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Review of tax compliance procedure for undisclosed foreign assets

Introduction

For several years, many countries have been introducing measures designed to punish taxpayers who fail to disclose their foreign assets to the tax authorities.

The OECD has issued several declarations hailing the end of the use of banking secrecy for tax purposes and indicating that the time has come for countries to automatically exchange information.

The principle of automatically exchanging tax information was approved at a meeting in Paris attended by all 34 member countries of the OECD.

These decisions follow various domestic measures and legislation designed to combat money laundering (cf. EU Directives).

In France, Acts 2013-1115 and 2013-1117 came into force on 6 December 2013 to reform the repression of tax fraud and serious economic and financial crimes.

Another Act then came into force on 27 May 2014, transposing Directive 2012/13/EU of the European Parliament.

All of this legislation – albeit European or French – reiterates the principle that all citizens should be treated equally in relation to tax matters and that tax fraud should be punished, as it is both morally and financially damaging to society as a whole, and it contravenes the principle of democracy.

These initiatives are more than simply political or legal initiatives however: even banks operating in countries that apply the principle of banking secrecy have come under pressure from Europe and the US, and are in turn putting pressure on their clients who hold undisclosed bank accounts, asking them to immediately disclose their assets in the countries of which they are residents for tax purposes.

In parallel to these Acts, the current French government has implemented a voluntary disclosure process, allowing taxpayers who own undisclosed foreign assets to voluntarily disclose their assets to the French tax authorities and to sign a voluntary disclosure agreement with the authorities once the information provided to them has been verified.

This process replaces the 'compliance unit' set up in 2009 by France's then Finance Minister, Eric Woerth.

This 'unit' has clearly been more successful than the previous one, as it has currently received over 25,000 disclosures, whereas only 4,700 individual taxpayers submitted a disclosure to the unit set up in 2009.
Clearly, the opportunity provided by the Cazeneuve Directive for taxpayers to correct their tax situation will generate a significant amount of tax revenue for the French government, using only limited resources.

WEALTH MANAGEMENT

1. French criminal and tax legislation

1.1. Under criminal law, failing to make a mandatory disclosure or payment could constitute tax fraud

Pursuant to Article 1741 of the *Code général des impôts* (French Tax Code), as amended by Act No 2013-1117 of 6 December 2013, taxpayers who fail to comply with the rules applicable to accounts opened or contracts entered into with an entity outside France – including through the intermediary of an individual, legal entity, organisation, trust or similar institution established abroad, by using a fictitious or false address abroad for tax purposes, by entering into a fictitious or sham transaction, or through the intermediary of a fictitious or sham entity – will be fined €500,000 and given a 5-year prison sentence. This fine is increased to €1 million and the prison sentence is increased to 7 years for taxpayers who open an account or enter into a contract with an entity located in a country or territory that has not been a party to a mutual assistance agreement with France for at least 5 years at the relevant time.

A fine of €2 million is imposed in the case of organised fraud or fraud committed or facilitated using a fictitious or false address abroad for tax purposes or through the intermediary of a fictitious or sham entity.

Furthermore, according to the Act of 6 December 2013 on the fight against tax fraud and serious financial crimes, any issue concerning complex organised fraud must be referred to the public prosecutor for financial matters.

This Act also increases the time limit for taking legal action for tax fraud from 3 to 6 years.

In addition, it increases the tax authorities' right to information and notably stipulates that the authorities may use information obtained from an illegal source.

1.2. Tax law

The French Tax Code provides for a variety of sanctions, particularly tax fines, as well as a right of recovery that can apply for up to 10 years after the year in which the tax should have been paid.

There is also a risk that undisclosed assets will be taxed at 60%

- a 40% surcharge will be applied for a deliberate tax default, which may be increased to 80% in cases of fraud;
- late-payment interest will be applied at a rate of around 0.4% per month;
- the undisclosed assets will be taxed on the basis of 125% of their value, and the taxpayer will not be eligible for the 40% tax allowance for income derived from interests held in financial structures established in countries that offer preferential tax treatment (Article 123 *bis* of the French Tax Code).

2. General principles of the compliance procedure

2.1. Legislation and guidelines

The fundamental aspects of the compliance procedure are stipulated in a Circular issued by the Minister Bernard Cazeneuve on 21 June 2013 entitled 'T*raitement des déclarations rectificatives des contribuables détenant des avoirs à l'étranger : transparence et droit commun*' (The treatment of disclosures made by taxpayers who hold assets abroad: transparency and general law).

The fundamental points of this Circular are as follows:

- The Circular draws a distinction between 'active' tax evaders and 'passive' tax evaders who, for example, have 'inherited undisclosed foreign assets', and stipulates that a penalty of 15% should be imposed on passive tax evaders, rising to 30% for active tax evaders. Similarly, the Circular caps the annual fine for failing to disclose foreign assets at 1.5% for passive tax evaders and 3% for active tax evaders.
- Taxpayers are required to submit their disclosures to the *Direction Nationale des Vérifications de Situations Fiscales* (DNVSF, the Directorate for the Verification of Tax Situations), which then forwards them to the *Service de Traitement des Déclarations Rectificatives* (STDR, the department that processes voluntary disclosures).
- Disclosures are processed by the STDR on a case-by-case basis. When submitting a disclosure, taxpayers must pay the full amount of tax evaded that may still be claimed by the tax authorities, and the corresponding fines and penalties must be paid when the voluntary disclosure agreement is signed.
- Unlike the unit set up in 2009, taxpayers cannot remain anonymous, and it is not possible to 'negotiate' a voluntary disclosure agreement with the authorities anonymously. A taxpayer who starts this process must submit a disclosure comprising his amending tax returns or, if he does not have the required information at his disposal at the time, a letter containing the name and contact details of the person making the disclosure, the name of his bank, his bank account number and a bank statement.
- Taxpayers whose personal tax situation is under review, or who are the subject of an investigation concerning registration taxes or proceedings initiated by the tax authorities with respect to undisclosed assets and accounts held abroad, are not eligible to participate in this procedure.
- The Circular specifies the procedure for submitting disclosures as well as the tax consequences involved.

A Circular issued by the same Minister on 12 December 2013 confirms the provisions of the Circular of 21 June 2013, even though the Act of 6 December 2013 relating to the fight against tax fraud and serious economic and financial crimes was enacted in the meantime.

The December Circular confirms that the Circular of 21 June 2013 applies to disclosures submitted on or after 6 December 2013, the date on which the aforementioned Act came into force, and to disclosures submitted on or after 1 January 2014.

No other legislation or guidelines have been issued in relation to disclosures, and no detailed comments on the two Cazeneuve Circulars have been published in the BOFP (French Official Public Finance Bulletin).

As neither of the Circulars are intended to address all situations referred to the tax authorities, taxpayers should, with the help of their tax advisers, prepare their disclosure in accordance with applicable legislation and regulations, with the help if necessary of the STDR, whose inspectors are willing to answer any questions taxpayers may have.

2.2. Application of the Circulars in practice

2.2.1. As mentioned above, taxpayers who are the subject of an investigation by the tax or customs authorities in respect of undisclosed assets are not eligible to participate in the procedure

Similarly, the procedure is not available to taxpayers whose undisclosed assets originate from an undisclosed activity, in which case an 80% surcharge is applied.

The Circular may not apply if a taxpayer has already submitted a disclosure but failed to disclose all his foreign assets or provided insufficient proof of the origin of his assets.

The tax authorities may initiate criminal proceedings against a taxpayer if they identify an offence other than tax fraud, such as cross-border loss offsets, money laundering, misuse of company assets or any operation that might be reported to the public prosecutor's office.

2.2.2. The distinction between an active taxpayer and a passive taxpayer (referred to as active and passive 'tax evaders' in the Cazeneuve Circulars)

A passive taxpayer is typically a person who has inherited a foreign bank account, who has not paid any funds into the account (such as rent collected in a foreign country) and who withdraws money from the account without any corresponding offset, provided that the taxpayer can explain why the funds have been withdrawn.

In practice, the STDR verifies such withdrawals and may classify a taxpayer as an active taxpayer if the amounts withdrawn are disproportionately high considering the amount of capital owned by the taxpayer abroad.

2.2.3. The tax adjustments, fines and penalties imposed in connection with the disclosure procedure

1. The principal amount of tax paid must equate to the amount that should have been paid at the appropriate time
   - income tax and the relevant employment and social security withholdings for 2006 to 2013;

- the wealth tax (*impôt de solidarité sur la fortune*) for 2007 to 2014;
- inheritance or gift tax for any inheritance/gift received on or after 1 January 2007;
- the late-payment interest provided for in Article 1727 of the French Tax Code, at the rate of 0.4% per month of delay, or 4.80% per year; and
- the fine provided for in Article 1736 of the French Tax Code for failing to disclose foreign assets.

A fine must be paid for each account disclosed and for each year for which the tax authorities are legally entitled to claim the relevant amount.

A distinction should be made between two periods:

Until 2010, taxpayers were fined €1,500 or €10,000, depending on whether their account was in a non-cooperative state or territory (that has not signed a mutual assistance agreement). Since 2011, the fine of 5% of the balance of the account as at 31 December of the year in which the disclosure is made has been capped at 1.5% for passive tax evaders and at 3% for active tax evaders.

If a disclosure is made by the heirs of a deceased person in the latter's name, only late-payment interest will be applied in addition to inheritance tax on the undisclosed assets.

The penalties imposed under general law apply to the additional taxes payable by a person's heirs in respect of their own situation for the period after the death if they fail to declare the assets inherited by them.

A surcharge is imposed for deliberately failing to disclose assets (Article 1729 of the French Tax Code).

This 40% surcharge is reduced to 15% for passive tax evaders and to 30% for active tax evaders, although anyone submitting a wealth tax return for the first time is required to pay a surcharge of 10% rather than 40%.

2. As a rule, the tax authorities allow any losses incurred on sales of securities, *i.e.* the capital losses incurred on sales of foreign assets, to be set off against the capital gains generated on securities sold in France and thus to be carried forward to the following year in accordance with general law.

Any taxes deducted at source abroad, such as safe-custody charges charged by banks, are tax-deductible.

As regards the wealth tax, all sums payable in connection with a disclosure, except tax fines, may be booked as liabilities.

3. No action to recover inheritance tax may now be taken if the account holder died before 1 January 2007.

If the account holder died after 1 January 2007, his heirs must pay tax on his undisclosed assets in his name up to the date he died.

After the date of death, the deceased's heirs must pay tax on the assets they inherit.

The matter of gifts is more complex as it depends on the date the account holder died, the relationship between the donees and the account holder, whether the donees inherit beneficial or legal ownership of the deceased's assets, etc.

The STDR may request an explanation should any significant sum be withdrawn on an account. The matter may be processed differently depending on whether the beneficiary and the account holder used the withdrawal for their own benefit or whether they made informal gifts of personal property (*dons manuels*) to beneficiaries, in which case those beneficiaries must be identified and required to pay gift tax.

2.2.4. The specific matter of intermediary structures and the application of Article 123 *bis* of the French Tax Code

Numerous taxpayers have been shocked to discover that their assets are being held by an intermediary structure, such as a foundation in Panama or Liechtenstein for example.

The legislation introduced by the Minister Eric Woerth in 2009 imposed a condition precedent whereby taxpayers who correct their tax situation must agree to liquidate the said intermediary structure before signing a voluntary disclosure agreement with the tax authorities.

Furthermore, under the Woerth legislation, the specific tax treatment applicable to foreign assets held via an intermediary structure is not taken into account.

Contrary to this, Bernard Cazeneuve decided that for any undisclosed foreign assets held via intermediary structures, the specific provisions of Article 123 *bis* of the French Tax Code should be applied along with other provisions of the same Code, such as Article 39, 1 (3) and Article 120 (9).

As a result of this specific tax treatment, the amount of tax payable is significantly higher if the intermediary structure is established in a non-cooperative state or has not signed a mutual assistance agreement with France, and if the arrangement could be considered a sham arrangement implemented with a view to circumventing tax legislation.

Overall, income received from intermediary structures is taxable as income from movable capital on the basis of 125% of its value, and is not eligible for the 40% tax allowance.

The accounting treatment of such income also needs to be determined as, in most cases, no accounts or records are kept.

The tax authorities therefore believe that, for an intermediary structure located in a country that has not signed a mutual assistance agreement with France or that is non-cooperative, an individual's taxable income should not be less than the fraction of net assets or the net book value of the assets of the entity concerned, less the tax paid abroad, multiplied by the interest deductibility rate on the related current accounts (Article 39-1 (3) of the French Tax Code), multiplied by a coefficient of 1.25.

The question of how income received from an intermediary structure should be treated poses numerous problems, as such structures generally do not have any accounting or legal records.

Profit generated by intermediary structures is deemed to have been distributed to the beneficiary, *i.e.* the individual taxpayer.

Any taxpayer making a disclosure is advised to liquidate any intermediary structure, although is not required to do so by the tax authorities. Any legal action must be taken within three years. Accordingly, for an intermediary structure liquidated in 2009, the three-year time limit has now expired, so the liquidation surplus will not be subject to tax.

For any intermediary structure that went into liquidation before 31 December 2013, the tax authorities will accept that Article 123 *bis* should not apply in respect of 2014.

If an intermediary structure is liquidated, the taxable liquidation surplus will be the difference between the net proceeds from the liquidation and the actual contribution or like payment made to the entity. This taxable surplus is determined following the deduction of income from movable capital.

If a liquidation surplus remains, liquidating the intermediary structure is tricky and may have significant tax consequences in the year in which the surplus is distributed or withdrawn.

In the case of a liquidation deficit, no disclosure needs to be made and of course no tax will be due, although the deficit should not be set off.

In conclusion, taxpayers who own foreign assets which they have not disclosed should disclose them, firstly due to the definite advantages offered by the Cazeneuve Circulars and secondly owing to the increased tax and criminal consequences that will arise should these assets be discovered by the tax authorities.

By voluntarily correcting their tax situation, taxpayers are also free to use their money as they see fit, including by leaving it abroad should they so wish.

Taxpayers should not put off disclosing their foreign assets, as the longer they do so, the more fines and penalties they will incur.

Another reason why taxpayers should disclose their foreign assets is the fact that countries are gradually introducing measures to facilitate the automatic exchange of information.