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Tax treatment of cross-border interest income and capital flights: recent developments*

Summary

The tax treatment of cross-border interest income continues to be a major issue in international taxation and in international finance. Recent developments will result in more extensive taxation of cross-border interest income, and consequently less capital flight and tax evasion. Although these recent developments are limited in scope, they may lead to further developments.

* The present paper was prepared by Mr. David Spencer and draws on several of his articles that appeared in the *Journal of International Taxation*. The views and opinions expressed are those of the author and do not necessarily represent those of the United Nations.

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I. Introduction

1. Consider a legal/tax structure that permits non-resident aliens and foreign companies (foreign persons) to derive interest on bank deposits and other interest-bearing instruments free of tax and also protected by bank secrecy or other confidentiality provisions whereby: (a) the jurisdiction receiving such investments (the source country, that is to say, the source of interest income) does not tax those foreign persons on the interest on such investments; (b) the source country provides confidentiality for such foreign persons by not exchanging information about such interest income with the residence country (the residence of the foreign person) and the source country may not even require the payer of such interest in the source country to report such interest income to the tax or other government authorities in the source country; and (c) the source country, such as the Organisation for Economic Cooperation and Development (OECD) financial centres, may tax domestic (non-foreign) persons on interest income, thereby providing preferential treatment to foreign persons (see example I).

II. Capital flight and tax evasion

2. The frequent result of this type of legal/tax structure is that the foreign person receiving such interest income does not pay tax on such interest income in either the source country or the residence country. Therefore, this legal/tax structure encourages capital flight and tax evasion.

3. Two recent proposals will impact (although in different ways) the taxation of such cross-border interest income: first, the European Union (EU) Directive on the Taxation of Savings (EU Savings Directive); and second, the OECD Proposals on Tax Havens and Harmful Preferential Tax Regimes (OECD Proposals).

III. Questions to consider

4. The EU Savings Directive and the OECD Proposals raise several important questions: What types of income do these proposals cover? What persons will be subject to these proposals? What principles do these proposals establish? What is the impact of these proposals on bank secrecy and other confidentiality rules? How will these proposals affect capital flight from (out of) EU and OECD countries? How will these proposals affect capital flight into EU and OECD countries? What is the relationship of these proposals with the exchange-of-information provisions of article 26 of the OECD Model Convention on the Taxation of Income and Capital (OECD Model Tax Convention) and article 26 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Tax Convention)?[1] Will these proposals lead to other related tax developments in the future? A technical analysis of these two proposals provides answers to these questions.

Example I

Source country

Bank deposit or other interest-bearing instrument

(a) Interest paid from source country to residence country
(b) Interest is tax-free in source country
(c) Bank secrecy/confidentiality in source country
(d) No exchange of information between source country and residence country

Residence country

Any recipient (individual or corporate)

IV. The European Union Directive on the Taxation of Savings

5. The EU Savings Directive (embodied in a November 2000 EU agreement, and modified by the EU Tax Package of January 2003) was adopted by EU on 3 June 2003. The EU Savings Directive has established an important principle, namely, that cross-border interest payments within EU to individual residents in EU (but not interest paid to companies resident in EU) should be subject to taxation. The mechanism for such taxation is either (a) the automatic exchange of information by the source country with the residence country or (b) a withholding tax in the source country (instead of automatic exchange of information with the residence country). The EU Savings Directive defines interest broadly to include interest on bank deposits and a broad range of other interest-bearing investments (EU Savings Directive, paras. 2-4, 7, 17, 18 and 27).

6. As of 1 January 2005, 12 of the 15 EU countries will automatically exchange information about cross-border interest payments within EU, to individuals resident in EU (irrespective of any bank secrecy or other confidentiality rules in the source country). However, three EU countries, namely, Austria, Belgium and Luxembourg, will not exchange this information. Instead, as of 1 January 2005, these three countries will impose a transitional withholding tax of 15 per cent, rising to 20 per cent on 1 January 2008, and to 35 per cent on 1 January 2011. The source country will retain 25 per cent of the withheld tax, and remit to the residence country 75 per cent of the withheld tax (EU Tax Package, para. 6) (see example II).

7. The EU Savings Directive is not based on any specific income tax treaty between EU member countries (except agreements between the EU and non-EU countries referred to below).

8. EU faced the displacement-of-income issue: the automatic exchange of information about cross-border interest payments within EU to individuals resident in EU, or the imposition of a withholding tax on such cross-border interest payments, would cause mobile assets in EU to be "displaced", that is to say, merely shifted, to non-EU jurisdictions. An individual resident of an EU country, rather than invest in another EU country (source country) that would (a) automatically exchange information with the residence country or (b) impose a withholding tax on such cross-border interest income, would move the investment to a non-EU jurisdiction (source country), such as Switzerland, the United States of America, the Cayman Islands or the Bahamas, that would not automatically exchange information with the residence country about the cross-border interest income or impose a withholding tax on that cross-border interest income.

9. In order to try to resolve this displacement-of-income issue, EU decided to negotiate with certain non-EU jurisdictions — Switzerland, the United States, Liechtenstein, Monaco, Andorra and San Marino — in order that similar rules might be imposed by such jurisdictions on interest payments from such jurisdictions to individuals resident in EU. Also, EU committed to applying the EU Savings Directive to EU-dependent and -associated territories. That is to say, with regard to interest payments to individuals resident in EU, EU-dependent or -associated territories would apply either (a) the automatic exchange-of-information rule adopted by the 12 EU member countries or (b) the withholding tax option adopted by Austria, Belgium and Luxembourg. (However, an EU resident might invest in other relevant jurisdictions, such as Panama, Hong Kong Special Administrative Region (SAR) of China or Singapore.)

Example II

EU source country

Bank deposit or other
interest-bearing
instrument

(a) Interest paid from EU source country to individual resident in EU country

(b) Under EU Savings Directive, EU source country either (i) exchanges automatically information with EU residence country or (ii) deducts the applicable withholdings tax

EU residence country

Individual (not corporation)
resident in EU country

10. The details of the agreements between EU and other jurisdictions are still being negotiated (in particular, whether in each case the exchange of information will be automatic or upon request, and whether the source country will have to apply both exchange of information and a withholding tax). Moreover, the implementation by EU of the Savings Directive to associated and dependent territories is still being determined, with such associated and dependent territories being concerned about their competitiveness; but the main point is that EU is negotiating with certain jurisdictions outside of EU, so that the EU Savings Directive can apply to cross-border interest payments from outside EU to individuals resident in EU, in order to reduce capital flight from EU.

V. The mechanics of automatic exchange of information

11. The EU Savings Directive will present a major practical challenge to EU: the effective implementation of automatic exchange of information for cross-border interest payments.

12. In order to be effective, the automatic exchange of information mandated by the EU Savings Directive for the 12 EU countries would require that: (a) each payee of interest give to the payer in the source country the name of the payee's country of residence and the payee's identification information (taxpayer identification number (TIN)); (b) the source country receive from payers of interest in the source country, relevant information (name of payee's residence country, payee's TIN in the residence country, and the amount of interest paid by the payer in the source country to that payee) (relevant information); (c) the source country transmit the relevant information to the residence country; and (d) the residence country use the relevant information to ensure compliance by the payee with his/her tax obligations in the residence country.

13. The most practical method seems to be the use of a standard certificate of residence, which the Council of OECD instructed the OECD Committee on Fiscal Affairs (OECD Fiscal Committee) to develop in order to contribute to standardization and increased transparency for the verification of fiscal status, and compilation of the relevant information based on the payee's TIN issued by the residence country. This was envisioned by (a) the 1997 OECD Recommendation on the Use of Tax Identification Numbers in an International Context (OECD TIN Recommendation) and (b) the 1997 OECD Recommendation on the Use of the Revised Standard OECD Magnetic Format for the Automatic Exchange of Information (OECD Magnetic Format Recommendation). The OECD TIN Recommendation was adopted, in part, from "the need to improve the effectiveness of exchange of information on cross-border income flows and thereby ensure that such income does not escape taxation".

14. The EU Savings Directive discusses the mechanics of exchange of information, including the information covered, and refers to the work of the OECD Fiscal Committee on the automatic exchange of information; it neither details the technical implementation of the exchange-of-information procedure nor specifically refers to the OECD TIN Recommendation. The EU Savings Directive (para. 20) states:

> "EU member States will review the technical implementation of the exchange-of-information procedure in an ad hoc group to be set up after agreement on the substantial content of the Directive, in parallel with the discussion with third States. The group could take as its basis the work done by the OECD (Fiscal) Committee on the automatic exchange of information."

15. The OECD Model Memorandum of Understanding on Automatic Exchange of Information for Tax Purposes refers in article 4 thereof to the tax identification numbers in both the residence (country) and the source country of the non-resident recipients of income.

16. The EU Savings Directive (paras. 50-54) also analyses the identification and residence of the beneficial owner.

17. Some argue that the impact of the EU Savings Directive has been substantially weakened because EU could not convince Austria, Belgium and Luxembourg (or Switzerland) to accept automatic exchange of information for cross-border interest payments to individuals resident in EU as of 1 January 2005, or to commit to automatic exchange of information at the end of the six-year "transition" period. Those three EU countries (especially Austria and Luxembourg) presumably attract more bank deposits and other interest-bearing investments than the EU countries that do not provide such secrecy. Therefore, the agreement by the other 12 EU countries to automatically exchange information about cross-border interest payments to individuals resident in EU might be regarded by some as only symbolic.

18. On the other hand, the EU Savings Directive could represent a significant development in international tax cooperation to combat capital flight and tax evasion. If EU successfully implements automatic exchange of information based on (a) a standard certificate of residence, (b) the OECD TIN Recommendation and the OECD Model Memorandum of Understanding on Automatic Exchange of Information for Tax Purposes and (c) the OECD Magnetic Format Recommendation, even if such automatic exchange of information is limited to cross-border interest payments from the aforementioned 12 EU countries to individuals resident in other EU countries, it might serve as an important first step and incentive for more extensive automatic exchange of information. Developments in international taxation, especially with regard to enforcement and compliance, frequently take place step by step.

19. However, whether it is pursuant to the EU Savings Directive that any cross-border interest payment from an EU jurisdiction to an individual resident in another EU country is subject to the automatic exchange of information or is subject to an interest-withholding tax, the EU Savings Directive clearly establishes the important principle that cross-border interest payments within EU to individuals resident in EU should not escape taxation. The importance of this principle should not be obfuscated or undermined by the decision of Austria, Belgium and Luxembourg, and Switzerland, not to accept at this stage the automatic exchange of information, but instead to impose the withholding tax.

20. The EU Savings Directive in effect confirms that in the case of cross-border interest income, because of its mobility and because of bank secrecy and other confidentiality rules provided by several source countries, the residence country by itself cannot resolve the problem of such capital flight and tax evasion, and that the cooperation of the source country is essential.

VI. Capital flight into EU

21. The EU Savings Directive does not apply to interest paid from EU countries to non-residents of EU. Based on example I discussed above, let us assume some additional facts, namely, that a non-resident (individual or corporate) of EU makes a bank deposit or another interest-bearing investment in EU, and that interest is paid from that EU jurisdiction to the non-resident of EU (example III). In such case, the EU Savings Directive does not require an interest-withholding tax or the exchange of information (automatic, spontaneous or upon request) between the source country and the residence country. That is to say, in such a situation, the EU Savings Directive does not modify any applicable bank secrecy or other confidentiality rules in EU. Therefore, the EU Savings Directive will have no direct impact on capital flight from residents of non-EU countries into EU, especially into EU financial centres such as Luxembourg and the United Kingdom of Great Britain and Northern Ireland.

22. In summary, the EU Directive on the Taxation of Savings is intended to reduce capital flight within EU (from one EU country to another EU country) and from EU to other jurisdictions; but it is not intended to reduce capital flight into EU from residents of non-EU jurisdictions.

VII. The OECD position on taxation of cross-border interest payments

23. In 1998, the OECD Fiscal Committee issued a report entitled, “Harmful Tax Competition: An Emerging Global Issue” (the 1998 OECD report). The OECD Council approved the 1998 OECD report, with significant abstentions from Luxembourg and Switzerland (see annex II of the 1998 OECD report containing statements by Luxembourg and Switzerland). The 1998 OECD report focused on “geographically mobile activities, such as financial and other service activities” (introduction, para. 6, and chap. II (Factors to identify tax havens and harmful preferential tax regimes), para. 38). It emphasized the conviction of OECD countries that “governments cannot stand back while their tax bases are eroded through the actions of countries that offer taxpayers ways to exploit tax havens and preferential tax regimes to reduce the tax that would otherwise be payable to them” (chap. III (Counteracting harmful tax competition), para. 85).

24. The 1998 OECD report and subsequent OECD reports focus on two types of “harmful tax competition” and “harmful tax practices”: (a) tax havens (low-tax and no-tax jurisdictions) and (b) harmful preferential tax regimes in OECD countries (1998 OECD report, chap. II (Factors to identify tax havens and harmful preferential tax regimes)); Towards Global Tax Cooperation: Progress in Identifying and Eliminating Tax Practices (2000 OECD report); and The OECD’s Project on Harmful Tax Practices: The 2001 Progress Report (2001 OECD progress report) (collectively, the OECD reports).

Example III

EU source country

Bank deposit or other interest-bearing instrument

(a) Interest paid from EU source country to non-EU residence country

(b) EU Savings Directive does not apply

Non-EU residence country

Any recipient
(individual or corporate)

25. In the context of these OECD reports, there are three categories of jurisdictions: (a) OECD member countries, (b) tax havens and (c) other jurisdictions (third countries). As most tax havens have small populations, tax havens are used primarily by residents (corporate or individual) of OECD countries or of third countries, frequently through the use of companies (or trusts) organized in such tax havens pursuant to local law.

26. With regard to tax havens, OECD issued a list of jurisdictions that it considered to be tax havens, based on the characteristics defined in the 1998 OECD report, categorizing these tax havens as either (a) cooperative tax haven jurisdictions which had committed to complying with the OECD guidelines on transparency and exchange of information within the time periods specified by OECD or (b) uncooperative tax haven jurisdictions which had not committed to complying with the OECD guidelines on transparency and exchange of information (2000 OECD report, chap. III (Evaluations and follow-up work), para. B (tax haven work)).

27. With regard to harmful preferential tax regimes in OECD countries, OECD prepared a list of such regimes that are potentially harmful (2000 OECD report, chap. III (Evaluations and follow-up work), para. A (member country preferential regimes)). The 1998 OECD report and the 2000 OECD report required OECD countries to terminate such harmful preferential tax regimes within time periods specified by OECD (see 2000 OECD report, chap. III (Evaluations and follow-up work), para. 15).

VIII. Cross-border interest flows and the OECD proposals

28. What do the OECD reports on tax havens and harmful preferential tax regimes state about the taxation of cross-border interest income, which is obviously a major aspect of capital flight?

29. The 1998 OECD report focuses on “geographically mobile” activities, including financial and other service activities. Assets such as bank accounts or other interest-bearing instruments are generally geographically mobile (perhaps the most mobile assets and therefore the most mobile income). An investor has the option of placing funds in interest-bearing assets in different jurisdictions, depending on the security, the return on the investment, the tax-free treatment, freedom from exchange controls, and the degree of confidentiality (non-disclosure to the tax authorities in the source country and no exchange of information between the source country and the residence country). Thus, as a technical matter, these geographically mobile assets and such cross-border interest income would definitely seem to be within the scope of the 1998 OECD report.

30. Discussed below is, first, the OECD treatment of harmful preferential tax regimes in OECD countries and, then, the OECD treatment of tax havens.

IX. Harmful preferential tax regimes in OECD countries

31. Based on example I above, some additional facts could be assumed, namely, that the source country is an OECD country and the residence country is a non-OECD country, that is to say, a person (corporate or individual) resident in a non-OECD country makes a bank deposit or other interest-bearing investment in an

OECD country (thus capital is flowing out of the non-OECD country and into the OECD country). Interest is paid from the OECD source country to the payee in the non-OECD residence country. As in example I, the OECD source country provides tax-free treatment of the cross-border interest income and confidentiality by not exchanging information with the residence country (example IV).

32. Based on these facts, is the OECD source country providing a harmful preferential tax regime, according to the OECD definition?

33. In the context of the 1998 OECD report, such a legal/tax structure in the source country should most likely be considered a harmful preferential tax regime (see the 1998 OECD report, chap. III, paras. 94 and 95; chap. III, recommendation 7, para. 112; and chap. III, recommendation 4, paras. 106-107). If such a legal/tax structure were considered to be a harmful preferential tax regime according to the 1998 OECD report and subsequent OECD reports, OECD countries (and primarily OECD countries that are financial centres) would be required to terminate such tax-free treatment and/or confidentiality within the time periods specified by the OECD reports for the termination of harmful preferential tax regimes. This would of course reduce capital flight into OECD countries. (Capital could also be flowing out of one OECD country into another OECD country, but the OECD proposals do not specifically apply to such capital flight within OECD and such cross-border interest payments within OECD.)

34. The 2000 OECD report lists potentially harmful tax regimes in OECD countries (chap. III (Evaluations and follow-up work), para. A (member country preferential regimes)). However, very significantly, such a legal/tax structure as diagrammed in example IV is not listed by OECD as a potentially harmful preferential tax regime. This is so even if the source country is an OECD country and the residence country is also an OECD country.

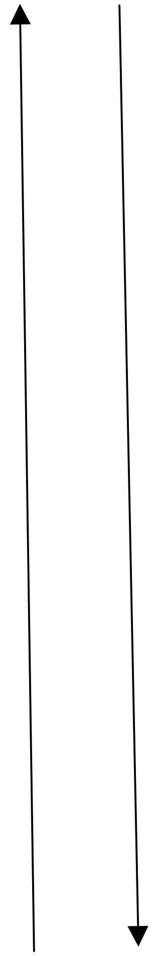
35. The 1998 OECD report indicates that the OECD project did not *at that stage* consider the tax treatment of interest on bank deposits and other cross-border saving instruments (introduction, pp. 9-10, para. 12). This is perhaps the basis for the Organisation's not treating such a legal/tax structure in example IV as a harmful preferential tax regime. Nevertheless, paragraph 12 of the 1998 OECD report specifically states that cross-border interest flows should not escape taxation:

> "The tax treatment of interest on cross-border saving instruments, particularly bank deposits, is not considered in this first stage of the project since the (OECD) Fiscal Committee is currently examining the feasibility of developing proposals to deal with cross-border interest flows, including the use of withholding taxes and exchange of information. (The OECD Fiscal Committee) has given a mandate to its Working Party on Tax Evasion and Avoidance to examine how exchange of information and withholding taxes can be used to ensure that cross-border interest flows do not escape taxation. The Committee attaches considerable importance to this issue and a first report will be available in 1999."

Example IV

OECD source country

Bank deposit or other interest-bearing instrument



(a) Interest paid from OECD source country to non-OECD residence country

(b) OECD source country provides (i) tax-free treatment, (ii) bank secrecy/confidentiality, (iii) no exchange of information with residence country and (iv) taxes its residents on such interest income

(c) OECD does not consider this a "harmful/preferential tax regime"

Non-OECD residence country

and recipient
(individual or corporate)

36. In April 2000, the OECD Fiscal Committee issued "Improving Access to Bank Information for Tax Purposes" (OECD bank information report), to which all OECD countries agreed, including Luxembourg and Switzerland, both of which had significantly abstained from involvement in the 1998 OECD report. This OECD bank information report, with its limited scope, focuses only on the access to bank information in the source country pursuant to a specific request made by a tax authority directly or indirectly, through a judicial or other administrative authority, that may be relevant to a specific case (preface, p. 3, and para. 5). The OECD bank information report covers only relevant bank information, and not information about other cross-border interest payments such as interest on corporate obligations and government obligations when the access to bank information is not an issue.

37. However, the OECD bank information report discusses the benefits of the automatic reporting of tax information by financial institutions to the relevant tax authorities for domestic tax administration purposes, and points out that such automatic reporting potentially expands the types of information that may be exchanged automatically with treaty partners. The OECD bank information report confirms that the OECD Fiscal Committee will continue to work on improvements in automatic reporting and automatic exchange of information in connection with its study of the use of information to enhance the taxation of cross-border interest flows:

> "The Committee is analysing ways to improve the exchange of information on an automatic basis within the context of its study of the use of withholding and/or exchange of information to enhance the taxation of cross-border interest flows and the Committee will review progress on this work" (OECD bank information report, preface and para. 109).
>
> "Improvements in automatic reporting and exchange of information are being examined in the context of the (Fiscal) Committee's study of the use of withholding taxes and/or exchange of information to enhance the taxation of cross-border interest flows" (OECD bank information report, paras. 58 and 5).

38. However, the OECD bank information report does not require or specify any compulsory measures. Rather, it only sets forth a standard that "ideally" should be met by OECD member countries (para. 20):

> "Ideally, all OECD Member countries should permit tax authorities to have access to bank information, directly or indirectly, for all tax purposes so that tax authorities can fully discharge their revenue-raising possibilities and engage in effective exchange of information. Some countries would need to undertake more substantial revision to their laws or practices than others to achieve this level of access. As a result, incremental steps towards that goal may need to be taken by such countries."

39. In spite of these statements, OECD has not yet actually required or suggested the imposition of a withholding tax or automatic exchange of information with regard to bank deposits and other interest-bearing investments from non-OECD countries into OECD countries and the resulting cross-border interest flows from OECD countries to payees in non-OECD countries (or even the imposition of a withholding tax or automatic exchange of information with regard to bank deposits and other interest-bearing investments from one OECD country into another OECD

country and the resulting cross-border interest payments from the OECD source country to the OECD residence country).

40. The failure of EU to convince Austria, Belgium and Luxembourg, and Switzerland, to implement automatic exchange of information in the context of the EU Savings Directive will undoubtedly delay any OECD initiative on mandatory automatic exchange of information. Furthermore, the United States has taken positions in favour of the exchange of information on request, rather than automatic exchange of information.

X. Treatment by tax havens

41. How do the OECD proposals treat interest-bearing investments into tax havens, and the resulting cross-border interest payments from tax havens?

42. With the same facts as set out in example I, some different additional assumptions can be made. Assume that the source country is a jurisdiction classified by OECD as a tax haven, and that the residence country is an OECD country. That is to say, a person (corporate or individual) resident in an OECD country makes a bank deposit or other interest-bearing investment in a tax haven jurisdiction (with capital flowing out of the OECD country into a tax haven jurisdiction and, consequently, cross-border interest payments from the tax haven jurisdiction source country to the OECD residence country) (example V).

43. The question is how the OECD proposals treat such capital flight from an OECD source country to a jurisdiction classified by OECD as a tax haven (residence country) and such cross-border interest payments.

44. Jurisdictions that OECD classified as tax havens in the 2000 OECD report were required by OECD to make certain basic commitments to OECD in order to be classified by OECD as a cooperative tax haven jurisdiction. These basic commitments were set forth in the Framework for a Collective Memorandum of Understanding on Eliminating Harmful Tax Practices issued by OECD in November 2000 (November 2000 OECD Framework). These basic commitments were evidenced by commitment letters from the respective tax haven jurisdiction to OECD, in order that the respective tax haven jurisdiction might be classified by OECD as cooperative; and such commitment letters frequently included additional comments by the respective tax haven jurisdiction.

45. Pursuant to the November 2000 OECD Framework, cooperative tax haven jurisdictions are required to have in place a legal mechanism that allows information on criminal tax matters and civil tax matters to be provided to tax authorities of OECD countries on request (but not automatic exchange of information or spontaneous exchange of information), according to specified effective dates. Cooperative tax haven jurisdictions are required to provide such information in spite of local bank secrecy or other confidentiality laws. This is clearly specified in the November 2000 OECD Framework. One major purpose of the November 2000 OECD Framework is to try to prevent capital flight from OECD countries to tax havens, by providing for exchange of information from the tax haven jurisdiction (source country) upon request by the OECD country (residence country) for civil and criminal tax purposes (but not automatic or spontaneous exchange of information) and by overriding such bank secrecy or confidentiality laws in tax havens.

Example V

Tax haven source country

Bank deposit or other interest-bearing instrument

(a) Interest paid from tax haven source country to OECD residence country

(b) November 2000 OECD Framework and OECD Model TIEA apply

OECD residence country

any recipient
(individual or corporate)

46. Significantly, the OECD proposals and specifically the November 2000 OECD Framework, which details the obligations of cooperative tax haven jurisdictions, apply to all types of income and do not specifically provide an exception for “cross-border savings instruments, including bank deposits”. In other words, the OECD proposals apply to a resident (corporate or individual) of an OECD country (residence country) making a bank deposit or other interest-bearing investment in a tax haven (source country), and to interest payments from the tax haven source country to the OECD residence country. Moreover, tax haven jurisdictions are in effect required by the November 2000 OECD Framework to override local bank secrecy and confidentiality laws applying to such bank deposits and other interest-bearing investments. In other words, the OECD proposals apply to such capital flight from OECD countries to tax havens, and such OECD proposals are intended to reduce such capital flight.

47. However, it must be remembered that OECD did not treat the facts in example IV as reflecting a harmful preferential tax regime in the OECD country and did not require the OECD countries (especially the OECD financial centres) to terminate such tax treatment. (A technical issue: the 1998 OECD report (introduction, pp. 9-10, para. 12) states that at this stage OECD does not consider the tax treatment of interest on bank deposits and other cross-border savings instruments. The subsequent OECD reports do not confront this issue. Therefore, could tax haven jurisdictions, whether classified by OECD as cooperative or uncooperative, argue that the November 2000 OECD Framework and the OECD Model Agreement on Exchange of Information in Tax Matters do not apply to cross-border interest payments from tax havens to OECD countries on bank deposits and other savings instruments in those tax havens?)

48. Furthermore, the November 2000 OECD Framework is not symmetrical: it requires cooperative tax haven jurisdictions to provide to OECD countries such information on request in criminal and civil tax matters; but the November 2000 OECD Framework does not require OECD countries to provide such information on request in criminal and civil tax matters to any other jurisdiction (whether an OECD country or not, and whether a tax haven or not).

XI. The OECD Model Agreement on Exchange of Information in Tax Matters

49. OECD issued on 18 April 2002 the OECD Model Agreement on Exchange of Information in Tax Matters (OECD Model TIEA). The OECD Model TIEA, providing for exchange of information upon request, was developed to implement the November 2000 OECD Framework. The OECD proposals in effect require cooperative tax haven jurisdictions to enter into the OECD Model TIEA with all OECD countries (whether on a bilateral or a multilateral basis).

50. The OECD Model TIEA is broader than the November 2000 OECD Framework in that the OECD Model TIEA provides for two-way exchange of information. That is to say, under the OECD Model TIEA (with specified effective dates), each contracting party thereto (the OECD country and the cooperative tax haven jurisdiction) can request information from the other contracting party, and each contracting party is required to provide information to the other contracting party, subject to the terms and conditions of the OECD Model TIEA. The OECD

Model TIEA specifies (article 5 (4)) that each contracting party must provide the information requested irrespective of local bank secrecy and other confidentiality laws. Therefore, it would seem that the OECD Model TIEA would also apply to bank deposits and other interest-bearing investments made from tax haven jurisdictions (inter alia, by a company organized in a tax haven jurisdiction) as a residence country into OECD countries as a source country, and that the OECD Model TIEA would require the "override" of bank secrecy and confidentiality laws in the OECD source country.

51. The OECD proposals do not require OECD countries to enter into the OECD Model TIEA with other OECD countries. Therefore, the OECD proposals do not apply to cross-border interest payments between OECD countries, that is to say, when the residence country is an OECD country and the source country is also an OECD country. (Also, the OECD proposals do not require cooperative tax haven jurisdictions to enter into the OECD Model TIEA with third Countries.)

52. It is not very significant that under the OECD Model TIEA, a cooperative tax haven jurisdiction (residence country) can request information from an OECD country (source country), and that the OECD country has to provide such information to the cooperative tax haven jurisdiction irrespective of local bank secrecy and other confidentiality laws in the OECD country. This is because under articles 1 and 5 of the OECD Model TIEA, a contracting party, the requesting party (in this case, the cooperative tax haven jurisdiction) can request only information from the other contracting party, the requested party (in this case, the OECD country), that is foreseeably relevant to the administration and enforcement of the domestic laws of the requesting contracting party (in this case, the laws of the cooperative tax haven jurisdiction) in civil and criminal tax matters. As tax haven jurisdictions generally impose no or low income taxes, compliance with income tax laws in a cooperative tax haven jurisdiction by a resident individual or by a local company is normally not an issue. Therefore, a cooperative tax haven jurisdiction as a residence country, which normally is not concerned about the administration and enforcement of income tax laws in that jurisdiction, would not be requesting any such information from the OECD source country.

53. Further, tax haven jurisdictions, most of which have very small populations, are not used frequently by residents (corporate or individual) of the respective tax haven jurisdiction, but are used more frequently by residents (corporate or individual) of third countries. Those residents of third countries frequently use a company organized in a tax haven jurisdiction to carry out activities in other jurisdictions (such as investing in an OECD country, including investing in bank deposits or other interest-bearing investments in the OECD country). However, under the OECD Model TIEA, the cooperative tax haven jurisdiction can request information from the OECD country only for the administration or enforcement of the domestic laws of the respective cooperative tax haven jurisdiction concerning taxes. That cooperative tax haven jurisdiction could not request from the OECD country information for the administration or enforcement of the laws of a third country (OECD Model TIEA, articles 1 and 5).

54. Therefore, the primary impact of the OECD Model TIEA will be the following: OECD countries would obtain tax information from cooperative tax haven jurisdictions, instead of cooperative tax haven jurisdictions' obtaining information from OECD countries.

55. Furthermore, any information that the requesting contracting party obtains pursuant to the OECD Model TIEA cannot be transferred by that contracting party to a third country without the express written consent of the requested contracting party (OECD Model TIEA, article 8). Therefore, it is unlikely that information obtained by either the OECD country or by the cooperative tax haven jurisdiction could be transferred by either to a third country.

56. In summary, in example IV, with an OECD country as the source country and a non-OECD country as the residence country, the OECD proposals do not consider such tax-free treatment in the OECD country of cross-border interest income or any applicable bank secrecy or other confidentiality rules in the OECD country as a harmful preferential tax regime, and do not require the OECD country to terminate such tax-free treatment or bank secrecy or other confidentiality rules; and the OECD proposals do not require the OECD source country (a) to impose an interest withholding tax or (b) to exchange information automatically with the residence country. Furthermore, the OECD Model TIEA should not significantly reduce capital flight from residents (individual and corporate) of non-OECD countries into OECD countries (whether directly from the third country, or indirectly from the third country through a tax haven company vehicle).

57. Therefore, the OECD proposals are not intended to reduce, and will not have the effect of reducing, such capital flight into OECD countries from tax havens and from third countries (whether directly or indirectly through tax haven jurisdictions (whether cooperative or uncooperative)).

XII. Relation of the OECD Model TIEA with (a) the OECD Model Convention on the Taxation of Income and Capital and (b) the United Nations Model Double Taxation Convention between Developed and Developing Countries

58. As discussed above, the OECD Model TIEA requires the source country to exchange information on request by the residence country, irrespective of any local bank secrecy or confidentiality laws (article 5 (4), and commentary to the OECD Model TIEA, paras. 46-56). In this regard, the OECD Model TIEA is significantly broader than (a) article 26 of the OECD Model Tax Convention and (b) article 26 of the United Nations Model Double Taxation Convention. The question is whether article 26 of the OECD Model Tax Convention and article 26 of the United Nations Model Double Taxation Convention will be modified to incorporate the broader provisions of article 5 (4) of the OECD Model TIEA.

XIII. Conclusion

59. **The EU Savings Directive and the OECD proposals have focused attention on capital flight, cross-border interest payments and tax evasion.**

60. **The EU Savings Directive and the OECD proposals differ in scope as to the type of income covered. The EU Savings Directive is limited to the taxation of cross-border interest payments within EU to individuals resident in EU and (in an attempt to solve the displacement-of-income problem) capital flight from**

EU and cross-border interest payments from outside EU to individuals resident in EU.

61. **The OECD proposals in effect focus on capital flight from the OECD countries to tax havens, and income paid from tax havens to corporate and individual residents in OECD countries. The OECD proposals do not consider capital flight within OECD countries; and, very significantly, the OECD proposals have delayed confronting directly the issue of cross-border interest payments on bank deposits and other savings instruments in OECD, a major aspect of capital flight from third countries into OECD, and especially OECD financial centres — indeed, perhaps the most significant aspect of capital flight.**

62. **As to the method of enforcement, the EU Savings Directive requires automatic exchange of information or a withholding tax, while the OECD proposals are limited to exchange of information on request.**

63. **In spite of these differences, both the EU Savings Directive and the OECD proposals have focused attention on capital flight, and the taxation of income thereon.**

64. **With this growing attention to capital flight, the EU Savings Directive and the OECD proposals will presumably lead to greater scrutiny by third countries of the policies of EU and OECD as regards their even-handedness. Both the EU Savings Directive and the OECD proposals in effect do not confront the issue of capital flight from third countries into EU and OECD countries. A major issue is the following: now that EU and OECD have emphasized the importance of the taxation of capital flight, how will third countries react?**

65. **The report of the High-level Panel on Financing for Development (also known as the Zedillo report, after the Chairman of the Panel, Ernesto Zedillo) dated 26 June 2001 (see document A/55/1000) recommends "tax information sharing that permits the taxation of flight capital" (recommendation 12).**

66. **The International Conference on Financing for Development (Monterrey, Mexico, 18-22 March 2002) called upon developing countries to mobilize resources for development. The Monterrey Consensus of the International Conference on Financing for Development[2] encourages, inter alia, strengthening "international tax cooperation, through enhanced dialogue among national tax authorities and greater coordination of the work of the concerned multilateral bodies and relevant regional organizations, giving special attention to the needs of developing countries and countries with economies in transition" (para. 64; see also paras. 10-19).**

67. **Developing the International Dialogue on Taxation: A Joint Proposal by the Staffs of the IMF, OECD and the World Bank (13 March 2002) (Joint proposal),[3] indicates that the staffs of the International Monetary Fund (IMF), OECD and the World Bank will assist developing countries in improving the effectiveness of their tax administrations, thereby increasing the governmental revenues of those countries.**

68. **In view of the recommendations contained in the Zedillo report and the Monterrey Consensus, and the Joint proposal, will IMF, OECD and the World Bank work with third countries and EU and OECD to confront the issue of capital flight from third countries into bank deposits and other interest-bearing instruments in the EU and OECD countries? Will IMF, OECD and the World Bank take steps under the Joint proposal to implement the taxation of cross-border interest income paid from OECD and EU countries directly or indirectly to residents in third countries on such flight capital?**

Notes

[1] United Nations publication, Sales No. E.01.XVI.2.

[2] *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (United Nations publication, Sales No. E.02.II.A.7), chap. I, resolution 1, annex.

[3] Available at http://www.imf.org/external/np/fad/itd/2002/031302.htm. Accessed on 16 September 2003.