

Forensic Accounting & Fraud

Pressure on to get every American tax dollar

By ALICE A. JOSEFFER

United States President Barack Obama plans to increase funding for Internal Revenue Service (IRS) enforcement, including for international tax compliance. But even before he was elected, IRS officials were focused on international tax enforcement and dispute resolution.

Compliance initiatives offer an opportunity to narrow the substantial gap between tax owed to the U.S. Treasury and what is actually paid.

With mounting deficits, narrowing the gap is more important than ever to the U.S. tax collectors.

The IRS anticipates increased interaction with foreign jurisdictions to enforce compliance. In the future, there could be joint audits. Currently, information sharing agreements between the IRS, the U.S. Department of Homeland Security, states, and other countries provide sources for identifying and investigating compliance issues.

For example, the Joint International Tax Shelter Information Centre, whose membership includes Canada and the U.S., among others, focuses on combating tax avoidance promoters.

The tax treaty between Canada and the U.S. provides for information sharing generally, as well as assistance in tax collection. As such, there is decreasing likelihood that non-compliance will go undetected.

The types of taxpayers and issues that are and will be the subject of IRS scrutiny vary. As always, non-filers such as U.S. citizens living outside the U.S. are of interest. Combating off-shore tax evasion is also a high priority. Sometimes such activity is conducted through offshore accounts or trusts.

Recently, reported violations of a qualified intermediary agreement between Swiss bank UBS and the IRS involved many taxpayers who apparently had unreported accounts at the bank. As a result, the qualified intermediary program, which is intended to facilitate sharing of tax information, may be subject to increased scrutiny.

United States citizens with interests in foreign accounts are required to file an annual information report regarding such accounts, and that requirement is separate from the requirement to file U.S. tax returns.

Under new IRS guidance, many individuals who are neither citizens nor residents of the U.S. may be required to file the report. Failure to file the Treasury Department form is subject to civil and



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potential criminal sanctions. For a six-month period beginning March 23, 2009, an IRS offer to significantly reduce penalties is available to eligible individuals.

To qualify, individuals must voluntarily disclose offshore accounts, file or amend relevant information returns, and pay income tax and interest going back six years. Individuals who do not come in through the voluntary disclosure program can expect the IRS to consider all available penalties, including criminal ones, in their cases.

Transfer pricing issues, particularly those related to intangibles, are also a high priority. Related or affiliated companies may try to inappropriately shift profits to low tax jurisdictions by pricing goods and services in violation of transfer pricing rules. Sometimes companies that simply fail to consider transfer pricing issues and document their pricing decisions are tripped up, even though they had no intent to avoid tax.

With appropriate consideration of pricing issues in the normal course of business planning, the pitfalls can be avoided.

International transactions are more complicated than domestic transactions and tend to involve more complicated structures. Choice of structures, such as use of hybrids, increases the potential for complexity, and sometimes minimizes tax. A hybrid is treated as a corporation under the laws of

one country but as fiscally transparent under the laws of the other country.

But in some situations hybrids have been used in authorized ways to avoid tax. Now, with recent changes to the tax treaty between the U.S. and Canada, certain previously acceptable uses of hybrids will no longer obtain tax advantages that made their use attractive. The changes in the law may create audit risks.



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Even compliant taxpayers may find themselves subject to scrutiny and need to defend their positions. If a tax issue involves treatment in both the U.S. and another jurisdiction, sometimes it is necessary to use the mutual agreement proce-

dures under tax treaties, such as the procedures in the Canada-U.S. tax treaty.

The IRS has specific procedures that a taxpayer can follow in such situations, from the examination level or administrative appeal to the highest level. The Canada-U.S. tax treaty has a new provision for arbitration, a final step for dispute resolution.

The IRS has also increased its focus on criminal enforcement. A recent addition to the IRS manual states, "The detection and deterrence of fraud is every compliance employee's responsibility and should be a top priority when discovered."

For taxpayers under examination (and their representatives), it is important to know when a civil examiner may be considering a referral to the criminal investigation division. Fraud technical advisors assist compliance personnel in all IRS operating divisions, and IRS counsel's counter-fraud working group co-ordinates civil fraud matters and criminal fraud referrals.

It also assists on assertion of the civil fraud penalty and the fraudulent failure to file penalty. An examiner may consult with a fraud referral specialist to determine if a case meets the criteria for a referral (firm indicators of fraud and criminal criteria).

If it is determined a potential fraud case has firm indicators and meets criminal criteria, the exam-

iner will suspend the examination without disclosing the reason and prepare a referral form.

Continued activity by the examiner might risk exclusion of evidence in a criminal prosecution due to claims of Fourth and Fifth Amendment protections (protections against unlawful search and seizure and self-incrimination, respectively). Attorney-client privilege becomes very important in such cases.

In the U.S., there is no accountant or tax advisor privilege with respect to criminal matters. A case that has been referred may proceed as a joint investigation or a parallel investigation. A parallel investigation may occur, for example, if there are taxable periods and other types of tax not included in the criminal investigation.

These same issues can arise in state tax investigations, since many states are also expanding enforcement efforts to include criminal investigations and sanctions. New York State is a perfect example. Just last year, the New York Tax Department quadrupled the number of auditors focused on criminal and civil fraud.

These so-called "fraud auditors" comprise an entirely new Special Investigations Unit (SIU) that is designed to deter tax avoidance and abuse by co-ordinating the tax department's audit, collection, and criminal investigation activities.

Cases that in the past were handled as a civil investigation — or cases that simply were not pursued — now are being brought in the criminal realm. And no type of tax, or taxpayer, is immune.

The SIU teams are investigating sales tax, corporate tax, residency and personal income taxes, franchise taxes, etc., and likely close to 100 convictions or guilty pleas have resulted in the past two years alone.

The best defence is a good offence, i.e., good tax planning to minimize tax lawfully and compliance with reporting obligations. An IRS or state inquiry or examination may result in 'no change' to what a taxpayer has reported or only minor changes.

The way the examination is approached by a taxpayer, such as responding to requests for information, affects the process and also the potential for a positive outcome.

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