3493.