

# La lettre

G E N E V A P R I V A T E B A N K E R S A S S O C I A T I O N

## REVISING THE TAX LAWS PANDORA'S BOX



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THE AFFAIR OF THE DVD STOLEN FROM THE SUBSIDIARY OF A LIECHTENSTEIN BANK, THEN BOUGHT BY THE GERMAN SECRET SERVICES FOR A KING'S RANSOM WAS ONLY THE PRELUDE TO AN ORCHESTRATED ATTACK ON SWITZERLAND AND HER BANKING SECRECY IN TAX MATTERS. THE CRITICISM, INITIALLY LAUNCHED BY A NUMBER OF GERMAN POLITICIANS, WAS THEN EMBRACED BY OTHERS, INCLUDING THE LEADERS OF THE SWISS SOCIALIST PARTY. AT THE CENTRE OF THE DEBATE LIES THE DISTINCTION SWITZERLAND MAKES BETWEEN TAX EVASION AND TAX FRAUD. WE ASKED A HIGHLY REGARDED EXPERT ON THE SUBJECT – PROFESSOR XAVIER OBERSON, OF GENEVA UNIVERSITY – TO EXAMINE THE CONSEQUENCES IF THE DISTINCTION WERE TO BE ABOLISHED. HE ARRIVES AT THE CONCLUSION THAT QUESTIONING IT WOULD LEAD TO AN OVERALL REVISION OF SWITZERLAND'S TAX SYSTEM.

## TAX EVASION AND TAX FRAUD

Switzerland's tax system, especially with regard to direct taxation, has always been based on a trilogy which tends to distinguish between aggressive tax avoidance, tax evasion and tax fraud.

The first is not an infringement of the law, but involves working with an unusual set-up in order to save on taxes. Under certain conditions the tax authorities have the right to question the procedure and to levy taxes according to the economic reality.

On the other hand, as far as infringement of the tax code is concerned, the fundamental boundary of the Swiss system lies in the difference

between tax evasion and tax fraud. Generally speaking, tax evasion means arranging things so there is no taxation or so that the taxation which is applied is incomplete. The penalty for this is a fine, which can reach as much as three times the evaded tax. As evasion is not liable to a prison sentence, it is termed as an administrative offence. As for tax fraud, this constitutes a criminal offence and can lead to imprisonment. It is qualified evasion, in the sense that the author has recourse to cunning acts

(forged documents are typical) in order to elude the payment of a large sum in taxes to the public authorities. There are two classic forms of tax fraud: the use of forged documents (in the case of direct taxation) and tax swindling (for taxes governed by administrative criminal law).

Following the affair involving German public figures with undeclared assets

deposited in Liechtenstein, in particular, the pressure on Switzerland has increased. In certain political circles voices have been heard calling for this distinction to be purely and simply rescinded. In other words, the idea would be to transform simple tax evasion into a criminal tax offence. Initially, the attraction of this proposition lies in its simplicity. In reality, a slightly more thorough analysis shows that questioning it, would have far-reaching

effects on the whole of the Swiss tax system. In the long run the question could be raised as to whether some taxes would still be justifiable, leading to increased pressure for them to be modified, or even abolished.

### CURRENT SCOPE OF THE DISTINCTION

The distinction between tax evasion and tax fraud is fundamental in Swiss tax law on more than one count.

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Under national law, banking secrecy can, in principle, be invoked with regard to the tax authorities, even in a case of tax evasion. The tax authorities may, therefore, only ask the taxpayer for information. He alone can ask his bank for the information required by the tax authorities. It is only in the case of a criminal tax offence (tax fraud) that the bank must comply directly with requests coming from the tax authorities. It should, nevertheless, be remembered that in the case of federal taxes governed by the federal law on administrative criminal law (ACL) (stamp duties, withholding taxes, VAT and customs duties, in particular) the banker is not released from his duty to testify when legal proceedings have been instigated, even in the case of tax evasion.

This limitation on the tax authorities' power to investigate is compensated in national law by the implementation of a retention tax at source system at a rate of 35% levied on certain types of investment income (withholding tax). Moreover, national law governing direct taxation is characterized, in comparison to international law, by heavy fines in the case of tax evasion (reaching as much as three times the amount evaded in serious cases), as well as particularly long periods of limitation (10 years).

Furthermore, the distinction between tax evasion and tax fraud is also essential in

#### Glossary

##### DTA

Double taxation agreement

##### ACL

Administrative criminal law

##### IMAC

Swiss Federal Act on  
International Mutual Assistance  
in Criminal Matters

##### VAT

Value-added tax

##### EU

European Union

international tax law. In particular, it defines the conditions for administrative assistance and mutual legal assistance.

Generally speaking, in the case of administrative assistance, Switzerland only agrees to exchange information if this exchange contributes to the proper application of a double taxation agreement (DTA). The scope of the DTA with the United States means that Switzerland does, however, also provide assistance in cases of "tax fraud or the like". A number of judgements issued by the Supreme Court related to the 1996 DTA have confirmed that this notion corresponds to that of aggravated tax fraud, i.e. using fraudulent schemes to avoid paying significant sums due in taxes (scheme of lies). Whilst on the subject, in 2004 a modification to the DTA with Germany also introduced the exchange of information in the case of tax fraud, defined in this context as an offence which both states recognize as a criminal offence punishable by imprisonment. This trend is being pursued with all the EU member states. In fact, as far as the Swiss-EU agreement on the taxation of savings is concerned, Switzerland agreed to open up the exchange of information in the case of "tax fraud or the like" as stipulated in the requesting state's legislation, on the basis of the DTAs entered into with each of the EU member states. Clauses like this exist not only with Germany but also with Norway, Austria and Spain and are about to

be concluded with other states, including France. Fundamentally, the regulation with Germany would seem to act as a model.

For the time being, Switzerland only provides judicial assistance in cases of tax fraud or the like, in accordance with article 3 paragraph 3 IMAC.

The current system means that all international assistance, whether administrative or judicial, relies on the distinction that is made between tax evasion and tax fraud. Simple tax evasion, in the case of direct taxes, does not give foreign tax authorities the right to obtain information from the Swiss tax authorities.

It should however be pointed out here that when the agreement with the EU on fraud comes into force, Switzerland will have to broaden the scope of mutual administrative and judicial assistance to include cases of simple tax evasion, but only with regard to VAT, customs and excise duties. However, the distinction made between tax evasion and criminal tax offences will remain decisive as far as direct taxation (the taxation of income) is concerned. Without going into detail, one can say that the Schengen agreement also tends to protect this fundamental separation.



## CONSEQUENCES IF THE DISTINCTION WERE TO BE ABOLISHED

It follows from the above that identical treatment of tax evasion and criminal tax offences would obviously have immediate consequences on national and international law.

Firstly, banking secrecy would be lifted in the case of evasion of direct taxes (not forgetting that already today, banking secrecy cannot be invoked with regard to taxes governed by the ACL). The tax authorities would therefore have direct access to the banking data of the taxpayers concerned.

Furthermore, administrative assistance would be immediately available, upon request, from all the EU member states – Germany in particular – that had negotiated a DTA modelled on the taxation of savings agreement. In effect, tax evasion would become a criminal tax offence for which the penalty would be imprisonment in terms

of Swiss law and consequently constitute tax fraud. Certainly, as far as the United States is concerned, it would require an amendment to the DTA, as to what constitutes tax fraud/aggravated tax fraud, which is spelt out plainly in the DTA's text. We

can count on it being difficult for Switzerland to maintain its demand which, in the process, it would have relinquished with regard to its European neighbours.

It is reasonable to expect that it would entail changes to the Swiss tax system that would be much farther reaching than those immediately noticeable. Indeed, the traditional distinction made between tax evasion and a tax offence lies at the heart of a delicate balance whereby certain restrictions to the tax authorities' investigative powers is compensated by tax mechanisms, and in particular a system of taxation at source.

Historically, withholding tax is the main tool used by Switzerland to tackle tax evasion. It is generally acknowledged that a withholding tax levied on debtors of payments such as income derived from financial investments, has two main goals.

On the one hand, where the withholding tax is reimbursed to taxpayers resident in Switzerland who report their (gross) taxable income correctly, it acts as a guarantee and aims at fighting tax evasion by encouraging taxpayers not to hide amounts taxed at source from the standard income tax. It therefore acts as an incentive.

On the other hand, the withholding tax has a purely fiscal aim where the beneficiaries of the earnings reside outside Switzerland. In fact, if they are not domiciled in Switzerland, these people can only obtain reimbursement (in most cases partial) of

the withholding tax on the basis of a DTA. Even in this case, the withholding tax works as an incentive in as much as the 35% tax rate is final if the alternative is that:

- the beneficiary is domiciled in a country with which Switzerland has not signed a double taxation agreement (offshore countries in particular),
- the beneficiary does not intend to declare the income in question in his tax return in his country of residence or
- the request for reimbursement based on an agreement appears abusive.

In terms of income, in 2006, for example, the tax generated nearly CHF 4 billion for the Confederation.

If the distinction between tax evasion and criminal tax offences were to be removed, and therefore banking secrecy lifted in the case of tax evasion, the very validity of the withholding tax would be called into question. The tax would consequently lose its function as a guarantee, at least for the beneficiaries domiciled in Switzerland, because the tax authorities would have access to the taxpayers' bank accounts in the case of tax evasion. It should be pointed out that this kind of taxation at source on income earned by residents in the state of the source is unique to Switzerland and is justified precisely by the fact that banking secrecy can be invoked when there is evasion of direct taxes. Of course, some states have a system of tax deduction at source on certain kinds

of income for their residents, but in most cases it is a final tax which means that it constitutes full discharge for the taxpayers. If the withholding tax were to be questioned, it would be the whole of Switzerland's traditional tax policy regarding international assistance in fiscal matters that would be shaken up. The agreement with the EU on the taxation of savings is supposed to be based on what is termed as a coexistence model between two systems, that of taxation at source (applied notably by three EU states, namely Belgium, Luxembourg and Austria, as well as third-party states targeted by the European directive) and the automatic exchange of information.

Thus, the agreement on the taxation of savings, which came into force on July 1<sup>st</sup> 2005, provides for a tax retention at source on income from savings paid by paying agents in Switzerland to individuals residing in the EU or, alternatively, a procedure of voluntary disclosure. This system was instigated with the aim of fighting tax evasion in the EU member states while maintaining banking secrecy in Switzerland. Recently, some EU member states have indicated that they intend to modify the taxation on savings directive – and therefore also the agreements with third party states – with the aim of extending its scope. It is predictable that if Switzerland decided to reorganize its own model, it would at the same time be obliged to

abandon the current system of a withholding tax in favour of the automatic exchange of information.

Likewise, it would become difficult to maintain the famous “opting out” clause – the fruit of bitter negotiations with the EU – that Switzerland managed to obtain as part of the Schengen agreement. For the record, this enables the Confederation to avoid using measures of constraint where evasion of direct taxes is concerned, within the framework of the body of EU law pertaining to international judicial assistance.

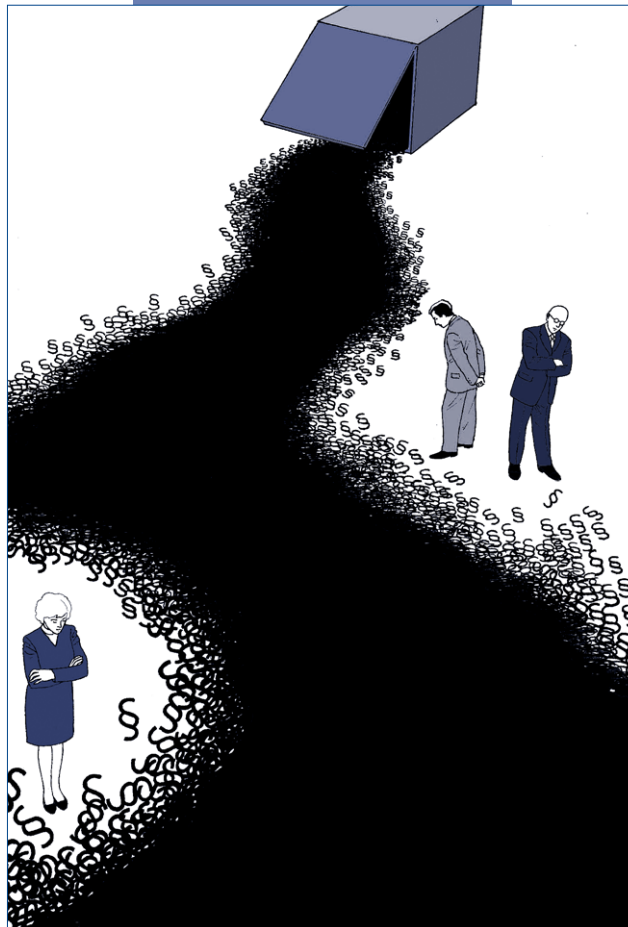
Furthermore, to abolish the distinction between tax evasion and tax fraud would require an overall revision of Switzerland's entire criminal tax law. On this point, it should be remembered that in 2004 a commission of experts looked into the question of a global revision of the criminal tax law. However, it reached the conclusion that there was no reason to make any fundamental changes to the current law and that the distinction made between tax evasion and tax fraud should be maintained, as well as the different procedures applied in the case of direct or indirect taxes.

As we have already mentioned, in this context, evasion is currently punished with a fine that can reach a sum equal to three times the amount of the taxes evaded. By international standards this is a very tough sanction, the aim of which is precisely to

discourage taxpayers from evading taxes. The same applies to the limitation period for the fiscal debt (usually 10 years). One can expect this severe regime to be questioned once the tax authorities have access to a much broader range of information about the taxpayers and have measures of constraint specifically for tax offences.

What is more, in the longer term, one can imagine that there would be increased pressure, calling for changes to or the abolition of a number of taxes which are economically questionable but have sometimes been justified – but only to some extent – because banking secrecy exists.

This applies, in particular, to the stamp duty which has often been defended in Switzerland as the price to pay for banking secrecy. This tax hits transactions related to the transfer of ownership by professional securities traders of taxable instruments, independent of the tax-paying status of the parties concerned. In addition to the comfortable revenue from this taxation, i.e. over CHF 1.7 billion in revenue for the Swiss Confederation in 2006, the idea of charging for using the banking sector is solidly anchored in people's minds.



Even the wealth tax is in part justifiable as an instrument allowing the tax authorities to check that a taxpayer is filing the correct return on his income. By monitoring the evolution of the taxpayer's wealth and his lifestyle, the tax authorities can obtain a fairly realistic idea of his income. One would say that tax evasion involves the wealth just as much as the income of the offending taxpayer. This is true, but by stepping up the tax authorities' means of control and especially their means of constraint, the wealth tax as an instrument of control would no longer be justified.

### REAPPRAISAL OF THE WHOLE TAX SYSTEM

The Swiss tax system relies on a delicate balance built around the fundamental distinction made between tax evasion and tax fraud in the field of direct taxation. As a general rule, the tax authorities do not have access to the taxpayer's banking details, even in the case of tax evasion. To make up for this, a federal withholding tax is levied on different investment revenues. Likewise, all of Switzerland's international policy regarding mutual assistance and judicial cooperation is reliant on this

delimitation. The notion of tax fraud or the like is therefore the key to international cooperation.

If this delimitation were to be challenged the immediate consequence would be that the tax authorities gain access to the taxpayer's banking data. On the basis of the DTAs entered into with EU member states, a foreign tax authority could also obtain this information. The second set of bilateral agreements entered into with the EU, in particular Schengen and the agreement on the taxation of savings, would have to be fully reviewed. That said, in the long run, it is the whole system that would be questioned. The withholding tax, affecting Swiss residents in particular, would no longer be justified. It would be the same for other taxes, further removed from the problems linked

to banking secrecy, like the stamp duty or wealth tax. Finally, it seems obvious that Switzerland's whole criminal tax law would face in depth reforms.

Basically, the traditional distinction made between tax evasion and tax fraud is the result of a skilful compromise between

the protection of personal privacy on one side and the tax authorities' right to check on the other. To question this compromise would open up a real Pandora's box. The Swiss tax system as we know it today, would definitely never be the same again. Once the tax authorities have powers of constraint similar to the ones they have for criminal tax offences, the idea, right at the heart of the edifice, whereby the taxation (if need be at source) replaces

or at best encourages the taxpayer to report his assets, loses its reason for being.

## GENEVA'S PRIVATE BANKERS

LIBERTY - INDEPENDENCE - RESPONSIBILITY

BORDIER & CIE  
(1844)

LOMBARD ODIER DARIER HENTSCH & CIE  
(1796)

MIRABAUD & CIE  
(1819)

PICTET & CIE  
(1805)

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