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Anonymous Withholding Agreements and the Future of International cooperation in Taxing Foreign Financial Accounts : Testimony before the Finance Committee of the German Bundestag, September 24, 2012 (Statement by Associate Professor Itai Grinberg, Geo. U. L. Center)

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ANONYMOUS WITHHOLDING AGREEMENTS AND THE FUTURE OF INTERNATIONAL COOPERATION IN TAXING FOREIGN FINANCIAL ACCOUNTS

Testimony before the Finance Committee of the German Bundestag
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Good afternoon, Chairwoman Reinemund and members of the Finance Committee. My name is Itai Grinberg, and I am an Associate Professor of Law at Georgetown University Law Center.[1] Thank you for the opportunity to testify before you today about the Swiss-German anonymous tax withholding agreement. In my testimony, I will make three key points:

- Automatic information exchange is superior to anonymous withholding for the purpose of combating tax evasion involving the use of foreign financial accounts.
- German ratification of the Swiss-German anonymous tax withholding agreement would stifle the emergence of a multilateral automatic information exchange system. As a result, Germany would be less able to address its own concerns with tax evasion through foreign accounts over the medium term. By ratifying this agreement, Germany would also slow the development of a multilateral system that would allow many other countries around the world to effectively address their concerns with tax evasion through foreign accounts.
- Switzerland has in effect agreed to automatic information exchange with the United States. Germany could pressure Switzerland unilaterally, multilaterally, and through the EU for a similar agreement.

I. The Future of the Taxation of Foreign Financial Accounts

The international tax system is in the midst of a battle between automatic information reporting and anonymous withholding models for ensuring that nations can tax the foreign financial accounts[2] of their residents.[3] At stake is the extent of many countries' capacity to impose an income tax on the investment income of individuals and the profits of closely held businesses in a world that is increasingly financially integrated.

New approaches to enhanced cross-border tax cooperation based on automatic information exchange are currently being developed in three separate but related projects. These projects are being led respectively by the Organisation for Economic

[1] Until the summer of 2011, I served in the Office of International Tax Counsel at the United States Department of the Treasury. In that capacity I was involved in the Obama Administration's legislative, regulatory, and diplomatic efforts to address offshore tax evasion. The views I express in this submission to the Finance Committee of the German Bundestag are solely my own.

[2] I use the term "foreign financial account" to refer to any account that is owned or controlled by an individual investor who is not tax resident in the jurisdiction where the financial institution (or the relevant subsidiary or branch of such institution) that provides the account is located.

[3] My views on the battle between automatic information reporting and anonymous withholding are laid out in much greater detail in two related papers. The more recent of these papers is entitled *The Battle Over Taxing Offshore Accounts* (forthcoming in the UCLA Law Review; available at http://www.uclalawreview.org/?p=3814). An earlier version of that paper, released in January 2012, is entitled *Beyond FATCA: An Evolutionary Moment for the International Tax System*, and is available at http://ssrn.com/abstract=1996752.

Cooperation and Development (OECD), the EU, and the United States in partnership with some of its major European trading partners, including Germany. Separately, Switzerland is promoting an anonymous withholding approach for addressing the question of foreign financial accounts. Both the automatic information exchange approach and the anonymous withholding approach are built on the premise that financial institutions should act as cross-border tax intermediaries. The debate around international tax cooperation has thus shifted from a dispute about whether financial institutions should function as cross-border tax intermediaries to a dispute about how financial institutions should perform that role and for which jurisdictions they should do so. This development represents a remarkable shift in international norms.

However, a great deal is at stake in the decision either to focus exclusively on the automatic information exchange practices being promoted by the OECD, the EU, and the United States and its partners, or to accept the anonymous withholding alternative that Switzerland is promoting. The triumph of the automatic information reporting model over the anonymous withholding model is important for several reasons: (1) it allows for the taxation of principal, (2) it helps maintain taxpayers' sense of fairness, and (3) it makes possible the emergence of a multilateral system in which financial institutions serve as cross-border tax intermediaries regardless of the jurisdiction in which the financial institution is located.

A. Automatic Information Exchange Is Superior to Anonymous Withholding

An automatic information reporting model is superior to an anonymous withholding model in addressing the taxation of foreign financial accounts for three reasons:

1. Automatic Information Exchange Can Reach Untaxed Principal

Anonymous withholding is inferior because, unlike automatic information reporting, it cannot address concerns regarding the accumulation of untaxed principal in a foreign financial account. Anonymous withholding is only triggered when interest, dividends, or capital gains are earned in a foreign account, whereas automatic information reporting can be structured to both report on income and gains and measure the growth of principal in a foreign account. Untaxed principal—domestic business income that escapes taxation through the use of foreign financial accounts to engage in outright tax fraud—is just as great of a concern for tax administrators around the world as untaxed investment income in a foreign financial account.

2. Automatic Information Exchange Helps Maintain a Sense of Fairness

Cross-border anonymous withholding also may damage tax morale by institutionalizing different and preferential treatment for the most sophisticated taxpayers, as compared to the rest of society. The more common foreign financial accounts become, the more the special treatment of anonymous account holders could undermine other taxpayers' sense of fairness. Furthermore, the Swiss-German anonymous withholding agreement is explicitly conditioned on German concessions to facilitate Swiss financial institutions' access to German clients. The concessions Switzerland extracted from Germany make it easier for Swiss institutions to legally compete with domestic German financial institutions without having any local footprint and without being subject to German regulation. As a result, more wealthy Germans may shift toward Swiss asset management, and as more wealthy Germans avail themselves of Swiss anonymity, other taxpayers' sense of fairness may well decline.

3. A Multilateral Solution Is Needed, and Multilateral Automatic Information Exchange Is Achievable

Anonymous withholding by Switzerland alone is unlikely to substantially deter tax evasion by German taxpayers through the use of foreign accounts. High-quality wealth management services are available in many jurisdictions. Tax evaders can easily close Swiss accounts and open accounts in other jurisdictions to circumvent the Swiss-German agreement. Any comprehensive solution to this tax evasion problem must therefore involve many countries assisting Germany, and should therefore be multilateral.[4]

As the OECD has recently documented, automatic information exchange is a growing practice, with many OECD countries sharing at least some information automatically in order to improve global tax administration. Recent negotiations between the United States and other countries for automatic information reporting have also accelerated global discussions about multilateral automatic information exchange. Most notably, France, Germany, Italy, Spain, the United Kingdom, and the United States recently issued a model intergovernmental agreement to improve tax compliance based on reciprocal automatic information exchange. The six countries also made a commitment to work together to achieve common reporting and due diligence standards for financial institutions in order to support a move to a more global system to combat tax evasion. As matters stand today, there is a substantial opportunity internationally to build a multilateral automatic information exchange system.

B. Ratifying the Swiss-German Agreement Would Stifle the Emergence of a Multilateral Automatic Information Exchange System

A comprehensive, multilateral automatic information exchange system is less likely to emerge if anonymous withholding is accepted as equivalent to automatic information exchange. Bilateral anonymous withholding agreements are likely incompatible with a comprehensive multilateral automatic information exchange system. Consistent coercive pressure from the large, developed economies is needed to forge a working multilateral system. Germany, and the EU as a whole, will find it much more difficult to pressure other jurisdictions to participate in automatic information exchange once Germany has agreed to anonymous withholding with Switzerland. This difficulty arises both with respect to countries within the EU (such as Austria and Luxembourg) and countries outside the EU (such as Singapore and Hong Kong). Thus, German ratification of the Swiss agreement would make it less likely for an effective regime that addresses the problem of tax evasion through the use of foreign accounts to take hold worldwide. Consequently, Germany would be less able to address its own concerns regarding tax evasion through foreign accounts, and Germany would also make it less likely that other countries would be able to effectively address their problems with tax evasion through foreign accounts.

1. Significance of the U.S. –Swiss Joint Statement Regarding FATCA

In June, the United States and Switzerland issued a joint statement that represents a U.S. victory against Swiss bank secrecy. The Swiss have, in essence, agreed to provide information automatically to the United States. The mechanism is more cumbersome

[4] The most comprehensive multilateral solution to address the taxation of foreign financial accounts would involve withholding that is not anonymous in combination with automatic information reporting. A system that provides both withholding and reporting cross-border is, however, not currently under consideration internationally.

than the reciprocal automatic information exchange agreement currently on the table between Germany and the United States, but the end result is highly similar. The U.S.–Swiss Joint Statement generally envisions direct reporting by Swiss financial institutions to the United States Internal Revenue Service (IRS). Accounts of consenting U.S. accountholders would be reported to the IRS individually, while accounts of non-consenting U.S. accountholders would be reported on an aggregate basis. Switzerland then agreed to accept and promptly honor group information exchange requests by the IRS for additional, individualized information about the non-consenting U.S. account holders. In the end, the U.S. receives the same information as it would have received under one-step automatic information exchange.

Switzerland abandoned bank secrecy in its dealings with the United States in order to avoid the sanctions imposed by a new U.S. law (known as "FATCA") that requires financial institutions to report on foreign accounts held by U.S. persons. Germany is a major economy with which Switzerland has strong ties; Germany should also have the power to pressure Switzerland bilaterally for an arrangement that is similar to the information reporting negotiated by the United States. Germany could also push for coordinated defensive measures to build a multilateral automatic information exchange system at the G-20 or lead an EU-level process to pressure Switzerland to provide automatic information exchange to the EU.

2. Consequences of German Ratification of the Anonymous Withholding Agreement

If Germany (and the UK) instead ratify their anonymous withholding agreements with Switzerland, the international impact of the U.S.–Swiss agreement will be diminished. Switzerland will have successfully defused U.S. pressure to engage in automatic information exchange, while being able to claim that the U.S. agreement represents a special case. If Germany ratifies its agreement with the Swiss, it will free Switzerland to promote anonymous withholding with those few other countries that have some leverage over the Swiss financial center and reject enhanced tax cooperation with everyone else. This dynamic may explain why the Swiss insisted that, as part of the Swiss-German agreement, Germany commit to not work against anonymous withholding in dealings with third parties.[5] If governments that are committing to increased automatic information exchange cannot coordinate with Germany to pressure Switzerland and other asset management jurisdictions to adopt a multilateral automatic information exchange system, then it will become difficult for the international community to effectively pressure Switzerland and other asset management jurisdictions to move towards a multilateral system. The absence of consistent, coordinated pressure in one direction would harm both German tax administration and other governments that are concerned about the global problem of tax evasion involving the use of foreign accounts.

Madame Chairwoman and members of the Finance Committee, thank you again for inviting me to participate in this hearing.

[5] See the Joint Declaration Concerning the Equivalence of this Agreement (Gemeinsame Erklärung der Vertragstaaten zur Gleichgewichtigkeit des Abkommens).