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ONLINE Special Report

Five Strategies to Deal With the New IRS Squeeze Against Offshore Privacy

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The U.S. Internal Revenue Service has quietly embarked upon a new policy that, if unchecked, will make it impossible for privacy seeking U.S. citizens or permanent residents to deal directly with offshore banks.

This policy is an offshoot of IRS regulations that require offshore banks maintaining U.S. custodial accounts with U.S. correspondent banks or brokers to adhere to various customer identification and disclosure requirements on their U.S. securities transactions, or have all income and *gross sales proceeds* derived from such transactions subjected to a 31% withholding tax.¹⁵ Such custodial accounts are generally used to purchase U.S. securities for the offshore bank's customers.

The regulations came into effect on January 1, 2001 and were purportedly issued to make it more difficult for U.S. persons investing in U.S. securities through offshore banks to evade U.S. taxes. To avoid the 31% withholding tax, many offshore banks opted to become "qualified intermediaries" (QI) under the new requirements. This step required that the country in which the offshore bank is domiciled, qualify under IRS "know-your-customer" regulations *and* that individual banks in that country with U.S. correspondent accounts sign QI agreements with the IRS. Offshore banks that signed QI agreements were obliged to provide the IRS with client details (such as Social Security numbers) on transactions in which *U.S. persons* (U.S. citizens, wherever they reside, and permanent U.S. residents, irrespective of their citizenship) made *U.S. securities transactions*.

To comply with these requirements, the offshore banks asked all of their clients to establish their tax status. From U.S. persons, the banks requested a completed IRS Form W-9 (identifying these individuals to the IRS). Banks operating in bank secrecy jurisdictions such as Switzerland, Austria and Luxembourg were also required by their domestic law to obtain authorization from their U.S. clients to divulge their identity and transactions to the IRS.

In return, U.S. clients could continue to purchase U.S. (and non-U.S.) securities through an offshore account, while continuing to be protected by bank secrecy in all matters other than taxes.



Non-U.S. depositors in offshore banks (which generally make up the majority of customers) were not required to complete Form W-9. Offshore banks could continue to purchase U.S. securities for such customers while maintaining bank secrecy.

Many U.S. clients were not willing to complete Form W-9. To protect their privacy, and to avoid the 31% tax, these clients sold their U.S. securities. From that point forward, they were effectively barred from dealing in U.S. securities through their offshore account.

As a consequence, those clients only had access to the two-thirds of world capital markets outside the United States.

But for many U.S. investors, this was not a serious problem, as the purpose of their offshore account was to gain access to non-U.S. investments and for currency diversification, privacy and asset protection.

IRS Now Wants Records Of Non-U.S. Securities Transactions

Access by U.S. persons who have not signed Form W-9 to *non-U.S.* securities through offshore bank accounts is now under attack by the IRS, due to a new interpretation of the QI agreements between the IRS and offshore banks.

The agreements stipulate that signatory offshore banks must submit to periodic audits by independent auditors to demonstrate their compliance with “know your customer” and other QI regulations. The IRS receives a copy of the audit report. It is now clear that these audits are leading to a dramatic deterioration in the quality of services available from offshore banks to U.S. persons and the manner in which their account relationships can be managed.

The first audit was of one of the world’s largest offshore banks—Swiss giant UBS. During this audit, a seemingly trivial term in the agreement—“deemed sales”—was reevaluated and renegotiated.

The outcome, however, is anything but trivial: *all* securities transactions, *both U.S. and non-U.S.*, by a U.S. person who has signed Form W-9, must now be reported by

UBS to the IRS. This is because the transaction is deemed to have initiated from within U.S. geographical boundaries.

In February 2002, UBS began informing their U.S. clients of the new situation. The letters also set out new procedures that would henceforth apply to the relationship between UBS and its U.S. clients that did *not* complete IRS Form W-9, apparently in an effort to comply with both the terms of the audit and Swiss bank secrecy rules.

Quoting From The Letter:

“We [UBS] will no longer be in a position to accept orders for transactions in securities ... we suggest that you give UBS a mandate to manage your account ... The reason for this sudden change of policy is the ‘U.S. Tax Law’ and especially the so-called ‘Deemed sales in the United States.’ This rule says that each transaction, which is potentially taxable in the United States, must be reported to the U.S. Authorities, regardless of the marketplace and the securities involved ... This reporting obligation is no longer limited on U.S. securities only, but includes all securities worldwide.” UBS no longer accepts *any* orders for U.S. or non-U.S. securities from U.S. persons who have not completed Form W-9 when the instructions are deemed to originate in the United States. This includes orders by telephone, fax, mail, email or the Internet.

UBS can accept securities trading instructions from such customers only if the instructions originate *outside* the United States or if the client delivers them *in person* at a non-U.S. *branch* of the bank. No



instructions may be accepted, or strategies discussed, in any U.S. location. The only instructions with a U.S. origin that will be accepted are payment instructions to the bank by whatever means was originally stipulated when the account was set up; i.e. by mail, fax, telephone, etc.

Finally, UBS will no longer mail *any* correspondence or account statements into the United States to U.S. customers who have not completed Form W-9. Consequently, such individuals who wish to receive account statements by mail will need to designate a foreign address for this purpose (such as a foreign mail drop).

Why was UBS the first target of the IRS? Most likely because of its huge size and extensive U.S. interests. Another factor may have been an agreement UBS signed in 1998 agreeing to provide U.S. regulators with all information "necessary to determine and enforce compliance with ...[U.S.] federal law." UBS signed the agreement as a condition for U.S. approval of its merger with Swiss Bank Corp. (SBC), which included SBC's U.S. subsidiaries and the U.S. branches of UBS, and was therefore subject to U.S. regulatory scrutiny.

The agreement granted no exception for U.S. tax laws. Rather than defend their clients' privacy rights, UBS compromised and is now paying the price.

For the moment, most other offshore banks continue to take the position that transactions in *non-U.S. securities* by U.S. persons do not fall under the QI requirements. However, as the audits continue, sources within the offshore banking community predict that all offshore banks that have signed QI agreements with the IRS will be forced to severely restrict contacts with U.S. persons who have not completed Form W-9.

Privacy Options for U.S. Persons

Many U.S. clients of UBS, or other offshore banks subsequently subjected to the "reinterpretation" of QI agreements, will agree to have all their securities transactions, both U.S. and non-U.S., reported to the IRS. However, other U.S. clients will wish to have their offshore portfolio administered privately. What options remain for such individuals?

1) They can set up a discretionary management mandate for their portfolio with the bank. After an initial meeting (most likely outside the United States), the bank can manage funds, reinvest maturing investments and buy and sell non-U.S. securities according to a mutually agreed upon management strategy.

2) They can set up a management mandate with an independent offshore portfolio manager. Such a manager residing outside the United States is not bound by any restrictions deriving from the QI agreement between the IRS and the bank. After the appropriate agreements are signed, the bank can freely discuss the portfolio of a U.S. person with the independent advisor. In turn, the independent advisor can talk freely to his or her U.S. client and place investment instructions with the bank on a discretionary basis or in ongoing dialogue with the client. The manager can also receive statements from the bank and forward them on to such individuals. The investor may also receive in this manner more personalized private banking services and have an additional layer of control over the bank.

3) They can employ an offshore representative and grant that individual a limited power of attorney for the relationship with the bank. This allows the representative to initiate, terminate and monitor investments with the bank based on the account owner's instructions and to receive



information and statements from the offshore bank to share it with the account owner. The limited power of attorney does not allow the representative to withdraw any funds from the account. The representative retains an independent position similar to an attorney or notary public, but should be specialized in financial services and global investing. The offshore representative is not subject to QI rules and does not have any QI restrictions to represent the account owner at the bank. This option should be less expensive than option #2 if the account owner wishes to make his or her own investment decisions.

4) They can place the portfolio into an offshore entity, such as an offshore trust or “trust-like” structure (e.g., a Liechtenstein establishment or *Stiftung*). The portfolio is managed by a professional trust company outside the United States. Due to the cost involved this is only advisable for large portfolios. In this context, the account holder at the offshore bank is the offshore entity and the bank does not deal with a U.S. person. The manager of the offshore entity is bound by the terms of the trust or other offshore structure to manage the portfolio in accordance with those terms. The offshore entity may also delegate the investment management to an independent professional money manager via a limited power of attorney or allow the bank to manage the funds on a discretionary basis. This approach also offers substantially greater asset protection than the first three options.

5) They can place the portfolio into an investment management vehicle through an insurance wrapper. The greatest flexibility is afforded by an offshore life insurance policy. Legally the investor is the client of the insurance company and the insurance company is the client of the bank. The funds will be managed by the bank or by an independent asset manager. In the latter case the investor indirectly has an option to influence the investment strategy.

This approach, unlike the first four options, may offer tax deferral on income generated within the insurance policy. The insurance company will provide quarterly statements directly to the U.S. investor.

(Editor’s Note: U.S. persons are legally obligated to pay taxes on their worldwide taxable income. This responsibility is not negated by the fact that they may manage their offshore portfolio in such a way as to avoid having such investments and the income or gain accruing from them automatically reported to the IRS by third parties.)

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