Paved Paradise: Analysis of the Common Reporting Standard to Combat Tax Avoidance

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Recommended Citation
Available at: https://ir.lib.uwo.ca/lajur/vol4/iss1/4
Abstract: Recent financial information leaks including the Panama Papers and the Paradise Papers received widespread international attention, highlighting the practice of tax avoidance and questions about its ethicality. These practices have been extensively examined by governments, independent groups, and the media who have called for action against the practice. This paper examines the Common Reporting Standard produced by the Organisation for Economic Co-operation and Development. More than 100 countries have signed in commitment to the standard with the aim of reducing tax evasion and avoidance worldwide. This paper recognizes that standardization is an important step in combating tax avoidance, but the incomplete cooperation by the United States, inability to enforce compliance, dependency on cooperation with independent financial institutions, and remaining loopholes require that the reporting standards continue to be refined.

Keywords: Common Reporting Standard; Tax Avoidance; Tax Evasion; OECD; Tax Policy.

Introduction

The Panama Papers brought tax avoidance to the forefront of public discussion in 2016, when over 11.5 million records from the offshore law firm Mossack Fonseca were leaked. Twelve national leaders and 148 politicians were among the 14,000 clients named, and subsequently scrutinized, for holding capital in foreign institutions to avoid paying their full domestic tax obligations.\(^1\) In addition to individuals, tax avoidance and offshore holdings of large transnational corporations have been highlighted due to media exposure of tax planning schemes by Starbucks, Google, Goldman Sachs, Amazon, and Apple.\(^2\) The media exposés of the offshore financial industry have continued, most recently with Paradise Papers released in late 2017. Although this information has led to numerous

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criminal convictions, the majority of the operations detailed are legal, taking advantage of tax policy loopholes rather than directly breaking any laws or regulations.

With the current reality of globalization and an expansive network of free-trade-reducing tariff and non-tariff barriers, groups and individuals have increasing access to international financial markets. Illegal tax evasion or legal tax avoidance are enabled by ‘tax haven’ countries with lower corporate taxes and financial systems which refrain from collecting or sharing accountholder information. Thousands of individuals and corporations hold investments in accounts outside of the country in which they reside, paying foreign tax at a lower rate than that of their country of residence. The information and capital resources necessary to take advantage of this practice result in disproportionately high engagement by the wealthiest individuals. While illegal evasion is prosecutable, debates involving the ethicality of tax avoidance focus on the uneven accessibility of the practice, lost tax revenue, and the lack of transparency in the use of avoidance by individuals and organizations.

The National Bureau of Economic Research estimates that the equivalent of 10% of worked GDP is held in tax havens. These offshore accounts are estimated to cost governments in excess of $500 billion USD annually in lost tax revenue. Recognizing that this lost revenue could be used to strategically improve the lives of citizens, legislatures from places such as Canada and the EU are working to combat tax avoidance. However, these measures require cooperation from governments which have consciously engaged in tax competition, strategically setting lower corporate tax rates with the aim of drawing economic activity to improve the domestic standard of living and increase tax revenue.

A comprehensive system of tracking international assets, income, and tax liabilities is necessary to achieve proper tax collection in a globalized world. It is critical to track the value added in each distinct country to avoid double taxation, double non-taxation, and payment of taxes to the incorrect government. Combating tax avoidance requires international cooperation because of the independent benefits to countries of engaging in competitive tax practices. The Organisation for Economic Co-operation and Development (OECD) was created in 1961 with the goal of facilitating economic cooperation. The OECD includes 35 developed and emerging member countries which have agreed to implement complementary policies for the wider economic benefit.

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In 2013, the OECD undertook the Base Erosion and Profit Shifting (BEPS) Project, aiming to increase the fairness and integrity of tax systems by reducing the ability of multinational corporations to disingenuously allocate profits to countries with low corporate tax rates. The BEPS Project has produced a series of reports which focus on 15 Actions which are areas of specific concern, including the digital economy, interest deductions, and conflict resolution. Related to Action 13 involving Country-by-Country Reporting, the OECD has recommended the Automatic Exchange of Information (AEOI) as information aides in tax collection. Most recently, the OECD introduced the Common Reporting Standard (CRS) to combat tax avoidance and evasion at the individual and private entity level. CRS calls on countries to collect information on individuals and entities from financial institutions within their jurisdiction, and under AEOI, automatically exchange that information with other jurisdictions on an annual basis. As at January 2018, approximately 100 countries had agreed to implement. This paper examines the strengths and weaknesses of CRS in its original purpose to combat tax avoidance and evasion.

**A brief history of international taxation**

International tax law has not significantly changed since the 1920s. At that time, the League of Nations created an international tax system with no formal oversight body in response to the problem of trade-restricting and welfare-reducing double taxation of international commerce. Under-taxation continued within this system largely due to the high risk of double taxation and tax competition between governments. Over time this has led to reductions in taxes, tax bases, and oversight in a race to the bottom.

A major development in international tax law occurred in 2010, when the United States passed the controversial Foreign Account Tax Compliance Act (FATCA) into law. FATCA requires foreign financial institutions and governments to report on the assets held overseas by US persons or entities to the Internal Revenue Service (IRS). If agencies do not comply, they are subject to having payments withheld by the American government. Prior to FATCA, inter-government tax information sharing was carried out through a network of bilateral tax treaties between countries by request on a case-by-case basis. Countries other than the US continued to operate in this manner, causing inefficiency and missed opportunities for governments to learn about the tax practices of citizens.

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The common reporting standard

The OECD Common Reporting Standard marks a significant step forward in international taxation reform. As its name implies, CRS requires individuals and entities to file tax and asset holdings information through a universal and standardized approach to selected financial intermediaries. These financial intermediaries then report this information to the relevant tax authorities who have jurisdiction over the individual. Through the OECD Model Competent Authority Agreement, government tax authorities and regulators automatically share this information with other agencies with jurisdiction.\textsuperscript{10}

CRS was first approved by the OECD Council on July 15, 2014, with rollout beginning in 2016 by the European Union. Over 100 jurisdictions publicly committed to implementing CRS into domestic law by the end of 2018. (Refer to figure 1 for a map of signatory countries.) Canada passed CRS into law in July 2017, and it will first take effect in May of 2018.\textsuperscript{11}

CRS applies to the accounts of individuals and entities identified as tax residents in one or more jurisdictions that have signed the agreement. The ultimate individual owner of all entity accounts must be reported, with this requirement being new for many tax jurisdictions. Certain entities such as publicly-traded corporations, governments and central banks, and international financial institutions do not have to disclose information on their accounts (Canadian Bankers’ Association, 2017).

CRS follows the American FATCA tax model. Despite this, CRS is not an extension of FACTA and the two tax regulations are independent. Although the US is a member of the OECD, it has not agreed to join the CRS regime, electing to continue collecting information on US persons through its existing FATCA legislation and not automatically share information. Consequently, American individuals and entities are exempt from CRS.\textsuperscript{12}

Similar to FATCA, CRS passes the regulatory burden of reporting to financial intermediaries. As described by an OECD report, “financial institutions that are required to report under CRS do not only include banks and custodians but also other financial institutions such as brokers, certain collective investment vehicles and certain insurance


companies”. To meet CRS requirements, financial institutions must collect information on their customers for reporting purposes when opening accounts or providing select services. CRS calls for penalties to be implemented against organizations that do not comply with reporting requirements under the new regime. However, the OECD does not provide a standard for penalties, leaving the decision to the jurisdictions with relevant authority.

**Strengths**

Due to increased financial transparency, CRS will diminish the incentive for individuals and entities to move money offshore, thereby reducing the amount of lost tax revenue worldwide. Placing a burden of reporting on third parties such as banks in addition to taxpayers is expected to further decrease tax revenue lost. A study conducted by the IRS found that tax filings not subject to third-party reporting result in a 56% net misreporting rate, and a similar trend is likely to occur with the third-party involvement in CRS. A value for the increased amount of tax revenue captured will be estimated in a 2020 OECD peer-reviewed study. Based on the current estimates of absent tax revenue, the global benefits of CRS implementation are likely to outweigh the costs. The implementation costs associated with the standard are relatively low, given that it is largely based on existing measures already undertaken by banks due to FATCA in 2010. For example, KPMG estimates that compliance costs would be approximately $125 million USD for global banks based in the UK. These costs primarily relate to technology adjustments and new customer outreach programs required to enforce CRS. For comparison purposes, Her Majesty’s Revenue and Customs agency, the UK’s tax authority, estimated that FATCA’s implementation cost £1.1bn-£2bn in the UK.

One of the most significant benefits of CRS is that it removes transparency as a negotiating tool in agreements involving tax haven countries, therefore producing increased co-operation between governments when combating tax evasion. Discretion is valued by users of tax havens because the practice either involves illegal activities or is of questionable morality, as was seen in the reaction to the Panama and Paradise Papers.

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Tax haven countries attract outside investors with a combination of low tax rates and discretion. For example, a haven such as Switzerland is renowned for secrecy and is, therefore, able to charge a higher corporate tax rate than a haven without this reputation. Recognizing this, countries such as Canada have aimed to specifically discourage tax evasion by negotiating with haven countries, permitting their domestic citizens to be charged a reduced amount of taxes related to offshore accounts in exchange for the offshore government being increasingly transparent with the account information. With CRS mandating transparency, the tax haven governments are unable to use a transparency agreement as a means to further reduce tax rates.

**Weaknesses**

The OECD is one of many NGOs which was born of the original League of Nations, and, as such, it does not have an official means to enforce compliance by member states. Tax competition is an application of game theory economics, with governments seeing an advantage in undercutting the tax rates of other countries to generate domestic economic activity and increase tax revenue. If a collective agreement is made to increase transparency, there is a benefit to dissent; a country may cut taxes or form a reputation of secrecy, acts which would improve its position as a tax haven. Without an official means of enforcement, the OECD depends on countries opting to comply based on pressure from other member states. For instance, Panama was unwilling to implement a standardized reporting system until pressure increased following the release of the Panama Papers. Succumbing to outside pressures can benefit governments by maintaining international relations, using this goodwill in other negotiations relating to trade or avoiding economic sanctions. Although these considerations have been sufficient in seeing numerous countries agree to CRS, it has not had the same effect in motivating the United States because the country has enough power to ignore these external pressures. Additionally, as an international organization without jurisdictional authority over individuals or businesses, the OECD is unable to levy penalties on individuals or organizations without the cooperation of multiple stakeholders. This limits CRS’s ability to be enforced in the same manner as FATCA, where individuals and organizations with reporting obligations face a 30% withholding fee for failing to report per their obligations.

As described in the Journal of International Taxation, there are numerous legal issues with CRS as it currently stands relating to taxpayers’ rights. The information being shared by the third-party reporters to government tax agencies includes the account holders

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name, address, TIN (Tax Identification Number), country (countries) of tax residence, account number and balances, and entity owner and classification if applicable.\textsuperscript{21} Reporting of this information is necessary, regardless of whether or not it is clearly linked to illegal activity. Information on financial transactions and asset holdings that is automatically shared between countries may breach privacy protection rules protected by the law and constitutions of affected persons, requiring implementation delays or absolute prevention.

CRS requires that private financial institutions submit client information to the government, a process which raises questions of ethicality as a long-term solution. The financial institutions in tax havens themselves benefit from tax competition, seeing greater holdings which can be used for the institutions to generate interest. Requiring extensive reporting creates a conflict of interest by the banks seeing benefit in drawing clients through their discretion, but risking large fines for improper reporting. Depending on these private institutions may not be possible, especially in smaller countries with potential for widespread corruption or an inability to police financial operations. Furthermore, financial institutions may deliberately avoid servicing individuals from CRS compliant countries, thereby circumventing any fines by not being required to submit the statements. Behaviour of this type was seen with the introduction of FATCA, with American citizens facing discrimination from financial institutions to avoid problems with the IRS.\textsuperscript{22} The aim of CRS is to reduce tax avoidance without inhibiting international investment. Despite agreement from governments, the behaviour of financial institutions cannot be controlled, and this absence of control potentially jeopardizes the implementation of CRS.

Critics of CRS claim that its scope is not wide enough to achieve its aims. Information on passive account balances at a point in time do not allow for the tracking of the flow of funds through accounts internationally. Hence, this system is not adequately effective for measuring annual income, or attributing revenue to the tax jurisdiction in which the gains were realized or value created. Additionally, CRS does not apply to public corporations, a group which has significant offshore holdings. Public companies have requirements to report financials, specifically asset holdings. However, the international flow and holding of funds may not be as accurately reported, particularly considering the discretion with which many offshore financial institutions operate. The way in which CRS acts as an extension of domestic tax law is to require the reporting of individuals and private firms, not public ones. Future expansion of CRS so that it applies to public corporations would likely be realized only with agreement from the US because of the common connection of public corporations to the country. Including information on the flow of funds of both public and private corporations would further work toward the CRS goal of tax fairness.


These measures would also assist in preventing other financial crimes, such as money-laundering and terrorism financing, by more closely tracking the movement of funds.

CRS’s ambiguity is a significant cause for concern during its implementation. A report completed by a representative of the Tax Justice Network claims there are no less than 26 possible loopholes under the current CRS rules. Additionally, the OECD report and guidelines on CRS are not available through open access and require purchase for $73 USD. The resulting perceived lack of transparency on the OECD’s part will likely hinder effective implementation of CRS.

Conclusion

CRS is a bold step forward with ambitious goals, and the OECD recognizes it as such. Moving forward, the organization will gather information from governments, financial institutions, and independent whistle-blowers with regards to potential CRS loopholes. Beginning in May of 2017, the OECD website has allowed for anonymous submission of schemes for circumventing reporting under CRS, encouraging people to do so to maintain the standard’s integrity and effectiveness. Information submitted is analyzed and actively addressed, and the CRS is adjusted to close these actual or perceived holes.

Although Canada’s Privacy Act allows for personal information to be shared at the discretion of government, this and similar policies internationally may be challenged through the argument that the magnitude of privacy infringement is disproportionate to the benefits. Data regarding the success of CRS may be necessary in such cases to justify the privacy infringement it requires. However, this compromise is necessary to allow tax authorities from multiple jurisdictions to coordinate tax information and collection effectively. Regardless, privacy cases will surely be brought forward in many CRS jurisdictions; their impact on automatic information sharing remains to be seen.

As advances in technology increase the frequency and complexity of international financial arrangements, governments must adjust taxation to meet changing practices. To increase the fairness of tax policies without compromising productivity in the global economy, measures such as CRS are necessary to facilitate cooperation between governments.

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25 OECD, “What is the CRS.”
Figure 1: CRS countries (as of January 14, 2018)\textsuperscript{27}

Green = Signed
Yellow = In Progress
Red = Refused to sign
Grey = Not applicable

\textsuperscript{27} OECD. “What is the CRS.”
Bibliography


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