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NOTES

Swiss Bank Secrecy Laws and the U.S. Internal Revenue Service

Are The Swiss To Blame For Tax Dollars That The U.S. Internal Revenue Service Cannot Collect When U.S. Citizens "Hide" Their Money In Swiss Banks?

To an American the thought of Swiss banks conjures up ideas of bank accounts registered to numbers instead of names, safe deposit boxes full of gold, and international wealth hidden behind the bank secrecy laws of a tiny country. Switzerland offers many advantages to the financially minded person in search of a unique capital market: a stable, freely convertible, sound currency; well-organized financial institutions in a neutral country; and a highly developed international communications and transportation market in a multi-lingual society.¹ The same bank secrecy provisions that make Switzerland so attractive to the investor serve to plague the U.S. Internal Revenue Service ("IRS").²

This Note will review the bank secrecy laws of Switzerland and the United States, the agreements between them that attempt to prevent the criminal use of Swiss banks, and the tax system used by the Swiss Government to prevent Swiss citizens from evading Swiss taxes by the use of their own bank secrecy laws. In addition, this Note will demonstrate that the United States is responsible for creating a treaty that permits its citizens to evade taxes by banking in Switzerland.

¹ Buzescu, *Foreign Bank Operations in Switzerland*, 19 INT'L L. 897, 899 (1985). See also H. MEYER SWISS CAPITAL MARKETS 2 (1983).

² The United States taxes its citizens based on their world wide income, when this income is hidden from the IRS the U.S. government is not able to tax it.

I. BANKING LAWS IN SWITZERLAND AND THE UNITED STATES

A. *Secrecy in Swiss Banking*

1. Pre-Statute Financial Information Protection

"Swiss banking," in the minds of the American public, brings with it many misconceptions. Principal in these misconceptions are the ideas that every Swiss bank account is issued to a number instead of a person's name and that it is this numbering process which provides the "secrecy."

Only a small percentage of all Swiss bank accounts are registered to a number. A numbered account is granted when the depositor is an established customer and can justify to a senior bank official the need for the number instead of the name on the account. Numbered accounts are commonly reserved for persons who have a name that would be easily recognized and so would attract unwanted attention from bank employees.³

There are no purely anonymous bank accounts in Switzerland. At least one bank official has access to the name of the party holder of each account.⁴ Numbered accounts do not receive any special treatment and the secrecy of the information in a numbered Swiss bank account is no more carefully maintained than the secrecy of any other bank account in the country of Switzerland.⁵ The only time an account can be maintained without at least one person in the bank knowing the identity of the depositor is when the account is maintained by a special Swiss agent.⁶

Prior to 1934 there were no statutes regulating the Swiss banking industry.⁷ Bank secrecy was implied from "personality rights" which had been protected by the courts.⁸ Later, courts implied a contract of confidentiality between the banker and the client.⁹ The first statutory protection of the privacy rights of Swiss citizens was approved in article 28 of the Swiss Civil Code in December 1907.

³ Rushford, *The Effect of Swiss Bank Secrecy on Insider Trading*, 7 B.C. INT'L & COMP. L. REV. 547, 548 (1984).

⁴ Honegger, *Demystification of Swiss Banking Secrecy*, 9 N.C. J. INT'L L. & COM. REG. 1, 5 (1983).

⁵ *Id.* at 4.

⁶ If a customer to a Swiss bank is represented by an agent who is a Swiss lawyer, notary, or member of a Swiss trust or auditing company, the agent does not need to identify the name of the principal to the bank. In this situation the Swiss bank depends on the agent's verification that the money is legally acquired. Honegger, *supra* note 4, at 8. It is recently reported that the Swiss Banking Commission has recommended that this policy, of permitting a Swiss agent to be named on the account, no longer be allowed. W. DIAMOND & D. DIAMOND, *TAX HAVENS OF THE WORLD*, 24.1 (1987).

⁷ Raifman, *Effects of US/Swiss Agreement on Swiss Banking Secrecy*, 15 L. & POL'Y INT'L BUS. 565, 571 (1983).

⁸ Honegger, *supra* note 4, at 2.

⁹ Raifman, *supra* note 7, at 571.

Swiss laws of agency have also been used to protect financial information by imposing a duty of loyalty upon banks as agents of the customer. This duty does not depend on an express agreement.¹⁰

a. Swiss Penal Code

Article 273 of the Swiss Penal Code makes it a crime to release financial information about a client to a foreign party. The Code supports bank secrecy in two other articles. Article 162 makes it a crime to disclose information that a party has a contractual obligation to protect, and article 159 makes it a crime to disclose freely any information when such a disclosure impairs a client's resources.¹¹

b. Swiss Bank Secrecy Act

The Bank Secrecy Act, first approved in 1934, was the first set of Swiss statutes created to fortify bank secrecy. This Act was promulgated because of the lack of confidence in world banking which followed the Great Depression and the failure of a significant Geneva bank. It was also enacted to protect the Jews from an influx of the Nazi regime that attempted to acquire the private assets of German Jews who held accounts in Swiss banks. The Act was an *ex officio* statute which mandated the government to protect an individual's privacy rights.¹²

Under Swiss private law the right of protection of financial secrecy is owned by the depositor, not by the bank.¹³ Article 47¹⁴ of the Bank Secrecy Act makes it illegal for a bank employee to disclose a secret entrusted to the bank and it broadens the scope of penalties to which a banker may be subjected for failure to protect the information.¹⁵

¹⁰ Rushford, *supra* note 3, at 546.

¹¹ Raifman, *supra* note 7, at 571.

¹² *Id.* at 572.

¹³ *Id.* at 575.

¹⁴ Article 47 of the Swiss Banking Law states:

1. Whoever divulges a secret entrusted to him in his capacity as officer, employee, mandatory liquidator or commissioner of a bank, as a representative of the Banking Commission, officer or employee of a recognized auditing company, or who has become aware of such a secret in this capacity, and whoever tries to induce others to violate professional secrecy, shall be punished by a prison term not to exceed six months or by a fine not exceeding 50,000.00 francs.

2. If the act has been committed by negligence, the penalty shall be a fine not exceeding 30,000.00 francs.

3. The violation of professional secrecy remains punishable even after termination of the official or employment relationship or the exercise of the profession.

4. Federal and Cantonal regulations concerning the obligation to testify and to furnish information to a government authority shall remain reserved.

See Honegger, *supra* note 4, at 4; *See also* Bundesgesetz über die Banken und Sparkassen of Nov. 8, 1934, as amended by Federal Law of Mar. 1, 1971.

¹⁵ *See generally* Raifman, *supra* note 7, at 572.

If a bank inappropriately releases information, the bank may be found criminally liable under the Swiss Penal Code. Such action may also create a civil liability. A bank customer may prove a tort action (or an action for breach of contract) by establishing that: 1) damages were sustained as a result of the banker's disclosure; and, 2) the disclosure was willful or negligent on the part of the banker (or the banker breached the implied contractual duty of non-disclosure); and, 3) the release of information was the proximate cause of the damages; and, 4) there was no legal provision or waiver by the client serving to legalize the disclosure.¹⁶ However, bank secrecy is not a right without exceptions.

2. Exceptions to Swiss Bank Secrecy

The general rule is that a banker in Switzerland can refuse to provide tax information to the tax authorities of any country.¹⁷ The exception to this rule is when a taxpayer falsifies documents in order to mislead the Swiss revenue service (the Federal Tax Administration or "FTA"). With this falsification of documents, the crime rises from simple tax evasion to the level of tax fraud.¹⁸ In three cantons¹⁹ tax fraud is considered a "crime" and thus criminal procedure will cause the bank secrecy to be annulled.²⁰

Besides criminal proceedings, which may include tax fraud, bank secrecy exceptions may be created three other ways. First, a client may consent to the release of information. For example, a client may be required to consent to release of information when securing a bank loan from another bank in another country or when applying for the right to use other branches of the same bank in another country.²¹ Second, civil family law proceedings will permit a person who has the legal obligation to manage the property of another to acquire information about that party's assets. Heirs will also be given access to the estate information.²² Third, certain public law limitations, including debt execution and bankruptcy proceedings, may require that bank information be divulged.²³

B. Secrecy in U.S. Banking

Secrecy in banking has not been safeguarded in the United States.

¹⁶ Honegger, *supra* note 4, at 3.

¹⁷ *Id.* at 7.

¹⁸ *Id.*; see *infra* note 105 and accompanying text.

¹⁹ In the cantons of Zurich, Geneva and Basel. A canton is a Swiss governmental unit similar to a state. There are 26 cantons in Switzerland. BIANCHI, TAX MANAGEMENT FOREIGN INCOME PORTFOLIO A-1 (1986).

²⁰ Honegger, *supra* note 4, at 7.

²¹ Buzescu, *supra* note 1, at 910.

²² Rushford, *supra* note 3, at 548.

²³ Honegger, *supra* note 4, at 5.

Legislation against bank secrecy appeared in 1970 with the Bank Secrecy Act ("BSA").²⁴ Congress enacted the BSA with its power under the commerce clause of the U.S. Constitution.²⁵ The BSA authorizes the Treasury Department to require financial institutions in the United States to keep certain records of financial transactions.²⁶ These records are designed to reveal white collar and organized crime activities by serving as a paper trail to be used to track money currents. The BSA was a unilateral attempt by Congress designed to make it impossible to move large amounts of money anonymously between U.S. banks and the banks of other countries.²⁷

U.S. banks must abide by the record keeping and reporting requirements of the BSA. Prior to this act, only the transactions which were considered "unusual" were reported to the Treasury Department²⁸ and this reporting was on a voluntary basis.²⁹

The BSA is divided into two titles:

Title I requirements are broadly stated in statutory form, and are specified in the Code of Federal Regulations. Financial institutions are required to record all major currency or extension of credit transactions. The identity of any person having a financial interest in foreign accounts must also be recorded. The regulations seek to set up recording systems for tracing all large deposits for up to two years. Thus, the institutions must copy the front and back of checks in excess of 100 dollars. Each financial item transaction of more than 10,000 dollars that is remitted or transferred to a person, account, or place outside of the United States must also be recorded. This requirement includes recordation of checks or drafts in excess of 10,000 dollars drawn or issued by a foreign bank which a domestic bank has paid or presented for payment. These regulations also extend to certificates of deposit. The name, address, and taxpayer identification number of each purchaser of a certificate must be recorded along with a description of the instrument, including the manner and date of payment. The regulations impose additional requirements for casinos, as well as brokers and dealers in securities. Title I records are to be kept for a period of five years.

Title II of the Act requires financial institutions to report directly to the Secretary certain domestic and foreign currency transactions. Like the BSA record-keeping requirements, the reporting provisions

²⁴ 12 U.S.C. 1730(d), 1829(b), 1951-1959 (1982); 31 U.S.C. 5311-5322 (1982), amended by 31 U.S.C. 5316(a), 5317 (b)-(c), 5323 (West Supp. 1985).

²⁵ Comment, *The Bank Secrecy Act: Privacy, Comity, and The Politics of Contraband*, 11 N.C. J. INT'L. L. & COM. REG. 667, 668 (1986).

²⁶ *Id.*

²⁷ 4 REDDEN, MODERN LEGAL SYSTEMS CYCLOPEDIA 347 (1984).

²⁸ Comment, *supra* note 25, at 672.

²⁹ *Id.*

are premised on the congressional finding of their usefulness in combatting criminal activity and are specified by regulation.

Domestic financial institutions are required to report the payment, receipt, or transfer of currency in excess of 10,000 dollars. . . . (citations omitted)³⁰

Constitutional challenges to the BSA have been unsuccessful. Theories advanced to test the BSA include substantive due process, first amendment, fourth amendment, and fifth amendment.³¹ Thus, the U.S. Supreme Court refused to find a protected privacy interest in banking records.³² The Court held that Treasury Department access to private banking records without customer notification is not an unreasonable search and seizure.³³

In an attempt to protect a privacy interest for the bank depositor in the United States (the BSA has received strong constitutional support from the courts), Congress enacted the Right to Financial Privacy Act of 1978 ("RFPA").³⁴ The RFPA does not grant any enforceable right of privacy to an individual but does place a legal procedural requirement upon a federal agency wanting to access a bank depositor's account information. Before the agency can have access to the information it must provide any one of the following: a formal written agency request, a grand jury subpoena, a judicial subpoena, an administrative subpoena or summons, a search warrant, or a customer authorization. The customer must have proper notice before any information is disclosed.³⁵

U.S. banking laws do not provide any secrecy of financial information to the customer.³⁶ They only create procedural requirements the federal agency must comply with in order to access the financial records.

³⁰ *Id.* at 673-74.

³¹ *Id.* at 678.

³² *California Bankers Assn. v. Shultz*, 416 U.S. 21 (1974).

³³ *Id.* at 23. See *Miller v. United States*, 425 U.S. 435 (1976).

³⁴ Comment, *supra* note 25, at 680.

³⁵ This Note also advises that "proper notice" requires the customer to be provided with a list of the records to be disclosed and advice on how this disclosure can be judicially challenged. *Id.* at 680-81.

³⁶ The U.S. Postal Service also does not provide for much privacy. In *United States v. Leonard*, the Second Circuit U.S. Court of Appeals rejected an "unreasonable search" argument in a constitutional challenge when Leonard was charged with tax evasion. He was discovered when the U.S. Post Office photocopied the front and back of envelopes arriving in the United States from Switzerland without return addresses. The IRS compared the postmark cancellations to those of Swiss banks and assumed they were bank statements being mailed to "secret" customers. *United States v. Leonard*, 524 F.2d 1076 (2nd Cir. 1975).

II. AGREEMENTS BETWEEN THE UNITED STATES AND SWITZERLAND ATTEMPTING TO PROHIBIT CRIMINAL USE OF SWISS BANKS

The United States and Switzerland have entered two agreements in an attempt to limit the criminal use of Swiss banks. These are the U.S.-Swiss Mutual Assistance Treaty and the Memorandum of Understanding.

A. *The U.S.-Swiss Mutual Assistance Treaty*

The 1973 U.S.-Swiss Mutual Assistance Treaty ("MAT") was enacted to combat organized crime. In certain circumstances, this treaty grants the U.S. government access to private Swiss banking records. Pursuant to the MAT, the Swiss can disclose otherwise secret information when the United States is investigating a serious crime, provided the United States has already made a reasonable but unsuccessful attempt to obtain the information.³⁷

This treaty was more than four years in the making. It has been reported that one of the factors causing this long delay to a compromise was that "Switzerland wanted a comprehensive agreement covering all aspects of judicial assistance equivalent to the European Convention on Mutual Assistance in Criminal Matters."³⁸ The United States wanted to lift the Swiss banking secrecy, especially where tax violations, securities law offenses and organized crime were prosecuted."³⁹

After the treaty was implemented it became obvious that it was not effective at dealing with the criminal activities associated with insider trading.⁴⁰ There were too many loopholes in the treaty and the legally counselled were able to escape prosecution.

By 1977 the Swiss banking industry realized it would need to provide more organized assistance in the prevention and prosecution of economic crimes in order to protect its reputation. The Swiss Bankers' Association, the Swiss National Bank, and the other banks of Switzerland wrote a private agreement containing a plan to deal with this problem. The pact was called the Agreement on the Observance of Care in Accepting Funds and the Practice of Banking Secrecy ("Agreement"). It was signed July 1977 and was updated October 1982. Nearly every bank voluntarily signed the Agreement.⁴¹

³⁷ Comment, *supra* note 25, at 690.

³⁸ See *infra* pt. III.

³⁹ Honegger, *supra* note 4, at 14; see also Meyer, *Swiss Banking Secrecy and Its Legal Implications in the United States*, 14 NEW ENG. L. REV. 18, 64 (1978).

⁴⁰ Comment, *supra* note 25, at 690.

⁴¹ Aubert, *The Limits of Swiss Banking Secrecy Under Domestic Law*, 2 INT'L TAX & BUS. LAW. 273, 282 (1984).

The Agreement had three principal objectives: a) to prevent Swiss bank use for illegally acquired funds by requiring the verification of depositors, b) to prevent illegal use of safe deposit boxes, and c) to prevent tax evasion.⁴² This Agreement still allows a depositor to be represented by a Swiss agent,⁴³ but the agents now must sign a declaration that they personally know the principal and that these funds are not in opposition to the Agreement.⁴⁴

When a U.S. district court declared sanctions against a Swiss bank for not providing the U.S. Securities and Exchange Commission ("SEC") with the names of its customers, the Swiss became interested in providing more assistance in the prevention of insider trading. In *SEC v. Banca Della Svizzera Italiana* ("BSI"), the court ordered a Swiss bank to disclose the identity of purchasers of stock and issued sanctions for any non-compliance.⁴⁵ The SEC needed the identity of the stock purchasers to investigate an insider trading scheme. The judge, in determining whether the identity must be provided by the Swiss bank, balanced the U.S. interest in having integrity in the U.S. securities markets against the Swiss interest to enforce its banking secrecy laws. The judge concluded that the U.S. interests were greater. The bank asked its clients to waive their own rights to Swiss bank secrecy. The information was provided and the Swiss bank was not prosecuted.⁴⁶

This pressure on the Swiss banking industry compelled the Swiss into action. The influence of the Swiss banking industry on the U.S. financial markets should not be underestimated. Swiss banks engage in forty percent of the foreign bank transactions that occur in U.S. securities markets.⁴⁷ Foreign bank transactions have been reported to be nine percent of the market volume.⁴⁸

The Swiss, in an effort to deal with the problems of insider trading, invited the United States to Bern, Switzerland in March 1982. The Swiss brought to the table the Agreement they had created within the Swiss banking community. In August 1982, after a series of negotiations, the two delegations signed an understanding as to how they would handle future insider trading problems that involved Swiss banks as buying agents on the U.S. stock exchanges. The document is called the Memorandum of Understanding.⁴⁹

⁴² *Id.* at 283.

⁴³ DIAMOND, *supra* note 7.

⁴⁴ Aubert, *supra* note 41, at 283.

⁴⁵ *SEC v. Banca Della Svizzera Italiana*, 92 F.R.D. 111 (1981) [hereinafter *BSI*].

⁴⁶ REDDEN, *supra* note 27, at 349.

⁴⁷ Honegger, *supra* note 4, at 22.

⁴⁸ Comment, *supra* note 25, at 670.

⁴⁹ Honegger, *supra* note 4, at 22.

B. *The Memorandum of Understanding*

The Memorandum of Understanding ("MOU") is not a treaty and has not been approved by the U.S. Senate or by the Swiss Parliament. As such it is not binding. It does declare the intent of both parties to cooperate in investigations of insider trading.⁵⁰ The MOU guarantees Swiss cooperation in SEC investigations even though there is no similar crime in Switzerland.⁵¹

The MOU declared that investigations by the SEC would be considered criminal investigations as opposed to administrative investigations. This designation inferred that the MAT would apply and provide mutual assistance in cases of insider trading. The MOU acknowledged that the Swiss do not have specific laws against insider trading but listed Swiss Penal Code violations that would be considered appropriate for prosecuting such activities. The MOU clarified the Swiss presumption that information released for a specific use was restricted to that use, and made the information released available to certain U.S. administrative and judicial proceedings.⁵²

III. AGREEMENTS BETWEEN THE SWISS AND OTHER EUROPEAN COUNTRIES TO PREVENT THE USE OF INTERNATIONAL BORDERS TO AVOID PROSECUTION

The Members of the Council of Europe signed the European Convention on Mutual Assistance in Criminal Matters on April 20, 1959. The purpose of this Convention was to achieve greater unity among the members of the organization in assisting the investigation of criminal matters. Under the general provisions of the Convention:

Art.2 Assistance may be *refused*:

(a) if the request concerns an offence which the requested Party considers a political offence, an offence connected with a political offence, or a *fiscal offence* (emphasis added);⁵³

⁵⁰ Raifman, *supra* note 7.

⁵¹ The biggest loophole in the use of the MAT alone was, that for the MAT to apply, the information sought had to be used for what would be recognized as a crime in Switzerland. Insider trading in Switzerland is not a crime.

⁵² Navickas, *Swiss Banks & Insider Trading in the U.S.*, 2 INT'L TAX & BUS. LAW. 159, 178 (1984). The terms of the MOU were implemented by Agreement XVI of the Swiss Bankers' Association. This private agreement states that a Swiss bank will disclose the alleged insider trading information only when the transaction occurred within 25 trading days of the public announcement of the proposed business activity. Szak, *International Cooperation in Insider Trading*, 40 WASH. & LEE L. REV. 1149, 1169 (1983).

⁵³ European Convention on Mutual Assistance in Criminal Matters, Dec. 13, 1957 at 284, Europ. T.S. No. 30, contained in *European Conventions and Agreements* Vol. 1 (1971).

The member states of the Council of Europe made a supplement to this Convention in March 1978. The Convention was amended to read:

Article 1

The Contracting Parties shall not exercise the right provided for in Article 2(a) of the Convention to refuse assistance solely on the ground that the request concerns an offence which the requested Party considers a fiscal offence.

Article 2

2. The request may not be refused on the ground that the law of the requested Party does not impose the same kind of tax or duty or does not contain a tax, duty, customs and exchange regulation of the same kind as the law of the requesting Party.⁵⁴

This change in the Convention now provides for a signatory country to ask another signatory country for assistance in collecting information that could lead to a tax violation, e.g., fiscal offense.⁵⁵ Now, no other crime than tax evasion must be committed before the members of this Convention can request other member countries to provide them with information necessary to prosecute the party for the crime.

IV. FINANCIAL ACTIVITIES THE U.S. GOVERNMENT WOULD LIKE TO PREVENT

"[The] white collar crimes of tax evasion, money laundering, and securities fraud substantially impact on the U.S. economy."⁵⁶ When asked by the U.S. Congress, the Commissioner of the IRS said, "We can't say with any real precision any more than others can as to the precise amount of tax revenue that is being lost through these things, but it is simply clear that the amounts are in the multiple of billions of dollars."⁵⁷

A. Money Laundering

[The drug] trafficker is often confronted with an enormous physical obstacle in evading the detection of law enforcement officials: the volume of currency in small denominations outweighs the volume of any drug the trafficker smuggles into the United States. To safely reap the rewards of his illegal gain, the trafficker must clandestinely transform his illegal cash proceeds into a form of wealth that is capable of

⁵⁴ Additional Protocol to the European Convention on Mutual Assistance in Criminal Matters Mar. 17, 1978 at 2, Europ. T.S. No. 99 (1978).

⁵⁵ The signatories of the Convention include the Grand Duchy of Luxembourg and Switzerland. *Id.*

⁵⁶ Comment, *supra* note 25.

⁵⁷ Weiland, *Use of Offshore Institutions to Facilitate Criminal Activity in U.S.*, 16 N.Y.U. J. INT'L L. & POL. 1115, 1117 (1984).

use and enjoyment. This entire process is commonly referred to as "laundering."⁵⁸

The IRS is confronted with two significant problems in attempting to deter "money laundering." First, the nations that have secrecy laws to protect depositors possess banking industries and other related financial services industries. These nations recognize that if they do not provide secrecy to their customers, their customers will seek out another country that does provide secrecy. Most countries that provide secrecy believe that they are handling "clean" money and that they have provisions to prevent the use of their banks by criminals. Tax haven countries claim no responsibility to aid other countries in their attempts to collect taxes. Second, when hundreds of billions of dollars each day are passed in international financial transactions, the millions of dollars in the money laundering processes go unnoticed.⁵⁹

B. Insider Trading

Insider trading is the act of buying or selling publicly held securities while in possession of material, nonpublic information about the future of those securities or the corporations those securities represent.⁶⁰ International participation in the buying and selling of securities in the U.S. markets has dramatically increased.⁶¹ Part of this increase is attributable to foreign investment. Swiss banks, acting as agents, trade on U.S. securities markets in the name of their institution. They do not reveal the name of their customer, who is the principal in these purchases.⁶² This practice makes investigations into insider trading by the SEC very difficult. Persons with "insider" knowledge have been able to buy securities through a Swiss bank and hide from the SEC behind the Swiss bank secrecy laws.

This activity has been challenged by the SEC. The court in *BSI* had the opportunity to rule on a motion to compel discovery and to force a Swiss bank to answer interrogatories concerning the undisclosed parties the bank had represented.⁶³ The SEC alleged insider trading on the part of the principals represented by the bank. The bank had purchased com-

⁵⁸ Horowitz, *Piercing Offshore Bank Secrecy Laws Used to Launder Illegal Narcotics Profits*, 20 TEX. INT'L L. J. 135, 136 (1985). This article, citing the *Crime & Secrecy Hearings*, 98th Cong. 1st Sess. 185 (1983), notes that \$1 billion worth of marijuana weighs two tons and \$1 billion worth of \$100 bills weighs ten tons.

⁵⁹ Nadelmanne, *Unlaundering Dirty Money Abroad*, 18 U. MIAMI INTER-AM. L. REV. 33, 72 (1986).

⁶⁰ H.R. Rep. No. 355, 98th Cong., 2d Sess. 1, 21, n. 33, reprinted in, 1984 U.S. CODE CONG. & ADMIN. NEWS 2274, 2293.

⁶¹ Szak, *supra* note 52, at 1149.

⁶² Rushford, *supra* note 3, at 541-42.

⁶³ *BSI*, 92 F.R.D. at 111.

mon stock and call options on common stock of St. Joes Corporation immediately prior to a cash tender offer by Joseph E. Seagram & Sons, Inc. This transaction led to a large profit for the bank's principal.

In considering whether to impose sanctions when a foreign law prohibits disclosure of information, the court acknowledged the dicta in *Societe Internationale Pour Participations Industrielles et Commerciales, S.A. v. Rogers* which provided for sanctions when a party uses foreign law to evade American law.⁶⁴ The *BSI* court held that "compelling the complete discovery demanded is not only justified in the instant case but required to preserve our vital national interest in maintaining the integrity of the securities markets against violations committed and/or aided and assisted by parties located abroad."⁶⁵ This case caused the Swiss to initiate the meetings leading to the MOU.⁶⁶

C. Tax Evasion

Off shore bank secrecy is also a haven of the tax evader. Even if account secrecy is pierced and the depositor's identity revealed, a successful prosecution will not reach the assets housed in the foreign account. For the IRS, it is a no win situation further complicated by the high costs associated with unsuccessful investigation and litigation.⁶⁷

A U.S. citizen is taxed on worldwide income.⁶⁸ Whenever a U.S. citizen is able to have capital assets in a foreign country and can prevent the IRS from gaining knowledge of those assets, the taxpayer is able to evade taxes. The taxpayer's success at avoiding taxes is dependent on the tax liabilities created by having the capital in the country involved.

When a U.S. individual invests in a foreign country and earns income, that income may be subject to taxes levied by that country and then additional taxes levied by the U.S. Government. In an attempt to avoid "double taxation" of U.S. citizens, such an investor is given a "foreign tax credit" to the extent that the income would be taxed in the United States.⁶⁹ When the foreign country's tax exceeds the equivalent U.S. tax, the individual is not able to benefit by claiming a tax refund from the U.S. Government.⁷⁰

In practice, investors should only be interested in sheltering money in a tax haven where the local taxes are significantly less than the

⁶⁴ *Societe Internationale Pour Participations Industrielles et Commerciales, S.A. v. Rogers*, 357 U.S. 197 (1958).

⁶⁵ *BSI*, 92 F.R.D. at 112.

⁶⁶ Rushford, *supra* note 3, at 561.

⁶⁷ Comment, *supra* note 25, at 671-72.

⁶⁸ I.R.C. § 61 (1986).

⁶⁹ I.R.C. § 901 (1986).

⁷⁰ I.R.C. § 904 (1986).

equivalent income tax in the United States.⁷¹ The exception to this will be the investor who has an otherwise criminal intent such as money laundering or insider trading.⁷² For the criminal, the secrecy provided will be so important that the added cost of taxes or sanctions may not be a deterrent.⁷³ Switzerland is not a "tax haven" if one considers a tax haven to be a place where there are no taxes. Switzerland only becomes a "tax haven" when the citizens of one country are able to avoid paying taxes in their country by having their money "hidden" in a Swiss bank. In this way individuals are able to hide their (perhaps criminally acquired) income from their own country's taxing authorities.

V. HOW THE SWISS PREVENT THEIR OWN CITIZENS FROM EVADING SWISS INCOME TAXES

Taxes in Switzerland are levied by the cantons.⁷⁴ The cantons decide who will be taxed. In Switzerland all corporations and all persons are subject to cantonal taxes⁷⁵ which include federal, cantonal and municipal taxes.⁷⁶

Swiss residents are taxed on their worldwide income and have unlimited tax liability.⁷⁷ Interest paid to a Swiss resident by a foreign source is taxed in Switzerland. Interest that is received in a foreign currency must be converted to Swiss francs for taxation, and the rate of exchange is determined by the rate of exchange on the date that the interest payment became due.⁷⁸ The Swiss, with few exceptions, receive no foreign tax credit unless it is expressly provided for by a treaty between Switzerland and the country that is the source of the income.⁷⁹

Swiss tax authorities are not able to pierce the Swiss banking secrecy laws to collect and assess their own taxes.⁸⁰ They have confronted this problem by creating an "anticipatory tax" (a withholding tax) on all income derived from capital, e.g., interest from banks and bonds, dividends, and cash lottery prizes.⁸¹ The stated purpose of this anticipatory

⁷¹ Finn & Pouschine, *Luxembourg: Color it Green*, FORBES, Apr. 20, 1987, at 42.

⁷² The Swiss are cooperating more to control these criminal activities, they appreciate that permitting these activities to occur serves only to harm the credibility of the Swiss banking industry.

⁷³ In *Marc Rich & Co., A. G. v. United States*, 707 F.2d 663 (2nd Cir. 1983), *cert. denied*, 463 U.S. 1215 (1983) the court upheld a \$50,000 per day sanction for failure of a foreign banking corporation, which was hiding behind bank secrecy laws, to comply with a grand jury subpoena.

⁷⁴ See *supra* note 19.

⁷⁵ REDDEN, *supra* note 27, at 299.

⁷⁶ DELOITTE, HASKINS & SELLS, 4 INTERNATIONAL TAX AND BUSINESS SERVICE 24-5 (1985).

⁷⁷ *Id.* at 4.

⁷⁸ 1 HARVARD LAW SCHOOL, WORLD TAX SERIES 708 (1976).

⁷⁹ *Id.* See also DELOITTE, HASKINS & SELLS, *supra* note 76, at 25.

⁸⁰ REDDEN, *supra* note 27, at 346.

⁸¹ FOREIGN TAX LAW ASSOC., TAX LAWS OF THE WORLD, SWITZERLAND, 49 (1988).

tax authorized by the Swiss Federal Council's Ordinance of September 1, 1943 and Ordinance No. 1 of the Federal Department of Finance and Customs of November 20, 1944⁸² is to prevent tax evasion.⁸³

The anticipatory tax must be withheld by the payor of the income and is paid directly to the Confederation.⁸⁴ The anticipatory tax rate is a standard thirty-five percent.⁸⁵ So, the payor of interest, for example, will pay sixty-five percent of the interest income to the party who deposited the money in the bank and will pay thirty-five percent of the interest income to the FTA. This is done periodically.⁸⁶ This anticipatory tax must be withheld regardless of whether the party earning the interest is an individual or corporation and regardless of whether foreign or domestic.⁸⁷

Even though this tax is withheld, the Swiss resident still must report the income to be taxed.⁸⁸ If a Swiss taxpayer refuses to complete tax declaration forms, the taxpayer can be taxed to the complete discretion of the Revenue authorities.⁸⁹

In the case of foreigners who earn interest income in Switzerland, this anticipatory tax commonly becomes the sole and final tax.⁹⁰ When the income to a non-resident alien is subject to a tax treaty the party can invoke the treaty by simply applying for a tax refund. This tax refund is requested by completing a tax refund form for the FTA.⁹¹ In the case of a U.S. citizen who is not a resident of Switzerland, the U.S.-Swiss Convention for the Avoidance of Double Taxation⁹² ("Double Tax Treaty") permits the Swiss Government to withhold the thirty-five percent anticipatory tax but then requires that the Swiss Government refund all but five percent of the original income subject to the tax.⁹³ So, a U.S. citizen

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ DELOITTE, HASKINS & SELLS, *supra* note 76, at 21.

⁸⁶ *Id.* at 22.

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ REDDEN, *supra* note 27, at 299.

⁹⁰ DELOITTE, HASKINS & SELLS, *supra* note 76, at 22. "In Switzerland interest income on bank deposits is taxable at 35% a year." Finn & Pouschine, *supra* note 71, at 42. The magazine was comparing it to Luxembourg where there is no tax on interest income. This article did not take into account the Double Tax Treaty which would permit a refund for all the Swiss tax except five percent of the interest income.

⁹¹ DELOITTE, HASKINS & SELLS, *supra* note 76, at 22.

⁹² Convention for Avoidance of Double Taxation, May 24, 1951, U.S. — Switz., 2 U.S.T. 1751, T.I.A.S. No. 2316.

⁹³ The Report of the Secretary of State, Dean Acheson, to the U.S. President on June 13, 1951 stated:

In other tax conventions a complete exemption from tax on interest has been accorded, upon certain conditions. In the case of the convention with Switzerland, a tax of 5

who is not a resident of Switzerland will receive a refund for thirty percent of the interest income they have received for the year.

The Swiss banking secrecy laws, which prevent the IRS from learning about the Swiss income and being able to levy taxes on it, do not prevent the Swiss from collecting their taxes. The Swiss withhold taxes in advance of the taxes due and in about the amount that the taxpayer will be liable.

VI. WHAT IS THE UNITED STATES TO DO?

If the United States did not have a Double Tax Treaty with Switzerland, the Swiss would tax interest income of U.S. citizens earned in Swiss banks at a rate of thirty-five percent.⁹⁴ Since this rate of thirty-five percent exceeds the U.S. tax rate of twenty-eight percent⁹⁵ a U.S. citizen would receive a foreign tax credit to the extent of the twenty-eight percent U.S. tax liability. The U.S. citizen would not have to pay the IRS any additional taxes on the income. Unfortunately, the U.S. citizen would not be able to receive any extra tax credit for the seven percent tax paid to Switzerland in excess of the equivalent tax due to the U.S. government.

The actual effect of the Double Tax Treaty, in combination with Swiss banking secrecy, is to limit the income tax the U.S. citizen has to pay the Swiss government without providing any additional revenue to the U.S. Government. The United States should amend this treaty so the Swiss will only have to refund part of the anticipatory tax, if the Swiss can document that the U.S. citizen is paying U.S. taxes on the Swiss income. The Double Tax Treaty could state that a refund of the part of the anticipatory tax (to thirty percent of the interest income) will be granted only after the U.S. resident: 1) provides documentation proving the income has been reported to the IRS or 2) when the depositor signs a waiver allowing the Swiss Government to report the taxes collected to the IRS.⁹⁶ If the depositor elects not to report it to the IRS,⁹⁷ the United

percent is retained because of the fact that in Switzerland there is imposed on interest, in addition to the income tax, a 5-percent coupon or stamp tax.

See also, HARVARD LAW SCHOOL, *supra* note 78, at 708.

This compromise by Switzerland and the United States, to permit the Swiss to collect a five percent tax when other treaties do not permit any tax, demonstrates a willingness of the two countries to compromise to each other's interests.

⁹⁴ DELOITTE, HASKINS & SELLS, *supra* note 76, at 22.

⁹⁵ I.R.C. § 1 (1986).

⁹⁶ As a result of the MOU, the Swiss banks currently have their customers sign a waiver which permits the bank to release the name of their customer in an insider trading investigation.

⁹⁷ When a U.S. taxpayer completes a "1040 Income tax form", if interest is earned in excess of \$400.00 a "Schedule B" must be attached. Line 10 in schedule B asks if "At any time during the tax year, did you have an interest in or a signature or other authority over a financial account in a foreign country?" If you answer "yes" then you must complete a "Form TD F 90-22.1". The TD F

States should not require Switzerland by treaty to reduce the normal thirty-five percent Swiss tax they would levy on the income.

As a result of the 1986 U.S. Income Tax Act there is now a maximum tax rate of twenty-eight percent.⁹⁸ The legitimate U.S. investor would be more likely to report the income from a Swiss bank and pay the U.S. tax of twenty-eight percent, receiving credit for the Swiss five percent tax, than to pay thirty-five percent to the Swiss.

The Double Tax Treaty could also be amended to contain a provision which would require the Swiss to provide the IRS documentary evidence in tax evasion cases. Once the Double Tax Treaty grants a U.S. citizen a Swiss tax refund only when the U.S. citizen is paying U.S. taxes on the income, the only tax evasion cases will be persons who have defrauded the Swiss government by receiving a refund on the Swiss tax (e.g., lied to the Swiss government by telling the Swiss that the income was reported to the IRS) and then have not reported the income to the United States.

The current Treaty expressly requires the FTA to provide information to the IRS. The treaty does not provide for "documentary" evidence which could be used in the U.S. court system in a criminal tax proceeding.⁹⁹ The United States could give insurance to the Swiss that they will not be going on any "fishing expeditions" by agreeing that the United States will only request information and evidentiary documentation from the Swiss when the IRS has initiated the request by having pursued a tax evasion suit in the U.S. courts.¹⁰⁰

The Swiss Federal Supreme Court has interpreted the provisions of the Double Tax Treaty very narrowly in releasing fiscal information to the U.S. Government. As a result of this narrow interpretation, the IRS has been denied the evidence they needed to pursue a tax fraud case they were investigating.¹⁰¹ Interestingly, the Swiss as a party to the amend-

90-22.1 form is the "Report of Foreign Bank and Financial Accounts". The instruction booklet on page 23 for this form states that if "[t]he combined value of the accounts was \$10,000 or less during the whole year" you can check "no" in the box on line 10 of form 1040 and then you do not have to answer the next part of the question, which asks you to identify the country. If you had more than \$10,000 then you must identify the country where the money is deposited. These forms were received from the Cleveland Office of the United States Internal Revenue Service.

⁹⁸ I.R.C. § 1, (1986).

⁹⁹ Mullhaupt, *Seeking Swiss Assistance*, 4 INT'L TAX & BUS. LAW. 144, 147 (1986).

¹⁰⁰ This would assume that after the Treaty is amended, documents provided by the Swiss to the United States showing a tax refund to a U.S. citizen who did not pay taxes on that income would be enough to initiate tax evasion proceedings.

¹⁰¹ This was reported by Mullhaupt (a Swiss lawyer) in Mullhaupt, *supra* note 99, at 147. He noted that:

The court denied this second request [for documentary evidence], relying primarily on three rationales. First, Article 16 of the Double Tax Treaty explicitly states that the FTA [Swiss revenue service] is required to submit only information, not documentary evidence,

ments in the European Convention¹⁰² are now required to provide information regarding a "fiscal offense" requested by another member country of the European Convention, yet the Swiss court system did not read the Double Tax Treaty broadly enough to grant a similar result.

After the Swiss Supreme Court decided the two cases which prevented the IRS from acquiring evidentiary documents, the Swiss Federal Assembly passed a statute called the International Judicial Aid in Penal Matters ("IJAP"). This statute codifies the Swiss response that will be granted to the United States in their tax violation investigations.¹⁰³ The IJAP limits Swiss assistance into foreign investigations to cases involving tax fraud. Cases involving simple tax violations are not considered in this statute.¹⁰⁴

Tax "fraud" as defined by Swiss law is willful and intentional massive tax evasion or the use of forged "documents" in tax preparation. Swiss law does not consider tax declaration forms to be "documents" for the IJAP. Swiss courts have determined that a taxpayer forges "documents" when false transactions were recorded in accounting books, contracts were falsified or bills were altered.¹⁰⁵

According to section 28 of the [IJAP], three conditions must be met before Swiss authorities will honor a request for assistance by foreign tax enforcement agencies: (1) a formal request, (2) a finding of a concomitant Swiss tax violation, and (3) a showing that the assistance obtained will be used only in the transaction for which the information was initially sought (the principle of speciality). The party seeking assistance from Swiss authorities must also file the request before certain Swiss statutes of limitations have run.¹⁰⁶ The [IJAP] restricts judicial aid to the collection of proof, the submission of documents, the hearing of witnesses, and the search of persons and premises, and expressly excludes the right of seizure or attachment of funds, in line

to the IRS. Next, citing article 2(a) of the European Convention on Mutual Assistance in Criminal Matters, as well as general Swiss doctrine, the court held that judicial aid in fiscal matters is not required in the context of criminal proceedings such as the one in question. Finally, the court reconfirmed that the Judicial Aid Treaty could be invoked only in cases involving organized crime and thus was not applicable here. . . .

Id. It is very important to note here that there is an error in the analysis. While it is true the Double Taxation Treaty requires only documentary evidence, the European Convention on Mutual Assistance in Criminal Matters was amended in March 1978 to not permit refusal to provide information because of it being fiscal in nature. *See supra*, note 54. This amendment was written after these cases were decided (which was 1973), but before Mullhaupt published. The rhetorical question is: if the United States had a similar treaty with Switzerland as the current European Convention, would the Swiss Federal Supreme Court have decided these cases the same?

¹⁰² *See supra*, note 54.

¹⁰³ Mullhaupt, *supra* note 99, at 147.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 148.

¹⁰⁶ *Id.* at 149.

with general Swiss legal doctrine.¹⁰⁷

To the United States it may not be important that Swiss bank account funds cannot be attached. When the IRS is required to institute a law suit against a taxpayer they believe is evading taxes, the U.S. court system will already have jurisdiction as to the alleged tax evader even before the Swiss will assist in providing fiscal information. If the IRS is able to get a judgment against the party for tax evasion, they will be able to extend the time of imprisonment if the taxpayer does not pay the back taxes. This ability will provide a strong incentive for the tax evader to either repatriate the funds or never to return to U.S. jurisdictional reach again.

Once the U.S.-Swiss Double Tax Treaty permits Switzerland to collect and retain Swiss taxes on Swiss income, the actual number of tax evaders will be reduced to those parties who have committed other crimes. The United States and Switzerland in the MAT¹⁰⁸ and MOU¹⁰⁹ have agreements which permit bank account attachment when more serious crimes are committed.¹¹⁰

VII. CONCLUSION

For the United States to limit the amount of tax evasion that will be successfully accomplished by the individual U.S. taxpayer who has invested capital in Switzerland, the United States must amend its treaties. The U.S.-Swiss Double Taxation Treaty must be relaxed so that the Swiss government can tax a resident U.S. citizen the standard Swiss rate of tax when the U.S. resident is not paying the U.S. taxes that are due on that income. The U.S.-Swiss Mutual Assistance in Criminal Matters Treaty should include the provisions requiring a member country to report "fiscal offenses", so it will be amended to be parallel to the European Convention on Mutual Assistance in Criminal Matters. The Treaty should also require the requested country to supply the appropriate evidentiary documentation with the agreement that the use of this evidence will be restricted to the immediate court proceeding for which the requesting government is seeking it.

The Swiss are not singularly to blame for the environment which permits a U.S. citizen to put money into a Swiss bank and to avoid pay-

¹⁰⁷ *Id.* at 151.

¹⁰⁸ Comment, *supra* note 25, at 7. *See supra* pt. II.A.

¹⁰⁹ *Id.* at 11. *See supra* pt. II.B.

¹¹⁰ *Barr v. United States Dept. of Justice*, 819 F.2d 25 (2nd Cir. 1987). The Second Circuit U.S. Court of Appeals refused to grant an injunction which would have prevented the Department of Justice from asking Switzerland to "freeze" Mr. Barr's Swiss bank accounts. Mr. Barr argued that the "freeze" violated his constitutional rights. The Court held that Mr. Barr's constitutional rights were not violated. *Id.*

ing U.S. income tax. An agreement must be reached balancing the Swiss interest of having a very stable financial community against the U.S. interest to tax all of its citizens on all of their world wide income.

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