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Common Reporting Standard & EU Beneficial Ownership Registers

Inadequate protection of privacy and data protection

Summary of Presentation to Art. 29 Working Party | Brussels, 8 Sept 2016

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This note contains a summary of a technical presentation to the Art. 29 Working Party, an independent data protection body established under Art. 29 of the EU data protection directive. Like numerous other European privacy and data protection bodies, Art. 29 WP raised concerns in the past about the proportionality of the CRS. The scope of the presentation was to illustrate the actual impact of the CRS based on practical examples analysed in the light of general tax law principles.

A similar presentation was made to the Council of Europe's Bureau of the Consultative Committee of the Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data in June 2016. (The Council of Europe is the platform used by 103 countries to implement the CRS on a multilateral basis).

1. Concerns about the general structure of the Common Reporting Standard (CRS)

The CRS is essentially a tax measure that was designed to combat tax evasion in the country of residence of the relevant account holder. As such, any privacy and data protection analysis should take into account specialist insight.

In terms of the CRS's general structure, I refer in particular to the *generalised* basis of information exchange and the fact that information is exchanged in a manner that is *independent of the detection of any actual risk of tax evasion*.

It is for data protection authorities to consider technical data protection issues in detail. However, it is noteworthy that the ECJ held as recently as 6 October 2015 that legislation permitting public authorities to have access, on a generalised basis, to the content of electronic communication, without any differentiation, limitation or exception and without providing for any legal remedies, did not respect the essence of the fundamental rights to privacy and data protection[1].

2. The bigger picture

The commentary published by the OECD confirms that the CRS was developed between 2009 and 2012 with the objective of capturing and exchanging the maximum amount possible of information, with very little concern for privacy and data protection issues.

Outside the field of taxation, the excesses of generalised data collection and exchange were exposed in 2013 by Edward Snowden, resulting in a public outcry and a counter-revolution to reassert the prevalence of the fundamental rights of privacy and data protection. In the EU, this culminated in the ECJ's decision of 6 October 2015 in the *Schrems* case and the EU data protection reform on 27 April 2016, which was introduced to *'allow people to regain control of their personal data*'[2]. Outside the field of taxation, public concerns for the right to privacy and data protection have been further strengthened by a number of high profile cases and data breaches that took place at

[1] *Schrems v Data Protection Commissioner*, Judgment dated 6 October 2015, Case C-362/14, available online at: http://curia.europa.eu/juris/liste.jsf?num=C-362/14. See Part D below.

[2] http://europa.eu/rapid/press-release_IP-15-6321_en.htm.

the end of 2015 and the beginning of 2016, including the *Apple v FBI* case[3] and the $81m heist against SWIFT.

The broader views of society in relation to privacy and data protection appear to be based on two contrasting sentiments depending on whether the debate focuses on the field of taxation or not. However, the right to privacy is *not a relative value*. Instead, *any* interference with an individual's right to privacy has to comply with the *same requirements* of legality, legitimate interest and proportionality, as outlined by The European Commission's Article 29 Working Party (WP29) in the past.

3. Data security

Over the past two years, several hacking incidents showed the inability of governments and supranational authorities to protect sensitive data of ordinary citizens. In addition to the attack against SWIFT (which led to the theft of $91m), it has been reported that government authorities in several countries (including the US, Turkey and the Philippines) lost sensitive data (passport details, fingerprints, background checks, social security numbers, etc.) concerning tens of millions of citizens to hackers.

Under the CRS, information about:

- the identity (name, tax identification number, date and place of birth); and
- detailed bank account information (account number, account balance, amount of income and sale proceeds, etc.)

of virtually every individual with a bank account abroad will be captured and exchanged electronically between banks and their tax authorities, and between tax authorities around the globe. This will provide the international hacking community, financial criminals and 'dark web' users with an unprecedented opportunity.

WP29 and other data protection bodies – including the European Data Protection Supervisor (EDPS) and the Council of Europe's committee on automatic processing of personal data – have already raised serious concerns in relation to the proportionality of the CRS. These include the general and automatic nature of information exchange, the fact that automatic exchange is independent of the detection of any actual risk of tax evasion, and other concerns based on *general principles of privacy and data protection law*.

4. A ticking bomb

Discussing 'DAC2', a European Council Directive on mandatory exchange of information, the group of experts appointed by the European Commission ('AEFI Group') issued a stark warning addressed to the EU institutions:

[3] In an interview with Time Magazine, Apple's CEO referred to the right to privacy as *'one of the founding principles of the country'* (http://time.com/4261796/tim-cook-transcript/). It is noteworthy that a wide segment of public opinion sided with Apple's controversial decision, showing a single-minded focus on the right to privacy *of law-abiding citizens* (even if it meant frustrating an investigation in a hideous crime).

> 'On many aspects, DAC2 may be compared with the Data Retention Directive which has recently been declared illegal by the CJEU. DAC2 must respect the principle of proportionality (…). A legal challenge might arise from the current version of DAC2 mainly because of the magnitude of the data to be collected and reported and the fact that it does not guarantee taxpayers a permanent access to their data and a mandatory notification in case of breach (…). In its current version, DAC2 might be challenged because it does not request the existence of such sufficient cause or indicia of unlawful behaviour. (…) The AEFI Group is concerned that information exchanged may happen to be irrelevant for taxation purposes in the receiving jurisdiction (home country) under domestic law and that reporting in such cases might be treated as being in breach of data protection law.

This quest for *total transparency* first introduced under the CRS seems to have spilled over to the field of public registers of beneficial ownership. Thus, despite the safeguards imposed by the 4th Anti-Money Laundering Directive of 20 May 2015 :

- at the beginning of 2016 the UK introduced public registers of 'People with Significant Control' in respect of UK companies and limited liability partnerships ('PSC registers') which may be accessed *by anyone*.

- on 10 May 2016 France introduced a *fully public* register concerning trusts (currently suspended by *an interim* decision of the French *Conseil d'État* pending a judgment in a claim brought by a US citizen on the basis of privacy and data protection).

Political inactivity in relation to the safeguard of fundamental rights in the context of the CRS and public registers requires a vigorous response ahead of the full implementation of the new rules. In the case of the CRS, this will take place at the beginning of 2017 for a number of countries ('early adopters'), as well as the EU)[4].

The lack of political engagement is the more perplexing as there are a number of existing alternatives, which would enable countries to combat tax evasion in a proportionate way. These include traditional information exchange mechanism (Art. 26 OECD Model Tax Convention), Tax Information Exchange Agreements (TIEAs – existing case law shows that they work) and calibrated automatic exchange agreement that enable taxpayers to choose between exchange of information and a withholding tax that reflects the level of taxation in their home jurisdiction. This is the solution contained in two agreements signed by Switzerland and two EU Member States (Austria and the UK), before the G-20 and the OECD decided to go down the FATCA route instead and unleashed the CRS storm.

5. Implementation process – Current threats

In order to be compatible with the European Human Rights Convention and the EU Charter of Fundamental Rights, an interference with an individual's right to privacy and data protection must

[4] In the EU, the CRS has been implemented through the EU Revised Directive on Administrative Cooperation ('**DAC2**'), Directive 2014/107/EU, accessible online at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0107.

be (a) in accordance with the law; (b) in pursuit of recognised legitimate aims (which include the prevention of crime); and (c) necessary in a democratic society.

6. **Blanket and indiscriminate nature of automatic exchange under CRS – (Proportionality I)**

WP29, the EDPS and the Council of Europe's T-PD have already identified a number of issues in relation to the proportionality of the CRS. Questions must also be raised in relation to the compatibility of the CRS with the principles laid down in the ECJ's decision in the *Schrems* judgment of 6 October 2015, where the ECJ held, *inter alia*, that:

(a) 'Legislation permitting the public authorities to have access on **a generalised basis** to the content of electronic communication **must be regarded as compromising the essence of the fundamental right to respect of private life**';

(b) 'Legislation that authorises storage of all the personal data on a generalised basis, **without any differentiation, limitation or exception** is not limited to what is strictly necessary.'

(c) Legislation **not providing for any possibility** for an individual **to pursue legal remedies in order to have access to personal data relating to him, to obtain the rectification** or erasure of such data, **does not respect the essence of the fundamental right to effective judicial protection**, as enshrined in Art. [8 of the European Convention on Human Rights and] Art. 47 of the EU Charter of Fundamental Rights.

Questions must also be raised in relation to the interaction between the CRS and the new EU data protection framework adopted on 27 April 2016, notably the General Data Protection Regulation (**'GDPR'**)[5] and the Data Protection Directive for the police and criminal justice sector[6], both of which were introduced to *'allow people to regain control of their personal data*'[7].

7. **Excessive level of information gathering under CRS – (Proportionality II)**

The CRS requires the gathering and exchange of vast amounts of information that is often not foreseeably relevant – or is even outright and clearly *irrelevant* – to the enforcement of domestic taxes.

8. **Specific concerns about the actual mechanics of the CRS**

During the presentation, the author discussed a number of specific CRS scenarios confirm and amplify the existing concerns about the proportionality of the CRS, notably:

[5] Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC, available online at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.119.01.0001.01.ENG&toc=OJ:L:2016:119:TOC.

[6] Directive (EU) 2016/680 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data by competent authorities for the purposes of the prevention, investigation, detection or prosecution of criminal offences or the execution of criminal penalties, and on the free movement of such data, and repealing Council Framework Decision 2008/977/JHA. This directive is accessible online at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.119.01.0089.01.ENG&toc=OJ:L:2016:119:TOC.

[7] http://europa.eu/rapid/press-release_IP-15-6321_en.htm.

(a) **The exchange of information concerning the *value* of investments**, in circumstances where it is clear that the taxpayer does not owe any tax in his/her country of residence in respect of the value of those investments (e.g. in countries that do not levy a wealth tax).

(b) **The exchange of information in relation to *taxpayers who benefit from a special tax regime***, in circumstances where it is clear that the information exchanged is not relevant in their country of residence in order to determine and monitor their tax liability. During the presentation, the following special tax regimes were considered: (a) '*cadre étranger'* (*Belgium*), *'régime des impatriés'* (France), 'habitual non-resident' taxpayers (Portugal), so-called 'Beckham' Law' (Spain) and the 'remittance basis' for 'non-domiciled' taxpayers (all European common law jurisdictions, notably Ireland, Malta, Cyprus and the UK).

(c) **The exchange of information concerning individuals in relation to companies, trusts, foundations etc. based on a single 'one-size-fits-all' concept (i.e. the concept of 'Controlling Persons'**).

The concept of 'Controlling Persons' (which is absent in FATCA) is independent of any domestic tax attribution rules under domestic law ('Controlled Foreign Companies' rules, 'Transfer of Assets Abroad' rules, etc.) and is at odd with the ECJ case law in this area (notably the *Cadbury Schweppes* case).

(d) **Taxpayers without any taxable income/gains in the relevant tax period**

The reporting of the value of the taxpayer's assets is also not relevant in circumstances where the taxpayer does not have any taxable income and/or gains in the relevant tax period, either in absolute terms or after deduction of expenses/losses in accordance with the domestic rules in the country of residence of the taxpayer.

(e) **Reporting scenarios in the case of Charities.** Charities are not generally exempt from reporting under the CRS and, in practice, the reporting profile of a charity depends on whether it is:

1) an 'active non-financial entity' (active-NFE) – in which case there is no reporting[8]; or

2) a Financial Institution – in which case the charity has to report any individual who has an 'Equity Interest' in the charity[9].

[8] The reason for the exclusion of active entities from the scope of the CRS stems from the US Foreign Account Tax Compliance Act ('FATCA'), which was introduced essentially to counter the activities exposed by banking scandals; those showed how private banks helped US taxpayers to hide money and investments behind anonymous accounts – such as numbered accounts and accounts held by offshore companies/trusts and foundations. In other words, the main focus of FATCA (and the CRS) is on 'empty'/' passive'/'secret' structures, which leaves out ordinary businesses such as an active enterprise.

[9] One would expect the term 'Financial Institution' to comprise banks and the like, not charities. Again, the reason for the extension of the concept of 'Financial Institution' to charities (and other entities) stems from FATCA. FATCA sought to root out the connivance of private banks with US tax fraudsters by introducing a withholding tax of 30% on US investments, which a financial institution (such as a bank) investing on behalf of its clients, could only avoid by registering with the IRS. Under the registration system, the relevant financial institution undertakes to disclose any 'substantial US owner' who may owe US tax. Also, by showing its registration number ('Global Intermediary Identification Number' or GIIN) to paying agents, the relevant bank may receive payments of dividends, etc. without the 30% withholding tax. As FATCA is about registration, certain companies/foundations/trusts, etc. may avoid complex reporting by their bank(s) by registering directly with the IRS. In this case, the relevant structure is treated as akin to a financial institution, meaning that any reporting lies with the entity itself (rather than the 'real' financial institution, i.e. the bank). In other words, the entity becomes the relevant 'Financial Institution' replacing the 'ordinary' financial institutions (banks, etc.) in the reporting chain.

The *general nature* of information gathering and the *automatic nature* of information exchange under the CRS may easily translate into a life in danger, regardless of the existence of any tax liability, for charities engaged in work in jurisdictions where the local authorities are resistant or opposed to their activities.

(f) **The complexity of the drafting technique used in the CRS**. The CRS is broadly a derivation of FATCA[10], which a US commentator defined as *'monstrous'* and *'daunting even to the most knowledgeable experts [of US tax law]"*[11]. Over the past year, EU-based banks, account holders and their advisers are struggling to follow the structure and provisions of what is effectively a complex piece of US law transposed globally.

This raises the question as to whether the limitations to the right to privacy caused by the CRS are 'in accordance with the law', that is, whether the CRS is adequately accessible and foreseeable to enable the individual to regulate his or her conduct (as confirmed by case law from the European Court of Human Rights).

(g) **The abstract nature of the CRS**. As a piece of US legislation, FATCA aims at ensuring that any tax liability arisen in accordance with the US tax rules is notified to the IRS. Accordingly, FATCA has been designed to comply with a specific domestic tax system (US tax law). By contrast, the CRS has not been designed with any particular tax system in mind, but broadly as a copycat of FATCA (with few alterations)

By applying a 'one-size-fits-all' approach that is independent of any domestic tax system, the CRS results in the exchange of excessive and often irrelevant information. Ultimately, this defeats the CRS's purpose of combating tax evasion, that is, the evasion of domestic tax laws in the country of residence of the account holder.

(h) **The arbitrary nature of the CRS**. In many instances, the nature and level of reporting depends on the legal structure of the account holder, without any apparent reason for the difference of treatment.

As FATCA seeks to stamp out secrecy, the system is relatively liberal when it comes to registration by foreign entities (as visibility is key).

Although the CRS system is not based on registration with the tax authorities it has maintained the distinctions introduced by FATCA. This means that certain structures qualify as 'Financial Institutions', thus relieving the relevant bank from reporting. Also, while a bank's reporting relates to its clients ('Controlling Persons' in the case of an entity), an entity that is treated as akin to a financial institution has to report on itself. This introduces a separate concept from 'Controlling Person', i.e. the entity has to report any person who has an 'Equity Interest' in the structure. The difference between 'Controlling Person' and 'Holder of an Equity Interest' has caused a lot of confusion, which has been partly fuelled by the OECD. Moreover, as the type of classification shifts the burden of reporting from the bank to the client (and vice-versa), discussions with banks ahead of the implementation of the CRS have tended to be quite fractious and divisive (as well as expensive) This topic is addressed further later in this paper, as the *lack of clarity* of the CRS affects its *proportionality* - a law must be adequately accessible and foreseeable, *i.e.* formulated with sufficient precision to enable the individual to regulate his or her conduct (see *Huvig v France* Appl. No. 11105/84, ECtHR 24 April 1990).

[10] The use of concepts such as **'FI' (Financial Institution)**, **'active NFE' (active Non-Financial Entity)**, **'passive NFE' (passive Non-Financial Entity)**, 'Equity Interest', etc. have been lifted directly from FATCA and have broadly the same meaning. Under FATCA, an FI (Financial Institution) is called an **F**FI (**Foreign** Financial Institution), an 'active NFE' is called 'active NF**F**E' ('active Non-Financial **Foreign** Entity, a 'passive NFI' is called a passive NF**F**I, etc.

[11] *'FATCA is a Leviathan. And it breathes fire. Its size is monstrous (544 pages long). Moreover, the regulations are painstakingly detailed and excruciatingly technical, a bewildering maze of rules, sub-rules, sub-sub-rules, cross-references, exceptions, exceptions to exceptions and so on. They are daunting even to the most knowledgeable experts" – see* P Cotorceanu, 'FATCA and Offshore Trusts: The First Nibble' 139.4 (2013) Tax Notes 409-20.

One example: under the UK guidance, a charity may be required to exchange information in respect of people who receive a grant, but only if that charity is organised as a *charitable trust* (the common law equivalent of a charitable foundation) – and not if it is organised as a *charitable company*.

(i) **The existence of a number of substantial contradictions**. The CRS contains contradictions in relation to a number of central concepts. In turn, this affects the amount and quality of information subject to information exchange. In particular, the OECD's Commentary and Implementation Handbook openly contradict various definitions contained in the CRS (e.g. in relation to the concepts of 'Controlling Persons' / holder of an 'Equity Interest').

These contradictions have a direct effect on the DAC2, raising the question of whether the limitations to the right to privacy operated by the CRS are 'in accordance with the law'.[12]

Filippo Noseda, September 2016

[12] '13. In implementing this Directive, Member States should use the Commentaries on the Model Competent Authority Agreement and Common Reporting Standard, developed by the OECD, as a source of illustration or interpretation and in order to ensure consistency in application across Member States. Union action in this area should continue to take particular account of future developments at OECD level'.