TAX MANAGEMENT
INTERNATIONAL
JOURNAL

a monthly professional review of current international tax issues

Reproduced with permission from Tax Management International Journal, Vol. 37, No. 8, 8/8/2008. Copyright © 2008 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Practice Exposures for the International Tax Professional in the 21st Century

by Carlos Albiñana, Esq., Jean-Blaise Eckert, Esq., Heather Gething, Esq., Ignacio Lacasa, Esq., André G.M. Nagelmaker, Esq., Christopher S. Rizek, Esq., and Stanley C. Ruchelman, Esq.[*]

TABLE OF CONTENTS

INTRODUCTION

PROFESSIONAL SECRECY, TIPPING OBLIGATIONS, AND ADVISOR'S LIABILITY FOR CLIENTS' ACTIVITIES

THE OECD STUDY INTO THE ROLE OF TAX INTERMEDIARIES

THE SWISS CODE OF CONDUCT FOR TAX
AUTHORITIES, TAXPAYERS AND TAX ADVISORS

THE MALPRACTICE ENVIRONMENT FOR TAX LAWYERS IN THE UNITED STATES

THE PROFESSIONAL MALPRACTICE ENVIRONMENT IN EUROPE, IN PARTICULAR IN SWITZERLAND

RECENT DEVELOPMENTS IN ANTI-MONEY-LAUNDERING RULES IN EUROPE

A VIEW FROM THE UNITED STATES

INTRODUCTION

by Carlos Albiñana, Esq.
Allen & Overy L.L.P
Madrid, Spain

International tax practitioners currently face new challenges when dealing with clients, competitors, financial regulators, and, in particular, tax authorities. These challenges occur both at a domestic level in each country and at the international level as part of the ''world of globalization.'' The tax practitioner faces constantly changing rules of practice in connection

[*] This article had its genesis in a presentation at the 8th Annual Tax Planning Strategies — U.S. and Europe Conference, held in Madrid, Spain, on April 3-4, 2008, and sponsored principally by the American Bar Association Section of Taxation, the International Bar Association Taxes Committee, and the Spanish Branch of the International Fiscal Association. A version will be included in Practicing Law Institute's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2008.

TAX MANAGEMENT INC.

with: (1) information reporting obligations; (2) anti-money-laundering campaigns; (3) omissions and errors litigation initiated by clients; (4) conflict of interest rules; (5) intermediaries' obligations under reports issued by the OECD; and (6) potential joint liability resulting from the non-compliance in tax matters by a client. Some of these challenges are common to other practice areas of the law, but in some cases they are specific to the tax practice.

Tax practitioners should base their practice on the fundamental pillars of independence, freedom, ethical conduct, and professional secrecy arising from privileged communication. No doubt that all these principles should be followed within the legal framework existing in a given jurisdiction and in the applicable international code of conduct or rules. However, these pillars are under attack by various levels of regulatory boards, and, as a result, standards of best practice are being imposed on the profession. These standards recommend refusal of representation for suspicious clients as defined by the regulators and the requirement to act as a collaborator to regulatory bodies and tax authorities.

An area of concern that is increasingly relevant for the tax advisor is money laundering. Regulatory bodies establishing best practice rules now require tax advisors to know their clients in much the same way as institutions in the financial services sector were encouraged as part of anti-money laundering measures. This entails following other principles such as transparency, traceability, and awareness in respect of the client, its transactions, and the transaction documentation.

Today, national tax authorities communicate regularly with a view of identifying cross-border tax plans being sold to major clients and implementing the conclusions and recommendations of the OECD Study into the Role of Tax Intermediaries. Tax advisors are seen as key elements in the relationship between national tax authorities and taxpayers.

Finally, a challenge to be faced, particularly in the United States, is the ever-widening scope of malpractice claims against tax advisors as part of the fallout of the tax shelter wars between the IRS and taxpayers. Today, clients — at least in the United States — are no longer reluctant to initiate claims against advisors in connection with tax shelter arrangements that were willingly sought after by the very same clients in order to reduce taxes on capital gains. Situations like errors, omissions, wrong advice, poor intake procedures, inadequate scope of representation, and, more specifically to tax matters, conflicts give rise to malpractice claims against tax lawyers.

This article will address all these risk exposure areas. It does so at times with a ''wide angle lens'' in order to alert the tax bar of exposure areas not typically of concern when a new client expresses interest in retaining a law firm in connection with a tax planning assignment.

PROFESSIONAL SECRECY, TIPPING OBLIGATIONS, AND ADVISOR'S LIABILITY FOR CLIENTS' ACTIVITIES

by Ignacio Lacasa, Esq.
Bufete Barrilero y Asociados
Barcelona, Spain

Introduction

A few weeks ago, while talking to a lawyer friend whose practice is based in Barcelona, for a moment I had the sneaking sensation that we were witnessing the end of our existence as professional tax advisors and that I had somehow failed to notice it. My colleague was telling me that the tax advisor's days were numbered and that he himself was busy ''packing his bags'' in order to ''emigrate'' to new professional fields with a more promising and profitable future.

His reasons were patently clear: the tax legislator had caught up to the advisor by passing laws against every creative alternative designed by tax advisors. In its zeal to maximize revenues, the Administration had imposed a series of obligations upon advisors forcing them to inform the government about their clients and leaving very little room for professional secrecy.

The essential function of the tax advisor — that of tax planning under more favorable conditions — had gone up in smoke. The tax inspector barely even had to work any more (labor strikes notwithstanding) and technological advances had brought the Administration and the taxpayer so much closer that the taxpayer no longer had use for an advisor — he could fulfill his fiscal obligations with the mere push of a button.

My colleague has moved to the fields of consulting with regard to management issues and the design of financial instruments. He's become an entrepreneur and (I hope) a future client. I've stayed put, but now have stronger convictions because I, unlike my ex-colleague, believe that the tax advisor's profession, in as far as the advisor's role in collaborating with the justice system, is just now, in the year 2008, about to reach its climax. It is entirely up to us to help shape and implement a new tax culture in our global community by rigorously and fearlessly taking on the challenges that we are now facing not only with respect to the fight against the scourges of the day — terrorism and organized crime — but also with regard to the obligations imposed upon us in order to fight against these blights.

However, we must take on these challenges without ceasing to defend our fundamental duties to up-

ISSN 0090-4600

hold the principles of independence, freedom, ethical conduct, and professional secrecy. These days, the tax advisor's role in collaborating with the justice system acquires a new dimension to the extent that society is demanding that we take relevant and vigorous action to defend our client's private interests and, at the same time, to protect the overriding common interest. In the 21st century, the triumph of a new tax culture that will once and for all do away with the notion that one Spanish author referred to as ''the tax on the idiots'' — that is to say, the notion that clever people have the means to avoid paying taxes — will depend on how each and every one of us, individually as well as collectively through our national and international organizations, manages to proceed.

This new tax culture must banish the warlike perspective that focuses exclusively on the confrontation between the tax advisor and public authorities, depicting the two as irreconcilable enemies. It must define a new collaborative framework in which the tax advisor becomes an active collaborator in the pursuit of general interest by:

- Having a thorough knowledge of regulations;
- Making better choices among different options;
- Explaining advantages and disadvantages objectively;
- Studying each approach in-depth;
- Always guaranteeing the client's legal security;
- Ensuring regulations are correctly implemented;
- Balancing discrepancies;
- Defending taxpayers at all times;
- Opposing arbitrariness; and
- Effectively collaborating in the fair resolution of review procedures with regard to measures that may have an impact on taxation.

It is clear that our profession and our role is not lacking in relevance. My initial worry over that conversation with my friend slowly turned into a calm satisfaction and even into gratitude: I kept a friend, won over a potential new client, had one less tax advisor to compete against, and was reflecting upon my professional career, rediscovering my vocation, and identified my introduction for this section of the article.

The aims of this section of the article are three-fold:

- Analyze the duty of professional secrecy in the face of new reporting obligations currently proliferating in different States.
- Analyze the various reporting obligations.
- Analyze legislative proposals that hold the tax advisor jointly liable along with his client in case of a tax fraud.

Professional Secrecy

Introduction

Professional secrecy, alongside independence and ethical conduct, is one of the pillars that determine and define the relationship between a tax advisor and his clients, guaranteeing their freedom and legal security. Upon these pillars rests the professional code of ethics that we, as professionals, must inevitably implement in our relationships with our clients and consequently defend whenever public authorities, whether justifiably or not, attempt to intervene in order to limit them.

Independence and ethics are hard to regulate, but professional secrecy is being submitted to regulatory and jurisprudential interpretations to which we, as a professional class, must offer a firm response. We are fully aware of the distinct approaches to professional secrecy that exist in the Anglo-Saxon Common Law and the Continental Civil Law legal traditions. Under Continental Law, which is the law under which European attorneys normally operate, professional secrecy constitutes an essential part of the justice system.

Regulation

Through legislation or codes of ethics that regulate the financial sector and various professions, professional secrecy is currently being regulated through legislation against money laundering. Money laundering has been a cause of serious international concern that, on a European level, has resulted in the proliferation of several Directives meant to suppress this activity.

Directives are regulatory acts that are compulsory for all Member States of the European Union as far as the intended purposes, but allow each State to choose the way and the means to realize those purposes. The Directive that most directly influences the professional secrecy of tax advisors (2005/60/CE) came into force on December 15, 2005, and required Member States to adopt conforming legislation before December 15, 2007. This Directive specifically contemplates three grounds under which an attorney must necessarily suspend the obligation of professional secrecy with respect to his client and report to the Financial Intelligence Unit (FIU):

- The legal counselor is taking part in money laundering or terrorist financing;
- Legal advice is provided for money laundering or terrorist financing purposes; or
- The lawyer knows that the client is seeking legal advice for money laundering or terrorist financing purposes.

ISSN 0090-4600

European States have incorporated in their respective national legislations certain cases in which an attorney is obliged to inform the relevant authorities of certain activities including those of his clients that could directly or indirectly involve money laundering activity. On the surface, this seems contrary to European laws that impose upon attorneys:

- The obligation to safeguard secrecy with respect to all facts or information, of any sort (and this includes tax advice), to which he has access by virtue of his professional activity;
- The prohibition against testifying on facts or information that he has come to know by virtue of his professional activity; and
- The punishment for disclosing professional secrets (the offence of revelation of secrets).

While it is understandable that money laundering has given rise to international policies aimed at fighting against the phenomenon, this, however, should not result in a violation of fundamental legal guarantees, one of which is, undoubtedly, the attorney's obligation of professional secrecy.

Criticism of the Regulation

The regulations have been criticized almost unanimously by European tax advisors. The criticism has focused on the following aspects of the implementing legislation:

- The ambiguity of most national regulation in development of the Directive.
- The uncertainty and legal insecurity with respect to the professional obligations of the tax advisors.
- The incongruity and lack of coordination of European regulation.
- The differences in the criteria used by the various Financial Intelligence Units (SEPBLA, in Spain).
- The lack of technological means to identify suspicious operations.
- Positioning the tax advisor as a government collaborator to the detriment of his professional independence.
- The attack on the obligation of professional secrecy and the forced treatment of the tax advisor as an informant and the encouragement of illegal traffic of confidential information. As example of the latter is the Liechtenstein matter in which the German tax authorities bribed a trust company officer to obtain information on German tax cheats. It is understood that German tax authorities are now sharing that information with tax authorities in other countries, as evidenced in a report by the U.S. Senate Permanent Subcommittee on Investigations that is addressed to tax haven banks and U.S. tax compliance, dated July 17, 2008.
- The resulting deterioration of the advisor-client relationship, loss of trust, confidentiality, independence.
- Excessive intervention from the authorities, which limits and restricts fundamental rights.

Conclusion

Every single fact that a lawyer may have access to in the course of guiding and defending the parties in a given procedure, or while consulting or advising on legal matters, must remain an absolute secret. The obligation of professional secrecy constitutes a fundamental guarantee for the client, to the extent that, without this obligation, the exercise of the legal profession would be impossible. For tax advisors, simultaneously informing on and giving legal assistance to the same client is a total contradiction, in the face of which we must respond by appealing to the invulnerability of professional secrecy.

Within our field, the prevalence of a lawyer's obligation of professional secrecy against the reporting commitments demanded by the tax authorities is now, more than ever, a lively and open debate of national as well as international scope. This debate is identical to that which, in the realm of international politics, pits security against freedom, portraying them as inherently antagonistic rights and establishing measures that impose a limitation of rights for security's sake. As a general rule, the tax advisor's obligation of professional secrecy must prevail, and should not become a weak point in the fight against the money laundering.

For these reasons, the main challenge that international tax advisors face is to urgently equip ourselves with an international code of ethics where, among other things, professional secrecy should be defined as an identifying mark of our profession and a guarantee of clients' rights.

Reporting Obligations

Introduction

In the European context, one side-effect of the fight against money laundering and terrorism has been that the role of tax advisor has begun to lose its traditional independent character and is more and more becoming somewhat of a ''forced'' collaborator of the public administration. In a sense, the tax advisor is now just another government official, albeit paid by the client.

ISSN 0090-4600

The tax advisor's privileged position with respect to his clients, which — thanks to the fragile bonds created by trust, independence, confidentiality, and the advisor's ethical conduct — allows the advisor full access to all sorts of information about his clients, is today being continually tested by the reporting obligations imposed by government agencies on the tax advisor.

On this point, we must affirm that the interpretation of these reporting obligations must be restricted. Nonetheless, it must be recognized that the obligation of maintaining a professional secret does not prevent the tax advisor from fulfilling other obligations with respect to identifying the client, determining his legal situation, or safeguarding his documents.

Reporting Obligation

As I mentioned before, reporting obligations in Europe are established by Directive 2005/60/CE, which specifically justifies the ''existence of a waiver of reporting obligations with respect to information obtained before, during or after a legal procedure or in the course of the determining a client's legal situation.'' Quite ambiguously, Europe only demands that legal advisors suspend the obligation of professional secrecy in three specific situations that, as I mentioned earlier, are decidedly complicated for the advisor himself.

Extra precautions must be taken before complex or unusually large transactions and unusual patterns of transactions that have no apparent economic or visible lawful purpose.

In Spain, Royal Decree 54/2005 has already established these obligations for notaries, attorneys, auditors, tax advisors, and real estate developers, among others, but attorneys alone are obliged to report in the following specific situations:

- Participating in the design, implementation, or advice on client's transactions involving the selling or buying of real estate or businesses;
- Managing funds, stocks, or other assets;
- Opening or managing bank accounts, savings accounts, or securities accounts;
- Organizing the necessary outlays to create, operate, or manage companies;
- Creating, operating, or managing trusts, corporations, or similar entities;
- Acting for and on behalf of clients, in any financial or real estate transaction.

In this way, the tax advisor is obliged to exercise extreme caution and pay special attention to any activity that his client may embark upon which, due to its very nature, is subjectively considered to probably bare some relation to money laundering.

The Advisor's Situation in the Face of Reporting Obligations

In the European context, reporting obligations are, in a deliberately ambiguous manner, generally left up to the advisor who, in the course of exercising his role as advisor, must discern between activities that may be considered normal legal activities and those that may be illegal.

European regulation makes use of concepts such as ''due diligence,'' ''precaution,'' ''special attention,'' and ''extremely high sums'' which, on the one hand, seem to safeguard the advisor's independence and personal discretion, but in actual fact reduce and limit his range of action, turning him into a mere government collaborator and informant. These ambiguous measures are achieving the exact opposite results of their intended purpose, and perhaps the most worrisome of these results is that they are making the tax advisor's role as a collaborator with the justice system irrelevant.

Our profession needs clear, appropriate, and precise regulation that, by respecting the principle of the hierarchy of norms, will allow us to adapt these norms to the new social reality. Regulating the reporting obligations imposed upon advisors with regard to money laundering is a good example. Obligations that should rightfully be assumed by the public Administration are being imposed upon the advisor. He is being asked to report on some of the activities of his clients, while no notice is made of the fact that one way in which the advisor may express his independence is by exercising his right to choose his clients.

In practice, the reporting obligations imposed on tax advisors by ambiguous local regulations in development of ambiguous international regulation are giving rise to a peculiar phenomenon that has a direct effect on free competition. Facing the scrupulousness of certain professionals who are really actively fighting against money laundering, some less scrupulous professionals have made a lose interpretation of these ambiguous regulations and are accepting clients and transactions that more principled professionals would reject.

In Spain, we have experienced the disrepute of our profession in a particularly intense manner in large-scale police operations against money laundering that included police searches of lawyers' offices. The main stumbling block to professional practice, despite the possible goodwill to collaborate and to inform on suspicious operations, is that of what to do when you are not suspicious. Money laundering does not have symptoms that give it away. This is, in fact, one of its basic characteristics, and therefore the advisor faces

ISSN 0090-4600

enormous technical difficulties in detecting money laundering.

Financial Intelligence Units

In developing the European regulation, each Member State has created its own national financial intelligence unit (''FIU'') to effectively fight money laundering and to receive, request, analyze and disclose to the competent authorities any information related to money laundering or the financing of terrorism. At the same time, international institutions such as the IMF, the World Bank, and the FATF are presenting periodic reports evaluating the degree to which each of the countries that has committed to the fight against money laundering and the financing of terrorism is actually fulfilling its commitment.

The latest of the FIU's assessment reports (2006) on collaborating countries reveals some deficiencies in the procedures for reporting information and highlights the urgent need to specify the tax advisor's obligations in the process. These reports also make evident the confrontational situation that is being created between tax advisors and the administration.

In Spain, the tax advisory bar does not get on very well with the FIU (known as ''the SEPBLA'') which has taken to heart the fulfillment of its primary goal, which is to strengthen control over those who have the obligation to collaborate in order to increase awareness and to assist in their collaboration. For this purpose, the SEPBLA sends menacing letters to lawyers' offices requesting all sorts of information about their activities and their clients and threatening to initiate an on-premises inspection.

In order to avoid this sort of situation, the international organizations and the European Union's own Directive foresee the possibility of creating ''self-regulating'' bodies that would serve to assist and coordinate between those who are ''legally accountable'' and the FIU, representing each group of professionals before authorities responsible for the fight against money laundering. It is easy to see that in the 21st century tax advisors must face their new professional functions by adapting their roles to the demands of today's society. They must clearly and precisely face up to the obligations that are imposed upon them without ever losing sight of their obligations to society, their independence, and their responsibilities with respect to their clients.

Conclusions

Tax advisors in Europe must:

- Adopt a restrictive but scrupulous interpretation of current reporting obligations established in the regulation against money laundering.
- Continue to champion the precedence of professional secrecy, confidentiality, and the advisor's independence.
- Demand clear, appropriate, and precise rules with respect to the reporting obligations set out in anti-money laundering regulation.
- Demand recognition of a precise delimitation of the tax advisor's role with respect to certain information obtained from his client.

Advisor's Liability for Client's Activities

Introduction

Among the challenges that today's society poses tax advisors in their relationship with clients are legislative initiatives and jurisprudential decisions whose objective is to degrade the tax advisor by considering him responsible for the illegal activities committed by his clients.

It is submitted that these proposals are misdirected. Instead of merely looking at the acts of the taxpayer, legislatures and courts should formulate a ''new tax culture'' adapted to new societal challenges that include the fight against money laundering and tax fraud. This new tax culture should focus on the enactment of very concrete measures that will provide taxpayers with legal certainty by:

- Favoring binding consultations;
- Avoiding constant legislative changes;
- Establishing markedly ethical tax practices;
- Favoring consensus over conflict;
- Avoiding changes in Administrative standards; and
- Regulating professional secrecy and reporting obligations.

In carrying out his professional role, the tax advisor must act only within statutory limits. When the advisor does not limit his function to offering advice within the boundaries of tax laws that define what is legally valid, but instead designs a plot directed at facilitating a client's attempt to evade his tax obligations, he is participating in an illegal activity for which he may be criminally liable. The essential element in determining whether the tax advisor's dealings may be considered a criminal offence is an analysis of his contribution to the tax evasion plan by the client. In other words, the analysis must examine the nature of the role that the advisor plays in the plan. We may identify the following conduct that could give rise to criminal liability for the tax advisor: necessary assistance; inducement; complicity; and omission.

Necessary Assistance

The tax advisor is in jeopardy when the advice he gives is a determining factor in his client's ability to

ISSN 0090-4600

commit the criminal act, in the sense that, without the advisor's help, the act would not have taken place. The European jurisprudence punishes the advisor when the assistance he gives the client is given mainly, necessarily, and essentially to enable the client to commit a criminal act. It is essential in these cases to determine clearly the causal relationship between the advisor's collaboration and the act of the client.

Inducement

In Continental European law, an instigator is one who intentionally makes another person consider committing an infraction. This subtle form of participation is barely acknowledged in European jurisprudence due to the difficulty of proving this special behavior on the part of the tax advisor. Inducement necessarily requires considerable pressure on the part of the instigator, enough to influence the client's will. A mere recommendation or simple advice will not suffice to prove inducement.

Moreover, the client typically brings to the conference with his advisor a clear intent to commit an illegal act by asking how the result can be achieved. For that reason, it is seldom the advisor who is guilty of inducement because it is the client who approaches the advisor with the determination to commit a tax fraud.

Complicity

This sort of participation is only possible when the tax advisor willingly takes collaborative action to ensure the success of his client's criminal activity. The charge is typically found in cases where the usual means of obtaining evidence do not succeed in proving the advisor's assistance. Complicity is thus presented as a residual form of participation that arises when one of the crucial elements of necessary assistance is missing.

Omission

The possibility of holding the advisor accountable for not having prevented his client's illegal behavior of which he may have had prior knowledge in the course of his professional activity is almost never accepted in European jurisprudence. The reason for its inadmissibility stems from the fact that there is virtually no rule that requires a tax advisor to report proposed acts to the tax authority. The advisor is not a guarantor of his client's legal obligations.

Moreover, the tax advisor is generally protected from accusations of omission by the obligation of professional secrecy that is owed to a client. Indeed, the advisor is penalized when he reveals secrets of his client. Of course, if the law imposes upon the advisor the obligation to perform a specific acct, and the advisor fails to comply with this obligation, he may be held liable on grounds of omission.

Conclusion

As we have seen, the internal legislation in European countries imposes certain reporting obligations on tax advisors in those cases in which the advisor's obligation of professional secrecy must be suspended in order to inform on his client's alleged money-laundering related activities. This sort of participation, which until now had been seldom used by European courts to hold tax advisors accountable, is being invoked by some international organizations such as the FATF when it recommends that States specifically include this sort of crime in national legislation in order to criminalize certain acts of tax advisors.

Our position as a profession must be to demand as many guarantees as possible from legislators when considering the enactment of this form of criminal legislation. It should not be the courts that define this form of participation, but instead it should be each country's legislators who determine whether to include this as potential criminal act on the part of professional advisors and the circumstances in which it is to apply.

Tax advisors should acknowledge that we are bound to advise our clients within the limits of the law. In some circumstances as defined by our legislatures, we may have to refuse certain clients, accept the suspension of professional secrecy, act as government collaborators, and fight against the great blights of today's society — all of this within an international framework, in which the professional codes of ethics and best practices are the same for everyone, in which the rules that regulate our profession are standardized throughout all the legal systems, and in which the limits of our professional dealings are the exception and not the rule.

There must be space for tax authorities, for the legislator, for the courts, for the taxpayer, and, of course, for the tax advisor. We must claim this space for the tax advisor ourselves if we are to avoid intrusion by the legislator who intends to regulate aspects of our work, such as ethical conduct and the advisor's own discretion and to avoid intrusion by the government officials who intend to encumber tax advisors with responsibilities that do not rightfully belong to them.

Faced with the new challenges of the 21st century society, the tax advisor must follow the advice of the Spanish writer Saint Teresa of Avila to make a virtue of necessity and to do so in order to gain advantage from disadvantage. Tax advisors must use today's challenges to improve relationships with clients and to promote the ethical and humanistic aspects inherent in the profession.

THE OECD STUDY INTO THE ROLE OF TAX INTERMEDIARIES

by Heather Gething, Esq.

ISSN 0090-4600

Herbert Smith L.L.P.
London, England

Introduction

This section of the article discusses the conclusions and recommendations of the OECD Study into the Role of Tax Intermediaries. The information contained within this section is from the OECD unless otherwise stated.

The Organization for Economic Co-operation and Development (OECD) created the Forum on Tax Administration in July 2002 with the aim of identifying and promoting good tax administration practices between revenue bodies of OECD countries.

The Third Forum on Tax Administration was held in Seoul on September 14-15, 2006. This forum enabled the Heads and Deputy Heads of revenue bodies from 35 countries to discuss their ideas relating to effective tax administration and confronting noncompliance with tax laws. The end product of this forum was the Seoul Declaration.

The Seoul Declaration noted four areas in which work would be commenced or intensified, namely, developing the directory of aggressive tax planning schemes, expanding its corporate governance guidelines, improving the training of tax officials on international tax issues, and examining the role of tax intermediaries in relation to noncompliance and the promotion of unacceptable tax minimization arrangements.

In response to the Seoul Declaration, the Forum on Tax Administration commissioned a study into the role of tax intermediaries (the ''Study''). The Terms of Reference for the Study were released on January 2007 with the mandate being to improve understanding of the role tax professionals play in tax administration generally and in unacceptable tax minimization arrangements in particular, and to identify strategies for strengthening their relationship with revenue bodies.

The Study team comprised HM Revenue and Customs (HMRC) in the United Kingdom and the OECD Secretariat. A core group of countries acted as a steering group for the work. The group consists of Australia, Canada, Chile, France, India, Ireland, Japan, Mexico, the Netherlands, South Africa, Spain, and the United States. There was extensive consultation with the private sector and drafts of the report were placed on the OECD web site for general public comment.

The Study was finalized for and discussed at the Fourth Forum on Tax Administration in Cape Town on January 10-11, 2008.

Context

Justification for the Study comes from recent experiences in OECD countries where the traditional business model of many accountants and law firms has changed as a result of increasing complexity in business, rapidly changing tax and legal systems, development of information technology tools, and the highly competitive tax intermediary market. This shift has led to an increased supply of and demand for ''mass marketed'' or ''off-the-shelf'' aggressive tax schemes.

The Study thus aims to research the development and promotion of aggressive tax schemes and the ways in which revenue bodies can combat them.

Scope

The scope of the Study changed significantly from the time of the issuance of the Seoul Declaration in September 2006 to its publication in January 2008.

The Seoul Declaration noted ''continued concerns about corporate governance and the role of tax advisors and financial and other institutions in relation to non-compliance and the promotion of unacceptable tax minimization arrangements.'' [1] By the time the Terms of Reference were published in January 2007, the tone changed to ''the role of tax intermediaries in promoting compliance and reducing non-compliance by their clients, and the risks they sometimes pose in developing tax minimization arrangements.'' [2] From a concern phrased in the negative, the focus of the Study shifted to a consideration of the positive and negative roles of tax intermediaries in the tax environment.

The final Study goes even further than this, focusing not just on tax intermediaries, but also taxpayers and the tripartite relationship between taxpayer, tax advisor, and revenue body. Rather than concentrating on the supply of aggressive schemes, the Study also considers strategies aimed at reducing demand. It notes that successfully reducing taxpayer demand for aggressive tax products should result in a reduction in supply under market principles.

The Study identifies two areas of concern, which are planning involving a tax position that is tenable but has unintended tax consequences and taking a position that is favorable to the taxpayer without disclosing that there is uncertainty whether matters in the return accord with the law.

In examining these areas of concern, the Study focuses solely on large corporate taxpayers as a result of time and resource limitations, but notes that high-net-worth individuals may also be a group of taxpayers at considerable risk. The Study also draws a distinction between: (1) tax intermediaries who are tax advisors, law, accounting, and other professional

[1] OECD (2006) Seoul Declaration, p. 3.

[2] OECD (2007) Terms of Reference.

ISSN 0090-4600

firms; and (2) those which are banks and financial institutions. The discussions in relation to banking are not considered here.

Conclusions and Recommendations

Chapters 4 to 8 of the Study lay out the main conclusions and recommendations. What follows is a discussion of the main issues with a focus on the impact they will have on tax intermediaries.

The Contribution of Tax Intermediaries

In contrast to the initial concerns raised in the Seoul Declaration, the Study emphasizes the important positive contribution of tax intermediaries:

> [T]he importance of the role tax advisors play in a tax system can be tested by answering a simple question: would compliance with tax laws improve if tax advisors did not exist? The Study Team found no country where the answer to that country is yes. Across the whole range of taxpayers, taxes and circumstances, the vast majority of tax advisors help their clients to avoid errors and deter them from engaging in unlawful or overly-aggressive activities.[3]

It also recognizes that tax intermediaries operate in a complex environment and their advice is influenced by a number of factors, including professional and ethical responsibilities to the client and to the law, financial and reputation risk, regulation (be it by a professional body and/or the revenue body), value-based fees, confidentiality privileges, and international accounting and auditing standards.

The recognition of the positive contribution of tax intermediaries and the complexities of the environment in which they operate is beneficial to tax intermediaries. Rather than having the tax intermediaries viewed as obstacles to tax administration, the Study emphasizes their role as facilitators. Indeed, the Study notes that the appetite for risk is set by the taxpayer and not the tax intermediary, noting:

> [T]axpayers are the ones who decide whether to adopt particular planning opportunities and there is significant scope to influence the demand by taxpayers for aggressive tax planning.

The Study thus focuses much more on the revenue body's relationship to the taxpayer than to the tax intermediary. This approach also sets the tone for the recommendations of the Study, which are conciliatory rather than confrontational.

The Study does note though that some tax intermediaries are involved in the development and promotion of aggressive tax schemes and recommends that the revenue bodies focus on this segment of intermediaries. This approach makes sense, but it should be borne in mind that the identification of aggressive tax planning is not straightforward both from revenue body and from tax intermediary standpoints and thus an understanding of the complexity of the tax environment should always be a consideration in decision-making.

Different Approach for Different Countries

The Study describes the approaches that could be taken by revenue bodies in combating aggressive tax planning but recommends that countries formulate their own methods of dealing with risk. This pragmatic approach is sensible given the number of countries studied and the differences in legal system, constitutions, tax rates and tax administrations among these countries. Were it otherwise, revenue bodies could find themselves implementing additional administrative burdens that would benefit neither taxpayers, nor tax intermediaries, nor the revenue authority involved.[4]

This approach makes it difficult though to determine the effect on tax intermediaries in different countries. While the central tenets of risk management, improved information, and an enhanced relationship will be taken into account by differing revenue bodies, the mechanisms by which these are achieved may differ considerably.

Risk Management

The Study notes that, given the increased complexity of the tax environment, revenue bodies must allocate resources effectively and risk assessment of taxpayers and groups of taxpayers is thus a necessity.

The approach for risk management in this context is deciding what the main compliance risks are, understanding the factors that influence behavior, identifying the strategies needed to treat risks, implementing strategies and monitoring their implementation.

The benefits of such an approach are described as including effective resource allocation, identification of areas of legal risk or unacceptably high compliance risk, informed analysis of the preferred response, and a defensible approach to managing taxpayer compliance that can withstand external scrutiny.

The Study states that risk management is best achieved through an understanding of the taxpayer

[3] Study, para. 3.9.

[4] Sanger, *Tax Adviser*, Feb. 2008, 24-25.

ISSN 0090-4600

and the tax issue. Understanding the taxpayer involves consideration of the taxpayer's commercial structure, size and activities, quality of processes and accounting system, and behavior, as well as the extent of agreement over interpretation of the law. Understanding the tax issue meanwhile involves a broader assessment of the issues in each taxpayer's return to determine whether it is likely to have been dealt with incorrectly, negligently, or justifiably.

As well as allowing the revenue body to focus on the issues and taxpayers that most pose a risk, risk management also allows revenue bodies to improve their transparency in determining which taxpayers or issues to audit. The Study recognizes the importance of a rational basis for selection in improving the levels of trust within the tripartite relationship, but notes that transparency should be on a broad policy level as opposed to specifics. It recommends that the mechanisms for selecting taxpayers or issues for audit (e.g., algorithms in risk engines) should not be publicized and to do otherwise would be to encourage those taxpayers looking to exploit the system. Any material improvement, however, in the amount of information available, regardless of the level at which this is required, will be beneficial to both compliant and noncompliant taxpayers and intermediaries.

Information

To manage risk effectively revenue bodies must have access to current, relevant and reliable information and the capabilities to gather and process that information.

While supplementary information may be provided under voluntarily or under statutory powers, the primary source of information for most revenue bodies is the tax return. This reliance means that there are informational gaps caused by the time lag between the transaction and the return being filed, the time taken to assess and analyze a return, and delays in the legislative response. There is also the wider problem of insufficient transparency in returns, with taxpayers only providing the information that they are legally obliged to report. The Study therefore lays out a number of techniques that revenue bodies have developed to improve the quantity and quality of the information they have at their disposal.

The majority of countries studied have a form of advance rulings for which taxpayers can apply. These rulings are beneficial to the taxpayer in that they enable early certainty as to the tax position of a transaction. They provide information for the revenue body at an early stage and thus allow anticipatory legislative and policy responses.

Several countries (e.g., Canada, South Africa, the United Kingdom, and the United States) go further with statutory rules that require the disclosure of certain schemes or arrangements to the revenue in advance of the return process.

The use of external information such as press releases, web site material, public accounts etc. is also noted as important in verifying returns and statements lodged by taxpayers. In particular, the Study highlights publicly available accounts as an important source of information.

In addition to improved domestic information, the Study states that the international aspects of aggressive tax planning require revenue bodies to engage in active international exchanges of information. A consideration of the practical aspects of this was laid out in the 2006 *OECD Manual on Information Exchange*, which takes a modular form with revenue bodies able to apply modules as they see fit.[5] The modules refer to requested information, information automatically disseminated, spontaneous exchange of information, as well as the involvement of foreign revenue bodies in domestic tax examinations. The spectrum of approaches laid out begs the question of the extent to which national taxpayers can be subjected to examination from foreign revenue bodies. The Study again does not provide a guideline for the appropriate level of international co-operation but, rather, offers encouragement to revenue bodies actively participating in such co-operation.

The Enhanced Relationship

The Study concludes that while revenue bodies want high levels of voluntary transparency, taxpayers want certainty and a "problem-solving attitude." The Study explains that to achieve this, an "enhanced relationship" is required — one which "favors collaboration over confrontation and is anchored more on mutual trust than on enforceable obligations." [6]

In an enhanced relationship, the taxpayer would disclose in real time rather than when the tax return is due any information that the revenue body would need to make a fully informed risk assessment. Such co-operation would be given as a result of the mutual trust and personal relationships between stakeholders in the tax environment. This is distinct from the basic relationship where the taxpayer and revenue body interact solely by reference to what each is legally required to do. The Study suggests that the revenue bodies should encourage such a relationship by demonstrating commercial awareness, impartiality, proportionality, openness through disclosure and transparency, and responsiveness.

The Study recognizes that taxpayers generally undertake transactions for commercial reasons with tax

[5] The OECD Manual on Information Exchange can be found at: *http://www.OECD.org/document/5/0,3343,en_2649_33767_36647621_1_1_1_1,00.html.*

[6] Study, para. 8.1.

ISSN 0090-4600

being but one factor in their decision-making. Commercial understanding is thus required and the Study states that this can be achieved through training given in conjunction with taxpayers and tax intermediaries. Impartiality requires that taxpayers be treated consistently. Proportionality means that revenue bodies should consider past dealings with a taxpayer and not make speculative audits where there is no reason not to trust the taxpayer. The Study also recommends that questions asked should be focused on the conclusion of the audit and that discussion of the implications of decisions should be made before they are taken. Openness and transparency are stated as central to the enhanced relationship. The Study highlights the importance of advance rulings, and while it recommends greater transparency on the general approach to risk management, as noted above, it stops short of recommending the publication of the mechanics of risk assessments. The Study also suggests the use of alternative dispute resolution mechanisms in solving disputes, but adds a disclaimer that the use of these is entirely dependent on countries' legal and administrative frameworks. Finally, responsiveness to queries is seen as desirable with taxpayers requiring prompt, efficient and certain responses from requests made of revenue bodies.

The enhanced relationship will require tax advisors to maintain a level of policy awareness. This will enable tax advisors to predict the issues revenue bodies will focus on and thus be in a position to better help their clients maintain an enhanced relationship. This is in contrast to the basic relationship where the tax intermediary solely provides advice to clients as to the legal boundaries of the relationship and represents clients in communications. This recommendation of the Study may prove problematic for tax intermediaries who seek to comply, given the often confusing nature of policy decisions. As but one example from the United Kingdom, small businesses were urged by a prominent minister in 2002 to run their business in corporate form in order to enjoy the £10,000 nil rate corporation tax band, only to discover in 2004 that they were regarded as having participated in an abusive tax plan because there was no tax purpose for the incorporation.[7] In order for tax advisors to use policy to help their clients maintain an enhanced relationship, the policy itself must be clear and unequivocal.

The Study further acknowledges that the enhanced relationship approach may involve significant resource and other costs to tax advisors (as well as to the taxpayer and to the revenue body). A compromise suggested by the Study is the option of this dialogue taking place with professional bodies rather than with the intermediary itself.

The enhanced relationship approach is familiar to practitioners in the United Kingdom as it is similar to that outlined by HMRC in the Varney Review of Links with Large Business published in November 2006.[8] This review came at a low point in the relationship between HMRC and large corporate taxpayers in the United Kingdom. It envisaged a spirit of trust as seen in the OECD Study and accompanied this with proposals for a new system of advance rulings and clearances, speedier resolution of issues, improved communication, and earlier certainty. This approach to the taxpayer-revenue relationship was warmly welcomed in the United Kingdom.[9]

There are benefits of the enhanced relationship for all parties in the tripartite relationship. The revenue body gets to concentrate its resources on uncooperative taxpayers whereas taxpayers and their advisors get early certainty and more information on revenue decision-making where a basic relationship is maintained.

That is not to say that there are no problems with the proposal. As already noted, it may be difficult for policy awareness to be increased and there may be substantial costs involved. A further significant issue is the personnel requirements of the enhanced relationship. In order for trust to develop, taxpayers and advisors must be able to communicate with well-trained and informed individuals who are able to provide an on-going relationship. In the United Kingdom this is a serious problem given historic and planned staff-cuts and the increasing complexity of the tax environment. On a similar note, there is also the problem associated with a personal relationship between the taxpayer and the revenue body. This is highlighted by Wales (2006) who cites the Dutch experience, where, in relation to the rulings process, well-informed businesses developed relationships with more lenient inspectors, so-called "inspector-shopping." [10] As well as trust, there is thus a need for objectivity, two characteristics difficult to reconcile.

Measures

For those taxpayers unwilling to offer enhanced disclosure and transparency, the Study recommends that revenue bodies should carry out risk analyses on the information available and make apparent to those taxpayers unwilling to co-operate that consequences will result. As noted in the Cape Town communiqué:

> [L]arge corporate taxpayers, and their advisers, who are unwilling to embrace transpar-

[7] Drysdale, (2007) *Tolley's Practical Tax Newsletter*, 28 *PTN* 9, 66.

[8] The Varney Review of Links with Large Business can be found at: *www.hmrc.gov.uk/large-business/review-report.pdf.*

[9] Drysdale, (2007) *Tolley's Practical Tax Newsletter*, 28 *PTN* 9, 66; Wales, (2006) *Tax Journal*, 864, 11.

[10] Wales, (2006) *Tax Journal*, 864, 11.

ISSN 0090-4600

> ency must learn they cannot expect to prosper at the expense of others.[11]

This is the main focus of the negative comments regarding tax intermediaries and is in contrast to the approach taken in the United Kingdom where the focus has been on the benefits of being tax-compliant rather than the negatives of being noncompliant.[12]

The Study discusses measures that could be taken by revenue bodies to deter such uncooperative taxpayers. According to the Study, it is important for revenue bodies to be able to identify tax intermediaries and describes a number of ways in which this can be achieved. In some countries (e.g., Japan), tax intermediaries are registered, with the intermediary-specific registration number required on all submissions. Alternatively, tax intermediaries can be allowed to self-regulate (e.g., the United Kingdom) often under the auspices of a professional body.

As stated above, in a number of countries more proactive measures are in place whereby the tax intermediary is obliged to disclose any scheme to the revenue body in advance of the tax return. Such measures significantly reduce the time taken by the revenue body to detect and respond to a scheme.

Future compliance arrangements are another potential measure. These place additional restrictions and standards on a tax intermediary and are usually imposed where the intermediary has engaged in behavior potentially subject to criminal or civil sanctions.

Penalty regimes are a form of deterrent and can be split between those penalties that underpin statutory obligations such as disclosure requirements and those that penalize involvement in aggressive tax planning. Countries, such as Australia, New Zealand, and Canada, have introduced regimes relating to the latter. The Australian regime was only introduced in 2006 but the Study notes that many professional and revenue officials in Australia believe that the penalties have significantly decreased the supply of mass-marketed schemes.

Courts may impose injunctions to stop the promotion of schemes. The Study cites the example of the United States, where courts have broad authority to enjoin promoters with injunction actions filed by the Tax Division of the U.S. Department of Justice (in 2007 the IRS secured 51 injunctions against promoters and nine injunctions against return preparers).

Professional conduct rules can also be used to discourage tax intermediaries through censure, suspension, or disbarment. However, there may be a conflict between the duty of the intermediary to maintain client confidentiality and to act in their best interests.

Several countries have general anti-avoidance rules, which, although applicable to taxpayers, may restrict the use of aggressive tax planning. The effectiveness of general anti-avoidance rules has increasingly been seen in the United Kingdom, with the courts comfortable looking through schemes to the underlying commercial transaction.

HMRC influence

Given the considerable HMRC influence on the researching and writing of the Study, it is not unsurprising that the Varney Review has been mirrored in the conclusions reached. With this notable HMRC influence, it seems inevitable that revenue bodies looking to implement the Study's recommendations will look to the example set by HMRC.

As stated above, the Study cites the use of advance disclosure regimes. The U.K. regime was introduced in 2004 and was extended in 2006 beyond perceived ''high risk'' areas, such as financial products and employee remuneration, to cover any tax arrangement relating to any aspect of income tax, corporation tax, and capital gains tax.[13] Disclosure is now required if certain hallmarks of a tax scheme are present. These are that: (1) there is an arrangement that enables (or might be expected to enable) a tax advantage; (2) the main benefit of the arrangement is (or might be expected to be) the tax advantage; (3) there is a promoter or the plan is devised for use ''in-house''; and (4) one of a series of tests is met.

The regime has not gone without criticism. Opponents have pointed to the lack of Parliamentary scrutiny, the burden on tax advisors, and ineffective guidance as to when disclosure is required.[14] There is also a constitutional concern in that powers introduced in the Finance Act 2007 allow HMRC to apply to the Special Commissioners for disclosure of schemes where they have reasonable grounds for suspicion of a tax avoidance arrangement.[15] This means that in effect the new regime requires the disclosure of schemes that not only fall within the statutory definition of a notifiable arrangement, but also those that HMRC ''reasonably suspects'' may do so, even if it is eventually found not to do so.

Next Steps

The Study recommends that, as a next step, a small task group be established to review the issues laid out in the Study and further work be undertaken to see whether the enhanced relationship is needed for ad-

[11] OECD (2008) Cape Town Communiqué, p. 4.

[12] Sanger, (2008) *Tax Adviser*, Feb. 2008, 24-25.

[13] There is also a regime for Stamp Duty Land Tax and draft legislation to extend the income tax disclosure regime to National Insurance Contributions.

[14] McKie, (2006) *Taxation*, 158, 4080, 53.

[15] FA 2004, §306A.

ISSN 0090-4600

dressing the risks posed by aggressive tax planning. The Study also recommends that further work be undertaken on the role played by banks and the behavior of high-net-worth individuals to see if the recommendations made in relation to corporate taxpayers could also apply.

For individual revenue bodies it is up to them to consider the recommendations and examples of the Study and consider how they may be implemented.

Conclusions for Tax Intermediaries

The Study is generally positive towards tax intermediaries in that their importance in the tax system is recognized and it is noted that the decisions to take tax risks come from the taxpayer.

The recommendations for revenue bodies are also mostly beneficial to tax intermediaries. The increased transparency in risk-management decisions will inform those taxpayers and intermediaries who wish to maintain a basic relationship just as much as those who wish to be involved in an enhanced relationship.

ISSN 0090-4600

Similarly, the recommendation that revenue bodies improve their commercial understanding, impartiality, proportionality, openness, and responsiveness can be nothing but a good thing for all tax intermediaries.

The tone of the Study is significantly different from how it could have been under the initial phrasing of the Seoul Declaration and Terms of Reference. The Study is more of a reference manual than a road map for change, and, as such, it could have been a lot more detrimental to tax intermediaries.

This is not to say that the Study is entirely positive. The examples given in relation to obtaining information and deterring tax aggressive schemes may represent an additional administrative burden on taxpayers and intermediaries if they are implemented. The Study states that each revenue body should consider the environment in which it operates and thus it would be hoped that there are no unnecessary administrative burdens placed in already well-regulated environments. It seems likely, however, that revenue bodies will follow the lead of HMRC. For example, where not already in existence, advance disclosure regimes may be adopted with tax systems becoming, as a result, more regulated.

THE SWISS CODE OF CONDUCT FOR TAX AUTHORITIES, TAXPAYERS AND TAX ADVISORS

by Jean-Blaise Eckert, Esq.
Lenz & Staehelin
Geneva, Switzerland

Introduction

Following the ‘‘Seoul Declaration’’ [16] that was adopted at the third meeting of the OECD and the Forum on Tax Administration in September 2006, the tax administration heads from more than 30 countries launched a broad study project on tax intermediaries under the auspices of the OECD (the ‘‘Study’’), intended to increase the understanding of the role tax intermediaries play in tax administration and to identify strategies for strengthening the relationship between tax intermediaries and revenue bodies. The Study team has published several working papers to explore relevant issues.

The Swiss ‘‘Code of Conduct for Tax Authorities, Taxpayers and Tax Advisors’’ (see Appendix) was developed during two forum meetings held at the Institute of Public Finance and Fiscal Law of the University of St. Gallen (Switzerland)[17] in December 2002 and June 2003. High executives of the Federal Tax Administration (FTA), representatives of tax advisors, and representatives of taxpayers participated in this effort.

It should be noted that the OECD Working Paper 6 on the Enhanced Relationship quotes the Swiss Code of Conduct with respect to the principles of an impartial approach to tax administration.[18]

Favorable Tax Climate

In Switzerland, there is a longstanding tradition of a ‘‘favorable tax climate’’ between tax authorities, tax advisors, and taxpayers. A favorable tax climate means that the tax administration can be easily approached in order to examine and discuss the tax consequences of a planned sthture or transaction, and to fix them in an advance tax ruling that is binding on the tax administration, provided the taxpayer acts in accordance with the factual background disclosed to the tax administration. This being said, this ‘‘collaboration’’ between tax authorities and taxpayers should not be seen as a negotiation field that has the objective of obtaining a kind of favorable, ‘‘tailor made’’ tax treatment.

This collaboration between tax authorities and taxpayers is particularly valuable in the Swiss legal context where the law generally provides only for general rules that need to be made concretized and implemented with respect to a given structure or transaction. In general, the FTA does not issue detailed and exhaustive administrative regulations — as, for example, those issued by the U.S. Department of the Treasury. For a tax advisor, it is thus very useful to have the opportunity to check whether the tax administration has the same interpretation of a given rule in a particular situation. This preliminary contact between the tax advisor and the tax administration, and the fact that the tax consequences of a given transaction or structure are discussed and fixed before the transaction or structure is implemented, minimize the risk of ending up in litigation. In addition, the taxpayer is aware of the tax consequences of his planned actions.

According to the promoters of the Swiss Code of Conduct, in the past few years the favorable climate has been troubled by various factors (among them the internalization of the fiscal culture, the growing competition between tax advisors, the public deficit, etc.), hence the need to promote and to agree on a code of conduct for the tax practice.

[16] *http://www.OECD.org/dataOECD/0/14/37463807.pdf.*

[17] *http://www.iff.unisg.ch.*

[18] OECD Tax Intermediaries Study, Working Paper 6 — The Enhanced Relationship, p. 18.

ISSN 0090-4600

Swiss Code of Conduct

The Code of Conduct lists some basic principles and rules of conduct for the tax profession. It aims to enhance the relationship between the tax administration, taxpayers, and tax advisors through an approach where mutual respect and trust are promoted; in addition, it aims to reach a better interpretation and application of the tax law consistent with their respective interests.

Practice Recommendations

Practically, the Code of Conduct is a list of recommendations in the form of principles, divided into three sets of rules:

1. General guidelines provide for the general approach that should be taken by the different parties involved in a discussion or a negotiation on a particular tax issue — as, for example, the recommendation to focus on interests rather than on taking positions, or to aim at an open and unbiased dialogue;
2. Rules as to psychology and good behavior provide for a long list of recommendations focusing on the relationship between the tax advisor and the tax administration. For example, under the subtitle "treat your counterparts respectfully as being fair and trustworthy," one of the most fundamental recommendations is to maintain a climate of trust between the tax administration and the tax advisors, thus avoiding arrogant or antagonistic behavior on either side. Even though the reasons for following such behavior should be quite evident, it is always worth restating it in any "do's" and "don'ts" list, particularly considering the above-mentioned "favorable tax climate" that the Code of Conduct aims to enhance.
3. The third part of the Code of Conduct (the rules regarding form, requests, facts, and motivation) focuses on the more practical question of how to approach a given issue and conduct the discussion with the tax administration.

Balanced Approach

One of the strong points of the Swiss Code of conduct is its balance. The Swiss Code contains general rules addressed to both parties, some addressed to tax advisors only (as for example the recommendation not to forum shop among different tax inspectors within the same tax administration), and others addressed more specifically to the tax administration (for example, the recommendation to provide for a systematic publication of administrative practices or timely announcements and publication of changes affecting administrative practices). The Code provides for some recommendations aimed to protect the tax advisor and others to protect the client. An example of the former is the recommendation that the tax advisor be able to say no to his client in any case in which the advisor might be instrumental to the adoption of dubious/questionable practices of the client. Another example is the recommendation that an advisor be able to protect the client from himself, by not heeding unreasonable requests and avoiding frivolous practices that will end up harming the client, the tax advisor, or both.

Response from Tax Bar

The Swiss Code of Conduct received positive feedback from tax practitioners working in both the public and the private sectors. With respect to the latter, in September 2003, the Swiss Tax Conference [19] — a body consisting of both the FTA and the cantonal tax administrations — approved the Code of Conduct. In addition, the Director of the FTA recommended to the FTA's staff that they implement the principles listed in the Code of Conduct in their daily practice. Moreover, the Swiss Government welcomed the Code of Conduct, affirming it has been favorable to its development since the beginning, as a valuable means to set some rules aimed at enhancing equity, mutual respect, and trust in the application of tax law.

Conclusion

Even though the Code of Conduct does not provide binding and enforceable rules, based on the aforementioned overall positive feedback — particularly from the tax authorities — one can consider that the Code of Conduct is now a codification in the form of a "gentlemen's agreement" of a long-established tradition of mutual respect and trust between tax practitioners and the various tax administrations.

[19] *http://www.steuerkonferenz.ch.*

ISSN 0090-4600

THE MALPRACTICE ENVIRONMENT FOR TAX LAWYERS IN THE UNITED STATES

by Christopher S. Rizek, Esq.
Caplin & Drysdale, Chartered
Washington, D.C.

Overview of the Malpractice Environment

In many instances of malpractice claims against tax lawyers or accountants, there is nothing that is uniquely tax-related in the claim. Rather, as a general proposition, malpractice cases in the tax planning area arise from the same causes as any other kinds of malpractice cases. These common causes are discussed, below. There are other causes that are relatively unique in tax practice, and these are discussed separately below.

Tax Shelters Have Changed the Landscape

In recent years the tax malpractice environment in the United States (like, arguably, the tax enforcement environment generally) has been somewhat distorted by a wave of tax shelter-related claims and litigation. Accordingly, following the discussion of causes, the typical claims in such cases are presented. Specifically, there is at the end of this U.S. section a discussion of participation in client frauds and then a discussion of the shelter war fallout.

Prevention Is the Best Cure

Many of the precautions recommended below may seem counter-intuitive. We all want to serve our clients, and to get new clients, and acting as if they are potential adversaries may not seem conducive to a close attorney-client or accountant-client relationship. A tax lawyer must sell to his clients, explaining that he is going to use the same care and attention to detail in his work with them as he will with potential counterparties or adversaries.

Many of the shelter-related issues have dissipated as a result of increased anti-tax shelter activity by the government, including criminal cases, enactment of new penalty legislation, enhanced disclosure and reporting requirements, and new ethical standards under Circular 230.

Common Causes of Malpractice in General

Poor Client Intake Procedures

Good intake procedures enable potential problems to be recognized early and prevented before they become significant. Conversely, problems may be missed if a firm does not have such good intake procedures. One prominent legal insurer frequently reminds law firms that ‘‘the best loss prevention tool is your front door,’’ i.e., the intake processes.

Poor procedures may result in missing the kinds of things that may cause problems later (and are discussed in more detail below): conflicts; inadequately identifying the client in an organization setting; poorly delineating the scope of the engagement; getting dragged into client misconduct; etc.

Warning signs include: (1) clients with no established business record; (2) clients who are reluctant to discuss their background or experiences; (3) clients who have changed advisors repeatedly; (4) clients with little experience dealing with their advisors and only the vaguest notion of what kind of services they need; and (4) clients with unrealistic expectations.

Good procedures may involve: (1) a second set of eyes (a practice group leader or committee reviewing all new client intakes); (2) determining a potential client’s financial capabilities; (3) some investigation or background checking on new clients (e.g., Dun & Bradstreet reports or Form 10-Ks, checking references, internet searching, etc.); (4) in-depth review of potential conflicts; (5) carefully delineating the identity and nature of the client, the scope of the engagement, etc.; and (6) documenting that all of these things have been done.

Conflicts

Experience shows that the simplest way for a plaintiff’s lawyer to make a case out against a law firm for professional malpractice is to identify a conflict that was not previously noticed or (worse yet) was identified but not disclosed or subjected to specific written consent. In practice, it does not really matter that the conflict is unrelated to the specific misconduct that causes the loss; the plaintiff’s lawyer will contend that the conflict rendered the firm incapable of doing an adequate job for the client. Juries tend to believe that.

One common source of potential conflicts arises from failure to define carefully who the client is in the representation of an organization. For instance, in a corporation, is it the manager who contacted the law firm, the board, or the shareholders? In a partnership, is it the general partner, the other partners, or ‘‘the partnership’’ in an abstract sense? Or in a trust situation, is it a specific trustee, the trustees or board as a whole, or the beneficiaries?

Other common issues that arise include potential conflicts in unrelated matters or separate jurisdictions, so-called ‘‘positional’’ conflicts, or when a lawyer or firm wears too many hats (as both an outside advisor and as a shareholder, inside director, or trustee, for instance).

Many conflicts will not materially limit the ability of a lawyer or firm to represent the client adequately,

ISSN 0090-4600

and can be consented to or ''waived'' by the clients involved. Careful attention to obtaining such consent can prevent many issues from arising.

Other situations that tend to be more common in tax practice are discussed below.

Inadequately Defining the Scope of Representation

A related issue derives from inadequately defining the scope of representation at the outset. This means identifying both the precise client and the subject matter of the representation.

A written engagement letter is critical for these purposes. Many jurisdictions require one, at least to describe the fee arrangement, which is the source of many disputes. Nevertheless, it is always good practice both to identify and surface potential issues at the outset and as evidence if a disagreement later arises.

It is advisable to be clear as to the specific issues on which the client is to be advised, what the jurisdictional limits are (e.g., U.S. tax law only, not U.K., French, etc.), what salient factual prerequisites may exist for favorable advice, what will happen when the project ends (e.g., disclaiming any responsibility to monitor and advise the client or other interested parties regarding future developments), who (client or firm) will do which work on the project, etc. This is also the opportunity to identify carefully and obtain consent to (or a ''waiver'' of) any potential conflicts, if such consent or waiver can cure them.

Negligent Opinions, Research, Advice

Most malpractice claims do not actually involve negligence in the research or analysis of an issue. Unless there is an obviously shoddy job — e.g., misreading a rule or missing a case directly on point in your jurisdiction — such work is usually done sufficiently well to avoid malpractice liability under a negligence standard. The cases more commonly involve failure to perform due diligence in ascertaining the facts, or in accepting factual representations that either are possibly untrue or are unrealistic future expectations. This has been especially prevalent in the tax shelter cases that are discussed later.

Participating in a Client's Bad Conduct

When a client fails, or loses investor funds in a transaction, the client's partners, shareholders, or investors may accuse the client's lawyer or accountant of ''aiding and abetting'' the failure or deepening the insolvency of the client. As in the conflict situation, it may not really matter whether a causal connection can be drawn between the loss and the professional's activities; the lawyer or accountant will be accused of not stopping obviously illegal or fraudulent behavior.

Missed or Late Elections or Statutes of Limitations

This is a common source of malpractice claims, and frequently one that cannot be remedied. For instance, a missed limitations period may be jurisdictional, and there may be no way to obtain relief once it is missed. But this problem is also easily prevented, by among other things: having a good calendaring system, accepting work only in areas you know well, having multiple eyes looking over things, and keeping communications clear and open as deadlines approach.

Inadequately Supervising/Staffing Complex Matters

Failure to have the right experts in place and involved at the right time can lead to critical errors. The more complex and multi-faceted (or multi-jurisdictional) the matter is, the more likely it is you will miss something. Conversely, inadequately supervising the team once it is in place can lead to poor coordination, sloppy or inconsistent work, and an overcharged and unhappy client.

Firms should also beware of the attorneys or accountants who do not share work internally — who knows what they're doing?! — or who dabble in areas beyond their expertise. Both may cause a mistake and resulting liability.

Failure to Address Errors Promptly

Dealing with a mistake promptly once it is recognized is one of the hardest psychological things for professionals to do. But sitting on the problem or ignoring it and hoping it goes away usually only compounds the problem. Often a mistake can be corrected if it is addressed promptly and appropriately.

It is very important to get objective advice and expertise in dealing with a problem once it is identified. Go to your inside counsel or retain outside counsel to fix the problem. Don't try to hide it or fix it yourself.

Beware of the potential limitations on attorney-client privilege. Communications over how to deal with the issue may not be privileged. Do not put anything in writing until directed to do so by your counsel.

When, where, and how to tell the client is another issue that requires careful attention and expert advice.

Common Causes of Malpractice in the Tax Area in Particular

The causes of malpractice in taxation are, as noted, generally the same as in any other practice area. However, there are some variations on these topics and certain factual situations in which these kinds of problems frequently arise for tax lawyers and accountants. Certain kinds of conflict situations arise quite frequently in tax practice. As noted previously, the presence of one of these kinds of potential conflicts will become a central part of any potential malpractice case against the professional, even if the causal rela-

ISSN 0090-4600

tionship to the damages the taxpayer has suffered is quite attenuated.

Prior Work Conflict

One kind of conflict situation is the so-called ''prior work'' conflict, which arises when a single tax professional or firm advises the taxpayer both during the transaction or return reporting and then again in the examination or litigation of the issue. In some respects, this is the routine ''bread and butter'' of a tax practice. We work on structuring a transaction, advise the taxpayer with respect to the return position, and represent the taxpayer during the audit or litigation. This is considered good, ongoing business with repeat clients. But the tax professional's previous conduct or advice, and often the client's reliance on that advice, can become issues in later proceedings. One of the most common situations is when an opinion on the correct tax treatment of the transaction is intended to be or actually is proffered by the taxpayer as part of a reasonable cause or reliance on counsel defense to the imposition of accuracy-related penalties.

This can create a conflict in which the lawyer's own interest in defending the correctness, or at least non-negligence, of the lawyer's prior advice or opinion may be different from the client's interest.

Most ethics regimes consider it a conflict of interest if there is a significant risk that the representation will be ''materially limited'' by a personal interest of the professional.[20]

A related aspect of this problem is that the professional may be called as a witness to testify regarding the facts of the transaction or the advice previously given to the client. Again, most ethics regimes recognize that a lawyer cannot serve as counsel in a matter in which the lawyer is going to be a witness.[21] There may be a high standard (e.g., that the lawyer be a ''necessary'' witness) in order to deter tactical use of this and the resulting disqualification by opposing counsel.

Uninformed Waiver

Many ''material limitation'' types of conflicts are subject to waiver by the informed consent of the client. Of course, it is critical that the consent be truly *informed*. There are thus good practices that should be followed to obtain informed consent, e.g., the consent should be in writing; the scope of the conflict should be clearly and thoroughly explained; counsel must explain that by the very nature of the problem they cannot advise the taxpayer what to do; etc.

Representation of Husband and Wife

Another common fact situation in which conflicts arise in tax practice is representing both husband and wife. Again, this is routine and, for joint filers, a practical necessity. It becomes a conflict in many situations, however, such as:

- Estate planning, where the desires of the husband and the wife may not be identical.
- Divorce or separation.
- Other situations where spouses have separate assets or liabilities, specifically, so-called ''innocent spouse'' relief from joint and several liability.

The issue surfaces whenever what may initially appear to be common interests actually become adverse. Unfortunately, once you have client confidences of both spouses, it can be very difficult even to continue to represent one spouse. You may have to withdraw from representing both once this issue arises. This in itself may be difficult to do without jeopardizing one client's interests or confidences. But failure to withdraw and continuing to represent one spouse may leave you with a malpractice claim from the other one.

Settlor and Beneficiaries

Another source of conflicts arises in representing both grantor or testator and beneficiaries or heirs. As in the husband-wife situation, these interests may appear initially to be aligned but may diverge quite quickly. Even when a tax advisor concurrently represents the testator or grantor and the favored heirs or beneficiaries, who may be very happy with the joint representation, any less-favored heirs or beneficiaries may claim a conflict exists, or, ''in hindsight,'' even the favored beneficiaries may not feel they have been sufficiently favored.

This problem becomes particularly acute when an attorney also serves as a trustee or protector of any trusts that are set up. The claim by the one person who is disgruntled will be that a conflict resulted in favoring others.

Special Problems in Defining the Scope of the Representation

This source of potential claims arises frequently in tax practice. For instance, does the tax planner want a tax project to terminate? It may be counterintuitive to tell the client that when one transaction is completed the professional relationship with the client will terminate. But if this is not done, an attorney may be held to have a continuing duty to advise the client regarding all kinds of changes in the tax law. Is that wanted?

[20] *See, e.g.,* ABA Model Rules of Professional Conduct Rule 1.7(a); Circular 230, 31 CFR §10.29; Tax Court Rules of Practice, Rule 24(g).

[21] *See, e.g.,* ABA Model Rules of Professional Conduct, Rule 3.7(a); Restatement of the Law Governing Lawyers, §108(4) and Comment b; Tax Court Rules of Practice, Rule 24(g).

ISSN 0090-4600

Another common source of these kinds of claims is in not limiting the scope of a tax project. Is the tax lawyer advising just with respect to a transaction's tax aspects, or also with respect to other aspects related to the transaction, such as securities law, regulatory rules, trade issues, etc.? Again, an attorney does not want to undertake potentially greater liabilities for not adequately limiting the project.

Practitioners therefore must carefully delineate the scope of a tax representation just like any other. Again, a detailed and carefully written paragraph in an engagement letter can forestall many problems later.

Negligence in Tax Opinions

Needless to say, taxation is by its nature a highly technical and complex subject. Nevertheless, and perhaps somewhat surprisingly, competent tax counsel are rarely sued successfully for negligence in connection with the technical or legal analysis set forth in a tax opinion. It may be that the tax issues are by their nature so complicated and debatable that more than one reasonable view can be held to be non-negligent. Or perhaps plaintiffs' lawyers simply have no desire to argue such issues before a jury of lay people.

Where tax professionals more commonly get malpractice claims is in connection with the facts underlying the opinion. This may be couched as failure to do due diligence in investigating the facts, or acceptance of unrealistic factual representations, or ''willful blindness'' to factual representations that are plainly false.

This type of fact-related negligence has been the source of many of the claims that have been in connection with tax shelter opinions in recent years. It has also been the subject of additional regulation by the IRS.[22]

Participation in Client Frauds Such as Tax Shelters

The numerous prominent business scandals of recent years have led to much litigation against lawyers and accountants. In particular, the wave of tax shelter transactions in 1998-2003 has resulted in an abundance of ongoing litigation in the United States. Most of these cases do not involve typical, unintentional tort-type claims (negligence or failure to meet various duties to the taxpayer/client). Rather, the plaintiffs, who are usually tax shelter investors themselves (or occasionally shareholders of companies involved in shelters), frequently claim that the tax professionals engaged in intentional tort-like behavior, such as fraud or conspiracy.

The plaintiffs may assert that they, along with the taxing authorities and the fisc, have been victimized by the professionals' illegal activities. The existence of criminal cases against some defendants, in particular criminal conspiracy charges, has helped plaintiffs' attorneys in making out these kinds of civil claims. The common defense to such claims is, of course, that the plaintiffs are not innocent victims, that is, that they knew exactly what was going on, were themselves responsible for the allegedly fraudulent representations, or were even the defendants' ''co-conspirators.''

Damages claims in such cases have been quite high, due to the amount of tax the plaintiffs attempted to avoid, the additional interest and penalties incurred when the IRS has caught up with them, and the amount of fees the defendants charged for the work. Settlements, however, have generally been more modest, limited to (all or some portion of) fees and penalties, on the theory that the taxpayer would have incurred the tax anyway and the client or former client had the time value of the money in the meantime (equal to interest charged by the IRS).

The substantive steps taken by the U.S. government to address the tax shelter problem have had the intended effect of reducing such activity. As expected, the wave of fraud claims against tax professionals is similarly subsiding.

Missed/Late Elections/Statutes of Limitations

There are very complex procedural deadlines in many areas of tax practice. Often if they are missed there is no remedy at all. For instance, in U.S. tax practice, if a petition for review of a statutory notice of deficiency is not timely filed in the Tax Court, the opportunity for pre-assessment review will be completely foreclosed. Worse, if you are beyond the time in which a refund can be claimed, there is simply no relief available, even if everyone agrees the tax at issue was not due and should not have been paid. On the other hand, certain missed elections, particularly in the estate planning area, may be subject to so-called ''9100 relief'' from the IRS. This relief allows a missed election that is not provided in a statute to be made retroactively as a matter of discretion by the IRS.

Obviously, a missed election or limitations period will be laid at the door of the professional who is supposed to be watching out for such issues. Even if it can be remedied, the cost of obtaining relief from the missed deadline may end up being borne by the professional. These kinds of claims can be prevented by good calendaring systems, working only in subject areas with which you are familiar, and having multiple professionals looking over the different aspects of every issue.

Another source of claims related to the last point comes from inadequate supervising or staffing of a

[22] *See, e.g.,* Circular 230, 31 CFR §10.35. Circular 230 was issued by the Department of the Treasury pursuant to authority granted by 31 USC §330.

ISSN 0090-4600

complex matter. Tax professionals who "dabble" in areas outside of their special expertise can get in trouble or cause trouble for their partners.

The general duty to supervise and adequately staff matters may become particularly acute in highly technical areas such as taxation. For instance, the IRS requires supervisors to take "reasonable steps" to ensure that a firm's procedures are consistent with best practices and covered opinion regulations.[23]

Another common source of claims arises from not bringing the tax department of a firm into a transaction soon enough. Practically every transactional tax professional can tell you a horror story about being asked to look at a transaction right before closing and recognizing a terrible problem that had not been noticed previously. Beware of not being told the entire story or understanding the entire transaction. Don't "just look at this one provision."

Exclusive Sources of Problems for Tax Professionals

There are some kinds of issues that arise almost exclusively in the tax context that may give rise to malpractice claims against practitioners.

Advice Regarding Return Positions

The longtime standard was that one could ethically and without penalty advise a taxpayer to take a return position so long as it had a "realistic possibility of being sustained on the merits." This has recently been revised upward by Congress, so that you cannot advise with respect to a return position unless the position is "more likely than not" or adequately disclosed.[24] It is widely expected that ethics and malpractice claims will follow suit.

The penalty regime has been tightened in the United States as well, especially with respect to suspected tax shelters. Of course, enhanced prospects of penalties against taxpayers means increased chances of claims against tax advisors, too.

Another unique area of tax practice in the United States is the wide variety of administrative processes and courts in which tax issues can be litigated. In recent years the IRS has introduced numerous new and different programs devoted to dispute resolution. Practitioners need to be aware of these alternatives and discuss them with clients.

Likewise, among the factors that have to be considered in selecting a forum are:

- Deciding whether to litigate pre- or post-payment;
- The availability of discovery;
- The availability of a jury trial;
- Identifying circuits that may have more favorable precedent on certain issues;
- Generalist versus specialist judges; and
- The government's ability to assert new issues.

For example, certain actions — such as starting a refund suit while the taxpayer's limitations period for further adjustments is still open — will be avoided by knowledgeable practitioners; other courses of action will routinely be taken. Forum selection can be quite complicated, and has to be tailored for each taxpayer's situation. Inadequate planning may lead to increased costs, which the taxpayer may blame on the tax professionals.

Shelter War Fallout

Much recent activity has derived from the "shelter wars." There have been claims and acknowledgements of criminal conduct by professional firms of accountants and lawyers, banks, and investment banks and advisory firms. As noted above, malpractice claims have moved beyond claims of mere negligence to claims of outright fraud against taxpayers as well as the tax system. Numerous statutory and regulatory rules and additional penalties have been enacted in response, substantially increasing the risks and costs of noncompliance.

The enforcement environment has also changed, in part due specifically to tax shelters and in part due to broader corporate frauds or governance failures. The IRS has responded by focusing additional duties and enforcement efforts on its regulation of practitioners before the IRS in Circular 230 (31 CFR), for example, by promulgating enhanced opinion standards.[25]

Congress has enacted new substantive and procedural (reporting) rules, and significantly increased penalties.[26] More broadly, Congress enacted the 2002 Sarbanes-Oxley Corporate Fraud and Accountability Act containing substantial reporting reforms.[27] Moreover, the Financial Accounting Standards Board (FASB) promulgated additional disclosure rules related to questionable tax positions in "FIN 48."

[23] *See* Circular 230, 31 CFR §§10.33(b), 10.36.

[24] §6694 of the U.S. Internal Revenue Code of 1986, as amended.

[25] 31 CFR §10.35.

[26] *See, e.g.,* §§6111, 6112, 6662A, 6694, 6707, 6708 of the U.S. Internal Revenue Code of 1986, as amended.

[27] P.L. 107-204, enacted July 30, 2002.

ISSN 0090-4600

THE PROFESSIONAL MALPRACTICE ENVIRONMENT IN EUROPE, IN PARTICULAR IN SWITZERLAND

by Jean-Blaise Eckert, Esq.
Lenz & Staehelin
Geneva, Switzerland

Introduction

General tendencies show that nowadays clients are much more inclined to sue their advisor for malpractice than in the past. As a consequence, malpractice is an increasing source of concern for tax advisors. Since no statistics are available, it is not possible to give an average amount of malpractice cases per year. This is mainly due to the fact that many cases (probably the majority) are settled out of court and are subject to nondisclosure covenants.

An important point to consider with respect to malpractice is the contractual relation between the tax advisor and the client. In Europe, tax advisors are generally bound by an obligation of means; in other words, the advisor is obliged to dedicate a certain amount of resources to achieving a particular result, without being obliged to achieve a specific result. In addition, general principles of law regarding tort and liability for breach of contract apply. The direct consequence of these principles is that lawyers can be held liable for having breached their duty of care under the circumstances, but not for having merely failed to reach the contemplated result. Another important point is the fact that the advisor specialization (i.e., the fact that the advisor is an ''expert'' on a specific field) is highly relevant to determining whether or not an advisor failed its duty of care. On the other side, an advisor who is not capable of advising on a specific matter should simply refuse the mandate.

Similarities and Differences in Europe and the United States

There are no significant differences between the United States and Europe as to the causes of malpractice. There are some trends which show a shift from cases dealing with missed deadlines to cases dealing with consequences of what is considered bad advice. Bad advice can be either too aggressive advice or advice that is not aggressive enough.

While the substantive risk areas may be similar, differences exist as to the direct consequences of a malpractice issue. Damages awarded to the client in Europe are much lower than those that could be awarded in the same circumstances if the case were litigated in the United States. European legal tradition simply ignores punitive damages. In addition, the amount of the damages allocated to the client is generally not determined by a popular jury. Finally, European insurance carriers that are indirectly involved in malpractice issues generally prefer settlement to litigation.

One of the main issues in Europe is the clear definition of the scope of the advice attorneys are requested to give. The growth of the problem parallels the economic integration in the European market and the growth in the number of clients having cross-border activities and business. As a result, the number of law firms having offices in more than one European State has grown, as well. Nonetheless, there is no single European tax law system. Rather, there is a harmonization — or at least coordination — of the European countries' tax systems. In this context, the tax law remains a national matter. Consequently, problems arise when there is no clear definition of the scope of the advice that is to be rendered. The problem does not result from the absence of a disclaimer; rather it typically arises because of a failure to identify clearly the client's expectations of the advisor and his assignment.

As a final point, it is worth mentioning the increasing weight of so-called ''duty to browse.'' The development of electronic databases and the Internet have played an increasingly important role for the tax profession in Europe. Information that is necessary to deliver first class tax advice is available online. Examples are court decisions, guidelines issued by the tax authorities, and articles. Because the information is easily available, the direct consequence is that an advisor is supposed to know it, or at least to look for it and find it. Best practices for the tax advisor now require constant and efficient browsing.

The Malpractice Environment in Switzerland

A General Overview

As per Swiss law, the contractual relation between the legal or tax advisor and the client is characterized as a mandate in which the advisor is not obliged to achieve a certain result (the so-called obligation of result), but he is obliged to dedicate a certain amount of resources to achieving a particular result (the so-called obligation of means). The advisor promises to the client to provide a service, without promising any result. We can find the same approach in various European countries.

As a practical consequence, the simple fact that the result sought by the client has not been achieved does not imply, by itself, that the advisor is liable for malpractice. A lawyer or an advisor can be sued for malpractice and thus held liable for having breached the duty of care, but not for having merely failed to reach

ISSN 0090-4600

a contemplated result. Moreover, due care is examined under the circumstances and the client always bears the burden of proving the breach.

Obviously, the client bears the burden of proving that its advisor did not dedicate a sufficient amount of resources to the matter and/or failed to reach the required level of due care in the circumstances. This is not an easy task. It is the client that bears the risk of proceeding with its transaction. The advisor is obliged to inform its client on the exact extent of the risk incurred.

A lawyer is particularly obliged to be aware of the actual standard of the relevant law, both statutory, regulatory, and case law. According to the Swiss Federal Tribunal cases, a lawyer must be aware of all of the most recent decisions. These include all the decisions that are only published on the Swiss Federal Tribunal website (around 30 new cases per day) in addition to the most important decisions (the leading cases) that are published in the official Swiss Federal Tribunal case law reporter, the ''Official Collection of the Decisions of the Federal Tribunal.'' [28] Scholars consider a lawyer should have knowledge of decisions that have been published for at least one month. The above is troublesome for tax advisors and the only way to comply with that standard is to reach a certain level of specialization and to decline a mandate in other fields of specialty.

Leaving aside disputes relating to legal fees charged by lawyers (which have no immediate connection to malpractice), there has not been much case law since 2004 dealing with lawyers' malpractice. Several extrinsic reasons might explain this dearth of litigation. One reason is the role of insurance carriers in any litigation and the general approach that settlement is preferable to litigation. A second reason is the burden of proof placed on the claimant. As a result of the intrinsic difficulty in proving that the lawyer failed in his duty of due care, many ex-clients ultimately refrain from spending the money to bring a claim against their advisors, investing good money after bad.

The situation is similar in other European countries. Unsatisfied ex-clients are generally not willing to sue former advisors because of the uncertainty of the issue and the practical difficulty of proving that the lawyer failed his duty of due care.

The Malpractice Issue in Switzerland

In general, a large majority of the conflicts between advisors and clients are primarily related to fees, that is, the client contests the amount of fees billed by its advisor. Setting aside the matters involving fees, very few other cases have been decided by the Swiss Federal Tribunal in the past four years.

In a decision dated June 28, 2001,[29] the Swiss Federal Tribunal found a lawyer liable for having ignored a very clear cut and unambiguous legal rule that, in order to be valid, a divorce agreement dealing with certain effects of the divorce must receive the court's approval. The court also laid down the principles on which a lawyer's liability will be evaluated. While it is the client, not the lawyer, who bears the lawsuit risks, it is the lawyer's duty to inform the clients about the risk and its scope. When assessing the lawyer's liability, the risk associated with law practice must be taken into account, but balanced with the fact that the lawyer's competency has been recognized by the authority via the bar examination. The fact that a lawyer may be ignorant of a point of law is not a defense to the negligence claim.

In a decision dated August 11, 2005,[30] the Swiss Federal Tribunal ruled that a lawyer's duties comprise the examination of the relevant facts and the examination of the legal situation. A lawyer must not accept a mandate to provide services when he does not have appropriate knowledge of the relevant rules. Appropriate knowledge means knowledge of the statutes, of relevant federal case law, and doctrine. In addition, the lawyer must regularly consult published local court decisions and all the decisions of the Swiss Federal Tribunal.

Finally, in a decision dated February 13, 2007,[31] the Swiss Federal Tribunal emphasized that the lawsuit risks lie with the client, not with the lawyer. The court held that it was clear from the facts that the client was duly informed of the difficulties that his suit could encounter. As a consequence, the lawyer did not breach his duty of care.

With respect to tax law, in a recent case decided by the Swiss Federal Tribunal on November 12, 2007,[32] the Swiss Federal Tribunal ruled that a taxpayer who did not report correctly his income on his tax return is solely liable for the fine and cannot sue his tax advisor for the payment of the fine. In this case, a company bought two luxury sport cars and took substantial depreciation expenses on the cars. At the end of the day, the book value of the cars was much lower than the fair market value. Two years later the company sold the two cars at their book value to its two shareholders, i.e., the taxpayer and his wife. The tax administration took the position that the company

[28] ''Amtliche Sammlung der Entscheidungen des schweizerischen Bundesgerichts (BGE)''/''Recueil des Arrêts du Tribunal Fédéral Suisse (ATF).''

[29] ATF 127 III 357.

[30] Decision nr. 4C.80/2005, available at http://www.bger.ch.

[31] Decision nr. 4C.398/2006.

[32] Decision nr. 4C.3/2007.

ISSN 0090-4600

granted a constructive dividend to its shareholders and, because the latter did not report the income, they were liable for penalties resulting from inaccurate reporting of income. The taxpayers sued their advisor arguing he was responsible for the above-mentioned scheme. The Swiss Federal Tribunal rejected the taxpayers' arguments.

RECENT DEVELOPMENTS IN ANTI-MONEY-LAUNDERING RULES IN EUROPE

by André G.M. Nagelmaker, Esq.
ANT Trust
Rotterdam, The Netherlands

Introduction

When thinking of money laundering, many different pictures may come to mind. In my case, I immediately think of some incomprehensible French film I saw long ago concerning a lady working as a prostitute, whose protector was seen laundering and ironing banknotes. It seems that the term ''money laundering'' comes from the 1930s when the mafia used laundromats as the ostensible legitimate source of their illegally obtained monies.[33]

As an expression in a judicial context, the same source states that the term ''money laundering'' first appeared in America in 1982. Actually, despite its earlier origins, money laundering only gained prominence during the 1980s when drug trafficking and its huge profits were perceived as a danger to legitimate industry. Integration of illicit funds with legitimate activities created a situation whereby the economy could become contaminated by opportunities for corruption in the economy and the state. This risk was exacerbated by developments in the international financial community. The liberalization of capital flows, reduction of monetary restraints, and development of international financial networks and institutions meant a serious reduction of control over capital flows. It was feared that this increased the risk of illicit funds being integrated into the legitimate economy through unsupervised cross-border transactions.

Initially, money laundering was primarily connected with funds directly derived from illegal activities such as drug trafficking, extortion, and prostitution. Now, it has evolved considerably, and one may say that any funds arising from an activity that is contrary to any particular law or morality in general may be considered to involve money laundering when typical transactions involving those funds change their appearance from illegitimate to legitimate. Consequently, white-collar crime has become part of the money laundering environment, involving tax evasion, real estate transactions, insider trading, and the like. Note that a study issued by the Utrecht School of Economics[34] considers tax fraud the second most important generator of funds for money laundering.

Given rapid swings in morality due to political changes or public disclosure of perceived wrongdoings, every professional must be extremely cautious in selecting both his clients and the instructions he is willing to accept. A mistake can expose the professional advisor to the risk of losing his or her reputation and licenses in addition to the imposition of fines, penalties, and possibly imprisonment.

Since the 1980s a host of publications, regulations, laws, and documents have been issued. The accepted international standard is the 40 Recommendations issued by the FATF in 1990[35] and updated and expanded subsequently. Led by the FATF/OECD, the European Union (EU) and the U.S. government, the anti-money laundering movement has created awareness among professional advisors. No longer can anyone ignore the potential existence of money laundering in a particular transaction. The advisor is forced to take responsibility in a field where earlier governments and their institutions were considered to be primarily responsible. The posse chasing the money launderers has thus increased tremendously.

This has further resulted in a complete industry and jargon. Compliance, KYC, client due diligence, FATF, NCCS, freeze lists, sanctions lists, source of wealth, identification, verification, gatekeepers, reliance, ultimate beneficial owners, clients, services, risk-based and principle-based approach — these are all new terms or existing terms with new meanings.

The most important extension came, of course, with the introduction of anti-terrorism financing as an important objective next to the existing anti-money laundering objectives. In this section, anti-money laundering provisions include provisions to fight against the financing of terrorism, although some differences exist.

The most important development is the implementation in national legislation of the third anti-money

[33] *See* ''Billy's Money Laundering Website'' at *www.laundryman.u-net.com.*

[34] The Amounts and Effects of Money Laundering, Report for the Ministry of Finance, Feb. 16, 2007. Actually the methodology of this study was heavily criticized and the Dutch Minister of Finance distanced himself from several of the conclusions.

[35] Organization for Economic Cooperation and Development, Financial Action Task Force, The Forty Recommendations, June 20, 2003.

ISSN 0090-4600

laundering directive in the EU.[36] This section will discuss several subjects and developments related thereto and hint at several practical issues and/or approaches.

Money Laundering

There is general agreement on the three phases of money laundering, though different terms may be used for each phase. The phases are placement, layering, and integration. Generally speaking, the professional sector — covering trust companies, lawyers, tax advisors, and accountants — is most at risk in the layering phase. In the integration phase, it is acknowledged that detection may be difficult for the professional. The risk, nevertheless, is not reduced nor is his responsibility.

Placement

Placement entails getting funds derived from criminal activities into the financial system — get the cash into a bank account.

Layering

Layering is an attempt to obscure the origins of the funds by passing these through different banks in different jurisdictions under different categories of transaction (capital contributions, loans, commissions, fees), changing amounts by constantly dividing and adding, so that at the end of the line, the amount placed in the system in total is the same although that fact is not easily discernible.

Integration

Integration entails investing the obscured funds in legitimate businesses or other forms of legitimate investments.

Anti-Money-Laundering

The anti-money-laundering movement currently is focusing on the following:

Transparency

Transparency is increased by making sure that any transaction or chain of transactions is visible, including all parties related to or involved with the transaction, avoiding as much as possible any forms of anonymity, secrecy, or other limitations on disclosure of the transactions itself, the source, the purpose, the motivation, and the ultimate beneficial owner.

Traceability

Traceability is increased by requiring that all relevant parties in a chain of transactions at any place and any time, including service suppliers and professionals: (1) document the transactions, their activities, and considerations in determining the transaction itself, the source, the purpose, the motivation, and the ultimate beneficial owner; (2) lay down the relevant requirements and best practice tools in policies and procedures; and (3) check on the implementation of these procedures by nominated officers internally and government-controlled or independent supervisory bodies externally.

Awareness

Awareness is increased by making sure that any party involved in a transaction or a chain of transactions is aware of the risk of money laundering and proactively attempts to establish complete and full knowledge of the transaction, the source, the purpose, the motivation, and the ultimate beneficial owner, through continuous training of staff, checking on the application of procedures, and continuous or periodical monitoring of staff and client files.

One may also speak of deterrence (transparency will scare the bad guys while awareness will scare the professionals), detection, and recordkeeping — we know where to find the bad guys and prove they are bad.

The last focus could be punishment or civil liability, motivating people to actively participate in anti-money-laundering procedures and programs. But one could consider punishment to be deterrence, as well.

Chain and Lifetime Awareness

One important development is the increasing demand for a more proactive approach from the professional, not only looking at the transaction itself but also considering the chain of events of which it is part. Ticking the box and filling in the blanks without thinking is no longer enough. Inconsistencies between source of wealth declarations and the actual wealth portrayed stemming from capital transfers or loans have to be identified and investigated. Can a recently retired ballet dancer indeed be the ultimate beneficial owner of a billion-dollar company? Is a commission of EUR 40 million paid by an investor to his coinvestor acting as the sales agent justifiable? How did the investor obtain this investment, at what price? What is the source of the capital contribution made by the parent company? Can tax fraud be involved as a source of funds or as a purpose of the transaction?

What should the professional advisor do in these cases? He can ask for underlying documents, identify and check on all parties involved to determine if they are listed or non-listed, regulated or unregulated, and whether financial institutions are involved. He should take into account local circumstances, the size of un-

[36] Commission directive 2006/70/EC and Directive 2005/60/EU.

ISSN 0090-4600

derlying transactions, and investigate what is common practice in the market. Using common sense continues to be a good guide.

Where anti-money-laundering measures initially focused on client-entry moments (Know Your Client (KYC), Client Due Diligence (CDD)), today emphasis is placed on awareness during the complete lifetime of a relationship. This includes keeping an overview on all transactions (source and destination of funds) during that relationship. In essence, lifetime awareness is now demanded from any professional or service supplier. Each time a client approaches a professional advisor for a new transaction or new instruction, the advisor must show the same level of awareness as if it were the first time this client came to him.

Risk-Based Approach

Generally speaking, lawmakers have become aware of the fact that the administrative demands placed on all professionals and financial institutions have become overly burdensome. In an attempt to address this burden, a risk-based approach has been introduced whereby one can apply simplified and enhanced due diligence measures proportionate to the risk that is allocated to a certain client, his background, the transaction, country of origin, etc.

In June 2007, the FATF published guidance on the risk-based approach. A risk-based approach should ensure that measures to prevent or mitigate money laundering are commensurate to the risks identified. The purpose is to allow for the most efficient allocation of resources. Resources should be prioritized in such a way that the greatest risks receive the highest attention. The purpose is also to discourage ''tick the box'' attitudes and practices, effectively increasing the responsibility of the professional involved. The guidance is focusing on financial institutions. During 2008, special guidance should be published for other institutions and professionals.

Before one can actually apply a risk-based approach, a risk management process based on a risk analysis system should be implemented, identifying and grading all risks. These processes and systems should be active and constantly evolve to reflect the latest developments. Higher risks mean enhanced customer due diligence checks and enhanced transaction monitoring. The benefits are said to be increased efficiency, better risk management, and better cooperation between competent authorities and financial institutions (including professionals). Looking at it from the viewpoint of a professional you may wonder what is more (cost-) efficient, simply ticking the box and getting the requisite documents in the required format or developing an active risk determination and management system that requires constant updating and proactive application by the professional. Note that most professionals already apply this risk-based approach under the denominator of ''common sense and a good deal of experience.'' [37]

The FATF views the risk-based approach as follows:

Potential benefits:

- Better management of risks and cost-benefits;
- Financial institutions (read here ''professionals'') focus on real and identified risks;
- Flexibility to adapt to risks that change over time.

Potential challenges:

- Identifying (read also ''obtaining'') appropriate information to conduct a sound risk analysis;
- Addressing short-term transitional costs;
- Greater need for more expert staff capable of making sound judgments;
- Regulatory response to potential diversity of practice.

Not mentioned:

- Loss of business opportunities due to overcautious behavior;
- Loss of reputation due to differences over risk assessment with supervisory bodies;
- Threat of risk-management through prejudiced opinions;
- Loss of income due to increased overhead requirements.

The guidance is primarily addressed to public authorities and financial institutions; it may, however, also be applicable to professionals, provided the professionals are not subject to rule-based legislation and regulations, such as the Dutch Act on the Supervision of Trust Companies. Considering the increased professional liability risk involved with a risk-based approach, rule-based legislation could be a blessing in disguise.

As stated earlier, the Third Anti-Money-Laundering Directive (''3AML Directive'') of the EU has also embraced the risk-based approach. The U.K. Law Society has issued a Practice Note on the Money Laundering Regulations 2007 as published in the United

[37] Several commentaries issued on the Dutch legislation implementing the Third Anti-Money-Laundering Directive demanded clearer guidance (read ''a more rule-based approach'').

ISSN 0090-4600

Kingdom, which are based on the 3AML Directive. It is recommended reading for any professional.

Risk assessment factors (some also mentioned by the Practice Note [38]) are in two areas. The first of these areas relates to client demographics:

- High turnover or stable client base;
- Acting for publicly disclosed persons;
- Acting for clients without meeting them;
- Clients convicted of acquisitive crimes;
- Clients affiliated to countries with a high level of corruption;
- Acting for entities having a complex ownership structure;
- Acting for corporate or private clients;
- Acting for listed or unlisted clients;
- Acting for regulated or unregulated clients;
- Acting for clients from democratic or non-democratic, stable or unstable, emerging or developed countries;
- Acting for clients in industries sensitive to money laundering (real estate, arms, high value goods, waste management).

The second area for risk assessment relates to the nature of the services and areas of law:

- Complicated financial or property transactions;
- Providing assistance in setting up trusts or company structures;
- Payments made to or received from third parties;
- Payments made by cash;
- Cross-border transactions.

When reading this list, any professional working in an international environment probably should consider his activities to be in the high risk range and thus apply enhanced client due diligence.

Note that the risk-based approach also entails that, based on your risk-profiling of clients and ultimate beneficial owners, a professional advisor is required to monitor and check on client due diligence files at regular intervals. Obviously, high-risk clients should be monitored more frequently than low-risk clients.

When reviewing the typologies report issued by the FATF,[39] it is surprising to find that no real attention is paid to international tax planning or corporate structuring related issues. In contrast, the study issued by the Utrecht School of Economics [40] suggests that special purpose entities are often off-balance-sheet, bankruptcy remote, private, and hence easily used for illegitimate causes. The IMF has estimated money laundering at 2-5% of world GDP and that special purpose vehicles showing a high turnover are thought to be heavily involved in money laundering. Nonetheless, anyone working in the financial industry, international tax planning, and corporate services industry will recognize this as a rather rash conclusion that does not comply with empirical data gained in practice. An explanation might be that the report loosely considers tax planning equal to tax evasion and categorizes tax-efficient countries (Netherlands, Luxembourg, and Ireland) as being similar to tax havens.

Reliance

The 3AML Directive has also ratified the instrument of reliance, which constitutes a new development. Reliance covers multiple situations. It may refer to a situation whereby the client is a professional who has applied KYC and CDD procedures within the realm of the 3AML Directive or any local legislation based on it to his clients. Alternatively, it may refer to a situation whereby a client is introduced to an institution by a qualified person such as a lawyer, accountant, or notary from another EU state. It is carefully applied though, allowing one to rely only on the client due diligence performed by other regulated persons. Reliance can be applied both in a national as well as an international context, provided the person you rely on is regulated and subject to supervision. What is surprising is that trust companies and corporate services suppliers are not mentioned. The reason for this is that not all trust companies or corporate services suppliers operating in the EU are licensed and placed under supervision.

In the Netherlands, trust companies are heavily regulated and actively supervised by the Dutch Central Bank. Excluding them from reliance in an international context seems unjustified and in contradiction with the goals of reducing the administrative burden of all anti-money-laundering measures. However,

[38] The Law Society, Anti-Money Laundering, Practice Note, Legal Policy, September 3, 2007, ch. 2.

[39] FATF, Money Laundering & Terrorist Financing Typologies, June 10, 2005.

[40] The Amounts and Effects of Money Laundering, Report for the Ministry of Finance, Feb. 16, 2007. As indicated earlier, the methodology of this study was heavily criticized and the Dutch Minister of Finance distanced himself from several of the conclusions.

ISSN 0090-4600

the Dutch legislature recognizes this and allows for reliance. Internationally this has no effect regrettably.

When a professional advisor does not actually meet the client and relies on centralized Client Due Diligence facilities or copies from other offices in his network, this is defined as outsourcing rather than reliance. The author is aware of several financial institutions having ''outsourced'' their client due diligence to regulated corporate service suppliers. Also several larger firms have centralized their Client Due Diligence and Compliance departments. Information obtained at a local level is reviewed and monitored at a central level. Some firms thereby prefer to have their centre in Switzerland for confidentiality purposes.

It seems that passporting is allowed in the United Kingdom, meaning that a client does not have to provide original identification material to each office of the same firm. Between the Netherlands and Luxembourg, this is not allowed for corporate services suppliers acting in the same group. Instead, it may happen that a client must provide for different documents at different times and in different offices.

Client and Ultimate Beneficial Owner Identification

In the framework of anti-money-laundering and anti-terrorist financing, the concept of ultimate beneficial owner was borrowed from the tax environment. Most unfortunately, not all experience gained in tax matters was applied in a uniform way. The 3AML Directive has introduced the ultimate beneficial owner as well and defines an ultimate beneficial owner as any individual (natural person) who ultimately owns or controls more than 25% of the share capital or voting rights in a body or exercises control over the management of that body. This applies to beneficiaries of companies, partnerships, trusts, foundations, etc. The Dutch Act on the Supervision of Trust companies sets the mark at 10% while Dutch tax law on controlling shareholders (*aanmerkelijk belang*) is set at 5%. Apparently, it is not possible or desirable to come to one global definition of an ultimate beneficial owner.

In order to establish whether an ultimate beneficial owner can be identified, the professional advisor should make reasonable and proportionate enquiries and verify his findings. This can be done by:[41]

- Getting assurances from the client (not being the ultimate beneficial owner);
- Getting assurances from regulated persons;
- Conducting searches on online registries (SEC, IMF, CSSF, etc);
- Obtaining information from the Internet (e.g., Google);
- Obtaining reports from specialized security agencies;
- Getting assurances from the ultimate beneficial owner himself;
- Obtaining a certified copy of the passport of the beneficial owner;
- Obtaining documents on the multiple layers and companies involved in the corporate chain.

When the information obtained is consistent and coherent and a clear overall understanding of the ownership and control structure leading to the ultimate beneficial owner is apparent, the verification process can be extended or simplified, depending on the risk profile of the identified ultimate beneficial owner and the risk profile of the intended transaction or instruction given.

When identifying the client, one should also identify and document the structure or group to which the client belongs (especially when the client is a corporate entity) and clarify (or document) the chain leading from the client up to the ultimate beneficial owner. In the opinion of the Dutch corporate services industry and several professional advisors, one should follow a differentiated approach here. The relations between the client (being a corporate entity) and its direct shareholders and investments should be identified and verified through documents, while the chain leading up to the ultimate beneficial owner should only be identified. For that purpose, a flowchart or organization chart, dated and signed, should be added to the client due diligence files and updated each time a monitoring of the client due diligence files takes place.

The 25% or 10% benchmark applied to determining the status of the ultimate beneficial owner leaves open the possibility that no ultimate beneficial owner can be identified. When all beneficial owners are financial institutions that are regulated and subject to supervision, this is no problem. When private persons are involved, it may be an acceptable practice to identify all of those beneficial owners or only those that are closest to the benchmark. This is subject to the comments that appear below on control.

It is also possible that for security reasons an ultimate beneficial owner cannot identify himself fully. For instance, when an ultimate beneficial owner is living under the imminent threat of a terrorist attack, one may decide to abstain from obtaining that person's home address or place of residence. It may also be that a person is so well known and connected to a certain company (Warren Buffett or Bill Gates is often

[41] Law society practice note plus Dutch practice.

ISSN 0090-4600

mentioned) that verification becomes an irrelevant nuisance and need not take place.

A clear distinction should be made between the client and the ultimate beneficiary. The client may be the representative of the ultimate beneficiary, or anyone who is issuing an instruction on behalf of the ultimate beneficial owner. The ultimate beneficial owner could also be the client, and one ultimate beneficiary might have several clients representing him. All of them should be identified and their identity verified. In the circles of professional advisors, this has meant that all professionals and service suppliers were forced to identify each other (sometimes per client). The 3AML Directive repairs this partially by allowing certain exemptions mostly related to public, regulated, or governmental institutions. The Dutch Government issued a statement on projected savings with its project of law. Strangely, it is rather difficult to relate to this statement in practice.

Finally, it is surprising to find that meeting the client in the flesh is still considered to be a prerequisite for applying ''lighter'' client due diligence procedures. In this globalized electronic world, business has become so international that asking someone to actually appear in person seems to be a demand originated from previous centuries.

Control

In several definitions of the ultimate beneficial owner the word ''control'' is also being used. The Law Society's Practice Note speaks of situations whereby:

> [s]uch control may rest with those who have power to manage funds or transactions without requiring specific authority to do so, and who would be in a position to override internal procedures and control mechanisms.

The difficulty with using the word ''control'' in this way is that it does not exclude the possibility that a person exercising control in this form may not be an ultimate beneficiary. When he is not, he should be qualified as a client or representative and be identified for that reason. It could, of course, raise the question whether the acting ultimate beneficial owner is a straw man. If so, that would form a requirement to identify the controlling person as the ultimate beneficial owner. It might be even better not to work for this person and the acting ultimate beneficial owner at all and report a suspicion of a potential illegal structure possibly related to money laundering.

Alternatively, the controlling person may be acting outside the scope of his formal and factual authority. In that case, it would be advisable to contact the ultimate beneficial owner and/or refrain from further acting upon instructions of this controlling person. Money laundering issues need not be involved in this case unless there are other facts and circumstances that are hinting towards money laundering.

Furthermore, it may very well be possible that in a closed circle of persons (such as a family) none of the members individually directly or indirectly holds more than the requisite 10% or 25% of the beneficial ownership rights, but still one person may appear at an early or later stage to be fully in control. Following this reading, one should always determine whether in the closed circle one person has such control through formal ways such as a power of attorney or through informal ways such as always being the one who takes and implements the decisions and issues instructions thereon.

Whatever the case may be, the facts leading to the conclusion that someone is a controlling person in this sense will only appear after one has started acting on behalf of this client and/or ultimate beneficial owner. That may make life even harder as one starts in conflict with anti-money-laundering regulations while a sudden withdrawal might be construed to be tipping off. This is the time to contact an organization's nominated officer, compliance officer, or supervisor and obtain their consent on the contemplated approach.

Source of Wealth

Identifying the client and the ultimate beneficial owner and understanding or knowing the corporate and financial structures that are involved are not always enough. The 3AML Directive therefore introduced the requirement that in cases where there is an increased risk of money laundering or terrorism financing, one should apply an enhanced or intensified client due diligence procedure. One of the elements of such enhanced due diligence is to investigate the source of wealth of a client and the ultimate beneficial owner. In the directive, this is only mentioned in the framework of a publicly disclosed person acting as client.

The Dutch Act on the Supervision of Trust Companies requires the licensed corporate services supplier (trust company) to make such investigation at all times.

The question is always how one can determine the source of wealth of a client/ultimate beneficial owner. In practice several instruments are being applied:

- Declaration issued by the ultimate beneficial owner himself;
- Declaration issued by a lawyer representing the ultimate beneficial owner;
- Declaration issued by a (private) bank; and

ISSN 0090-4600

- Overview of (results of) transactions of the ultimate beneficial owner supported by underlying transaction documents, formal filings and declarations by authorities, news clippings (e.g., Google again), and affidavits or "*declaration sur l'honneur*."

Also here consistency and coherence of the data coming from the several sources, the facts as presented by the client, the ultimate beneficial owner and his representatives and a good deal of common sense should determine when the source of wealth is sufficiently identified and verified. One does not ask Bill Gates to show you his garage where he started his business and the savings account he accessed to get this business off the ground. On the other hand, it is customary to ask a client coming from Central Eastern Europe where he got the funds to invest in a privatization scheme. For this type of client, is the source of funds sufficient when a client declares he got his wealth from hard work and steady savings? Not without supporting documents.

For Dutch licensed corporate services suppliers, there is no light or enhanced client due diligence procedure. Hence, one should always identify and verify:

- The ultimate beneficial owner;
- The source of wealth of any ultimate beneficial owner;
- The goals and motivation in respect of a structure of any ultimate beneficial owner; and
- The purpose of the structure used by any ultimate beneficial owner.

The System

As we no longer live in a world of gentlemen and gentleladies who can be trusted and as government is judged by its ability to prevent mistakes and mishaps and/or its ability to prevent society from making mistakes, regulations and procedures must be applied to secure that government and society act within the parameters defined through the democratic process.

As stated above, transparency and traceability are essential elements of anti-money-laundering. So procedures must be implemented to secure that rules and regulations are obeyed at all times. Moreover, the execution of these procedures must be recorded electronically or on paper in all instances at all times. This process enables the government to check and supervise the activity.

It is, therefore, also important that the procedures, authorities, rights, forms, best practice tools, documents, files, etc. together form a system that is closed, consistent, self-sustaining, learning, and evolving. In practice it has meant that professionals and corporate services suppliers have had to implement policy and procedures manuals, train their staff, and ensure application throughout their organizations.

Systems also involve separating tasks and responsibilities by creating compliance officers, internal auditors, nominated officers, compliance committees, and commercial incentives to meet client due diligence demands.[42]

Thereby a check is created on the commercially driven, preventing these from doing harm to the reputation of the firm but also creating substantial overhead and increasing costs substantially. All this has been done for the greater good of preventing money laundering and terrorist financing.

The extent to which the internal controls system is formed and guides and controls the processes in a firm depends on the following issues in most cases:

- Risk assessment of the existing and expected client portfolio;
- Risk assessment of the activities of the firm, areas of practice geographically or economically;
- The complexity and scale of the transactions performed by the firm;
- The size of the firm;
- The skill or educational level of personnel in the firm;
- The level of personnel allowed discretion in client acceptance, client dealings, and transactions; and
- Whether and to what extent client due diligence activities are outsourced.

The client due diligence system should ensure that at all times the demands imposed by the 3AML Directive and related directives, national laws, and regulations (do not forget the sanction and freeze lists!) are fulfilled. The systems should therefore settle amongst others:

- When client due diligence is performed;
- What information should be laid down in the client due diligence;
- How this information can be verified;
- What level of client due diligence is applied and when (under what circumstances);
- When and how often existing client due diligence files are reviewed;

[42] Such are widely used to address the problems arising from the inability to charge time on a client that is not formally accepted and granted a client identification number.

ISSN 0090-4600

- Who signs off on client due diligence files;
- Who has access to client due diligence files;
- Where and how long (minimum five years) you keep the client due diligence files;
- Who accepts clients and when;
- When servicing of the client can start;
- How ongoing transactions and activities in client files are monitored; and
- How training of staff is organized and secured.

Not all firms are large enough to carry the burden of all related overhead or have the staff to divide and separate tasks. Solutions found are outsourcing of all client due diligence and anti-money-laundering related activities to specialized compliance agents or using shared service centers (offering compliance officers, committees, internal auditors) with other small firms. Whatever measures have been taken, the final responsibility for complying with all client due diligence and anti-money-laundering regulations remains with the firm and its partners.

The real challenge in designing a system is to maintain a proper balance between risk-averse behavior (in the form of ''tick the box,'' always demanding the maximum attainable information, or saying ''no'' to a client) and commercial agility and flexibility (in the form of avoiding, mending, and bending procedures opportunistically, ignoring disturbing facts and circumstances, taking the easy way at all times, and following a minimal approach on client due diligence).

Parallel Processing or Process Alignment

When applying anti-money-laundering in practice, the question of due diligence procedures can be raised when entering into a business relationship. The principle is that client due diligence is required prior to establishing a business relationship and/or carrying out an occasional transaction. Suppose one of your professional contacts has referred one of his clients to you. You do the normal conflict checks and have an introductory meeting with this person. Parallel processing then requires you to identify him and verify this by making a copy of his passport. Following this meeting, you send the client a short note on the meeting. Should you not be formally engaged but still charge for this, then you might be speaking of having entered into a business relationship despite the lack of continuity. Should you charge your professional contact, then that person is the client but the person you met with could be the ultimate beneficial owner. In either event, you will need to identify that person and verify his identity without entering into a direct business relationship. Does this mean that as soon as you have the intention to charge for your services, either directly or indirectly, you enter into a business relationship requiring client due diligence? In practice, the costs and administrative burden of setting up a client due diligence file may prevent you from charging anything and thus establishing a business relationship during this investigative period. This may not be correct, but it is still very practical.

Parallel processing as referred to above refers to the situation whereby you already start acting for a client, even when not all demands on client due diligence have been fulfilled, while parallel to these actions you complete the client due diligence procedure. This is, of course, skating on thin ice. A risk-based approach should be applied here. Depending on your risk assessment, you should either be very strict or flexible. In the Dutch corporate services practice, parallel processing is applied whereby the basic principle is that the identity of the ultimate beneficial owner should at all times be known prior to undertaking any preparatory actions. Identification and verification of the ultimate beneficial owner's identity and his source of wealth and goals, motivation, and purpose of the structure should be done prior to actually completing any structure or transaction. Without this nuance, it would be impossible to operate. For you as a professional, this may be less of an issue as you are involved earlier in the process when time constraints and secrecy are less of an issue.[43]

Parallel processing may also be required in cases where other regulatory constraints do not allow the ultimate beneficial owner to give full clarity on the intentions, goals, and motivations. Most commonly, this situation occurs when insider trading regulations and corporate governance demands require the circle of persons fully informed to be as small as possible. In these cases, a risk assessment should determine whether it is acceptable to the professional and corporate services supplier to operate to some extent in the dark.

The 3AML Directive and rules and regulations based thereon do not actually permit or forbid parallel processing. The express introduction of a risk-based approach in these circumstances apparently was one step too far. Yet, in practice, it can be unavoidable to use parallel processing in order to avoid conflict with other regulations guarding the integrity of the legal and financial system.

[43] Actually, Dutch legislation will allow this. It states that verification can be performed while the business relationship is being established, provided this is done for reasons of not disturbing the servicing of the client and provided there is little risk of money laundering or terrorist financing. Article 4 *Wet ter voorkoming van witwassen en fianciering van terrorisme*.

ISSN 0090-4600

Process alignment in this case refers to the situation where things are done one step at a time and in perfect order. When the risk assessment does not allow for parallel processing, process alignment should be followed. This is, of course, a commercial challenge and can easily result in conflicting situations where a transaction or completion is stalled due to formal demands. Not every client is understanding in these situations.

Money Laundering Warning Signs

As money launderers are said to be extremely innovative, no list of warning signs can ever be complete or up to date. As with the virus-checker on your computer, you have to update it constantly.

One problem is, however, that the information on money laundering is not freely shared and actively distributed by government agencies and compliance departments to you, the gatekeepers in the system. As a result, a large disparity exists between the information available to governments and the information available to professionals. The absence of any mechanism allowing for the exchange of information from governments to the professional advisor other than sanction lists means that the professional is not compensated for his efforts to any extent by receiving useful intelligence from supervisory bodies in the government. It is only after his reputation has been sullied that the professional may discover that he did not know enough or find enough information on a client — information that was known contemporaneously by supervisory bodies in government. Of course, if all information were freely exchanged by supervisory bodies, suspicious fact patterns would become common knowledge and could lead to witch hunts causing many innocent victims. Clearly, some form of balance is required.

In the absence of government information on specific persons, the following is an incomplete list of warning signs of the existence of money laundering, as identified in professional literature and practice:

- Excessively secretive clients;
- Instructions that are unusual, either because they are outside your area of expertise or because they are unusual in your area of expertise;
- Changing instructions, where the changes are not expected and are not justified by predictable commercial, financial, legal, or tax changes in the actual situation of the client as initially portrayed to you;
- Disputes settled too easily;
- Loss-making transactions;
- Cash payments;
- Use of client accounts;
- Sudden unpredicted payments and transfers to your client accounts;
- Transactions in or involving persons from suspect territories;
- Use of trusts without disclosure of beneficiaries;
- Use of unregistered charities;
- Use of proxies and attorneys;
- Multiple transactions involving a high-value good at different prices between different parties (A-B-C transactions);
- Use of offshore companies;
- Use of complex international structures;
- Use of territories applying bank secrecy laws;
- Use of funds derived from unregulated third parties;
- Unusual valuations of high- or low-value goods and real estate;
- Back-to-back financing;
- Re-invoicing and/or fictitious sales and purchases;
- Use of correspondent banks from doubtful territories in a transaction;
- Cash-based real estate transactions;
- Quick and considerable gains on transfers of assets or financial products;
- Gradually changing profile of counterparties in subsequent transactions;
- Gradually increasing transactions lacking an apparent commercial reason (no profits);
- A consistent flow of smaller incoming amounts followed by large transactions of accumulated funds;
- Any use of bearer documents (shares, certificates, bonds, CDs, LCs);
- Inconsistencies in accounting treatment between companies in a group structure;
- Introduction of foreign territories in a transaction for no apparent reason;
- Complex transfers of goods;
- Use of special purpose vehicles;
- Use of bankruptcy remote vehicles (foundations, *stiftungs*, trusts);
- Use of travelers' checks;

ISSN 0090-4600

- The person referring the business to you is not known to you;
- The client is coming to you without proper introduction; and
- The client is coming to you on a Friday afternoon.

Please be aware of the warning in the money laundering report issued by the Utrecht School of Economics: "Money launderers have no tattoos but wear ties." The inevitable conclusion is that you have to use your common sense at all times, ignore nothing, show awareness, be proactive in raising questions and demanding when reviewing documents, and apply a healthy amount of skepticism in respect of any client or transaction.

Conclusion

It has not been possible to deal with every aspect of anti-money-laundering in this section. Tipping off, making a disclosure, legal professional privilege, and professional liability are dealt with separately. Each country will eventually have its own enforcement system, so we did not deal with that.

Though there are common denominators in the form of the EU Directives, FATF recommendations, and UN-based regulations, each country will fill in the several elements of anti-money laundering rules differently. Most likely, different risk-based approaches will occur. Some systems will be more formal, other more principles-based. Definitions of the ultimate beneficial owner, client, and representative are already different and have already caused confusion inside one territory between different professional groups such as banks, legal professionals, and corporate service suppliers.

The risk-based approach translates into a tendency to make extra checks. In larger organizations, the "CYA" [44] approach will no doubt occur, increasing the transaction costs of any movement in goods, assets, and financial means in the society. Studies on the actual benefits (decrease in crime, decrease in "black" money, and decrease in tax fraud) of all anti-money-laundering measures are difficult to find, as are actual cost-benefit studies. As prevention of crime and reduction of money laundering cannot be measured, the benefit side of the equation cannot be filled in.[45] The study issued by the Utrecht School of Economics still suggests that the economic cost of crime involved in money laundering in the long run is higher than the economic cost of compliance with anti-money-laundering procedures. It is hoped that the economic difference and the social benefits are actually big enough to justify the effort put into anti-money-laundering. However, no current study empirically measures whether the increased transparency and the resulting decrease in commercial confidentiality is compensated by a substantial decrease in crime and extra safety measures from the government.

Consider that, as a result of all these laws and regulations, you, a professional working in an international environment, have to present certified copies of your passport to numerous persons, authorities, etc. All your personal data can be found on those copies. Whenever somebody would abuse that data, no compensation could be found anywhere except possibly with the perpetrator of the abuse. The damage to your reputation may, however, not be compensated in any way. The thought of it does not enhance my sense of security.

The benefit for the professional and for the corporate services supplier is that it has become easier to deny access to the unwanted, be it clients or transactions. Moreover, in the unfortunate event that you are involved in a fraudulent scheme of some kind, you can at least show that you have done what can reasonably be done to prevent such involvement and even perhaps prevent such crime.

A VIEW FROM THE UNITED STATES

by Stanley C. Ruchelman, Esq.
The Ruchelman Law Firm
New York, N.Y.

Introduction

As the end of the first decade of this millennium comes into view, tax advisors have become concerned with responsibilities to persons other than clients. In the United States standards of practice are being raised and civil and criminal penalties can be imposed that place the tax advisor in jeopardy if he or she fails to heed responsibilities that were unknown during most of the 20th century.

The advisor has responsibilities to the Internal Revenue Service, which has an interest in regulating the

[44] CYA is a coarse but brief description of the attitude portrayed in larger organizations where priority is given to diminishing one's own responsibility at the cost of burdening the organization with additional procedures, sign-offs, advices, internal approvals, etc.

[45] In answer to parliamentary questions, a government report on Dutch anti-money-laundering law states that 172,865 money laundering reports were made in 2006, of which 34,531 were considered suspect. Actual cases were only 835 and at the date of writing of the report only 363 cases went to court — a fine result of 0.21% of all reports at a cost of an estimated EUR 231.6 million for banks in the Netherlands alone.

ISSN 0090-4600

practice of persons providing advice to taxpayers. If the advisor proposes a plan that fails to follow those standards, a client's tax return preparers may disclose the inherent risk in the plan at the time a tax return is prepared, which ultimately can lead to further examinations by the IRS. The U.S. tax advisor may find that he has responsibilities to a foreign government that has an interest in collecting revenue from persons within its tax jurisdiction. If the advisor's clients follow a plan that is viewed to result in the evasion of foreign taxes, violation of that responsibility could encompass technical violations of U.S. criminal law — not tax law. Criminal laws are enforced by the Justice Department or the U.S. Attorney for a particular federal district.

In a kinder and gentler world, tax advisors could advise clients with the expectation that all advice given would remain confidential or would be reviewed in the context of the four corners of the document in which the advice was embodied. Today, that expectation is unwarranted. Even in a non-tax shelter matter, third parties have interests in the advice that is given to a client and the risks that a client may be willing to take regarding U.S. and foreign tax law. Advisors who ignore those interests do so only at their peril. This section will comment on several ways in which the interests of third parties affect the outside tax advisor in the United States when advising the client.

Factual Context

To illustrate the way in which the advisor's relationship has changed, a brief fact pattern, based on a Tax Court decision in 1996, will be helpful. The case is *InverWorld Inc. v. Comr.*[46] The case is wonderfully complex and the technical issue is beyond the scope of this article. However, in brief, this is what was involved:

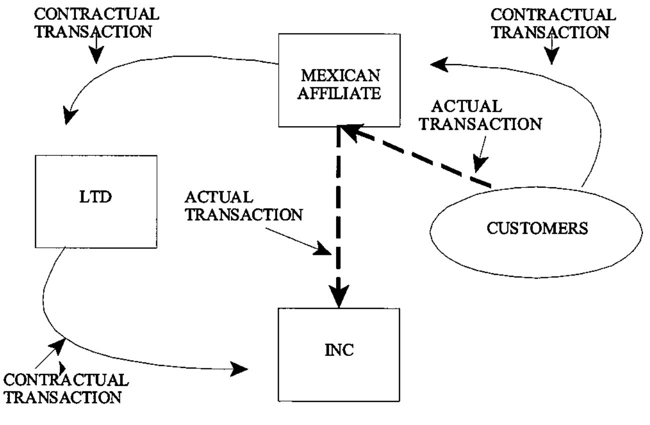
LTD was an investment management and financial services company organized pursuant to the laws of the Cayman Islands. LTD owned all the shares of HOLDINGS, a U.S. corporation, which in turn owned all the shares of another U.S. corporation identified as INC. INC was registered with the SEC as an investment advisor pursuant to §203 of the Investment Advisors Act of 1940.

LTD was created by the owners of a securities brokerage firm that was registered in Mexico and headquartered in Mexico City. The owners of LTD managed a diverse group of financial services companies. At the time, wealthy Mexicans sought opportunities outside Mexico for investments that were considered safer than domestic investment opportunities. In response to the capital flight, the Mexican government placed restrictions on the operations of Mexican financial institutions and closed its borders to non-Mexican financial institutions. This culminated in the imposition of exchange controls by presidential decree and the nationalization of the country's private banks. No Mexican-chartered bank or financial institution was permitted to handle foreign-currency-denominated accounts.

INC was engaged by LTD to provide back room services, investment advice, and to manage the portfolio maintained on behalf of LTD's clients on a fully discretionary basis. Copies of LTD's client records were retained at the office of INC in San Antonio, Texas. These included transactional documents (i.e., statements of account, brokerage account numbers, and the like) and a correspondence file. LTD's client clearing account was maintained in the United States. In addition, INC prepared the periodic statements for clients of LTD. These statements were then provided by INC directly to account representatives in Mexico.

The intercompany agreement was executed on behalf of LTD by legal counsel in the U.S. An officer of INC executed the agreement on its behalf. In return for the services, INC was paid a monthly fee. These fees represented in excess of 90% of the revenue derived each year by INC.

In some instances, the customers of LTD's affiliates in Mexico were directed to LTD for investments that could not be placed in Mexico. The customers met with officers of INC in San Antonio. In other instances, orders were placed directly with INC acting on behalf of LTD. In broad terms, the following diagram describes the flow of the transactions:



LTD never filed any U.S. tax returns or information statements with regard to clients investing in the United States. It was of the view that, except for the activities of INC, its business was carried on outside the United States. It viewed INC as an independent contractor who was paid an arm's-length fee for per-

[46] T.C. Memo 1996-301.

ISSN 0090-4600

forming certain back room activities, rendering investment advice, and for executing trades in securities markets. Thus, LTD believed that it was not engaged in a trade or business in the United States and had no effectively connected income.

The IRS determined that LTD was engaged in a U.S. trade or business and that most of its income was derived from sources in the United States. The IRS sought to impose income tax and branch profits tax or, depending on the year, dividend withholding tax. It asserted taxes, penalties, and interest.

The IRS won a resounding victory on the issues. That is beyond the scope of this article. We are concerned only with the penalties that were asserted on the taxpayer, the defense raised by the taxpayer, and the way in which the company's tax advisors addressed the issues at the time business was conducted.

At trial, LTD argued that penalties should not be imposed because legal counsel advised the company that it was not engaged in a U.S. trade or business. It argued that it retained one of the large international accounting firms and a well-known law firm in New York with an excellent reputation in advising foreign investors in the United States. Both had full knowledge of the facts; indeed, the lead attorney drafted the intercompany services agreement and executed that agreement on behalf of LTD. It was asserted that these facts should have been sufficient to demonstrate reasonable cause for the failure to file tax returns under a case that stated:

> When a corporate taxpayer selects a competent tax expert, supplies him with all necessary information, and requests him to prepare proper tax returns, we think the taxpayer has done all that ordinary business care and prudence can reasonably demand.[47]

Unfortunately, the Tax Court determined that neither the law firm nor the accounting firm actually addressed all the issues involved when a foreign corporation appoints a services company in the United States to carry on activities. Here is what it found:

> The record contains one letter, dated December 18, 1984, in which [the attorney] writes ''in response'' to [the accounting firm]'s questions as to whether LTD ''is subject to United States income tax.'' [The attorney] concludes that LTD ''is not subject to United States tax other than on any 'fixed or determinable annual or periodical' United States source income that it may receive.'' In his letter, [the attorney] does not address the issue of whether LTD must file a U.S. income tax return.
>
> Similarly, [the accounting firm]'s work papers do not address the issue of whether LTD must file a U.S. income tax return. In its work papers for taxable years ended June 30, 1984, 1985, 1986, 1987, and 1989, [the accounting firm] refers to section 8 of petitioners' permanent file to support its conclusion that petitioners have no U.S. tax liability. That section of the permanent file contained [the attorney]'s letter to [the accounting firm] dated December 18, 1984, and * * * [an] internal memorandum dated August 28, 1985, * * * [stating] that [the accounting firm]'s tax analysis of LTD in the 1984 and 1985 financial statements is ''appropriate'' based on a discussion with * * * [the client and an internal] analysis. [The accounting firm]'s financial statements for petitioners conclude that LTD ''is not subject to U.S. federal or state taxes on income as it has no offices in the United States, no U.S. source income, and no income effectively connected with the conduct of a U.S. trade or business.'' [Footnotes omitted.]

Clearly, to the extent that the advisors to LTD provided any analysis, it was limited to a regurgitation of the plain meaning of Code §§864 and 1441. It is safe to say that the advisors evidenced relatively little sensitivity to facts that might have been inconvenient for the client's position and had no concern whatsoever for the basic business model of LTD, which was the funneling of Mexican money into U.S. dollar-based investments, contrary to Mexican currency law and outside compliance with Mexican tax law.

If the New York law firm or the major accounting firm were retained today, the issues that each would likely consider to be relevant would be far different; the concerns of stakeholders would have to be taken into account even if those concerns would conflict with the goals of the client.

Pasquantino and the Incidence of Wire Fraud

Although not generally thought of as a subject in a law school corporate tax course, the application of the wire fraud statute to a cross-border planning transaction should now be evaluated whenever a cross-border client takes steps to prevent a foreign country from collecting tax in connection with a particular transac-

[47] *Haywood Lumber & Mining Co. v. Comr.*, 178 F.2d 769, 771 (2d Cir. 1950), *modifying* 12 T.C. 735 (1949).

ISSN 0090-4600

tion. Under the holding in *Pasquantino*,[48] the federal government has established itself as a stakeholder with respect to the business morals of the population in relation to a foreign government's right not to be "cheated" out of taxes due. Tax advisors that assist clients in those matters may discover that the concept of money laundering is relatively broad in its application. The operative concept on a go-forward basis might revolve around the practical meaning of the term "cheated."

The U.S. wire fraud statute [49] provides as follows:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined under this title or imprisoned not more than 20 years, or both. If the violation affects a financial institution, such person shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

Pasquantino involves an attempt to deny the Canadian government of its rightful excise taxes on alcoholic beverages. The case involved New York residents who engaged in smuggling operations across the Canadian border. The plan for smuggling was simple. Periodically, the defendants would call a discount liquor shop in Maryland and order liquor at a relatively low price. One of the defendants would then drive to Maryland, purchase the liquor, and drive back to New York. Thereafter, he would cross the border into Canada.

The defendant was convicted of wire fraud because of the use of interstate telephone lines. The conviction initially was reversed by the Fourth Circuit, then reinstated by an *en banc* panel of the Fourth Circuit, and finally was affirmed by the Supreme Court of the United States. While much of the Supreme Court's discussion addresses the viability and scope of a legal doctrine known as "the revenue rule," which prevents courts from enforcing tax laws of other countries, the more sweeping part of the decision is the finding that Canada had a valuable property right in the form of its entitlement to collect taxes.

The Supreme Court concluded that the defendant participated in a scheme or artifice to defraud and the object of the fraud was money or property in the hands of the victim, here, the Canadian government. These are the basic elements of the crime that must exist in order for the jury to convict. The Court found that they were present in the case. The fact that the victim of the fraud happened to be the government of Canada, rather than a private party, did not lesson the injury. The proscribed activities took place in the United States and the federal government had an interest in prosecuting the crime. The Court stated:

> Petitioners used U.S. interstate wires to execute a scheme to defraud a foreign sovereign of tax revenue. Their offense was complete the moment they executed the scheme inside the United States; "[t]he wire fraud statute punishes the scheme, not its success." *United States v. Pierce*, 224 F. 3d 158, 166 (CA2 2000) (internal quotation marks and brackets omitted); see *Durland*, 161 U.S., at 313 ("The significant fact is the intent and purpose"). This domestic element of petitioners' conduct is what the government is punishing in this prosecution, no less than when it prosecutes a scheme to defraud a foreign individual or corporation, or a foreign government acting as a market participant.

Had *Pasquantino* been decided prior to the occurrence of the underlying facts in *InverWorld*, would the advisors have acted differently? Quite likely the answer would be yes.

First, it is not unwarranted to assume that the entire structure involving LTD in the Cayman Islands and INC in the United States was not thought up in the Cayman Islands or Mexico. The plan was likely formulated or approved in the United States and communicated to InverWorld management from offices in the United States. Clearly the mail or telephone wires were used to communicate the plan.

Although the principal goal of the arrangement may have been to circumvent currency control rules in Mexico, the plan nonetheless contained a Mexican tax evasion element, as the income from the investments was not reported in Mexico by some or all the customers of LTD even though the income was likely taxable under the rules then in effect. Clearly, evasion was not the locomotive for the plan, but it was an element. Conceivably, U.S. management of INC would be in jeopardy under the rationale of *Pasquantino*. By setting up the structure and inviting Mexican residents to utilize the structure for investments, it is not inconceivable for a U.S. Attorney — meaning a federal prosecutor — to allege, and for a jury to determine, that every person involved participated in a scheme or artifice to defraud the Mexican government and the object of the fraud was its right to collect tax revenue.

[48] *Pasquantino v. U.S.,* 544 U.S. 349 (2005).

[49] 18 USC §1343.

ISSN 0090-4600

None of the advisors seemed to ask whether the arrangement assisted Mexicans in avoiding their home country tax obligations. Rather, the advisors focused their attention on matters in which they were expert — the application of U.S. international tax rules to specific transactions of a Cayman Islands corporation and its affiliated service company in the United States. As a result of *Pasquantino*, such focus is probably inappropriate in light of the risks for all who are involved.

Some may argue that the advisors to InverWorld were merely vendors to management, akin in their function to an automobile sales person who sells a car to a new customer intent on robbing a bank and who is in need of a getaway car. Just as the automobile sales person is not an aider or abetter to bank robbery, the advisors to InverWorld should not be co-conspirators to fraud of the customers of their client. This analogy goes only so far — the automobile dealer did not have knowledge of how the automobile was to be used and could not have the requisite intent. In comparison, the lawyers and accountants to LTD and INC presumably knew of the intended function for LTD and INC in InverWorld's worldwide business plan, and acquiesced to that purpose. Even if the advisors were not "aiders and abetters," the advisors, unlike the auto dealer, knew of the plan at the time services were performed and fees received. As will be seen in the discussion of money laundering below, those facts may be sufficient to place the advisor and his firm in jeopardy under the money laundering statutes.

Money Laundering

One noted treatise on the rules addressing white collar crime in the United States[50] begins its section on money laundering with the following quote from a presidential commission:

> "Money laundering" has been defined as "the process by which one conceals the existence, illegal source, or illegal application of income, and then disguises that income to make it appear legitimate."

Although typically thought of as a tool to attack narcotics traffickers, mobsters, and terrorists attempting to legitimize the revenue from their activities or providing funds which are to be used in those activities, the reach of the money laundering statute in the United States is broad in scope. It criminalizes everyday financial transactions that are not subject to criminal sanctions absent a specific intent.

The money laundering provisions of U.S. law appear in two sections of Title 18 of the U.S. Code. The first, §1956, makes it a criminal offense to engage in a financial transaction with the proceeds of some form of unlawful activity with the intent, inter alia, of promoting the carrying on of a specified unlawful activity or of concealing or disguising the nature, the location, the source, the ownership, or the control of the proceeds of specified unlawful activity.

The intent to promote is what gives the section broad application. While cases are not consistent, several U.S. circuit courts of appeal provide that any financial activity that involves the proceeds of a crime violates the statute because the purpose of the crime is to obtain funds illegally and to benefit from the use of the funds.[51] To place the scope of the provision in perspective, if the Pasquantino brothers retained a lawyer to provide tax planning for the investment of the proceeds of the business involving the smuggling of whiskey into Canada, the brothers likely would be guilty of a technical violation of the statute.

The criminal penalty for violating §1956 by engaging in a financial transaction with the proceeds of an unlawful activity accompanied by the requisite intent is a fine of not more than $500,000 or twice the value of the property involved in the transaction, whichever is greater, or imprisonment for not more than 20 years, or both. A civil penalty is also provided in the statute. It calls for a $10,000 fine or, if greater, the amount involved.

The second money laundering provision is §1957 of Title 18 of the U.S. Code. It provides that a technical violation of the law exists when any person engages in a monetary transaction in criminally derived property of a value greater than $10,000 where the money or property is derived from a specified unlawful activity. This is commonly referred to as the "receipt and deposit" statute because if the property is dirty and that fact is known, a technical violation of the statute may have occurred. In that regard, §1957 differs materially from §1956 because of the absence of any requirement of intent to promote or conceal. In addition, knowledge of the precise source of the funds on the part of the recipient is not relevant if the recipient knew that the funds were derived from some form of criminal activity or intentionally ignored the facts.

For the statute to be violated, the transaction must involve a monetary instrument that affects interstate or foreign commerce. A monetary instrument is defined as follows:

[50] Comisky, Feld & Harris, *Money Laundering, Asset Forfeiture and Related Topics*, §11.01 (6th ed. 2008).

[51] *U.S. v. Maher*, 108 F.3d 1513, 1525–1528 (2d Cir. 1997); *U.S. v. Hill*, 167 F.3d 1055 (6th Cir. 1999), *cert. denied*, 528 U.S. 872 (1999); *U.S. v. Montoya*, 945 F.2d 1068, 1076 (9th Cir. 1991).

ISSN 0090-4600

> [T]he deposit, withdrawal, transfer, or exchange, in or affecting interstate or foreign commerce, of funds or a monetary instrument * * * by, through, or to a financial institution * * *, but such term does not include any transaction necessary to preserve a person's right to representation as guaranteed by the sixth amendment to the Constitution.

The criminal penalty for violating §1957 is up to 10 years in prison and a fine of $250,000, or, if greater, twice the amount involved in the monetary transactions. A civil penalty is also provided in the amount of $10,000,[52] or, if greater, the amount involved.

To place the scope of the provision in perspective, the tax lawyer providing tax advice to the Pasquantino brothers involving investments of the profits of their business may risk being guilty of a technical violation of the statute when he deposits the resulting retainer or fee in his firm's bank account. This presumes, of course, that he has knowledge that the Pasquantino brothers are engaged in some form of criminal activity that is used to fund their lifestyle. Again, the level of knowledge required to sustain a conviction is not that the attorney knew the wire fraud statutes in the United States had been violated. The standard is that some unlawful activity has occurred that could be used to fund expenditures.

As seen in the foregoing excerpt of the statutory language, an exception exists in §1957 that allows a criminal defendant to fund his right to counsel in a criminal trial. However, in the circumstances of the lawyer in the above example, the matter giving rise to the fee relates to tax planning, a noncriminal matter. Legal fees for noncriminal matters are not covered by the exception.

In addition to the penalties that are provided in §§1956 and 1957, civil or criminal forfeiture provisions are also applicable under §§981 and 982 of Title 18 of the U.S. Code. Civil forfeiture applies to any property involved in a money laundering transaction and any property traceable to that property. In criminal forfeiture proceedings, the forfeiture reaches other assets of the defendant — so called ''substitute assets'' — when the laundered assets have been disposed of or are otherwise unavailable.

For the tax advisor caught in this bind, the sting of the penalty or the forfeiture is worsened by §162(f) of the U.S. Internal Revenue Code (Title 26 of the U.S. Code). Under that provision, a business expense deduction is not allowed for any fine or similar penalty paid to a government for the violation of any law. While that provision may not apply to court-ordered restitution payments under which the proceeds of fraud are returned to the victim,[53] forfeiture to the government is not restitution even though it results in a loss.

In sum, a money laundering offense is a real threat for an advisor whose plan assists a client in the violation of a foreign tax law, once it is realized that use of interstate or foreign means of communication used by the client assists in defrauding a foreign government of its rightful tax payment. In such case, the tax advisor may not have ''aided or abetted'' the crime, but he received the proceeds of an activity that was known or that should have been known to be criminal in the United States. When the proceeds are received in a ''plain vanilla'' commercial transaction, the lawyer is at risk. The U.S. Attorney need prove only that: (1) a financial transaction took place; and (2) the transaction involved ''dirty money.''

Circular 230

Circular 230 establishes rules governing the recognition of attorneys, certified public accountants, enrolled agents, and other persons representing taxpayers before the IRS. It includes rules relating to the authority to practice, prescribes the duties and restrictions relating to such practice, and sanctions the disciplinary proceedings for violating the rules. A practitioner may be suspended or disbarred from practice before the IRS. Where that occurs, others may not, knowingly and directly or indirectly, accept assistance from or assist that person in any matter constituting practice before the IRS.

Section 10.35 of Circular 230 addresses covered opinions. In pertinent part, it provides that attorneys and accountants who prepare a covered opinion must comply with the standards of practice set forth in that section. Section 10.36 of Circular 230 imposes obligations on those persons who have principal authority and responsibility for overseeing a firm's tax practice. Management of the tax function must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees to comply with the standards of §10.35. Moreover, management of the tax function is subject to discipline for failing to comply with this requirement through willfulness, recklessness, or gross incompetence where members of the firm violate the standards of §10.35. Discipline is also possible if management of the tax function fails to correct the problem once it becomes known or once it should have become known.

[52] The civil penalty appears through a cross-reference from §1956(b).

[53] *Stephens v. Comr.*, 905 F.2d 667 (2nd Cir. 1990), *rev'g* 93 T.C. 108 (1989).

ISSN 0090-4600

We focus on only a small part of covered opinions — reliance opinions. A reliance opinion must relate to an entity, plan, or arrangement for which the avoidance or evasion of any tax imposed by the Internal Revenue Code is a significant purpose. Written advice is categorized as a reliance opinion if the advice concludes at a confidence level of at least more-likely-than-not that one or more significant federal tax issues can be resolved in the taxpayer's favor. Excluding tax shelters, written advice is not treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. To be prominently disclosed, at a minimum, an item must be set forth in a separate section (and not in a footnote) in a typeface that is the same size or larger than the typeface of any discussion of the facts or law in the written advice.

Section 10.35 establishes standards for covered opinions. In some respects, the standards could be analogized to legal research and writing courses that are mandatory in law school. For example:

- Reasonable efforts must be made to identify and ascertain the facts and to determine which facts are relevant. The opinion must identify and consider all facts determined to be relevant.
- The opinion must not be based on any unreasonable factual assumptions, such as an amorphous, unnamed business purpose or projections prepared by an unskilled person.
- The opinion must not be based on any unreasonable factual representations, statements, or findings of the taxpayer or any other person.
- The opinion must relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts.
- The opinion must not contain internally inconsistent legal analyses or conclusions.
- The opinion generally must consider all significant federal tax issues.
- The opinion must provide a conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant federal tax issue considered. If a conclusion cannot be given, the opinion must so state.
- The opinion must describe the reasons for the conclusions, including the facts and the legal analysis.
- The opinion must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement.
- The opinion must provide an overall conclusion and the reasons in support thereof.
- If the opinion is a limited scope opinion, less than all of the significant federal tax issues may be addressed, provided that the taxpayer's potential reliance on the opinion for purposes of avoiding penalties is limited to the federal tax issue(s) addressed.

In *InverWorld*, LTD argued that it relied on the opinion of recognized experts in determining that no tax returns had to be filed because no effectively connected income existed. In that regard, the New York law firm provided a one-page letter written in 1984 that conveyed no reasoning, but concluded that only items of fixed and determinable income were taxable. The letter was replicated in the accounting firm's permanent file each year.

Were Circular 230, as it currently exists, in existence in 1984, it is likely that the law firm and the accounting firm would have acted differently.

First, all communication from the law firm to the client or the accountants other than reasoned opinion letters would have been crafted to avoid being categorized as reliance opinions. Hence, that correspondence would have contained the now universal disclaimer of law firms and accounting firms: "This communication is not intended or written to be used, and it cannot be used, by the taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer." The disclaimer is so widely accepted that it is often found on e-mail messages from non-U.S. firms that render no U.S. tax advice whatsoever.

Second, assuming that the client needed the letter in order to respond to an inquiry of its accountants as to the exposure of LTD to U.S. tax, the one-page letter would have been expanded to address all issues addressed in the Tax Court opinion. The Tax Court opinion rambled over approximately 90 pages, addressing various sections of the Internal Revenue Code, from §482, to §§871 and 881, to §861, to §864, to §1441, and then to the penalty sections of the Code, §§6651, 6653, 6655, and 6656. Presumably, any written tax advice short of a limited opinion — which would not have been appropriate here in light of the scope of the question posed — would have addressed these issues as well. Today, the opinion letter would have addressed the following issues, at a minimum:

- Did LTD have economic substance?
- Did it have an office outside the United States at which activity was conducted?
- Did it have an office inside the United States?

ISSN 0090-4600

- Was INC an independent agent?
- What was LTD's trade or business?
- Did LTD make loans to the public?
- Did it have effectively connected income?
- Was it the payor of interest to foreign persons?
- Was it exposed as a withholding agent?

Finally, the accounting firm would likely not have accepted a one-page letter from a New York law firm, no matter how prominent the law firm. See the discussion below regarding preparers' penalties and Code §6694.

Interestingly, if Circular 230 as it currently exists were in existence at that time, the client might have had a better opportunity of avoiding penalties. In many respects, *InverWorld* extended the law in ways that some advisors believe is not supportable. For example, the court concluded that an agent that serviced only one principal is a dependent agent in principal part because it serviced only one client.[54] However, the income tax regulations that were in issue clearly state that such fact should not necessarily be determinative.[55] Presumably, the taxpayer's positions with respect to some or all of the issues that were decided against the taxpayer were justifiable in light of the practice at the time and a covered opinion would have addressed those issues.

Section 6694 — Tax Return Preparers' Penalty

While Circular 230 establishes standards of conduct for persons who practice before the IRS, §6694 of the U.S. Internal Revenue Code imposes penalties for tax return preparers who prepare returns in which there is an understatement of liability reported by the taxpayer. In general, the penalties established in §6694 are integrated with the standards in Circular 230.

Prior to its amendment in 2007, the penalty under §6694(a) imposed a first-tier penalty of $250 if all of the following three circumstances existed with regard to a tax return reporting an understatement of liability. The first was that a part of an understatement of liability with respect to any return or claim for refund was due to a position for which there was not a realistic possibility of being sustained on its merits. The second was that the income tax return preparer knew or reasonably should have known of the unrealistic position. The third was that the unrealistic position was not disclosed or was frivolous.

In addition, §6694(b) imposed a second-tier penalty of $1,000 if either of the following two circumstances existed with regard to a tax return reporting an understatement of liability. The first was that the understatement in whole or in part reflected a willful attempt by the income tax return preparer to understate the tax liability. The second was that the understatement in whole or in part reflected a reckless or intentional disregard of rules or regulations by the preparer.

The Small Business and Work Opportunity Tax Act of 2007 (the "Act")[56] made several extremely important amendments to these provisions. Regarding the penalty under §6694(a), the Act changed the standard that must be met to avoid a penalty for undisclosed positions. The "realistic possibility" standard of prior law has been replaced with a requirement that there must be a "reasonable belief" that the tax treatment of the position would more likely than not be sustained on its merits. The Act also changed the standard that must be met to avoid a penalty for disclosed positions. The "nonfrivolous" standard of prior law has been replaced with a requirement that there must be a "reasonable basis" for the tax treatment of the position.

A tax return preparer is considered to reasonably believe that the tax treatment of an item is more likely than not the proper tax treatment if — without taking into account the possibility that the tax return will not be audited, or that an issue will not be raised on audit, or that an issue will be settled — the tax return preparer analyzes the pertinent facts and authorities

[54] The court stated as follows in part A.2 of its opinion:

> The record shows that INC had few clients other than LTD and LTD's clients. The services that INC performed were almost exclusively for LTD, such as bookkeeping, effecting trades in securities, generating client statements, and effecting currency exchange transactions. The percentage of INC's gross revenues derived from LTD were as follows: 94.1 percent in 1985, 99.1 percent in 1986, 91.8 percent in 1987, 94.0 percent in 1988, and 95.8 percent in 1989. Moreover, the record does not establish that INC marketed its services to clients on its own. Based on the record in the instant case, we conclude that INC was not an "independent agent" within the meaning of section 1.864-7(d)(3), Income Tax Regs. Consequently, we hold that LTD did not engage in trading in stocks or securities through an independent agent within the meaning of section 864(b)(2)(A)(i).

[55] Regs. §1.864-7(d)(3)(iii) provides as follows:

> Where an agent who is otherwise an independent agent within the meaning of subdivision (i) of this subparagraph acts in such capacity exclusively, or almost exclusively, for one principal who is a nonresident alien individual or a foreign corporation, the facts and circumstances of a particular case shall be taken into account in determining whether the agent, while acting in that capacity, may be classified as an independent agent.

[56] P.L. 110-28, 121 Stat. 190.

ISSN 0090-4600

and, in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS.[57]

In addition, the Act significantly increases the penalties. For a violation of §6694(a), the penalty is $1,000, or, if greater, 50% of the fee derived from the preparation of the return. For a violation of §6694(b), the penalty is $5,000, or, if greater, 50% of the fee derived from the preparation of the return.

At the end of last year the IRS issued interim guidance on §6694 in the form of several notices.[58] Proposed regulations under §6694 were issued on June 16, 2008.[59]

Conclusion

Tax advisors in the 21st century practice in a world where parties other than clients have an interest in the advice that is given to clients. As a result, duties to clients must be measured against the advisor's responsibilities to third parties, such as the following:

- The Justice Department and U.S. Attorneys in federal districts across the country, who have interests in prosecuting crimes that on certain levels do not involve the United States, and who sometimes target third party "gate keepers" that provide goods and services to those who commit certain crimes;
- The IRS in its role of providing professional governance to those who practice before it; and
- The client's tax return preparers who are concerned with preparers' penalties for plans other than those that are more likely than not to succeed.

In this environment, it is no wonder that the advisor's relation with clients has come under pressure in the United States. Tax advisors are often viewed to be "gate keepers" for their clients. Stakeholders around the world understand that pressure can be applied to recalcitrant taxpayers by applying pressure to advisors. The net effect of that pressure is enhanced compliance with standards imposed by outsiders that limit the attorney-client relationship. *Pasquantino*, the money laundering rules in the United States, Circular 230, and the return preparers' penalties share a common goal — to incentivize the advisor to step back from the client and to pay attention to the interests of a broader community.

Appendix
Code of Conduct for Tax Authorities, Taxpayers and Tax Advisors

(Source: http://www.estv.admin.ch/e/dokumentation/grundlagen/dok/code_of_conduct.pdf)

1. General Guidelines

- *Separate personal from factual and legal issues*
- *Focus on interests rather than taking positions*
- *Be independent as far as judgment and actions are concerned*
- *Aim at an open and unbiased dialogue*

2. Rules as to Psychology and Good Behavior

(a) Treat your counterparts respectfully as being fair and trustworthy

- Maintain a climate of trust between the tax administration and the tax advisors, thus avoiding arrogant or antagonistic behaviour on either side; avoid any favoritism
- Look for a clear division of work between the tax administration and the tax advisors, and avoid any conflicts of interest
- Be even handed: disclose your objectives and avoid any hidden agenda; look for open, accurate and transparent communication as to the facts and the law
- Thorough preparation on both sides allows for competent discussions on the interpretation and the application of the tax laws
- Be proportionate and efficient: do not unnecessarily use the resources of the tax administration (meetings should be arranged only when necessary)
- Do not "forum shop" among different tax inspectors within the same tax administration
- Do not look for a more favorable answer by presenting the same facts a second time
- Listen to what the other side has to say before voicing any criticism in public

[57] See proposed §10.34 of Circular 230 dealing with the obligation to disclose positions that are not more likely than not to succeed. See also Regs. §1.6662-4(d)(3)(ii) regarding the process for determining whether a reasonable belief exists that a position is more likely than not to succeed and its application to §6694(a) as a result of Notice 2008-13 in lieu of the need to file a Form 8275 in certain circumstances.

[58] Notice 2008-11, 2008-3 I.R.B. 279; Notice 2008-12, 2008-3 I.R.B. 280; Notice 2008-13, 2008-3 I.R.B. 282.

[59] REG-129243-07, 73 Fed. Reg. 34560-34597 (6/16/08).

ISSN 0090-4600

(b) Do not put your counterpart under undue pressure

- Avoid unrealistic objectives and time constraints: to look for an answer within 24 hours is generally not a realistic approach
- Avoid any threats with either internal (head of section, division manager or head of department) or external administrative proceedings (controlling authority, parliament, lobbying)
- Do not threaten the tax administration with adverse economic consequences (relocation of the company, moving headquarters abroad, lay-offs, etc.)
- The tax administration should not refer taxpayers or their advisors to judicial proceedings as long an efficient and timely solution can still be reached
- Tax advisors should not threaten to unduly delay the assessment procedure by taking legal action
- The tax advisor must be able to say "no" to his client in any case in which he might be instrumental to dubious/questionable practices of the client
- The tax administration should not disqualify the tax advisor vis-á-vis his client or any third party

(c) Take advantage of freedom of movement

- "Protect the client against himself," i.e., avoid unreasonable requests and frivolous practices that will end up by harming the client, the tax advisor, or both
- Legality and equal treatment: equals should be treated equally, and unequals should be treated unequally; taxpayers' cases will be treated differently only if the distinctive factual or legal features can be proven

(d) Ensure full transparency of administrative practices

- Systematic publication of administrative practices
- Timely announcements and publication of changes affecting administrative practices, while avoiding announcements on matters that in the end will not change
- Unpublished court decisions must also be taken into consideration (equal treatment)
- Transparency and equal treatment: no concessions for the taxpayer that would not also be granted to his advisor
- Disclosure of interests and any potential conflicts of interest

3. Rules Regarding Form, Requests, Facts and Motivation

(a) Form

- Disclose taxpayer's identity and his relationship with his advisor
- There should be an interest justifying a request for an advance tax ruling or a request for a binding information, such as the completion of a given transaction depends on a tax ruling; uncertainty as to the law and an objective to avoid legal disputes; or the desire for competent authority, there being no precedents as to the particular fact situation involved
- Relax the formal standards if the taxpayer acts without a professional advisor

(b) Requests (demand/legal issues)

- Request either an advance tax ruling or a binding information
- Look for a fair presentation of the legal issues involved

(c) Relevant Facts

- Do not misstate the facts, and duly consider that the presentation of the relevant facts should be accurate, true and complete; there should be no voluntary omissions; anything that has no proper bearing on the final determination should be omitted
- Be clear in presenting your case: use a national language, be precise, use a systematic approach, include exhibits only to the extent that they are needed to support your factual issues
- Outline your starting position, the intermediate steps, and your final objectives
- The responsibility for the presentation and the determination of the relevant facts lies with the tax advisor; any documents submitted should be in final form; do not enclose extensive files with drafts attached
- Make a clear distinction between the facts and their legal assessment

(d) Motivation/legal considerations (legal interpretation offered by the taxpayer or his advisor)

- Identify the relevant legal issues involved
- Take doctrine and precedents into consideration
- Analyze legal considerations applicable to the underlying facts
- Outline taxpayer's point of view

ISSN 0090-4600

(e) Final Conclusions

- Resulting conclusions to be drawn based on the legal considerations applicable to the underlying facts
- Tax consequences; approval (or denial) of taxpayer's request

(f) Appeals

- Ask for formal decision subject to appeal only in case where such appeal would be seriously taken into consideration (proportionality and efficiency)

ISSN 0090-4600