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Tax Information Exchange Agreements and Financial Secrecy: Impediments to Effective Implementation

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Abstract

Globalization and trade liberalization have created opportunities for investors to move capital to economies where they can create higher shareholder value and tap into new business markets. This has seen the advent of MNEs across the world mostly with offshore financial investments. Sadly, too, investors have taken advantage of weak tax administration in some economies, especially in Africa through treaty shopping. Some businesses also engage in tax evasion and avoidance schemes as well as other harmful tax practices. African economies are targeted due to their resource endowment and poor control measures in managing natural resources at national level. Operations in several jurisdictions protect such investments from the direct control of the tax authorities, hence the need for co-operation amongst affected jurisdictions and secrecy jurisdictions. This cooperation requires exchange of information on taxpayers through TIEAs. Challenges in information exchange have been noted where the required information is with third parties or is subject to legislated secrecy provisions in the taxpayers jurisdiction . It has also been noted that the structure of the current OECD developed Model TIEA template does not adequately cover the requirements, providing a loose arrangement, which leaves most weak economies unable to negotiate effectively, rendering the model itself ineffective.

KEY TERMS: Financial Secrecy, Illicit Financial Flows, Tax Information Exchange Agreements, Secrecy Jurisdictions, Tax Havens

1. Introduction

Most economies and tax administrations find themselves struggling to keep up with the increasing demands on tax administration that are created by globalization and market liberalization. With increasing globalization, consumers are now exposed to previously unknown wants and needs, developed new tastes in food, clothing and other luxuries, thereby attracting the services of global supply chains.

These dynamics in demand and supply have re-shaped the design and strategies in marketing and trade. Businesses have formed relationships across borders to form synergies that create benefits for them. Tax administrations have not been able to effectively keep up with new trends in business activities, more so where these are designed to limit the effect of taxation.

This has created the need for bilateral arrangements between or amongst jurisdictions not only to deal with historical economic activities with implications to taxation, but also to anticipate

and pre-empt harmful tax practices. The negotiation and establishment of Double Taxation Agreements (DTAs) and Tax Information Exchange Agreements (TIEAs) is meant to enable fair tax treatment for business and the sharing of taxpayer information for effective tax administration respectively.

In spite of the provisions of tax agreements that override domestic legislation, legislation in most economies, particularly legislation governing the financial sectors provides for financial secrecy that inhibits access to tax and other information required for effective revenue management. The Organization for Economic Cooperation and Development (OECD) developed a Model Tax Information Exchange Agreement (TIEA) in 2002 following work carried out to assess the extend and impact of harmful tax practices. According to the 2016 Economic Development in Africa Report under the auspices of the United Nations, the Organization for Economic Cooperation and Development (OECD) Committee on Fiscal Affairs introduced a model protocol for TIEAs in June 2016 for standardization. This model has given rise to the challenges in terms of ineffectiveness. Tax havens have been quite willing to sign these agreements, giving the perception that transparency has finally come to the front. In 2012, the OECD world count for TIEAs between jurisdictions in stood at 518, most of which were between European countries and tax havens. Interestingly, tax havens feature prominently on this list some with multiple treaties between them and several non-tax haven jurisdictions. Considering that the financial secrecy in tax havens is considered the biggest impediment to taxation of income in tax havens, and the effectiveness of the implementation of TIEAs, the surprising ease with which other tax havens signed treaties with tax administrations is unusual. Until this is viewed in the context of the relaxed regulations in tax havens that preclude the provision of identification of individuals and companies in registration. Thus with or without a treaty, the crucial audit information is not in the records anyway, and the agreement does not cater for the supply of information that is not ordinarily a required under the domestic requirements of the requested state.

The African Tax Administration forum remains seized with the issue, noting the challenges this has on African tax authorities whose wealth, amassed by their taxpayers, has been moved to tax havens. In 2016, ATAF provided technical assistance in the form of training on Exchange of

Information (EOI) to some African tax administrations, followed by monitoring as part of assistance in capacity building for developing economies.

1.1 Statement of the Problem

Regional integration has facilitated intra-African trade. Trade liberalisation has also encouraged African businesses to invest offshore in jurisdictions off the continent. This has also opened opportunities for the businesses to place their finances and other assets in tax havens or jurisdictions with low taxation. While globalization has created good opportunities for investment, it has also created challenges resulting from general non-compliance in taxation, including illicit financial flows notably through transfer pricing or trade mispricing. These challenges are made worse by complex transactions in this advanced technological era, including aggregated financial reporting by multinationals to avoid country by country reporting. Country by country reporting disaggregates incomes and assists tax authorities to determine their taxing rights and hence effectively tax the respective income. The era of globalization, geographic boundaries and distances have become irrelevant. The taxation challenges resulting from this have a huge impact on a state's sovereignty and a state is forced to allow significant freedom to other parties, particularly private agents in the running of business (Bhat, 2009)

Most African economies are aware of both DTAs and TIEAs. The majority have existing DTAs both with African economies and with economies outside Africa. A few have TIEAs, the majority of which seem to be with jurisdictions out of Africa. The challenge with DTAs is that they cannot be negotiated with tax havens due to the irrelevance of reciprocation; tax havens would still not tax their citizens for incomes accruing from investment elsewhere. Yet tax information exchange agreements with these secrecy jurisdictions would be most ideal for the sharing of information on the finances and assets of individuals answerable, for tax purposes, in other jurisdictions that tax income.

The secrecy associated with financial institutions in tax havens is a major inhibitor to information exchange, noting that bank provisions provide protection even to finances illegally moved from resource rich economies, mostly Africa (Fjeldstad, Jacobsen, & Ringstad, 2017).

The limits to access to tax information on businesses for the effective tax control is enabled by low capacity to negotiate appropriate agreements and more by the protective nature of provisions in the laws of other parties, particularly laws that are meant to protect financial investments. Most low income countries are not able to effectively use the protocols provided by TIEAs due to low capacity or the absence of significant political influence to establish agreements with each other or with other jurisdictions, worse with tax havens.

While tax administrations may be able to request and obtain financial information for tax purposes in respect of taxpayers in their jurisdictions, obtaining such information for, or passing any information they already have, to third parties has also been subject to various secrecy provisions.

Double Taxation Agreements (DTAs) provide for information exchange in loose terms, their purpose being largely for the prevention of taxing businesses twice, while Tax Information Exchange Agreements (TIEAs) are designed to enable the provisions of information, being structured to enable contracting parties' access to information for effective taxation. The complementary effect of TIEAs to DTAs alone cannot help crack cases where information is required from third parties such as banking institutions. In most cases, domestic legislation that governs the disclosure of specific taxpayer information to third parties exists in most jurisdictions. Some of the required information may lie within institutions that are not party to the agreement, for example banking institutions, which are protected by the secrecy provisions in domestic legislation. Faced with these challenges, Africa needs to review the platform on which these agreements are based to make them worthwhile. In any case, the global economies face the same challenges, except that in the case of developed countries, there is higher leverage that enables them to strike favourable agreements.

1.2 Research Objectives

The overall objective of this study sought to investigate the impediments to the implementation of tax information exchange agreements and financial secrecy, and develop a set of assertions that could be used to make suitable recommendations to close the gaps. This research also looked at the effects of financial secrecy provisions in tax havens or in ordinary economies, to

the extent that they impede the effective implementation of TIEAs. From this examination and the findings thereof, a set of assertions were made, which provided information to enable the researcher to offer some recommendations as possible solutions to the gap.

2.0 Empirical Review

The literature review was carried out in two parts to enable a separate examination of the impediments due to the structure of the Model TIEA and impediments due to financial secrecy provisions. Most discussions revolved around reports and literature by the OECD, UNDP, the Tax Justice Network and several authors who have looked at the effects of Illicit Financial Flows (IFF) and financial secrecy provisions on the effective implementation of TIEAS.

2.1 Impediments in the Structure of Taxpayer Information Exchange Agreements

A Tax Information Exchange Agreement is a bilateral agreement entered into by two countries for the official exchange of financial information on tax matters (Higgs & Johnson, 2014).

Generally, taxpayers have no fear of tax information exchange agreements, even those entered into with tax havens (Sawyer, 2011). One of the reasons is that tax havens do not tax anyone and have nothing to lose by failing to cooperate with jurisdictions that have active tax models. He further notes that jurisdictions in tax havens have no obligation to provide information they do not collect, and by their very nature, they do not collect the useful information such as the identity of a taxpayer, which is by far the most crucial element for tax administrators.

The OECD Model has procedural restrictions that prevent broad or general enquiries, typically referred to as “fishing expeditions”. This virtually makes it difficult for any jurisdictions to obtain effective information, when there is a requirement to provide in the request, specific information or indications of the suspected fraudulent activity by the taxpayer under audit or investigation. Needless to say, valuable time is lost in the back and forth communication as the requested party seeks clarification from the requesting party, a situation that may render the audit timed out.

The Tax Justice Network observed that double taxation agreements are broadly designed to help authorities avoid taxing the same income twice (TJN, 2009). This encourages investment as

well as fairness, one of the canons of taxation. Furthermore, TJN argues that DTAs also encourage treaty shopping as businesses create tax planning models that place their various portfolios in jurisdictions with little or no tax. This may be effected by for example assigning profits to subsidiaries in low tax jurisdictions and allowable deductions or costs to subsidiaries in high tax jurisdictions. Thus, TJN considers tax information exchange agreements as complementary to DTAs as they enable jurisdictions more insight into the accountability of offshore operations. The current Model TIEA, though appearing to provide for both bilateral and multilateral provisions, has been noted to effectively provide only for bilateral agreements. Its multilateral clauses, worded similar to the bilateral, provide for a bundle of bilateral agreements within a cluster of economies, which effectively would require parties to negotiate separate agreements with individual economies for specific bilateral provisions.

There are two challenges with this arrangement; firstly, it provides very few links among a number of players as one agreement cannot be used to access information on a taxpayer in a jurisdiction that is not party to the agreement (TJN, 2009). Secondly, there is not much in the agreement to cover developing countries, most likely because they were designed at a higher economic platform without the involvement of the economies most negatively affected by financial secrecy. The irony is that African tax administrators are struggling with the effective taxation of multinationals originating from the same developing countries that are instrumental in developing TIEAs. Tax Justice Network also notes that the other challenge faced by developing countries is their limited leverage to strike a good agreement during negotiation. With greater negotiating leverage, developing countries push and secure effective clauses in the agreement. Without leverage, developing countries are unable to challenges inhibiting factures, which can be addressed, say by redefining the so-called fishing expeditions to enable them to access information even where they do not suspect fraud. As it is now, tax information exchange agreements do not provide for spontaneous information exchange while efforts are being made for automatic exchange of information (TJN, 2009). The Model TIEA does not specify the criteria for information exchange, leaving it to the negotiating parties. This places the weaker negotiating party at a distinct disadvantage. Absent from the model agreement are requirements that place an obligation on the requested state to carry out administrative measures which are variance with the domestic laws or to seek information that is not obtainable under the domestic

laws or to implement administrative procedures of the state being party to the agreement (TJN, 2009) . In other words, a requested party is only obliged to provide information that, by virtue of the domestic provisions and procedures, is already in the records or is required to be in the records. Yet the concept of tax treaties is that their provisions supersede those of the domestic provisions. The noted omission is thus a considered impediment.

2.2 Impediments in the Financial Secrecy Provisions

The standard OECD Model is "sporadic" especially in that when a tax haven banking jurisdiction is the requested party (Sheppard, 2009), it is highly impossible to obtain or exchange information. Secrecy provisions, particularly in financial institutions, worse in tax havens, form a significant impediment to effective implementation of TIEAs. In essence, only available information can be provided. This may sound a lame statement until we re-examine TJN's argument that information availability depends on the legal and administrative requirements in the secrecy or any other jurisdiction for that matter. The crucial information required is usually not available, and in the case of secrecy jurisdictions, this is deliberate. The jurisdiction does not require provisions of such information from the asset owner, in line with its secrecy provisions.

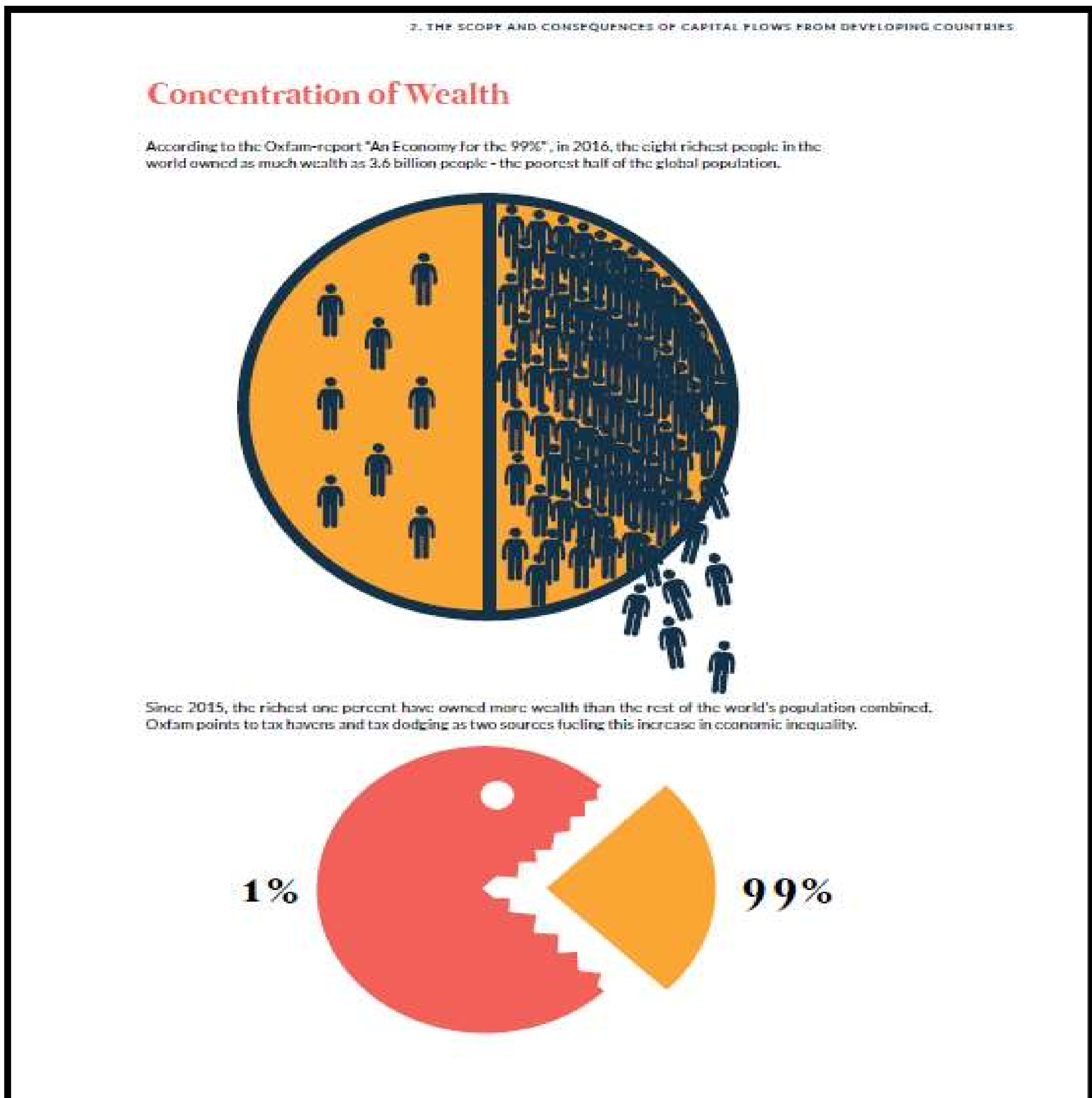
Information leaks suggest that most of Africa's wealth is secreted away in tax havens, in processes that are enabled by illicit financial flow systems and shielded by secrecy provisions in these tax havens (Fjeldstad, Jacobsen, & Ringstad, 2017). The global network of Offshore Financial Centres (OFCs) commonly referred to as tax havens or secrecy jurisdictions enable wealthy individuals and companies to take away immense wealth from economies, mostly African economies, beyond the reach of the entitled taxing jurisdictions.

Even when the affected economies become aware, ascertaining the exact assets, their values or the finance taken away remains difficult. Information leakages such as those provided by the Panama Papers may indicate some inventory but still without being exhaustive. It is important to note however, that tax havens themselves are not the evil in tax evasions. They feature prominently in the equation simply because when the media covers a scandal involving illicit financial flows, tax havens as states, cannot escape mention. However, TJN points out that the

states in tax havens are politically weak and it is the secrecy industry in the form of financial institutions that is responsible for the vice.

The inequalities in wealthy distribution around the world is astronomical, mostly because the wealth held by individuals has been amassed through illicit flows and kept away from taxation in the secrecy industries in tax havens. The Tax Justice Network cites reports by Oxfam in 2016 indicating that the eight richest individuals in the world owned wealth equivalent to that held by 3.6 billion people in the poorest nations, while in 2015, the world's richest individual owned more wealth than the rest of the world. The absurdity of it is that this wealth in essence belongs to several other people, the poor included, if it were distributed equitably through taxation that leads to proper government expenditure.

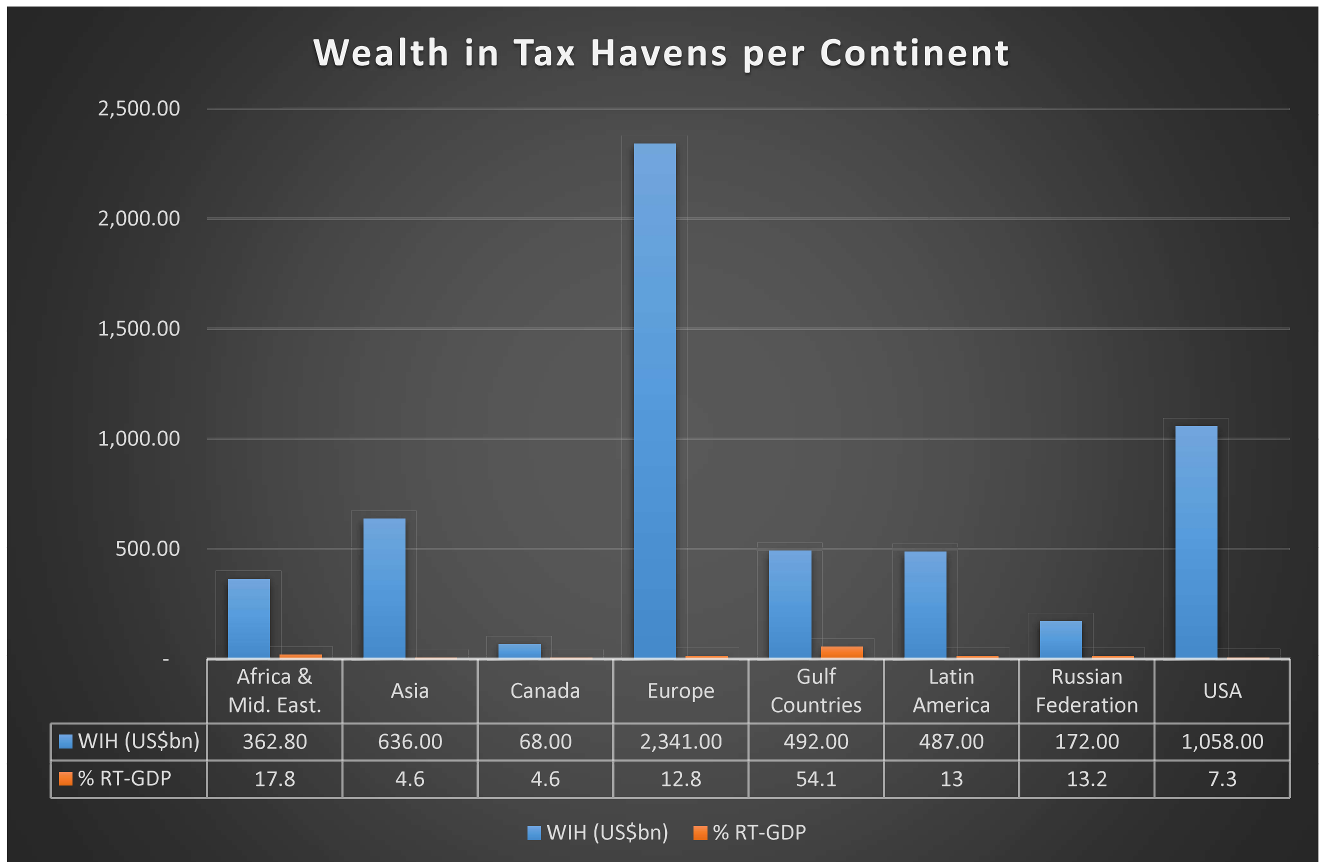
Figure 1 shows the uneven distribution of wealth as reported by Oxfam in the 2015/2016 Report.



Source: Tax Justice Network (Adapted from 2015/2016 Oxfam reports)

Figure 5: Concentration of Wealth

Figure 2 shows the world's wealth in tax havens (WIH) by continent, and its percentage relativity to the continent's GDP (%RT-GDP).



	Africa & Mid. East.	Asia	Canada	Europe	Gulf Countries	Latin America	Russian Federation	USA
WIH (US$bn)	362.80	636.00	68.00	2,341.00	492.00	487.00	172.00	1,058.00
% RT-GDP	17.8	4.6	4.6	12.8	54.1	13	13.2	7.3

Source: Alstadsaeter, Johanncsen, Zucman (2017): Who owns the Wealth in Tax Havens? Macro Implications for Global Inequality

Figure 6: Wealth in Tax Havens per Continent

Tax havens have three distinct tax shielding characteristics; **they have low or no taxes, they have limited regulations** and **they have secrecy provisions on asset and company ownership**. In the context of tax information exchange, no information can be obtained from financial or tax authorities in secrecy jurisdictions, because none has been collected in the first place. A tax information exchange agreement with a tax haven is therefore virtually untenable.

The national bank secrecy provisions in tax havens are actually designed to prevent the sharing of client information (Zucman, 2014). This facilitates secrecy around the ownership and registration of companies, most of which are mere shells. Sadly, the economic activities of these entities are not in the secrecy jurisdictions, but in economies which have the taxing rights.

For example, in the Cayman Islands, there exists a very small building called Ugland House, that miraculously is home to **12 748** companies with no visible business activity, amongst them Coca-Cola and Intel Corp. The absurdity of this typical tax haven phenomenon was aptly defined by former US President Barack Obama who said of Ugland House, "Either this is the largest building in the world or the largest tax scam."(Holan, 2009). Needless to say, the former president, during his tenure in office, nominated a man who had massive investments in the same building to the United States Treasury House in 2013.

While Africa may appear the victim of secrecy practices in developing economies, discussions around the Financial Secrecy Index, published every two years by the Tax Justice Network, suggest that all jurisdictions the world over hold a position on the FSI spectrum, with none close to perfection in terms of transparency (Fjeldstad, Jacobsen, & Ringstad, 2017). Therefore as much as one jurisdiction is unable to access taxpayer information from another, all jurisdictions appear to have within their policy and legal frameworks, provisions that make them culpable of impediments to other parties.

The prime impediment therefore resides also within each jurisdiction, posing the question, "How much can we provide in terms of information exchange with other jurisdictions when we are incapacitated in respect of accessing information on those taxpayers within our own jurisdiction?"

Besides just the tax authorities and government, business has also become increasingly concerned with the lack of financial transparency. In the interest of safeguarding shareholder value and company reputation, business is genuinely concerned. The B Team, a coalition of global business leaders led by Sir Richard Branson now demands transparency on the beneficial ownership of companies (B-Team, 2016) to protect the rights of other businesses. It is good business for companies to know ***who*** one is doing business with, for financial institutions to know ***whose*** funds they are handling and for ***what*** purpose and for the public, the taxpayer, to

know ***who*** is benefitting from public funds. Above all, financial transparency is crucial in combating crime and terrorism, other than just for the management of tax compliance.

3.0 Research Findings

The OECD Model TIEA template is considered inadequate in terms of providing cover for effective provisions in the agreements. The template leaves the design of crucial clauses to the contracting parties, which prevents states with limited political leverage from securing effective agreements when negotiating with developed economies. Information is scant on the prevalence of TIEAs between or amongst African economies and their success rate cannot therefore be determined with certainty. Financial secrecy, whether in secrecy jurisdictions or in the local economy, is a significant impediment to the implementation of effective tax information exchange agreements. On the other hand, the OECD has in the past touted tax information exchange agreements as effective tools in tax information sharing, an assertion that has no empirical substantiation.

The Panama Papers have burst the TIEA effectiveness bubble. Developing economies may still be struggling to recover lost capital from use of this information, as there still would be a requirement for the involved financial institutions to confirm the existence of foreign assets in their possession, and to indicate the actual owners of such assets. International legislation on information exchange does not seem to show unity of purpose, which would enable spontaneous or even automatic information exchange. Most bilateral or multilateral agreements cover trade, or vague mutual administrative assistance arrangements, falling short in execution when other tax administrations request for information.

It is apparent that financial institutions in economies that lose wealth to tax havens may be compromised in terms of complicity, deliberate or forced by corrupt officials in authority in facilitating illicit financial flows and in addition for failing to share or disclose such information, using secrecy provisions as an excuse. To that end, sound corporate governance across both the public and private sector is key to the prevention of IFFs. The gains of illicit financial flows and securing financial secrecy from offshore financial institutions are high, hence the high risk appetite in the institutions and individuals involved. There is a marked lack of research to

increase knowledge, which would enable the provision of insights for developing suitable solutions.

African economies are set to benefit from ongoing training programmes on exchange of information given by the African Tax Administrative Forum since 2016. The OECD has also made indications towards capacity building for African economies, particularly given that the previous assurance of the effectiveness of the TIEAs suffered a dent following the Panama Papers. Given that tax havens have no taxation provisions, negotiating TIEAs with them is pointless. In addition, regulations in tax havens are weak and promote secrecy in the provision of crucial tax information as records. Therefore, even if tax havens agreed to provide information, they would still not hold the crucial information other jurisdictions require for effective taxation, for example the identity of taxpayers. Financial secrecy provisions exist both in tax havens and ordinary economies. They remain as one of the most significant impediments to effective implementation of TIEAs. The Financial Secrecy Index shows that all jurisdictions occupy a position on the FSI spectrum.

4.0 Recommendations

African economies can tap into the UN and OECD capacity building programmes to increase awareness and training. The programmes are a crucial initiative towards this as reported in the ATAF 2016 Report (ATAF, 2017). There is need to complete the training phases for the countries that have received some training while those that are yet to receive training should request such training.

Under Domestic Resource Mobilization (DRM) initiatives, African tax administrations should consider incorporating not only the training of their staff in managing information exchange, but also engage other administrations and financial providers to build capacity towards negotiating and implementing effective tax information exchange agreements.

Tax administrations can work around the current Model TIEA to design a template that speaks to the continental needs and press for recognition of the deficiency in leverage to give developing economies an edge in terms of negotiations. This concept has been applied to the

UN and OECD Model DTAs, which have been used to develop customized agreements for African economies.

African tax authorities can tap into the Taxes Inspectors without Borders (TIWB) programme under the auspices of the OECD and UNDP. Under the programme, experts are seconded to tax administration who request assistance to build tax audit capacity. These programmes complement the ongoing international community efforts to strengthen cooperation on tax matters and contribute to domestic resource mobilization in developing countries.

5.0 Conclusion

The structure of current Tax Information Exchange Agreements does not provide the envisaged effectiveness given the challenges noted. The perception around TIEAs that they provide wholesome international information flows from a simple request by a tax authority is misplaced. The impediments created by the current policy and legal framework provide a nigh impenetrable shield to information access or sharing.

The OECD's Model TIEA is practically slow and cumbersome and overall, much less effective than perceived. It is also resource intensive and its application creates costs for the contracting parties to the extent of that it defeats its purpose.

Its adoption by most tax havens may seem a success when in fact tax havens support the withholding of crucial information that tax authorities seek to access using TIEAs.

The structure of the OECD Model TIEA, the financial secrecy provisions within jurisdictions and the secrecy provisions with legislation in most economies collectively form an insurmountable impediment to effective implementation of TIEAs.

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