

Taxes—Swiss Parliament Approves Treaty: Tax Evaders to be Identified

It has been a long and winding road, but based on a tax treaty enacted in mid-June 2010, UBS will turn over the names of thousands of suspected U.S. tax cheats to the Justice Department, opening the way for tax fraud charges against the named individuals.

The tax treaty comes in the wake of nearly a year of legal maneuvers and negotiations that reportedly reached as high as the White House. Many in Switzerland oppose the treaty on the grounds that it violates a long tradition of secrecy among Swiss private bankers. U.S. officials view the disclosure of the long sought-after information as essential to fair enforcement of securities and tax laws applicable to U.S. citizens and financial services companies working with them.

In the absence of the treaty, an earlier ruling in a Swiss court would have prevented UBS from making the disclosures, which could have left the bank vulnerable to further criminal charges and cessation of all of its U.S. banking operations. Almost 37 percent of UBS's 65,233 employees worked in the Americas at the end of 2009. UBS's Wealth Management Americas unit managed 690 billion Swiss francs (\$604 billion US) at the end of the year. At stake for the U.S. was an estimated \$50 billion in unpaid income taxes.

U.S. Law

The United States taxes U.S. citizens, residents, and corporations on all income, whether derived in the United States or elsewhere. The United States generally cedes the primary right to tax income derived from sources outside the United States to the foreign country. Thus, a credit against the U.S. income tax imposed on foreign-source taxable income is provided for foreign taxes paid on that income. In order to implement the rules for computing the foreign tax credit, the Code and the regulations there under set forth extensive rules governing the determination of the source, either U.S. or foreign, of items of income, and the allocation and apportionment of items of expense against such categories of income.

To facilitate collection of tax on foreign income, U.S. citizens must report offshore accounts that contain more than \$10,000.

U.S. securities laws require firms acting as broker-dealers and investment advisers to U.S. citizens on U.S. soil to register with the SEC.

Swiss Law

Swiss law facilitated the tax fraud alleged by the Justice Department in two ways. First, Swiss law requires non-disclosure of customers' financial data held by banks in nearly all situations. Under a 75-year-old law, bank secrecy can only be lifted when individuals are deemed to have deliberately defrauded tax authorities as opposed to failing to declare all assets. Second, Switzerland has long been known as a tax haven with relatively low tax rates applying to residents and income earned on assets of non-citizens.

Time Line

Prior to 2009, Justice Department officials began an investigation into possible fraudulent tax evasion by U.S. citizens. Justice also believed that UBS had facilitated such tax evasion through its "cross border" transactions, which involved sending private bankers from Switzerland to the U.S. to meet with wealthy Americans and helping them squirrel away assets in secret accounts between 1998 and 2007.

June 2008— The U.S. District Court in Miami authorizes the IRS to serve a "John Doe" summons on UBS, seeking records that would identify thousands of U.S. taxpayers with secret off-shore accounts at UBS.

June 2008— Former UBS private banker Bradley Birkenfeld pleads guilty to a charge of conspiring to defraud the United States for his alleged role in overseeing the United States cross-border business. Birkenfeld is later sentenced to 40 months in a federal penitentiary.

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As part of the deferred prosecution agreement, and in an unprecedented move, UBS agrees to immediately provide Justice with the identities of, and account information for, certain U.S. customers of UBS's cross-border business. UBS also agrees to expeditiously exit the business of providing banking services to U.S. clients with undeclared accounts. UBS further agrees to pay \$580 million in fines, penalties, interest and restitution.

November 2008—Former UBS head of U.S. wealth management, Raoul Weil, is indicted by a federal grand jury in Fort Lauderdale and charged with conspiring to defraud the United States. Weil is formally declared a fugitive when he fails to show for a January 2009 court hearing.

"Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands."

Judge Learned Hand

February 18, 2009—UBS enters into a deferred prosecution agreement with Justice on charges of conspiring to defraud the United States by impeding IRS. According to settlement documents, UBS sometimes set up shell financial entities and “blind accounts” to hide assets of U.S. citizens.

As part of the deferred prosecution agreement, and in an unprecedented move, UBS agrees to immediately provide Justice with the identities of, and account information for, certain U.S. customers of UBS’s cross-border business. UBS also agrees to expeditiously exit the business of providing banking services to U.S. clients with undeclared accounts. UBS further agrees to pay \$580 million in fines, penalties, interest and restitution.

February 18, 2009— The SEC files an enforcement action against UBS, charging the firm with acting as an unregistered broker-dealer and investment adviser. The SEC's complaint alleges that UBS's conduct facilitated the ability of certain U.S. clients to maintain undisclosed accounts in Switzerland

and other foreign countries, which enabled those clients to avoid paying taxes related to the assets in those accounts. Specifically, the complaint alleges that to conceal its use of U.S. jurisdictional means to provide securities services, UBS client advisers typically traveled to the U.S. with encrypted laptop computers that contained account-related information, to show marketing materials for securities products, and occasionally to communicate orders for securities transactions to UBS in Switzerland. Client advisers also received training on how to avoid detection of their activities by U.S. authorities.

UBS agrees to settle the SEC's charges by consenting to the issuance of a final judgment that permanently enjoins UBS from engaging in similar activity and orders it to disgorge \$200 million in addition to the \$580 million paid in connection with the Justice Department settlement.

February 19, 2009—The Justice Department files criminal charges, seeking immediate enforcement of its John Doe summons, requiring UBS to disclose the names of over 50,000 U.S. Citizens.

March 2009— The IRS launches a six-month program offering lower penalties to Americans who voluntarily disclose previously secret offshore assets and agree to pay taxes on the money. Participation in the program generally means no criminal charges will be filed, and requires payment of back taxes and interest for at least six years, plus some penalties. Essentially, this means that taxpayers stepping forward will avoid jail time.

July 31, 2009—Justice reaches a settlement agreement with UBS regarding enforcement of the John Doe summons on the condition that UBS immediately begin disclosing names and providing files of suspected U.S. tax cheats. To date, UBS has turned over information on only about 250 U.S. citizens.

June 17, 2010—Following litigation and contentious negotiations, the Swiss Parliament finally enacts a treaty that makes it legal for UBS to comply with the John Doe summons and break with a long tradition of secrecy in Swiss banking. Many in Switzerland see the legislation and anticipated disclosures as necessary for salvaging UBS and restoring integrity to Swiss banking.

Bottom Line

Judge Learned Hand wrote years ago that “Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one’s taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.”

People sometimes forget that in the case in which that language was written, *Gregory v. Helvering* 69 F.2d 809, 810 (2d Cir. 1934), *aff’d*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935), Judge Hand went on to create the “economic substance doctrine.” This long-standing doctrine draws a distinction between tax planning to minimize taxes and outright tax avoidance. Judge Hand emphasized that activities lacking economic substance and entered into simply to avoid paying one’s fair share of taxes were illegal.

Lest anyone have any doubt, the sad saga of UBS demonstrates that some things haven't changed that much since 1935. While the lines are often more difficult to discern than in the UBS case, wealth managers need to be as aggressive as their clients want to be when it comes to tax planning while at the same time steering clear of tax schemes and dodges that seem too good to be true.

Taxes and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: www.cannonfinancial.com.

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