

## IRS Seeks Names of U.S. Account Holders at HSBC (India)

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*Just a few short weeks ago, we described in these pages (Indictment of Offshore Account Holder Portends – a New Round of Aggressive Enforcement [2011] 4 ILT 163) a recent grand jury indictment of a U.S. taxpayer who held an unreported account at HSBC (India), and predicted that the criminal charges in U.S. v. Dahake heralded a new wave of U.S. tax enforcement against taxpayers of Indian descent with accounts at that bank.<sup>1-2</sup> We judged it likely that in a matter of weeks, the IRS would issue a "John Doe" summons seeking to identify U.S. taxpayers holding accounts similar to the one maintained by Dahake at HSBC. This has now occurred.*



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*On April 7, 2011, the U.S. Justice Department filed pleadings in federal court in San Francisco, California seeking authorization for the IRS to serve a summons upon HSBC Bank USA, N.A. ("HSBC USA") for a specified category of account records maintained for a specific class of persons holding accounts from 2002 through 2010 at The Hongkong and Shanghai Banking Corporation Limited in India (HSBC India).<sup>3</sup> The U.S. tax code authorizes issuance of a "John Doe" summons in situations where the IRS is conducting an investigation of a specified class of individuals thought to have violated the law, but it cannot yet identify them by name. The district court swiftly granted the IRS permission to serve the summons seeking production of the described documents. The court's order will now trigger either further litigation or, as we expect, production by HSBC USA of the account records that have been demanded.*

*In this article we will examine the factual basis for the John Doe summons, the legal issues involved in the matter, and the important implications for anyone who held, but failed to report, an account at HSBC (India).*

### 1. Background and Factual Basis

U.S. tax law requires U.S. citizens and residents to report and pay tax on all of their worldwide income, so any holder of a foreign account must report and pay tax on all interest, dividends, capital gains and any other income derived from foreign financial accounts. Similarly, such U.S. persons are also required on an annual basis to acknowledge in their tax return their holdings in foreign financial accounts and to report in a separate filing (known as an "FBAR") their financial interest in or signature authority over such accounts. The wilful failure to comply with these requirements can be prosecuted as a criminal offense and may be the basis for the assessment and collection of substantial civil money penalties. The IRS can also penalize non-wilful failures to report.

For the past four years, U.S. tax authorities have significantly ramped up enforcement efforts against American taxpayers who have failed to report investment income from foreign accounts and who have not reported ownership of such accounts to the Treasury Department. In well-publicized actions involving U.S. account holders at the Swiss bank UBS, the Tax Division of the U.S. Justice Department has brought dozens of criminal indictments against account holders, bankers, and other third parties, alleging tax evasion arising from the failure to report. UBS also signed a landmark "Deferred Prosecution Agreement," whereby it paid over \$750,000,000 US to the United States and disclosed the names of account holders. The IRS similarly reached agreement with UBS to produce the names of 4,450 account holders after service of a John Doe summons in 2009. Also in 2009, some 17,000 U.S. taxpayers came forward to the IRS in a voluntary disclosure program, identifying their banks and bankers and agreeing to pay tax, interest, and penalties for their prior non-compliance. Whistleblowers and informants continue to provide secret account information, and the U.S. and other nations have enhanced agreements and procedures for mutual information

exchange. This combination of enforcement and voluntary compliance activity has resulted in a considerable diminution of banking secrecy for Americans around the world.

Well over a year ago, rumors began surfacing that the U.S. government had obtained information of potential tax evasion by thousands of U.S. taxpayers of Indian descent who banked with HSBC. Early this year, federal prosecutors indicted Vaibhad Dahake, an account holder at HSBC, for a variety of felony offenses arising from his failure to report an HSBC India account.<sup>4</sup> The indictment alleged that Dahake's bankers advised him with regard to various steps to keep his account concealed from U.S. tax authorities, and on April 11, 2011, Dahake pled guilty to conspiracy charges arising from the indictment and a second guilty plea by another HSBC India account holder was entered in Brooklyn NY on April 13. Whether Dahake has been cooperating, or will cooperate, with the U.S. authorities is not a matter of public record, but the pleadings just filed in San Francisco confirm that the IRS has obtained information from a number of HSBC India account holders sufficient to warrant further investigation.

The Justice Department's pleadings in San Francisco federal court paint a picture of widespread non-reporting of HSBC India accounts by "Non-Resident Indians," or "NRIs." The U.S. describes how HSBC India built up its American business by opening offices in New York and Fremont, California, which is located in the high tech corridor known as Silicon Valley. HSBC created a special "Premier" program for high net worth individuals to be able to access their HSBC India accounts worldwide at any time, giving access through a "globally integrated account."

Unlike U.S. financial institutions, HSBC India was not required to issue annual IRS Forms 1099. Such forms report both to the IRS and to account holders all investment income earned in a financial account during a given calendar year. Importantly, though, the U.S. filings allege that HSBC India bankers explicitly assured their customers that the bank would not report their accounts to the IRS:

Armed with the knowledge – provided by HSBC bankers – that the bank will not disclose their foreign accounts or income to the IRS, NRI clients of HSBC India in the United States have been able to maintain these foreign accounts with reasonable confidence that the IRS would not discover them.<sup>5</sup>

Indeed, the U.S. filings describe that the IRS has specific evidence:

In some instances, NRI Services employees made explicit representations to prospective clients that the accounts and income from them would not be reported to the IRS. United States clients of HSBC India have confirmed to the IRS that NRI representatives in the United States assured them that they could invest in accounts at HSBC India without paying interest earned on the accounts, and that HSBC would not report to the Internal Revenue Service income earned on HSBC India accounts.<sup>6</sup>

In its filings, the Justice Department notes that when a financial institution does not report accounts to the IRS, account holders then generally fail to report the accounts on their tax returns. Indeed, the IRS apparently can even quantify the extent of HSBC non-compliance with respect to HSBC India accounts. The filings note that approximately 9,000 U.S. residents held Premier accounts at HSBC and also had funds on deposit with HSBC India as of September 2010. Figures from 2009 reveal that such persons had over \$400,000,000 US on deposit. Yet, in calendar 2009 the U.S. Treasury Department received fewer than 1400 "FBAR" forms reporting only 1,921 HSBC India accounts.

This suggests, of course, that thousands of American taxpayers have failed to report their accounts at HSBC India. The purpose of the John Doe summons is, quite plainly, to allow the IRS to identify these taxpayers so it can take appropriate criminal or civil action against them.

## 2. Legal Issues

For the IRS to serve a John Doe summons, it must satisfy a U.S. federal judge in an *ex parte* proceeding<sup>7</sup> that the summons "relates to the investigation of a particular person or ascertainable group or class of persons," that there is a "reasonable basis for believing" that such person or persons have not complied with U.S. tax law, and that the

information sought by the IRS is not readily available from other sources. The IRS made this showing as to HSBC through the Declaration of a senior IRS agent responsible for offshore enforcement matters.<sup>8</sup> Relying on information obtained in the Dahake investigation and from, apparently, multiple other sources, the IRS lays out a compelling factual basis for the summons.

Interestingly, the IRS proposes to serve the summons on HSBC USA, and not on HSBC India. This is likely because HSBC India (for whatever reason) closed its U.S. offices in September 2010 and thus, as a formal matter, is not itself currently subject to service of process in the United States. But HSBC India continued to operate in the United States by using other HSBC affiliates, and HSBC India still maintains at least a post office box in Buffalo, NY. The IRS notes that the records it seeks of HSBC India accounts remain available through – and, apparently, only through – HSBC USA, which "has access to the records of HSBC India through the globally integrated banking system of HSBC Holdings plc and through its direct relationship with HSBC India as its U.S. representative."<sup>9</sup>

HSBC India has a lawful right to decline to comply with the John Doe summons and force the IRS to bring an enforcement action in court to compel production. However, from the limited information available, we do not expect that this will occur; rather, we think it likely that HSBC USA will produce the requested documents within a time frame negotiated with the IRS. HSBC could not, under U.S. law, volunteer the documents to the IRS. The U.S. "Right to Financial Privacy Act" forbids banks from voluntarily providing specific account information except in unusual circumstances, but they may of course do so in response to a valid summons or subpoena.

In contrast with the protracted litigation between the IRS and UBS in 2009, there does not appear to be any issue of "bank secrecy" here. The Justice Department's filings note that India is "not considered a tax haven or financial secrecy jurisdiction."<sup>10</sup> Instead, the U.S. position is simply that HSBC India's failure to report the accounts on Form 1099, plus the assurances to clients that the IRS would not learn about the accounts, has led to the widespread non-compliance. It does not appear that HSBC India has any basis in foreign law to argue that HSBC USA should not produce the requested records.<sup>11</sup>

If HSBC chooses to litigate, we expect that the U.S. would prevail or, more likely, a settlement will soon be reached. After months of protracted litigation in Florida, the U.S. and UBS eventually came to an agreement whereby the bank provided 4,450 names of account holders and their data, pursuant to negotiated criteria. Most U.S. judges will routinely grant an IRS request to enforce a John Doe summons in circumstances such as those presented here. If that occurs, the bank's continued refusal to comply could result in significant sanctions for contempt of court. It would be foolish, in our view, for anyone to assume that the IRS will not eventually secure the records sought in this matter.

Finally, we would not be surprised if in the near future HSBC and the U.S. government enter into a Deferred Prosecution Agreement, or perhaps a Non-Prosecution Agreement, resolving matters between federal authorities and the bank as a whole. Under U.S. law, if HSBC India bankers operating in the U.S. or elsewhere engaged in conduct to aid, assist, or conspire with U.S. account holders in violating tax laws, the bank as a whole could, in theory, be prosecuted. Dahake has now pled guilty, acknowledging that he conspired with HSBC bankers in connection with his own tax filings. The U.S. appears to have additional substantial evidence of misconduct by individual bankers, and it is likely to obtain more such evidence. A financial institution of the size and caliber of HSBC would not want, and probably could not accept, a criminal indictment. It was precisely this dynamic that led the United States and UBS to enter into a Deferred Prosecution Agreement in February 2009. The case involving HSBC appears headed in a similar direction.

### **3. Implication for Account Holders**

The summons served on HSBC USA seeks broad categories of information, largely amounting to every piece of data relating to NRI account holders – whether in Premium accounts or not – at HSBC India for the calendar years 2002 through 2010. We expect HSBC USA to provide this information in short order. The production of this information

will likely trigger IRS civil examinations and potentially criminal investigations of any account holder who failed to report substantial income from the HSBC India accounts and who failed to report those accounts on the required FBAR forms. To the extent the U.S. can prove that an account holder wilfully failed to comply with the law, the IRS can seek civil money penalties that may be triple the value of any undeclared HSBC India accounts, and could seek to indict, convict, and incarcerate any such account holder.<sup>12</sup>

HSBC India account holders who have not reported their accounts to the IRS in prior years still have time to avoid these potentially catastrophic consequences. The IRS has initiated an Offshore Voluntary Disclosure Initiative, which expires on August 31, 2011. Pursuant to this program, U.S. taxpayers who come forward before the IRS is aware of their non-compliance may avoid criminal prosecution by filing amended tax returns and complete and accurate FBARs, and by paying tax, interest, and penalties, including a penalty of 25% of their foreign financial and non-financial assets connected to their non-compliance.

The IRS is explicit that the service of a John Doe summons *does not* disqualify account holders from making a voluntary disclosure. IRS guidance provides:

The mere fact that the Service has served a John Doe summons does not make every member of the John Doe class ineligible to participate. However, once the Service obtains information under a John Doe summons that provides evidence of a specific taxpayer's non-compliance with the tax laws, that particular taxpayer may become ineligible. For this reason, a taxpayer concerned that a party served with a John Doe summons will provide information about him to the Service should apply to make a voluntary disclosure as soon as possible.<sup>13</sup>

We could not word it any better. Any U.S. taxpayer who has failed to report an account at HSBC India should immediately seek tax counsel and consider initiating a voluntary disclosure. The process to enter the voluntary disclosure program is simple and fast – all that is required is a short letter faxed to the IRS identifying the taxpayer and enclosing an IRS power of attorney for the taxpayer's counsel. Once HSBC USA provides the information sought in the John Doe summons, it will be too late for anyone whose name appears in the materials provided to come forward under the voluntary disclosure initiative, and the consequences for any such person could be serious.

#### **4. Conclusion**

The U.S. war on undeclared foreign accounts continues. We expect John Doe summonses against other banks in the near future, seeking records of unreported foreign accounts. The Justice Department's Tax Division will continue to investigate potential criminal offenses by account holders, bankers, and banks. Whistleblowers and informants will approach the IRS with more information. The IRS will mine data obtained from thousands of taxpayers who continue to come forward in the voluntary disclosure program. And new legislation enacted in 2009, the Foreign Account Tax Compliance Act, will likely eliminate most banking secrecy for Americans anywhere in the world. The John Doe summons served on HSBC is another step toward a more transparent global financial system. Affected account holders should act now to inoculate themselves from draconian civil or criminal consequences arising from a prior failure to report.

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1-2. "Indictment of Offshore Account Holder Portends New Round of Aggressive Enforcement," by Scott D. Michel, H. David Rosenbloom and Oluyemi Ojutiku, *Taxmann*, February 1, 2011.

3. HSBC USA and HSBC India are subsidiaries of HSBC Holdings plc, the international bank headquartered in London.

4. The Dahake indictment does not specifically mention HSBC India, but published reports confirmed the widespread assumption that this was the bank in question.
5. "Memorandum in Support of *ex parte* Petition for Leave to Service John Doe Summons," *In the Matter of the Tax Liabilities of John Does, etc.*, No. CV 11-1686 (N.D. Cal., April 7, 2011), p. 5 (hereinafter "*Memorandum*").
6. *Id.* at p. 7.
7. In an *ex parte* proceeding, only one side of a potential litigation dispute appears before the court.
8. Declaration of Daniel Reeves, *In the Matter of the Tax Liabilities of John Does, etc.*, No. CV 11-1686 (N.D. Cal., April 7, 2011).
9. *Id.*, at p. 13.
10. *Memorandum* at p. 7.
11. In case litigation does ensue, it is noteworthy that the Justice Department lawyer identified in the U.S. pleadings is the same Justice Department lawyer who headed the U.S. litigation team in the UBS John Doe summons litigation in 2009.
12. The civil penalty for the wilful failure to file the "FBAR" form can be as high as 50% of the balance in the undeclared account(s) per year of non-compliance. There is a six year statute of limitations on this penalty, meaning that the maximum penalty could equal 300% of the account value. Tax evasion, and the wilful failure to file the FBAR forms, are felonies punishable by up to 5 years imprisonment for each violation.
13. 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions, No. 21.