Money laundering and tax evasion risks in freeports and customs warehouses

Study at the request of the Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3)

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EXECUTIVE SUMMARY

Justification

This paper provides an insight in the money laundering, tax evasion and tax avoidance risks in relation to free zones, particularly those that function as (semi-) permanent storage for high value goods often referred to as 'freeports'.

It is based on an analysis of relevant legislation, academic literature, annual and special reports by authorities, think tanks and operators in the art business, articles in mainstream and specialised media, interviews with experts at the European Commission, the OECD, authorities in Luxembourg and one of the licensed operators at 'Le Freeport' in Luxembourg.

The motivation to look into the case of the Luxembourg Freeport was twofold.

Firstly, the Freeport in Luxembourg aims at (semi-) permanent storage of art and other high value assets. It imports the business model of the Geneva Freeport, which - within the EU - is a novelty, and it has one of the private shareholders of Geneva as its owner.

Secondly, following a national risk assessment, Luxembourgish lawmakers realised that there were money-laundering risks within the Freeport and decided to bring the licensed freeport operators under national anti-money laundering law already in July 2015, almost five years ahead of its obligation to do so. Analysing the consequences of the application of anti-money laundering (AML) laws on the Freeport and its licensed operators could provide interesting insights into the potential effects on similar facilities elsewhere in the EU after the transposition of the fifth anti-money laundering directive (AMLD5), the deadline for which is 10 January 2020.

Summary conclusions

Freeports are conducive to secrecy. In their preferential treatment, they resemble offshore financial centres, offering both high security and discretion and allowing transactions to be made without attracting attention of regulators and direct tax authorities.

Goods sold in freeports, often works of art or antique, are not subject to value added tax. No withholding tax is collected on capital gains or inheritance, though sellers may need to report to the tax authority in the country where they are tax resident.

The high level of monetary transactions, the unfamiliarity of enforcement agencies over values and the portable nature of art itself all contribute to the art market being a suitable vehicle for illegal activity. As art is still one of the few unregulated markets, it can be a means of tax evasion and capital flight and one could make the case for regulating the market for investment art.

As of 10 January 2020, freeport operators as well as other actors in the arts market, such as auction houses or galleries, will become obliged non-financial entities under EU AMLD5. This means they will become AML-gate keepers, as they will have to report suspicious transactions to FIUs and have to carry out client due diligence research in order to identify the beneficial owner of the stored goods.

Proceeds of sales of art or the possession of substitute goods like art, antique or jewellery do not fall within the categories for automatic exchange of information between tax authorities under DAC1. As freeport operators are not financial institutions, they are not obliged to provide bulk data

regarding their clients to tax authorities under the FATCA, CRS or DAC1 and therefore the exchange of such information between tax authorities is likely to be low.

Access to these UBO records held by obliged non-financial entities is only available to the AML-supervisor for supervision purposes. Direct tax authorities are not allowed to "fish" in these data, but they can have access "upon request" since the entering into force of DAC5 on 1 January 2018. However, given that the identity of beneficial owners in freeports, but also in customs warehouses, are "unknown unknowns" to these authorities, they will need to have a prior suspicion in order to substantiate such a request. In this context, the likelihood of "spontaneous exchange" or "exchange upon request" with other direct tax authorities is low.

Tax fraud and tax evasion are considered predicate offenses for money laundering, since the entering into force of AMLD4 in June 2017. The effects hereof remain to be seen as it is almost impossible for a freeport operator to establish if a client who sold or inherited a piece of 'investment art' had to declare capital gains or inheritance as well as to establish if this client actually did declare to the direct tax authorities in the country of tax residence.

The UCC allows for significant flexibility as to who presents the goods upon entry and it does not require the holder of the procedure or of the authorisation to provide information to customs about the UBO. For the moment, it can be anyone, as far as the UCC is concerned.

Currently, apart from Luxembourg, there is not one country in the world that made freeport operators subject to AML-legislation. As UBO data are not required it is therefore relatively simple to hide the UBO's identity behind another layer of secrecy, which can be an offshore firm, a trust or foundation, a lawyer or a gallery or a combination of these.

The UCC provides the legal basis for (indirect) tax deferral as it allows for the permanent storage of goods under a freeport or customs warehousing procedure. The fact that investment goods in such facilities can be sold tax-free implies that if they are sold indirect taxes have - in effect - been avoided by the seller.

The wording in the AMLD5 is not consistent with that of the UCC. Firstly, "freeports" are not recognised as such in the UCC, but are formally considered as any other "free zone". This may lead to confusion regarding the scope of the AMLD5.

The AMLD5 (art.2.3.j) explicitly refers to persons "storing, trading or acting as intermediaries in the trade of works of art when this is carried out by free ports". Given that freeports fall under the so called 'free zone procedure' in the UCC, which is almost on the same legal footing as the UCC's 'custom warehousing procedure', it opens the discussion whether 'customs warehouses' or 'bonded warehouses' are also within the scope of the directive.

Bringing operators such as auction houses and dealers under AMLD5 will pose challenges on them, but also on supervisors. The future success of AMLD5 in the arts market depends on the willingness of these new obliged entities to report suspicions to FIUs and on the deterrent effect of future supervision and possible sanctions. The poor implementation of the AMLD3 by financial institutions throughout Europe and the failing AML supervision of the financial sector, revealed by the Panama Papers and many other leaks and ongoing scandals in the banking sector, may be taken as a warning.

Luxembourg is the only country that put licensed freeport operators on the same footing as non-financial obliged AML-entities - almost five years ahead of its obligation to do so. Freeport operators had lost clients after AML-legislation unilaterally entered into force in Luxembourg in 2015 and they

had to carry out customer due diligence (CDD). Some existing clients refused to provide information concerning beneficial ownership of the goods and took their business elsewhere. It also became much more difficult for operators to on-board new clients because of this clampdown on secrecy. Owners can no longer use offshore companies, trusts, their lawyers, nominees or galleries to shield their ownership of goods in the Luxembourg Freeport from AML-authorities and for some this appears to be a problem.

Despite the strict AML-regime in Luxembourg and – as of 2020 in the whole of the EU – the success of the AML-framework will depend heavily on the good faith of obliged entities and their willingness to act as AML-gatekeepers by reporting suspicions. Even after the entering into force of AMLD5, the likelihood of exchange of information between tax authorities is low as a consequence of limited access to AML-data kept by non-financial obliged entities.