Tackling Tax havens in the US and EU: A Strategy of Not In My Backyard (NIMBY)

In April 2009 the G20 announced the intention to take action against non-cooperative jurisdictions, proclaiming themselves, 'ready to deploy sanctions to protect [their] public finances and financial systems', and the, 'era of banking secrecy is over.' This coupled with the increasingly corrosive impact of tax avoidance and evasion on the tax bases of states negotiating the politics of austerity has since proved fertile grounds for a plethora of policy debates and initiatives.

The regulation of tax havens has foundered on the rocks of territorially bound, mutually exclusive legal authority and increasingly mobile capital. Those seeking to ameliorate the impact of tax havens on the world economy face an apparently intractable collective action problem. First, each state stands to gain from imposing the least exacting tax and regulatory requirements upon mobile capital. Second, in the absence of unanimity amongst states and uniformity in terms of tax and regulation, policy and regulation can easily be gamed.

In this context, both the US and the EU are shifting towards unilateral policy as a basis upon which to reinvigorate and reinforce from what has been a largely ineffective OECD led multilateralism. This involves establishing rules within their own jurisdictions that potentially curtail the capacity of individuals and corporate entities to simultaneously live or do business within their jurisdictions while taking advantage of the differential services offered by tax havens. NIMBY seems defeatist and piecemeal, but given the combined economic weight of the US and the EU appearances in this case may yet prove deceptive; 'NIMBY' may open the way to an effective multilateralism, but by the backdoor.

The U.S. Foreign Accounts Tax Compliance Act (FATCA 2010) targets avoidance and evasion by U.S. taxpayers using foreign accounts. The legislation requires Foreign Financial Intermediaries (FFI) to report to the Inland Revenue Service (IRS) the value and income accruing to accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial interest. The legislation covers both accounts held directly and those held by corporate entities benefitting U.S. individuals. FFIs, effectively coerced as U.S. IRS inspectors, are placed in a position where non-participation renders them uncompetitive. Non-participating intermediaries are subject to a punitive withholding tax on payments from U.S. sources. This is levied on payments to the FFI as well as those to U.S. individuals, and participating intermediaries are required to impose the same tax on non-participating intermediaries. Effectively then, a potential policy diffusion process has been built into legislative enforcement mechanisms on the basis the threat of direct or indirect market exclusion.

There are grounds for optimism. Access to the U.S. market will be dependent on compliance with high levels of automatic information exchange. The benefits of this seem to flow largely to the U.S., but may serve as precedent for bi-lateral and multilateral exchanges. A series of 'son of

FATCA' agreements amongst Europe's largest members and with the U.S. suggests this may be so. Further, any compliant firm in being able to identify U.S. account holders, will necessarily have corresponding information on the accounts of other nationals. FATCA then could constitute the basis of cascading reciprocity.

The development of a European policy towards tax evasion has been a somewhat tortured in the navigation of the strictures of the Treaty of Rome and the conflicting policies and preferences of its member and associated states. However, in 1998 the EU Commission proposed a directive intended to ensure that a minimum effective tax rate was imposed on interest income earned through accounts held by a resident taxpayer in a foreign EU country. Under the Directive all member state would provide automatic exchange of information. The EU's own tax havens – Austria, Luxembourg and Belgium – are afforded a 7 year transition period during which they may choose to impose withholding tax. The agreement of these jurisdictions relied upon equivalent measures being adopted in non-EU member states and dependent territories such as Switzerland and the Channel Islands. Ironically, insistence on equality of treatment by the EU's tax havens provides a basis for EU policy to constitute a multilateral mechanism with broad geographical coverage.

The European Union Savings Directive (2003/48/EC) came into force in July 2005. The Savings Directive left EU policy in a curious half way house. Firstly, it could not capture interest payments accruing to accounts held by corporate entities rather than individuals. Changing the identity of the beneficial owner from a natural person to a trust or limited company meant transparency could be circumvented. Secondly, member states could choose either to exchange information or withhold. The three European tax havens and most of the dependencies of the Netherlands and UK chose the withholding model.

While this impasse remains in place, in February 2011 the Directive on Administrative Cooperation in the Field of Taxation the EU (2011/16/EU) mandated the Commission to widen the categories of income that member states must report beyond interest payments and therefore rendered the EU regime potentially compatible with FATCA requirements. This along with now hotly debated proposed changes to EU Savings Tax (COM 2008 7279), which extend the coverage of the Directive to interest payments to EU residents channelled through tax-exempted structures established in non-EU countries lends EU policy real substance.

While progress in the fight against tax havens has been slow, haphazard and hampered by acute collective action problems, a certain direction of travel is discernible. The EU Savings Directive and the Directive on Administrative Cooperation in the Field of Taxation contain the seeds of automatic exchange with non-member countries and dependencies in the form of built-in mechanisms of extension. The U.S. and the EU have side-stepped the collective action problem by acting alone, deploying private firms as tax intermediaries and, crucially, targeting activities rather than the aberrant legislation of numerous sovereign states. Driven by the powerful catalyst of FATCA, the strategy of ‘not in my backyard’, which the EU shares with the U.S., may signal a sea change in the transnational regulation of ‘harmful tax competition’.

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