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Session 8: Gimme Shelter: Offshore Tax Planning, Evasion and Investigation, from the Rolling Stones to Apple Inc. to Swiss Bankers to the Panama Papers

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I. Background and Foundation

a. Viewpoints on Taxation and Tax Avoidance from the Bench and the Gallery, via *Helvering v. Gregory*, *Gregory v. Helvering*, and Tim Cook

b. The United States' Approach to Individual and Corporate Taxation of Income Earned Outside the United States

II. The Rolling Stones: It's Only Tax Planning, But We Like It

a. It All Started With Allen Klein

  i. When things go bad, sometimes there's a silver lining. Allen Klein took over as the Rolling Stones' manager in the mid 1960s.

    1. Allen renegotiated (and renegotiated) the Rolling Stones' Decca contract which resulted in the band receiving $2.1 million in advance, more than the Beatles were earning at the time.

  ii. At the same time, allegations were made that Klein had withheld royalty payments worth approximately $100 million today, stole the rights to the Rolling Stones' pre-1971 songs (Sticky Fingers and earlier albums) via his publishing arm ABKCO, and neglected to pay the Rolling Stones' taxes for eight years.

  iii. At this time, the band members each owed $1,000,000 (today's value) in taxes to the British government, and were earning their income at a time when the highest rate was 83% for earned income and 98% for un-earned income.

b. "Rupie the Groupie" Was a Real Prince

  i. The Rolling Stones got rid of Klein, and found Prince Rupert, an Oxford educated merchant banker business advisor and financial manager with a penchant for classical music and offshore financial arrangements.

  ii. Prince Rupert was the architect of the Rolling Stones' escape from England to the South of France, and behind creation of the offshore structure protecting their assets. It was Prince Rupert

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that taught the band that a Rolling Stone gathers little tax if it travels wisely.

c. FED Up with UK Taxation, or How the United Kingdom's Foreign Earning Deduction and France's Tax Regime Led to the Exile on Main Street

i. The UK has a territorial system of income taxation, which means that a UK citizen is subject to income tax to the extent that he or she is deemed a UK resident for fiscal purposes. This is an important distinction because under the UK's Foreign Earning Deduction, income earned by a UK citizen outside the UK is generally not subject to UK taxation so long as the citizen is abroad for a sufficient amount of time, approximately 305 days a year.

ii. At the same time, the French tax regime allowed the Rolling Stones to pay no French taxes on what they earned as long as they resided in France for at least a year and spent at least $500,000 a year.

d. Exile on Main Street

i. In 1971, the Rolling Stones moved offshore, taking tax exile in the South of France.

ii. While in exile, they recorded their new album Exile on Main Street. They returned to touring in 1972, with a world tour starting in North America and began rebuilding their finances.

e. Dutch Processed: Johannes Favie and the Dutch Royalty Conduit Shelter

i. By using the Dutch License Royalty Conduit Company Shelter, the three have paid $7.2 million in tax on their 1986-2006 earnings of $450 million, which equates to a tax rate of about 1.5%.

1. Prince Rupert had four different companies set up in the Netherlands: Promotour (concert touring), Promopub (merchandising), Promotone (video and music recordings and films), and Musidor (music rights). The four companies are managed by Promogroup, headed by reclusive accountant named Johannes Favie and run by him and a small group of 7 other persons.

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2. The Dutch license company is called a "royalty conduit" because once the use of the IP is licensed to it, it merely exists as a conduit to receive royalties and pass them on to another jurisdiction.
3. In general, the Netherlands has tax treaties with most countries that fall between a 0% and 5% rate. Thus, income coming from a foreign country where a concert took place or an album was sold enters the Netherlands having been minimally taxed. The royalties, dividends and interest payments that flow into or out of a Dutch license company are exempt from Dutch taxes. Those same treaties with other countries, including the EU countries, reduce or eliminate taxes when those earnings are passed to another country (say, for example, when transferred to a UK bank account), or even better, when passed to a 0% tax haven.

III. How I Learned to Stop Worrying and Love the Tax Incentives – A Discussion of the Key U.S. Tax Provisions Used to Avoid Taxation of International Income

a. Congress' Creation of Subpart F

i. Subpart F was enacted in 1962 to deter U.S. taxpayers from using a controlled foreign corporation (a "CFC") to defer taxation on certain income earned in a foreign jurisdiction by immediately taxing it in the U.S.

ii. There are several different categories of (immediately taxable) Subpart F income, but it generally consists of movable income, like foreign based company income (FBCI) which includes:

1. Foreign personal holding company income (FPHCI) which includes investment income like dividends, interest, rents and royalties.

b. The IRS's Check the Box Regulations and the CFC Look-Through Rule

i. 1997's "check the box" regulations were designed to simplify the tax rules for determining whether for federal tax purposes an entity was a corporation, a partnership, a sole proprietorship or a disregarded entity. The election to be treated as a disregarded entity means that for tax purposes the entity will not be treated as a separate entity from the company that owns it.

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ii. In 2006, Congress enacted Section 954(c)(6) the CFC Look Through Rule, which generally eliminated from Subpart F income certain passive income, including payments of dividend, interest, rents and royalties received or accrued by one CFC from another related CFC so long as such payments are attributable or properly allocable to active, non-Subpart-F income of the related CFC. That was issued on a temporary basis, but has been extended several times, now through 2019.

c. Transfer Pricing and Section 482 Re-Allocations

i. Transfer pricing comes into play when IP or IP rights (such as the right to receive royalties on a license) are transferred between a parent company and a CFC. When determining the true taxable income of a CFC, the Regulations apply an arms-length standard, consistent with the results that would have been realized if unrelated taxpayers had engaged in the same transaction. Section 482 allows the IRS to distribute, apportion or allocate gross income, deductions, credits or allowances between or among two or more organizations owned or controlled directly or indirectly by the same interests, if the IRS determines that such action is necessary in order to prevent evasion of taxes or to clearly reflect income.

d. R&D cost-sharing agreement

i. Similar to a transfer pricing agreement, under an R&D cost-sharing agreement, the parent company and the CFC are each assigned a specific percentage of funds and resources they must contribute to new products.

ii. The real effect of a cost-sharing agreement is to allocate sales away from the high-tax rate U.S. to any other place in the world having a lower tax rate.

iii. The cost-sharing agreement between Apple Inc. and ASI is what drives offshore income to ASI instead of directly to Apple Inc.

1. In the cost-sharing agreement, Apple retains legal title to and owns all marketable rights to the developed property for the regions North and South America and the Caribbean, but the offshore affiliate ASI receives the marketing rights and the profits for the rest of the world.

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2. Apple states it secured the blessing of the Internal Revenue Service for the deal. The IRS gave Apple an advance pricing agreement, or APA, which establishes how the IRS will treat a transaction between affiliates for tax purposes, before it is entered into.
3. Between 2009-2012, ASI paid approximately $5 billion to Apple Inc. as its share of the agreement, at the same time it had $74 billion in profits. Apple Inc. paid $4 billion under the agreement and declared profits of $38 million from sales in the Americas.
4. Cost-sharing agreements must also meet an arms-length standard. Here, Apple Inc. gave up twice the profit for the same amount of contribution.

IV. Diving Into the Deep End of the International Tax Planning Pool - Apple Inc.

a. Apple Inc. and Ireland Go Way Back … to the 1980s

i. Apple's first foray into Europe came at a precipitous time. Apple was looking for a European manufacturing center, and Ireland was ready to deal.

b. I Like Mike

i. Apple Tax Director Mike Rashkin Sets Up Apple's First Tax Play

1. Mike Rashkin arrived at Apple in 1980 as its first tax director.
2. In 1980, Ireland was providing a 0% tax holiday for 10 years to foreign companies arriving by the end of the year. Apple set up a factory in Cork, Ireland to build the company's Apple II computer. It would later build disc drives, Mac computers and others. These would be sold in Europe, the Middle East, Africa and Asia.
3. After 10 years, the tax break was supposed to end and have Apple pay at Ireland's 12.5% corporate rate. What we now know is that Apple renegotiated the deal at least once. The Irish agreement eventually turned Ireland's 12.5% corporate tax into just 0.005% tax in 2014. Testimony indicates that the rate was never higher than 2% at any time.

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c. The Think Different Shelter: How Apple Made $74 Billion Disappear

i. Strong Negotiations and Good Structure Were the Key

1. ASI – Contracts with Chinese factories to manufacture Apple products. Receives the income for all sales made outside North and South America and the Caribbean.
2. AOE – Manufactures computers and peripherals for Europe from a factory in Cork, Ireland.
3. AOI – Top-level CFC for all Apple Inc. foreign operations.

ii. Companies with No Countries: for Tax Purposes AOI, ASI and AOE Remain "Stateless"

1. Ireland does not look to a corporation's place of incorporation when determining whether a corporation is subject to income tax in Ireland on its earnings. Instead, it looks to where the management and control occurs. Conversely, the United States does look to where a corporation is incorporated when determining whether that corporation is subject to income tax in the United States. Therefore, if a corporation is incorporated in Ireland but managed and controlled in the United States, that corporation may avoid income taxation in both jurisdictions.
2. Ireland's taxation by location of management and control versus the U.S.'s taxation by place of incorporation makes AOI, ASI and AOE taxable nowhere.
3. On January 1, 2015, Ireland passed a law requiring that companies which incorporate in Ireland must be tax resident there, preventing this arbitrage treatment after 12/31/2020.

iii. The Interest Earned on CFC Income is Taxable, So Apple Moves it to States With No State Income Tax

1. The interest that Apple earns on its overseas income is taxable. That interest income is collected by an Apple subsidiary Braeburn Capital, which also manages and invests Apple's cash.

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2. Braeburn Capital is the Apple company that manages and invests a portion of Apple Inc.'s profits into stocks, bonds, and other financial instruments, and also collects and invests the taxable interest on foreign income income. Nevada has no state income tax. By locating Braeburn in Reno, Apple avoids California's 8.84% corporate income tax rate, and pays no state tax on those investment earnings

d. Shocked, Shocked I Say, Part I – Apple Testifies Before Congress

i. Testifying before the Permanent Subcommittee on Investigations, Apple's CEO and its CFO reveal much of the structure of the foreign operation, leaving the Subcommittee aghast at the scale of the potential tax loss.

1. In 2013, the Permanent Subcommittee on Investigations uncovered that AOI hasn't filed a corporate tax return in the past five years—anywhere—although it took in $29.6 billion from its subsidiaries including ASI, between 2009 and 2012.

2. ASI made $74 billion in sales from 2009 through 2012. In 2011, ASI, which sells iPhones, iPads, MacBooks and other products to overseas distributors, recorded $22 billion in pretax earnings, but paid $10 million in taxes, which is a rate of about .05%.

3. The European Commission's report found that AOE and ASI had splitting agreements with Ireland that permitted each to allocate a portion of their income to a "head office" that was offshore, further reducing the income that would be taxed in Ireland to a rate of 0.005% by 2014.

e. Sad Apple – on August 30, 2016 the European Commission Orders Ireland to Collect $14.5 Billion Plus Interest from Apple For Unpaid Taxes from 2003 forward

f. Shocked, Shocked I Say, Part II – At Least He is Consistent

i. The day after the European Commission ordered Ireland to collect from Apple, Tim Cook released a public statement on its Ireland homepage, stating "Apple follows the law and we pay all the taxes we owe."

ii. The United States stands by Apple, Inc. After reading through the Permanent Subcommittee on Investigations' reports, I have to admit that I didn't see this one coming.

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iii. Sometimes the End is Just the Beginning. Apple reports that it is "currently under an extensive audit by the Australian Tax Office." Australia's Treasurer Scott Morrison responds that its government was committed to "shutting down tax avoidance strategies used by multinationals, such as large IT companies, who have exploited gaps and mismatches in the international tax system."

g. Irish Eyes Aren't Smiling - Why Ireland Doesn't Want Apple to Pay Up

i. Apple isn't the only U.S. operations with their overseas headquarters located in Ireland. Others include Google, Amazon and Microsoft.

V. The Fall of the House of Swiss Bankers

a. It Was Going So Well, Until Bradley Birkenfeld Had To Spoil It

i. In October 2005 Birkenfeld resigned from UBS, providing senior management with written complaints documenting the private banking group's illegal practices. A UBS internal review found no wrongdoing.

ii. Frustrated, Birkenfeld traveled to the United States in 2007 and voluntarily registered as an IRS whistle-blower with the intention of exposing UBS's complicity with illegal tax evaders. For over a year Birkenfeld provided inside information to officials from the IRS, the Justice Department, and the SEC. The information he provided became the foundation for the UBS investigation. Birkenfeld did not obtain immunity from prosecution in exchange for his disclosures.

iii. The investigation resulted in a $780 million deferred prosecution agreement against Switzerland's largest bank UBS and led to the adoption of a Protocol amending the U.S.-Switzerland tax treaty providing for the exchange of information for tax purposes with UBS, then later extended in 2013 to all Swiss Banks.

b. The Truth Hurts, and Can Lead to Jail Time …

i. Lesson number one: tell the whole truth and nothing but the truth. Bradley Birkenfeld learned that the hard way. He failed to tell the U.S. authorities his own role at UBS. One of his clients ended up pleading guilty to a tax crime in 2007, which led the authorities back to Birkenfeld.

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ii. He was arrested in 2008, and pled guilty to a single count of conspiracy to commit tax fraud. The prosecutors recommended a reduced 30 month sentence, but in 2009, the judge sentenced Birkenfeld to 40 months in prison.

c. … But can also Lead to Money, Money, Money

i. Upon his release, Birkenfeld applied for a reward under Section 7623(b), the tax whistleblower statute which pays 15-30% of collected funds.

ii. He received $104 million in 2012, which was 27% of the money the IRS received from UBS in the deferred prosecution agreement, after subtracting $400 million in restitution, backup withholding, interest and penalties. He received no portion of the approximate $5 billion in voluntary disclosures that came as a result of the investigation into Swiss Banks.

d. … And Fame, Fame I Tell You

i. You may not remember this, but in 2009, Tax Analysts named Bradley Birkenfeld as its inaugural “Person of the Year.”

VI. Mossack Fonseca & The Panama Papers

a. It Was the Best of Times Until it Was The Worst of Times

i. In 2015, a John Doe approached the German newspaper Suddeutsche Zeitung and offered to provide a treasure trove of information, the biggest cache of inside information into the tax haven system that anyone had ever seen. The John Doe said he was motivated by “the scale of the injustice that the documents would reveal.” That cache consisted of 2 terabytes from Mossack Fonseca, a Panamanian law firm; over 11 million documents, including every email, account record, spreadsheet, .pdf and note in their law firm files from 1977 to the present. It revealed the secrets of people from more than 200 countries.

b. Champagne Wishes and Panama Dreams

i. Why does that matter? Mossack Fonseca creates offshore entities in tax-free jurisdictions for its many clients. It has more than 500 employees, 40 offices around the world, and its 2013 billings were $42 million.

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ii. The treasure trove revealed information on more than 214,000 companies in 21 offshore jurisdictions. The top 5 jurisdictions were in the tax havens British Virgin Islands, Panama, Bahamas, Seychelles, and Niue, and revealed that Mossack Fonseca's clients included current and former heads of state and their cronies from around the world.

c. How Mossack Fonseca Set Up Offshore Companies in Tax Havens, and Then Shifted Strategies With the Political Winds

i. In 1988, Mossack Fonseca established a British Virgin Islands office, because BVI had passed a law that made it easy to set up offshore companies without public disclosure of owners and directors. Mossack Fonseca has now incorporated 113,000 companies in BVI.

ii. In 1994, Mossack Fonseca stepped up its game by approaching the government of Niue, a South Pacific outcrop with a population of 2,000.

1. They helped Niue draft legislation that would allow for incorporation of offshore companies, and offer registration in Chinese and Cyrillic.
2. They also secured a 20-year exclusive agreement to be the only firm that could register offshore companies in Niue.
3. Within 7 years, Mossack Fonseca registrations in Niue accounted for $1.6 million of Niue's $2.0 million budget. That same year, the U.S. State Department began questioning the arrangement, and warned that Niue's offshore industry had been linked with the laundering of criminal proceeds from Russia and South America.
4. By 2003, Niue began declining renewals of corporations incorporated by Mossack Fonseca. That didn't stop Mossack Fonseca; it simply had clients reincorporate in nearby Samoa.

iii. Similarly, in 2005, when BVI cracked down on bearer shares (that means the company ownership was not by name, but by possession of certificates), Mossack Fonseca moved that business to Panama.

iv. Mossack Fonseca has continued this hopping. Its registrations in Anguilla doubled between 2010 and 2011, and is now one of Mossack Fonseca's top four jurisdictions for incorporations.

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d. The Evil that Men Do

i. The ICIJ investigation shows that Mossack Fonseca was creative, even going so far as establishing nonprofits whose assets were payable to a charity like the World Wildlife Foundation, but whose beneficiary could be changed at will, or backdating documents when trouble arose, or even reportedly helping a financial advice author from New York hide $1 million from the IRS in an HSBC account in Guernsey by providing a natural person as a nominee who stepped in and said that he, a Mossack Fonseca employee, was the owner of that investment account.

ii. Pleadings filed in the Nevada federal court claimed that Mossack Fonseca had created 123 companies in Nevada that had been used by a political crony of Argentina's former president to steal millions of dollars from government contracts. It appears that Mossack Fonseca didn't want to comply with a summons served upon it, and Jurgen Mossack testified under oath that the local company M.F. Corporate Services (Nevada) Limited was not part of the Mossack Fonseca group. However, records obtained by the ICIJ showed that behind the scenes, Mossack Fonseca was quickly wiping data from telephones and computers to remove any traces of connection to Mossack Fonseca's computer information system. The documents even showed that a Mossack Fonseca employee traveled from Panama to Las Vegas to remove paper documents linking the two.

e. I See Nothing Wrong Here

i. Mossack Fonseca denies culpability for its clients' use of offshore accounts.

VII. How to Advise and Protect Your Clients that Have Failed their Reporting Requirements

a. Overview. U.S. taxpayers must report their offshore accounts and assets. The requirements can be lengthy depending upon the type of foreign assets or holdings and their value, but generally, there are:

i. IRS return-side reporting on various forms which are submitted with the tax returns on their due date, including any extensions of the return due date, and

ii. Treasury-side reporting on Form TD F 90-22.1. These are filed electronically by June 30 of the following the close of the prior calendar-year reporting period. There are no extensions.

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b. Is your client eligible to make a voluntary disclosure to fix the failed reporting?

   i. The taxpayer is not under civil or criminal investigation by the IRS,

   ii. The IRS has not received third party information alerting the IRS to the taxpayer's noncompliance (informant, another governmental agency, the media, foreign financial institution),

   iii. The IRS has not received information identifying the taxpayer from a criminal enforcement action (search warrant, grand jury subpoena), and

   iv. The income sources are legal.

c. The Three Tiers of Voluntary Disclosure Programs

   i. The choice of programs turns on whether your client was willful. Non-willful conduct is conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law.

   ii. If your client is an entity or was willful in the failure to report offshore assets and accounts to the IRS and Treasury, their best options is the "2014" OVDP (Offshore Voluntary Disclosure Program). This option requires reporting for the last 8 years. The penalty on the highest aggregate balance (comparing the 8 years to each other) for the offshore assets and accounts is 50% if the FFI has been publicly identified as under investigation or as cooperating with an investigation, or a 27.5% penalty if it has not, plus the 25% FTF and 25% FTP and a 20% accuracy related penalty on the underpayments. Here's why you would advise a willful client to come forward and pay all of those penalties: the IRS agrees to not recommend to DOJ a criminal prosecution of your client, so long as your client is truthful in the disclosure.

   iii. If your client is an individual and was not willful and does not meet the nonresident test, then the Streamlined Domestic Offshore Procedures is your best option. The client will file amended returns for the last 3 years, and FBARs for the last 6, along with a narrative establishing nonwilfulness. The client will pay the tax and interest due on those 3 amended returns, plus a 5% miscellaneous penalty on the highest balance/value of the offshore assets and accounts, and does not face any criminal prosecution.

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iv. If your client is an individual and was not willful, had no U.S. abode and lived outside the United States for at least 330 full days in any of the last 3 years, then the Streamlined Offshore Procedures are your best bet. The client will file amended returns for the last 3 years, and FBARs for the last 6, along with a narrative establishing nonwilfulness. The client will pay the tax and interest due on those 3 returns, but will pay no other penalty and does not face any criminal prosecution.

d. The "Missed a Document" Procedures

i. Sometimes a client included in income the income generated by the offshore asset, but their accountant missed filing an informational document to either the IRS or the Treasury.

1. Delinquent FBAR Submission Procedures. This program is for clients that have just failed to file their FBARs but did previously report the income and pay the tax. Here, the client files the delinquent FBARs electronically, and when doing so includes a statement explaining why the FBAR is being filed late. The IRS will not impose a penalty for the failure to file a delinquent FBAR where the client previously reported the income on his return and paid the tax due on that income, and has not been contacted for examination for those years.

2. Delinquent International Information Return Submission Procedures. This program is for taxpayers that filed their returns but did not include all of the required forms used to report offshore assets. The taxpayer must attach a statement setting forth under the penalty of perjury their "reasonable cause" for not filing the information returns. If the information returns are being filed for an entity, the statement must certify that the entity was not engaged in tax evasion. No penalties are assessed for reasonable cause.

a. Reasonable cause is generally any reason which establishes that you used all ordinary business care and prudence to meet your Federal tax obligations but were nevertheless unable to do so. Advice of counsel is such a defense.

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