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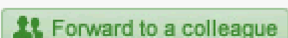

In this month's FS*taxworld*, we outline the circumstances by which payments made as part of the DoJ Program could be tax deductible business expenses under Swiss law.

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The View from Deloitte

Dear Reader,

On 29 August 2013, Switzerland and the U.S signed a joint statement with the aim to end the tax dispute between Swiss banks and the United States Department of Justice ("DoJ") and several other U.S. authorities. The so called "DoJ Program" that resulted from the joint statement had an unprecedented impact on the Swiss banking sector. Swiss banks faced demanding deadlines to assess whether they should join the program and, if they opted to, which of the available categories they should select:

- Category 1 is reserved for banks already under criminal investigation by the DoJ and thus was not an option for other banks;
- Category 2 is designated for banks that have reason to know that they have violated U.S. law in the past;

  o Banks in category 1 and 2 are expected to incur substantial financial sanctions for violating U.S. tax law;

o While the calculation of the sanctions for category 1 banks was not specified, banks that selected category 2 will pay 20-50 percent of the maximum assets under management from their undeclared U.S.-related accounts; and

- Categories 3 and 4 are only an option if a bank did not violate any U.S. tax law and thus anticipated no corresponding sanctions from the DoJ.

The DoJ Program required Swiss banks to conduct a thorough assessment of their U.S. exposure. The Swiss authorities generated additional stress by publicly warning banks in December 2013 to select category 2 if they had any doubts that a violation of any U.S. tax law might have occurred. As of early 2014, reportedly more than 100 Swiss banks had elected for category 2 treatments. Together with the 13 banks under criminal investigation, roughly 120 Swiss banks may have to pay substantial financial sanctions to the U.S. authorities. In anticipation of these payments, banks started to scale up their reserve provisions.

Naturally, questions emerged regarding the Swiss tax law treatment of such reserves set aside for the DoJ sanctions. In general, Swiss tax law allows entities to deduct expenses as long as they are commercially justified and business-related. However, tax fines ("Steuerbussen") are explicitly excluded from the treatment as deductible business expenses. In the absence of a ruling from the Swiss Federal Court on the proper treatment, it remains controversial whether the payments resulting from the DoJ program may be treated as tax fines or as business-related expenses. While the legal community in general tends to the latter view, debates in the media and among law-makers challenge the position that the Swiss taxpayer should suffer any costs for the alleged misbehavior of the banks.

On 9 July 2014, the Administrative Court of the Canton of Zurich ("Verwaltungsgericht des Kantons Zürich") rejected an appeal from the Zurich cantonal tax office regarding the deductibility of cartel fines, specifically the accumulation of reserve provisions in anticipation of a cartel fine imposed by the European Union. In denying the claim, the Court reasoned that, under the existing law, such a financial sanction may be considered a business-related expense as a whole. However, the ruling from the Court was not unanimous; A minority view in the chamber favored the tax office's argument. The tax office subsequently appealed against the ruling and thus in the near future the Swiss Federal Court will issue a final decision on this question.

In order to help dispel the uncertainty concerning reserves set aside for the DoJ sanctions, several legislators from the National Council ("Nationalrat") requested that the Swiss Federal Council ("Bundesrat") clarify its view of the legislative provisions regarding the deductibility of these payments. A report published on 12 September 2014 outlines the Swiss Federal Council's position with the following key observations regarding the DoJ sanctions:

- In general, fines themselves are not business-related expenses and therefore cannot be deducted from the assessment basis for taxable profit. The deductibility of such fines under tax law would reduce the punitive effect of the fines. The same applies to tax fines, provided they are imposed for punitive purposes.

- Profit disgorgement penalties, however, are tax-deductible because their purpose is not punitive. Rather, they constitute business-related expenses because these profits were taxed previously as corporate income.

- If an imposed sanction contains a punitive portion as well as a portion with respect to profit disgorgement, the burden to identify and substantiate which amounts relate

to which purposes falls on the taxpayer. Where no supporting evidence is available, the whole payment will be considered a fine by default and therefore not tax deductible.

- Furthermore, where an entity operates a subsidiary or a branch abroad, it needs to determine to which entity the profit disgorgement should be allocated and thus in which jurisdiction it would be tax deductible.

Although this report effectively clarified the Bundesrat's view on the distinctive treatments of punitive fines and disgorgements of profits, a third pillar of sanctions under the DoJ Program remained unaddressed: The restitution of the victim, specifically the tax that should have been paid to the IRS by U.S. persons with undeclared assets (i.e. "back taxes"). As this restitution represents the settlement of a U.S. tax liability not paid in the past, arguably it more closely resembles a business-related expense than a punitive fine.

It is expected that the DoJ payment demands will be issued in the aggregate without an itemized breakdown of the composition of such payments. Therefore, Swiss banks will need to disaggregate the discrete components of the payments in order to clarify independently the possible components of such a financial sanction for Swiss tax purposes.
To that end, a brief look at past settlements between Swiss banks and U.S. authorities for the sake of comparison is useful. With regards to financial sanctions imposed by U.S. authorities for servicing U.S. clients with undeclared assets by Swiss banks, publicly available information from three recent cases yields valuable insights into the calculation of sanctions in analogous scenarios:

- The published ruling regarding Bank Wegelin & Co. (Wegelin) in 2013 clearly splits the payment into three broad categories. First, there is a punitive part for the "willful conspiracy to defraud the IRS and to evade taxes". The second part of the total payment is considered restitution to the victim of the illegal conduct, the IRS. The amount approximately represents the total of unpaid taxes as of the date of sentencing. The third part represents the gross fees earned by Wegelin as a result of its illegal conduct. In sum, the back taxes and the repayment of the gross fees account each for roughly 25 percent of the total sanction paid by Wegelin, while the other half represents the punitive part.

- In 2008, the U.S. imposed a financial sanction on UBS in relation to U.S. tax evasion. It was calculated in a similar manner as for Wegelin. A notable exception in that, in part due to the disruptions caused by the financial crisis, the U.S. authorities explicitly refrained from imposing a punitive fine. In other words, the UBS payment was calculated by adding the restitution of unpaid taxes to the IRS and the disgorgement of the gross fees generated by the U.S. cross-border business with U.S. clients with undeclared assets within a given period. Both components account for roughly 50 percent of the total payment.

- The most recent financial sanction imposed on a Swiss bank concerned Credit Suisse. As far as the publicly available information suggests, the amount was not itemized by source or purpose. With further U.S. financial sanctions to come, it must be expected that all payments that result from the DoJ program will be sentenced in the same manner, i.e. without being broken down into the three major parts punitive fine, back taxes, and disgorgement of gross fees earned from servicing U.S. clients that owned undeclared assets.

Deloitte has developed a tool by means of which banks can calculate the amount of foregone U.S. taxes. Regarding the possible deductibility of a DoJ sanction, such a calculation is vital because if the bank does not provide a substantive elaboration regarding the breakdown of the components of the payment, the full amount will be considered a punitive fine and thus, no deduction will be granted. Inputting data provided by the bank, the Deloitte "Back Taxes

Engine" can help to calculate the approximate annual tax liability of each U.S. account. The calculation model was developed in collaboration with Deloitte's U.S. tax experts and considers capital gains from security transactions as well as interest and dividend income, applying the dedicated tax rates for each category by further incorporating specialties of U.S. tax law such as the possibility to carry forward losses. The Deloitte "Back Taxes Engine" can help determine the U.S. taxes that should have been paid by U.S. clients with undisclosed assets. In line with the report of the Swiss Federal Council, this amount would be tax deductible because it can be considered a business-related expense. Furthermore, we can assist banks in verifying their calculations regarding their gross fees from U.S. clients with undeclared assets in the relevant time period and provide support for negotiations with the tax authorities.

Regards,

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Report from the FATCA Frontlines – Alternative IGA Certifications for NFFEs

As entity account holders submit Forms W-8BEN-E, Forms W-8IMY or other valid self-certification forms to the financial institutions where they maintain accounts, as part of either new account on-boarding or pre-existing account due diligence, an absence of full awareness around NFFE compliance paths continues to pose challenges.

As a preliminary matter, many FATCA entities and even certain financial institutions fail to grasp a subtlety of FATCA compliance paths: The location of the account holder entity determines its FFI or NFFE classification as well as its FFI compliance path options, but the location of the account (i.e. the jurisdiction of the financial institution maintaining the relevant financial account) determines the NFFE compliance path of the entity account holder.

For example, a BVI-incorporated company with an account with a Swiss bank is an FFI or NFFE based on the terms of the BVI IGA and accompanying guidance notes, but, if the BVI company qualifies as an NFFE, its NFFE compliance path depends on the specific possibilities set forth in Annex I of the Swiss IGA.

One particularly rude potential consequence of this system infects an entity account holder with financial accounts in multiple jurisdictions with the risk of different compliance paths for the same entity. Fortunately, significant overlap between the types of compliance paths and eligibility criteria set forth in Annexes I of the IGAs and in the Treasury Regulations mitigates the risk. Other problems, however, persist.

Foremost, is a problem of basic labelling of NFFE compliance paths. Under the Treasury Regulations, all NFFE that do not qualify as passive NFFEs are categorized as Excepted NFFEs and the typical compliance path for an active operating business, Active NFFE, along with other options (e.g. non-profit entities, entities in bankruptcy, etc.), are sub-categories

of the Excepted NFFE category. Under the IGAs, however, all NFFEs that do not qualify as passive NFFEs are categorized as Active NFFEs and the compliance path options (e.g. non-profit entities, entities in bankruptcy, etc.) are sub-categories of the Active NFFE category. The various W8 instructions remedy this nomenclature gap by instructing Form preparers to select the Excepted NFFE compliance path on the Form that most closely resembles the one in the IGA, even if the sub-category name is not precisely correct.

Like a Russian Matryoshka Doll, however, the solution to one problem reveals another. Where an analogous sub-category is selected, the NFFE must complete the corresponding certification on the Form. In certain circumstances, the certification parts set forth the eligibility criteria present in the Treasury Regulations, but absent in Annex I of the relevant IGA or vice versa. Rather than compel certifications under penalties of perjury to something not technically accurate, the various W8 instructions permit, in such circumstances, the use of alternative IGA certifications, While numerous questions surround the practice and availability of such alternative IGA certifications, so far it appear to provide the best available resolution to the NFFE false certification quandary.

Brandi Caruso
Paul Millen
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Deloitte GIIN Validation Tool

With a range of different options available for FFIs to validate Global Intermediary Identification Numbers ("GIINs") of clients and counterparties, Deloitte is preparing a fully automated software solution to improve upon the manual, decentralized process (e.g. typing GIINs and entity names on the IRS portal) currently in use by many Financial Institutions. Deloitte's GIIN Validation Tool will be a Deloitte-managed service via a secure Swiss cloud and allow each Financial Institution to set a certain confidence level in order to avoid false positives.

Example solution features that will significantly expedite the GIIN validation process include:

- Archive function with respect to superseded IRS FFI lists;
- Statistical information (e.g. additions, deletions, EAG information, country distribution, etc.);
- Search and upload functionality for client FFI list (i.e. xls, xml, csv, etc.);
- Automated comparison of the client FFI list with the official IRS FFI list (including branches that cannot be identified by name but only through the main office entry as the branch entry in the IRS FFI list is only "branch");
- Insightful presentation of results from "perfect match" to "no match at all" considering possible abbreviations, language differences or transposed characters; and
- Printing or exporting of results.

For further information on the Deloitte GIIN Validation Tool or a live demonstration, please contact James Frei.

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