TAX JUSTICE BRIEFING – January 2011

BRIEFING PAPER ON EU-SAVINGS TAX DIRECTIVE AND AUTOMATIC TAX INFORMATION EXCHANGE - Prepared by Markus Meinzer, TJN-IS

1. Why Automatic Tax Information Exchange (AIE)?

1.1 Globalisation removed barriers to cross-border trade and investment. In conjunction with the internet, it has become considerably easier to move money and other assets around the globe. In the words of Jeffrey Owens of the OECD[1]: *"the creation of offshore financial accounts, shell companies and the like are just a click of a mouse away."* Usually, residents of one country need to pay tax on all of their worldwide income, including on the income generated by foreign held assets (such as bank deposit interest). This is for reasons of fairness: a citizen should contribute to financing the public goods and services where she uses them and according to her ability to pay.

1.2 However, because international cooperation among states has not kept pace with globalisation, the opportunities to evade taxes on foreign income have increased dramatically. One particular problem is that the existence of a bank account in country B owned by a resident of country A is usually not known by the tax authority of country A. This leaves it entirely in the control of the individual to decide whether she wants to report the income paid on this account in her annual tax return. Research has shown that this 'freedom' to pay or evade taxes is harmful for tax morale, i.e. the voluntary compliance with tax laws. As a result the temptation to use offshore secrecy jurisdictions to evade tax has been substantially increased. The price of tax evasion is paid by honest tax payers and citizens with low incomes, who do not have the possibility to accumulate savings outside their home country.

1.3 Automatic Tax Information Exchange (AIE) aims to rectify this situation by requiring country B's bank to report to its tax authority the interest paid on the account of the citizen of country A, and in a second step to transfer this information to the tax authority of country A. This information can then be checked for accuracy against the tax return submitted by the taxpayer.

2. What is the EUSTD about?

2.1 The EU-Savings Tax Directive (EUSTD) entered into force in 2005 after decades of futile attempts to bring about European cooperation to counter this kind of tax evasion. Its ultimate aim "is to enable savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident in another Member State to be made subject to effective taxation in accordance with the laws of the latter Member State." (Council Directive 2003/48/EC[2]). This passage summarises the

[1] http://www.theglobalist.com/DBWeb/StoryId.aspx?StoryId=6212; 16.1.2008.

[2] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:157:0038:0048:en:PDF; 13.1.2011.

core and limitations of the current EUSTD. Information about income payments to non-residents is routinely (or automatically) reported and transferred to the resident state of the taxpayer.

2.2 The directive's current limitations are fourfold. Firstly, only interest payments are covered, leaving out dividends and royalties. Second, only payments to individuals (or natural persons) are covered, omitting companies and trusts (legal persons). Third, it is limited geographically to the EU, although equivalent measures have been established in separate treaties (multilateral or bilateral) with 15 additional jurisdictions enjoying close ties to the EU (total of 42 jurisdictions[3]). Fourth, Luxembourg and Austria negotiated a transitional exclusion from the automatic information exchange process by substituting a withholding tax of currently 20% (from July 2011 it will be 35%) on the interest payments to the concerned non-residents. They share the revenue with the country of residence of the account holder, with the latter receiving 75 percent of the total. The same withholding tax provision has been agreed with eleven of the 15 non-EU jurisdictions, including Switzerland, though this agreement is not considered transitional.

3. What has happened since 2005?

3.1 A review of the directive in 2008 highlighted these weaknesses, revealing changes in the pattern of investments in response to the directive. There was a relative flight away from debt securities (interest bearing instruments, such as bonds, obligations) towards equity securities (shares, stock). This switch was probably at least partly motivated by attempts to avoid the directive[4]. The second observable reaction was a geographical displacement of funds to jurisdictions beyond the scope of the directive. In reaction to this, a proposal for a revised directive was submitted by the European Commission to the EU-Council in November 2009[5]. This proposal addresses two out of the four limitations, those relating to legal entities and those relating to geographical scope.

3.2 In addition, agreement on a new European directive on administrative assistance in tax matters has been reached[6]. Apparently designed to complement the EUSTD, this directive seeks to strengthen administrative and technical cooperation between the participating countries and to establish automatic information exchange under certain circumstances beyond interest income, notably on income from employment, director fees, certain life insurance products, pensions, and ownership of and income from real (immovable) property[7]. Unfortunately, dividends, royalties and capital gains remain excluded from the automatic information exchange process[8]. The possibility of further progress in this directive has been delayed until 2017, when a report is due from the Commission with the vague possibility of extending automatic information exchange to other income categories.

4. What happens next?

4.1 The transitional period for the exceptional withholding tax will end once the EU reaches agreement with Switzerland, Liechtenstein, San Marino, Monaco and Andorra to exchange

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[3] More information on page 19, here: http://www.taxjustice.net/cms/upload/pdf/AIE_100926_TJN-Briefing-2.pdf; 17.1.2011.

[4] http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/SEC%282008%292420.pdf; 5.3.2010.

[5] http://register.consilium.europa.eu/pdf/en/09/st16/st16473-re01.en09.pdf; 5.3.2010.

[6] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/118257.pdf; 13.1.2011.

[7] http://taxjustice.blogspot.com/2010/12/council-of-european-union-and-exchange.html; 17.1.2011.

[8] http://taxjustice.blogspot.com/2010/11/belgian-back-room-dealings-try-to-water.html; 13.1.2011.

information *upon request* conforming to the weak OECD-2002 model (the model is here[9], our analysis of it here[10]). These countries have recently withdrawn their general objections to this OECD-standard. The way has been opened to move ahead with achieving an agreement with these jurisdictions. The agreement with Liechtenstein is already drafted[11].

4.2 The principal obstacle at this moment lies with Austria and Luxembourg blocking the EU-Council from mandating the European Commission to open negotiations with Andorra, Monaco, San Marino and Switzerland. This blocking tactic has meant that the draft negotiation mandate presented by the European Commission to the EU-Council is currently help-up in the relevant working group of the EU-Council.

4.3 A particular risk has arisen as a result of Switzerland offering a final withholding tax as a substitute for information exchange to selected European countries, notably Germany and UK. Preliminary negotiations have started[12] between these three countries: if a deal is struck on this proposal the prospects of a coordinated European position for an agreement with Switzerland would diminish, implying that the 'transitional period' of the EUSTD might never end.

4.4 Luxembourg and Austria are caught in a classical "turkeys don't vote for Christmas" situation. If they agree to open negotiations between the EU and Switzerland, they will soon be required to implement fiscal transparency in their own jurisdiction. Avoiding stalemate will require that considerable political pressure is applied to both countries. Apart from political will, a possible point of departure could be Article 65 of the Treaty on the Functioning of the European Union[13] which allows exceptional restrictions on the free circulation of capital within the EU. If a few large European states coordinated their legal position on this issue and implemented defensive measures against both Austria and Luxembourg, progress could come sooner rather than later.

4.5 TJN aims for AIE between all states. Bilateral and regional agreements such as the EUSTD, and unilateral provisions for automatic information exchange such as FATCA in the USA[14], and ideas for reduced information exchange on beneficial owners[15], are all moves in the right direction. The European Steering Committee of TJN is closely following the process of AIE in the EU.

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[9] http://www.oecd.org/dataoecd/15/43/2082215.pdf; 17.1.2011.

[10] http://www.taxjustice.net/cms/upload/pdf/Tax_Information_Exchange_Arrangements.pdf; 17.1.2011.

[11] http://register.consilium.europa.eu/pdf/en/09/st16/st16990.en09.pdf; 17.1.2011.

[12] http://taxjustice.blogspot.com/2010/11/swiss-uk-german-tax-deals-money-not.html; 13.1.2011.

[13] http://www.jura.uni-augsburg.de/fakultaet/lehrstuehle/moellers/materialien/1_europarecht/primaerrecht_pdfs/egv_9_5_2008_eng.pdf; 17.1.2011.

[14] http://taxjustice.blogspot.com/2010/05/fatca-new-automatic-info-exchange-tool.html; 18.1.2011.

[15] http://www.taxresearch.org.uk/Documents/InfoEx0609.pdf; 18.1.2011.