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PRACTITIONERS' CORNER

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This article provides a technical update in light of many media reports that the ongoing negotiations between the U.S. and Swiss governments will purportedly result in a global tax settlement agreement with an immediate turnover of Swiss banking data otherwise protected by Swiss bank secrecy law. A great deal of confusion exists on this topic, and our objective is to provide technical clarification to this highly complex developing story.

Recent Media Reports

Although the two governments may contractually enter into whatever form and substance of a settlement agreement they deem appropriate, each government must be respectful of the other's applicable legal system in crafting a settlement resolution. The media has reported that the Swiss and U.S. are negotiating a global resolution in which affected Swiss banks could opt in and pay a proportionate share of the agreed-upon fine, rumored to be in the billions of U.S. dollars, as well as hand over American accountholder data to the U.S. government.

Further, some reports surmise that upon signing a global settlement or other resolution, the Swiss will immediately turn over American client data to the U.S. government. Alternatively, other media reports indicate that the settlement may be structured on a per-bank basis, with perhaps Credit Suisse being the first participant. In whatever manner the ultimate settlement agreement is resolved, if at all, it is important to understand and clarify the applicable governing law from both a Swiss and a U.S. perspective regarding the possible handover of bank-secrecy-protected data from Switzerland to the United States.

February 2009 vs. Today

Transmission of confidential American client bank data from Switzerland to the U.S. is protected by Swiss bank secrecy law and related Swiss due process law. Many media reports relate back to the February 18, 2009, turnover of Swiss bank-secrecy-protected American accountholder data by UBS to the Swiss government and then in turn to the U.S. government as precedent for allowing an immediate turnover of Swiss bank-secrecy-protected American accountholder data in connection with the current negotiations. This is an improper reference of what went on back then relative to what is occurring today. Remember that the February 2009 data transmission was specifically ordered and carried out by the Swiss Financial Market Supervisory Authority (FINMA) and eventually approved by the Swiss Supreme Court in 2011 as being an appropriate and legal move under Swiss law.

In contrast, in today's banking and political environment we are not dealing with a likely scenario in which FINMA would intervene in order to protect the

Swiss banking system from potential failure, but rather we are dealing with two countries negotiating with each other within the framework of the existing domestic laws of each jurisdiction's respective legal system. The interplay of each jurisdiction's legal system has been governed by a historical bilateral income tax treaty, as modified by a September 2009 protocol to the treaty that would further affect data handovers. An understanding of these separate legal systems, treaty provisions, and related principles is critical to understanding the technical basis upon which Swiss bank-secrecy-protected American accountholder data may be passed from Switzerland to the U.S. government.

The 1996 Treaty

By way of background, in 1996 the United States and Switzerland entered into a bilateral income tax treaty (the 1996 treaty) that is intended to address potential double tax scenarios as well as ensure that improper tax avoidance or tax evasion does not occur. In the spirit of mitigating tax avoidance or evasion, the 1996 treaty contains an exchange of information provision under article 26 that states, ''As is necessary for carrying out the provisions of the present Convention or for the prevention of tax fraud or the like in relation to the taxes which are the subject of the present Convention.'' Accordingly, the parties may freely exchange information that falls within the ''tax fraud or the like'' standard.

The 2003 Mutual Agreement

As illustrated in the 2003 mutual agreement to the treaty, mutual assistance for the exchange of information was restricted to the ''tax fraud or the like'' standard. Under Swiss law, the mere underreporting or non-reporting of income, which is considered tax evasion, would not rise to the level of ''tax fraud or the like'' and thus would not be subject to exchange of information under the 1996 treaty. However, if the particular case involved forged or falsified documents, or used a scheme of lies, then the ''tax fraud or the like'' standard would be deemed met and the information would be subject to exchange of information under the 1996 treaty.

The 2003 mutual agreement provides 14 examples of what constitutes ''tax fraud or the like'' under Swiss legal principles to guide both countries in determining whether and to what extent a request for information would be honored under article 26 of the 1996 treaty. Furthermore, the August 19, 2009, settlement agreement between the U.S. and the Swiss Confederation provided for the passage of data from UBS through the Swiss government and to the U.S. government so long as the subject data satisfied the parties' agreed-upon protocol interpreting ''tax fraud or the like.''

Parliamentary Approval Required

However, upon appeal by a U.S. accountholder, the Swiss Federal Administrative Court held in a judgment issued January 21, 2010, that the interpretation given by the parties to the August 19, 2009, agreement went beyond the standard of ''tax fraud or the like'' as defined in the 1996 treaty and the 2003 mutual agreement and that such an extension of the scope of exchange of information required parliamentary approval. It is for this reason that in March 2010 the U.S. and Switzerland entered into a protocol amending the August 19, 2009, agreement, which was then submitted to the Swiss parliament for approval.

Fact-Pattern Treaty Request

On March 5, 2009, the Swiss Administrative Court held that based on a request for mutual assistance from the U.S. (the request was later incorporated into the August 19, 2009, settlement agreement noted above), exchange of information under the 1996 treaty is available even if no specific names of clients are mentioned, if the request identifies certain patterns of behavior that in their entirety constitute ''tax fraud or the like'' within article 26, paragraph 1 of the 1996 treaty.

The 2009 Protocol

As mandated in article 2 of the August 19, 2009, settlement agreement, on September 23, 2009, Switzerland and the U.S. signed a protocol amending the 1996 treaty; since that time the protocol has been approved by the Swiss parliament but is still awaiting ratification by the U.S. Senate. Once the protocol is ratified by the U.S. Senate (which seems virtually certain) and the appropriate instruments of ratification are exchanged, the protocol will become a binding part of the 1996 treaty, and the actions and the procedures set forth in the protocol will become effective as of the date of the signing, retroactive to September 23, 2009.

The protocol specifically addresses mutual assistance and states:

> The competent authorities of the contracting states shall exchange such information as may be relevant for carrying out the provisions of the Convention or to the administration or enforcement of the domestic laws concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1 (citing Article 26, Paragraph 1).

Accordingly, the exchange of information under the protocol will no longer be limited to cases of ''tax fraud or the like'' but will also encompass cases of mere tax evasion. Therefore, an action that would merely constitute tax evasion under Swiss law (for example, mere non-reporting of income and failure to pay applicable tax thereon) but not ''tax fraud or the like'' would be subject to mutual assistance and would override otherwise applicable Swiss bank secrecy provisions.

Fishing Expeditions or Fact Pattern?

The comments to the protocol as well as later OECD comments indicate that the exchange of information provision dealing with mutual assistance in the protocol should not be extended to so-called fishing expeditions. But two important developments materially affect this particular general prohibition of so-called fishing expeditions.

First, when the August 19, 2009, settlement agreement was adopted, the last page of that document contains a separately executed one-page ''Declarations'' stating that the Swiss Confederation ''will be prepared to review and process additional requests'' for mutual assistance ''based upon a pattern of facts and circumstances that are equivalent to those of the UBS case.'' Accordingly, if presented with a substantially similar fact pattern of offshore abuse as was present in the UBS case, then the Swiss government declared it will ''be prepared to review and process'' mutual assistance requests, but subject to applicable laws of Switzerland — not that the Swiss would make an immediate handover of confidential data to the U.S. government. However, the legal framework for carrying out this bilateral proclamation is indeed the protocol (as article 2 of the August 19, 2009, settlement agreement mandated) that the two governments signed in September 2009 — but still not yet ratified by the U.S. Senate.

Second, in light of the most recent developments within the OECD (Committee on Fiscal Affairs) and with a view to the developments regarding the disclosure requests from the U.S. regarding Swiss banks allegedly harboring noncompliant American accountholder funds, the Swiss federal government recently submitted to the parliament a proposal to complement the ratification resolution in the protocol based on a mere fact-pattern-based request for information. This proposed addendum to the ratification resolution mandates satisfaction of four conditions.

The first condition is that the U.S. IRS must indicate why the information requested is necessary and relevant. Second, a detailed description of the alleged fact pattern must be given. Third, a violation of the law by those people fitting the alleged fact pattern must be plausible. Fourth, an act of active behavior of the bank or of one or several of its employees must be credible.

The Swiss parliament decided to postpone both the discussion and a vote on this key addendum until after the recently completed October 22-23 election. It is fair to say that this postponement is due to the way the parliamentarians expect such a passing of a resolution to be viewed by the Swiss voters because it is commonly believed beyond a doubt that no UBS-style agreement would pass the parliament under any circumstances. For completeness sake, the upcoming December 2011 elections in Switzerland will be for the federal government only in that the parliament will elect the seven members of the federal government.

It is anticipated that once the new parliament is in place, the above addendum will be very high on the agenda. As a matter of fact, on October 18, 2011, the Swiss Foreign Affairs Committee of the upper house debated this addendum in the above-mentioned criteria and essentially voiced its consent. Even if this addendum is adopted and even if the protocol is ratified by the U.S. Senate with instruments exchanged to make it effective as of September 23, 2009, there is no reason to believe that affected American accountholders subject to a fact-pattern-based treaty request would not be granted full due process of Swiss law. Therefore, in view of governing Swiss law described below, such accountholders should not be subjected to an immediate turnover as was the case with the 255 or so accountholders as ordered by FINMA in connection with the UBS February 18, 2009, deferred prosecution agreement.

Swiss-U.S. Considerations

The Swiss Federal Constitution explicitly states that the right to be heard is an immutable right, and may not be circumvented or denied by whatever decision might be relevant at the time. Accordingly, as was the case of the August 19, 2011, UBS settlement, affected accountholders should be notified in advance and they should be given time to appeal the proposed disclosure to the Swiss Federal Tax Administration and later be allowed to file an appeal with the Swiss Federal Administrative Court regarding any adverse decision by the Swiss Federal Tax Administration, all of which must occur before any disclosure may be made to the U.S. government.

Also, under Swiss legal principles, the fact that an American accountholder chooses to pursue these appeal rights will not be disclosed to the U.S. government by the Swiss government, although there may be an obligation in such case to provide notice to the U.S. attorney general, under 18 U.S.C. section 3506. Furthermore, because the IRS voluntary disclosure process involves a historical review (for example, the 2011 offshore voluntary disclosure initiative covered 2003 through 2010), this information typically does not come to light in this process.

Assuming an American accountholder believes that a noncompliant account legally should not be subject to mutual assistance, such an accountholder may elect to file with the Swiss Federal Tax Administration for an administrative review of the case. If the Swiss Federal Tax Administration rules adversely on the case, the accountholder may appeal that decision to the Swiss Federal Administrative Court. If the accountholder ends up in an adverse position as a result of the court proceeding, the accountholder should have the right to file for participation in the IRS voluntary disclosure program given that the taxpayer's application should be deemed ''timely.'' A significant U.S. legal issue here is the potential application of the notice provision of 18 U.S.C. section 3506 at both the Swiss

Federal Tax Administration level as well as the judicial review level, and the impact of such provision on the timeliness requirement among other U.S. legal principles.

Swiss Due Process Applicable?

In summary, unless some extraordinary element enters into the current negotiations, such as what we saw in the February 18, 2009, FINMA-mandated turnover of bank data otherwise protected by Swiss bank secrecy law, which seems unlikely to occur, we will most likely expect the above Swiss due process to kick into gear and provide appeal rights to relevant American accountholders as was the case in the August 19, 2009, settlement agreement's 4,450 accountholders.

On the other hand, we are in very unpredictable times, and in the course of governmental negotiations the foregoing technical observations as well as political and nationalistic factors could result in a twisted and unusual outcome. But the point remains that to navigate and complete the turnover of Swiss bank-secrecy-protected American accountholder data based on a fact-based pattern of alleged offshore abuse, the protocol needs to be ratified by the U.S. Senate in full, the pending Swiss resolution adopted, and even then applicable Swiss due process will apply. In simple terms, due to these considerations, there should be no overnight handover of Swiss bank-secrecy-protected American accountholder data as a part of a global resolution (unless FINMA or another similar force enters the proceeding to override Swiss due process).

Global Resolution vs. Data Transfers

Furthermore, in the end, the Swiss parliament will likely have to approve any global resolution proposed by the Swiss federal government, and the authors do not believe that such an approval would be met with insurmountable objections because the Swiss public would like to see finality of this ongoing dispute, as would the participating banks. The passing of Swiss bank-secrecy-protected American accountholder data to the U.S. is a separate issue from a global resolution, although the latter could include the former within its settlement framework. The point is that any data transfer should be subject to Swiss due process. And this means that under the current 1996 treaty and without taking into account the still-pending U.S. Senate ratification of the protocol, the handover of data would need to follow the UBS blueprint, including approval of any deal by the parliament, which might not take place. But even in this case Swiss due process, as outlined above, would apply and thus allow affected accountholders to petition for review.

Assuming the request is based on a fact pattern, the other and less burdensome course of action would be for the U.S. Senate to ratify the protocol, and then instruments of ratification would need to be exchanged so that a new treaty as modified by the protocol could take effect. The Swiss parliament would also complete the complementary fact pattern resolution with the proposed addendum. Thereafter, the IRS could submit the request for information to the Swiss Federal Tax Administration under the amended treaty and thus avoid parliamentary approval. But even in this scenario Swiss due process would allow accountholders to pursue their due process rights under Swiss law; hence, there should be no immediate turnover of data.

Closing Comments

The authors believe that the IRS request is already in process and the U.S. Department of Justice is focusing its investigative efforts on specific Swiss-based banking institutions that are caught in this legal and political quagmire. But remember that a global resolution is really separate and distinct from the mutual assistance course of conduct described above. In other words, the IRS could submit its request for mutual assistance under the revamped treaty as modified by the protocol, and the Swiss due process procedures described above would be implicated.

A separate but related issue is whether and to what extent a global resolution might be entered into between the two governments and participating Swiss-affected banks and also whether and to what extent this resolution would have coverage to employees acting on behalf of such Swiss banks. It would seem particularly harsh for those employees of Swiss banks not to be covered in some sort of settlement protocol so long as those employees acted within the scope of their employment and simply carried out the duties and wishes of their supervisors.

Ultimately, however, the merging of a dual criminal and civil resolution of this dispute in a single global agreement may not be feasible; or for that matter, we may see not a global agreement but a series of separate settlement agreements, and perhaps even separate agreements for criminal and civil resolution of each bank deal. But however the cards fall in this complex deck, we are quite certain that each country will abide by its internal due process law. ◆