BUSINESS RECORDER
Founded by M.A. Zuberi

30 October 2018

Swiss banking secrecy: myths and realities: Automatic exchange of information

Pakistan is one of those few unfortunate countries that have been less than adequately vigilant in governing outflow of untaxed funds outside Pakistan. A substantial sum of untaxed money has flown out of the country. There can never be an exact estimate of the funds so stashed away; however, empirical evidence reveals that these sums are material in relation to the size of economy of Pakistan. United Kingdom, United Arab Emirates, Switzerland and Canada are four major destinations of the funds stashed out of Pakistan. Tax havens such as Cayman, Bermuda, Panama, etc. are not the ultimate destinations. These jurisdictions only act as a 'conduit' in this process.

It is generally considered domestically and internationally that Switzerland is the ultimate destination for a lot or substantial part of such liquid funds. This presumption, which may be true, emerges on account of stringent and well preserved banking secrecy laws of the Federation of Switzerland. In the following paragraphs, some pertinent aspects of the system prevalent and the development taking place in Switzerland have been discussed in brief.

Recent development

Last week, the Federal Swiss Supreme Court has announced an important decision that may change the course of history on this subject. Swiss Supreme Court has absolved 'Rudolf Elmer', an accountant of a Swiss bank (Julius Baer's Cayman Island Branch), based in Cayman Island, from the charges of breaching Section 47 of the Swiss banking secrecy laws. This section deals with the penalty and prosecutions for the breach of Swiss banking secrecy regulations. This is an important event for a very strong Swiss banking industry that rests inter alia on preservation of the secrecy provisions relating to the account holders.

The Swiss Supreme Court held that Elmer is not chargeable of any breach as the 'event' of releasing of information that would have been taken as breach of Swiss regulations, if applicable, has taken place in Cayman Island which is 'outside' Swiss jurisdiction or in other words Cayman Branch of the Swiss Bank Julius Baer is not covered within the larger and wider definition of a 'Swiss Bank'. This appears to be a simple case of jurisdiction of a specific provision of law, however, as described in the following paragraphs, the author considers that this is an event that will have far reaching implications in the near future for 'residents' of other countries acting through a 'conduit' jurisdiction. It is the beginning of the end of a regime that may be called 'Tax Free Capitalism'. It is important to note that Federal Court had been involved for the reason that lower court had also acquitted Elmer and it was the government's appeal.

Elmer, being an employee of a Swiss Bank's branch in Cayman Island, was charged with divulging information that is prohibited under Swiss banking laws. The prosecutors in Elmers' case argued that any disclosure even outside 'Switzerland', i.e., in Cayman Island is tantamount to breach of Swiss banking regulations as the same indirectly / effectively disseminates the information about an account or transaction in a Swiss bank account. The Supreme Court of Switzerland, adopting a prudent approach, decided that laws of Switzerland are restricted to the geographical territory of Switzerland therefore, divulging any information outside Switzerland falls outside the ambit of Swiss law. Accordingly, Elmers was acquitted. In this writer's view, this is a very broad and practical application of Swiss law, and is effectively a departure from generally accepted presumptions.

This decision can be reviewed from two angles. As discussed earlier, Switzerland is the ultimate destination, whereas tax haven jurisdictions like Cayman Island are the conduit in such transactions. The first premise is that accounts in a Swiss bank's branch outside Switzerland, say in Cayman Island, is not protected by Swiss

legislation. The second premise is that a person exercising function outside Switzerland can divulge information about assets in a Swiss Bank, held in the balance sheet of an entity of non-Swiss jurisdiction such as a Cayman Trust and others. Nevertheless, there is the other side of the picture also. In essence, in Elmer's case, the Swiss Federal Supreme Court has reaffirmed the validity of Swiss banking secrecy provisions for 'assets in Switzerland' and falling within the Swiss banking system'. It is, therefore, important to have a basic understanding of Swiss banking secrecy system.

It is important to note that Article 7 of the Swiss Penal Code mentions that a crime is deemed to have taken place in both the place where the offender has acted and the place where the consequences occurred. This aspect was also examined in similar cases.

What is Swiss Banking Secrecy?

The civil obligation of Swiss banks to respect confidentiality of client's accounts arises from three legal principles:

The civil right to personal privacy;

The contractual relationship between customer and bank; and

The specific statutory provisions governing banking secrecy as contained in Section 47 of the Banking Laws.

In addition, personal and administrative sanctions apply to breaches of banking secrecy. While not specifically stated in the law, the client may expressly release the banker from the obligations of banking secrecy.

When the Federal Penal Code was adopted twelve years after the Banking law, it was deemed more appropriate to leave banking secrecy article in Banking Law itself.

According to judicial decisions in Switzerland, banks must not disclose to third parties, whether private persons or 'government authorities', information subject to secrecy, unless by legal order. The mandate of secrecy covers all activities in the banking domain, including the relationship between client and bank, information given by client about his financial circumstances, the clients relationship with other banks, if any and bank's own transactions, if disclosure would harm a customer.

The secrecy law, as described above, is well laid down in Switzerland and has been well protected by all judicial decisions in the past, including the recent judgment of Elmer referred above.

Limits of Banking Secrecy under Swiss Legislation

Contrary to the general assumption, Swiss banking secrecy is by no means an absolute right of the customer. Secrecy can be overridden by other provisions of law, which compel the banker to give information. These other cases emanate from:

Inheritance;

Debt collection and bankruptcy; and

Tax claims.

In the context of discussion in Pakistan, it is important to understand the nature of tax claims and the Swiss banking secrecy law.

Under the Swiss laws, third parties including banks are generally not obliged to furnish information directly to the tax authorities. Banking secrecy can properly be invoked against demands by fiscal authorities for production of information. In some circumstances, tax claims can lead to the judicial lifting of banking secrecy depending upon the nature of the offence. It is also important to note that under Swiss law, the terms 'Tax Evasion' and 'Tax Fraud' have been defined differently and all cases of tax evasion are not considered as tax fraud. In general, there is no possibility to seek legal injunction for lifting the banking secrecy in the case of tax evasion. It is only the case of 'tax fraud' that may lead to the possibility of some injunction. Nevertheless, in general, the possibility of injunction arises only in the case of Swiss tax. The possibility of such injunction in the case of a foreign tax is almost remote; except as discussed in the following paragraphs.

Overriding Factors

In the context of banking secrecy, as discussed above, following two overriding factors have to be taken into account. These are:

(i) The Swiss Bankers' Association Agreement: In order to dispel impression about abuse, the Swiss Bankers' Association prepared a 'Private Agreement on the Observance of Care in Accepting Funds and the Practice of Banking Secrecy'. It is not a law but a voluntary agreement signed by almost all bankers. The underlying principles are:

a) To ensure that identity of account holder and depositors is reliably ascertained;

b) To observe care in renting safe deposit lockers;

c) To prevent aiding and abetting the flight of capital and evasion.

Under the third objective, banks may not collude with their clients in attempts to deceive authorities at home and 'abroad', by making incomplete and other misleading attestations. Furthermore, banks undertake not to aid and abet capital transfer from countries with legislation restricting investment of funds abroad. The last step is the place where Pakistan as a country miserably failed as after 1992, there was effectively no restriction / regulations for investment abroad if foreign currency accounts are used, even though same may have been fed by untaxed money.

(ii) Swiss Law on International Assistance in Criminal Matters: The Swiss Parliament passed a law that came into force from January 1, 1983 which facilitates assistance in cases of crime committed outside Switzerland. Under this law, assistance is available when inquiry comes from a country with which Switzerland maintains reciprocity. Furthermore, assistance is generally not for tax evasion. The assistance may be forthcoming in tax frauds. This law also lifts banking secrecy when the information requested relates to a crime punishable both in the foreign country and in Switzerland. Through this rule, Switzerland emphasizes its determination to prevent use of its banking system as a means of concealing the proceeds of criminal activities in other countries. This is considered as a big step in overriding banking secrecy provisions.

An overview of these two overriding provisions, if so construed reveal that Swiss authorities have maintained the general concept of banking secrecy, however, being a part of responsible international community, there is a possibility of lifting the veil of secrecy, provided it is established on the other side that a crime has been involved in other country in obtaining that money and essentially it is a case of 'tax fraud' as generally determined under the Swiss legislation. Furthermore, with regard to transfer of capital to Switzerland, Swiss law will only come into force when there is restriction or prohibition on the movement of funds. In these circumstances, in the context of Pakistanis' funds outside Pakistan 'substantial homework' is required in Pakistan, including determination of conditions summarily laid down in the aforesaid paragraphs. In authors' view, our hands are not tied up by any Swiss legislation provided there is evidence that funds relate to corrupt practices and crimes under Pakistan law.

Multilateral Treaty and Automatic Exchange of Information (AEI)

There is a lot of confusion on the matter of automatic exchange of information under the multilateral treaty arranged by OECD.

In the past years, the ultimate goal of international community led by OECD has been to improve tax transparency. Over 100 countries, including Pakistan have signed OECD's multilateral agreement on the introduction of the automatic exchange of tax information and have thus committed to implementing AEI in order to reach this goal.

The objective is to make sure that taxpayers pay the right taxes to the right jurisdiction by exchanging bank information of taxpayers holding assets in financial accounts outside of their country of tax residence.

However, each country that has signed the OECD multilateral agreement will only exchange tax related information with other country with which it has signed an additional, bilateral agreement on such exchange.

Switzerland has signed multilateral convention and within that framework has also signed such bilateral agreements with the European Union (28 countries) and 30 other countries so far. As per author's information, no bilateral agreement has yet been signed by Switzerland with Pakistan. Even in the cases where such treaties have been signed, such as India, the exchange of information will start in 2019 concerning information collected in the year 2018.

As mentioned above, starting in 2018, financial institutions in Switzerland will be required to report to the Swiss Federal Tax Administration on accounts held by tax residents of countries with which Switzerland had signed an agreement on the exchange of tax information (so called "Partner Jurisdictions"). The reporting financial institutions include not only banks, brokerage and asset management companies, but also certain collective investment vehicles, insurance and trust companies.

Swiss banks are thus required to identify the 'tax residence' of each of their clients. They will then perform due diligence on the accounts of clients with tax residence abroad, and, for clients with tax residence in a Partner Jurisdiction, collect certain information about their accounts. Existing bank customers will be contacted if their country of tax residence is unclear from the documentation on hand at the bank. The due diligence obligations for individual accounts are more stringent if the account has a value of over CHF 1 million.

The clients affected by these due diligence obligations are, firstly, individuals with tax residence in Partner Jurisdiction. These are individuals who spend at least 183 calendar days a year in that jurisdiction, Secondly, the due diligence will also seek to identify certain entities with their domicile in that Partner Jurisdiction and certain foreign entities whose controlling persons and beneficial owners have residence in that Partner jurisdiction. Controlling persons and beneficial owners are determined on the basis of various criteria; control can mean share ownership or control through other means, such as a position in senior management. The entities concerned also include trusts, whose settlers, trustees, protectors and beneficiaries are all considered controlling persons, as well as foundations.

What information is exchanged, with whom and how?

When a bank identifies that an account is held by a tax resident of a Partner Jurisdiction, it will gather the following information:

- Identification information (e.g. name of the individual or entity, address, country of tax residence, tax identification number and date of birth for individuals);

- Account information such as the account number; and

- Financial information (e.g. account balance and gross income from dividends, interest and other revenue).

Swiss banks started obtaining this "snapshot" of the accounts of residents of Partner Jurisdictions annually, for the first time in 2017.Each bank reported the relevant information annually, for the first time in June 2018, to the Swiss tax authorities, who will forward the data to the tax authorities of Partner Jurisdictions in September of each year; if so applicable and where applicable.

As per author's information, Switzerland and Pakistan have not yet signed a bilateral agreement to conduct AEI, and exchange will most likely be implemented after 2018 as in any other case. Nevertheless, for practical purposes, Swiss banks, as per our information, are performing due diligence on all their foreign resident account holders after 2017, including those from Pakistan, in order to ascertain their clients' effective tax residence. Swiss banks are also increasingly demanding that their clients prove that they are tax compliant in their countries of residence.

If a bilateral agreement is signed in year X, for example, it is possible that information exchange would begin in year X+l and would already concern information from year X. Careful clients will thus anticipate such changes and plan in advance.

In these circumstances, it appears that there is an urgent need to enter into the queue for bilateral agreement with Switzerland to achieve the desired objective of receiving information about assets held by Pakistani tax residents in Switzerland.

Conclusion

The discussion in the aforesaid paragraphs reveals that there is a very strong legal and judicial system prevalent in Switzerland with respect to banking secrecy and the same is well protected; nevertheless, there are overriding elements through which any other country can achieve the desired result of lifting the veil of banking secrecy. That step, however, requires adequate homework in the country of residence of the foreign person holding assets in Swiss Banking System. In other words, the process of identification has to start from Pakistan and has to be duly supported by evidence and judicial decisions establishing 'tax fraud' within the definition of Swiss law. If so, there is adequate remedy for retrieval of due taxes for Pakistan and Swiss banking law provide suitable mechanism for the same. Secondly, multilateral treaty organized by OECD has opened the door for automatic exchange of information with Switzerland, however for that there is a need for immediate action with regard to related bilateral treaty within that framework with Switzerland.

In the author's view, a process has started in the world.

This will end up on positive tone. It appears that in the future world, there will be no tax free capitalism. Pakistan cannot afford to be out of that civilized financial system.

SYED SHABBAR ZAIDI