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Paradigms in Motion - Switzerland leads historic revision of banking secrecy

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Jay Krause
PARTNER | UK

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In the most significant development in private banking since the Second World War, Europe's champions of banking secrecy have pledged to implement information exchange arrangements consistent with OECD standards. Switzerland, Austria, Liechtenstein, Belgium, Andorra, Luxembourg and Monaco have all announced in recent days their intentions of implementing varying degrees of tax information exchange.

Switzerland, whose reputation is synonymous with private banking, has promised that its tradition of banking secrecy will continue, while at the same time acknowledging that banking secrecy will 'not protect any form of tax offence'. These changes represent shifts of historic proportions for jurisdictions long considering tax evasion a non-criminal offence.

Pressure had been mounting on so-called 'secrecy jurisdictions' in the last few weeks with repeated calls from leaders in Europe and the United States to end banking secrecy and improve transparency. Reports had surfaced that the OECD was preparing a new list of uncooperative jurisdictions in advance of the G20 summit in London on 2 April, 2009. Switzerland, Luxembourg, Austria and several other European jurisdictions are all rumoured to have been on the list and the acceptance of OECD standards on administrative assistance in tax matters is seen as an effort to avoid international blacklisting.

The announcements by European jurisdictions come on the heels of recent promises by Singapore and Hong Kong to amend their domestic legislation to enable their governments to enter into tax treaties with interested jurisdictions. The simultaneous action by the major offshore financial centres to succumb to international norms is a substantial development that will have a significant effect on the form and function of the global banking industry.

Implementation of OECD Model Standard

Not all of the jurisdictions have provided details regarding the specific actions they will take to improve transparency and information exchange. However, the general consensus is that these jurisdictions will renegotiate existing tax treaties and will negotiate new treaties with interested jurisdictions. These treaties will likely include the relevant exchange of information provisions contained in Article 26 of the OECD Model Tax Convention.

Article 26 of the OECD Model provides that the competent authorities of the treaty countries shall exchange such information as is 'foreseeably relevant' to secure the correct application of the provisions of the particular tax treaty or of the domestic laws of the treaty countries. The commentary to the OECD Model states that information exchange can be automatic, spontaneous or upon request, but it is up to the individual jurisdictions to negotiate what process they will require. When information is exchanged upon request, those requests need to be specific and not merely 'fishing expeditions' in which the requesting jurisdiction seeks information indiscriminately.

The future of Swiss banking privacy

The Swiss government has repeatedly emphasised that banking secrecy will remain intact. However, as the government has pointed out, banking secrecy 'does not protect any form of tax offence'. The practice of banking privacy, a central part of banking secrecy, will remain in place in Switzerland, with the heralded bank-client confidentiality practice continuing. To support this position, the Swiss government has resolutely rejected any automatic exchange of information and has pledged to limit exchanges to instances where 'specific and justified' requests for taxpayer information has been made.

Switzerland's domestic laws do not recognise tax evasion as a criminal offence unless the taxpayer has committed fraudulent activity, such as falsifying documents. Accordingly, Switzerland has historically refused to exchange information except in cases of fraud and has generally refused to exchange information in cases of mere tax evasion. Switzerland, which already has OECD-based double tax treaties with a substantial number of jurisdictions, agreed to accept without reservation Article 26 of the OECD Model which will permit the exchange of information in the event of tax evasion and tax fraud in individual cases where a specific and justified request has been made. The Swiss government has emphasised that clients of Swiss banks will 'continue to be protected from unauthorised access to information concerning private assets'.

The distinction in Swiss law between tax evasion and tax fraud will continue under Swiss domestic law. This means that the Swiss tax authorities will not be able to pierce banking secrecy in the case of domestic tax evasion.

The future of international private client planning

Privacy has long been an important benefit of jurisdictions such as Switzerland and Liechtenstein and this importance will continue long after information-sharing agreements have been put into place. However, it is vital that clients wishing to benefit from privacy by operating in countries that have traditionally had banking secrecy laws ensure that their activities are able to withstand scrutiny in the event that their information is passed to another jurisdiction. Recent trends towards full transparency and exchange of information will continue the erosion of secrecy laws around the world.

For example, under certain treaties incorporating the full provision of Article 26 of the OECD Model Tax Convention, exchange of information is not limited to taxpayer-specific information, and may even be shared automatically or on a spontaneous basis. The OECD Commentary to Article 26 also permits that information received by a contracting state be disclosed to a third country provided that there is an express provision in the particular bilateral treaty between the state allowing such disclosure. In addition to OECD standards, exchange of information for tax matters can also be based on bilateral or multinational treaties on mutual assistance, as well as simultaneous examinations, tax examinations abroad and industry-wide exchange of information. In recent years, domestic courts in the US have been able to put significant pressure on foreign institutions such as UBS. This trend is not expected to recede.

Ugland House v Delaware

Progress towards greater transparency also is being made within the United States itself. While it is widely published that a building in the Cayman Islands known as Ugland House is home to more than 18,000 companies, more than one international commentator has observed that Delaware is home to more than 850,000 business entities. Most offshore financial centres have more robust fiscal transparency and KYC requirements than most, if not all, US states. Unlike Delaware, jurisdictions such as the Cayman Islands require formation agents to obtain and keep a record of KYC information for the beneficial owners of business entities. Senator Carl Levin has noted that 'the failure of States to collect adequate information on the beneficial owners of the legal entities they form has impeded federal efforts to investigate and prosecute criminal acts such as...tax evasion'.

According to Senator Levin, problems have arisen because certain US states 'routinely permit persons to form corporations and LLCs under State laws without disclosing the names of any of the people who will control or benefit from them.' In a little known provision of the Stop Tax Haven Abuse Act (discussed in more detail below), US-based entity formation agents would be required to identify beneficial owners of the entities they form as part of a standardised KYC process. Further, within the last several days, Senator Levin has also introduced a stand-alone bill, the Incorporation Transparency and Law Enforcement Assistance Act, which would require the states themselves to keep records of entity beneficial owners.

The US position and UBS

Now that jurisdictions are agreeing to conform to international standards, many in the banking industry are asking whether non-automatic information sharing agreements will be sufficient to satisfy the United States?

In February, Swiss bank giant UBS entered into a deferred prosecution agreement under which it agreed to pay $780 million in fines and acknowledged that certain bankers assisted US taxpayers in concealing ownership or beneficial interest in accounts. UBS, with the authorisation of the Swiss Financial Market Supervisory Authority (FINMA), also agreed to the monumental step of turning over the names of 250 to 300 of these individuals who were determined to have committed tax fraud under Swiss rules. Despite this historic agreement, the very next day the US government filed a new subpoena in federal court seeking enforcement of its July 2008 'John Doe' subpoena and increasing the number of alleged 'undeclared accounts' held at UBS to 52,000.

The Swiss government has announced it will hire a US law firm to prepare an amicus curiae brief on behalf of the Swiss government in the civil case against UBS. The brief will outline Switzerland's legal position regarding information requests not linked to specific taxpayers and emphasising 'Switzerland's sovereign interest'.

The UBS John Doe summons sets out the IRS rationale for undertaking US court action against UBS rather than requesting taxpayer information pursuant to the information exchange provisions of the US – Swiss treaty: in many instances the IRS does not yet know the identity of the individual taxpayers with UBS accounts and, thus, cannot specifically identify the taxpayers in question. Without such specificity, it may be possible for jurisdictions to remain within OECD standards of information exchange while denying broad information requests such as the John Doe summons.

Under the deferred prosecution agreement, UBS will be in material breach of the agreement if the US federal court orders it to comply with the John Doe summons by turning over taxpayer names and UBS refuses. It is unclear how this critical aspect will play out as the US information requests go beyond the minimum level of cooperation required under OECD information sharing standards.

Unilateral US action?

Senator Levin introduced the Stop Tax Haven Abuse Act (the 'STHAA') in March 2009, pledging to clamp down on 'tax havens' by, in part, creating a blacklist of 34 jurisdictions, many of which already have information sharing agreements or treaties with the US. When introducing the legislation Senator Levin made it clear that having information exchange arrangements with the US was not sufficient to avoid blacklisting. Jurisdictions would have to demonstrate their willingness to share information in practice. The legislation appears to have the support of the

Obama administration (indeed, a version of the same legislation that was proposed in 2007 had then-Senator Obama as a co-sponsor), but it is not yet clear whether the bill will be enacted.

Before it can be enacted, the STHAA must first clear the Senate Finance Committee chaired by Senator Max Baucus, which is where the STHAA legislation died the last time it was introduced. Senator Baucus has introduced his own bill aimed at improving tax compliance regarding offshore transactions, however, the Baucus proposal is far less expansive and would not create a blacklist.

While many headlines have touted the possibility of the STHAA creating a jurisdictional 'blacklist', many of the key provisions of the STHAA are not linked to the blacklist. For example, these relevant provision will operate regardless of blacklist status: financial institutions acting as 'withholding agents', whether or not based in the US, may be required to provide information about US taxpayers establishing non-US accounts or entities; any non-US trust allowing US persons to benefit from trust 'personal use' property, such as real estate, cars, planes, yachts or artwork would be deemed to make distributions to those persons; and certain non-US companies would become subject to US taxation if they are deemed to be 'managed and controlled' from the US (this latter provision is, in part, targeted at hedge fund managers and other investment managers).

What of the QI rules?

While the US may or may not enact the STHAA or other competing legislation, the IRS has already announced that it intends to modify the so-called Qualified Intermediary ('QI') rules which allowed UBS to take the position that as a financial institution it was not obligated to turn over to the IRS the identity of US taxpayers investing through non-US companies. In October the IRS announced that it intended to make changes to both substantive rules and administrative procedures regarding how the implementation of the QI rules is monitored. The substantive changes are expected in the next several months, but proposed administrative changes were outlined in October and include the need for a US accounting firm to undertake the annual required compliance audit with the auditor agreeing to be 'jointly and severally liable' for the QI obligations of the financial institution which it is auditing!

On the substantive front, it is widely anticipated that in cases where a financial institution's KYC procedures identify the existence of a US beneficial owner, the IRS will require either the identification of the US persons or automatic withholding of tax.

Coming clean

The IRS Commissioner, Douglas Shulman, has urged US taxpayers with undeclared assets 'to get right with their government'. Individuals looking to 'get right' with the IRS can do so through the IRS's voluntary disclosure process. This process allows US taxpayers who are not compliant with their US tax obligations to mitigate the risk of criminal prosecution by filing six years of amended income tax returns and foreign bank account reporting forms ('FBARs'). The taxpayer must pay the associated tax liabilities, penalties and interest on the foregoing amounts.

Timing is vital because the voluntary disclosure process is not available to individuals who have been identified by the IRS or have already been notified of an audit or investigation. Once the IRS is alerted to a taxpayer's non-compliance, whether by an IRS investigation or through a third party informant, that individual is no longer eligible for the voluntary disclosure procedure. According to the IRS Commissioner, 'having the IRS find you could mean a much heavier price than coming forward on your own'.

Apart from the US, other jurisdictions offer similar tax amnesties or voluntary disclosure programs to their residents, often on much better terms compared to the US voluntary disclosure process. Given the multinational reach of international families, and the trends in information exchange as noted above, proactive steps to 'come clean' may be highly advantageous to those families.

Conclusion

While it will take months, if not years, for international financial centres to revise their domestic laws and treaties to conform with the promises they have made to the international community, the members of the G20, and particularly the United States, are likely to pay close attention in confirming that promises are converted to practicalities, particularly in light of declining tax revenues as a result of the global economic crisis. While a long road ahead may remain in the drive towards fiscal transparency, the international community and the G20 in particular have made it clear that there is only one road to travel.

Authors

Jay Krause

PARTNER | LONDON

Private client and tax

+44 20 7597 6350

jay.krause@withersworldwide.com