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The Panama Papers and the International Battle Against Tax Havens: Lessons for the EU

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Introduction

On April the 3rd, 2.4 terabyte of data from the Panamanian lawyer's office Mossack Fonseca were made public. The collaborative work of the International Consortium of Investigative Journalists (ICIJ) revealed how Mossack Fonseca facilitated wide-scale tax evasion through more than 214,000 offshore entities. Connections to persons and companies in more than 200 countries and territories were exposed, covering a wide range of high-level persons such as politicians, sportsmen and wealthy elites. While the size of the Panama Papers leaks is unprecedented, so are its revelations about the sheer size of tax evasion through offshore constructions – especially considering that the Panama Papers uncovered the offshore activities of only one law firm. Given the numerous tax scandals provoked by whistleblowing and/or press leaks over the past decade (e.g. UBS, HSBC, SwissLeaks, LuxLeaks), the Panama Papers are only the latest indication that massive tax avoidance and evasion are a structural feature of contemporary global capitalism. In his recent book Gabriel Zucman estimated that about US$7,6 trillion of financial wealth is held in offshore tax havens, leading to a loss of tax revenue of $190 billion. His estimate of tax evasion does not take into account the even higher fiscal losses associated with aggressive tax planning by big businesses or individuals, which aims to exploit the limits of the law in order to minimise tax payments. In 2013 the European Commission estimated that governments in the EU loose around €1 trillion each year to tax evasion and avoidance.

The systemic problem of tax dodging delivers an additional blow to the legitimacy of the globalised financial regime, whose many excesses were brought to the surface by the global financial crisis. The crisis created an unprecedented momentum to regulate the offshore world. Offshore financial centres (OFC) were blamed for contributing to the growth of the 'shadow banking system': the 'light touch' regulation of tax havens provided an important channel through which complex and often opaque derivative instruments, which were at the source of the global financial turmoil, could be wrapped and distributed all over the global financial system. When American and European banks had to be saved from bankruptcy by the use of taxpayer money, the battle against tax havens and OFCs gained traction. American and European politicians raised objections about bailing out banks with public money at a time when many of these banks were in the business of helping companies and individuals to avoid and evade taxes, including through their own branches in tax havens.[1] The crisis also put pressure on western governments to find new sources of tax revenues, as bank bailouts and countercyclical fiscal stabilisation policies in the aftermath of the crisis generated a huge increase in public deficits and debt levels. In order to bring these deficits back to normal levels, governments adopted harsh austerity measures that have largely affected the lower and middle classes: one study found that a consolidation of 1 percent of GDP is, on average, associated with an increase in income inequality of around 0.4-0.7 percent over the next two years (Woo *et al*., 2013). As a result, public debates have intensified on the issue of international tax evasion, the abuse of 'unfair' opportunities for international tax arbitrage by wealthy individuals and multinational corporations and the need to spread the burden of fiscal consolidation more evenly across society.

The global fight against international tax evasion and avoidance is, therefore, especially important for the EU, whose stringent fiscal rules have forced governments in the region to embark on senselessly tough austerity measures. The EU and several of its Member States – France and Germany in particular – have been at the forefront of the global battle against tax havens and bank secrecy, yet they have contributed mainly through their membership of the G20 and the Organization for economic cooperation and development (OECD). The G20 and the OECD have been responsible for drafting an ambitious multilateral tax agenda in response to the global financial crisis, culminating into the adoption of ‘automatic exchange of information’ (AEoI) between national fiscal authorities as a new international standard. While AEoI is a critical instrument in the fight against tax evasion, it was the US rather than the EU that led the G20 and OECD to embrace the new standard. In the rest of this contribution we will trace the origins of AoEI and explain its importance, discussing several lessons that the EU could draw from the power of the US in international tax governance.

The G20 and OECD’s fight against bank secrecy

At their 2009 London Summit, the G20 leaders made a bold statement, declaring that ‘the era of banking secrecy is over.’ During the summit they mandated the OECD, which has been the most prominent multilateral forum for international taxation governance since the 1960s, to design an information-exchange regime in order to make an end to tax evasion practices: the international exchange of information on the ownership of foreign bank accounts and the amount of income generated through these accounts remains one of the most effective ways to promote transparency and ensure adequate taxation of foreign-earned income.

The initial OECD response was twofold. The first solution was the adoption of an amended version of the *multilateral convention on Mutual Administrative Assistance on Tax Matters*. This convention, first devised in 1988, stipulated core requirements of bilateral information exchange agreements, covered a broad range of taxes and allowed for joint tax investigations (Kudrle, 2014). More importantly, it also contained new rules for information exchange and was opened up for all countries (as opposed to just OECD members), thus providing a multilateral basis for the new information exchange regime. The second solution was a blacklist of what the OECD deemed ‘uncooperative tax havens’, which was an update of a previous blacklisting effort from the OECD’s 1998 harmful tax competition project. The OECD stipulated four criteria for a jurisdiction to be labelled as a tax haven: (1) very low or no taxes on business or investment income; (2) a lack of willingness to participate in the effective exchange of information; (3) a lack of transparency via an inappropriately high level of client confidentiality based on impenetrable secrecy laws; (4) no need for financial institutions and/or corporate structures to have a physical presence. Jurisdictions could escape the list, however, by signing 12 bilateral agreements on information exchange. As a result of the blacklisting efforts, more than 800 tax treaties have been signed since 2009, the majority of which by targeted uncooperative jurisdictions (Johannesen & Zucman, 2014; Palan & Wigan, 2014).

The main problem was that these agreements only required exchange of information on request (EoIR), which is a deeply inadequate way of curbing tax evasion. While preferable to no information exchange at all, EoIR does not pierce the veil of banking secrecy and offshore companies. Generally, a tax administration would have to know the name of the citizen it wants to request information upon, in which jurisdiction his/her account is located and at which financial institution it is held in order to provide a well-grounded reason to request information. Otherwise the request might be labelled as a fishing expedition (Grinberg, 2012). Tax administrations are typically unable to offer these data, because this is exactly the kind of information they are looking for in the first place. Given the limitation of EoIR as a standard for information exchange, the G20 countries started to support the adoption of AEoI. The EU’s 2005 Savings Directive had already installed a regime for AEoI between its member states, yet offered opt-outs for Austria, Belgium and Luxemburg and only targeted savings accounts held in the name of owners. Accordingly, the main effect of the Savings Directive ‘has been to encourage Europeans … to transfer their wealth to shell corporations, trusts, and foundations’ that do not fall under the scope of the directive (Zucman, 2015: 72). Following an endorsement for AEoI from the G20 in St.Petersburg in 2013, the OECD was mandated to devise a more comprehensive regime that would target accounts held through intermediaries as well.

This new regime, dubbed the ‘common reporting standard’ (CRS), introduced a uniform standard for AEoI and is open to all the signatories of the multilateral convention. States can either choose to automatically share information bilaterally by signing tax information exchange agreements or to step into a new multilateral framework. They can do so by signing a multilateral competent authority agreement (MCAA) that is based on the 2010 amended multilateral convention and activates AEoI.[2]

As of 2016, 80 states have signed the MCAA; 54 states have pledged to start sharing information in 2017, while 26 others will follow suit in 2018. All member states of the EU have signed the MCAA and will start sharing in 2017, except for Austria which will commence sharing in 2018. In order to comply with the OECD's CRS and apply the multilateral standard to its internal market, the EU had to amend its 2011 directive on enhanced administrative cooperation in the field of taxation (DAC) in 2014. The amended DAC now mandates member states to share information automatically with each other under the same provision as the CRS starting in 2017 (except for Austria which got a one year delay), bringing the EU in line with international standards about AEoI (Council of the European union, 2014, 2015; European Commission, 2015). Because the DAC overlapped with the Savings Directive and had a much broader scope, the European Council repealed the directive in November 2013 and made the DAC the single legal basis for AEoI in the EU (Council of the European union, 2015). Panama does not participate in the CRS, yet other notorious offshore locations such as the British Virgin Islands and the Cayman Islands – through which Mossack Fonseca mostly operated – do (OECD, 2016).

Evidence from the Panama Papers suggests that AEoI and the CRS regime might already be bearing fruit in terms of transparency promotion: data from the ICIJ show a steep decline in the number of offshore companies incorporated by Mossack Fonseca from 2012 onwards, which coincides with the introduction of AEoI.[3]

The origins of AEoI: FATCA and its global effects

The unwillingness of OFCs to provide information on offshore tax account to foreign authorities has always been an intractable problem for international tax cooperation: whereas OFCs have strong incentives to protect the privacy of their clients through bank secrecy laws and practices and collect no or very low taxes, western states have usually responded in the past by lowering tax rates to protect their tax base from capital flight to offshore tax havens. So how can the rise of AEoI as a new global norm be explained? While the EU pioneered AEoI with the Savings Directive, it was a US law that would serve as the catalyst for the multilateral shift to AEoI. In 2010 the US government introduced the US Foreign Account Tax Compliance Act (FATCA) in response to the UBS offshore banking scandal, which revealed that many US citizens held secret Swiss bank accounts without reporting or paying the prevailing US taxes on these accounts. FATCA compels foreign financial institutions (FFIs) to gather information on the value – and income – of accounts held by US citizens or by foreign entities in which US citizens have a substantial interest or share, regardless of location, and report to the IRS beginning in 2014 (Palan & Wigan, 2014). It also compels US citizens to report information on certain foreign financial accounts and offshore assets, and attach it to their income tax return (IRS, 2015). FATCA is a remarkable piece of legislation in the sense that it unilaterally demands compliance of financial institutions over which the US holds no direct jurisdiction. In order to accomplish this, the US government imposes a penalty for non-compliance in the form of a 30% withholding tax on US-based financial activities, such as payments from US sources and proceeds from US investments, from non-complying FFIs (Grinberg, 2012; IRS, 2015).

The FATCA legislation clearly clashed with bank privacy and secrecy laws that are in place in many countries and make it illegal for FFIs to share account information with foreign governments. As such, FFIs from these countries found themselves between a rock and a hard place: they either had to break domestic law or face the 30% withholding tax. In order to alleviate these concerns and ensure maximum consistency between FATCA and foreign legislation, the US made a joint statement (early 2012) with five European nations – Germany, France, The UK, Spain and Italy – in which they committed to an intergovernmental approach to FATCA. This resulted into the FATCA Intergovernmental Agreements (IGAs), which come in two variants (Eccleston & Gray, 2014). Under model 1, FFIs have to give the required information to their domestic fiscal authorities, which in turn reports to US authorities. Under model 2, FFIs should share the information with the US authorities directly after establishing the consent of the account holder. The latter obligation explains why countries with stringent bank secrecy laws, such as Switzerland, have opted for a model 2 IGA.[4]

Nevertheless, so far 73 countries have signed model 1 IGAs while only eight chosen model 2. 26 others have an agreement in substance on a model 1 and five more on a model 2 IGA (United States Treasury department, 2015). FFIs from jurisdictions that did not sign an IGA are still subject to the withholding tax for non-compliance. Notably, Panama had an IGA model 1 agreement in substance as of 2014.

The promotion of FATCA by the US government is widely seen as a 'game changer' that has helped to dislodge the long-lasting stalemate with regard to the introduction of AEoI by ensuring the compliance of all the major OFCs (Emmeneger 2015; Eccleston & Gray 2014). The centrality of the US dollar-based financial system in the world economy endowed the US government with the structural power to impose FATCA agreements onto OFCs. As Emmeneger (2015: 478) explains: '[T]here is virtually no possibility for a bank to be internationally active without repeatedly trading in US dollars, with US-based institutions, or with other banks that trade in US dollars or with US-based institutions. However, by doing so, international banks are, from the point of view of US regulatory agencies, subject to US jurisdiction.' Due to the combination of international banks' economic dependence on access to the dollar-based financial system and the ability of US authorities to control access to it, even 'uncooperative' OFCs were forced to sign FATCA agreements. The capacity of the US to impose AEoI onto OFCs was a key reason why the G20 endorsed the new standard and instructed the OECD to design a new framework. As a result, OFCs also faced international demands to comply with the OECD's CRS. Given that FATCA had forced FFIs and national fiscal authorities in OCFs to build the infrastructure for the reporting of information, OCFs became more interested in applying a single global standard in order to minimise compliance costs.

FATCA: implications and lessons for the EU

The proliferation of bilateral FATCA-IGAs not only supported the rise of the OECD's CRS standard. Interestingly, it also allowed the EU to close important loop holes in its Savings Directive by ensuring that even Member States with opt-outs had to adopt AEoI. First, since the 2011 DAC and its 2014 amendment contained a most-favoured-nation clause, EU Member States have been obliged to extend AEoI to all EU member once they had granted it to a third state. Therefore, the need arose for a coherent intra-EU AEoI system after the EU member states had signed FATCA IGAs that granted AEoI to the US. Second, FATCA started a trend of world-wide AEoI, reducing the fear of Austria and Luxemburg for wide-scale capital flight to third countries as a result of the acceptance of AEoI at the EU level. FATCA alleviated the 'weakest link problem' in international tax cooperation – that is, the problem that the benefit of non-compliance will increase when the number of cooperating states increases: capital looking to evade taxation will always try to find its way to jurisdictions with less regulation, thus giving non-complying states a relatively larger share of the available capital. Because FATCA regulations operate worldwide and increase the likelihood of beyond-EU tax cooperation, there is less potential for capital flight to non-complying jurisdictions. Accordingly, FATCA diminished the weakest link repercussions of AEoI-compliance for EU member states with large banking sectors that benefit from financial secrecy (Hakelberg, 2014).

The FATCA-induced adoption of AEoI by all the EU Member States raises the interesting question whether the EU will be more able to use its market power to impose sanctions on non-complying states. The inability to reach unanimity in the Council of Ministers is the main reason why the EU has been unable to translate market size into power in the fight against tax evasion in the past (Hakelberg, 2016: 6). Given that EU members aiming to profit from financial secrecy (such as Luxembourg and Austria) were able to block mandates for the European Commission to negotiate over international tax issues and cooperation, their adoption of the intra-EU AEoI arguably made unanimity in the Council of Ministers more likely with regard to international tax issues. These member states now have obtained a clear interest in strengthening the ability of the EU to exert market power in order to maintain an international 'level-playing-field' and ensure compliance by jurisdictions that may aim to unfairly attract foreign capital and financial businesses by refusing to meet the OECD's CRS requirements. In this regard, it should be noted that the euro is the world's second reserve currency and that the European financial system rivals the US system in terms of market size, allowing the EU – in theory – to enforce compliance by such uncooperative jurisdictions and their FFIs by controlling their market access and imposing FATCA-like sanctions. Although its capacity to impose sanctions might be constrained by the fact that the EU has limited competence in tax policy (which remains central to the national sovereignty of the member states), the introduction of the financial transaction tax shows that EU Member States have been willing to collaborate in international tax matters through the 'enhanced cooperation' procedure even if unanimity is lacking.

The need to bolster the EU's power in international tax governance is all the more important in light of the lack of US commitment to reciprocate information sharing. Many scholars and observers remain sceptical about the extent to which the model 1 FATCA-IGAs legally binds the US to reciprocity (Eccleston & Gray, 2014; Hakelberg 2016). Considering that the US refused to sign to the OECD's multilateral treaty, it might be possible that the US will become the world's largest tax haven: as one Swiss-based lawyer recently stated, 'How ironic— no, how perverse—that the USA, which has been so sanctimonious in its condemnation of Swiss banks, has become the banking secrecy jurisdiction du jour … That "giant sucking sound" you hear? It is the sound of money rushing to the USA' (quoted in Drucker, 2016). The wide-scale interest of Europe's rich elites in using offshore accounts to hide their financial wealth from their national tax authorities, as revealed by the Papama Papers, shows that the EU has much to benefit from guaranteeing reciprocity in information sharing by the US government. The history of AEoI suggests that speaking with one voice and strengthening the EU's market power will be the only way to do so.

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[1] Interestingly, the Panama Papers revealed that a subsidiary of Dexia, one of the major Belgian banks that had to be bailed out and nationalised in the wake of the global financial crisis, assisted in the creation of more than 1,000 offshore accounts through Mossack Fonseca.

[2] Based on article 6 of the multilateral convention.

[3] See the following graph from the Panama Papers: https://panamapapers.icij.org/graphs/1/.

[4] If bank clients are unwilling to give their consent, the FFI is required to report aggregate account information to the IRS. It is then possible for the IRS to lodge a 'group request' about these unwilling bank clients. As such, 'the process of information exchange under Model 2 agreements is more complex and less automated, but still offers a mechanism through which the IRS can monitor offshore holdings' (Eccleston & Gray 2014: 329).