

# The Tax Collector's Big Brother

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The current Israeli tax reform could affect privacy laws because of the wide reporting requirements introduced by the law and regulations of the "Knesset" (Israeli Parliament).

One of the most controversial subjects has now been decided by the Supreme Court of Israel: the mandatory reporting requirement by banks to the tax authorities. This obligation requires banks to disclose to the tax authorities information on clients who receive interest payments in excess of NIS 12,000 (around \$2,500) per annum on their deposits. It was introduced by the Income Tax Regulations (Withholding Tax on interest payments) which the Knesset adopted in November 2002. The information required by the tax authorities is very detailed and consists *inter alia* of the client's name, identity number, and revenue from interest paid.

The Association of Banks in Israel, a private body consisting of representatives of Israel's major banks, strongly objected to these regulations at the time of the Knesset deliberations but their arguments were refuted. Left with no choice, the Association decided to file a petition to the Supreme Court of Israel requesting these regulations to be abolished. The arguments put forward by the Association are that the detailed reporting of clients' information will cause significant damage to bank secrecy and the banking privilege towards clients and will lead to serious harm to the privacy of a large portion of the banks' clients as well as forcing the banks to remove the "veil" behind which the public manages its financial assets. The Supreme Court of Israel has dismissed the petition of the Association of Banks in Israel and held that these requirements were enacted properly. The reporting requirements are therefore applicable to banks as provided by the legislation.

Imposing on banks a duty to disclose information to the tax authorities may be argued both ways. On the one hand it seems quite legitimate to require banks to disclose information on financial matters of their clients in order to prevent tax evasion and ensure proper enforcement of the law. However, on the other hand the disclosure of such information could amount to a breach of privacy and could negatively affect private details of individuals if the information stored in the database of the tax authorities leaks to third parties interested in it. The Israeli legal system provides laws prescribing the procedure when and how an individual's personal information shall be stored in various databases.

A similar problem has also arisen in other countries, even prior to September 11, 2001. The events of September were the reason for the enactment of the "Patriot" laws of the United States during the last few months. These laws further extended the mandatory disclosure of information of banking and other financial institutions regarding their clients' financial matters. There is now a battle raging relating to the disclosure requirements and its scope ("The Withholding Tax War") in the United States and Europe.

## **I. The OECD's Initiatives**

In May 2001, The Organization for Economic Co-operation and Development (OECD) authored and tabled a report entitled *Report on the Misuse of Corporate Vehicles for Illicit Purposes*. This Report was released in November 2001 under the title *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes*. The Report calls on government authorities to ensure that they are able to obtain information on the beneficial ownership and control of "corporate vehicles" in order to combat their misuse for illicit purposes.

The Society of Trusts and Estate Practitioners (STEP) furnished the OECD with a study entitled *Towards a Level Playing Field: Regulating Corporate Vehicles in Cross-Border Transactions* it conducted together with the International Tax and Investment Organisation (ITIO) which determined that the public has doubts about the ability of governments to maintain data security or to resist the temptation to access information for political, economic or other purposes. The leakage of this information to unauthorised parties may endanger the freedom and even the lives of individuals living in particular countries as transfer of assets abroad may amount to a criminal offence in these countries (e.g., South Africa and several countries in Latin American). Furthermore, criminal sources may obtain this information and use it for extortion purposes.

In the United Kingdom, the Inland Revenue self-assessment service was suspended in May 2002 due to significant security concerns. Users managed to examine other people's data on the website ("Revenue Offline" *Financial Times*, June 11, 2002 and "No Data for Return at Online Revenue Service", *Financial Times*, June 6, 2002).

## II. The United States: Qualified Intermediary

In 2000 the U.S. tax authorities (IRS) initiated a withholding tax on transactions in U.S. securities made outside the United States. In order to achieve this, a complicated system was set up which became known as the Q.I. (Qualified Intermediary). According to the system, every bank that wishes to perform U.S. security transactions for its clients must sign a contract with the U.S. tax authorities and pass several assessment criteria which were introduced in order to ensure that in case the client is a U.S. citizen, tax will be payable to the United States either by way of a withholding tax or by the direct reporting by that citizen to the U.S. tax authorities.

The above Q.I. arrangement was a compromise between the U.S. tax authorities and banking institutions worldwide whereby only clients who are U.S. citizens will be disclosed to the U.S. tax authorities.

## III. Europe: Savings Tax

The finance ministers of the 15 European Union countries and the European Commission concluded in January 2003 one of the European Union's longest running sagas: the taxation of overseas savings. The deal was made between 12 E.U. countries, and their dependant territories. Under the deal, the countries will exchange information on non-resident's savings from January 2004. However, Luxembourg, Austria, Belgium and Switzerland will be entitled to retain their banking secrecy in return for levying a withholding tax which will start off with 15 percent in 2004 and progressively rise to 35 percent in 2010. These four E.U. countries have the right to decide when their withholding tax will be dropped and the exchange of information will begin.<sup>1</sup>

This major breakthrough in Europe presents the E.U. citizen with four choices of where to put their savings: The first is to leave the funds at a domestic bank and pay the domestic tax on dividends received (e.g., 25 percent in Germany). The second option is to deposit the funds in Switzerland, Luxembourg, Austria or Belgium, where the withholding tax rate would initially be 15 percent and enjoy the "temporary" banking secrecy promised but take into account the progressive increase in tax rates. The third choice would be to put the funds in one of the four "withholding countries" and instruct them to pass information back to the home country and thereby enjoy a possible lower tax rate (e.g., 15 percent in Switzerland instead of 25 percent in Germany). And finally there is the option to deposit money in one of the other 12 E.U. countries and allow the information to be passed back to the domestic authorities which will then levy the domestic tax.

## IV. Israel: Unique Reality

In Israel, the special composition of the population must be taken into account as well to the status of foreign residents and new immigrants willing to invest in Israel. Israel is home to hundred of thousands of families that have emigrated from various countries. These families brought with them considerable amount of assets but in some cases were obliged to leave their assets behind. Many of them continue to have families still residing in their country of origin.

The disclosure of personal information of clients by banks to the tax authorities may reveal information of persons who also have financial interests in foreign countries. Past experience shows that it is impossible to keep absolute secrecy of information held in databases and it is possible to break into the most secure database in the world. Therefore there exists the fear that such information which is of sensitive nature may leak to third parties. In addition, the Israeli tax authorities may be obliged to disclose information on Israeli citizens to other countries with whom they have signed double-taxation treaties.

As can be seen, "Big Brother", as in George Orwell's book, *1984*, may soon become a reality with all the negative implications arising therefrom!

<sup>1</sup> Jubilant Luxembourg deals savings tax deal with a kiss, *Financial Times*, January 23, 2003.

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