Automatic exchange of tax information

The solution to the problem of capital flight and tax evasion in the international context is the automatic exchange of tax information between governments, writes David Spencer.

Globalisation and the liberalisation of economic activity have resulted in the exponential increase in cross border commercial and financial transactions, in effect converting the private sector into a world without borders. This has created a major problem for national tax authorities, because globalisation in the private sector has not been accompanied by similar changes in the reach and enforcement powers of national tax authorities. As a general rule, national tax authorities continue to be constrained by national borders, and those national tax authorities continue to try to enforce their national tax laws generally with the some powers as if the commercial and financial world were in its pre-globalisation condition.

Problems faced by national tax authorities

In confronting the impact of globalisation and liberalisation of economies, national tax authorities face several problems:

First, national tax authorities are precisely that, an administration of one national government. Second, there is not yet any international tax administration. Third, there is a traditional legal rule that one government does not enforce the tax laws of other governments. That is, one government will not help another government collect that other government's taxes. Fourth, as a general rule the technical expertise of national tax authorities has not developed sufficiently to cope with the growth in volume and complexity of commercial and financial transactions.

Fifth, bank secrecy and other confidentiality laws ('de jure bank secrecy') in many jurisdictions prevent the disclosure by financial institutions and other payors of cross border income of relevant information to government authorities, except in specified limited fact situations. This de jure bank secrecy exists in some countries which are international financial centres, and in most tax haven jurisdictions. Tax havens present a 'double problem'. First, some are financial centres, which receive bank deposits and other passive investments. Many tax havens have such de jure bank secrecy laws preventing the disclosure of relevant information about such bank deposits and other passive investments. And second, often investments from third countries are routed through tax havens to acquire the cloak of confidentiality. For example, a resident (corporate or individual) of country X, sets up a corporation in country Y, a tax haven with a confidentiality and/or bank secrecy law (de jure bank secrecy). And that resident of country X uses the corporation in country Y to make an investment in country Z. Therefore, the resident of country X, by routing an investment through a tax haven jurisdiction, benefits from de jure bank secrecy that the country X resident would not otherwise have.

Sixth, many governments do not normally obtain from financial institutions and other payors of cross border income the relevant information. Therefore, those governments do not have the relevant information to exchange with other governments. This results in 'de facto bank secrecy'.

Seventh, the laws of several countries prohibit the transfer of tax related information to other governments except if there is an international (bilateral) agreement between the two governments authorizing such transfers of tax related information.

Eighth, there are practical problems in implementing exchange of information between governments, especially automatic exchange of information, which entails the transfer of substantial amounts of information from one government (the 'Transmitting Government') to another government (the 'Receiving Government'), and the Receiving Government may have difficulties processing such voluminous information.

Ninth, governments have conflicting interests with regard to exchange of information. Governments usually want to obtain information about the income that their residents and citizens derive in other countries. However, some governments, in particular in international financial centres, usually want to attract investments from foreigners, in particular bank deposits and other interest bearing investments. Those governments can attract such investments by offering (a) tax free treatment for the interest income resulting from such investments and (b) bank secrecy or other confidential treatment for such investments (that is, no exchange of information). Therefore, governments wanting to attract such investments may not want to exchange information with the government of the country where the foreign investor is a resident or a citizen. Therefore, the reluctance of major financial centres to cooperate fully on exchange of information between governments has created major obstacles to effective exchange of information.

Governments need for additional tax revenues

Governments have suffered from the loss of tax revenues, including in particular, as a result of:
(a) transfer pricing, which result in taxpayers shifting income from one jurisdiction to another, usually from higher tax jurisdictions to lower tax jurisdictions.
(b) capital flight. The Tax Justice Network, in *The Price of Offshore* (2005), has estimated that the tax revenues lost worldwide as a result of capital flight stand at about US$250 billion annually.

As a result of the need for greater tax revenues, governments have recognised the need for more exchange of information. Because enforcement of national tax laws is the responsibility of national tax authorities, national tax authorities have sought to confront the aforementioned changes in the private sector. Those national tax authorities recognize that exchange of tax information between them is essential in confronting the challenges presented by private sector globalisation.

Recent developments favouring exchange of tax information

Recent developments evidence some progress toward increased exchange of information in tax matters:

(a) The OECD's 1998 Report, *Harmful Tax Competition: An Emerging Global Issue*, attacked bank secrecy in tax matters, and emphasized the need for effective exchange of information between national tax authorities. This 1998 OECD Report led to the OECD Proposals on Harmful Tax Practices, calling for restrictions on tax havens (required transparency and some limited exchange of information).

(b) In 2005 the OECD revised Article 26, *Exchange of Information*, of its Model Income Tax Treaty, in order to provide specifically that the obligation of national governments to exchange information must override bank secrecy and other confidentiality laws. That is, under the revised Article 26 of the OECD model income tax treaty, if a government requests tax information from another government, that other government must generally provide that information in spite of bank secrecy or other confidentiality laws in that other country. It is expected that the United Nations Model Tax Treaty between Developed and Developing Countries will be similarly modified. Also, the OECD added to its Model Income Tax Treaty a new article 27, *Collection of Taxes*, by which, in general terms, one government would agree to help another government collect taxes.

(c) Bank secrecy and other confidentiality laws have come under attack as a result of non-tax laws, such as in efforts against money laundering, terrorism financing and corruption.

Different methods of exchange of information

Exchange of information between governments normally can be effected through three different procedures: (1) exchange of information upon request; (2) spontaneous exchange of information; and (3) automatic exchange of information.

(1) Exchange of information upon request

Income tax treaties and tax information exchange agreements ('TIEA') normally require only exchange of information on request. That is one government ('Requesting Government') requests information from another government ('Requested Government'). This procedure is normally effective only if (a) the Requesting Government presents a sufficiently detailed request (for example, the name and location of the bank or other financial institution where the taxpayer has a bank account) and (b) the Requested Government can obtain the relevant information. If the Requesting Government does not present a sufficiently detailed request, and if the Requested Government itself does not have sufficient information, exchange of information upon request will not be productive.

(2) Spontaneous exchange of information

Spontaneous exchange of information occurs when one government ('Transmitting Government') has information which it believes would be of interest to the other

government ('Receiving Government') and the Transmitting Government spontaneously provides such information to the Receiving Government. This is a very limited form of exchange of information. Further, governments which have de jure bank secrecy may be required under a bilateral agreement to provide information when requested by another government. But such de jure bank secrecy laws may prevent spontaneous exchange of information. Also, de facto bank secrecy may effectively limit spontaneous exchange of information.

(3) Automatic exchange of information

Automatic exchange of information could be the most productive type of exchange of information, but it is the most difficult type of exchange of information to implement. Automatic exchange of information would normally cover cross-border payments such as interest, dividends and royalties. The payors of such cross-border income would provide the relevant information to their government (Transmitting Government). And that Transmitting Government would provide the relevant information to the government (Receiving Government) of the country where the recipient of such income is located (normally the place of organization for a company, and the place of residence and/or citizenship for an individual).

Automatic exchange of information is difficult to implement for at least three major reasons:

(a) The Transmitting Government and the Receiving Government have to specifically agree to such automatic exchange of information. The Commentary to the OECD Model Income Tax Treaty and the Commentary to the UN Model Income Tax Treaty refer to automatic exchange of information, but do not require it. The EU Directive on the Taxation of Savings requires automatic exchange of income on certain interest paid within the EU to individuals resident within the EU (except for Austria, Belgium and Luxembourg which during an interim period impose a withholding tax).

(b) Automatic exchange of information would normally involve the transfer by the Transmitting Government to the Receiving Government of a substantial volume of data. In order for the Receiving Government to be able to process such information, such information should be ideally compiled based on the Taxpayer Identification Number ('TIN') used for taxpayers (companies and also individuals) by the Receiving Government. That would require the Transmitting Government to gather, compile, maintain and transmit such information ideally based on the TIN used by the Receiving Government. But the Transmitting Government may not be technically equipped to gather relevant information based on the TIN of the Receiving Government. The OECD has been working on the mechanics of automatic exchange of information: OECD Council Recommendation on the Use of Tax Identification Numbers in an International Context (C(97) 30 (Final) dated March 13, 1997; (ii) the OECD Council Recommendation on the Use of the Revised Standard Magnetic Format for Automatic Exchange of Information (C(97) 30 (Final dated July 10, 1997; and (iii) the OECD Council Recommendation on the Use of the OECD Model Memorandum of Understanding on Automatic Exchange of Information for Tax Purposes (C(2001) 18/Final).

(c) Two countries (country X and country Z) may agree to implement automatic exchange of information. But the resident (corporate or individual) of country X may route the investment in country Z through a corporation in a third country, such as a country Y tax haven, as discussed above. Therefore, the resident of country X can 'defeat' the automatic exchange of information between country X and country Z, unless country X and country Y agree on automatic exchange of information between them, and country Y and country Z agree on automatic exchange of information between them.

In summary, governments need to rely on exchange of information between them, in order to overcome the challenges to national tax authorities presented by globalisation and liberalisation. But implementation of effective exchange of information between governments, especially automatic exchange of information, is not an easy task. The EU Directive on the Taxation of Savings, if successfully implemented, could serve as a model for the automatic exchange of information between other countries.