General Corporate — Commentary — Articles — English — Vern Krishna —, 2009-04-22 -- Swiss Tax Fight Highlights Evasion Issue; U. S. Crackdown on Tax Havens Meets Resistance

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Search Details

Search Query:	Table of Contents

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Most significant tax disputes in domestic and international law hinge upon the interpretational nuances of small words. What, for example, is the difference between income tax “evasion” and tax “fraud”? Considerable, if you are the Swiss government shielding your largest bank from the prying eyes of the tax authorities or an individual with a Swiss bank account.

Swiss Tax Fight Highlights Evasion Issue; U. S. Crackdown on Tax Havens Meets Resistance

Date: April 22, 2009

Vern Krishna

Most significant tax disputes in domestic and international law hinge upon the interpretational nuances of small words. What, for example, is the difference between income tax “evasion” and tax “fraud”? Considerable, if you are the Swiss government shielding your largest bank from the prying eyes of the tax authorities or an individual with a Swiss bank account.

In broad fiscal terms, we can categorize countries in three groups: tax havens, low-tax jurisdictions and full-tax jurisdictions. Capital will generally flow from tax jurisdictions with high rates to those with lower rates to maximize return on investment. Understandably, high-tax countries do not wish to see their treasuries depleted through the outflow of capital to tax havens.

There is no standard definition of a “tax haven.” At the very least, a tax haven is a jurisdiction with no—or minimal—taxes on income. A tax haven must, however, also have two other attributes in order to make it attractive for investors: First, a tax haven should have banking secrecy laws that forbid the disclosure of banking information. Second, a haven should not be party to treaties that require it to disclose financial information to any other country.

In contrast, a full-tax jurisdiction will usually be a party to international tax treaties to prevent double taxation and tax evasion. Most treaties contain provisions about exchange of information that oblige the signatories to divulge fiscal information to the tax authorities of respective countries. The scope of these provisions varies considerably between treaties and raises difficult interpretational problems.

Switzerland, for example, is a full-tax jurisdiction. However, it also has famously developed banking secrecy laws that make it a crime to disclose bank information to unauthorized persons. Hence, Switzerland has always been a repository for dictators, criminals, tax evaders and fraudsters.

On February 18, 2009, the United States Justice Department deferred criminal prosecution of the largest Swiss bank—UBS AG—in exchange for the bank revealing the identity of approximately 300 of its U. S. customers. The UBS acknowledged its participation in violating U. S. law and in a scheme to defraud the United States. The bank also agreed to pay a penalty of $780US-million.

Deferral of the criminal prosecution of the alleged U. S. taxpayers did not, however, prevent the Internal Revenue Service of the United States from pursuing claims against other U. S. taxpayers. The IRS issued “John Doe Summonses” to UBS asking

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for information on 52,000 accounts the bank holds, with an estimated value of $14US.8-billion in assets. The Swiss government refuses to comply with the summonses, saying they violate Swiss banking secrecy laws.

The United States-Switzerland Tax Treaty has a clause on exchange of information that requires the respective tax authorities to exchange tax information for the prevention of tax fraud or the like. However, the treaty also provides that neither country is obliged to carry out administrative measures that vary with their domestic regulations and practice or supply particulars that would not be procurable under domestic legislation.

The summonses have triggered an international legal battle that will test Swiss banking secrecy laws against tax treaty obligations. The Swiss government maintains that under its treaty with the United States, it is obliged to turn over client information only if the U. S. government alleges tax fraud, and that tax evasion is not in itself evidence of tax fraud.

UBS argues that disclosing the banking information in respect of the 52,000 accounts would violate domestic Swiss laws that carry substantial prison terms for such violations in addition to fines, penalties and other sanctions. The proceeding will be determined by a U. S. federal judge in the United States District Court.

Hence, the conundrum: UBS admits being party to fraudulent activities that resulted in the deferral of criminal prosecutions, but asserts that fraud is not the same as tax evasion and so will not disclose the requested information.

All of which has the U. S. Senate puzzled. As Senator Carl Levin, D-Michigan, cochairman of the U. S. Senate subcommittee investigating tax evasion by U. S. clients of UBS, said: “The question, then, is of what value is our treaty with them if even when they have accepted responsibility for violating our law—their words—and where they have participated in a scheme to defraud our IRS, if we can’t get the names of the people with whom they schemed?”

In response to the stalemate, Senator Levin introduced the Stop Tax Haven Abuse Act on March 2. The current budget created by Barack Obama, the U. S. President, includes more than $200US-billion for offshore tax enforcement. President Obama co-sponsored an earlier version of the bill when he was a senator.

We may never discover the difference between tax evasion and tax fraud. However, if—as is likely—the bill is enacted into law, it will substantially alter the landscape for using tax havens to evade taxes and make the question moot.

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