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Beyond FATCA: An Evolutionary Moment for the International Tax System

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Working Draft, January 27, 2012

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Beyond FATCA: An Evolutionary Moment for the International Tax System¹

Itai Grinberg²

Draft of January 27, 2012³

Abstract

The international tax system is in the midst of a novel contest between information reporting and anonymous withholding models for ensuring that states have the ability to tax offshore accounts. At stake is the extent of many countries' capacity to tax investment income of individuals and profits of closely held businesses through an income tax in an increasingly financially integrated world. Four incongruent initiatives of the European Union, the OECD, Switzerland, and the United States together represent an emerging international regime in which financial institutions act to facilitate countries' ability to tax their residents' offshore accounts. The growing consensus that financial institutions should act as "tax intermediaries" cross-border represents a remarkable shift in international norms that has yet to be recognized in the literature. What remains is a contest as to how financial institutions should serve as tax intermediaries cross-border, and for which countries. Different outcomes in this contest portend starkly different futures for the extent of cross-border tax administrative assistance available to most countries. The eventual triumph of an information reporting model over an anonymous withholding model is key to (1) allowing for the taxation of principal, (2) ensuring that most countries are included in the benefit of financial institutions serving as tax intermediaries cross-border, and (3) encouraging taxpayer engagement with the polity and supporting sovereign policy flexibility, especially in emerging and developing economies. The article closes with proposals to help reconcile the emerging automatic information exchange approaches and produce an effective multilateral system.

¹ I thank Lily Batchelder, John Brooks, Julie Cohen, Steve Cohen, Michael Doran, Michael Graetz, Oona Hathaway, Greg Klass, David Luban, Allegra McLeod, Tanina Rostain, and David Super for comments on earlier drafts and/or conversations about the project more generally. Philippe Stephany and Dylan Marck contributed excellent research assistance. All errors remain my own.

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³ On February 8, 2012, France, Germany, Italy, Spain, the United Kingdom and the United States issued a joint statement that contemplates a shared commitment to developing a common model for exchanging information automatically for tax purposes. This announcement represented yet another move in the ongoing global contest between information reporting and anonymous withholding regimes for ensuring that states have the ability to tax offshore accounts. This working draft does not reflect that development.

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Introduction

In 1972, Niles Eldridge and Stephen Jay Gould published a landmark paper noting that the fossil history of most species evidences long periods of stasis punctuated by brief periods of rapid change.⁴ Like the fossil record studied by Eldridge and Gould, the history of cross-border tax administrative assistance is characterized by long periods of stasis. But the well-publicized cross-border tax evasion scandals of 2008 have focused political attention on offshore tax evasion in the world's major economies. As a result, we are in the midst of a brief period in which cross-border administrative assistance for tax purposes is evolving rapidly.

The ability to make, hold, and manage investments through offshore financial institutions⁵ has increased dramatically in recent years, while the cost of such services has plummeted.⁶ Individuals now find it substantially easier to underreport or fail to report investment earnings through the use of offshore accounts, and experience suggests that such accounts may also be used to help evade tax on income earned domestically by closely held businesses. Consequently, the principal held in offshore accounts as well as the investment earnings generated through such accounts may go untaxed.

Beginning in 2008, well-publicized cross-border tax evasion scandals focused political attention in the world's major economies on the issue of offshore tax evasion. In 2009, leaders of the G20 countries declared that for tax purposes “[t]he era of banking secrecy is over,” and stated that they “stand ready to use countermeasures” against jurisdictions that do not conform to international standards for tax information exchange.⁷ Finance ministers of the G20 also declared the importance of including developing countries in what they said would be “a new cooperative international tax environment.”⁸

For many developing countries and emerging economies, the question is not whether their wealthy taxpayers' access to offshore accounts will weaken enforcement, but whether given such access taxes on capital income can be enforced at all. In these economies, the bulk of the individual income tax base is often comprised of a highly concentrated group of well-off individuals. Domestic financial institutions are also often

⁴ Niles Eldridge & Stephen J. Gould, *Punctuated Equilibria: An Alternative to Phyletic Gradualism*, in *MODELS IN PALEOBIOLOGY* 82 (T.J.M. Schopf ed., 1972).

⁵ I use the term “offshore financial institution” to refer to any financial institution outside the jurisdiction of legal residence or tax domicile of a given investor. In this way, my use of the term “offshore financial institution” differs from much of the literature regarding “offshore financial centers.” That literature tends to categorize individual jurisdictions as “onshore” and “offshore” centers. In contrast, I view a financial institution in the UK serving an Indian investor as an “offshore financial institution” with respect to that Indian investor.

⁶ Maintaining the capacity for large, developed economies to tax capital income under such circumstances has been a subject of scholarly concern for many years. See, e.g., Vito Tanzi, *Globalization, Technological Developments, and the Work of Fiscal Termites*, 26 *BROOK. J. INT'L L.* 1261, 1262, 1274–75 (2001).

⁷ The Group of Twenty, *Declaration on Strengthening the Financial System*, G-20 (Apr. 2, 2009), <http://www.g20.utoronto.ca/2009/2009ifi.pdf> (last visited Jan. 30, 2012) [hereinafter April 2009 London Communiqué].

⁸ *Id.* at 5.

relatively undeveloped. Thus, it is commonplace for the wealthy to hold investments through offshore accounts. Without proper support mechanisms for the overstretched tax administrators of these countries, it is difficult to constrain their citizens from evading domestic tax liability on capital income and closely held business income by using offshore accounts and offshore entities.

Since April 2009, a growing number of governments⁹ and NGOs¹⁰ have called for automatic exchange of tax information to address these concerns. The European Union's Savings Directive resulted in a limited form of automatic information exchange among most EU countries, and proposals of the last few years would expand its scope. Financial institutions have expressed interest in providing governments with automatic information on cross-border investors and their investment income, at least when promised relief from withholding tax for such investors. "FATCA," legislation enacted by the United States in 2010, will eventually require foreign financial institutions to report financial information about accounts held by specified United States persons or be subject to a punitive withholding tax. Finally, the recently revised Convention on Mutual Administrative Assistance in Tax Matters ("Multilateral Convention") creates a platform for automatic information exchange according to agreed international standards.

However, in August 2011 both Germany and the United Kingdom signed treaties with Switzerland that reject automatic information exchange and substitute anonymous cross-border tax withholding. Under these agreements, Swiss financial institutions will impose withholding tax on behalf of a foreign government and the Swiss government will remit that tax anonymously to the countries of residence of the investors, without revealing the names or other information regarding the account holders whose investment earnings give rise to these payments. The Swiss agreements are important because more than twenty-five percent of the world's offshore wealth is managed from Switzerland, while approximately another twenty-five percent of the world's offshore wealth is managed from the UK and its dependencies.¹¹ Switzerland often acts as a leader for offshore asset management centers, while Germany and the UK are among the few economic and financial centers with sufficient leverage to exert pressure on governments that are the home to important offshore asset managers. The Swiss agreements, particularly if ratified, represent a major blow to expanded information reporting. Bilateral anonymous withholding agreements are incompatible with a broadly multilateral automatic information exchange system.

⁹ One of the strongest statements came from Indian Prime Minister Manmohan Singh, who suggested that "G-20 countries should take the lead in agreeing to automatic exchange of tax related information with each other . . . in the spirit of our London Summit [declaration] that 'the era of bank secrecy is over'." *PM Sends Strong Message to Stop Tax Evasion*, IBN LIVE (Nov. 3, 2011), <http://ibnlive.in.com/news/send-strong-message-on-tax-evasion-pm-to-g20/198996-2.html> (last visited Jan. 30, 2012)

¹⁰ The Tax Justice Network has been particularly active and effective in encouraging civil society to focus on the issue of automatic exchange of tax information.

¹¹ BOSTON CONSULTING GROUP, *GLOBAL WEALTH 2011: SHAPING A NEW TOMORROW* 13 (June 2011), available at <http://www.bcg.com.pl/documents/file77766.pdf> [hereinafter BCG, GLOBAL WEALTH].

Both cross-border information exchange and anonymous cross-border withholding share one thing in common: they require financial institutions to be cross-border tax intermediaries. Together, the moves by governments and financial institutions towards these two forms of cross-border administrative assistance represent an important shift for the international tax system. For years, financial institutions have acted as domestic tax intermediaries by providing information reporting on their domestic payees to the tax administration of their country of residence or withholding from such payees and remitting the withheld amounts to the domestic tax administration, or both. But even five years ago, no one would have claimed that financial institutions were obligated to act as cross-border tax intermediaries or that there was an emerging consensus that they do so.

Academic discourse has hardly addressed the emerging approaches for cross-border tax intermediation of the last few years.¹² Professional authors and the press generally focus on a single emerging approach, or occasionally note that automatic information exchange and anonymous withholding are in conflict with one another. The commonality between these systems is, however, more important than their differences: the emergence of the EU, OECD, Swiss, and U.S. approaches to cross-border tax administrative assistance has shifted the discourse of international tax cooperation from a dispute about whether financial institutions should function as tax intermediaries cross-border to a dispute about how financial institutions should perform that role.

This paper makes three key contributions. First, it highlights the commonality between automatic information exchange and anonymous withholding, and argues that we are witnessing the birth of a new international regime in which financial institutions act as tax intermediaries with respect to offshore accounts.¹³ Second, it explains why automatic

¹² The only article of which I am aware that addresses the differences between the emerging information reporting models in any detail is Stafford Smiley, *Qualified Intermediaries, The EU Savings Directives, Trace—What Does FATCA Really Add?*, CORP. TAX'N, Sept–Oct. 2011, at 20. Although I disagree with certain of that article's conclusions, and it does not consider the clash with anonymous withholding, Smiley makes an important contribution to the literature. Richard Harvey has recently written an article focused on the implementation of FATCA, but it does not discuss the international context or other emerging approaches. J. Richard Harvey, Jr., *Offshore Accounts: Insider's Summary of FATCA and Its Potential Future*, 57 VILL. L. REV. (forthcoming Dec. 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1969123. In late 2009, Jefferson VanderWolk wrote an insightful short article suggesting that the change in international norms with respect to information exchange upon request was likely to be an initial stage in a process that would eventually result in broader and more automatic exchanges of information between tax authorities. Jefferson P. VanderWolk, *The New World of Tax Information Exchange*, ASIA-PAC. J. TAX'N, Autumn/Winter 2009, at 166. An early paper emphasizing that “multilateral coordination has become necessary to achieve the effective international information exchanges required for residence-based taxation of foreign portfolio income,” and that “the threat of coordinated multilateral defensive measures may coerce tax havens into entering into information exchange agreements with OECD countries,” is Michael J. Graetz and Itai Grinberg, *Taxing Foreign Portfolio Investment Income*, 56 TAX. L. REV. 538, 579-85 (2003).

¹³ By an “international regime” I mean to employ Stephen Krasner's classic definition: “implicit or explicit principles, norms, rules and decision-making procedures around which actors' expectations converge in a given area of international relations.” Stephen D. Krasner, *Structural Causes and Regime Consequences: Regimes as Intervening Variables*, 36 INT'L ORG. 185, 186 (1982).

information reporting solutions are preferable to anonymous withholding solutions.¹⁴ Finally, the paper addresses how to reconcile the emerging and incongruent proposals for automatic information reporting in a manner that will promote the emergence of a multilateral automatic information reporting system.

Part I of this article introduces the events that catalyzed the present evolutionary moment in cross-border tax cooperation, and describes why the push for greater transparency to mitigate offshore tax evasion is even more important to developing countries and emerging economies than it is to developed economies. Part II describes the nascent approaches to cross-border tax cooperation being developed by the EU, the Organisation for Economic Cooperation and Development (OECD), Switzerland, and the United States. It argues that all of these approaches build on the premise that financial institutions should be cross-border tax intermediaries. The fact that both government and private sector expectations are converging around this premise marks the emergence of a new regime.

Part III argues that the information reporting model is superior to the anonymous withholding model. Automatic information reporting solutions can address concerns regarding the accretion of untaxed principal, whereas anonymous withholding solutions cannot. Automatic information reporting also preserves tax morale, maintains the expressive values associated with taxation of capital income, and supports sovereign policy flexibility, particularly outside the large developed economies.¹⁵ Finally, unlike anonymous withholding, an automatic information reporting solution has the capacity to develop into a broadly multilateral regime. It is therefore important to move towards a multilateral automatic information reporting system, before a critical mass of anonymous withholding agreements can take shape and produce a suboptimal equilibrium that would only allow a few countries to reap the benefits of financial institutions functioning as tax intermediaries cross-border.

At present it is unclear whether the world is on the path towards automatic information exchange, anonymous withholding, or some combination thereof. Part IV provides proposals as to how the emerging information reporting models could be harmonized to

¹⁴ From the perspective of a tax administrator, this comparison is between two second-best alternatives. The ideal compliance system would provide for both non-anonymous withholding and related information reporting. This paper does not address that possibility because it is not presently under consideration internationally.

¹⁵ Some might query whether the degree to which the tax and development literature supports progressive personal income taxation and challenge the recommendations of this paper on those grounds. *See generally* Eric M. Zolt & Richard M. Bird, *Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries*, 52 UCLA L. REV. 1627 (2005). However, if administration were less of a concern due to improved global cooperation, then scholars with concerns regarding administrability might be more likely to endorse schedular income taxation of capital income by developing countries, at least at the top of the income distribution, as one part of a broader strategy to address inequality. *See id.* at 1659–60, 1689–92.

encourage the development of a multilateral automatic information exchange system. Part V concludes.¹⁶

I. The Beginning of Evolutionary Change in Cross-Border Tax Administrative Assistance

A. Achieving Information Exchange Upon Request, and Its Inadequacy

Most governments of major developed countries agree that access to information from other countries is vital to the full and fair enforcement of their tax laws.¹⁷ Consequently, bilateral tax treaties generally provide for the exchange of information between tax authorities. Such provisions have appeared in tax treaties since at least World War II.¹⁸ However, the OECD Model Tax Convention (“OECD Model Treaty”), the world’s dominant model tax treaty, only requires information exchange *upon request*, while permitting but not requiring *automatic information exchange*.¹⁹ The OECD’s standards

¹⁶ As a study of a particular problem in international tax diplomacy and regime conflict, this paper is also responsive to Diane Ring’s observation that the international tax literature lacks such scholarship, and could greatly benefit from it. Diane Ring, *International Tax Relations: Theory and Implications*, 60 TAX L. REV. 83 (2007).

¹⁷ For example, over the years the International Tax Counsel of the United States has consistently testified before the Senate Foreign Relations Committee that access to information from other countries is critically important to the enforcement of U.S. tax laws. See, e.g., *Tax Convention with the United Kingdom (T.Doc. 107-19) and Protocols amending Tax Conventions with Australia (T. Doc. 107-19) and Mexico (T. Doc. 108-3): Hearing Before the S. Comm. on Foreign Relations*, 108th Cong. 9 (2003) (statement of Barbara M. Angus, Int’l Tax Counsel, U.S. Dep’t of Treasury) (“Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program. If a country has bank secrecy rules that would prevent or seriously inhibit the appropriate exchange of information under a tax treaty, we will not conclude a treaty with that country.... it is one of a very few matters that we consider non-negotiable.”); *A Review of Treaty Doc. 112-01: Protocol Amending Tax Convention with Swiss Confederation; Treaty Doc. 111-08: Protocol Amending Tax Convention with Luxembourg; Treaty Doc. 111-07: Tax Convention with Hungary; Treaty Doc. 110-23: Investment Treaty with Rwanda; Treaty Doc. 111-06: Mutual Legal Assistance Treaty with Bermuda: Hearing Before the S. Comm. on Foreign Relations*, 111th Cong. (2011) (statement of Manal Corwin, Int’l Tax Counsel, U.S. Dep’t of Treasury).

¹⁸ Steven Dean, *The Incomplete Global Market for Tax Information*, 49 B.C. L. REV. 605, 648–53 (2008). (describing bilateral tax information exchange upon request as a barter system that allows pairs of governments to barter with one another for information that each can use to enforce their own taxes, noting that some early treaties called for automatic information exchange, and exploring the possibility of a market for cross-border tax information in which governments could buy and sell taxpayer information for consideration other than reciprocity).

¹⁹ Articles of the Model Convention with Respect to Taxes on Income and on Capital art. 26 (Org. for Econ. Cooperation & Dev. 2008) [hereinafter OECD Model Convention]. The OECD’s Model Convention and Model Tax Information Exchange Agreement (for countries wishing to agree to tax information exchange without a broader tax treaty) require exchange of information *upon request* where it is (1) “foreseeably relevant” to the administration and enforcement of the domestic laws of the treaty partner; (2) no restrictions on exchange caused by bank secrecy or domestic tax interest requirements; (3) availability of reliable information and powers to obtain it; (4) respect for taxpayers’ rights, and (5) strict confidentiality of information that is exchanged. OECD, OVERVIEW OF THE OECD’S WORK ON COUNTERING INTERNATIONAL TAX EVASION (Dec. 23, 2009). These standards were eventually endorsed by the G-8, the

do not permit “fishing expeditions” in a request for information from one country to another. Historically, that limitation was understood to allow only requests about specific taxpayers, identified by name, in circumstances where the requesting government could explain why they had reason to suspect they needed information about that taxpayer’s affairs.

Prior to 2009, the major developed economies and the OECD were hamstrung in their efforts to achieve comprehensive information exchange upon request, even though most countries recognized that information exchange upon request represented a relatively low level of administrative cooperation among tax authorities. The chief obstacle was the fact that four OECD member states—Austria, Belgium, Luxembourg, and Switzerland—were committed to bank secrecy as a bar to tax information exchange upon request.²⁰ One of these countries, Switzerland, is the location for more than twenty five percent of the global offshore wealth management industry as measured by assets under management.²¹ The others also have important histories as offshore banking centers. Significant non-OECD financial centers (e.g., Hong Kong, Liechtenstein, Panama, and Singapore) felt comfortable following the lead of Switzerland and the other OECD bank secrecy jurisdictions in rejecting exchange upon request of bank information.

In 2008, the issue of offshore tax evasion took on greater global significance, largely as a result of two notable scandals. The first involved tax evasion through accounts held at LGT bank in Lichtenstein, primarily by residents of Germany and other large European countries.²² The second scandal led the United States to act against the United Bank of Switzerland (UBS), the second largest bank in Europe, for conspiring to defraud the United States by helping U.S. customers conceal their ownership of, or beneficial interest in, income and assets held through offshore accounts in Switzerland and other jurisdictions.²³

G20, and the UN, leading the OECD to describe the results as representing international standards for transparency and exchange of tax information.

²⁰ The OECD had historically pressured non-members to conform to high standards regarding tax information exchange but, given its consensus-based system for agreement among member countries, found it difficult to pressure its own four bank secrecy jurisdictions. Statements regarding the importance of information exchange and compliance with international standards could not hide the fact that there was no true consensus among developed governments as to how to manage “their own” outliers (such as Austria and Switzerland) on this issue. The unwillingness or inability of the major developed economies to confront fellow OECD members sparked understandable calls of hypocrisy from other offshore financial centers during the late 1990s, in the course of the OECD’s efforts to combat so-called “harmful tax competition.” Those outcries were effective in limiting pressure on jurisdictions opposed to liberal global tax information exchange rules.

²¹ BOSTON CONSULTING GROUP, *GLOBAL WEALTH 2010: REGAINING LOST GROUND* 13 (June 2010) (available by request from the Boston Consulting Group).

²² Lynnley Browning, *Banking Scandal Unfolds Like a Thriller*, N.Y. TIMES, Aug. 15, 2008, at C8; *Liechtenstein Tax Evasion Scandal: Informant in Investigation ‘Fears’ for His Life*, SPIEGEL ONLINE INT’L, Mar. 3, 2008, <http://www.spiegel.de/international/business/0,1518,540283,00.html> (last visited Feb. 2, 2012); *Over 160 Tax Dodgers Confess in Liechtenstein Probe*, SPIEGEL ONLINE INT’L, Feb. 26, 2008, <http://www.spiegel.de/international/business/0,1518,537839,00.html> (last visited Feb. 2, 2012).

²³ *DOJ Announces Deferred Prosecution Agreement with UBS*, TAX ANALYSTS, Feb. 19, 2009, 2009 TNT 31–32.

In the midst of the financial crisis and its incumbent budgetary pressures, the political response to these offshore tax evasion scandals was swift, and included personal interventions from Presidents and Finance Ministers.²⁴ At the April 2009 G20 London Summit, world leaders issued a communiqué declaring that “the era of banking secrecy is over.” The G20 emphasized that they “stand ready to take agreed action against those jurisdictions that do not meet international standards for tax transparency,”²⁵ and that they had developed a toolbox of counter measures for countries to consider. The G20 then called attention to the fact that on the same day as the London Summit the OECD had published lists of countries that had not committed to or substantially implemented international standards. For the first time, such an OECD list included the bank secrecy countries that were OECD members.²⁶

The April 2009 G20 Summit and OECD list catalyzed the present evolutionary moment in cross-border administrative assistance for tax purposes.²⁷ Within a few years of being threatened with sanctions by the G20, those jurisdictions previously unwilling to exchange information upon request in accordance with OECD standards changed their position and began to comply with the new global norm. However, information exchange on request is, on its own, inadequate to combat offshore tax evasion. The ability to request information regardless of bank secrecy does have some chilling effect on tax evasion, because evaders cannot rely on bank secrecy to conceal their activities. At the same time, in order to receive information upon request, a tax administration is generally required to name the taxpayer, know which jurisdiction to ask for information, know at which financial institution a taxpayer may hold her account, and have a credible

²⁴ German Finance Minister Peer Steinbrück asked the global community to blacklist Switzerland because it “offers conditions that invite the German taxpayer to evade taxes.” Ben Hall & Bertrand Benoit, *Berlin Calls for Swiss to be on Tax Blacklist*, FIN. TIMES, Oct. 21, 2008, available at <http://www.ft.com/intl/cms/s/0/1f8a19ba-9f9f-11dd-a3fa-000077b07658.html#axzz11FR7VjbW>. Nicholas Sarkozy suggested that Europe was in complete agreement on the need for a blacklisting of tax haven jurisdictions, with punitive sanctions for noncompliance. *EU to remove Switzerland, Austria and Luxembourg from OECD “Tax Haven” Blacklist ahead of G20 Summit*, THE GUARDIAN, Mar. 20, 2009, <http://www.guardian.co.uk/business/2009/mar/20/g20-tax-haven-blacklist> (last visited Nov. 21, 2011). President Obama emphasized the issue of offshore tax evasion on the campaign trail. David J. Lynch, *Does tax code send U.S. jobs offshore?*, USA TODAY, Mar. 21, 2008, available at http://www.usatoday.com/money/perfi/taxes/2008-03-20-corporate-tax-offshoring_N.htm.

²⁵ April 2009 London Communiqué, *supra* note 8, at 4–5.

²⁶ *Id.* at 4.

²⁷ Asset management jurisdictions that previously resisted endorsing or implementing OECD standards came to believe that “defensive measures” might be put in place by the major developed economies if the governments of the offshore asset management jurisdictions did not change position. Following the release of the G20 communiqué, previously recalcitrant jurisdictions made formal commitments to the OECD information exchange upon request standard and shortly thereafter began passing legislation to implement their stated commitments. *See, e.g.*, David Crawford & Jesse Drucker, *Swiss to Relax Bank Secrecy Laws*, WALL ST. J., Mar. 14, 2009, available at <http://online.wsj.com/article/SB123694252262918343.html>. *See also* Global Forum on Transparency and Exchange of Information for Tax Purposes, *A Progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard*, OECD (Dec. 15, 2011), <http://www.oecd.org/dataoecd/50/0/43606256.pdf> (last visited Feb. 2, 2012).

suspicion of tax evasion. Otherwise, the request may be denied as a “fishing expedition.” Thus, the requirement that a requesting tax administration have such specific and detailed information severely limits the effectiveness of information exchange upon request as a means to systematically combat offshore tax evasion.²⁸

Recent actions by legislatures, tax administrations, and prosecutors of the world’s major developed economies demonstrate their belief that information exchange upon request is inadequate to fight offshore tax evasion. Various G7 governments have purchased account data stolen by insiders from banks,²⁹ shared stolen information among themselves and used it to prosecute tax evaders,³⁰ required foreign banks to report on or close their residents’ accounts,³¹ opened up investigations of and prosecuted financial institutions with large offshore asset management businesses,³² entered agreements to require anonymous withholding on their residents’ offshore accounts,³³ demanded automatic information reporting,³⁴ and linked enhanced penalties for offshore tax evasion by their citizens to the tax transparency of the territory in which the income or gain

²⁸ See also John Christensen & David Spencer, *Stop this Timidity in Ending Offshore Tax Haven Abuse*, FIN. TIMES, Mar. 4, 2008, available at <http://www.ft.com/intl/cms/s/0/63cdb642-ea03-11dc-b3c9-0000779fd2ac.html#axzz1hJI1DvU3> (“The OECD’s approach to tax transparency requires information to be exchanged with other jurisdictions only on request. In other words, you must know what you are looking for before you request it. This is shockingly inadequate. We need the automatic exchange of tax information between jurisdictions and all developing countries must be included”).

²⁹ Carter Dougherty & Mark Landler, *Tax Scandal in Germany Fans Complaints of Inequality*, N.Y. TIMES, Feb. 18, 2008, available at <http://www.nytimes.com/2008/02/18/business/worldbusiness/18tax.html>.

³⁰ H. Arnold Sherman, *The War on Offshore Tax Evasion*, STEP J., Sept. 2010, http://www.stepjournal.org/journal_archive/2010/step_journal_september_2010/the_war_on_offshore_tax.aspx (last visited Dec. 21, 2011) (Canada, Germany France, Italy, and the UK all using stolen information purchased from bank employees of foreign banks to prosecute taxpayers’ evading domestic tax obligations).

³¹ Memorandum of Understanding Between the Government of the Principality of Liechtenstein and Her Majesty’s Revenue and Customs of the United Kingdom of Great Britain and Northern Ireland Relating to Cooperation in Tax Matters, Aug. 11, 2009, <http://www.hmrc.gov.uk/international/joint-declaration-lich.pdf> (last visited Jan. 10, 2012). The UK entered into a treaty in which Liechtenstein, under pressure, agreed that financial intermediaries in Liechtenstein will identify persons that may be liable to tax in the UK, and either obtain certification that such person is compliant with their UK tax obligations or close their account. Somewhat similarly, the U.S. FATCA legislation requires foreign financial institutions to report on, withhold on, or close U.S. accounts.

³² Randall Jackson, *U.S. Offers 11 Swiss Banks Deals to End Tax Evasion Investigation*, 134 TAX NOTES 71 (2012).

³³ Agreement between the Swiss Confederation and the United Kingdom of Great Britain and Northern Ireland on Cooperation in the Area of Taxation, U.K.-Switz., Oct. 6, 2011, <http://www.hmrc.gov.uk/taxtreaties/swiss.pdf> (last visited Jan. 10, 2012); See Agreement on Cooperation in the Area of Taxation, Ger.-Switz., art. 19(1), Sept. 21, 2011, (Ger.) [hereinafter Ger.-Switz. Cooperation Agreement], available at http://www.bundesfinanzministerium.de/nrnn_74882/DE/BMF__Startseite/Aktuelles/BMF__Schreiben/Internationales__Steuerrecht/Staatenbezogene__Informationen/Schweiz/016__a,templateId=raw,property=publicationFile.pdf.

³⁴ See, e.g., Hiring Incentives to Restore Employment Act of 2010 (HIRE Act), Pub. L. No. 111-147, § 501-35, 124 Stat. 71, 97-115 (2010) (foreign account tax compliance title); Council Directive 2011/16/EU, Administrative Cooperation in the Field of Taxation and Repealing Directive 77/799/EEC, 2011 O.J. (L 64) 1 [hereinafter the February Directive]. See also Singh, *supra* note 9.

arises.³⁵ These unilateral techniques, while somewhat effective, often are not available to less powerful countries looking to address their own offshore tax evasion concerns.

B. Emerging Economies and Developing Countries Are Most Exposed

The best available data suggests that compliance concerns over tax evasion through offshore accounts are likely to be greater for emerging economies than for developed economies. Meanwhile, the emerging economies' lower administrative capacity reduces the efficacy of information exchange upon request as a tool with which they can combat offshore tax evasion. They often lack the audit and investigative skills to determine which country to ask about which resident taxpayer.

Offshore wealth represents 6.4% of the more than \$120 trillion of global wealth.³⁶ However, the extent to which taxpayers' assets are managed offshore is not uniform across regions of the world. BCG estimates that less than 2% of North American wealth and less than 8% of European wealth is held offshore.³⁷ In contrast, more than 25% of all Latin American household wealth, representing \$900 billion, and almost 33% of all Middle Eastern and African wealth, representing \$1.4 trillion, is held offshore.³⁸ Households outside the major developed economies hold approximately 25% of global wealth (including \$21.7 trillion in wealth for households in Asia-Pacific ex-Japan).³⁹ Wealth is also much more concentrated⁴⁰ and growing at a significantly faster rate outside North America, Japan, and Western Europe, with experts expecting that trend to continue.⁴¹ Thus, the taxation of offshore wealth should be of greater relative importance to Latin America, the Middle East, and Africa, than to the United States and Canada or

³⁵ See, e.g., Finance Act 2010, 2010, c. 13, §§35, 10 (Eng.), available at <http://www.hmrc.gov.uk/about/tackling-offshore-tax-evasion.htm>.

³⁶ BCG, GLOBAL WEALTH, *supra* note 11, at 13. For this purpose, offshore wealth is defined as "assets under management booked in a country where the investor has no legal residence or tax domicile."

³⁷ \$0.7 trillion of \$38.2 trillion in North American wealth is held offshore, representing 2% of North American wealth. \$3 trillion in European wealth is held offshore, representing 8% of European wealth. *Id.* at 7, 13.

³⁸ BCG estimates that global wealth at the end of 2010 stood at \$121.8 trillion. Households outside the major developed economies hold approximately 25% of global wealth, with \$21.7 trillion in wealth held by households in Asia-Pacific ex-Japan, \$4.5 trillion in the Middle East and Africa, and \$3.5 trillion in Latin America (defined to include Mexico). Global wealth for this purpose is understood to include all assets under managements across all households worldwide, including worldwide cash deposits, money market funds, listed securities held directly or indirectly through managed investments, and to include all onshore and offshore assets. It excludes wealth attributed to individuals' own businesses, residences, or luxury goods. The major developed economies for this purpose are Canada, Europe, Japan, and the United States. *Id.* at 5, 7, 7 n.1.

³⁹ *Id.*

⁴⁰ In Europe, for example, 1.1% of households held more than \$1 million in assets under management, representing in total 26% of European wealth. In contrast, in Latin America, 0.24% of households held more than \$1 million in assets under management, representing 36% of total Latin American wealth, and in the Middle East and Africa, 0.3% of households held more than \$1 million in assets under management, representing 54% of total Middle Eastern and African wealth. *Id.*

⁴¹ See, e.g., BCG, GLOBAL WEALTH, *supra* note 11, at 10. See also MERRILL LYNCH CAP GEMINI, WORLD WEALTH REPORT 6 (2011).

the major European economies. Data on actual revenues lost by developing countries and emerging economies overall from offshore tax evasion is unreliable. However, OECD estimates put such losses, only a portion of which are attributed to the use of offshore accounts by resident individuals, at a magnitude that approximates all official development assistance worldwide (totaling \$120 billion per year).⁴²

Nor are emerging economies' concerns with offshore tax evasion limited to revenue loss. As in the developed world, an inability to collect tax on income and wealth held through offshore accounts and entities may undermine tax morale and threaten the broader administration of the domestic tax system. Moreover, in administrative regimes characterized by limited competence, widespread awareness of evasion through offshore accounts by the wealthy or privileged may undermine the authority and effectiveness of the state. The Indian Supreme Court, which handled a series of cases associated with corruption and tax evasion in recent years, described the problem:

Unaccounted monies, especially large sums held by nationals and entities with a legal presence in the nation, in banks abroad...would also indicate a substantial weakness in the capacity of the State in collection of taxes on incomes generated by individuals and other legal entities within the country. The generation of such revenues is essential for the State to undertake the various public goods and services that it is constitutionally mandated, and normatively expected by its citizenry, to provide. A substantial degree of incapacity, in the above respect, would be an indicia of the degree of failure of the State; and beyond a particular point, the State may spin into a vicious cycle of declining moral authority, thereby causing the incidence of unlawful activities in which wealth is sought to be generated, as well as instances of tax evasion, to increase in volume and in intensity.⁴³

⁴² OECD Development Assistance Committee, *Investing in Development: A Common Cause in a Changing World*, OECD 3 (2009), available at <http://www.oecd.org/dataoecd/14/1/43854787.pdf>. A number of commentators estimate that offshore tax evasion in the developing world is more extensive than the OECD estimate, which is intended to capture some amount of corporate abuse in addition to individual offshore tax evasion through offshore accounts, would suggest. See, e.g., GLOBAL FINANCIAL INTEGRITY, ILLICIT FINANCIAL FLOWS FROM DEVELOPING COUNTRIES: 2002–2006, available at http://www.gfintegrity.org/index.php?option=com_content&task=view&id=149&Itemid=70 (illicit financial flows out of developing countries estimated at \$850 billion to \$1 trillion a year). However, Fuest and Riedel are skeptical of the higher figures and further conclude that “most existing estimates of tax revenue losses in developing countries due to evasion and avoidance are not based on reliable methods and data. Moreover, it seems that too much emphasis is put on producing aggregate estimates of tax revenue losses for the developing world as a whole.” Clemens Fuest & Nadine Riedel, *Tax Evasion, Tax Avoidance and Tax Expenditures in Developing Countries: A Review of the Existing Literature*, (Oxford University Centre for Business Taxation, Working Paper 2009).

⁴³ *Ram Jethmalani & Ors v. Union of India & Ors*, (2011) 8 S.C.C. 1, ¶ 8 (India).

II. Beyond Information Exchange Upon Request

At the start of the twenty-first century, outside of information exchange upon request, there were only very limited mechanisms in place by which governments or financial institutions automatically provided any assistance to a foreign sovereign attempting to tax assets held offshore by the foreign sovereign's residents.⁴⁴ This situation persisted despite the fact that financial institutions have served as tax intermediaries domestically in almost all major developed economies for decades, and despite large, wealthy economies' concern over evasion of domestic tax burdens through offshore accounts during that entire period.⁴⁵ Even within the European Union—a *sui generis* pooling of sovereignty with significant inter-state cooperation—debates about routine cooperation on the taxation of a single category of income—interest—had not progressed for decades.⁴⁶ Germany, the EU's most powerful government, was forced to change its regime for taxing capital income when its citizens found it too easy and tempting to evade German taxes by holding assets through a foreign account in another EU jurisdiction.⁴⁷

Some discussions in the late 1990s suggested small steps towards improving the availability of bank information for cross-border tax purposes,⁴⁸ but progress in this

⁴⁴ One noteworthy example was U.S. bank deposit interest reporting to Canada and reciprocal Canadian reporting to the U.S. with respect to financial payments made to any person disclosing a permanent U.S. address. See Treas. Reg. § 1.6049-8. There were also certain other routine information exchanges relating to certain passive income flows, often providing bulk data that was not attributable to any given taxpayer. Existing routine information exchange mechanisms generally do not provide information about specific investors' investments in a manner that can routinely assist with tax enforcement.

⁴⁵ At least as early as 1970, the U.S. Congress was concerned about the issue, as they noted in a congressional report accompanying the passage of the Bank Secrecy Act of 1970, which stated: "These days when the citizens of this country are crying out for tax reform and relief, it is grossly unfair to leave the secret foreign bank account open as a convenient avenue of tax evasion." H.R. Rep. No. 91-975, at 4 (1970), reprinted in 1970 U.S.C.C.A.N. 4394, 4397. See also Thomas Rixen & Peter Schwarz, *How Effective is the European Union's Savings Tax Directive?: Evidence from four EU Member States*, 50 J. COMMON MARKET STUD. 151 (2011) (arguing that agreement on the EU Savings Directive in 2003 was the product of 35 years of negotiations). Indeed, French concerns with tax evasion through Swiss banks pre-dates World War II. *Journal Officiel de la République Française, Débats parlementaires, Chambre des Députés, Séance du 10 novembre 1932*, p. 2997 et seq.

⁴⁶ Charles-Henry Courtois, *The Impact of the European Commission on the Council of Ministers' Decision in the Field of European Taxation: The Case of the European Savings Directive*, 2 INT'L PUB. POL'Y REV. 29 (2006); Alex Easson, *The Tax Competition Controversy*, TAX NOTES INT'L, Jan. 25, 1999, at 371 (describing how a 1989 EU Commission predecessor proposal to the Savings Directive was "quickly dropped").

⁴⁷ Germany saw a major outflow of domestic capital to Luxembourg and other European states after imposing a withholding tax on domestic interest income, and was forced to repeal that tax to staunch the losses. Cooperation to enforce direct taxation of capital income was viewed as being nearly impossible. See Courtois, *supra* note 46. See also Claudio M. Radaelli, *Harmful Tax Competition in the EU: Policy Narratives and Advocacy Coalitions*, 37 J. COMMON MARKET STUD. 661 (1999).

⁴⁸ See OECD, IMPROVING ACCESS TO BANK INFORMATION FOR TAX PURPOSES (2000), available at <http://www.oecd.org/dataoecd/3/7/2497487.pdf>; OECD, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998), available at <http://www.oecd.org/dataoecd/3/0/1904176.pdf>.

direction was limited;⁴⁹ any hopes of grander steps proved largely illusory. As recently as 2005, routine cross-border tax cooperation to systematically support residence country taxation of capital income remained nearly nonexistent and deeply controversial. The most important nascent example of such cooperation was the European Union's Savings Directive (EUSD). That directive required financial institutions in a specific subset of jurisdictions to report information on certain interest income (and only interest income) paid to EU residents who resided cross-border.⁵⁰ The EUSD generally came to be viewed as part of the EU's progression towards a confederal state. Scholars believed that it could be a forerunner of broader international cooperation, but that hope had yet to be realized.⁵¹

In the last few years, the global landscape has changed radically. Interest in automatic information exchange grew in parallel to the mounting universal acceptance of information exchange upon request as a global norm. Since 2007, three models have emerged: the OECD's authorized intermediary project, the EU's Directive on Administrative Cooperation in the Field of Taxation and proposed revision of the EUSD, and the United States' FATCA legislation. These models demonstrate how information on investment income earned through offshore accounts⁵² could flow automatically from financial institutions to residence country governments, thereby facilitating enforcement of residence country tax burdens on income earned through offshore accounts. The only academic commentator who compares these three systems describes the models as competing with one another.⁵³ A fourth model, the Swiss anonymous withholding model, presents an even sharper contrast. Instead of offering an information reporting solution, this approach emphasizes anonymity in combination with a withholding regime for collecting revenue from non-resident account holders.

However, focusing on the inconsistencies and conflicts between the emerging systems obscures their commonality, which is far more important than their differences. All four models share a key feature that the literature has yet to recognize: each requires domestic financial institutions to routinely provide cross-border administrative assistance to a sovereign outside the country in which the financial institution is located, and thereby serve as cross-border tax intermediaries. This alone is a critically important achievement.

⁴⁹ See, e.g., Remarks of Angel Gurría, OECD Secretary-General, OECD Debate at the Parliamentary Assembly of the Council of Europe (Oct. 6, 2010) ("we have achieved important breakthroughs in combating tax evasion. This includes the exchange of information for tax purposes, where we have made more progress in the past two years than in the previous ten").

⁵⁰ A European Union directive is a non-self-executing resolution of the European Council that European Union member states must implement, whether by national legislation or regulatory action. Treaty on European Union art. 249, Feb. 7, 1992, O.J. (C 191) [Maastricht Treaty].

⁵¹ See Michael J. Graetz and Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX L. REV. 537, 585 (2003).

⁵² Note that I use the term "offshore accounts" to refer to any account through which investments are intermediated on behalf of an individual who is not tax resident in the jurisdiction in which the institution that provides the financial intermediation services (or the relevant subsidiary or branch of such institution) resides.

⁵³ See Smiley, *supra* note 12.

Countries are agreeing to a higher level of international tax cooperation and demanding that multinational financial institutions play an additional role in tax collection. In some sense this is a reclamation of sovereign authority over cross-border asset management, and in another sense it is an acknowledgement that multinational financial institutions are a necessary part of the mechanics of tax collection in a globalized economy.

A. Background: Source Country Taxation and Financial Intermediation

This Section introduces nomenclature used throughout the article, and describes the United States' qualified intermediary system (QI). The Section begins with a simplified example of how modern financial intermediation of cross-border portfolio investment works. The example is intended to help readers understand the details of the various emerging information exchange approaches discussed in Part II. B. and thereafter. This Section then addresses QI, which began operating in 2001 and was primarily intended to ensure that non-U.S. persons making portfolio investments in the United States were being properly taxed by the United States on income from those investments. QI was therefore directed at taxation of U.S. source income received by foreigners ("source country taxation"), rather than the problem of taxing U.S. citizens and residents on investments made through foreign financial institutions (a part of "residence country taxation"). In this sense, QI is *not* a precursor to the emerging approaches to cross-border administrative assistance, each of which address *residence country* concerns with respect to cross-border tax evasion. Still, the QI system is relevant historically because: (1) it marked the first time financial institutions routinely acted as cross-border tax intermediaries; (2) it included seeds of the anonymous withholding approach currently being promoted by Switzerland as a means to address residence country tax concerns; and (3) the OECD's authorized intermediary project, discussed in Part II. B., started with a QI model, although it ultimately developed an approach that is more responsive to residence country tax-enforcement concerns.

Cross-border Portfolio Investment and Source Country Taxation

Host country tax on non-residents who make portfolio investments in securities⁵⁴ issued by an entity in that country (the "source country") is usually assessed by means of a tax that a domestic payor is required to withhold from gross payments made to foreign investors. These taxes are commonly known as "withholding taxes." Like most countries, the U.S. imposes a withholding tax on portfolio dividends (30% under U.S. law⁵⁵) and then reduces that tax rate under bilateral treaties, but only when a qualifying resident of the treaty country beneficially owns the dividend.⁵⁶ This legal structure presents administrative challenges. It means that different rates of withholding tax apply

⁵⁴ These portfolio investments include small investments in debt and equity securities by non-institutional investors.

⁵⁵ I.R.C. § 871 (2010).

⁵⁶ U.S. Model Income Tax Convention of Nov. 15, 2006, art. 10, *available at* <http://www.treasury.gov/press-center/press-releases/Documents/hp16801.pdf> [hereinafter United States Model Income Tax Convention].

to different foreign investors depending on where they reside and whether they are eligible for the benefits of a treaty.

This administrative challenge is exacerbated by the highly intermediated nature of modern cross-border portfolio investment. A simplified example both illustrates the problem and introduces key terminology for the remainder of the paper. A typical investment made by an Indian national in a U.S. company can involve the Indian national providing funds to Singapore Bank A, which in turn provides those funds to Singapore Bank B, which in turn provides the funds to U.S. Bank C, with U.S. Bank C then making the investment in the U.S. company by holding shares through a central securities depository, a type of clearinghouse for securities transactions (U.S. Clearinghouse). Income from those investments will generally flow from the U.S. company to its paying agent, then on to the U.S. Clearinghouse, then to U.S. Bank C, on to Singapore Bank B, and from Singapore Bank B to Singapore Bank A, which will credit the relevant funds to the Indian national's account. In this example, India is the country of residence of the investor ("residence country"), the United States is the country of source of the income ("source country"), and Singapore is the country from which the assets are being managed ("asset management country").⁵⁷

Absent some mechanism to provide more detailed information, only Singapore Bank A knows on which client's behalf the given investment was made. At every other stage in the process, the investment is generally made through so-called omnibus accounts that identify the financial institution from which the investment is received rather than the investor on whose behalf the investment is made. No private or public institution in either the residence country or the source country need know the identity of the client who is the beneficial owner of the investment.

In this example, determining the tax rate that the United States should impose on the income resulting from the investment is an aspect of source country taxation. The question is whether the ultimate investor, the Indian national, is eligible for a reduction in withholding pursuant to a treaty between the U.S. and India, and how that information is taken into account by the U.S. payor that is responsible for imposing the proper withholding tax on a dividend payment it makes to Singapore Bank B. It is important to note that the residence country taxation question—how India, the residence country, will effectively administer its tax on the earnings from this investment by an Indian national, which will be earned through an account at Singapore Bank A—is entirely separate from the question of how the source country administers its withholding tax.

⁵⁷ To generalize more broadly, income payments arising from securities typically will flow from the issuer to its paying agent and from the paying agent through multiple intermediaries to the end investors. See OECD, *Report of the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-border Investors on Possible Improvements to Procedures for Tax Relief for Cross-Border Investors*, OECD (Jan. 12, 2009), available at <http://www.oecd.org/dataoecd/34/19/41974569.pdf> (hereinafter "ICG Report").

The Qualified Intermediary System

In the 1990s, the United States began to grapple with taxing growing flows of cross-border portfolio investments, including small investments in U.S. debt and equity securities by large numbers of non-institutional investors.⁵⁸ QI represented a bargain between the United States and non-U.S. financial institutions, a bargain through which the United States addressed this challenge and ensured that the tax it imposes on non-resident portfolio investors is properly enforced.⁵⁹ Under QI, non-U.S. financial institutions agree to collect information from their customers investing in the United States as to whether those customers are U.S. persons or non-U.S. persons, and which of the non-U.S. persons are entitled to reduced rates of withholding tax.⁶⁰ Before QI, there was no practical regime in place by which the IRS or U.S. withholding agents could make these determinations.⁶¹ The United States provided non-U.S. financial institutions three inducements to cooperate with the new regime: (1) non-resident client anonymity from U.S. financial institutions (thus protecting their clients' identities from their competitors), (2) anonymity from the IRS (thus ensuring that the IRS would not provide information to the tax administration of the investor's country of residence), and (3) accurate and timely treaty benefits for non-U.S. persons.

The QI rules were of particular importance to private banks engaged in asset management, because a QI was able to conceal the identity of its non-U.S. customers from both competitor institutions and the IRS. As a result, a QI could ensure that other financial institutions in the chain of intermediation would not be able to steal its customers, and could assure its customers that the IRS would not provide information to their customer's home country tax authority. After imposition of the QI rules, these benefits generally existed for QI institutions, but not for non-QI institutions. If Singapore Bank A is a QI, it determines the rate of U.S. withholding that should apply to the Indian national, and informs Singapore Bank B as to the rate of withholding that should apply with respect to a "pool" of investments it is making on behalf of its customers through Singapore Bank B (including the Indian national's investment). It does not, however, provide Singapore Bank B with the identity of the Indian national. Singapore Bank B then forwards the "pooled" information on to U.S. Bank C, which uses that information to impose withholding tax. On the other hand, if Singapore Bank A did not agree to become a QI, new U.S. rules imposed at the same time as the QI system required the bank to collect information from its non-U.S. customers who sought reduced withholding, and send that

⁵⁸ See, e.g., William L. Burke, *Tax Information Reporting and Compliance in the Cross-Border Context*, 27 VA. TAX REV. 399, 403 (2007).

⁵⁹ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-99, QUALIFIED INTERMEDIARY PROGRAM PROVIDES SOME ASSURANCE THAT TAXES ON FOREIGN INVESTORS ARE WITHHELD AND REPORTED, BUT CAN BE IMPROVED (2008) [hereinafter GAO, QUALIFIED INTERMEDIARY PROGRAM].

⁶⁰ These reduced rates may be available under a tax treaty or a U.S. statutory rule. For a thorough discussion of the QI rules as originally promulgated, see Carol Doran Klein & Diane Renfro et al., *The Final Withholding Regulations: A Rube Goldberg Contraption—Will it Work?*, 27 TAX MGMT. INT'L J. 67 (1998).

⁶¹ See Stephen Shay, J. Clifton Fleming, Jr., and Robert Peroni, *What's Source Got to Do With It?: Source Rules and U.S. International Taxation*, 56 TAX. L. REV. 81, 122 (2002).

information up the chain of financial institutions and potentially all the way to the IRS. As one group of prominent practitioners wrote at the time, “[b]ecause of the relative secrecy benefits provided to non-U.S. citizens or residents, the failure of a private bank to qualify as a QI would put that bank in a competitive disadvantage in the marketplace.”⁶²

QI effectively created the first major operational precedent for the concept of a cross-border anonymous withholding regime.⁶³ Ten years after coming into operation, however, the UBS scandal demonstrated the extent to which QI could be abused to facilitate U.S. residence country tax evasion by U.S. persons⁶⁴—even as it provided the IRS some assurance that source country taxation of nonresidents was being collected.⁶⁵ The compromises made to launch the QI program and the consequent UBS scandal together laid the groundwork for the most recent U.S. legislation intended to address offshore tax evasion by U.S. persons.

B. Emerging Approaches to Automatic Residence-Based Tax Information Exchange

Cross-border information reporting models that are substantially focused on residence country taxation are emerging from the European Union, the OECD, and the United States. This Section describes these models and their histories, in order to highlight that the new regime for financial institutions to serve as cross-border tax intermediaries emerged only in the last few years. It also highlights three of the key features that distinguish these information reporting approaches from one another: (1) what information they require to be reported cross-border (reporting), (2) how they route

⁶² Thomas A. O’Donnell, Philip Marcovici & Marnin J. Michaels, *The New U.S. Withholding Tax Regime: To Be or Not to Be a “Qualified Intermediary,”* TAX PLANNING INT’L REV., June 2000, at [].

⁶³ There were a few opaque and ill-understood precursors that functioned to collect some amount of withholding for the United States. See, e.g., H. Schneider & A. Hubschmid, *Swiss Banks Say They Will Resist Elements of Proposed Regs (Section 1441—Nonresident Alien Withholding)*, 96 TAX NOTES TODAY 161-32 (1996) (discussing the “additional withholding U.S. regime” employed by Switzerland, under which, in certain circumstances, the Swiss Federal Tax Administration apparently collected the excess of the statutory 30% U.S. withholding rate over the treaty rate applied by the U.S. payor, and remitted such amounts to the IRS).

⁶⁴ The United States Justice Department showed that UBS used QI status to suggest to U.S. clients that it was a more secure institution through which U.S. citizens could evade U.S. tax. *United States v. UBS AG*, No. 09-60033-CR (S.D. Fla. Feb. 18, 2009) [hereinafter UBS Deferred Prosecution Agreement], available at http://www.justice.gov/tax/UBS_Signed_Deferred_Prosecution_Agreement.pdf. UBS then helped U.S. residents set up entity structures to avoid the reporting and withholding nominally required by QI with respect to U.S. persons’ investments back into the U.S., thereby allowing them to achieve the anonymity with respect to U.S. investments that was supposed to be provided only to non-resident investors. See *id.* at 2-4 (“Acceptance of Responsibility for Violation of Law”). Hearings and investigations in Congress highlighted the inadequacy of the QI system as a backstop for U.S. residence country taxation. *Tax Haven Banks and U.S. Tax Compliance: Hearing Before the S. Permanent Subcomm. on Investigations*, 110th Cong. (2008), available at http://hsgac.senate.gov/public/_files/071708PSIRreport.pdf. Sadly, the design features that produced these inadequacies were widely commented upon and accepted by U.S. government officials as part of the bargain made with foreign financial intermediaries to improve U.S. source country non-resident taxation. See, e.g., Stephen Shay et al., *What’s Source Got to Do With It?: Source Rules and U.S. International Taxation*, 56 TAX. L. REV. 81, 125–6 (2002).

⁶⁵ GAO, QUALIFIED INTERMEDIARY PROGRAM, *supra* note 59.

information from financial institutions to residence country governments (routing), and (3) what mechanisms they use to encourage financial institutions and governments to participate (incentives and mandates). Understanding the alternative ways that the emerging information reporting models address reporting, routing, and incentives is necessary in order to understand the comparison of information reporting to anonymous withholding in Part III.

Part IV, which provides some observations about the bases for a multilateral information reporting system, discusses how to reconcile the different reporting, routing, and incentives features in the emerging information exchange approaches. It also considers three further design features: (4) which financial institutions are included in the system (scope), (5) how the systems identify taxpayers and their country of residence (identification), and (6) how the systems ensure financial institutions comply with the system's rules (verification). Together, identification, reporting, verification, scope, routing, and incentives constitute the six key features of any cross-border information reporting regime.

The European Union

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 country that was a EU member.⁶⁶ After a few years of bitter debate between EU member states supporting bank secrecy and EU member states supporting information exchange, and a series of failed compromises, a proposal emerged. Under the proposal, EU member states could either provide information to other member states on interest income earned by residents of fellow member states of the EU through financial accounts in the reporting state's jurisdiction, or introduce a tax on interest income paid to accounts held by taxpayers resident in other EU states, and transfer the bulk of the proceeds of that tax to the taxpayers' residence countries.⁶⁷ Information exchange was treated as the preferred mechanism for reducing evasion of tax on interest income by EU residents, but EU jurisdictions were allowed to impose a withholding tax during a so-called "transitional period." However, the EU's bank secrecy jurisdictions (Austria, Belgium, and Luxembourg) took the firm position that they would only agree to the proposal if both small banking centers like Liechtenstein and the Channel Islands, and

⁶⁶ Having failed miserably with a 1989 suggestion to impose a single 15% withholding tax on interest income across the EU, in 1998 the Commission tried to focus exclusively on tax evasion associated with interest income. EEC, *1989 Commission Report*, at 11 (June 7, 1989) (1989 proposal for a Council Directive on a common system of withholding taxes levied upon interest at a 15% rate within the EEC). The Commission described its 1998 proposal narrowly, as a mechanism to address perceived economic distortions arising from non-taxation of cross-border interest payments made to individuals. *See also* Courtois, *supra* note 46, at 31 (interviewing Commission staff on the history of the European Union Savings Directive).

⁶⁷ *See infra* note 73 for details of the final arrangement.

major non-EU financial centers like Switzerland and the United States agreed to adopt equivalent measures.⁶⁸

Non-EU financial centers were not amenable to the EU bank secrecy jurisdictions' demand. Switzerland objected to any information exchange or withholding. Meanwhile, the Clinton administration objected to the "implicit assumption that a withholding tax would be an adequate substitute for the exchange of information."⁶⁹ With opposition to the directive from all sides, at the beginning of the millennium the intra-EU conversation about cross-border administrative assistance was stymied. Then, in 2002, Glenn Hubbard, the chairman of the White House Council of Economic Advisers in the Bush administration, announced definitively that the United States would not agree to EU requests for across-the-board sharing of information on U.S. savings accounts held by EU residents.⁷⁰ By that point, the continuing European Union Savings Directive (EUSD) debate was mostly about the parameters of an ever-closer European Union.⁷¹ Broader acceptance of financial institutions as cross-border tax intermediaries did not appear to be forthcoming.

In mid-2003, the European Union agreed to forge ahead internally on a version of the EUSD that would apply after 2005 and was intended to meet the relatively narrow goal of ensuring information reporting or withholding on interest payments earned by EU residents holding, in their own name as individuals, accounts earning interest at financial institutions within Europe.⁷² If an EU country exchanges information under the EUSD,

⁶⁸ In June 2000, Luxembourg Prime Minister and Finance Minister Jean-Claude Juncker epitomized the EU bank secrecy jurisdictions' unflinching opposition to cooperating in the absence of non-EU member cooperation by stating that "there would be blood on the table if certain other delegations do not change their point of view." George P. Gilligan, *Whither or Wither the European Savings Tax Directive? A Case Study in the Political Economy of Taxation*, 11 J. FIN. CRIME 56, 59 (2003).

⁶⁹ Albertina Fernandez & Thomas Field, *Canada Tax Foundation Holds First World Tax Conference*, 20 TAX NOTES INT'L 1056 (2000) (statement of Phillip West, then International Tax Counsel of the United States, at the World Tax Conference, "Taxes Without Borders," held in Tampa Bay, Florida, Feb. 26–Mar. 1, 2000). The public record suggests that significant discussions between the United States and the EU regarding cross-border administrative assistance may have occurred during this period. It is possible that some U.S. officials at the time may have been prepared to contemplate reciprocity if the EU moved to an information reporting system rather than an anonymous withholding system or a coexistence system. Whatever policymakers' intentions, no progress was made.

⁷⁰ Edward Alden & Francesco Guerrera, *US Opposes Sharing Information on Savings*, FIN. TIMES, Sept. 26, 2002. In August of 2002 the Bush Administration withdrew proposed regulations issued in the dying days of the Clinton Administration, Guidance on Reporting of Deposit Interest Paid to Nonresident Aliens, 66 Fed. Reg. 3925 (proposed Jan. 17, 2001), that would have required U.S. banks to collect and report to the IRS information generally of the type needed to join the Savings Directive. See 67 FR 50386 (August 2, 2002) (withdrawing and re-proposing the bank deposit interest regulations). Initially, those regulations were replaced with proposed regulations that would have required the collection of bank deposit interest information for nonresident alien individuals that were residents of certain designated countries, including some (but not all) members of the EU. The Bush administration did not finalize the revised proposed regulations and they never came into effect.

⁷¹ The other question was the relationship of EFTA countries like Liechtenstein and Switzerland to the EU.

⁷² The European Union Savings Directive (EUSD) was agreed among EU member states on June 3, 2003, and came into force on July 1, 2005. Council Directive 2003/48/EC, On Taxation of Savings Income in the Form of Interest Payments 2003 O.J. (L.157/38) [hereinafter EU Savings Directive]. EU member states

financial institutions in that country report information to the tax administration of the EU member state where the financial institution is resident, and then relevant information is routed from that tax administration to the tax administration of the member state where an account holder is resident.

The EUSD mandates only that member states *either* exchange information with one another *or* impose a withholding tax to be deducted from interest income, for so long as an indefinite “transitional period” continues.⁷³ Most countries within the EU adopted the information exchange regime. The three EU member bank secrecy states adopted the withholding tax system, as did many of the ten dependent territories of the UK and the Netherlands, including the Channel Islands.⁷⁴ Switzerland agreed to cooperate with the directive due to a combination of substantial coercive pressure and important financial incentives (notably, Swiss companies were granted the benefits of the EU Parent-Subsidiary Directive, thereby exempting from cross-border withholding taxes dividends paid by an EU subsidiary of a Swiss company to its Swiss parent). Four smaller non-EU European offshore banking centers followed Switzerland’s lead (Andorra, Liechtenstein, Monaco, San Marino).⁷⁵ Their bilateral agreements with the EU adopted the withholding system of the EUSD, but explicitly permitted Switzerland, Liechtenstein, and the rest to maintain a withholding tax indefinitely in place of information exchange.⁷⁶ The indefinite transitional period for EU member bank secrecy jurisdictions, and the EU’s agreement to permanent anonymous withholding by Switzerland and other European offshore banking centers, created an uneasy truce between information reporting and

agreed that for the Directive to apply and be meaningful as an enforcement measure for offshore accounts it was necessary that at least six non-EU countries (Switzerland, Liechtenstein, Andorra, Monaco, San Marino, and the United States) also comply with the EUSD. Nevertheless, they made the Directive effective beginning in 2005, provided that Switzerland, Liechtenstein, Andorra, Monaco, and San Marino, but not the United States, met certain conditions. *Id.* at art. 17(2)(i).

⁷³ Jurisdictions opting for the so-called transitional withholding tax system share the revenue with the country of residence (handing over 75% of receipts and keeping 25% of receipts). *Id.* at 12(1). The withholding tax option initially was assessed at a rate of 15%, with a schedule that increased the rate up to 35% after June 30, 2011. *Id.* at art. 11(1). Whenever the “transitional period” is deemed to end, all EU member states must move to the information reporting system. *Id.* at art. 17(2)(ii). Technically, under the terms of the EUSD, the transition period ends whenever (1) there is an agreement between the European Community and the last of Switzerland, Liechtenstein, San Marino, Monaco, and Andorra to exchange information upon request on interest consistent with international standards (as they were then embodied in the so-called “OECD Model Agreement on Exchange of Information in Tax Matters), (2) the United States commits to exchange of information upon request at the same standards, and (3) the European Council unanimously agrees that conditions (1) and (2) have been met. *Id.* at art. 10(2). Practically speaking (although perhaps not technically) conditions 1 and 2 have already been met. The real barrier is the European Council’s inability to unanimously agree that the transition period is over.

⁷⁴ *Id.* at art. 10(1). In contrast to the arrangements with five non-EU sovereigns, discussed *infra* at note 84 and accompanying text, the dependent or associated territories of the UK and the Netherlands (including the Channel Islands and various Caribbean islands) that did not agree to exchange information automatically are required to participate in the EUSD as withholding jurisdictions and to move to automatic information exchange at such time as the transitional period ends.

⁷⁵ Similar bilateral agreements were reached between the EU and Monaco, Andorra, and San Marino.

⁷⁶ *See, e.g.*, Agreement on Taxation of Savings Income in the Form of Interest Payments, EU-Switz., Oct. 26, 2004, 2004 O.J. (L 385) 30. [EU Savings Directive, *supra* note __, at art. 17(2)(ii).]

anonymous withholding models for tax administrative assistance regarding interest income within Europe.

At one point in the current evolutionary period in cross-border administrative assistance, this truce appeared to be ending. In February 2011, the European Union adopted a roadmap to automatic information exchange among EU member states for categories of income other than interest.⁷⁷ Unlike the EUSD, the Directive on Administrative Cooperation in the Field of Taxation does not mandate a given EU member state to participate in broader automatic information exchange within the EU, let alone provide incentives to encourage any country outside the EU to participate. However, it does provide that the European Commission must submit proposals to the European Council before July 1, 2017 regarding the categories of capital and income that member states should be mandated to report to one another, with one aim being to extend that list to include capital gains, dividends, and royalties.⁷⁸ If the European Council were to decide to require mandatory information reporting on these categories of income, in addition to interest reported through the Savings Directive, EU information reporting would generally overlap with the income reporting, but not the asset reporting, required under new U.S. legislation known as “FATCA”.

The OECD

In 2006, the Committee on Fiscal Affairs of the OECD (“CFA”), which brings together the senior international tax official of each OECD member state government, agreed to work with many of the major global cross-border financial institutions on a project to improve the process by which portfolio investors may claim reduced source country withholding tax rates under tax treaties.⁷⁹ Like the QI system, this project began as an effort largely focused on source country taxation, rather than residence country taxation.

⁷⁷ Council Directive 2011/16/EU, Administrative Cooperation in the Field of Taxation and Repealing Directive 77/799/EEC, 2011 O.J. (L 64) 1 [hereinafter the February Directive]. The February Directive generally requires that, beginning January 1, 2014, the competent authority of each member state automatically report to other member states whatever information the communicating member state has available regarding certain categories of both labor and non-labor income paid from the reporting member state and received by taxpayers resident in the other member state. The February Directive initially covers income from employment, director’s fees, pension income, life insurance products not covered by other EU legal instruments on exchange of information and other such measures, as well as income from immovable property. *Id.* at art. 8(1). Under the February Directive member states that do not wish to receive information can opt out (for now) of both reporting and receiving information. *Id.* at art. 8(3). The February Directive also provides that limitations on the application of European Union Directive 95/46/EC (“European Union Data Protection Directive,” related to European data protection laws) are necessary and proportionate in the case of tax information exchange and cooperation in view of the potential loss of revenue for member states and the crucial importance of the February Directive in the effectiveness of the fight against fraud. *Id.* at art. 27. Thus, an EU data subject’s right to information about the use of their personal data, access to that data, and judicial remedy for breach of their rights under the European Union Data Protection Directive is restricted for purposes of obtaining information exchange among the member states. *Id.* at art. 25. The potential conflict between EU data protection law and the crucial needs of non-EU tax authorities in a globalized economy is beyond the scope of this article.

⁷⁸ *Id.* at art. 8(5)(a).

⁷⁹ The CFA is the world’s leading multilateral body in international tax policy.

Conceptually, the objective was to recommend for countries to develop systems akin to the QI system.

The 2008 tax evasion scandals and the consequent shift in the focus of OECD tax administrations from source country taxation to residence country taxation of offshore assets rocked the foundations of the OECD's project. The initial project ended as scheduled in 2009, with limited opportunities to adjust to the new residence country enforcement focus of tax administrations. Nevertheless, the resulting report of the Informal Consultative Group (the "ICG Report") addressed one of QI's major perceived shortcomings: that it bottles up customer-specific information about the beneficial owner of any given payment at the level of the financial institution closest to the customer, so that source countries never receive that information and therefore can never provide it to residence countries.

The ICG Report recommended that OECD countries develop systems similar to QI.⁸⁰ Taking the example provided in Part II. A. as a starting point, under the system proposed in the report Singapore Bank A would inform Singapore Bank B as to what tax rate should apply to the earnings on the Indian national's investment in the United States (without revealing that person's identity). However, unlike the QI system, Singapore Bank B would also route information directly to the IRS regarding the Indian national's identity and return on investment (so long as the investment was of a type that benefitted from a reduced rate of withholding under the system). The IRS could then, in principle, route this information on to India. The additional reporting therefore represents a pro-residence country compliance modification of the QI system, and abandons the anonymous withholding component of QI.⁸¹ Financial institutions from Asia, Europe, and North America strongly endorsed the ICG Report, making clear their willingness and ability to serve as tax intermediaries cross-border.

The OECD System was developed based on the principle of consensus between governments and financial institutions. The resulting approach relied exclusively on incentives for financial institution participation rather than penalties. The OECD System could ask only so much of financial institutions in exchange for these incentives.⁸² The focus on reporting in exchange for benefits for investors limited the potential reporting benefit to residence countries to information on those kinds of payments, like dividends, that benefit from a reduced rate of tax withholding. Many kinds of cross-border investment income, such as capital gains and certain interest income, generally are not subject to source country taxation and therefore withholding. This means they are not

⁸⁰ ICG Report, *supra* note 57, at 2-3. Like QI, these systems would allow authorized financial institutions to contract with governments to make tax treaty withholding relief claims on behalf of their customers on a "pooled" basis.

⁸¹ *See id.*

⁸² Thus, for example, the OECD System's scope is generally limited to the largest financial institutions, those that function as global custodians or otherwise intermediate cross-border investments for very large groups of investors and volunteer to participate.

implicated by, or reported in, a QI-like system. Recognizing the various weaknesses⁸³ with the OECD System as a means to address residence country concerns, the senior international tax officials of the OECD governments decided to further develop the OECD System through an initiative known as the Treaty Relief and Compliance Enhancement (“TRACE”) project. With a mandate to take into account residence country tax compliance concerns, and now working on a governments-only basis, the TRACE group could consider coercive mechanisms to encourage financial institutions to do more for residence governments.⁸⁴

FATCA

In 2010—following on the UBS scandal, and President Obama’s campaign commitment to crack down on offshore tax evasion⁸⁵—the United States Congress enacted sections 1471 to 1474 (generally known as “FATCA”⁸⁶) of the Internal Revenue Code. Under FATCA, foreign financial institutions are generally required to report information on financial accounts of U.S. persons and foreign entities with significant U.S. ownership (“U.S. accounts”) directly to the IRS beginning in 2014.⁸⁷ Foreign financial institutions must report the account balance or value of each U.S. account,⁸⁸ and the amount of dividends, interest, other income, and gross proceeds from the sale of property credited to a U.S. account.⁸⁹ The rules are intended to provide reporting both on accounts held

⁸³ In addition to the weaknesses described above, no financial institution is likely to voluntarily contract to act as a reporting institution with respect to every source country. Incentives to do so fall precipitously the less important that country is as an investment destination for a financial institution’s customers or the less reduced withholding tax rates matter to its customers with respect to investments into a given jurisdiction. For a QI-like approach to address residence country enforcement concerns, every significant offshore asset management institution would have to voluntarily sign up with every significant source country to be an authorized financial institution for that country. Furthermore, all major source countries would have to agree to provide automatic information exchange to each residence country interested in improving residence country tax compliance. The ICG Report assumed the existence of such arrangements, leaving open the question of how the world would reach that point without some measure of coercion.

⁸⁴ See OECD, *Treaty Relief and Compliance Enhancement (TRACE)*, available at http://www.oecd.org/document/9/0,3746,en_2649_33767_45700745_1_1_1_1,00.html.

⁸⁵ April 2009 London Communiqué, *supra* note 7, at 5.

⁸⁶ Sections 1471 to 1474 of the Internal Revenue Code (“Code”) were enacted in the “Foreign Account Tax Compliance” title (Title V) of the Hiring Incentives to Restore Employment Act of 2010 (HIRE Act). Hiring Incentives to Restore Employment Act of 2010 (HIRE Act), Pub. L. No. 111-147, § 501-35, 124 Stat. 71, 97-115 (2010). An earlier version of the Foreign Account Tax Compliance title of the HIRE Act was introduced in Congress as the Foreign Account Tax Compliance Act. The acronym “FATCA” stuck with these provisions. Title V of the HIRE Act also included various other cross-border compliance provisions.

⁸⁷ The statutory effective date is January 1, 2013, but regulatory guidance has effectively delayed implementation of FATCA by one year. Notice 2011-53. U.S. accounts are technically defined as financial accounts that are held by specified U.S. persons or U.S.-owned foreign entities. § 1471(d)(1)(A). Financial accounts are broadly defined by the statute in a manner that is intended to pull in interests in hedge funds, private equity funds, and other investment arrangements.

⁸⁸ I.R.C. § 1471(c)(1)(C) (2010).

⁸⁹ Notice 2011-34. See Section IV.B. of the Notice, which exercises Treasury authority to redefine the meaning of Section 1471(c)(1)(D)), and makes reporting consistent with EUSD income measurement

directly by individuals and on interests in accounts held by shell entities for the benefit of U.S. individuals.

Congress explained that in enacting FATCA, the legislative intent of the provisions was to “force foreign financial institutions to disclose their U.S. account holders or pay a steep penalty for nondisclosure.”⁹⁰ Accordingly, FATCA imposes a withholding tax on the gross amount of certain payments from U.S. sources and the proceeds from disposing of certain U.S. investments (“withholdable payments”) on foreign financial institutions that do not comply and become a “participating FFI.”⁹¹ This withholding tax also applies to certain other payments to the extent the funding for those payments may be attributed to withholdable payments (“passthru payments”).⁹² Importantly, this withholding tax is not limited to payments to U.S. persons. In other words, if foreign financial institutions will not agree to report to the United States on income earned by U.S. individuals through accounts at those institutions, FATCA requires withholding on a wide range of payments from the United States to those same financial institutions, regardless of whether the payments are beneficially owned by U.S. persons on which the IRS wants reporting, non-U.S. customers of the institution, or the institution itself. Section 1471 also requires participating foreign financial institutions to withhold on payments to nonparticipating foreign financial institutions. It thus is intended to (1) induce foreign financial institutions that are investing in or through participating financial institutions, but that are not investing in the United States, to also agree to participate in FATCA,⁹³ and (2) disincline participating foreign financial institutions from doing business with non-participating financial institutions, because business between participating and non-participating financial institutions is likely to require withholding under U.S. law. Through the passthru payment mechanism, FATCA tries to use the combined weight of U.S. financial markets and financial institutions that must, as a practical matter, do business in the U.S. marketplace as leverage with other foreign financial institutions to

concepts. In contrast to the EUSD, the rules are intended to provide reporting on both accounts held directly by individuals and interests in accounts held by shell entities for the benefit of U.S. individuals.

⁹⁰ HIRE ACT, 156 Cong. Rec. S1745-01, S1745, 2010 WL 984520.

⁹¹ More technically, withholdable payments are (generally) any payment of fixed or determinable annual or periodical income, if such payments are from sources within the United States, and gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States. I.R.C. § 1473(1)(A) (2010).

⁹² In addition to requiring withholding by U.S. financial institutions on withholdable payments to non-participating FFIs, as part of the FFI Agreement, section 1471 requires participating FFIs to deduct and withhold a tax equal to 30% of any passthru payment which is made by the participating FFI to a recalcitrant account holder or a non-participating FFI. § 1471(b)(1)(D)(i). The statute defines recalcitrant account holders to be those account holders that fail to comply with reasonable requests for information by a participating FFI in order for it to meet its reporting obligations under an FFI Agreement, or that fail to provide a waiver in any case in which any foreign law would (but for such waiver) prevent the reporting of any information an FFI is required to report under its FFI Agreement. § 1471(d)(6).

⁹³ When an FFI is not acting as a custodian or nominee and is not a tax transparent entity receiving payments on behalf of its members, payments that FFI makes to account holders (including investors in its equity or debt instruments) would be treated under generally applicable U.S. tax principles as non-U.S. source income of those account holders, and therefore would not be “withholdable payments.” Thus, in the absence of a “passthru payment” concept, the many FFIs that do not do business directly in U.S. securities, and their account holders, would generally fall outside the scope of FATCA.

ensure near-comprehensive participation in FATCA's cross-border information reporting.⁹⁴ It is unclear, however, whether the United States can achieve near-comprehensive financial institution participation through unilateral measures alone.

A related difficulty is that as legislated FATCA's reporting is also unilateral; it benefits the United States alone while putting significant burdens on foreign financial institutions. Furthermore, FATCA routes information reporting directly to the U.S. government, and can require closure of certain account holders' accounts and/or withholding on payments made by a foreign financial institution to account holders and other foreign financial institutions. As a result, compliance with FATCA may require foreign financial institutions in many jurisdictions to violate contractual relationships as well as data protection, bank secrecy, or other laws of the jurisdiction in which they are located.⁹⁵ In her first major public address on these issues on December 16, 2011, Acting Assistant Secretary Emily McMahon acknowledged the difficulties associated with FATCA's unilateral approach. She stated that the United States could not ask foreign financial institutions to routinely report to the United States if the United States did not routinely collect certain information on nonresidents from domestic financial institutions that it could provide to cooperating foreign sovereigns.⁹⁶ She went on to suggest that the United States was committed to entering into bilateral and multilateral agreements that would allow financial institutions to comply with FATCA without violating local law, by having those institutions report information on U.S. persons to the country in which the institution resides, and then have the information transferred to the United States by the foreign sovereign.⁹⁷ That routing mechanism, in contrast to FATCA's statutory direct reporting to the IRS, would bring the United States into line with the routing mechanism of the EUSD. Finally, McMahon described FATCA as a vehicle to achieve a transition to a multilateral system.⁹⁸ Thus, the U.S. Treasury's rhetoric with respect to FATCA has recently become multilateral, even though the statute itself adopts a unilateral approach.

⁹⁴ The coercive force of FATCA's withholding mechanism is also important as a vehicle to bring in non-traditional financial institutions such as private equity funds, hedge funds, and insurance companies.

⁹⁵ See, e.g., HSBC Bank USA, *Comments in response to Notice 2011-34*, Letter to Manal Corwin, Deputy Assistant Secretary Tax Policy (Int'l), U.S. Dep't of the Treasury, Michael Danilack, and Steve Musher, IRS (June 7, 2011), available at http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_HSBC_060711_WithCopyright_062311.pdf (last visited Jan. 9, 2012).

⁹⁶ Emily McMahon, Acting Assistant Secretary, U.S. Treasury, Keynote Address at the George Washington University Law School & I.R.S. Conference: Current Issues in International Taxation (Dec. 16, 2011) (author's notes from speech; the conference is widely viewed as one of the premier annual gatherings of U.S. international tax practitioners and government tax officials, with over 700 international tax lawyers in attendance). The Obama Administration in 2011 proposed regulations that would require U.S. financial institutions to collect and report to the IRS bank deposit interest information for all nonresident alien individuals, whatever their country of residence.

⁹⁷ Allison Bennett, *U.S. Open to Intergovernmental Approach To FATCA Information Sharing*, *Official Says*, 243 DAILY TAX REPORT, at G-11 (Dec. 19, 2011).

⁹⁸ See McMahon, *supra* note 96. See also John Herzfeld, *FATCA rules in final review stages; McMahon notes billions in offshore yields*, 15 DAILY TAX REPORT, at G-4 (Jan. 25, 2012) (reporting McMahon making same point and observing that FATCA "cannot be the end of the story").

Similarities and Differences Between the Three Information Exchange Approaches

The OECD, EU, and U.S. approaches to cross-border tax information exchange each take a somewhat different tack. These three approaches are challenging to reconcile, because the three emerging approaches inconsistently address identification, reporting, scope, verification, routing, and incentive issues.⁹⁹ Part IV of this article returns to these inconsistencies and makes some observations regarding how they could be reconciled. The more fundamental point is that, despite the differences, the commonality among them is far more important. Each requires financial institutions to operate as cross-border tax intermediaries for residence country governments.

All three approaches include a critical component: the automatic provision of tax information originally held by financial institutions to the governments of countries of residence of the individual investors. The differences that exist among the approaches can be overcome. For instance, the U.S. Treasury has suggested that the United States is prepared to enter into international agreements that would adopt the EU system for routing information from financial institutions to residence country governments.¹⁰⁰ Similarly, in administrative guidance the U.S. Treasury replaced FATCA's statutory rule for what information should be reported by financial institutions with a rule requiring reporting of dividends, interest, and other income, determined under the same principles that a financial institution uses to report information in its jurisdiction of residence. The U.S. Treasury's exercise of its authority in this regard conforms the basis for determining amount and character of income for FATCA reporting purposes to the European Union's Directive on Administrative Cooperation in the Field of Taxation.¹⁰¹ The key point, which is obscured by excessive concern with differences between the models, is that the shared commitment to information exchange sets TRACE, the EUSD, and FATCA apart from an alternative approach being aggressively promoted by the Swiss government.

C. Anonymous Withholding: The Swiss Approach

Switzerland's substitute for the tax information reporting models provided by the OECD, the European Union, and the United States has gained significant traction. The approach was developed largely by Swiss financial institutions and was subsequently adopted by the Swiss government.¹⁰² It provides for anonymous withholding and regularization of

⁹⁹ A full description of the details of the proposals and their similarities and differences would require an additional paper. In this paper, I mention only a few of the most salient points.

¹⁰⁰ George Washington University Law School / Internal Revenue Service Conference on Current Issues in International Taxation, Keynote Address (December 16, 2011) (author's notes from speech). *See also* John Herzfeld, *supra* note 94 (reporting on Acting Assistant Secretary McMahon's remarks to a New York tax audience).

¹⁰¹ *See supra* note 89 and accompanying text.

¹⁰² *See infra* note 126 and accompanying text. In February 2011 the CEO of the Swiss Bankers Association reported with satisfaction that the Swiss government had adopted the SBA's strategy and was efficiently implementing that strategy. CLAUDE-ALAIN MARGELISCH, SWISS BANKERS ASS'N, FOREWORD, WEALTH MANAGEMENT IN SWITZERLAND: STATUS REPORT AND TRENDS (Feb. 2011), available at http://www.swissbanking.org/en/20110107-bro-vermoegensverwaltungsgeschaef_t_de-rva.pdf.

untaxed assets for residents of key Swiss trading partners, is intended to substitute for automatic tax information exchange cross-border with respect to non-Swiss residents holding Swiss accounts, and is justified as a means to protect the financial privacy of account holders.¹⁰³ Its fundamental objective is to ensure that automatic tax information exchange does not take hold as a global system.

Both Germany and the United Kingdom recently signed treaties with Switzerland based on this Swiss approach. Further, Greece is reported to be negotiating such an agreement with Switzerland.¹⁰⁴ At one point the Italian Senate supported such an agreement, and the French parliament asked the French finance ministry to study such an agreement.¹⁰⁵ Such agreements are important because Switzerland is the world's most important offshore asset management center (managing approximately 27% of the world's offshore wealth)¹⁰⁶, as well as the headquarters for certain systemically important global financial institutions. Switzerland also has the power to lead other offshore asset management jurisdictions by its example, and has done so in the past. The German and UK agreements therefore have dealt a significant blow to the emergence of automatic cross-border information reporting, and will deliver a further blow if they are ratified.¹⁰⁷

¹⁰³ Client privacy issues are not the focus of this paper. However, those who claim that financial institutions should not report information cross-border to the government of a country in which a client resides for financial privacy reasons must argue either (1) that bank secrecy vis-à-vis tax administrations is part and parcel of a basic right to privacy, and that the information reporting / information availability model for tax enforcement in almost every major developed economy is thus unjust, (2) that individuals who have the wherewithal and sophistication to bank internationally should have access to elective bank secrecy, or (3) that bank secrecy needs to be preserved vis-à-vis authoritarian and corrupt regimes. The first of these arguments rejects long-standing legal and policy notions in every major developed economy that tax administration access to resident taxpayer financial information is consistent with a taxpayer's reasonable expectations of privacy. The second argument is entirely untenable; there is no credible basis for arguing that having sufficient wealth or sophistication to access offshore banking should give an individual the right to bank secrecy. The third argument conflates the idea that the benefits of a multilateral information exchange system should not be extended to all governments with the proposition that any individual, regardless of whether they reside in a just or unjust, democratic or undemocratic, or morally legitimate or illegitimate state, should have the option to individually elect to securely evade their taxes.

¹⁰⁴ *Greece seeks withholding tax agreement with Swiss*, STEP J., Oct. 31, 2011, http://www.stepjournal.org/news/news/secondary_news/greece_seeks_withholding_tax_a.aspx (last visited Dec. 20, 2011).

¹⁰⁵ Giuseppe Fonte, *Italy senate urges Swiss-Italy tax deal*, REUTERS, Sept. 16, 2011, <http://www.reuters.com/article/2011/09/16/italy-tax-idUSL5E7KG2VH20110916> (last visited Dec. 20, 2011). As of late November 2011 French Budget Minister, Valérie Pécresse opposed a similar agreement with Switzerland. Noemie Bisserbe, *UPDATE: French Budget Min: No Agreement with Switzerland on Tax Evasion*, DOW JONES NEWSWIRE, Nov. 24, 2011, <http://online.wsj.com/article/BT-CO-20111124-705354.html> (last visited Dec. 20, 2011).

¹⁰⁶ BCG, GLOBAL WEALTH, *supra* note 21, at 13.

¹⁰⁷ *But see* Matthew Allen, *Rubik tax treaties face serious hurdle*, SWISSINFO.CH (Nov. 25, 2011), available at http://www.swissinfo.ch/eng/Specials/Rebuilding_the_financial_sector/Spotlight_on_banking_secretary/Rubik_tax_treaties_face_serious_hurdle.html?cid=31638262 (noting that France has “closed the door” on an anonymous withholding agreement and describing EU Commission legal objection to anonymous withholding); *Steuerabkommen mit der Schweiz?—Italien winkt (noch) ab*, SCHWEIZER FERNSEHEN (Dec. 8, 2011), available at

The Swiss-German and Swiss-UK agreements provide that investment income and capital gains of German and UK residents with Swiss deposits or accounts will be taxed by Switzerland at agreed rates that vary by country and category of income, with the proceeds remitted anonymously to Germany and the UK.¹⁰⁸ The agreements both specify that once the withholding tax is imposed by Swiss financial institutions, the investor's tax obligation to Germany / the UK will be fulfilled.¹⁰⁹ German and UK residents with Swiss bank accounts will not be required to declare those accounts to the German or UK government, respectively.¹¹⁰ The relevant persons do not have any tax liability or information reporting obligation to Germany or the United Kingdom on income or capital gains with respect to which the anonymous withholding tax is imposed.¹¹¹

German and UK residents that held Swiss accounts in the past and choose to keep those accounts after May of the year the agreement enters into force will generally be charged a one-time lump-sum by the Swiss institutions that hold their accounts, and be subject to withholding on future dividends, interest, and capital gains.¹¹² The anonymous tax on existing assets of account holders resident in Germany or the UK varies from between 19%

<http://www.tagesschau.sf.tv/Nachrichten/Archiv/2011/12/08/Schweiz/Steuerabkommen-mit-der-Schweiz-Italien-winkt-noch-ab> (Prime Minister Monti's government does not intend to enter into a tax agreement with Switzerland on the model of Bern's agreements with Germany and the UK).

¹⁰⁸ The Swiss-German agreement specifies that the Swiss will impose the same tax rate applicable to investment income and capital gains earned by German residents through any institution that does not impose anonymous withholding, while the UK agreement provides for rates slightly below the regular UK rates on the relevant categories of income. Thus, the Swiss-UK agreement provides that future investment income and capital gains of UK residents with Swiss deposits or accounts will be taxed by Switzerland at a rate of 40% on dividend income, 48% on interest income and other investment income, and 27% on capital gains. Agreement on Cooperation in the Area of Taxation, U.K.-Switz., art. 19(1), Aug. 24, 2011 [hereinafter U.K.-Switz. Cooperation Agreement]; The German-Swiss agreement specifies a tax rate of 26.375% for investment income and capital gains, as from January 2013, in line with the 25% German tax rate, plus the 'solidarity surcharge.' Press Release, Swiss Federal Department of Finance, Switzerland and Germany Initial Tax Agreement (Aug. 10, 2011), available at <http://www.efd.admin.ch/dokumentation/medieninformationen/00467/index.html?lang=en&msg-id=40533>.

¹⁰⁹ U.K.-Switz. Cooperation Agreement, *supra* note 108, at art. 9(7), -9(12), -9(13), -19(5) ; Ger.-Switz. Cooperation Agreement, *infra* note 110, at art.7(6), -18(4).

¹¹⁰ U.K.-Switz. Cooperation Agreement, *supra* note 108, at art. 22(1). See also Agreement on Cooperation in the Area of Taxation, Ger.-Switz., art. 21(1), Sept. 21, 2011, (Ger.) [hereinafter Ger.-Switz. Cooperation Agreement], available at

http://www.bundesfinanzministerium.de/nn_74882/DE/BMF__Startseite/Aktuelles/BMF__Schreiben/Internationales__Steuerrecht/Staatenbezogene__Informationen/Schweiz/016__a,templateId=raw,property=publicationFile.pdf. Certain tax credits are intended to ensure that a German or UK resident is never disadvantaged by choosing to take advantage of Swiss anonymity. *Id.* at art. 21(1). For example, tax that might be assessed under the EU Savings Directive is credited against the withholding tax imposed on any UK or German resident with a Swiss account. *Id.* at art. 20(1). Similarly, any tax that is levied at source by the UK or Germany on investments into the UK or Germany by the anonymous UK or German resident on account of their being a foreign anonymous person presumptively ineligible for tax treaty benefits is credited against the withholding tax, as is tax levied on interest and dividends by third-country source countries. *Id.* at art. 21(2)-(4). See also *id.* at art. 20(1)-(4).

¹¹¹ U.K.-Switz. Cooperation Agreement, *supra* note 108, at art. 19(5).

¹¹² *Id.* at art. 9; art. 43. See also *id.* at art. 7.

to 34% of the assets in question.¹¹³ This one-time charge is intended as a rough proxy to compensate for past tax evasion.¹¹⁴

However, under the agreements, if UK and German investors move their Swiss accounts out of Switzerland prior to May 31 of the year the agreement enters into force, potentially opening replacement accounts in other offshore financial centers (including non-Swiss branches of Swiss banks) they avoid the lump-sum payment, future withholding, and disclosure of their accounts. Thus, under the agreements, German and UK residents can evade both taxation and disclosure if they wish.¹¹⁵ Swiss banks have agreed to guarantee Germany at least 2 billion euros in revenue and to guarantee the United Kingdom at least CHF 500 million, regardless of how much withholding is actually assessed under the one-off assessments imposed by the agreements.¹¹⁶

Switzerland will report to the United Kingdom and Germany the ten jurisdictions to which UK and German residents who close their accounts transfer the largest volume of assets. Switzerland will also tell the UK and Germany how many of their residents moved funds out of Switzerland to those various ten jurisdictions, but will not identify those people. These arrangements simultaneously maintain client anonymity and encourage the United Kingdom and Germany to pressure the jurisdictions where UK and German residents move their money to provide anonymous withholding, thereby helping to further spread the Swiss approach.

The Swiss agreements with both Germany and the United Kingdom assert that this bilateral system achieves “a level of cooperation which has, with regard to taxation in respect of income and gains on relevant assets an enduring effect equivalent to the outcome that would be achieved through an agreement to exchange information about such individuals on an automatic basis.”¹¹⁷ This declaration achieves a central aim and key political goal of Swiss policy: gaining acceptance of the idea that anonymous

¹¹³ The one-time tax rate on assets varies based on a formula that takes into account the duration of the client’s relationship with the withholding financial institution as well as the initial and final amount of the capital in the account over the period assessed under the agreements. Press Release, Swiss Federal Department of Finance, Switzerland and Germany Initial Tax Agreement, *supra* note 108. See also Press Release, HM Treasury, Agreement with Switzerland to Secure Billions in Unpaid Tax, available at http://www.hm-treasury.gov.uk/press_98_11.htm. U.K.-Switz. Cooperation Agreement, *supra* note 108, at art. 9; Ger.-Switz. Cooperation Agreement, *supra* note 110, at art. 7.

¹¹⁴ Account holders may elect to have their accounts and yearly statements of assets from 2002 onwards disclosed to their country of residence, rather than having the asset tax imposed. U.K.-Switz. Cooperation Agreement, *supra* note 108, at art. 10; Ger.-Switz. Cooperation Agreement, *supra* note 110, at art. 9. If an account holder complied with her residence country tax obligations while holding a Swiss account and therefore has nothing to hide, agreeing to information reporting allows her to avoid the tax on existing assets.

¹¹⁵ For instance, UK taxpayers in Switzerland will be subject to a one-off deduction in 2013 only so long as the account was open on December 31, 2010 and is open on May 31, 2012. U.K.-Switz. Cooperation Agreement, *supra* note 108, at arts. 7(1), 9(1) & 10(1).

¹¹⁶ *Id.* at art. 17(2). See also *id.* at art. 15(2).

¹¹⁷ *Id.* at 1; Ger.-Switz. Cooperation Agreement, *supra* note 110, at 1.

withholding is equivalent to automatic information exchange.¹¹⁸ For this reason, the Swiss press almost universally described the German and UK agreements as a major coup in Switzerland's rearguard effort to defend bank secrecy.¹¹⁹

D. A New International Regime?

It is easy to see the OECD, EU, U.S., and Swiss approaches to cross-border tax administrative assistance as four competing systems. Yet doing so obscures a more fundamental point. At the start of the 21st century, neither governments nor financial institutions believed the institutions had a systematic role in quelling offshore tax evasion. Today, all the emerging systems for cross-border tax cooperation assume financial institutions will function as cross-border tax agents, whether as a withholding agent or as an information reporting agent. Despite the differences among these proposed systems, the fact remains that the United States, the European Union, the OECD, and Switzerland have all coalesced around this conclusion. That consensus represents a remarkable shift in global understandings. It has allowed the discourse of international tax cooperation to shift from a dispute about *whether* financial intermediaries should function as tax intermediaries cross-border to a dispute about *how* financial intermediaries should perform that role.

Financial institutions themselves appear to have accepted this new international regime. Whereas only a few years ago these same institutions eschewed any meaningful role in global efforts to police cross-border tax evasion, they now seek to shape the role they will play. For example, in response to FATCA, the U.S. Treasury has received hundreds of detailed submissions with comments from a variety of non-U.S. financial intermediaries, including traditional banks as well as pension funds, insurance companies, hedge funds, bond traders, and trust vehicles, as well as industry associations and national chambers of commerce. The record of submissions provides a unique window into the present views of financial actors around the world on the role of financial institutions in cross-border tax administration. The submissions consistently accept, either explicitly or implicitly, that the time has come for financial intermediaries to be tax intermediaries cross-border.¹²⁰ Financial institutions are embracing a multilateral approach, if only to best

¹¹⁸ See, e.g., Press Release, Swiss Federal Department of Finance, Switzerland and the UK Initial Tax Agreement, available at <http://www.sif.admin.ch/00488/index.html?lang=en&msg-id=40731> (the Swiss approach will have a long-term impact that is "equivalent to the automatic exchange of information in the area of capital income.).

¹¹⁹ See, e.g., Matthew Allen, *Ist das Schweizer Bankgeheimnis gerettet?*, SWISSINFO.CH (Oct. 29, 2011, 3:16 PM), http://www.swissinfo.ch/ger/Wirtschaft/Finanzsektor_im_Umbruch/Bankgeheimnis_im_Rampenlicht/Ist_das_Schweizer_Bankgeheimnis_gerettet.html?cid=28660632 (last visited Feb. 2, 2012).

¹²⁰ Some might describe industry comments endorsing a global system as financial institutions trying to extend the time horizon before they will need to comply with any regime and simultaneously make lemonade out of lemons by ensuring they face only one regime. The key point here is that those purported motives (which may or may not reflect the motives of any given institution) do not change their basic decision to endorse a multilateral regime. See, e.g., Alternative Investment Management Association, *Foreign Account Tax Compliance ('FATCA')*, Letter to Steven Musher, Assoc. Chief Counsel, Int'l, IRS, and Manal Corwin, Int'l Tax Counsel, U.S. Dep't of the Treasury (June 29, 2010),

manage their compliance costs as tax intermediaries cross-border.

Thus, the British Bankers Association (BBA), although scathingly critical of FATCA in a series of comments letters to the U.S. Treasury, noted that although FATCA is intended to combat U.S. tax evasion, the problem is a global one that can only be solved with participation by financial institutions. The BBA, in what counts as a moment of shocking clarity by the standard of financial industry submissions to tax regulatory processes, suggested that “[i]n the longer term, we urge the U.S. and other nations to work towards an alternative global multilateral solution, where there would be reciprocal arrangements for all jurisdictions, and where information could be collected and exchanged between governments. We propose that consideration of a multilateral solution be an agenda item for upcoming meetings of the G20 since this is clearly an issue of international concern that requires a coordinated response.”¹²¹ This proposal comes from the leading association for banking and financial services in the United Kingdom, which represents banking organizations headquartered not only in the United Kingdom but also around the world. A series of other industry groups and national banking associations expressed similar sentiments about the importance of developing a coordinated multilateral approach for financial institutions to serve as cross-border tax intermediaries.¹²²

Financial sector commentary regarding the OECD’s TRACE project highlights the same convergence around the idea of financial institutions as tax intermediaries cross-border. Consider the submission of the Capital Markets Tax Committee of Asia (CMTCA) to the OECD’s work. CMTCA is a financial services industry body consisting of major commercial banks, investment banks, securities firms and other diversified financial services institutions operating in Asia. In their submission to the OECD, the CMTCA

<http://www.bsmlegal.com/PDFs/AIMASubmissiontoUSTreasuryandIRSreFATCA29June.pdf> (last visited Dec. 22, 2011). See also *infra* notes 121–122 and accompanying text.

¹²¹ British Bankers Association, *Comments for Notice 2010-60* (Oct. 29, 2010), available at http://www.bsmlegal.com/PDFs/FATCA_BBA_20101029.pdf. See also British Banking Association, *Comments for Notice 2011-34* (June 7, 2011), available at http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_British_Bankers_Ass_06072011_061611.pdf.

¹²² For example, see International Council of Securities Associations, *Re: Implication of the Foreign Account Tax Compliance Act (FATCA)* (June 28, 2011), available at <http://www.icmagroup.org/ICMAGroup/files/e7/e7614021-a8d4-4bbc-919f-caa7e6e8bfd5.pdf> (“Rather than the unilateral approach taken by FATCA, we suggest that a more appropriate approach would be the development of a global framework that would allow the US and other governments to obtain information regarding income paid to citizens of their countries by foreign financial institutions which is in harmony with each jurisdiction’s existing laws and does not create an excessive compliance burden for financial institutions.”); Dutch Banking Association, *Comments on the Foreign Account Tax Compliance Act, as well as Notice 2010-60 & Notice 2011-34* (June 9, 2011), available at http://www.deloitte.com/view/en_US/us/Services/tax/40f3486234d42310VgnVCM2000001b56f00aRCRD.htm (“[The Dutch Banking Association] would suggest a coordinated approach of states similar to what has been done in the area of transfer pricing, where through development of common concepts compliance efforts have been limited to a manageable position for taxpayers.”); European Banking Federation & Institute of International Bankers, *Re: Comments on Notice 2010-60 Providing Preliminary Guidance on FATCA*, Letter to Stephen E. Shay, et al. (Nov. 12, 2010), http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_EBF_IIB_FATCA_Comment_Letter_Nov12_121010.pdf (last visited Dec. 22, 2011) (making similar comments).

suggests that “cross-border information gathering and information exchange represents the new reality of the global economy.”¹²³ They do not object to rules requiring their members to make customer and account information available to tax administrators on a routine basis for the purpose of cross-border information exchange.¹²⁴ Indeed, they write that “because of their unique position in the global economy, it is inevitable that financial institutions will be increasingly called upon to make such information available to tax administrators.”¹²⁵ The CMTCA’s submission is more remarkable because it demonstrates that a leading tax-related association of major financial institutions operating in Hong Kong and Singapore—the two most important financial centers popularly understood to be resistant to cross-border tax intermediation by financial institutions—has at least resigned itself to this new regime.

Finally, and as described earlier, not only have Swiss financial institutions consented to the anonymous withholding approach—they are in fact its originators. As the Swiss Banking Association pointed out in its 2009-2010 Annual Report, “[t]he flat rate tax project represents an important element of both the Swiss Bankers Association’s 2015 Financial Centre Strategy and the financial market strategy of the Swiss federal government, published in December 2009. The flat rate tax project proposal was developed in a body constituted by the Swiss banks.”¹²⁶

Together the United States, the EU and its member states’ dependencies, and the other OECD economies (including Switzerland) represent 59% of global GDP,¹²⁷ and the management location for well more than 80% of global financial assets.¹²⁸ The comments on the EU, OECD, and U.S. systems that endorse some form of automatic multilateral tax information exchange come from associations that represent much of the global financial industry.

The views of both private and public sector actors are thus converging around new principles and norms wherein financial institutions act as tax agents for governments cross-border. We are witnessing the birth of a new international regime for cross-border tax administrative assistance with respect to income and assets held through offshore accounts. The most basic contour of the emerging regime—financial institutions as tax intermediaries cross-border—is already established. Two other key elements remain to be determined: the nature of the cooperation required by the regime (anonymous

¹²³ Letter from Capital Markets Tax Committee of Asia to Jeffrey Owens, Director, CTPA, OECD (Aug. 18, 2010), <http://www.oecd.org/dataoecd/40/60/46019879.pdf>.

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ SWISS BANKERS ASS’N, TÄTIGKEITSBERICHT 2009 / 2010 [2009-2010 ANNUAL REPORT] (2010), <http://www.swissbanking.org/en/taetigkeitsbericht-2010.pdf> [hereinafter SBA ANNUAL REPORT 2009/2010].

¹²⁷ *What is the OECD?*, U.S. DEP’T OF ST., <http://usoecd.usmission.gov/mission/overview.html> (last visited Dec. 20, 2011).

¹²⁸ 82% of financial assets globally (managed both domestically and offshore) are managed from the United States, the United Kingdom, Switzerland, France, Germany or Japan. The remaining 18% of assets consists in significant measure of assets of a resident of one of the other OECD economies managed from within that OECD economy. SWISS BANKERS ASS’N, WEALTH MANAGEMENT IN SWITZERLAND 7 (2009), available at <http://www.swissbanking.org/20081223-300-bro-wealthmanagement2009-rva.pdf>.

withholding or information reporting), and the scope of beneficiaries of the regime (major financial centers and states politically bound to those financial centers, or the greater part of the world).

III. Anonymous Withholding vs. Automatic Information Reporting

Automatic information reporting systems and cross-border anonymous withholding systems both clearly break from past practice, moving towards a global norm of financial institutions serving as tax agents for governments cross-border. Neither system represents the most comprehensive solution to address offshore accounts, which would involve non-anonymous cross-border withholding in combination with information reporting. However, when choosing between the two systems presently under consideration internationally, an information reporting model is superior to an anonymous withholding model. Anonymous withholding is substantively inferior because information reporting is able to address concerns regarding the accretion of untaxed principal, whereas withholding solutions are not. Furthermore, contrary to some conventional wisdom, anonymous withholding is not significantly cheaper, simpler, or more administrable than information reporting.

More importantly, cross-border anonymous withholding institutionalizes differentiated treatment of the most sophisticated taxpayers from the rest of society. In doing so, it undermines tax morale and the expressive role in citizenship that taxation plays in a democratic polity. Information reporting instead empowers the tax system to act as a building block of liberal democracy. Where anonymous withholding reduces policy flexibility and sovereign authority, information reporting preserves sovereign policy autonomy. Particularly outside the largest developed economies, these differences argue strongly in favor of information reporting.

Finally, politically speaking, anonymous withholding will not be accepted globally, while an automatic information reporting solution has the capacity to develop into a global regime. Information reporting regimes could conceivably grow to serve a wide range of states, whereas anonymous withholding regimes will, at best, only serve the interests of the wealthiest states with the most influential financial centers. Despite the superiority of information reporting, if a crucial subset of major financial centers accepts anonymous withholding, the suboptimal result represented by anonymous withholding for a limited number of countries may become a stable equilibrium. This dynamic makes the outcomes of the current evolutionary moment crucial to the development of cross-border administrative assistance.

A. Effectiveness and Administration

Reaching Untaxed Principal

Automatic information reporting has the capacity to address concerns regarding the accretion of untaxed principal. Anonymous withholding is triggered only when interest, dividends, or capital gains are earned in a foreign account, whereas automatic

information reporting can be structured to both report on income and gains and to measure the growth of principal in a foreign account. Untaxed principal is a significant concern for tax administrators. While scholarly discussions of tax evasion often focus on tax revenues lost because of untaxed investment income,¹²⁹ discussions with policymakers reveal that government officials have focused equally on the use of offshore structures to evade taxation on domestic business income of closely held businesses, with the proceeds from that evasion then being invested through offshore accounts so as to evade tax on the resulting investment income.¹³⁰ For instance, the hearings of the Permanent Subcommittee on Investigations (“PSI”), which served as a catalyst for recent U.S. efforts to crackdown on offshore tax evasion, focused intently on exactly this kind of tax evasion. A number of the evasion cases PSI studied involved offshore shell entities used in combination with fraudulent billing arrangements, disguised related-parties loans, and other mechanisms to reduce U.S. tax on business income earned within the U.S. and to transfer assets offshore.¹³¹ U.S. Department of Justice prosecutions have similarly reflected the concern that taxpayers are evading tax by fraudulently shifting domestic taxable income offshore.¹³² These same concerns are shared by tax administrators outside the United States, as demonstrated by their discussions in global forums.¹³³

¹²⁹ See JANE G. GRAVELLE, CONG. RES. SERV., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION (2009), available at http://assets.opencrs.com/rpts/R40623_20090709.pdf. But see Joseph Guttentag & Reven Avi-Yonah, *Closing the International Tax Gap*, in BRIDGING THE TAX GAP: ADDRESSING THE CRISIS IN FEDERAL TAX ADMINISTRATION (Max B. Sawicky ed., 2005).

¹³⁰ Discussions between author and current and former government officials from Australia, Denmark, France, Germany, India, and the United States.

¹³¹ *Tax Haven Abuses: The Enablers, the Tools and Secrecy: Hearing Before the Permanent Subcomm. on Investigations of the Comm. on Homeland Sec. & Gov’t Affairs*, 109th Cong. 33, 45 (2006).

¹³² See, e.g., Boyd Massey, *Convicted Bank Chairman is Key to Dozens of New Tax Haven Cases*, TAX NOTES TODAY 171–72 (Sept. 3, 1999); GAO, QUALIFIED INTERMEDIARY PROGRAM, *supra* note 54, at 24 (describing 2007 indictment of adult entertainment mogul for using offshore companies that he owned, but whose ownership was concealed, to overstate business and personal expenses); Statement by Defendant in Advance of Plea Guilty, *United States v. Taylor*, No. 2:08-cr- 00064-TC (D. Utah Jan. 24, 2008); Statement by Defendant in Advance of Plea Guilty, *United States v. Petersen*, No. 2:05-cr-00805-TC-DN (D. Utah Jan. 18, 2008). See also *Tax Haven Banks and U.S. Tax Compliance*, *supra* note 60, at 17–18.

¹³³ See OECD, Seoul Declaration, Third Meeting of the OECD Forum on Tax Administration (September 15, 2006) (35 tax commissioners and deputy tax commissioner from OECD and non-OECD economies express concern regarding outright fraud to conceal income and assets using offshore business entities); see also, e.g., National Assembly of France, Finance Commission, Report Nr. 1802, at 204 (September 8, 1999), available at <http://www.assemblee-nationale.fr/rap-info/i1802-10.asp>; National Assembly of France, Finance Commission, Report Nr. 1902, at 147 – 156, September 10, 2009, available at http://www.assemblee-nationale.fr/13/rap-info/i1902.asp#P551_60172 (two French National Assembly reports within ten years making recommendations regarding means to address evasion of domestic business income); Gesetz zur Bekämpfung der Steuerhinterziehung (Steuerhinterziehungsbekämpfungsgesetz) [Act to fight against tax evasion (tax evasion act)], Jul.29, 2009, BGBl I at 2302, available at http://www.bundesfinanzministerium.de/nr_4146/DE/BMF__Startseite/Aktuelles/Aktuelle__Gesetze/Gesetze__Verordnungen/040__SteuerhinterziehungsbekG__anl,templateId=raw,property=publicationFile.pdf (increasing reporting requirements for business transactions with entities in jurisdictions lacking tax transparency).

Understanding the prevalence of concerns regarding the fraudulent use of offshore structures to evade domestic business income tax is imperative to a cogent evaluation of anonymous withholding. Even if an anonymous withholding system were adopted by all countries, it would not address or deter the use of offshore structures and specious transactions to evade domestic taxation. Withholding in any anonymous withholding system only applies to investment income, not contributions to principal. Thus, the Swiss agreements use a one-time charge as a proxy to acknowledge past untaxed principal, but have no mechanism to help address the evasion of domestic business income tax through offshore accounts on a forward-going basis. Furthermore, anonymous withholding exists to limit exchange of information, and thus such a regime runs counter to the extensive cross-border administrative assistance necessary to ferret out tax evasion on principal. Conversely, an appropriately structured system of information exchange can call attention to the existence of assets of a domestic taxpayer that may be funded from income, profits, or gains that evaded taxation. The U.S. FATCA regime, for instance, requires annual asset reporting as well as income reporting, including assets held by shell entities. This reporting attempts to deter and identify patterns suggestive of the use of offshore accounts to evade tax on domestic income earned by closely held businesses.

Agreements between the United States and Switzerland over more than a decade demonstrate that non-taxation of principal is an important concern for U.S. tax administrators. Normally, the U.S. insists that tax treaties provide unfettered information exchange upon request,¹³⁴ but until 2010, Switzerland refused to provide information exchange upon request to any country with which it entered into tax treaties. The compromise agreed to in 1996 was that the Swiss would provide information to the U.S. in situations of “tax fraud,” rather than mere “tax evasion” (run-of-the-mill tax evasion is not a crime under Swiss law). One difficulty with this compromise was that it forced the two states to define the term “tax fraud” for purposes of the treaty.¹³⁵ The United States pressed the Swiss on this issue repeatedly, which resulted in three sequential agreements,¹³⁶ the substance of which sheds light on U.S. tax administrators’ offshore tax abuse concerns during the Clinton and Bush administrations. The agreements focused heavily on issues likely to arise through the fraudulent use of offshore structures to evade taxes on domestic business income.¹³⁷

¹³⁴ United States Model Income Tax Convention, *supra* note 56, at art. 26(1).

¹³⁵ The history suggests that U.S. officials were not pleased with Swiss officials’ initial (narrow) interpretation of the meaning of the term “tax fraud,” which was defined in paragraph 10 of the protocol accompanying the 1996 Convention treaty to mean “fraudulent conduct that causes or is intended to cause an illegal and substantial reduction in the amount of tax paid to a Contracting State.”

¹³⁶ The controversy about the meaning of “tax fraud” existed well before the UBS case magnified the importance of the issue. *See, e.g.,* Thomas A. O’Donnell, *Impact of EU Savings Directive on Switzerland*, 16 J. INT’L TAX’N 57, 61 n.9 (2005). The United States and Switzerland agreed on a Protocol that accompanied the 1996 treaty to address the “tax fraud” definitional issue, followed by a further competent authority agreement a little over a year later, and another memorandum of understanding between the two states regarding the issue in 2003.

¹³⁷ For instance, the initial protocol to the 1996 convention emphasized that “fraudulent conduct is assumed in situations where a taxpayer uses, or has the intention to use, a forged or falsified document such as a double set of books, a false invoice, an incorrect balance sheet or profit and loss statement, or a fictitious order or, in general, a false piece of documentary evidence.” Protocol Amending the Convention for the

The UK Treasury emphasized the distinction between information reporting regimes and anonymous withholding regimes in deterring tax evasion on domestic business income when it championed information exchange over anonymous withholding in the early debates over the EUSD at the turn of the 21st century. The UK noted that an information exchange system can deter taxpayers from concealing business income through offshore structures, while “[e]ven if withholding arrangements were adopted by all countries globally, this would not provide an effective solution to evasion,” because such systems would not “deter and detect the ‘laundering’ of the proceeds of tax evasion through investment abroad.”¹³⁸

Administrability

Another argument made in favor of anonymous withholding is that even if automatic information reporting is a substantively preferable system, anonymous withholding is less costly and more administrable. This claim is grossly overstated. Anonymous withholding and automatic information reporting share almost all of the same operational challenges. A multilateral anonymous withholding system along the lines of the Swiss model must (1) determine how to identify taxpayers’ country of residence, (2) collect information about amounts of interest, dividends, capital gains, and other income in order to impose the right withholding rates, (3) determine which financial institutions are included in the withholding system, (4) ensure financial institutions comply with the requirements to identify taxpayers with a country of residence and withhold appropriate amounts on identified types of income, (5) determine how to route payments to residence

Avoidance of Double Taxation with Respect to Taxes on Income ¶ 10, U.S.-Switz., Oct. 2, 1996, 27 U.S.T. 1996. The conduct defined as fraudulent is primarily relevant in relation to evasion of tax on business income, rather than investment income. The protocol then dwells on how a state should determine “whether tax fraud exists in a case involving the active conduct of a profession or business (including a profession or business conducted through a sole proprietorship, partnership or similar enterprise).” *Id.* In 2003 the definition of “tax fraud” for purposes of the convention was clarified again, and again focused in substantial measure on examples of issues that would most likely arise in connection with evasion of domestic business income through the fraudulent use of offshore structures. Mutual Agreement Regarding the Administration of Article 26 (Exchange of Information) of the Swiss-U.S. Income Tax Convention of October 2, 1996, U.S.-Switz., Jan. 23, 2003 (tax fraud includes “[c]onduct that involves the destruction or non-production of records, or the failure to prepare or maintain correct and complete records, that a person is under a legal duty (tax or otherwise) to prepare and keep as sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any tax return, if the person has not properly reported such amounts in any such tax return.”).

¹³⁸ See HM TREASURY, UNITED KINGDOM, EXCHANGE OF INFORMATION AND THE DRAFT DIRECTIVE ON TAXATION OF SAVINGS ¶ 3 (Feb. 2000), <http://archive.treasury.gov.uk/docs/2000/eoi.html> (last visited Feb. 2, 2012) [hereinafter HM TREASURY, EXCHANGE OF INFORMATION]. Note that the current UK government appears to be prepared to accept anonymous withholding. Perhaps the change of perspective is because of the UK’s growing role as a major offshore asset manager. The United Kingdom and its dependencies are the world’s second largest asset manager, with an industry that is almost the size of Switzerland’s (although offshore asset management is a much smaller part of the UK economy than it is of the Swiss economy). Alternatively the change may simply reflect differing perspectives on appropriate mechanisms for addressing tax evasion between a former Labor government and the current Tory government.

country governments,¹³⁹ and (6) determine how to encourage widespread multilateral participation. The only important aspect of information reporting that is more burdensome than anonymous withholding is its requirement for taxpayer identification numbers (TINs). On the other hand, an anonymous withholding system is more burdensome than information reporting along other dimensions. In an anonymous withholding system a financial institution must keep track of tax rates and rate changes in different categories of income for every country in the world for which it applies withholding and then must in fact withhold, instead of simply tracking income and reporting it.

The only important element of a regime for cross-border administrative assistance that an information reporting system must develop more thoroughly than an anonymous withholding regime is a mechanism to transmit information from the asset management jurisdiction to the residence country in a form that tax administrations can match against residents' tax returns.¹⁴⁰ Assuming that a financial institution were to arrange its IT systems to successfully collect the necessary information to impose a withholding tax the rate of which varies by type of income and country of residence of the customer, providing automatic information reporting instead of withholding requires adding only two pieces to the system: TINs, and information technology solutions to allow secure transfer of the requisite information in a mutually intelligible format. Solving the former problem requires every residence country interested in benefitting from automatic information exchange to issue its taxpayers TINs if it has not done so. It also requires every financial institution with offshore accounts to collect those numbers from nonresident account holders.¹⁴¹ Solving the latter problem involves significant but feasible investment in IT development and allowing time to implement the new technology. That much has already been demonstrated by the successful operation of the EUSD,¹⁴² as well as the work of expert groups at the OECD.¹⁴³

¹³⁹ Routing appears to be a non-issue for anonymous withholding simply because the Swiss system is the only extant model. In the Swiss system, Swiss financial institutions managing nonresident accounts withhold and route the money to the Swiss government, which in turn routes the money to countries of residence for which Switzerland has agreed by treaty to provide this service (at whatever price Switzerland extracts). Conceptually this is not the only routing alternative for anonymous withholding. Imagine the U.S. accepted anonymous withholding but not the Swiss government's price (for example, a Swiss demand for preferred access to U.S. markets for Swiss financial institutions). In principle, the U.S. could require financial institutions to withhold on U.S. persons anonymously and remit the proceeds to the U.S. or else suffer 30% withholding. They could then require the Swiss financial institutions to allow the Big Four to audit whether the anonymous withholding was performed properly.

¹⁴⁰ Anonymous withholding as proposed in the Swiss agreements still requires financial institutions to be prepared to report on individual account holders (at their request), but the scale of that reporting may be small enough that it can be done manually.

¹⁴¹ See *Recommendation of the Council on the use of Taxpayer Identification Numbers in the International Context* (C(97)(29)), OECD (May 23, 1997), available at [http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=C\(97\)29/FINAL&docLanguage=En](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=C(97)29/FINAL&docLanguage=En). See also David Spencer, *OECD Information Exchange Recommendations are a Significant First Step in Resolving Tax Evasion*, 8 J. INT'L TAX'N 353 (1997).

¹⁴² See Report from the Commission to the Council, COM (2008) 552 final, at 2 (September 15, 2008) (emphasizing the need for TINs, and with that caveat suggesting exchange is workable through preexisting channels of communication established among European Union member states).

The Swiss Banking Association estimates the compliance cost for Swiss anonymous withholding for all financial institutions throughout Switzerland will be between three hundred and five hundred million CHF.¹⁴⁴ Further, they imply that this one-time fixed cost does not increase substantially with the number of jurisdictions for which Swiss financial institutions search for non-resident account holders. Three to five hundred million CHF diffused across the industry is an expensive but manageable cost. Although the additional cost of collecting TINs and building the IT system for fully automatic routine information reporting may be significant, it is unlikely to vastly exceed the costs, common to automatic information exchange and anonymous withholding, of identifying taxpayers and their country of residence, (2) collecting information about interest, dividends, capital gains, and other income earned by nonresident taxpayers, and (3) ensuring financial institution compliance.¹⁴⁵

Advocates of anonymous withholding often suggest that anonymous withholding is more administrable and less costly than information reporting by comparing the Swiss model to FATCA and noting that anonymous withholding does not require withholding on any entity, or on passthru payments, as does FATCA. These arguments are specious. The withholding imposed by FATCA on financial institutions for noncompliance is not a cost of the information reporting system. Rather, it is simply the stick chosen by the United States to try to encourage global compliance. The United States could equally have chosen to use FATCA's withholding rules to instead impose an anonymous withholding regime. Any system with global aspirations needs a combination of carrots and sticks if it is to drive the vast majority of institutions and governments into the system. FATCA attempts to create a global regime to improve cross-border administrative assistance in the face of resistance from certain foreign sovereigns and financial institutions. It therefore requires means of coercion without which various financial institutions and sovereigns would not comply. Swiss anonymous withholding, in contrast, is intentionally characterized by contracting. It requires no coercive measures, because Switzerland is not attempting to globalize the regime. Indeed, Switzerland would prefer to establish anonymous withholding with only as few countries as is necessary to stop the spread of automatic information reporting. Coercion inevitably imposes greater compliance and political costs than contracting, even if the results from coercion are justified.¹⁴⁶

¹⁴³ See, e.g. David Spencer, OECD Information Exchange Recommendations are a Significant First Step in Resolving Tax Evasion, 8 *Journal of International Taxation* 353 (August 1997).

¹⁴⁴ SBA ANNUAL REPORT 2009/2010, *supra* note 126, at 17. *But see* Swiss Banking Association, *FATCA Notice 2011: Submission of the Swiss Bankers Association*, Letter to Manal Corwin, Deputy Assistant Secretary Tax Policy (Int'l), U.S. Dep't of the Treasury, Michael Danilack, and Steve Musher, IRS (June 10, 2011), available at http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_SBA_061011_NOCOPYRIGHTNEEDED_062311.pdf (last visited Dec. 22, 2011) (complaining about the excessive cost of FATCA account identification, due diligence, and verification procedures as proposed in Notice 2010-60 and Notice 2011-34).

¹⁴⁵ It is of course possible that the estimated costs of the Swiss system are low because it does not do enough to identify tax evaders or otherwise ferret out evasion. The most important point is simply that there will not be a monumental "cost differential" in an apples-to-apples comparison of automatic information exchange and anonymous withholding systems.

¹⁴⁶ See generally STEPHEN D. KRASNER, *SOVEREIGNTY: ORGANIZED HYPOCRISY* 7 (1999).

It is inappropriate to think of the cost of mechanisms used by an information reporting system to encourage widespread multilateral participation among financial institutions and governments as a cost of the system itself. That cost is simply the cost of trying to create a multilateral system. Certainly the United States could be criticized for coercing by withholding 30% on a wide range of payments arising in or indirectly attributable to the United States for the sake of a regime that addresses a global problem in a way that benefits only the United States. If such costs were imposed to ensure that automatic information reporting was available from most financial institutions in the world to most jurisdictions that complied with relevant international standards, however, the calculus regarding the cost of coercion would change. Nothing about that calculus is inherent to the choice between information reporting and anonymous withholding.

B. Governance Concerns

Tax administration plays a central role in developing national institutions. First, robust tax administrations are important for national institutions more generally because they usually provide the lifeblood of a country's government. Setting aside aid-dependent and rentier states, tax administrations fund all other national institutions and, as the practical expression of tax policy, represent an important component of a country's economic policy. Tax administrations also mediate more regularly between many private citizens and government than any single other government institution. The tax administration embodies and asserts a government's exclusive authority to tax, and demonstrates a government's effective level of control (or lack thereof) in performing its sovereign task of gathering resources for the state.¹⁴⁷ For these reasons, from a state-building perspective not only does it matter how *much* revenue a government raises, but also *how* the government raises that revenue.¹⁴⁸

Even if anonymous withholding could be globalized (which I will argue it cannot be), most countries, especially emerging economies, should prefer automatic information reporting for governance-related reasons. This claim may be controversial, because anonymous cross-border withholding could theoretically provide revenue to emerging economy government fiscs without those governments needing to build an effective tax administration in order to collect that revenue. I argue that anonymous cross-border withholding threatens domestic tax morale, undermines the expressive role of taxation as a building block of liberal democracy, and erodes sovereign policy flexibility. Meanwhile cross-border information reporting undergirds tax morale and strengthens the capacity to govern.

¹⁴⁷ Cf. Kyle Bagwell & Robert Staiger, *National Sovereignty in an Interdependent World* (NBER Working Paper No. 10249, 2004) (the capacity to exercise unilateral control over policy instruments and to operate without outside influence in internal affairs are the key features of sovereignty).

¹⁴⁸ See also Eric M. Zolt & Richard M. Bird, *Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries*, 52 UCLA L. REV. 1627, 1630 (2005) ("A country's tax system is thus both an important and a highly visible symbol of its fundamental political and philosophical choices.").

Tax Morale

Compliance with domestic tax policy is quasi-voluntary; tax collection is significantly less costly and more effective if it is motivated by a willingness to cooperate (“tax morale”) even while backed by coercive authority. As long as domestic authorities handle tax compliance, governments are compelled to respond to citizen demands in order to enhance tax compliance and sustain state revenues.¹⁴⁹ Cross-border anonymous withholding obviates the need to strengthen governance institutions in order to collect revenue, as it presupposes collection and remittance by a foreign financial institution under the regulatory authority of a foreign sovereign. In contrast, automatic information exchange strengthens domestic governance institutions both by improving the capacity of domestic authorities to handle tax compliance and forcing an interaction between government and taxpayers in order for tax to be collected.¹⁵⁰

Evidence from experimental studies and survey data reveals that tax morale is affected by factors such as citizens’ trust in other citizens’ compliance and perceptions of the trustworthiness and competence of the government.¹⁵¹ Recent work further suggests that tax measures that increase the transparency of tax matters help build a culture of tax compliance, and thus help maximize revenue while minimizing political conflict.¹⁵² In contrast, cross-border anonymous withholding prevents governments from receiving the data that would suggest that tax is being collected equitably or indicating to a citizenry that the government is seeking out non-payers.¹⁵³ It singles out an elite class of potential

¹⁴⁹ See, e.g., Mick Moore, *How Does Taxation Affect the Quality of Governance?* (IDS Working Paper 280, 2007), available at <http://www2.ids.ac.uk/gdr/cfs/pdfs/Wp280.pdf>; LEVI, OF RULE AND REVENUE; *infra* note 159.

¹⁵⁰ Even when tax is enforced domestically via withholding by domestic financial institutions, domestic tax authorities must regulate the process by which withholding is imposed, which forces them to develop the capacity to oversee such withholding.

¹⁵¹ James Alm & Benno Torgler, *Culture Difference and Tax Morale in the United States and in Europe*, 27 J. ECON. PSYCHOL. 224, 228 (2006) (arguing that “tax morale is likely to be influenced by such factors as perceptions of fairness, trust in the institutions of government, the nature of the fiscal exchange between taxpayers and government, and a range of individual characteristics”).

¹⁵² See Richard M. Bird, Jorge Martinez-Vazquez & Benno Torgler, *Societal Institutions and Tax Effort in Developing Countries* (CREMA Working Paper No. 2004-21, 2004), <http://ssrn.com/abstract=662081>. Individual participation in the process of paying taxes can also act as inoculation against attempts to evade taxes, in particular with respect to categories of income where evasion is a plausible option. Thus, advocates of simplifying income taxes in the United States for average citizens sometimes advocate a process that would have the government send a taxpayer a presumptive return, and ask them to certify that return to be true and correct, or make changes as appropriate. See Joseph Bankman, *Simple Filing for Average Citizens: The California ReadyReturn*, 107 TAX NOTES 1431 (2005). Final non-anonymous withholding systems imposed through domestic agents (for example for taxpayers subject to tax exclusively on labor income), are also entirely unobjectionable from a transparency perspective, and preferable from an enforcement perspective. In these circumstances the person withheld upon is identified to the government through information reporting. According to the General Accounting Office, as of 1996 thirty-four countries had final withholding systems for at least some taxpayers. U.S. GENERAL ACCOUNTING OFFICE, GAO/GGD-97-6, TAX ADMINISTRATION: ALTERNATIVE FILING SYSTEMS 4 (1996), available at <http://www.gao.gov/archive/gg97006.pdf>.

¹⁵³ Cf. Joshua Blank, *In Defense of Privacy*, 61 EMORY L.J. ____ (forthcoming 2012). Blank argues that tax privacy, understood as the inability of other taxpayers as opposed to the government itself to see the details

non-payers who have the sophistication to utilize foreign institutions and provides them with special treatment. The nature of that special treatment is such that a cross-border anonymous withholding system can never provide any evidence to citizens that revenues are being collected in a reasonably equitable manner. That belief in equitable treatment is absolutely crucial to tax morale.

Tax compliance research also suggests that the government's level of commitment to enforcing the tax law has an important effect on tax morale.¹⁵⁴ If there is a widespread perception that the government is not willing to detect and penalize tax evaders, then tax evasion is socially legitimized and tax morale falls.¹⁵⁵ In countries like Greece, Italy, or the Philippines, weak tax administrations lacking vigorous enforcement programs have contributed to a state of affairs in which tax evasion carries very little moral opprobrium. Thus, in discussing anonymous withholding, Sigmar Gabriel, Chairman of Germany's Social Democratic Party, has suggested that the Swiss-German anonymous withholding agreement is "making common cause with lawbreakers," "destroying people's sense of justice" and sending a message that "whoever is rich can buy themselves free from punishment."¹⁵⁶

Similarly, when the UK Treasury evaluated the anonymous withholding component of the early "coexistence model" for the EUSD in effect at the end of the 20th century, which treated withholding and reporting as equally satisfactory systems, the UK Treasury noted that "exchange of information encourages compliance with the tax system. It provides a deterrent to the non-declaration or under-declaration of income. In contrast a [cross-border anonymous] withholding system, without exchange of information, might appear to give the impression of legitimising tax evasion, since it fails to deter non-declaration."¹⁵⁷ Anonymous withholding arguably represents the tax administration forswearing any independent effort to collect tax that is due. Thus, it may well legitimize tax evasion not only through offshore accounts but also more broadly.

of a taxpayer's income and tax payments, enables the government to influence individuals' perceptions of its tax enforcement capabilities by publicizing specific examples of its tax enforcement strengths without exposing specific examples of its tax enforcement weaknesses. My argument here is different; I support Blank's conclusions regarding the benefits of tax privacy understood as the confidentiality of taxpayer information from other taxpayers, but argue that the government itself must be aware of a taxpayer's income and tax payments. Indeed, this circumstance is assumed in Blank's claim that the government can use its information about taxpayers' to publicize salient examples of tax cheaters the government has caught, and thereby improve tax compliance.

¹⁵⁴ See Ronald G. Cummings et al., *Tax Morale Affects Tax Compliance: Evidence from Surveys and an Artefactual Field Experiment*, 70 J. ECON. BEHAV. & ORG. 447 (2009).

¹⁵⁵ James Alm & Jorge Martinez-Vazquez, *Institutions, Paradigms, and Tax Evasion in Developing and Transition Countries*, in PUBLIC FINANCE IN DEVELOPING AND TRANSITIONAL COUNTRIES 146, 151 (Jorge Martinez-Vazquez & James Alm eds., 2003). See also Bruno S. Frey & Benno Torgler, *Tax Morale and Conditional Cooperation*, 35 J. COMP. ECON. 136 (2007) (noncompliance by other taxpayers tends to decrease a taxpayer's tax morale and compliance).

¹⁵⁶ Michael Backhaus & Angelika Hellemann, *Sigmar Gabriel: Und wir sollten die Bürger darüber abstimmen lassen*, BILD, Sept. 25, 2011, at pt. 2, <http://www.bild.de/politik/inland/sigmar-gabriel/wir-muessen-die-eu-reformieren-die-buerger-abstimmen-lassen-teil-2-20134564.bild.html> (last visited Dec. 21, 2011).

¹⁵⁷ HM TREASURY, EXCHANGE OF INFORMATION, *supra* note 138, at ¶ 3.4.

Expressive Role of Taxation

A cross-border anonymous withholding system also undermines the expressive role that taxation plays within a liberal democracy. Even in major developed economies, anonymous withholding raises concerns about the taxpayer's engagement with the polity and the equality of citizens in the face of the taxing authority.¹⁵⁸ These concerns have even greater salience in many emerging and developing economies, where tax evasion is frequently characterized as systemic, and the taxation of elites is often a source of special concern.¹⁵⁹ In contrast to anonymous withholding, information reporting, like identified withholding, allows the income taxation of elites to be sufficiently visible to support the legitimacy of the governance structure in the eyes of all citizens.

When taxpayers feel they are subject to generally applicable taxes imposed by the sovereign, they are more likely to collectively insist on meaningful representation.¹⁶⁰ Some historians explain the contrast between English liberty and French absolutism for three hundred years in part with reference to the prevalence of tax exemptions for French nobles, as compared to a transparent direct tax burden borne relatively uniformly by the English nobility. The argument is that in England, elites were motivated to ensure a robust national assembly with meaningful authority and rule of law that constrained the executive, whereas in France, those incentives were lacking.¹⁶¹ The slogan “no taxation without representation” neatly summarizes the basic point.

A generation of economists, economic historians, sociologists, and political scientists has been influenced by the idea that relatively broad-based and transparent taxation generally tends to produce more representative government.¹⁶² For example, some scholars

¹⁵⁸ See Backhaus & Hellemann, *supra* note 224 and accompanying text. See also text accompanying *infra* notes 150–51.

¹⁵⁹ James Alm & Jorge Martinez-Vazquez, *Institutions, Paradigms, and Tax Evasion in Developing and Transition Countries*, in PUBLIC FINANCE IN DEVELOPING AND TRANSITIONAL COUNTRIES 151 (Jorge Martinez-Vazquez and James Alm eds., 2003); Clive Gray, *Enhancing Transparency in Tax Administration in Madagascar and Tanzania* (African Economic Policy Discussion Paper 77, 2001) (noting that 75% of respondents favored the publication of the names of tax evaders, along with the cost of their evasion activities to the Tanzanian Treasury, in order to provide transparency as to what segment of society was avoiding paying its fair share of the burden of governance).

¹⁶⁰ See note 198 and accompanying text, *infra*.

¹⁶¹ Aristide Zolberg, *Strategic Interactions and the Formation of Modern States: France and England*, 32 INT'L SOC. SCI. J. 696 (1980).

¹⁶² See generally Robert H. Bates & Da-Hsiang Donald Lien, *A Note on Taxation, Development, and Representative Government*, 14 POL. & SOC'Y 53 (1985); Robert H. Bates, *The Economics of Transitions to Democracy*, 24 P.S. POL. SCI. & POL. 24 (1991); NIALL FERGUSON, *THE CASH NEXUS: MONEY AND POWER IN THE MODERN WORLD, 1700-2001*, at 51, 77–87 (2001); MARGARET LEVI, *OF RULE AND REVENUE* (1988) [hereinafter LEVI, *OF RULE AND REVENUE*]; Seymour Martin Lipset, *Some Social Requisites of Democracy: Economic Development and Political Legitimacy*, 53 AM. POL. SCI. REV. 69 (1959). See also DOUGLASS NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE* 49 (1990); Mancur Olson, Jr., *Dictatorship, Democracy, and Development*, 87 AM. POL. SCI. REV. 567 (1993); Martin C. McGuire & Mancur Olson, Jr., *The Economics of Autocracy and Majority Rule: The Invisible Hand and the Use of Force*, 34 J. ECON. LIT. 72 (1996); Charles Tilly, *COERCION, CAPITAL AND EUROPEAN STATES*, AD 990-

suggest that external funding allowed third-world client regimes during the Cold War to avoid entering into implicit or explicit social fiscal contracts with their citizenry in which they exchanged law and representation for resources.¹⁶³ Others argue that oil wealth hinders liberal democracy because it allows oil-rich governments to avoid taxation of domestic residents and the societal bargains that come with such taxation.¹⁶⁴ In both examples, external funding allowed autocrats to avoid liberal democracy. Similarly, in an anonymous withholding regime, tax collected abroad becomes more akin to a source of external funding than to funding provided by citizens in a transparent relationship with their government.

Some scholars suggest that visible, progressive taxation of capital income and closely-held business income at the top of the income distribution is a necessary symbol of the commitment to fairness in a liberal democracy.¹⁶⁵ Others suggest that imposing taxes on mobile assets in a transparent manner encourages collective bargaining with the sovereign and results in the emergence of more representative and classically liberal government.¹⁶⁶ An automatic information reporting system that identifies prosperous individual taxpayers and requires them to participate in the act of paying taxes (or to lobby against those taxes, or for a tax base that exempts capital income) achieves both of these ends.

1990, 96-126 (1990); Conference Paper, James E. Mahon, *Liberal States and Fiscal Contracts: Aspects of the Political Economy of Public Finance*, (Ann. Meeting of the Am. Pol. Sci. Ass'n, 2005); Michael Ross, *Does Taxation Lead to Representation?*, 34 BRIT. J. POL. SCI. 229 (2004) (regressions consistent with the hypothesis that higher taxes relative to total government services makes states more democratic, but failing to indicate that higher taxes relative to income lead to democratization).

¹⁶³ CHARLES TILLY, COERCION, CAPITAL AND EUROPEAN STATES, AD 990-1990, 207-22 (1990).

¹⁶⁴ See Michael L. Ross, *Does Oil Hinder Democracy?*, 53 WORLD POL. 325 (2001); Hazem Beblawi, *The Rentier State in the Arab World*, in THE ARAB STATE 85-98 (Giacomo Luciani ed. 1990); Giacomo Luciani (1994), *The Oil Rent, the Fiscal Crisis of the State and Democratization*, in DEMOCRACY WITHOUT DEMOCRATS? THE RENEWAL OF POLITICS IN THE MUSLIM WORLD 130-55 (Ghassan Salamé ed. 1994). See also Thomas L. Friedman, *Drowning Freedom in Oil*, N.Y. TIMES, Aug. 25, 2002, available at <http://www.nytimes.com/2002/08/25/opinion/drowning-freedom-in-oil.html><http://www.nytimes.com/2002/08/25/opinion/drowning-freedom-in-oil.html>.

¹⁶⁵ See, e.g., Maureen B. Cavanaugh, *Democracy, Equality, and Taxes*, 54 ALA. L. REV. 415 (2003); Zolt & Bird, *supra* note 12, at 1683 (noting that “symbols matter” and that in the developing world a progressive income tax, “whatever its defects in practice, may be an important and sometimes critical symbol of concern with the distributive outcomes of the market system”). See also MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS, A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 52-58 (2008) (noting that even schoolchildren conclude that fairness in a democracy involves some degree of progressive taxation based on ability to pay).

¹⁶⁶ Robert H. Bates & Da-Hsiang Donald Lien, *A Note on Taxation, Development, and Representative Government*, 14 POL. & SOC'Y 53 (1985); LEVI, OF RULE AND REVENUE. Niall Ferguson suggests that direct taxes on elites are positively associated with the growth of representative institutions. NIALL FERGUSON, THE CASH NEXUS: MONEY AND POWER IN THE MODERN WORLD, 1700-2001 51, 77-87 (2001). See also Wilson Pritchard, *Taxation and State Building: Towards a Governance Focused Tax Reform Agenda*, 24-26 (IDS Working Paper #341, 2010) (“The greatest challenge in improving enforcement equity, and thus strengthening the basis for collective tax bargaining, lies in improving taxation of elites. The poor enforcement of personal income taxes is in some respects the defining feature of developing country tax systems, with implications for revenue and legitimacy.”).

Automatic information reporting can encourage income taxpayers to collectively demand governmental accountability. In contrast, relying on foreign financial institutions for routine tax collection, rather than on domestic withholding, information reporting, or quasi-voluntary self-assessment, may reduce the capacity of compliant and visible taxpayers to bargain for law and representation in exchange for tax revenues. Anonymous withholding thus undermines the prospect that a sovereign's desire for tax revenue will give compliant taxpayers a tool to press for classically liberal democracy.¹⁶⁷

At the same time, information reporting provides some assurance to the entire society that tax on capital income is in fact being collected from wealthy taxpayers. A government can, for example, provide reports showing distributional breakdowns of the tax burden. In contrast, cross-border anonymous withholding can undermine the perceived legitimacy of the government by eroding the citizenry's confidence that the government is raising funds in an equitable matter.¹⁶⁸ If the transparency of taxation has any role to play in constituting the democratic experience, then moving to an anonymous withholding system to collect those taxes most likely to be associated with privilege undermines that role.

Anonymous cross-border withholding of income tax on capital income changes the taxing relationship between the citizen and the state. At minimum it reduces the taxpayer's awareness of a domestic fiscal process and any consequent likelihood to engage the polity to demand accountability.¹⁶⁹ Beyond that, cross-border anonymous withholding may shake all citizens' confidence that the government is raising funds equitably, and therefore weaken the legitimacy of the state.¹⁷⁰ In this sense it differs dramatically from domestic withholding or information reporting systems for collecting tax revenues. In the context of major developed economies, the consequent pressures on liberal democracy may be significantly less relevant. But in the context of emerging and developing economies still working to achieve robust democratic governance, these same pressures should not be underestimated.¹⁷¹

¹⁶⁷ It is precisely because automatic information exchange will never be perfect that government will tend to heed the concerns of taxpayers and attempt to achieve quasi-voluntary compliance in an information reporting system.

¹⁶⁸ For instance, if anonymous withholding were commonplace it would not be possible to accurately show what part of the income tax was paid by the top 1% of income earners. See Margaret Levi & Audrey Sacks, *Achieving Good Government—and Maybe Legitimacy*, in *NEW FRONTIERS IN SOCIAL POLICY 4* (Anis Dani & Ashutosh Varshney eds., forthcoming), available at <http://siteresources.worldbank.org/INTRANETSOCIALDEVELOPMENT/Resources/ACHIEVINGGOODGOVERNMENT.pdf> (the legitimacy of a government we might consider a good government requires a belief by the citizenry that the government is raising funds in an equitable manner, in addition to serving the public good).

¹⁶⁹ See Richard A. Musgrave, *Clarifying Tax Reform*, 70 *TAX NOTES* 731, 732 (Feb. 5, 1996) (making this argument in a quite different context).

¹⁷⁰ See generally Levi & Sacks, *supra* note 168. In contrast, cross-border information reporting can provide a tool to preserve the role of the state as the ultimate enforcer of tax assessments. In doing so, automatic information reporting also helps ensure a more legitimate state, which—particularly in emerging and developing economies—is an essential precondition for maintaining tax morale and tax collections.

¹⁷¹ See generally Richard M. Bird, Jorge Martinez-Vazquez & Benno Torgler, *Societal Institutions and Tax Effort in Developing Countries* (CREMA Working Paper No. 2004-21, 2004), <http://ssrn.com/abstract=662081>.

Maintaining Policy Flexibility

In contrast to automatic information reporting, anonymous withholding substantially reduces sovereign authority and policy flexibility, especially for less powerful states, by permanently outsourcing tax collection on capital income to foreign sovereigns and removing unilateral control over tax policy instruments. Anonymous withholding thus threatens the organization and effectiveness of domestic administrative and political authority, as well as sovereign autonomy, understood as the capacity to exclude external actors from domestic policy decisions.

The Swiss-UK and Swiss-German agreements show hints of each of these problems. Under the terms of those agreements, if Germany or the UK adjust their tax rates on income or gains after the agreements are signed, withholding tax imposed by Switzerland is amended by the same number of percentage points that the statutory rates are amended, unless the competent authority of Switzerland decides that it will not adjust the applicable tax rates.¹⁷² The agreements thus cede to Switzerland a measure of final authority over whether the income and gains of German and UK residents will be taxed according to German and UK law. From a practical standpoint, it is difficult to imagine Switzerland refusing to adjust withholding rates consistent with German or British policy decisions, out of fear of retaliation and a desire to see the Swiss approach accepted internationally, at least currently. But when generalized to other countries, the fact that the Swiss retain even a nominal right to overrule British and German tax policy decisions with respect to German and British nationals has remarkable implications for tax sovereignty. It highlights that the Swiss view that Germany and the United Kingdom's receipt of income from their nationals investing through Switzerland is a discretionary Swiss policy decision rather than a matter of right. In principle the Swiss agreements require jurisdictions to (1) cede a measure of their ability to assert their taxing authority domestically over their residents, (2) consider Swiss reactions in the course of making domestic taxing decisions, and (3) forego the option of seeking additional information from their residents.

These problems crystallize when one imagines anonymous withholding along the lines of the Swiss–UK/German agreements, but in the context of an agreement between an asset management jurisdiction and a less powerful middle-income economy. A country without significant market leverage over Switzerland or other offshore asset management jurisdictions would, by entering into anonymous withholding agreements, significantly

¹⁷² U.K.-Switz. Cooperation Agreement, *supra* note 108, at art. 20(2). The United Kingdom and Germany may change their tax rates applicable to income and gain, and in such instances they must inform Switzerland without delay. At that point, Switzerland has 30 days to inform the countries as to whether it refuses to adjust the rates at which it withholds anonymously by the same percentage as the rates have changed under UK or German law. *Id.* Under the Swiss-UK Agreement, the UK is allowed to terminate the agreement with six months' notice if Switzerland does not adjust its withholding rate to correspond with a domestic UK rate change. *Id.* at art. 44(4). This is more flexible than the general termination rules under the agreement, which are intended to lock both jurisdictions into the agreement by requiring at least two years notice to terminate. *Id.* at art. 44(1).

compromise its unilateral control over the appropriately domestic decisions about tax rates on capital income of domestic residents. Policymakers in such a jurisdiction would need to ask whether, if they altered their domestic taxing regime, Switzerland and every other jurisdiction providing them with anonymous withholding services would agree to go along. If such a jurisdiction were to rely on anonymous withholding, some of the resources that sustain the state would be in another sovereign's hands. Sovereign autonomy could be significantly compromised for most countries, and over time, large asset management jurisdictions could gain significant power over many countries' tax policy choices.

Further, imagine a country that wanted to maintain or move to a comprehensive income tax system. The Swiss agreements assume a jurisdiction has chosen to have a schedular income tax system (taxing different categories of income at fixed, flat rates) rather than a comprehensive income tax that applies a graduated rate schedule to all income or defined categories of income. Progressive income tax systems are not compatible with an anonymous withholding regime. Information reporting and anonymous withholding cannot coexist even in theory except in a schedular system; anonymous withholding necessarily precludes a comprehensive income tax with graduated rates and other tax benefits that phase-out with income.¹⁷³ In this way, anonymous withholding agreements compromise any state's authority over the domestic tax regime.

A critic might acknowledge the above concerns regarding domestic policy flexibility and sovereign autonomy, but dismiss them as alarmist, since there is heavy bias for home-country asset management. Today only 6.5% of global wealth is managed offshore. As described in Part I, this statistic masks the reality that in some regions outside the most-developed economies, offshore asset management is effectively the norm. For example, in Argentina, at least 47% of national wealth (and 64% of the wealth controlled by households with greater than \$100,000 in managed assets) is managed offshore.¹⁷⁴ Further, the offshore asset management industry continues to grow. The potential for expanded growth in the context of anonymous withholding is highlighted by the fact that the Swiss-German anonymous withholding agreement was explicitly conditioned on German concessions to facilitate Swiss financial institutions' access to German customers.¹⁷⁵ The concessions Switzerland extracted from Germany make it easier for wealthy Germans to bank exclusively through Swiss institutions without the Swiss

¹⁷³ For example, it does not seem possible to administer an income tax system that includes an earned income tax credit that is not available to those with substantial amounts of capital income in a system characterized by anonymous withholding of capital income.

¹⁷⁴ BCG, GLOBAL WEALTH, *supra* note 18, at 12. Nor is Argentina unique. For instance, in Mexico, in the period from 2005 to 2010, 75% of the 47% of national wealth held by millionaire households was managed offshore. *Id.*

¹⁷⁵ The Swiss negotiated for simplified exemptions from regulation under the German Banking Act for Swiss financial institutions that want to supply banking and financial products in Germany, and were able to eliminate the requirement to either create a subsidiary or branch in Germany, or operate in partnership with an existing German financial institution, in order to legally serve German clients. *See* Press Release, Swiss Federal Department of Finance, Switzerland and Germany Initial Tax Agreement, *supra* note 108.

institution maintaining any German footprint.¹⁷⁶ If, in exchange for anonymous withholding, offshore asset management jurisdictions were able to consistently extract concessions allowing them to legally compete with domestic financial institutions without having local footprints or being subject to local regulation, a further shift toward offshore asset management among wealthy individuals could easily become a reality.

In contrast to anonymous withholding, an automatic information exchange regime would strengthen sovereign authority and thereby improve policy flexibility and governance capacity, particularly for less powerful sovereigns. Rather than constraining the set of tax policy choices a government may make, as anonymous withholding would, automatic information exchange broadens the potential for tax policies that can be consistently enforced among all residents. It allows for a more legitimate and comprehensive domestic political authority while reclaiming for the state authority over the consequences of financial globalization. Thus, automatic information exchange regimes fortify sovereign state-building and effective governance, particularly for emerging economies and less powerful states.

C. Political Dynamics

Practically speaking, most nation-states are unlikely to provide anonymous withholding, and those that do are unlikely to provide anonymous withholding to all other nation-states. Furthermore, the proponents of an anonymous withholding system have no interest in its globalization. Most policymakers should prefer automatic information reporting to anonymous withholding because the latter cannot be globalized, and there will come a point when anonymous withholding arrangements will impede progress towards information reporting arrangements for all but the most economically powerful countries. Thus, if only a small number of developed countries accept the anonymous withholding model, this is likely to produce a system that benefits an only slightly broader circle of developed economies without helping most other governments. In contrast, automatic information exchange solutions that initially meet the demands of developed economies can be globalized over time to also provide benefits to other tax administrations.

The likely equilibrium for an anonymous withholding regime like that put forth by Switzerland would be that Switzerland reaches essentially one-way agreements with the

¹⁷⁶ The German Banking Act generally provides that financial service providers from non-European Economic Area countries (Switzerland is not in the EEA) that want to supply banking and financial products in Germany must obtain a permit to create a subsidiary or branch in Germany. KREDITWESENGESETZ [KWG] [GERMAN BANKING ACT], Sept. 9, 1998, BUNDESGESETZBLATT [BGBL.] 1522, as amended, § 32(1), § 33(1)(6), § 53(1) (Ger.). Such financial institutions are subject to the German banking rules regardless of whether they are established or resident in Germany, or are located or resident abroad but have focused on the German market to carry out business with persons who are resident or ordinarily resident in Germany. *Id.* § 32. Furthermore, client relationships with German residents must be established through a domestic financial institution. Under the agreement reached between Switzerland and Germany, the permit exemption procedure that was technically available to Swiss institutions will be simplified, and the obligation for Swiss institutions to initiate legal client relationships via a local German financial institution will be eliminated.

large developed economies that can exert pressure on Switzerland for cross-border tax administrative support, and then ceases to negotiate further anonymous withholding agreements with other governments. In time, pressure from the major developed economies would likely lead other large offshore asset-management jurisdictions to follow Switzerland's lead and reach agreements with these states as the price of resolving conflicts with the major developed economies. The other imaginable equilibrium is a reciprocal broadly multilateral anonymous withholding regime in which most jurisdictions around the world agree to withhold anonymously for most other jurisdictions. This result is highly implausible, in part because large developed economies are unlikely to agree to automatically collect tax for other, less powerful sovereigns.

Limited One-Way Anonymous Withholding Agreements

Switzerland's leadership recognizes that anonymous withholding in a small number of targeted agreements can diffuse pressure for Swiss information reporting to a broader group of countries.¹⁷⁷ Thus, in their agreements with the UK and Germany, the Swiss insisted that those countries each commit to uphold the anonymous withholding model and not to work against it in dealings with third parties.¹⁷⁸ Once anonymous withholding agreements are reached with each of the large financial centers with which the Swiss financial industry does business (and in which Swiss banks have substantial business operations), the remainder of the world's jurisdictions would be relatively powerless to put pressure on Switzerland or its banks to further erode bank secrecy, or even to make anonymous withholding more widely available to other jurisdictions.

While providing anonymous withholding for a few large financial centers may result in the loss of a dedicated tax-evader business for clients residing in those jurisdictions, the Swiss could continue to manage the assets of nonresidents from most of the world on a tax-shielded basis. Eventually the large financial centers may be able to pressure other offshore asset management centers into similar anonymous withholding agreements if they wish. The Swiss-UK and Swiss-German agreements appear structured to produce precisely such negotiations. Each agreement includes provisions that both allow German and UK taxpayers to evade the force of the agreement by moving their assets before the effective date, and also give Germany and the UK information on the jurisdictions to which those taxpayers most commonly choose to move those untaxed assets.¹⁷⁹

¹⁷⁷ See *Steuerabkommen: Daumen drücken*, BILANZ.CH (Dec. 10, 2011), available at <http://www.bilanz.ch/unternehmen/steuerabkommen-daumen-druecken>.

¹⁷⁸ Both agreements provide that the parties will "neither violate the provisions [of the agreement] through an unilateral act nor work against the agreed provisions in their dealings with third parties." Agreement between the Swiss Confederation and the United Kingdom of Great Britain and Northern Ireland on cooperation in the area of taxation, Joint Declaration Concerning the Equivalence of this Agreement; Ger.-Switz. Cooperation Agreement, *supra* note 110, Gemeinsame Erklärung der Vertragsstaaten zur Gleichgewichtigkeit des Abkommens (Joint Declaration Concerning the Equivalence of this Agreement).

¹⁷⁹ British and German residents who transfer their assets before the last day of the fifth month following the effective date of the agreement can avoid the withholding tax imposed as the default compliance

It is important to recognize that for any large developed economy, anonymous withholding by Switzerland alone is unlikely to substantially deter tax evasion. High-quality wealth-management services are available in many jurisdictions. Arrangements based on the German and UK agreements only ensure that dedicated tax evaders from countries with such agreements do not keep Swiss bank accounts if they wish to avoid taxation. Evaders can easily close Swiss accounts and open accounts in other jurisdictions (e.g. Singapore), including non-Swiss branches of a Swiss bank. The agreements between Switzerland and the United Kingdom and Germany state that Swiss banks will not “actively encourage” their current clients to use this strategy—a provision of questionable enforceability and relevance, given that the agreements both permit and anticipate the transfers. Swiss banks are allowed to facilitate these asset transfers on request from current customers, and to promote evasion through non-Swiss branches of Swiss banks going forward. Thus, the statistical disclosure in the Swiss agreements enables Switzerland to enlist Germany, the UK, and other governments with which it enters agreements to level the playing field for Switzerland, relative to other offshore asset management jurisdictions.

While Germany and the UK would be motivated to pursue further anonymous withholding agreements after ratifying their agreements with Switzerland, they (or any other developed economies that accept the Swiss model) would be highly unlikely to act as surrogate negotiators for automatic information exchange with the rest of the world. Having accepted the premise, with Switzerland, that anonymous withholding is an acceptable substitute for automatic information reporting, and having agreed not to work against the anonymous withholding model, the current German and UK governments are somewhat unlikely to take another position in subsequent negotiations. This would include any negotiations with jurisdictions that Swiss data suggests are the major destinations for German and UK evader funds.¹⁸⁰ To regain policy flexibility to support automatic information exchange, Germany and the UK likely need to affirmatively decide not to ratify (or decide to terminate) their agreements with Switzerland.

Broadly Multilateral Reciprocal Anonymous Withholding

The second imaginable steady-state solution arising from the Swiss approach is a broadly multilateral anonymous withholding regime in which jurisdictions around the world agree to withhold anonymously for one another. Such a solution is unrealistic. Offshore asset-management jurisdictions have no interest in a global reciprocal anonymous withholding system. More importantly, the large developed economies would not contemplate such a system. The revenue Germany and the UK would receive through anonymous withholding from Switzerland greatly exceeds the amounts they would need to transfer to

provision under the treaties. See Ger.-Switz. Cooperation Agreement, *supra* note 110, at art. 16; U.K.-Switz. Cooperation Agreement, *supra* note 108, at art. 18.

¹⁸⁰ The Labor party in the UK and the SPD in Germany both oppose the Swiss agreements, such that those agreements may not be ratified or, if ratified, might be terminated by a subsequent German or UK government.

Switzerland if they were withholding on its behalf. Nevertheless, in their agreements with Switzerland, Germany and the UK agree only that Switzerland may request that measures be introduced by the UK or Germany that provide exchange of information from the UK or Germany to Switzerland, and only to the extent similar approaches are adopted by the UK or Germany in relation to other states.¹⁸¹ Switzerland represents an unusual case in which the revenue flow would be overwhelmingly in Germany or the UK's favor. It is hard to imagine that these jurisdictions would be prepared or willing to provide anonymous withholding in the vast majority of cases, where the outflows from the German or UK fisc could vastly exceed the inflows to those fiscs.

British and German hesitancy in this regard is both predictable and consistent with widely prevailing concepts of sovereignty in the tax context. In contrast to information reporting, anonymous withholding implies more than mere cooperation among governments. Rather, it requires governments to collect tax for one another. Cross-border anonymous withholding is a form of automatic collection assistance provided to other sovereigns. In the common law countries (which represent approximately half of the world's GDP),¹⁸² the presumption against collecting revenue for other governments runs deep, both as a legal matter and as a policy matter. It is judicially enshrined in the "revenue rule." The revenue rule overrides what are otherwise commonly applicable norms of cross-border judicial comity, and holds that a court will not give domestic effect to the taxes, fines, or penalties imposed by a foreign sovereign.¹⁸³ Having come into the common law in England in the 18th century,¹⁸⁴ this rule was recognized in U.S. law in the early 19th century,¹⁸⁵ and by high courts in a variety of other common law

¹⁸¹ U.K.-Switz. Cooperation Agreement, *supra* note 108, at art. 35; Ger.-Switz. Cooperation Agreement, *supra* note 110, at art. 33.

¹⁸² M. Marshall, *World Economy Hinges on China's Bankruptcy Law*, *Wood Says*, VA. L. (Mar. 16, 2005), http://www.law.virginia.edu/html/news/2005_spr/china_wood.htm http://www.law.virginia.edu/html/news/2005_spr/china_wood.htm (last visited Jan. 9, 2012).

¹⁸³ RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 483 & reporter's note 1 (1987) (citing *Holman v. Johnson*, (1775) 98 Eng. Rep. 1120 (K.B.)) ("Courts in the United States are not required to recognize or to enforce judgments for the collection of taxes, fines, or penalties rendered by the courts of other states."). The sovereignty concerns underlying the revenue rule also explain why tax debts and claims are generally excluded from conventions and instruments regulating international cooperation in recognizing and enforcing legal judgments that are of general (rather than tax-specific) application. *See, e.g.*, Brussels Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters, Sept. 27, 1968, 1998 O.J. (C 27) 1 (consolidated version); Council Regulation on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, EC/44/2001, L/12/2 (Dec. 22, 2000) (excluding revenue, customs, and administrative matters from its scope of application via article 1.1 of that regulation). *But see* European Convention on Mutual Assistance in Criminal Matters, Apr. 20, 1959, 472 U.N.T.S. 185 (allowing assistance in processing fiscal offences).

¹⁸⁴ The rule as known at common law dates at least to *Attorney General v. Lutwydye*, a 1729 English court case in which an English court held that it could not enforce a bond executed in Scotland to enforce Scottish import duties on tobacco because the obligation was a foreign tax obligation. *Att'y Gen. v. Lutwydye*, (1729) 145 Eng. Rep. 674 (Ex. Div.). *See also* Brenda Mallinak, *The Revenue Rule: A Common Law Doctrine for the Twenty-First Century*, 16 DUKE J. COMP. & INT'L L. 79 (2006).

¹⁸⁵ *See, e.g.*, *Ludlow v. Van Rensselaer*, 1 Johns. 94 (N.Y. Sup. Ct. 1806) (defendant could not avoid enforcement of promissory note on the basis that plaintiff had violated a French revenue provision requiring French stamp tax first be paid).

jurisdictions, both before and after that period.¹⁸⁶ And although it began as a common law doctrine, the revenue rule is now so deeply entrenched as a default in both common law and civil law jurisdictions that it is sometimes described as “the first and most fundamental rule of international tax law.”¹⁸⁷

Policymakers commonly understand limitations on the extent to which a nation will provide collection assistance as a straightforward application of the principle of territorially limited state sovereignty. A key component of exclusive territorial authority is the unique right to impose tax on that territory. As a first-order matter, maintaining sovereignty requires the sovereign authority within a state to exclude another state from pursuing its tax claims in the territory of the home state.¹⁸⁸ The default assumptions that stipulate appropriate behavior by a political entity in a given situation create a substantial presumption against collection assistance.¹⁸⁹ States may agree to provide a taxing benefit on their territory to other states, but they must be provided significant incentives to do so.

Without strong contrary incentives, powerful states are particularly unlikely to allow the erosion of their sovereign authority through facilitation of extraterritorial exercise of taxing power within their territory. This fact explains why, although the OECD Model Tax Convention has included a model provision for assistance in collection in specific cases (assuming all necessary information can be provided by the residence country)

¹⁸⁶ See, e.g., *United States v. Harden*, [1963] 41 D.L.R.2d 721 (Can.); *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398, 413–14, 448, 450 n.11 (1964). See also *Williams & Humbert Ltd. v. W&H Trade Marks (Jersey) Ltd.*, (1986) 1 All E.R. 129, 133–34 (H.L.) (Although the “revenue laws may in the future be modified by international convention or by the laws of the European Economic Community[,] . . . at present the international rule with regard to the non-enforcement of revenue and penal laws is absolute.”); *Peter Buchanan L.D. v. McVey*, [1955] A.C. 516, 524–28 (Ir. H. Ct. 1950) (surveying application of the revenue rule by United Kingdom courts), *aff’d*, [1955] A.C. 530 (Ir. S.C. 1951); *Government of India v. Taylor*, [1955] A.C. 491, 508 (H.L.) (denying claim of Indian government for unpaid taxes against company in liquidation in Britain because British courts would not enforce Indian revenue laws, stating “we proceed upon the assumption that there is a rule of the common law that our courts will not regard the revenue laws of other countries: it is sometimes, not happily perhaps, called a rule of private international law: it is at least a rule which is enforced with the knowledge that in foreign countries the same rule is observed.”); William S. Dodge, *Antitrust & the Draft Hague Judgments Convention*, 32 LAW & POL’Y INT’L BUS. 363, 373 n.43 (2001) (treating the application of the revenue rule in both common law and civil law countries as a subcategory of a disinclination to enforce foreign public law).

¹⁸⁷ Vitaly S. Timokhov, *Enforcing Tax Judgements across Borders: How Collection Assistance Can Overcome Limitations of the ‘Revenue Rule’* (pts. 1 & 2), J. INT’L TAX’N, June 2003, at 34, 14 J. INT’L TAX’N, Sept. 2003, at 20.

¹⁸⁸ See, e.g., U.N. Secretariat, *Mutual Assistance in Collection of Tax Debts*, Report of the United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters, U.N. Doc. ST/SG/AC.8/2001/L.2 (Aug. 30, 2001); Jeffery C. Atik, Comment, *The Problem of Reciprocity in Transnational Enforcement of Tax Judgements*, 8 YALE STUD. WORLD PUB. ORD. 156 (1981); ASIF H. QURESHI, *THE PUBLIC INTERNATIONAL LAW OF TAXATION* (1994); Alan R. Johnson, Lawrence Nirenstein & Stephen E. Wells, *Reciprocal Enforcement of Tax Claims through Tax Treaties*, 33 TAX LAW. 469 (1980); Ludwig, R., *L’assistance internationale au recouvrement de l’impôt*, 56 REVUE DU TRÉSOR, Nos.10–12, 1975.

¹⁸⁹ See generally KRASNER, *supra* note 146 (arguing that in the international system logics of consequences, meaning rational calculation designed to maximize a given set of unexplained preferences, tends to trump logics of appropriateness).

since 2003, the official commentary describes the provision in realist terms.¹⁹⁰ The agreed commentary observes that during negotiations each contracting state will need to decide whether collection assistance upon request (i.e., limited to specific cases) should be included in a treaty with another state based on its own instrumental motives and legal traditions.¹⁹¹ The OECD Model Commentary acknowledges that even when tax debts are fully determined by the residence state, and even in the limited context of case-specific assistance, collection assistance will only be provided between sovereigns where there is an alignment of interests and a shared judgment as to mutual economic benefit.¹⁹²

Multilateral Automatic Information Exchange

Unlike cross-border collection assistance, the idea of cross-border tax information exchange has global acceptance, at least upon request. Since 2009, every financial center of any significance, including all 100+ member countries of the Global Forum on Transparency and Exchange of Information, has endorsed the international standards calling for tax information exchange. Those standards are also endorsed by the G8, the G20, the United Nations, and the OECD. They call for exchange of information on request where it is “foreseeably relevant” to the administration and enforcement of the domestic laws of the treaty partner, provided that the exchanged information is only used for legitimate tax administration purposes. There are no restrictions on exchange permitted on the basis of bank secrecy or domestic tax interest requirements.¹⁹³ A “high-

¹⁹⁰ The United Nations Model Double Taxation Convention between Developed and Developing Countries has no collection assistance provision, although the UN Tax Committee is reported to have agreed to include an assistance collection provision in the next version of the UN Model Convention. Michael Lennard, Chief of the Int’l Tax Cooperation & Trade Section at the U.N. Fin. for Dev. Office, *The UN Model Tax Convention as Compared with the OECD Model Tax Convention—Current Points of Difference and Recent Developments*, 15 ASIA-PAC. TAX BULL. 4 (2009).

¹⁹¹ OECD Model Convention, *supra* note 19, at art. 27 cmt. ¶ 1. These factors are similar to the factors cited by the Joint Committee on Taxation in explaining the inclusion of a collection assistance provision in the 1995 Protocol to the U.S. Tax Treaty with Canada. JOINT COMM. ON TAX’N, JCS-15-95, EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND CANADA SCHEDULED FOR A HEARING BEFORE THE COMMITTEE ON FOREIGN RELATIONS UNITED STATES SENATE ON MAY 25, 1995 (Comm. Print 1995).

¹⁹² The idea of cross-border collection assistance in some form does have a longstanding place in international tax dialogue, but has never made much headway. The first proposal for cross-border collection assistance arose in the League of Nations and resulted in the formulation of a specific model treaty dealing with intergovernmental collaboration in recovering the tax claims of another state in specific cases. Fiscal Comm., London and Mexico Model Tax Conventions: Commentary and Text, League of Nations Doc. No. C.88.M.88.1946.II.A., at 100 (1946) (Model Bilateral Convention for the Establishment of Reciprocal Administrative Assistance for the Assessment and Collection of Direct Taxes; Model Bilateral Convention for the Establishment of Reciprocal Administrative Assistance for the Assessment and Collection of Taxes on Income, Property, Estates and Successions). Subsequently the OECD developed the Model Convention for Mutual Administrative Assistance in the Recovery of Tax Claims in 1981. OECD, MODEL CONVENTION FOR MUTUAL ADMINISTRATIVE ASSISTANCE IN THE RECOVERY OF TAX CLAIMS (1981). In both cases collection assistance was limited to specific cases, rather than any form of automatic withholding arrangement, let alone anonymous withholding. Neither convention ever came into force.

¹⁹³ See, e.g., JEFFREY OWENS & PASCAL SAINT-AMANS, OECD, PROMOTING TRANSPARENCY AND EXCHANGE OF INFORMATION FOR TAX PURPOSES: A BACKGROUND INFORMATION BRIEF 2 (2010); *Work on Exchange of Information and Conclusion*, U.N. E.S.C.O.R. Comm. of Experts on Int’l Cooperation in Tax

level working panel” convened by the United Nations has previously proposed an International Tax Organization to provide a mechanism for multilateral tax information sharing to curb the scope tax evasion on investment income earned abroad.¹⁹⁴

The globally agreed standards are formally cabined to information exchange upon request. Thus, the breach of bank secrecy that these standards require technically only applies where there is a request for foreseeably relevant information about a specific individual. However, there is nothing in the standards that is conceptually limited to exchange upon request, and no normative reason for exchange to be limited to information about one individual at a time. Indeed, a newcomer with fresh eyes looking at these internationally agreed standards would have a difficult time understanding why they did not mandate that all ascribing jurisdictions routinely provide information exchange in those cases where the information is “foreseeably relevant” (e.g., capital income accumulating to a known resident of another state with an income tax).

The recently revised Convention on Mutual Administrative Assistance in Tax Matters (the Multilateral Convention) provides a multilateral framework under which automatic cross-border tax information exchange could be established among a broad range of sovereign participants. The Multilateral Convention’s stated objective is to enable each party to the convention to counter international tax evasion and better enforce its national tax laws, while simultaneously respecting the rights of taxpayers. In 1988, the convention was opened for signature by the fifty-four countries that are members of either the Council of Europe or of the OECD (or both). As structured originally, the Multilateral Convention was of limited applicability and no practical import.¹⁹⁵ In 2009, the G20 requested that the treaty be modernized and that developing countries be allowed to benefit from a new, more cooperative international tax environment.¹⁹⁶ To this end, in

Matters, 2d Sess., Oct. 30–Nov. 3, 2006, E/c.18/2006/6/Add.1 (2006); G8, *The Gleneagles Communiqué* 14(i) (2005); G20, *Communiqué: Meeting of Finance Ministers and Central Bank Governors* ¶20 (2005), available at http://www.g20.org/Documents/2005_china.pdf; G7, *Economic Communiqué: Making a success of globalization for the benefit of all* ¶16 (1996), available at www.g7.utoronto.ca/summit/1995halifax/financial/index.html; OECD, *THE GLOBAL FORUM ON TRANSPARENCY AND EXCHANGE OF INFORMATION FOR TAX PURPOSES 2* (2011). See also, e.g., OECD, *OVERVIEW OF THE OECD’S WORK*, *supra* note 19; OECD, *TAX CO-OPERATION 2010: TOWARDS A LEVEL PLAYING FIELD—ASSESSMENT BY THE GLOBAL FORUM ON TRANSPARENCY AND EXCHANGE OF INFORMATION FOR TAX PURPOSES* 9, 15 (2010). A “domestic tax interest requirement” is a domestic law rule that tax information can only be exchanged with another government if it is also relevant to the tax burden imposed on the taxpayer by the jurisdiction providing the information.

¹⁹⁴ Report of the High-Level Panel on Financing for Development, U.N. GAOR, 55th Sess., Agenda Item 101, U.N. Doc. A/55/1000 (June 26, 2001), <http://www.un.org/esa/ffd/a55-1000.pdf> (last visited Feb. 2, 2012).

¹⁹⁵ OECD, *Convention on Mutual Administrative Assistance in Tax Matters* pmbl., May 27, 2010, available at <http://www.oecd.org/dataoecd/63/49/48980598.pdf>. (acknowledging that the Multilateral Convention appeared to be a novel step forward in multilateral tax cooperation when agreed in the 1980s, but was thereafter disregarded and left almost entirely unused even by its signatories).

¹⁹⁶ *The Convention on Mutual Administrative Assistance in Tax Matters—Background*, OECD, June 4, 2010, http://www.oecd.org/document/2/0,3746,en_2649_33767_44886082_1_1_1_1,00.html (last visited Dec. 20, 2010). UK Prime Minister Gordon Brown, as chair of the G20, indicated in a letter to the OECD that “it would be helpful, in this regard, if an effective multilateral mechanism could be developed”. *Id.*

2010, the Multilateral Convention was amended in 2010, and membership was opened up to all countries, putting particular emphasis on including emerging economies.

The 2010 protocol made certain changes that (when integrated with the pre-existing convention) made the Multilateral Convention a landmark agreement. The protocol incorporates the internationally-accepted standards for the exchange of foreseeably relevant information regardless of bank secrecy, and moves in the direction of routine information exchange by requiring signatories to accept requests with respect to “ascertainable groups or classes of persons,” instead of requests with respect to specific identified individuals. This aspect of the protocol indicates a shift in international norms toward automatic information exchange.¹⁹⁷ The Multilateral Convention further opens the door to automatic information exchange through provisions intended to facilitate such exchange, if competent authorities choose to bring automatic information exchange into force.¹⁹⁸

The amended Multilateral Convention can function as a full-fledged vehicle for automatic information exchange among signatories, while requiring countries to protect taxpayer information from misuse and respect taxpayer rights. On June 1, 2011, the convention was opened to signature by any country in the world. As of December 2011, Argentina, Australia, Brazil, Azerbaijan, Belgium, Canada, Denmark, Finland, France, Georgia, Germany, Iceland, Indonesia, Ireland, Italy, Japan, Korea, Mexico, Moldova, Netherlands, Norway, Poland, Portugal, Russia, Slovenia, South Africa, Spain, Sweden, Turkey, the United Kingdom, the United States, and the Ukraine had signed the Protocol to the Multilateral Convention, and every G20 member had endorsed it.¹⁹⁹

¹⁹⁷ The protocol amends the convention so as to clarify that a request can be made without the name and address of a specific taxpayer, Article III of the 2010 Protocol, Amending Article 18 of the Convention (information to be provided by the applicant state), and the Explanatory Report to the Convention goes on to explicitly bless requests made with respect to ascertainable groups or classes of persons. See Explanatory Report to the Convention as amended by the Protocol, Protocol amending the Convention on Mutual Administrative Assistance in Tax Matters, para. 194 (May 27, 2010), available at <http://www.ustreas.gov/press/releases/reports/oecd%20maa%20tax%202010.pdf><http://www.ustreas.gov/press/releases/reports/oecd%20maa%20tax%202010.pdf>.

¹⁹⁸ Art. 6 of the Multilateral Convention.

¹⁹⁹ Council of Europe, *Status of the Convention on Mutual Administrative Assistance in Tax Matters and Amending Protocol*, COUNCIL OF EUR. (Dec. 20, 2011), <http://conventions.coe.int/Treaty/Commun/ChercheSig.asp?NT=127&CM=1&DF=&CL=ENG> (last visited Jan. 30, 2012). The members of the G20 are Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, the Republic of Korea, Turkey, the United Kingdom, and the United States. *About G-20*, G-20, <http://www.g20.org/en/g20/what-is-g20> (last visited Jan. 30, 2012). At the November 2011 G20 Summit, all G20 countries noted that “we will consider exchanging information automatically on a voluntary basis as appropriate and as provided for in the convention.” The Group of Twenty, *Cannes Summit Final Declaration – Building Our Common Future: Renewed Collective Action for the Benefit of All*, G-20 ¶ 35 (Nov. 4, 2011), <http://www.g20-g8.com/g8-g20/g20/english/for-the-press/news-releases/cannes-summit-final-declaration.1557.html> (last visited Jan. 30, 2012).

One of the critical principles under today's existing international standards for information exchange upon request is that the residence state receiving information must ensure that exchanged information is only used for legitimate tax administration purposes.²⁰⁰ Countries that do not abide by this standard are not entitled to information exchange upon request under current international standards. The Global Forum on Transparency and Exchange of Information for Tax Purposes ("Global Forum"), a peer review body that includes over 100 member jurisdictions, is mandated to assess jurisdictions to ensure that they all adhere to this high standard, and those assessments are ongoing today. In an automatic information exchange system, the same high standards proscribing misuse of information would presumably apply. In fact, the current members of the Multilateral Convention have clarified that they will not admit to the convention new countries that do not have proper safeguards in place to ensure that exchanged information will not be misused. A multilateral automatic information exchange system would need to enforce both (1) the existing Multilateral Convention's upfront requirement that governments have laws in place consistent with international standards to prevent the misuse of exchanged information and (2) provide for monitoring systems and credible sanctions over time (most notably, denial of information exchange or removal from the multilateral system) as part of the establishment of any multilateral automatic information exchange system.²⁰¹ Taking these two steps would both protect the integrity of an automatic information exchange system and very substantially encourage

²⁰⁰ The current globally-agreed rules developed over a long period in response to, *inter alia*, the concern that information exchange could be used to facilitate improper efforts to attach or confiscate assets by abusive or illegitimate regimes. Such concerns are important in an information exchange upon request system. Indeed, these concerns are more pronounced in information exchange upon request than in automatic information exchange, because unlike automatic information exchange, information exchange upon request asks the requested jurisdiction to use its investigatory powers on behalf of the requesting state. The protections for taxpayer rights and exchanged information built into the current international standards are focused on ensuring that exchanged information is only used for legitimate tax administration purposes. See OECD Model Convention art. 26(2); OECD Model TIEA art. 8; Terms of Reference to Monitor and Review Progress Towards Transparency and Exchange of Information for Tax Purposes, Global Forum on Transparency and Exchange of Information, at 8 *available at* <http://www.oecd.org/dataoecd/37/42/44824681.pdf> (describing the globally agreed standard against which all 102 members of the Global Forum are presently being assessed, including terms of reference C.3. and C.4. regarding protecting against misuse of information and ensuring safeguards for taxpayers) [hereinafter "Global Forum Terms of Reference"]. *See also supra* note 103.

²⁰¹ The appropriate monitoring system could involve an expansion of the current Global Forum assessment process, with a special in-depth ongoing monitoring system on the question of whether automatically exchanged information is used by a government that receives information in ways consistent with the existing international standards that protect taxpayers' rights and proscribe use of exchanged information for purposes other than legitimate tax administration purposes. Indeed, the beginnings of such a process will commence later in 2012. At that point, the Global Forum on Transparency and Exchange of Information will launch "Phase II" peer reviews of whether jurisdictions comply in practice with existing international standards for information exchange upon request. The Phase II peer reviews will consider whether, in practice, jurisdictions conform to the rules limiting the use of information exchanged upon request to legitimate tax administration purposes. *See Revised Methodology for peer Reviews and Non-member Reviews*, Global Forum on Transparency and Exchange of Information for Tax Purposes (2011), *available at* <http://eoi-tax.org/keydocs/2e322d785ed58b73985d040598b1aea9>. *See also Tax Transparency 2001: Report on Progress*, Global Forum on Transparency and Exchange of Information for Tax Purposes (November, 2011), *available at* <http://www.oecd.org/dataoecd/52/35/48981620.pdf>.

improved compliance with global standards for protecting taxpayer information from misuse.

The trend in universally-accepted standards for information exchange, the development of a series of emerging automatic information exchange approaches, and the progress made by the Multilateral Convention suggest that acceptance of a widely utilized system that requires financial institutions to function as cross-border tax intermediaries through automatic information reporting may be within reach.²⁰²

IV. The Path Towards a Multilateral Automatic Information Reporting System

Any new regime for routine cross-border administrative assistance is likely to become an institutionally embedded structure that is susceptible to long periods of stasis. The risk of stasis following the present evolutionary moment in cross-border tax administrative assistance raises the stakes in the present contest between anonymous withholding and automatic information reporting. Since a partial anonymous withholding system can emerge via contracting while automatic information exchange requires coercion, partial anonymous withholding is the easier and more likely default. To avoid partial anonymous withholding and establish the superior automatic information reporting system, governments will have to make steady progress towards multilateral approaches to information exchange, and impose coercive incentives for participation.

As suggested in Part II, the starting point for a multilateral system likely involves reconciling the current OECD, EU, and U.S. approaches.²⁰³ Building such a system requires substantial agreement among participating countries about certain design features. The key dimensions of the OECD, EU, and U.S. systems that would need to be reconciled are routing, identification, reporting, scope, verification, and incentives. A comprehensive blueprint for reconciling the emerging approaches to automatic information reporting along each of these dimensions is beyond the scope of this article.²⁰⁴ The purpose here is to offer some general observations as what can be done to reconcile the emerging approaches and promote a multilateral system. That said, the remainder of this Part is primarily intended for stakeholders and policymakers who may

²⁰² The United Nations proposal for an International Tax Organization, discussed *supra* note 194, shows normative support for a global routine information reporting regime, but as a practical matter the Multilateral Convention and the internationally agreed standards on tax information exchange and transparency are more important given the current distribution of influence among multilateral organizations in the international tax area.

²⁰³ Note that among other things, this section responds to my colleague Stafford Smiley's important question, "What does FATCA have to add?" See Smiley, *supra* note 12.

²⁰⁴ One obvious point is that reciprocal identification and reporting obligations would need to be imposed on financial institutions in all participating jurisdictions. This would mean that, for example, U.S. financial institutions would need to collect the same information on accounts of non-U.S. persons that the U.S. wished to receive with respect to U.S. persons with offshore accounts. The U.S. Treasury Department has not yet provided regulatory guidance to this effect as a companion to its efforts under FATCA. There are a wide range of other issues related to reconciling the emerging information exchange approaches that are beyond the scope of this article.

engage this debate, and assumes some prior knowledge. Some readers may wish to skip to the conclusion.

First, the rules for establishing a multilateral automatic information reporting regime should be bifurcated: participating jurisdictions should impose one set of obligations on financial institutions located in other participating jurisdictions, and a different, more stringent set of obligations on financial institutions located outside participating jurisdictions. Not only are different design decisions appropriate for these two fact patterns, but, as the discussion below illustrates, creating two separate regimes would likely spur financial institutions to pressure governments to participate, since participation could reduce the burden for domestic financial institutions. Second, governments also must agree on a set of coercive incentives that push non-cooperating jurisdictions to join the system and financial institutions to comply even before their governments do. While bifurcated rules are necessary, they are not alone sufficient to encourage the creation of a multilateral automatic information exchange system. The following discussion illustrates the application of these two principles for building a multilateral automatic information exchange system by considering certain design questions associated with routing, identification, verification and incentives in a multilateral system.

Routing

Routing issues are important because they represent the most basic structural inconsistency between today's emerging automatic information exchange approaches. Routing also deserves attention because routing raises questions about sovereign access to and authority over information. Under the OECD approach, financial institutions report information regarding specific items of income received by a taxpayer *to the government of the country of source of the income received by the taxpayer*. That government may then decide to exchange the information with the taxpayer's country of residence if it so desires and if appropriate information exchange arrangements are in place. Under the EU approach, in contrast, financial institutions report on specific items of income received by an EU resident to the government *where the financial institution managing the assets resides*. Information related to each other's resident taxpayers is then exchanged between EU governments through arrangements of reciprocity. Finally, under FATCA, foreign financial institutions report comprehensively on assets and certain measures of income of U.S. persons held and/or earned through accounts at those institutions.²⁰⁵ They report directly to the government of the jurisdiction *where the taxpayer resides* (the United States).

The EUSD's routing system is superior for jurisdictions that are cooperating with one another. It ensures that financial institutions in cooperative jurisdictions need only send information to one government, under whose law they already operate, thereby avoiding the specter of thousands of financial institutions attempting to comply with different reporting obligations to dozens of governments. Reporting by financial institutions to the

²⁰⁵ See Notice 2011-34.

government of the jurisdiction in which they reside, followed by government-to-government exchange, also conforms most closely to current global understandings regarding first-instance sovereign access to banking information. The government of the asset management country presumptively can already access the relevant information today.²⁰⁶ The EUSD system thus avoids the conflict-of-law issues associated with financial institutions reporting directly to foreign sovereigns. It also avoids concerns about power shifts associated with adopting a multilateral information exchange regime that alters the distribution of information with respect to nonresident accounts.²⁰⁷

FATCA's routing system for reporting directly from financial institutions to foreign sovereigns violates the local law of many jurisdictions. It is therefore inappropriate for countries that are cooperating with one another. However, requiring information reporting directly from would-be-compliant financial institutions located in non-participating jurisdictions pressures those jurisdictions to cooperate. It also allows financial institutions that wish to cooperate with new global norms to do so regardless of their government's policy decisions. Thus, FATCA's routing system provides a useful tool to elicit compliance from cooperative financial institutions in jurisdictions that resist cooperating with a multilateral information reporting regime, and to pressure those governments to cooperate.

The OECD system's routing model, on the other hand, is inapt for a multilateral regime focused on residence taxation. It sends information "around the horn" from account holders' financial institutions to source countries, and from source countries on to residence countries. In the process it disaggregates the information relevant to residence countries—a complete picture of their residents' offshore accounts—and excludes part of that picture, namely information related to payments not eligible for reduced withholding.

²⁰⁶ Indeed, they are required to have access to such information for tax information exchange purposes pursuant to the internationally agreed standards for tax information exchange upon request. *See* Global Forum Terms of Reference, *supra* note 197.

²⁰⁷ To illustrate the point, consider two simple hypotheticals. First, imagine that in order to comply with FATCA, the IRS issued administrative guidance requiring financial institutions to provide the IRS information on the accounts of all non-resident account holders (not just U.S. accounts). Imagine the IRS then promised to forward information it received about each country's residents to tax administrations around the world. In principle this arrangement could create a multilateral system. For certain sovereigns, such a system might even be attractive, especially if it would give them valuable information they did not believe they could obtain by other means. However, if such a system applied to non-resident accounts of all countries, the U.S. would have access to and control of all information about all non-resident accounts around the world. Many sovereigns would oppose such a system. Second, imagine that countries agreed multilaterally to require specified information reporting about all nonresident accounts to a central server. Then whoever controlled the central server would control information about all non-resident accounts around the world. All sovereigns might have concerns about such a system. In contrast to these two alternatives, a globalized version of the EU routing system would send information about non-residents through the country where asset management occurs. The government of the asset-management country presumptively already could access that information today. For that reason alone, this system seems both the most fair and least disruptive. Further, the EU routing system forwards only information about a country's residents to that country's government. In this way, it does not raise the same issues about informational power raised by the above hypotheticals.

Identifying Taxpayers and Their Country of Residence

The taxpayer identification rules for participating financial institutions in the OECD System require those institutions to check a customer's self-declared identity and residence against all other information the institution already has in its possession.²⁰⁸ The OECD system's principle (that is to say, using information already in a financial institution's possession) is a more accurate starting point for a multilateral system than the EUSD's current rule that treats a taxpayer as residing wherever they resided at the time their most recent passport was issued.²⁰⁹ FATCA's customer identification rules are just one way of fleshing out the details of the OECD's principle, and those identification rules may prove a useful starting point for discussions of how to implement a multilateral regime.²¹⁰ However, FATCA's rules for customer identification (as described in the U.S. Treasury's 2010 and 2011 Notices) are highly prescriptive.²¹¹

In some cases highly prescriptive rules may be costly to implement, particularly with existing account holders, without providing any substantial benefit to governments. Rules that allow financial institutions to exercise greater judgment could substantially reduce costs. Governments should not be concerned about less prescriptive rules for financial institutions *in participating jurisdictions*, if participating jurisdictions (1) impose legal sanctions on domestic financial institutions that fail to discharge their duty to identify nonresident account holders, and (2) commit to use credible domestic regulatory mechanisms to enforce these (potentially risk-based) rules. However, a more

²⁰⁸ An "Implementation Package" detailing how the OECD System could be practicably implemented requires account holders to self-declare their identity and country of residence to financial institutions. It requires financial institutions to check that declaration against other information they have available to them in order to ensure proper identification. *Report by the Pilot Group on Improving Procedures for Tax Relief for Cross-Border Investors*, OECD (Feb. 8, 2010), available at <http://www.oecd.org/dataoecd/20/36/44556378.pdf>.

²⁰⁹ This description oversimplifies the EUSD rule. The general rule is that financial institutions determine an account holder's identity and their country of residence based on whatever address is shown on the passport or official identity card that the account holder presents to a financial institution in the process of opening an account. Rules differ for accounts opened before and after Jan 1, 2004. Regardless, these rules are not consistent with the way EU countries impose tax, since all of them assert taxing jurisdiction over individuals on the basis of where a taxpayer currently resides, rather than their citizenship or the place they lived when their passport was issued. Discussion of proposals to, inter alia, strengthen the identification rules of the EUSD and ensure that it covers all payments that are equivalent to interest have been ongoing since 2008, but the EU has not yet reached unanimity on these matters. See Commission Proposal for a Council Directive amending Directive 2003/48/EC on taxation of savings income in the form of interest payments, at 4, paragraphs 3.2 and 3.3, COM (2008) 552 final (September 15, 2008). The current proposal to revise the EUSD would ask financial institutions to identify an account holder's current address based on the best information available to them. *Id.* ¶ 3.1.

²¹⁰ An eventual multilateral system would be unlikely to retain FATCA's concern with identifying non-resident citizens. The United States is almost alone globally in taxing bona fide non-resident citizens as if they were residents. Indeed, bona fide nonresident citizens of the United States working outside the United States have in some instances encountered serious difficulties banking in the countries in which reside as a result of FATCA. Such persons rightfully note that their bank accounts in the country where they reside are not "offshore accounts" and that it is inappropriate for regulatory rules to make it difficult for them to maintain residence country financial accounts.

²¹¹ Notice 2010-60; Notice 2011-34.

prescriptive system, with tougher customer identification rules, is appropriate where domestic regulatory oversight is absent and therefore does not provide an additional incentive to good-faith compliance. The U.S. experience with UBS and other private banks might suggest some caution regarding reliance on “know-your-customer” information and subjective “reason to know” standards alone for financial institutions not located in participating countries.

Verifying Financial Institution Compliance

If financial institutions must report the same information for both resident and nonresident account holders to the tax administration of the country in which they are located, then it is reasonable to rely on participating countries’ self-interest in their own tax base to ensure appropriate implementation of the taxpayer identification and information reporting rules. Further verification arguably becomes unnecessary. The EU sensibly relies on this principle, on the presumption that institutions whose compliance with the EUSD would need to be verified are already subject to domestic regulatory regimes that make similar demands.

For compliant institutions in non-complying jurisdictions, however, some independent verification system is needed to ensure compliance. Of course, non-cooperative sovereigns will not let the tax administration of a complying sovereign into their country to verify financial institution compliance. Thus, relying on independent accounting firms to verify compliance seems the most viable approach. Again however, the key point is the need for a bifurcated system with different rules for financial institutions in compliant and non-compliant jurisdictions.

Encouraging Compliance

As described in Part III. D., ensuring compliance with a new global regime is likely to require some level of coercion, or what the G20 calls “defensive measures.” FATCA’s 30% withholding tax is best understood as such a “defensive measure.” Here, FATCA differs from the OECD approach, which lacks coercive measures to ensure broad compliance. It also differs from the EU approach, which can mandate government participation within the EU but currently lacks mechanisms to broaden the system beyond the member states. A multilateral regime that realistically intends to ensure global compliance should require all participating jurisdictions to impose some defensive measure. Participating jurisdictions need not necessarily impose 30% withholding, but some coercion is a necessary component of a multilateral automatic information reporting system. Otherwise non-cooperative jurisdictions and institutions benefit from defecting from the emerging regime, because they can become repositories of choice for tax evader assets, without paying a significant price for making that business decision.

Coercive measures are both necessary to bring a multilateral automatic information exchange system into being and incompatible with permitting bilateral anonymous withholding arrangements. In other words, if one or more major financial centers were prepared to impose “defensive measures”, but were willing to suspend those measures if

they were receiving anonymous withholding from another jurisdiction on a bilateral basis, that would undercut the coercive force of coordinated measures. The lost leverage would affect not only the countries receiving anonymous withholding, but also all other countries participating in the multilateral automatic information exchange system. A jurisdiction could defect from the automatic information exchange system, provide anonymous withholding to a few powerful financial centers, and continue promoting anonymity without withholding for residents of all other jurisdictions. For this reason, the German and UK bilateral anonymous withholding arrangements with Switzerland are difficult to reconcile with a multilateral automatic information exchange system.

Coercive measures should function on the principle that a financial institution in a non-cooperating jurisdiction will not be punished if it reports information directly, and circumvents the tax administration of the country in which the institution is located. Such measures put pressure on financial institutions to comply regardless of local law and pressure governments to change local law to allow financial institutions to comply.²¹²

V. Conclusion

In just a few short years, the world has gone from assuming financial institutions generally do not support residence country taxation cross-border to arguing about how they should act as tax agents for residence countries. This is a remarkable shift in international norms. Focusing exclusively on the novel contest between the information reporting and anonymous withholding models for a new regime inappropriately obscures this growing consensus. The competing initiatives for cross-border tax administrative assistance put forth by the United States, the EU, the OECD, and Switzerland, and the response of financial institutions to those proposals, all highlight the development of a new international regime in which financial institutions will be tax intermediaries cross-border.

Nevertheless, a great deal is at stake in the decisions currently being made between an anonymous withholding and information reporting regime for administrative assistance cross-border. The choice between the two approaches is real even if the consequences of the choice seem somewhat distant for most jurisdictions. Path dependence and the tendency for institutional structures in this area to become embedded suggests that sub-optimal initial choices made by a small number of powerful actors may dictate outcomes for both those actors and the rest of the world for a prolonged period. Thus the choices being made in the current evolutionary moment in cross-border administrative assistance

²¹² Once the contours of a multilateral system are sufficiently well-developed and norms associated with the system, including with respect to proper use of information, are deeply enshrined, outcasting mechanisms, like the agreed countermeasures for countries to consider and non-cooperative jurisdiction list the G20 used in 2009 to achieve information exchange upon request, may also serve as useful tools to both promote and sustain a functional multilateral regime of cross-border automatic information exchange. See Oona A. Hathaway & Scott J. Shapiro, *Outcasting: Enforcement in Domestic and International Law*, 121 *YALE L.J.* 252 (2011). Hathaway and Shapiro's outcasting model captures the nature of what happened with regard to information exchange upon request over a short three-year period beginning in early 2009, as described in Part I.

are important.

Anonymous withholding is not likely to be made available to most countries. In contrast, information reporting provides a workable architecture for an emerging regime of financial institutions as cross-border tax intermediaries in which most countries may reasonably aspire to participate. Even though some jurisdictions can be counted on to resist a broadly diffused routine information reporting system, if these countries become outliers, international regimes will evolve around them, and eventually pressure may make non-compliance with the regime unsustainable.

Emerging economy governments and other stakeholders, including civil society, have many reasons beyond sheer revenue to weigh in on the choices made by the major actors in this evolutionary moment. Information reporting can help sustain tax morale in a financially integrated world. Information reporting also allows capital income taxation to play an expressive role in building a liberal democracy that is accepted as legitimate by its people, and to encourage taxpayers to engage with the polity and demand government accountability. In contrast, anonymous withholding institutionalizes differentiated treatment for the most sophisticated taxpayers from the rest of society. Further, anonymous withholding systems leave open the possibility that foreign jurisdictions may one day decline to implement a country's changes in its own tax regime, thereby undermining domestic authority, as well as policy flexibility, especially for less powerful states.

Together, the emerging models presented by the OECD, the EU, and the United States hold within them the seeds of a workable automatic information reporting regime. Multilateral vehicles also already exist to work towards a multilateral system. For instance, the Coordinating Body of the Multilateral Convention has the authority to study methods and procedures to increase international cooperation in tax matters, and the Multilateral Convention provides the legal authority for multilateral automatic information exchange. International tax policymakers should seize the present evolutionary moment, and push for the emerging automatic information exchange approaches to be reconciled in a manner that supports the tax administration needs of developed and emerging economies alike.