Briefing paper

Why Europe should impose withholding taxes on payments, to crack open secretive tax havens

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The 2015 Financial Secrecy Index published in November reveals progress in rolling back secrecy practiced by the world's tax havens or secrecy jurisdictions. The OECD, a club of rich countries, is putting in place a global system, the Common Reporting Standard (CRS,) to implement the automatic exchange of information (AIE) across borders, so each country can tax their own residents fairly and effectively. The CRS is the first potentially global system of AIE and while it has shortcomings and loopholes – especially due to the lack of access to data by developing countries - it is a big step forwards from a mostly transparency-free past.

Why is financial secrecy a problem?

Financial secrecy is different from legitimate confidentiality. Your bank manager rightly won't publish your bank details, just as a doctor won't publicise your medical complaints.

But tax authorities, crime-fighting authorities and others need to be able to find out about their citizens' financial affairs. Financial secrecy facilitates corruption, financial crime, market rigging, illicit financial flows, state looting, tax evasion and more. It distorts markets and damages democracy: the large majority of hidden wealth is held by the richest one percent (or 0.1 percent) of the world's population. Financial secrecy means one set of rules for them – and another set for everyone else.

Yet there are major obstacles. Several tax havens are resisting change -- and the biggest is **the United States**. In essence, the U.S. has been actively cracking down on offshore tax evasion by its *own* citizens – but has been far less willing to share information in the other direction to help others, and becoming a haven of choice for the world's criminals and tax evaders.

So the EU should implement a new withholding tax regime to counter this global threat – essentially copying the scheme that the U.S. is using to protect itself. Details and options for how this may be done are provided below.

Background: tax haven USA

The U.S.' main tool for cracking down on its own tax cheats is the Foreign Account Tax Compliance Act (FATCA,) a potent tool that predates the CRS. The CRS is modeled on FATCA's intergovernmental agreements (IGAs)[1]. But – and this is a big 'but' – the U.S. will not implement the CRS: it says that because FATCA is technically similar, it will implement FATCA instead. It promises to share information reciprocally – but it doesn't, as the pink box explains.

The legal framework for the international exchange of information as required by FATCA is through the IGAs. Of the three possible IGAs, only one, "Model 1 A" provides a 'reciprocal' exchange of information (as the box explains)[2]. The U.S. cites these IGAs as evidence that it is engaging in reciprocal, two-way exchange of information. But it isn't. Under the 'reciprocal' IGAs, the amount of information the United States will yield is "astonishingly little," as one expert puts it. We said recently:

> *"Washington's independent-minded approach risks tearing a giant hole in international efforts to crack down on tax evasion, money laundering and financial crime."*

Those opaque IGAs

The U.S.' Intergovernmental Agreements (IGAs) to implement FATCA are bilateral deals that take account of other countries' laws, such as bank secrecy laws, which could stop banks giving U.S. authorities the necessary data on U.S. taxpayers.

The IGAs promise reciprocal information exchange, in one of its three possible models: Model 1A. This has boilerplate language promising 'equivalent levels of exchange' to other countries. For example, the US-Germany IGA states:

*"The United States of America collects information regarding certain accounts maintained by U.S. financial institutions held by residents of the Federal Republic of Germany and is committed to exchanging such information with the Federal Republic of Germany **and pursuing equivalent levels of exchange**."*

Yet these 'reciprocal' IGAs are only a U.S. *Treasury* promise to reciprocate, with no timeframe. Republicans hold both Houses of Congress and have vetoed legislation to collect certain information for exchange, or to exchange it. FINCEN rules to collect information on many categories of US-sourced income are just proposals; even these only apply to new accounts, and they exclude identifying the beneficial owners of trusts. *See the list of IGAs here.*

[1] There are several differences: See Mark Morris' CRS versus FATCA page.

[2] The IGAs come in a couple of different flavours (a list of them is available here). Though the IGAs contain a general U.S. promise – articulated by the U.S. Treasury – to engage in equivalent levels of information exchange (see Box 2), Treasury hasn't been able to force Congress to enact the implementing legislation. What is more, the IGAs themselves contain many one-sided specifications that do not allow for effective information exchange. Individual IGAs do define categories of income very narrowly. For example, FATCA partners won't receive information on cash accounts held by entities (such as shell companies), or on interest paid on US government bonds (see more here). Yet even though it is true that the granular *details* of the FATCA IGAs are imperfect, it is the general promise of fully reciprocal information exchange under FATCA that must be the EU test for applying the withholding tax. The U.S. Ways and Means and Finance Committees have argued that reciprocal exchange would "discourage investment" into the U.S. An EU-level withholding tax such as the one we are proposing would, of course, transform those incentive arguments. See more in our Loophole USA blog and in our November 2015 narrative report on how the United States became a secrecy jurisdiction.

A withholding tax: lessons from the U.S.

With FATCA, the U.S. wields a big stick. In essence, any US-sourced payment to a foreign financial institution that doesn't participate in FATCA will have a 30 percent tax withheld on that payment. That is a huge incentive for those financial institutions – and by extension other countries where they operate – to play ball.

Yet the CRS – which is technically almost a copy of FATCA – did not include this big stick, though we urged the OECD to include it[3]. So tax havens like the United States only have weak[4] incentives to supply transparency.

This leads to ironic and odd situations. Under the IGAs signed between the U.S. and each EU country, EU financial institutions must not only collect and report far more information than their U.S. counterparts need to, but only EU financial institutions are sanctioned for non-compliance. And the EU's own financial centres are losing assets to more opaque jurisdictions – especially the U.S. Meanwhile, tax evasion and other crimes proliferate. Why would powerful European countries agree to such a terrible state of affairs?

The European Union holds the key to changing this. It could establish a withholding tax scheme, similar to FATCA's 30 percent, on all EU-sourced payments to financial institutions located in non-compliant financial centres until they implement the CRS (or equivalent levels of information exchange, in the U.S.' case) with Europe and vulnerable developing countries. Or, as a narrower proposal, the EU could initially target U.S. financial institutions with a withholding tax scheme, before rolling out withholding taxes more widely.

We outline possible scenarios for how and how widely such a withholding tax would be applied, and against which financial institutions, below.

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[3] See fix no. 2 on page 30 of TJN's "The end of bank secrecy?" Nov 24th, 2014.

[4] Here's how the OECD-led process applies sanctions. If two countries are supposed to exchange information and one does not comply, the 'sanction' is that the exchange is stopped. But a developing country withdrawing co-operation from a tax haven (with no interest in receiving the data from that developing country) is basically no sanction at all. For countries that do not even *participate* in the CRS the only "sanction" is that (maybe) by 2019 the Global Forum will conduct a peer review which *might* affect that country's image. Even then, history shows that the Global Forum tends to point fingers mostly at small countries, letting bigger miscreants (like the United States) off the hook. This was the case, for example, in the Global Forum's rating of October 2015: the "problem" countries were identified as Micronesia, Guatemala, Kazakhstan, Lebanon, Liberia, Nauru, Trinidad & Tobago, Vanuatu, Andorra, Anguilla, Antigua & Barbuda, Barbados, Costa Rica, Curacao, Indonesia, Israel, St. Lucia, Samoa, St . Maarten and Turkey. By contrast, countries like Switzerland were found to have a legal framework transparent enough to move on to phase 2, despite major problems with banking secrecy and registration of ownership of companies and trusts. The U.S. seems even more problematic. First, it was considered 'largely compliant' after its phase 2 review despite (for example) allowing anonymous unsupervised companies to be incorporated in every one of its 50 states. And when the U.S. declared that it would not implement the CRS but would apply FATCA instead, it was not put with all the non-committing countries. On top of all this, some countries cannot even get a 'partial reciprocity' agreement with the U.S. (see below): they must simply send information to the U.S. or be subject to the withholding tax, with little or nothing in return.

If Europe fails to do this, the entire emerging global architecture of financial transparency will be in peril, starting with the most important player in the game. If the United States can be turned away from tax haven activity and instead made into a co-operative partner in the fight against crime and financial abuses, a host of other global benefits and possibilities will emerge.

Helping others beyond the EU

When the CRS was first published by the OECD in February 2014, it contained strong wording in favour of benefiting developing countries[5]. By July 2014, when the CRS was re-published with Commentaries and new Annexes, these references had been removed.[6]

We believe developing countries should start benefiting from the CRS' information-sharing project straight away, and not in some distant future[7]. We recently proposed a template for Statistics on automatic information exchange, so that financial institutions in financial centres collect information on residents of developing countries too. While this information will not reach developing countries' authorities yet (because the OECD requires full reciprocity from them before they can join the CRS), financial centres should still publish aggregate information about developing countries' deposits and income held there. As our briefing shows, this won't compromise anyone's confidentiality – but it will let them find out how much money their residents hold in each financial centre.

But the EU should do far more to help developing countries: the OECD has failed them on this and there doesn't seem to be any other body with the clout to protect their interests.

Both the experience of FATCA – and declarations by the likes of Switzerland, Bahamas and Panama about cherry-picking the countries they will deign to share information with – show that goodwill is not enough when dealing with tax havens. They may end up agreeing to exchange information with other rich and powerful countries so as not to lose market access, but they will continue to thumb their noses at many developing countries. The big stick is required.

So the EU should extend the proposed withholding tax, not only against financial institutions located in financial centres and in tax havens that do not exchange

[5] "We are committed to making automatic exchange of information attainable by all countries, including low-income countries, and will seek to provide capacity building support for them" and "… stressed the importance of developing countries being able to benefit from a more transparent international tax system" (CRS, page 6).

[6] See The full picture of OECD's AIE Standard is unveiled: Catering to tax havens at the expense of developing countries, TJN, July 20, 2014

[7] Some jurisdictions cherry-pick: refusing to send information to the greatest victims of élite looting: developing countries. Paradoxically many countries such as Switzerland demand full reciprocity (i.e. from developing countries) before agreeing to send data via the CRS, while they agreed to send information to the U.S without receiving anything in return via FATCA IGAs.

information with EU countries, but also those that refuse to send information to developing countries[8]. No financial centre or tax haven should be allowed to refuse to send information to these developing countries, or at least to those developing countries with which the EU is exchanging information via the CRS. Recalcitrant ones should be subject to the proposed EU withholding tax.

How would the proposed EU withholding tax scheme work?

FATCA imposes a 30 percent withholding tax on certain US-sourced payments to foreign financial institutions that do not comply with FATCA and agree to collect and share relevant information[9]. This effectively shuts noncompliant institutions out of the all-important U.S. market: it gives non-US financial institutions powerful incentives not only to join in and report under FATCA, but also to lobby foreign governments to play ball.

The use of financial institutions as tax-collection agents is a fairly recent development in international finance, but the principle is now well established. Financial institutions have the direct cross-border reach that governments don't have, so they need to serve as the tax collection intermediaries. They are also the ones that hold the accounts: "that's where the money is."

There are different possible ways to proceed. Here are the main alternatives.

Scenario 1: The Ideal

A 30 percent withholding tax would apply to all EU-sourced payments to any financial institution based in a financial centre[10] that is not sharing sufficient information with the EU, or with any 'fit and ready' developing country[11]. This

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[8] The OECD will determine which countries (including developing countries) are able to implement the CRS because they have the necessary legal framework and comply with confidentiality requirements.

[9] So for example a foreign bank subsidiary whose clients invest in the U.S. bond markets would see a 30 percent tax levied not just on all bond interest payments remitted from the U.S. back home – but also 30 percent levied on the absolute value of that bond itself once that value is remitted. As noted, this is a big stick.

[10] It is necessary to explicitly identify "financial centres" which are recalcitrant, otherwise a bunch of developing countries that aren't tax havens would see their local financial institutions get hit with damaging withholding taxes only because they still lack the resources to implement AIE. An objective measure of financial centres would have to be devised, to avoid political tinkering by powerful countries. For example, the Financial Secrecy Index (FSI)'s approach could be used. The FSI's "Global Scale Weight" measures each jurisdiction's market share of financial services for non-residents. A threshold could be imposed, for example, any jurisdiction with at least 0.1% of the market share would be considered a 'financial centre' by the EU.

[11] Any financial centre could rightly refuse to send information to a developing country which does not comply with confidentiality requirements (i.e. if there is a risk that the information received will be leaked). However, if the EU or the OECD consider that a developing country is 'fit and ready' to receive information because it complies with all requirements, no financial centre should refuse to exchange information with such developing country.

would potentially target the U.S., Switzerland, Singapore and many others. This could be unilaterally applied, such as through a new EU Directive.

Advantages: it would cover all relevant tax havens and financial centres, and benefit developing countries directly.
Disadvantages: it would be politically tough to target a wide range of countries. The U.S. may also decide that this approach violates the IGAs already signed with European countries, requiring renegotiation.

Scenario 2: EU self-interest only

This would be like the ideal scenario, except that the jurisdictions targeted would only have to share information with the EU. Financial institutions based in any jurisdiction that isn't sharing information with the EU would see a 30 percent withholding tax applied to any EU-sourced payments to them. This could be unilaterally applied, such as through a new EU Directive.

Advantages: there would be less political opposition than with the ideal scenario, and it would also force all financial centres (especially the U.S.) to put in place mechanisms to *collect* the relevant information, paving the way to benefiting developing countries in future.
Disadvantages: the main disadvantage of this proposal is its narrow coverage, though it's broader than the US-focused one. Still, its "target range" could be broadened over time.

Scenario 3: Narrow U.S. - EU focus (first)

The EU would impose a 30 percent withholding tax on all EU-sourced payments to any U.S. financial institution, until the United States commits to effective reciprocal information exchange with EU countries, in line with the promise contained in the FATCA IGAs. (We would still urge the EU to push rapidly onwards towards the ideal scenario.)

Advantages: It is politically and technically easier to target one (admittedly powerful) country than to target many. Crucially, it wields the U.S.' own tool, creating a political consistency that is very hard to argue against. Once the U.S. becomes more transparent this removes the main political blockage in global transparency efforts and open up many new political possibilities to help developing countries and others[12]. It would also force the U.S. to create mechanisms to *collect* the relevant information, paving the way to benefiting developing countries in the future.
Disadvantages: it doesn't directly and immediately help developing and other countries that desperately need to stem their élite looting. The EU would have to investigate whether it could implement this unilaterally, or whether it would have to renegotiate the IGAs.

[12] What is more, the U.S. doesn't currently even *collect* (let alone exchange) much of the relevant data. This proposal would push the U.S. to allow this data to be collected, paving the way for others to eventually receive it.

Other possible scenarios:

Other possibilities might be considered. For instance, the EU might impose this withholding tax against financial institutions based in any non-financial centre (including a developing country) that has signed a FATCA IGA: if they can supply data to the U.S. then they can supply it to Europe (and possibly to others). Or the EU might impose the ideal scenario, by implementing it against U.S. financial institutions through renegotiating IGAs -- and issuing a Directive for others. We offer a table, below, outlining possible scenarios, laid out in a different form.

Scenario	**Condition for EU WHT: not sharing enough information with . . .**	**Direct target for WHT**	**Implementation**
1. Ideal	EU and any 'fit' developing country.	Financial institutions located in any recalcitrant financial centre. Option to target also financial institutions located in a non-financial centre that has signed a FATCA IGA	Unilateral (e.g. Directive) for all.
1b. Ideal, but softly-softly on US	As above.	As above.	Unilateral (e.g. Directive), except for the U.S., where IGAs are renegotiated.
2. EU self-interest	EU first (with 'fit' developing countries later)	As above.	As any of the above.
3. US-EU initial focus	EU first (with 'fit' developing countries later)	U.S. financial institutions, until the U.S. provides CRS-equivalent levels of information exchange.	As any of the above.

We urge the EU to impose the first, most courageous option.

Read more:

Loophole USA: the vortex-shaped hole in global financial transparency, Tax Justice Network, Jan 26, 2015

Proposal for the EU to impose a withholding tax on EU-sourced payments to US financial institutions. Mark Morris, Best of Both Worlds. (The TJN proposal is based substantially on discussions with Morris.)

Hiding in plain sight: how to avoid FATCA and GATCA, Peter Cotorceanu, Oct 2014

Narrative report on the USA: Financial Secrecy Index, Nov 2015. A history of how the United States became a secrecy jurisdiction or tax haven.

The mega-haven: The Economist, Nov 7, 2015. This is the first newspaper to reference our proposal, which we initially made as a one-liner in the press release for the launch of our Financial Secrecy Index.