Examination

Making Sense of the Model 2 FATCA Agreement Between Switzerland and the United States and What's on the Horizon

By Michael DeBlis

As you may have heard by now, Switzerland is in the process of negotiating a Model 1 FATCA agreement with the United States. With the new agreement, U.S. accountholder information would be exchanged automatically with the U.S. government on a reciprocal basis.[1] At present, Switzerland and the United States have a Model 2 IGA Agreement, which was approved by the Swiss Parliament on September 27, 2013.[2]

For those who may be wondering, the FATCA agreement between Switzerland and the United States allows for such a change.[3] In fact, according to the Swiss government's Federal Department of Finance (FDF), "Questions and Answers" on the automatic exchange of information, negotiations on a Model 1 Agreement are already under way.[4]

When will the transition from Model 2 to Model 1 officially occur? If we use our imaginations and enter the land of "Make Believe," Model 1 might be the modern-day equivalent of the King sitting on his throne inside a castle with the inscription "King of FATCA" emblazoned on the gold trim of his crown. For those who find this comparison to be too tenuous, keep in mind that Model 1 is considered to be the gold-plate standard for information-sharing between governments. Indulging in this fiction, the date of the first exchange of data would be analogous to the infamous bugle call announcing the arrival of the King.

Returning to reality, if the Swiss Parliament approves the Federal Council's proposed automatic exchange of information agreement, Swiss financial institutions could begin collecting U.S. accountholder information as early as 2017, with the first exchange of information occurring in 2018.[5]

To many people, the terms "Model 1" and "Model 2" are as confusing as the maze—with all of its obstacles and dangers—that Harry Potter had to navigate in order to become the champion of the Triwizard Tournament in HARRY POTTER AND THE GOBLET OF FIRE. In fact, it has been snidely referred to as, "a riddle wrapped in a mystery inside an enigma" by more than just a few taxpayers. Unfortunately, we tax practitioners have not done enough to clear up the murky waters.

MICHAEL DEBLIS, Esq., is an Attorney with DeBlis and DeBlis in Bloomfield, New Jersey.

Very simply, we have fallen woefully short in deconstructing these "riddles" so that they can be easily understood by the "average Joe." For example, many articles covering Model 1 and Model 2 delve right into a high-level discussion of the mechanics of each, never bothering to lay any foundation. With vague and ambiguous terms that would tie the leaders of the eight leading industrialized countries into knots, it is no wonder why readers have thrown up their hands, looked up at the sky and shaken their heads in despair.

And this brings the IRS one step closer to uncovering the buried treasure: the accountholder's identity.

The purpose of this column is to lay the groundwork for understanding Model 1 and Model 2. After reading this column, tax practitioners and taxpayers alike will have a better understanding of why they exist and what impact Switzerland's transition to Model 1 will have on U.S. taxpayers with unreported Swiss bank accounts.

Let's begin with some basic concepts that are at the heart of Model 1 and Model 2. To ease our way into this, whenever the acronyms "FATCA," "Model 1" or "IGA" are mentioned, you can assume that the discussion relates to U.S. persons who hold offshore accounts at participating Foreign Financial Institutions (FFIs). For reasons that will soon become clear, the U.S. government wants the names and accountholder information of all pre-existing U.S. accounts held by these banks.

While the IRS's voluntary disclosure program has proven to be very successful, the United States recognizes that there are still a disproportionate number of U.S. citizens and residents that remain in the shadows and have yet to come forward to report their offshore accounts. As a result, the United States has put the full court press on Swiss financial institutions to do its dirty work for it: namely, identify accounts held by U.S. clients and report information pertaining to these accounts to the U.S. government.

An inherent tension lies at the heart of this. Even if a foreign bank was so inclined to assist the U.S. government in its hunt for U.S. accountholders with "hidden" offshore accounts—and make no mistake about it, very few are—without a Model 1 or Model 2 agreement, doing so might just as well amount to treason. Why? Swiss law jealously guards the anonymity of Swiss banking clients, to the point that reporting a client's account to a foreign government could result in a prison sentence as stiff as the one handed down by Judge James Wilkerson to Al Capone after he was convicted of tax evasion.[6]

To spare you the details of Swiss banking law, I've reduced it to its bare bones and given you the READER'S DIGEST version: Swiss law prohibits Swiss financial institutions from reporting bank information to the United States. The section of the Swiss Criminal Code that is feared as much by Swiss bankers as "He Who Must Not Be Named"[7] is by "Muggles" in the wizarding world of Harry Potter, is Article 271 (1). Article 271 (1) explicitly states that, "[a]ny person who carries out activities on behalf of a foreign state without lawful authority …" commits a crime.

In the run-up to the Swiss-U.S. Model 2 IGA, critics of U.S. foreign policy accused the United States of attempting to force Swiss financial institutions into breaking Swiss law by demanding the exchange of U.S. accountholder information. This put Swiss financial institutions in the untenable position of having to choose between two extremes: acquiescing to the U.S. government's demands in order to appease the U.S. government and avoid the threat of onerous financial penalties or thumbing its nose in the face of FATCA.[8] Any bank that was courageous enough to choose the former not only was branded a "Maverick" by the Swiss media, but was also in violation of Swiss Criminal Code, making it only a matter of time before they experienced the wrath of the Swiss criminal justice system.[9]

Enter the Model 2 Agreement. Under the Model 2 Agreement, the Swiss government authorizes Swiss financial institutions to report U.S. account information directly to the IRS without the threat of prosecution.[10] Thus, these institutions are guaranteed immunity from prosecution at the hands of the Swiss government.[11]

Before delving into the mechanics of Model 2, I wouldn't be forthcoming if I didn't provide the following disclaimer: these procedures are not only technical in nature, but they contain unique terms and phrases that must be fully understood in order to understand Model 2.

In general, the Swiss-U.S. Model 2 IGA provides for direct reporting of specific accountholder information by FFIs to the IRS, subject to one very important condition: the consent of the U.S. accountholder.[12] The operative phrase here is "accountholder consent." Information can be transferred directly from the financial institution to the IRS only if the client has *consented* to the transfer.[13]

What information must the FFI report? Any existing accounts identified as "U.S. Accounts," along with the U.S. taxpayer identification number (TIN), name, address and date of birth of the respective accountholder.[14] This standard applies to both natural persons and legal entities.[15]

Putting it mildly, because U.S. persons might have inadvertently "forgotten" to report such accounts to the U.S. government, it should come as no surprise that many taxpayers are not willing to consent. Indeed, to say that this information is potentially incriminating would be like saying that "Moaning Myrtle," the ghost who haunts the girls' bathroom at Hogwarts, is a little emotional.

One metaphor that I like to use to describe how risky consenting is likens it to an old-fashioned western duel where one cowboy—let's refer to him as the "taxpayer"—gives the other cowboy—let's refer to him as the dreaded "IRS Revenue Agent"—all of the bullets and ammunition from his gun. And what is the revenue agent likely to do with this now-loaded pistol? Exactly what you might expect. Point it at the poor, defenseless taxpayer while squeezing the trigger. In a very real sense, it's the "knockout punch" that the government needs to successfully prosecute a taxpayer who has willfully failed to disclose an offshore account.

This begs the question: "What happens in the all too common scenario where the accountholder withholds consent?" Can the foreign financial institution still release the accountholder's information to the IRS? No.[16] Why not? Doing so would violate Swiss banking secrecy rules, which are still in effect.[17] Does that mean that it all ends there? Of course not. If that were the case, then every U.S. taxpayer would refuse consent. Recognizing that there will always be accountholders who refuse consent, Model 2 IGA contains a built-in procedure for dealing with what FATCA refers to, in not so flattering terms as, "recalcitrant accountholders."[18]

Although an FFI is forbidden from disclosing the identity of any "recalcitrant accountholder" to the IRS, that does not mean that the FFI is prohibited from providing general information about the account itself. For example, an FFI must still provide the IRS with "nameless aggregates" and the number of accounts belonging to "recalcitrant accountholders."[19]

And this brings the IRS one step closer to uncovering the buried treasure: the accountholder's identity. Based on the aggregate information reported by an FFI, the IRS can subsequently make a "group request" for further information.[20] What is a group request? It is nothing short of a "demand for *complete* information on all recalcitrant accountholders."[21] Upon receipt of such a demand, an FFI must "report this information to its respective government for exchange with the IRS."[22] The foreign government "has six months to provide the requested information, in the same format as it would have been reported if the FFI had reported directly to the IRS."[23]

If the response is delayed, "the FFI must treat the relevant accounts as recalcitrant and withhold, beginning on the date of the six-month deadline and ending on the date that the information is exchanged with the IRS."[24] To the extent that the "foreign government cooperates timely with the IRS information request," the FFI has no obligation "to withhold tax on or close a recalcitrant account."[25]

Can an FFI *automatically* make an aggregate disclosure to the IRS? No, however the only thing standing in its way is little more than a technicality. Before doing so, an FFI must notify all recalcitrant accountholders of what will happen if they don't consent.[26] As you can imagine, this has the potential to stop such accountholders dead in their tracks and reconsider their position altogether. While this notice requirement might sound similar to a U.S. citizen's right to procedural due process under the Fifth and Fourteenth Amendments of the U.S. Constitution, do not be lulled into a false sense of security.

Recall that the minimal procedural protections that a U.S. citizen is entitled to when the government threatens to deprive him of life, liberty or a property interest is notice of the allegations and an opportunity to respond. The opportunity to respond usually takes the form of a hearing by an impartial decision-maker. Model 2 IGA falls woefully short of this standard. Unlike the opportunity for a hearing by a neutral decision-maker, Model 2 IGA requires nothing more than a letter describing the parade of horribles that an accountholder can expect to face if he or she does not consent.

This information is typically contained in a "declaration of consent" letter which, at the very minimum, must include the following:

- That "information with respect to such accounts will be reported to the IRS on an aggregate basis"[27]
- That the IRS may "subsequently request specific information about the accounts, which the FFI must then report to its respective government for exchange with the IRS"[28]

Below is an excerpt from a declaration of consent letter:

> Please note that under FATCA, any U.S. Person who does not consent to his/her identity being reported will be identified as recalcitrant. Swiss Banks must close the accounts of recalcitrant account holders, resulting in them showing up on the leaver list of the Program. This disclosure will be made on a no-name basis. However, the identity of the beneficial owner(s) can be pursued through a U.S. treaty request for further information.

At the end of the day, a group request provides the IRS with the same information "that the financial institution would have reported had it originally received the accountholder's consent."[29] The only difference is that it takes two steps—the reporting of accounts on an aggregate basis followed by an IRS group request—instead of just one (*i.e.,* obtaining the accountholder's consent). As a result, it takes longer to obtain the information when the accountholder withholds consent.[30]

By now, you are probably asking yourself the question, "What do Swiss financial institutions stand to gain by entering into a Model 2 agreement with the IRS?" In other words, what's in it for them? Three things:

1. First, the United States eliminates the prohibitively high "30% withholding tax on all payments made to Swiss financial institutions that have entered into an FFI agreement with the IRS."[31]
2. Second, the United States "excludes retirement plans from the withholding and due diligence requirements by treating them as deemed-compliant or exempt entities."[32]
3. Third, "Swiss financial institutions are neither required to close bank accounts of recalcitrant accountholders or deduct a withholding tax on payments to recalcitrant accountholders."[33]

What about the Swiss government? Under Model 2, is it entitled to reciprocal exchange of information from the U.S. government on Swiss taxpayers with bank accounts in the United States? No,[34] but for a reason that you might least expect. Insisting on reciprocal exchange of information would have undermined Switzerland's credibility because it "stood in perfect contradiction to [Switzerland's] official stance on *automatic information exchange*," which it strenuously opposed at the time Model 2 was approved.[35]

Now that you have a firm grounding in Model 2, you will have a deeper appreciation for Switzerland's historic announcement that it will be transitioning to Model 1.

What is a Model 1 IGA? Under a Model 1 IGA, a foreign financial institution must report information directly to its respective government.[36] The government, in turn, automatically exchanges this information with the tax authority in the relevant partner country once per year "pursuant to an income tax treaty or exchange of information agreement."[37] When it comes to the United States, the relevant tax authority is none other than the IRS.

What happens with the data once it gets into the grubby little fingers of the IRS? According to the Swiss Government's FDF-issued "Questions and Answers on the automatic exchange of information," it is used solely for the "agreed" purpose.[38] And what is that purpose? To establish a correct tax assessment.[39] The means for obtaining such an assessment—*i.e.,* whether it will be a spot check or verification, on the one hand or an extensive examination as probing as a rectal examination on the other—are unknown.[40]

What are the major differences between a Model 1 IGA and a Model 2 IGA? First, under Model 1, a foreign government "serves as an intermediary to the supply of information from FFIs to the United States."[41] Under Model 2, foreign financial institutions report *directly* to the IRS. The only time that a Model 2 involves a foreign government *directly* is when the IRS makes a group information request, in response to one or more U.S. accountholders refusing consent.[42] Only then must the foreign government provide specific U.S. accountholder information *directly* to the IRS.

This leads to an important point. One of the reasons why Model 1 IGAs are disfavored is because they place a greater administrative burden on the foreign government.

The second difference is the requirement under Model 2 IGA that FFIs first obtain the consent of U.S. accountholders *before* reporting their account information to the IRS.[43] Indeed, nothing short of a U.S. accountholder's unbridled consent is required before an FFI can report that information to the IRS. On the contrary, accountholder consent is not required under Model 1 IGA because accountholder information is being exchanged *automatically* between the tax authorities of two countries.

Finally, part and parcel of point one, Model 1 IGA contemplates a "direct" and "automatic" exchange of information between taxing authorities.[44] A simple way of looking at automatic exchange is that it refers to information that is put in a box, wrapped in a bow and delivered to the doorstep of the IRS, complements of the Swiss taxing authority. Model 2, on the other hand, contemplates an *indirect* exchange of information that achieves the same result as Model 1, but requires two steps instead of one. In that sense, a Model 2 IGA does *indirectly* what an automatic exchange under a Model 1 IGA does *directly*.[45]

Nary a day goes by that I don't get an email from a concerned client wanting to know if it is possible to challenge a FATCA group request in Swiss court. The drafters anticipated that the group request provision would be "tested" as soon as the first wave of accountholders became herded up like cattle in an IRS group request.[46]

Certainly there are arguments, one of which centers on the scope of the term, "group." Under the Swiss Tax Administrative Assistance Act, passed by Swiss Parliament in 2012, the definition of "group" is much "narrower than the definition of group under the FATCA regulation."[47] Thus, a compelling argument can be made that group requests should be barred under the Tax Administrative Act.[48]

But for those who see this as a loophole that can be exploited by a clever tax attorney, don't get too excited. The probability that Swiss courts will rule in favor of U.S. taxpayers is slim to remote. Why? Because of what is explicitly stated in the Swiss-U.S. Model 2 Agreement—namely, that "a group request based on aggregate reports is admissible."[49]

And lest you think that the Swiss-U.S. Model 2 Agreement is not binding on Swiss courts, you would be mistaken. On the contrary, the Swiss Parliament's approval of the Model 2 Agreement establishes a legal foundation for FATCA group requests that is *binding* on Swiss courts.[50]

But even for those who are eternally optimistic and live their lives pursuant to the proverb, "Hope Springs Eternal," looming out in the distance is the other shoe that is waiting to drop. And that shoe is what is expected to be the Swiss Parliament's approval of the Model 1 Agreement with the United States in 2015.

And when that happens, raising any challenge to the release of accountholder information on the grounds of a narrow interpretation of a single word becomes utterly useless. Why? Because a group request is not needed under a Model 1Agreement to obtain a U.S. accountholder's complete information. Instead, this information is automatically released in an exchange of information between the Swiss taxing authority and the IRS.

For this reason, taxpayers can learn a valuable lesson from Harry Potter and Ron Weasley. And that lesson is this: Don't miss the first sound of the Swiss Model 1 train approaching the FATCA station! If you do, you might find yourself in as dire a predicament as Harry and Ron after missing the Hogwarts Express in Harry Potter and the Chamber of Secrets: lost in the Forbidden Forest while stuck inside a flying car and being pounded by a "Whomping Willow." Of course, as unpleasant as that encounter might be, it still pales in comparison to the one that awaits taxpayers whose accounts have become the subject of a group information request by Uncle Sam.

ENDNOTES

1 Questions and answers on the automatic exchange of information, Swiss Federal Department of Finance (FDF), available online at *www.news.admin.ch/NSBSubscriber/message/attachments/36827.pdf*, at 1 (last visited on November 4, 2014).

2 Intergovernmental agreement (IGA) monitor, Price Waterhouse Coopers, available online at *www.pwc.com/us/en/financial-services/publications/fatca-publications/intergovernmental-agreements-monitor.jhtml* (last visited on November 4, 2014).

3 *Supra* note 1, at 1.

4 *Id.*, at 2.

5 *Id.*

6 Wikipedia, Al Capone, *http://en.wikipedia.org/wiki/Al_Capone* (last visited on November 4, 2014).

7 A reference to "Lord Voldemort," who was dedicated to rid the wizarding world of "Muggles" and to establish himself as its supreme ruler, from J.K. Rowling's Harry Potter series.

8 Swiss Banks' Tradition of Secrecy Clashes With Quests Abroad for Disclosure, NY Times, July 8, 2014, available online at *www.nytimes.com/2014/07/09/world/europe/swiss-banks-tradition-of-secrecy-clashes-with-quests-abroad-for-disclosure.html?ref=business&_r=0* (last visited on November 4, 2014).

9 *Id.*

10 William Byrnes and Robert Munro, *FATCA and Switzerland: Model II, LexisNexis Guide to FATCA Compliance*, Ch. 19, May 2013, available online at *www.lexisnexis.com/legalnewsroom/tax-law/b/fatcacentral/archive/2013/02/15/fatca-and-switzerland-model-ii.aspx* (last visited on November 4, 2014).

11 *Id.*

12 The FATCA Model 2 Intergovernmental Agreement, International Tax Advisory, Alston & Bird LLP, Dec. 15, 2012, available online at *www.alston.com/files/publication/eb4b2a00-c3a5-469c-92f7-0fd5a3bf5e89/presentation/publicationattachment/0ebf9793-24e9-46c6-a551-1016be8efd7e/int%20tax%20adv%2012-12.pdf,* at 1 (last visited on November 4, 2014).

13 *Supra* note 10.

14 *Supra* note 1, at 1.

15 *Id.*

16 *Supra* note 10.

17 *Id.*

18 *Id.*

19 *Id.*

20 *Id.*

21 *Id.*

22 *Supra* note 12, at 1.

23 *Supra* note 12, at 2.

24 *Id.*

25 *Id.*

26 *Id.*, at 1.

27 *Id.*, at 1.

28 *Id.*, at 1.

29 *Supra* note 10.

30 *Id.*

31 *Id.*

32 *Id.*

33 *Id.*

34 *Id.*

35 *Id.*

36 *Supra* note 12, at 1.

37 *Id.*

38 *Supra* note 1, at 1.

39 *Id.*

40 *Id.*

41 *Supra* note 12, at 2.

42 *Id.*

43 *Id.*

44 *Supra* note 10.

45 *Id.*

46 *Id.*

47 *Id.*

48 *Id.*

49 *Id.*

50 *Id.*

