SHIELDING THE SECRET : SWISS TAX HAVEN JURISDICTION AND BLACK MONEY PROBLEM IN INDIA – AN ANALYSIS

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Abstract

Offshore banking business is the order of the commercial world. Alarmingly, some of these banking jurisdictions act as tax havens due to their client account secrecy rule and guard it even against a legitimate tax enforcement enquiry undertaken by a country; sometimes shielding criminal activity or tax evasion. Around $11 trillion of global wealth is stashed away in these banks, out of which $1.4 trillion Indian money (amount equivalent to India's total gross domestic product) is in Swiss Banks. It is therefore important to understand the Swiss Banking Secrecy Laws and the existing Indian legal apparatus to curb the problem. The purpose of this paper is not just to evaluate the previous offshore tax enforcement programmes, but particularly to track the problems with the information sharing clause under the Indo-Swiss Tax Treaty Agreement.

Introduction

On 17th April, 2009, when Mr. *L.K. Advani*, the Prime Ministerial Candidate for Bharatiya Janata Party of India, brought into focus the issue of Indian money hidden in foreign bank accounts, most people viewed it as a political manifesto. Two years later, on 27th January, 2011 India took notice of the matter when public interest litigation came up for hearing in the Supreme Court filed by Mr. *Ram Jethmalani*, former Union Law Minister. Some people still view it as a political motivated move but the fact of the matter lies unaltered.

Reports of roughly 1.4 trillion dollars of Indian money in the secret Swiss Bank Account are doing the rounds, even during the times of global economic meltdown. Such an amount of money is untaxed, untouched and could possibly be used for criminal activities which can shock the public conscience.

Over the last twenty years due to the advances in technology and the telecommunications, access to off-shore banking facilities became easier. Today, offshore banking business is one of the major global businesses spanning approximately half of the world's financial transactions by value[1]. Therefore, it is startling to note that around 11 trillion dollars of the world's money is locked away in such off-shore banks which due to their Bank Secrecy Laws can guard it even against a legitimate tax enforcement enquiry undertaken by a country. The use of offshore tax havens to shield criminal activity or criminal tax evasion has now become a global issue which needs urgent redressal.

This paper addresses the problem of Swiss banking secrecy laws and steps India should take to mitigate the Indian black money in off-shore banks. Part I of this paper explains the meaning of banking secrecy jurisdictions and Part II elaborates on its effects in Indian economy. Part III points out the drawbacks of previous off-shore tax enforcement programmes. Part IV identifies the problems with the existing Indo-Swiss Tax Treaty and Part V throws light on the possible solutions which India should ponder upon.

1. *Kimberly Carlson*, "When Cows Have Wings : An Analysis of the OECD's Tax Haven Work as it relates to Globalization, Sovereignty and Privacy" 35 *J. Marshall* L. Rev. 163 (2001-2002).

I. Banking Secrecy Jurisdictions and Tax Havens

It is a matter of common knowledge that banks and other financial institutions offer to their clientele a level of secrecy to their accounts. But use of such a service to hide illegal money and evade taxes has been looked down by nations across the world and India is no exception. Trouble brews when banks of foreign countries meticulously engage in such a service, invite clients from across the world and shield their accounts from enquiries made by a foreign Government even for a major violation of another country's laws. Commentators have observed that the ways in which taxpayers can take advantage of the Secret Foreign Bank Accounts to evade taxes are as numerous as the ways of earning money[2].

Origin of Banking Secrecy Jurisdictions

Banking secrecy has its origins in the common law of Great Britain. In *Tournier v. National Provincial and Union Bank of England*[3], the common law principle of bank secrecy was explained as that an implied contract exists between the banker and his client that the banker will treat his customer's affairs as confidential[4]. Therefore, most of the British Colonies and other European countries have continued this practice and affirmed these rules of secrecy in their national laws.

Bank Secrecy Jurisdictions Act as Tax Havens

Broadly, tax haven is a country which offers itself as a place to be used by non-residents to escape taxes in their country of residence[5]. Limited exchange of information due to bank secrecy provisions of one country to another country also makes the former country a tax haven[6].

Therefore, by offering commercial secrecy to banking transactions and providing lucrative opportunities to the possible taxpayers to evade tax in their home country strengthens the trade and commerce of the tax havens. This is viewed as illegal tax competition which is a growing global issue.

II. Swiss Tax Haven – Threat to India's Economy

The Indian Government on various occasions has tried to curb this growing trend of use secret foreign accounts for illegal purposes, but without much progress. Recently the Government acknowledged the reports of illegal domestic transactions of currency to foreign shores and has issued notices to 50-odd Indians having accounts with LGT, a bank in Liechtenstein bordering Switzerland[7].

Estimates

Swiss Tax Haven could severely blow India's economy. According to the estimates, Indian wealth in Swiss Bank Accounts is to between $500 billion to $1.4 trillion. The global wealth stashed away in tax havens is estimated to be over $ 11.5 trillion[8].

2. Legal and Economic Impact of Foreign Banking Procedures on the United States : Hearings before the House Committee on Banking and Currency, 90th Cong., 2d Sess. 14(1968) (statement of Robert Morganthau, United States District Attorney, S.D.N.Y.)
3. 1 KB 461 (1924)
4. Id.
5. Supra n. 1; Also see generally *Sean D. Murphy*, "OECD Listing of States for Unfair Tax Practices," 94 Am. J. Int'l L. 677, 696-97 (2000).
6. Id.
7. Ghosh Gugata, "Battle against black money has a new theme : Sharing of Tax-Evasion Data," (2009), available at http://econimictimes.indiatimes.com/Opinion/Money-Banking/Battle-against-black-money-has-a-new-theme-Sharing-of-tax-evasion-data/articleshow/4695948.cms (last visited on 13th February 2011).
8. *K.R. Srivats*, "India files request with Swiss Government on tax pact," (2009), available at http://www.thehindubusinesslinc.com/2009/06/22/stories/2009062251770300.htm. (last visited on 1st February, 2011)

Non-disclosure of such significant amount of money can have many negative fall outs.

1. The undisclosed money is roughly the size of India's Gross Domestic Product. As it was not taxed, this could one of the major reasons for fiscal deficit in the recent years.

2. It also had a damaging effect on the India's Balance of Payment thereby lowering economic security of the country.

3. It has also unreasonably burdened the honest taxpayers thus affecting their purchasing power and standard of living.

4. But most importantly it could harm the national security as those funds could be used to fuel the terrorist activities[9].

Therefore, this problem of tax haven and hoarding of illegal income combines protecting of economy and security of India.

III. Challenges of the Indian Tax Enforcement Mechanism in Tax Havens- Lessons from the Past

Unilateral Measures

To overcome the problem of Secret Foreign Bank Account for illegal purposes, the Indian Government took certain unilateral measures in the past.

Voluntary Disclosure of Information Scheme, 1997 :

Under this scheme, the income tax defaulters were given an opportunity to disclose and get an umbrella protection of immunity from major laws relating to economic offences like the Foreign Exchange Regulation Act, 1973, the Income Tax Act 1961, the Wealth Tax Act, 1957, and the Companies Act 1956. However, it did not get any big response.

9. Id

The major reasons for failure are simple arguments that why should a resident who has been conveniently using numbered accounts for years decide to bring back the money ? He is not even offered lower taxes which he enjoys in the tax haven. All that is offered is protection from prosecution. This is not enough bait as in any case, due to Bank Secrecy Laws the Indian Tax Officials will not be able to track the Swiss Bank Account information. Therefore the problem is informational. It is a difficult task ahead for the Income Tax Department to collect evidence to connect taxpayers with offshore funds in legally admissible form.

Bilateral Arrangements and Information Exchanges

India has employed two different types of Treaty Arrangements to gather more information about the Indian taxpayers from outside sources. The primary method employed by India is exchange of information provisions in double taxation conventions. As an alternative, India has negotiated mutual assistance treaties affecting criminal matters including the coverage of tax problems. India has followed the lead of United States in this matter[10].

However, the Indo-Swiss Double Taxation Avoidance Agreement which has been in force since 1995 has also not proved very helpful. Part IV (infra) will elaborate on the same.

Langer's Proposal to the United States : Economic Sanctions

According to *Marshall J. Langer*, as information exchange is vital, United States should enter into agreements with all the countries for such information exchange, with which United States does not already have an

10. Workman, *Douglas* J., "The Use of Offshore Tax Havens for the Purpose of Criminally Evading Income Taxes" 73 J. Crim. L & Criminology 675 (1982).

existing tax treaty. *Langer* proposed imposition of economic sanctions on refusal from any country[11].

Economic sanctions may suit United States but it would be fatal for developing countries like India to take such drastic measures as economic sanctions on European countries like Switzerland would mean no foreign direct investment. Again, it would be the Indian economy which will be hit by such sanctions.

Furthermore, even in practice, informational exchanges provisions typically include express limitations on the obligations of the parties to gather or exchange information. Ordinarily the States agree to gather only information that is available under the laws of the requested State. The information exchanges are also normally limited by standard international law restrictions on a State's responsibility to place its public administrative machinery at the service of a sister State.

India has not entered into Mutual Assistance Treaties for tax purposes and hence it has a limited experience in this area. Also, in mutual assistance treaties as exchange takes place between regular law enforcement officials, they may be ignorant of technicalities of tax enforcement.

Thus, even Mutual Assistance Treaties are not so effective to detect illegal money in offshore banks.

IV. The Indo-Swiss Double Taxation Avoidance Agreement- An Analysis

To solve the problem of tax enforcement, India and the Swiss Confederation entered into Bilateral Treaties but an analysis of the same shows that such an agreement is still not very effective to deal with the black money situation in India.

Provisions for Bilateral Arrangements in the Income Tax Act, 1961 :

S.90[12], enables the Central Government to enter into Double Taxation Avoidance Agreements (DTAA) with our countries, to address various problems of double taxation. The Tax Treatises offers relaxation from double taxation, by providing release or by providing credits for taxes paid in one of the countries. Relief against double taxation can be provided either unilaterally or bilaterally[13]. Bilaterally, India can enter into a mutually agreed treaty with another country and protection is provided either by completely avoiding overlapping of tax or waiving a certain amount of tax payable in India. Under the same instrument, provisions as to information exchange for the purpose of tax enforcement can also be agreed upon.

Provision for Information Exchange in Indo-Swiss DTAA, 1995 :

According to Article 26[14], only the information which is

(1) At the disposal of the authorities in their normal course of administration;

(2) That which does not disclose any professional secret or trade process;

(3) That which would not be contrary to its sovereignty, security or public policy and

(4) That which is procurable under its own legislation,

11. Id.; The Use of Offshore Tax Havens for the Purpose of Evading Income Taxes : Hearings before the Sub-committee on Oversight of the House Committee on Ways and Means, 96th Cong., 1st Sess. 1 (1979) (statement of *Marshall J. Langer*).

12. The Income Tax Act 1961

13. See Section 91 of the Income Tax Act, 1961.

14. Agreement between the Republic of India and the Swiss Confederation for the Avoidance of Double Taxation with respect to taxes on Income, No.GSR 357(E), dated 21.4.1995, available at : http://www.allindiantaxes.com/swiss%20confederation%20.php (last visited on 13th February, 2011).

shall be provided by the Contracting States under confidentiality.

Effectiveness

The effectiveness of this treaty to provide fiscal and tax related information is however doubtful. Article 26 does not cover disclosure of information of illegal foreign bank accounts held by Indians due to interpretational and sovereignty issues.

They are as follows:

1. Definition and Interpretational Issue

This is a current problem which India faces with respect to an information exchange with Switzerland. Article 26 of the Tax Treaty with Switzerland does not cover tax evasion for the purpose of agreed sharing of data. In fact, tax evasion is not even a subject under the existing tax treaty[15].

In any case, it is interesting to note that tax evasion is not a crime in Switzerland. It is not viewed as a fraud. There is a distinction in Swiss Law between Steurbetrug, tax fraud and Stererhinterziehung, tax evasion[16]. The Swiss definition of fraud is restricted than the Indian Definition; "it encompasses only the falsification of documents intended for proving a fact of legal significance;"[17]. Wilful failure to file returns to obstruct proper tax collection which qualify tax evasion are not offences punishable by a penal Court in Switzerland[18].

Therefore, the existing Indo-Swiss DTAA disqualifies information sharing for tax evasion in India by the Swiss authorities.

2. Inadmissibility of such information

Even if the Swiss authorities do give such information to the Indian Tax Enforcement Officials, it would have limited utility as evidence in a Court of law. In a similar situation under the U.S. – Swiss Tax Treaty, the Swiss Supreme Court in the case of *X & Y-Bank v. The Swiss Federal Tax Administration*[19], expressly held that by giving away such information, Switzerland fulfils its treaty obligations by merely furnishing an official report as opposed to providing legal assistance in judicial proceedings. This renders the information inadmissible as evidence.

3. Presumption of legality

The Swiss assume that the money deposited in the Swiss Bank Accounts by the public is legitimate and legal due to the special nature of relationship between the State and the Individual[20]. On the contrary, the Indian side views that some of the private money that lies in the foreign bank accounts to be illegal as they have not been filed as returns. Income to which no reasonable explanation as to the source is offered will be taxed in India.

The Swiss argue that not all offshore account holders are criminals[21]. A legitimate reason to seek privacy is a desire to protect assets from an unstable Government's confiscation or from frivolous alleged

15. Id.

16. Meier, "Banking Secrecy in Swiss and International Taxation," 7 INT'L LAW 16, 17 (1973).

17. The Use of Offshore Tax Havens for the Purpose of Evading Income Taxes : Hearings Before the Sub-committee on Oversight of the House, Committee on Ways and Means, 96th Cong., 1st Sess. 1 (1979); In the case of *X v. Federal Tax Administration*, BG 96 I, 71-1 U.S. Tax Cas. (CCH) P9435 (1970), the Federal Supreme Court of Switzerland has confirmed that the Swiss definition of fraud is applicable to U.S.-Swiss Tax Convention which faces similar interpretational problem as that of Indo-Swiss Tax Convention.

18. Supra n. 8.

19. BG 101 I 160, 76-1 U.S. Tax. Cas. (CCH) P9452 (1975).

20. Supra n. 8.

21. Terence Corcoran, "Know Your Regulators!: Offshore Account Probe is Another Twisted Venture," Fin. Post : Editorial, Oct. 18, 2001, at 15, available at 2001 WL 28026420; R. Larkins, "Multinationals and Their Quest for the Good Tax Haven : Taxes are One, Albeit an Important, Consideration", 25 Int'l Law. 471, 478-79 (1991).

creditors[22]. Another legitimate reason to seek privacy may be to keep information from competitors or non-governmental organizations which feel that "too much profit is itself evidence of exploitation"[23]. Therefore, the presumption of legality subsists which stops the Swiss authorities from disclosing any information.

4. Issue of Sovereignty

If information exchange disclosing the details of account holders in Swiss Banks takes place, then the Swiss economy which relies on the lucrative private banking business would lose millions of dollars in lost customers. It is to be noted that Switzerland abstained from the OECD's 1998 Report because the OECD advocated abolishing bank secrecy[24]. Due to the value of these sectors to its economy, its cause for concern is legitimate[25].

In any case, it is well-established in International Law that a country has its sovereign right to regulate its own fiscal policies[26].

Similarly, Switzerland has a right to operate its own tax regimes and should not need to put its economy, which is primarily based on the offshore investment market, at risk to ensure that India maintain its tax base[27]. Furthermore, customary international law does not require one State to aid to another in connection with the first State's administrative or criminal investigation or proceedings and infringe its own sovereignty[28].

5. Issue of Privacy

Privacy in Switzerland is a statutorily enforceable right by virtue of Article 28 of the Civil Code and Articles 41 and 49 of the Code of Obligation. Switzerland believes that "the right to personal confidentiality is one of the keys to democracies" and it will seek to protect that right[29]. Therefore, Swiss Law assigns a higher priority to the sanctity of individual and his personal rights than does Indian Law[30]. This is why the Swiss Government views disclosure of bank account holders as a violation of its Municipal Law.

6. Equivalent to an extradition treaty

Swiss may also be reluctant to apply this information exchange agreement as practice shows such treaties have been traditionally viewed as extradition treaties which cover fiscal or tax violations[31].

V Workable Solutions in the Light of Recent Developments

The magnitude of the use of offshore tax havens for tax evasion purposes, coupled with the inability of the Indian Tax Department of deter such a use have made tax haven issue a controversial one. It is not just a problem of tax evasion, but also of

22. Id.
23. Tarquinio, J. Alex, "Squirrelling Your Money Abroad, Forbes.com," available at http://forbes.com/2000/01/08/feat.html (last visited on 13 February 2011).
24. Supra n.5.
25. See "New Lease on Life for the Swiss Banquier Prive, Int'l Money Mktg.," Aug. 6, 2001, at 21, available at 2001 WL 13947788 at 21 (describing Switzerland's private banking sector). Measured by assets, two of Switzerland's private banks are the largest in the world. Id. UBS is the largest bank with Credit Suisse coming in third. Id. The private banking sectors of these banks are highly profitable. Both UBS and Credit Suisse "earn more than half of their entire profits from their private banking arms." Id.
26. See Davidson, James Dale and Lord William Rees-Mogg, The Sovereign Individual : Mastering the Transition to the Information Age 24 (Touchstone Books 1999) (1997).
27. Supra n. 1
28. Supra n. 5
29. See Theresa Tedesco, "OSC Won't Lead Way in Offshore Crackdown : We Will Not Put Our Industry at a Disadvantage", Fin. Post, 19th Oct. 19, 2001 at 1, available at 2001 WL 28026552.
30. Article 19 of the Constitution of India protects individual privacy but is subject to reasonable restrictions.
31. Supra n. 10

use of such funds for organized crime and terrorist activities. This makes it difficult to arrive at a solution with the existence strict commercial secrecy laws.

However, it can be said that the problem is both informational and substantive. Lack of information of the Swiss bank accounts is a major problem for the tax enforcement authorities. This problem cannot be efficiently tackled by the information exchanges or mutual assistance treaties without change in the substantive laws of Swiss Confederation which allow utmost privacy and confidentiality to its banking transactions that do not allow even a legitimate enquiry by foreign tax official for a major violation of law.

Discussing this very issue, the United States Seventh Circuit Court of Appeals case of *United States v. First National Bank of Chicago*[32], held that though privacy interests are important, the interest in deterring criminal behaviour is equally important. The Court in First National indicated that tax evasion is a crime and the same standard should be applied to the discovery of information due to its criminal nature[33].

Recent Developments

The recent efforts of the Organization for Economic Co-operation and Development (OECD) to bring in transparency in banking laws have been noteworthy. It has put in peer pressure on the countries which practice such policies and has published a list of tax havens which included Switzerland[34], upon whom the G-20 countries were keen to impose economic sanctions on.

Reacting to the above, the Swiss Confederation has signed over 10 agreements willing to share tax evasion related information and is now out of the listed tax havens[35]. Switzerland has also agreed to share tax evasion data "on specific request by the Government of India[36]."

Yet there is reason to worry as implementation of the same may be time taking. United States experience shows that out of the 52,000 U.S. account holders information demanded, the Swiss Government disclosed only 12 of them[37]. As the account holders have a right to sue, there may be a pool of litigation before the actual information comes to light.

Furthermore, the treaties signed may not be ratified at all in the Swiss Confederation as it follows the system of referendum. The policy of disclosure of secret accounts may not go down well with the Swiss people whose priority is privacy and protection of individual rights.

Therefore, in the light of the above, it can be said that the threshold issue still is even though India has re-negotiated the existing Indo-Swiss Tax Treaty, the Swiss authorities will be able to put the agreement into effect only after it has been ratified by their Parliament-which is the ultimate catch.

Other Workable Solutions

1. United States President, *Barrack Obama's* proposal can be effective even for the Indian situation. According to his proposal, registration of financial intermediaries is a compulsion. Hedge funds of the wealthy citizens are to be

32. 699 F.2d 341 (7th Cir. 1983)
33. First Nat'l, 699 F.2d at 345.
34. Supra n. 5
35. Jucca Lisa, "Swiss eyes tax haven list as G-20 starts," available at : http://www.reuters.com/article/worldNews/idUSTRE58N1NR20090924, (last visited on 3rd February, 2011).
36. "India, Switzerland conclude talks to revise tax treaty", available at: http://economictimes.indiatimes.com/personal-finance/tax-savers/tax-news/India-Switzerland-conclude-talks-to-revise-tax-treaty/articleshow/6239322.cms.(last visited on 12th February 2011).
37. Id.

registered with the Social and Economic Council of the United Nations[38], which should actively deal with such global fiscal problems.

2. The brokerage system should be well documented. To facilitate information gathering, the investment brokers should be subject to 'know your client' rule. As the brokers are required to uphold the integrity of the capital markets by having sufficient knowledge of their client's affairs. This could eventually help in tracking down the beneficial owners of accounts[39].

3. Role of the United Nations : United Nations seeks to empower nations by offering training to tax administrators of transitional and developing economies[40]. This training includes "practical methods and strategies for combating tax evasion" and gives "tax administrators" the opportunity to discuss their own tax systems.

Though there is no direct solution, the above mentioned could go a long way to reduce the criminal tax evasion via tax havens.

Conclusion

As India is not quite familiar with the negotiating process, it should internally build a strong administrative support system which can detect cases of criminal tax evasion with proper documentation and record-keeping. Co-ordination among the State, Judiciary and the Income Tax Departments is essential to develop a functional tool to stop the problem. Externally, India can take help from the United Nations or the OECD to better present its problems and to arrive at an effective tax treaty to avoid the problem of tax evasion.

In conclusion, transparency and information sharing are to be viewed as an opportunity but not as a threat. Better liaison of the banks with global tax authorities would only make the system clear. Obviously, account holders seeking privacy may well be discouraged, but, equally, higher standards and regulation will attract legitimate investors and make them feel more comfortable. Therefore, Swiss authorities should be more open as transparency reinforces confidence. This does not mean that privacy should be done away with. But, balance of personal rights with that of criminal deterrence should be achieved.

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38. Supra n. 7.

39. Supra n. 29

40. Eighth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters : Report of the Secretary General, U.N. ESCOR, 1998 Sess., 8th mtg., Agenda Item 13(d), P 2-3, U.N. Doc. E/1998/100 (1998), available at http://www.un.org/documents/ecosoc/docs/1998/e1998-57.htm (last visited on 1st February, 2011).