# International tax co-operation via exchange of information – the transatlantic point of view[1]

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## Introduction

Since the end of the last century developed countries, in particular European, have been paying growing attention to the international tax competition, its potential threats and consequences. Economists, tax professionals and politicians are not unified as to whether international tax competition is harmful[2]. Nevertheless several developed countries initiated closer international tax cooperation to fight harmful tax competition.

There are two main ways of international tax cooperation: unification of tax provisions and exchange of information for tax purposes. Even if the last one is hardly acceptable, still it seems to be more tolerable than the former one. Exchange of information can help combating international tax avoidance and competition.

This paper focuses on the exchange of information for interest incomes tax purposes; in particular it focuses on the comparison of the OECD, the EU and the USA positions in this matter. The first part reviews internationally adopted measures on exchange of information, mainly those adopted by the OECD and the European Commission. Here the main principles and advantages of the EU Savings Directive are analysed. In the second part we move to the description of the US rules used in taxation of non-business interest incomes of non-residents. Attention is paid to two issues: position of the USA to exchange of information for tax purposes and US measures to tax interest incomes. Finally, in the third part, we draw several reasons that possibly lie behind the US position.

## 1. Internationally adopted measures on exchange of information

### 1.1. OECD initiatives

The OECD views the exchange of information for tax purposes as an important element in the international tax co-operation. The article on exchange of information is incorporated in the *OECD Model Tax Convention,* namely in the

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[2] WILSON, J. D. – WILDASIN, D. A.: Capital Tax Competition: Bane or boon? In: *Journal of Public Economics* Vol. 88, 2004, Issue 6, p.1065 – 1091.

*Article 26 – Exchange of information.* However, the Model Tax Convention is not only initiative of the OECD in this hot matter.

The OECD nicknamed by opponents as a "Paris-based bureaucracy" or "the club of high-tax nations" adopted several additional reports and measures to assure exchange of information between tax jurisdictions. They are listed below.

1. The OECD report entitled *"Harmful Tax Competition: An Emerging Global Issue"*. In 1998 the OECD here published criteria to determine harmful tax regimes in the form of preferential tax regimes or tax havens. The criteria to determine preferential tax regimes are:
   - (i) the regime imposes no or low effective tax rates;
   - *(ii) lack of effective exchange of information;*
   - (iii) lack of transparency;
   - (iv) regimes are ring-fenced.

   Tax jurisdiction is deemed to be tax haven if:
   - (i) the regime imposes low or no effective tax rates;
   - (ii) there is lack of effective exchange of information;
   - (iii) there is lack of transparency;
   - (iv) there are no substantial activities of foreign taxpayers.

   The OECD as a sign of the harmful tax practices deems lack of effective exchange of information for tax purposes, as it makes hard for foreign governments to tax income earned abroad.
2. Report *"Improving Access to Bank Information for Tax Purpose"*. The OECD Committee on Fiscal Affairs published report in March 2000. The issue of banking secrecy represents one of the main barriers to accept international exchange of information on interest incomes between tax administrations. The OECD report considers ways to improve international co-operation with respect to the exchange of information in the possession of banks and other financial institutions for tax purposes.
3. *The OECD Model Memorandum of understanding between the competent authorities of (State X) and (State Y) on the automatic exchange of information for tax purposes* adopted by the OECD Council on 22 March 2001.
4. *The OECD Model Agreement on Exchange of Information on Tax Matters* released on 18 April 2002.
5. *Amendment of the provisions of the Article 26 of the OECD MTC.*

Development and adoption of several reports on the exchange of information for tax purposes led to amendments in the Article 26. Its amended version is included in the revised version of the OECD Model Tax Convention of July 2005.

The original paragraph 1 was split into two paragraphs. Paragraph 1 states that the competent authorities of the Contracting States shall exchange information as foreseeably relevant for carrying the provisions of MTC or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States.

The new paragraph 2 includes a rule permitting disclosure of information to oversight authorities. Recent paragraph 2 is renumbered for paragraph 3, and its wording is without changes. Important is a newly added paragraph 4. It states that the requested Contracting State shall use its gathering measures to obtain the requested information, even though requested State may not need such information for its own tax purposes. Thus it is no more possible to decline to supply information solely because requested State has no domestic interest in such information. Besides, impossibility to decline exchange of requested information is strengthened by the paragraph 19.8. of the Commentary. It clarifies that a Contracting State may decline to supply information upon request only in case of substantive economic reasons.

The newly added paragraph 5 mirrors banking secrecy issue, which was presented as a serious barrier to exchange of information. It states that information held by a bank, another financial institution, nominee or person acting in an agency or fiduciary capacity or information which relates to ownership interests in a person cannot be solely declined to supply only because of provisions of paragraph 3 of the Article 26. Nevertheless, countries that did not adopt regime of automatic exchange of information under the Article 9 of the EU Savings Directive (Austria, Belgium, Luxemburg), and Switzerland have already made reservations to paragraph 5 of the Article 26.

### 1.2. EU initiatives

Both, the OECD and the EU, intensify effort to put in real life exchange of information for tax purposes. Several EU Directives incorporate the exchange of information procedure:

1. *Directive 77/799/EEC* concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, certain excise duties and taxation of insurance premiums. There are listed three kinds of information exchange:
   - (i) the information exchange upon request,
   - (ii) a spontaneous exchange of information, and
   - (iii) an automatic exchange of information.

   While exchange of information upon request is conceptual model similar to that one under the Article 26 of the OECD Model Tax Convention, an automatic exchange of information is considered to be one step forward. On one hand, the automatic exchange of information is more powerful tool to fight tax avoidance, but on another hand it retrieves the strongest public opposition in several countries.
2. *Council Directive of 10 June 1991* on prevention of the use of the financial system for the purpose of money laundering. It requires identification of customers of credit and financial institutions, insurance companies and collective investment undertakings by means of supporting evidence when opening an account or savings accounts, or when offering safe custody

facilities. The identification requirement shall also apply for any transaction with other customers involving a sum amounting to EUR 15 000 or more.

*3.* Joint Council of Europe/OECD Convention on *Mutual Assistance in Tax Matters.*

4. *Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income* (*EU Savings Directive).*

There are two main pillars of the EU Savings Directive:

(i) The rule that non-resident interest income will be taxed only in the beneficial owner resident state and in accordance with resident country tax provisions.

(ii) Tax administrations will regularly, once per year automatically exchange information on non-resident identity and amount of interest income paid by the paying agent in the country of source.

Provisions on automatic exchange of information are incorporated in the article 9 of the EU Savings Directive. Countries to agree automatic exchange of information for the purposes of interest income taxation apply its provisions. Paragraph 2 states, that "the communication of information shall be automatic and shall take place at least once a year, within six months following the end of the tax year of the Member State of the paying agent, for all interest payments made during that year". The provisions of Directive 77/799/EEC shall apply to the exchange of information under the EU Savings Directive, provided that the provisions of this Directive do not derogate therefrom.

## 2. The EU Savings Directive - aims and expected advantages

The expected benefits of the interest income tax regime under EU Savings Directive are as follows:

1. *Protection of tax revenues of the country of residence.* The EU Savings Directive, in contrast to the non-exclusive right to tax interest income introduced by Article 11 of the OECD Model tax convention, introduces an exclusive right to tax interest income to the country of residence of the beneficial owner.
2. *Reduction of tax motivated outflow of national savings*. There are differences in the levels of statutory tax rates imposed by countries of source of interest incomes that are given by provisions of domestic tax law. Those differences led to speculative capital outflow from high-tax countries to low tax countries. In contrast, when the country of residence collects interest income tax with compliance of its national tax provisions, one of the main driving forces to shift savings from country of residence abroad disappears.
3. *Mitigation of tax competition* for savings inflow among EU Member States.

4. *Restriction of treaty shopping.* More favourable tax rates for taxes withdrawn in source countries that are incorporated in bilateral tax treaties, unwittingly created a side effect - grounds for abusing the bilateral tax treaties by third entities. This worked to create the growing of global tax planning structures.
5. *Fighting corruption, international organised crime and money laundering.* Not only the establishment of the right to taxation for a country of residence is important. Even more importantly, there appears to be automatic exchange of information as this may facilitate a contest against tax avoidance, corruption, international organised crime, money laundering, and terrorism.

Undoubtedly, all above listed potential benefits are desirable. If potential effects of the EU Savings Directive were reached globally, one might say the idea was perfect. However, the EU is not the sole group of countries in the globalized world. It represents only a regional group of 27 geographically neighbouring countries. Some non-EU countries agreed to adopt the common rules on taxation of interest incomes under the EU Savings Directive automatic exchange of information, but other important world economic players did not.

Table 1 shows a review of those EU and non-EU countries, which acceded to EU Savings Directive rules on interest incomes taxation; most of them adopted the automatic exchange of information mechanism.

Table 1:
**Countries which adopted the EU Savings Directive or signed agreement to follow its provisions**

| EU countries | Non-EU countries |
|---|---|
| Belgium, Luxembourg, Austria, Estonia, Cyprus, Czech Republic, Denmark, Finland, France, Greece, Netherlands, Ireland, Lithuania, Latvia, Malta, Hungary, Germany, Poland, Portugal, Slovenia, Spain, Italy, Great Britain, Sweden | Anguilla, Cayman Islands, Montserrat, Aruba, Switzerland, Andorra, Liechtenstein, Monaco, San Marino, Jersey, Guernsey, Isle of Man, British Virgin Islands, Turks and Caicos, Netherlands Antilles, |

In contrast, numbers of influential world economic players, among them the main EU trade partner, the USA, are missing in the list.

## 2.1. Statutory interest income tax rate after the EU Savings Directive

The main goal of the EU Savings Directive is to ensure, that EU taxpayers will not avoid non-business interest income taxes and will not shop anymore for tax jurisdiction with lower or zero interest income tax rates. This is has been finally reached by adoption of the principle of resident-based taxation of interest incomes.

The table 2 shows that resident-based taxation of the non-business interest income allows European Union Member States to keep statutory interest income tax rates without fear of international tax competition. It is obvious, that statutory tax rates remain quite different and one might say, that this is thanks to the EU Savings Directive. Statutory tax rates of interest income tax do not converge thanks to the resident-based interest income taxation.

Table 2

**Statutory non-business interest income withholding tax rates for residents after the EU Savings Directive, 2007 [%]**

| Country | Tax rate | | Country | Tax rate | |
|---|---|---|---|---|---|
| | Resident | Non-resident | | Resident | Non-resident |
| Austria | 25 | -/15 | Latvia | - | - |
| Belgium | 15 | 15 | Lithuania | - | - |
| Cyprus | - | - | Luxembourg | - | -/15 |
| Czech republic | 15 | 15 | Malta | - | - |
| Denmark | - | - | Netherlands | - | - |
| Estonia | - | - | Poland | 19 | 20 |
| Hungary | - | - | Portugal | 20 | 20 |
| Finland | 28 | - | Slovakia | 19 | 19 |
| France | 27 | - | Slovenia | - | - |
| Germany | 31 | - | Spain | 15 | 20 |
| Greece | 10,3 | 10 | Sweden | 30 | - |
| Ireland | 20,0 | - | United Kingdom | 20 | - |
| Italy | 27 | 27/12,5 | USA | - | - |

Source: own compilation from EU MSs' tax law

## 3. The US position towards EU Savings Directive

### 3.1. The exchange of information

The U.S. is a Member State of the OECD and articles of the OECD Model Tax Convention may influence U.S. approach to exchange of information on non-residents interest incomes. Nevertheless the U.S. regularly specifies its reservations to particular OECD positions to which the U.S. does not agree. In addition, the U.S. adopted the United States Model Income Tax Convention of September 20, 1996, which includes Article 26 – Exchange of information and administrative assistance. The wording of Article 26 in revised OECD Model Tax Convention of July 2005 differs from the wording of Article 26 of the U.S. Model Tax Convention.

Several days before the end of Clinton administration the IRS commissioner appointed by former U.S. president Bill Clinton issued proposal on regulation REG-133245-02 to help foreign governments to tax interest incomes of non-US residents earned in the USA. Nevertheless, the "Clinton-era IRS regulation" did not come into force.

While Clinton Administration supported the OECD effort in the field of exchange of information, to the contrast, the Bush Administration withdrew support for the part of the OECD initiative on "harmful tax competition". On May 10, 2001, U.S. Treasury Secretary Paul O'Neil clarified the U.S. reservations on the OECD's harmful tax practices initiative. He announced that "the U.S. does not support efforts to dictate to any country what its own tax rates or tax systems should be, and will not participate in any initiative to harmonize world tax systems". [3] According to O'Neil, the OECD project is "not in line with tax and economic priorities [of the U.S.]".

Currently, the Treasury renounces the interest-reporting requirements and recommends adopting regulation [REG-133254-02; REG-126100-00] and *Guidance on Reporting of Deposit Interest Paid to Non-Resident Aliens*.[4] Recently some important changes were made in the Regulation proposed draft, particularly adjustment of the list of countries to be covered by the Regulation. Latin American countries were deleted from the list. This might be due to the risk of capital outflows from U.S. commercial banks' banking accounts. Now the list of countries to be covered for the purposes of collecting and exchanging of information contains 15 developed countries - majority of them EU member states - Australia, Denmark, Finland, France, Germany, Greece, Netherlands, Ireland, Italy, New Zealand, Norway, Portugal, Spain, Sweden, United Kingdom.

Even though the IRS regulation on banking information reporting is prepared, it is sharply criticized and strong public opposition views are presented.

### 3.2. Non-resident interest incomes taxation

To investigate possible reasons of the US position towards automatic exchange of information one should turn attention to the issue of non-business interest income taxation of non-resident. The provisions of the US Internal Revenue Code (IRC) govern it.

There is more than 80 years old provision on non-resident interest income tax treatment. Interest paid on bank deposits held by foreign persons has been

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[3] O'NEILL, P.: Confronting OECD's Notions on Taxation. The Washington Times, May 10, 2001.

[4] U.S. Treasury. Internal Revenue Service: Guidance on Reporting of Deposit Interest Paid to Non-resident Aliens. In: *Federal Register*, 2002. p. 50386-50389.

effectively exempted from U.S. income tax since 1921 provided that the income is not effectively connected with the conduct of a U.S. trade or business.

Currently, under the Sections 871(i) and 881 (d) of the IRC interest income earned on certain deposits by non-resident aliens is exempted from the 30-percent tax even though the interest is treated as U.S.-source income. According to experts exemption of interest earned on certain deposits on bank accounts held by non-resident aliens from taxation is aimed *to encourage foreign persons to use U.S. banks and savings institutions.*

Subject to favourable tax treatment are certain types of portfolio investment interest incomes paid to non-resident aliens. Under §§871 (h) and 881(c) of the IRC most interest payments to foreign persons on publicly traded debt securities, e.g. bonds and other debt issued by the U.S. government, that are either registered obligations or are bearer obligations will *not be subject to the withholding tax*. It must be assured that interest is payable only outside of the United States to foreign persons – requirements are specified in Section 163(f)(2)b.

"Although the US government does not advertise the existence of these benefits to foreigners, banks and brokerage houses see to it that any foreigner who needs to know does know about them" notes Langer.[5]

## 4. Possible reasons for the US position

Above all possible reasons the financial privacy seems to be especially important one. Financial privacy rights represent one of the traditional democratic rights. There is no doubt that financial privacy is an important issue particularly in the US – country, which traditionally keeps and protects privacy rights. Privacy rights are highly valued by Americans and this can explain strong resistance of the US government against exchange of information on interest income paid to non-resident aliens.

However reasons for U.S. positions cannot be reduced only on the issue of financial privacy. To the contrast, there may be listed complex and more sophisticated reasons that lie behind US position: political, legislative, administrative, and economic.

A favourable tax treatment of interest income in case of non-residents has important economic consequence: it effectively reduces interest costs to the U.S. government to be paid to foreign investors. This is because decision making of foreign investors is influenced, along with other factors, by the after-tax return on investment.

Mastromarco and Hunter[6] summarise reasons against IRS regulation to manage collection of information by financial institutions:

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[5] LANGER, M.: Harmful Tax Competition: Who are the Real Tax Havens. In: *Tax Notes Int'l*, 18 Dec. 2000, p. 2831-2840, p. 6.

[6] MASTROMARCO, D. - HUNTER, L.: The U.S. Anti-Savings Directive. In: *Tax Notes International*, January 13, 2003, p. 159–78. p. 160

1. It is example of extraordinary degree to which privacy rights must be sacrificed to sustain extraterritorial double taxation of savings in today's digital world.
2. The United States government would become the business-tax collector for European countries wishing to impose double taxation on investments in the U.S.
3. None of the initiatives is actually needed to enforce U.S. tax law.
4. All the proposals are economically harmful and legally dubious because they would require the IRS to exceed its statutory authority by taking actions that would drive investments away from the United States and stifle beneficial competition among nations to attract mobile capital by providing a better tax environment. They are all nearly the same proposals simply reconstituted in a different form.

## Conclusion

Taking into account competition for capital inflow between U.S. and EU, awareness of possible effects of information sharing and residence-based taxation of interest incomes on direction of capital flows is legitimate. In these circumstances there is ground for further economic research. In particular, the question whether, how and to what extent directions of capital flows in the world economy depend on information sharing and effective taxation of interest incomes should be answered.

**Key words**
non-business interest incomes, non-residents, taxes, exchange of information, European Union, USA

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**Summary**

The paper reviews initiatives and positions of the OECD, the EU and the USA towards exchange of information for interest income tax purposes. It also compares statutory interest income tax rates after the EU Savings Directive has been launched. The main results are, that the EU and OECD heavily support further development in exchange of information for tax purposes, and go far beyond the article 26 of the OECD Model Tax Convention. However survey of the statutory interest income tax rates for non-business interest incomes of non-residents after the EU Savings Directive came into effect shows that it did not lead to the unification of interest income tax rates. To the contrast, level of interest income tax rates remained quite different and do not converge. Both, investigation of the tax provisions and survey of tax rates, show that non-business interest income of non-residents is tax-free in the USA. It may imply that besides the financial privacy issue the US have other sophisticated reasons not to adopt principles of the EU Savings Directive.

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