

Tax Design Issues Worldwide

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Tax Design Issues Worldwide

Edited by
Geerten M.M. Michielse
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Preface

Tax Design Issues Worldwide is a collection of articles that is based on the presentations given at a conference ‘Current Tax Issues for Developing Countries’ held in Washington, DC in early 2014. The presenters are primarily tax legal drafting experts that the International Monetary Fund (IMF) has been using in its technical assistance projects. The conference was held on the occasion of the retirement of Victor Thuronyi, who worked for over twenty years at the Legal Department of the IMF as their lead counsel (tax).

The contributions in this book shed some light on a number of fundamental tax issues. The first chapter takes aim at the question whether the base for taxation should remain ‘income’ or shift (partly) to ‘consumption.’ The following part covers various issues in corporate taxation. After a basic discussion on the role the International Financial Reporting Standards (IFRS) could play in determining taxable profits, the systemic bias towards debt financing is addressed and suggestions are made to overcome this issue in practice. The final chapter on corporate taxation provides some base-erosion solutions for developing countries. The next area discussed is international coordination, especially the role tax treaties play in developing economies, how these countries deal with international tax planning, and to what extent exchange of information will help collect revenues. There follows a part dealing with VAT: after the VAT and customs treatment of the mining industry in Sub-Saharan Africa, some lessons are drawn for VAT design from working in various developing countries. The book’s final part concerns the interaction of anti-money-laundering and tax, an emerging area that is relatively unfamiliar to many tax lawyers but promises to play an important role in the future.

*Geerten M.M. Michielse
Victor Thuronyi
Washington DC
February 2015*

CHAPTER 7

International Standards, Base Erosion and Developing Countries

Ana Paula Dourado

§7.01 TAX GOOD GOVERNANCE AND HOLISTIC APPROACHES

In recent years, and as a result of the G20 reactions to the 2008 financial crisis, tax good governance has become associated with holistic approaches and international standards. First, bilateral exchange of information upon request, except in the context of so-called fishing expeditions, was declared to be the international standard as a means to combat tax evasion and avoidance. According to the Global Forum:

[t]he international standard, which was developed by the OECD in co-operation with non-OECD countries and which was endorsed by the G20 Finance Ministers at their Berlin Meeting in 2004 and by the UN Committee of Experts on International Cooperation in Tax at its October 2008 Meeting, requires the exchange of information on request in all tax matters for the administration and enforcement of domestic tax law without regard to a domestic tax interest requirement or bank secrecy for tax purposes. It also provides for extensive safeguards to protect the confidentiality of the information exchanged.¹

More recently, the OECD presented an Action Plan to combat base erosion and profit shifting (BEPS) that is also expected to have a dimension that goes beyond the geographical boundaries of OECD Member States.

1. OECD, *Tax Co-operation 2009: Towards a Level Playing Field*, 2009, available at www.oecd.org, at 8.

§7.02 BACKGROUND: THE 1998 OECD REPORT ‘HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE’

The international standard on exchange of information is not a new proposal, but the financial crisis created the optimal conditions for it to be finally implemented on a broad geographical scale. Exchange of information has been proposed as one important tool to eliminate harmful tax practices since the 1998 OECD Report ‘*Harmful Tax Competition: An Emerging Global Issue*’ (the ‘1998 Report’). According to the 1998 Report, harmful tax competition leads to tax evasion and avoidance and these were therefore linked to tax havens and harmful preferential tax regimes.

The Report concerned and identified both categories. Tax havens were identified by the 1998 Report (and until 2009) if four criteria were met: the jurisdiction imposes no or only nominal taxes; lack of transparency; laws or administrative practices prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from no or mere nominal taxation; absence of a requirement that the activity be substantial.² In turn, preferential tax regimes provided favourable locations for holding passive income or book keeping profits.

Three features were common to tax havens and preferential tax regimes, according to the 1998 Report: absence of true taxes, lack of effective exchange of information, lack of transparency.³ In tax havens there was no substantive activity by taxpayers benefiting from the preferences and a main feature of preferential tax regimes was ring fencing of benefits in order to attract non-resident investors.⁴

§7.03 HARMFUL TAX COMPETITION AND BEPS

Harmful tax competition was associated with erosion of tax revenue in other jurisdictions, allowing individuals to evade income taxes in their residence countries, allowing firms to shift book profits to tax havens, to divert economic activity from other jurisdictions, to intensify tax competition, and allowing financial sector firms to circumvent regulation and force other countries to lower the standards on regulation. Moreover, bank secrecy could facilitate internationally organized criminal activities. Tax havens and preferential tax regimes are also characterized as “parasitic” on the tax revenues of the non-haven countries, inducing them to expend real resources in defending their revenue base and in the process reducing the welfare of their residents’.⁵

The OECD published a list of tax havens in 2000 and by 2004 all of the identified jurisdictions but five agreed to exchange information. There are other possible classifications of tax havens. The OECD list was not totally coincident with the

2. http://www.oecd.org7document/63/03343/en_2649_33745_30575447_1_1_1_37427,00.html.

3. Report, 23-25.

4. Report, 24. Ruchelman, S. C. & Shapiro, S., ‘Exchange of Information’, 30 *Intertax*, 409 (2002).

5. Slemrod J. & Wilson J., *Journal of Public Economics*, 1261-1271 (2009).

classification by Dharmapala and Hines.⁶ Maffini⁷ distinguishes between small tax havens and large tax havens and includes only the offshore fiscal centres in which the ultimate owners in the working sample own a subsidiary and does not include an exhaustive list of low-tax jurisdictions.

After the G20 meeting in London in April 2009, the OECD cleared the list of uncooperative tax havens on the basis that the era of bank secrecy was over. All efforts have been concentrated on the global forum peer-review action on exchange of information and global good tax governance. In contrast, under the EU Tax Good Governance Platform, a common black list of harmful tax jurisdictions may be recommended in the near future to all EU Member States, which shows a less confident attitude by the European Commission in respect of transparency and to some extent not totally consistent strategies by the OECD and the EU.

In the second half of 2012, published news in some mainstream media about multinationals not paying taxes, gave rise to declarations by the G20 in late 2012 and the attribution of a mandate to the OECD, to find adequate measures to fight against the phenomenon of BEPS. Harmful tax competition and the phenomena of tax evasion and avoidance are not exclusively associated with tax havens anymore.

It is (finally) acknowledged that they also result from inadequate international (OECD) rules to cope with the phenomenon of tax planning by multinationals and increasing specialization of functions by related parties in different jurisdictions:

loopholes, gaps, frictions or mismatches in the interaction of countries' domestic tax laws" and any "double non-taxation in areas previously not covered by international standards and that address cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it. Moreover, governments must continue to work together to tackle harmful tax practices and aggressive tax planning.⁸

Interestingly, some of the Actions (e.g., Action 3 on the strengthening of CFC rules; 5 on transparency and substance; 6 on preventing treaty abuse; 10 on transparency, regarding data collection, targeted information and transfer pricing documentation) correspond to constraints already identified in the 1998 OECD Report: The 1998 Report makes nineteen recommendations, divided into three groups and aimed at improving international cooperation and responding to harmful tax competition:

6. Dharmapala, D. & Hines, J. R. Jr., 'Which Countries become Tax Havens', 93 *Journal of Public Economics* (2009) at 1058-1068; Dharmapala D., "What problems and opportunities are created by tax havens?" 24 *Oxford Review of Economic Policy*, 4 661-679 (2008).

7. Maffini G., 'Territoriality, Worldwide Principle and Competitiveness of Multinationals: A Firm-level Analysis of Tax Havens', *Oxford Centre for Business Taxation, WP 12/10*, Table 4.

8. OECD (2013) Report *Action Plan on Base Erosion and Profit Shifting*, p.13; In 2012, the G20 asked the OECD to analyse the topic of base erosion and profit shifting by multinationals, and to report about the progress of the work for their February 2013 meeting. As a response, the OECD (2013) issued the Report *Action Plan on Base Erosion and Profit Shifting*. The EU Reacted: *Communication from the Commission to the European Parliament and the Council, An Action Plan to Strengthen the Fight against Tax Fraud and Tax Evasion*, (187637/12) Brussels (6.12.2012), COM (2012) 722 Final; *Commission Recommendation of 6.12.2012*, Brussels (6.12.2012), C(2012) 88006 final; *Conclusions of the European Council*, Brussels (22.5.2013), EUCO 75/13, pp.6-8; ECOFIN, *Conclusions on Tax Evasion*, Brussels (14 May 2013), 9549/13, FISC 94.

recommendations dealing with domestic legislation and practices (e.g., introduction of controlled foreign company rules; adoption of information reporting rules for international transactions; access to banking information for tax purposes), addressing tax treaties (e.g., greater and more efficient use of exchange of information) and recommendations to increase international cooperation in response to harmful tax practices (e.g., production of a list of tax havens).

Although it is not mentioned in the OECD Action Plan, it constitutes a follow up to the 1998 Report. The focus of the OECD BEPS Action Plan now lies in the inadequacy of rules more than in the individual non-cooperative behaviour of jurisdictions, and therefore requires more fundamental amendments to the current rules and concerted action.⁹

§7.04 BEPS AND DEVELOPING COUNTRIES

The OECD BEPS Action Plan (2013)¹⁰ foresees that other States beyond the OECD Member States take part in the Plan: the G20 States that are not OECD Member States will be expected to be associate members and other non members can be invited to participate on an ad hoc basis. The BEPS Action Plan does not clarify what the criteria underlying the decision to invite non G20 States will be.

In respect of developing countries, the Action Plan recognizes that:

they also face issues related to BEPS, though the issues may manifest differently given the specificities of their legal and administrative frameworks. The UN participates in the tax work of the OECD and will certainly provide useful insights regarding the particular concerns of developing countries. The Task Force on Tax and Development (TFTD) and the OECD Global Relations Programme will provide a useful platform to discuss the specific BEPS concerns in the case of developing countries and explore possible solutions with all stakeholders. Finally, existing mechanisms such as the Global Fora on Tax Treaties, on Transfer Pricing, on VAT and on Transparency and Exchange of Information for Tax Purposes will all be used to involve all countries in the discussions regarding possible technical solutions.

Developing countries have different administrative frameworks (generally simpler and lacking technical and human resources) that make it more difficult for them to approach transfer pricing issues and to introduce mechanisms of enhanced tax cooperation, such as advanced pricing agreements, mutual agreement procedures and (international) tax arbitration.

Most of them, however, have transfer pricing rules – or at least principles – and inbound international investment is to be dealt with according to transfer pricing methods, unless that investment benefits from tax holidays.

9. *Action Plan on Base Erosion and Profit Shifting – Report: 2013* (OECD 2013), p. 13. See, e.g., BEPS Actions 2 and 6: the OECD/G20 Base Erosion and Profit Shifting Project, *Neutralising the Effects of Hybrid Mismatch Arrangements* (2014) and OECD/G20 Base Erosion and Profit Shifting Project, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (2014), pp. 10 et seq.

10. *Action Plan ...* OECD (2013), supra note 9.

This means that the legal framework is not so different from the OECD Member States framework, but the administrative constraints to raise revenue from multinationals, more serious. In other words, the legal framework in developing countries can instead be simpler and therefore the BEPS effects have a much greater dimension in every type of services or industry, including in the case of specific industries related to natural resources. It is clear that States outside the G20 are also affected by the BEPS phenomenon and some of them have attractive tax regimes for conduit companies and are concluding TIEAs.

§7.05 EXCHANGE OF INFORMATION AS AN INTERNATIONAL STANDARD

Exchange of information as an international standard was originally understood to require information exchange on request (See Protocol of 7 October on Exchange of Information to the Austria-Slovenia bilateral tax treaty), since that corresponds to the scope of Tax Information Exchange Agreements (TIEAs).

The international standard on exchange of information results not only from Article 26 of the OECD MC but also from Article 1 of the 2002 OECD Model Agreement on Exchange of Information and its 2005 Commentary and the 2010 Protocol to the Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters. They require exchange of information on request in the case of foreseeable relevance to tax administration without regard to the domestic interest of the requested State, bank secrecy¹¹ or dual criminality.¹² Taxpayers' rights and confidentiality of the information exchanged have to be safeguarded. Exchange of information is being disseminated outside the OECD by the Global Forum and it implies the conclusion by a State of at least twelve treaties on exchange of information.

While exchange of information upon request is expanding geographically, the international standard is rapidly moving into a multilateral and automatic exchange of information standard. In March 2013 the G20 declared the automatic exchange of information to be the international standard and the OECD has presented a multilateral model convention on automatic exchange of financial account information based on the US intergovernmental agreements (FATCA 2): the Standard for Automatic Exchange of Financial Account Information in Tax Matters has been published by the OECD on 21 July 2014 and includes the text of the Model Competent Authority Agreement (CAA), the Common Reporting Standard (CRS) and the Commentaries thereon as they read on 15 July 2014, as well as guidance on relevant technical solutions such as a standard regarding the IT aspects of data safeguards and confidentiality and transmission and encryption for the secure transmission of information

11. See OECD, Manual on the Implementation of Exchange of Information for Tax Purposes, General Module, paras. 43-44 (Jan. 23, 2006).

12. Malherbe P. & Beynsberger M., "2011: The Year of Implementation of the Standards?" in: Rust, A. & Fort, E. (eds), *Exchange of Information and Bank Secrecy* (2012) Kluwer Law International BV, The Netherlands, at 131; Switzerland traditionally had a different approach: Malherbe, J., *Journal de Droit Fiscal*, 358 et seq. (1982). See Huber M. F. & Duss F., *Bulletin for International Taxation*, 567 (2009).

under the CRS. Together, the CAA Model and the CRS constitute the model of automatic exchange of financial account information (the Global Model).¹³

In the current global tax good governance context, exchange of information is one condition for an anti-BEPS action to be successful.

However, it is disputed among economists whether exchange of information would cause low-tax jurisdictions once identified as tax havens to abandon their low-tax policies. Recent research has concluded that jurisdictions with low or zero taxation have signed TIEAs with countries with which they have strong economic links in the form of foreign direct investment and trade.¹⁴ But recent research has also shown that significant exchange of information has had no effect on the repatriation of income:¹⁵ Dharmapala has concluded that the impact of the OECD initiative has been small, probably because of the inadequacy of the initiative as information exchange has not been implemented to a sufficient degree, because corporate tax planning is unaffected by information exchange and may be more important than individual evasion related to tax havens;¹⁶ according to Hines, that evidence indicates that ‘tax havens contribute to financial market competition, encourage investment in high tax countries, and may ultimately, in their little island ways, promote economic growth elsewhere in the world’.¹⁷

§7.06 INTERNATIONAL STANDARDS, HERCULES LEGISLATORS AND DEVELOPING COUNTRIES

The next question is whether and to what extent a developing country and the rest of the world benefit from being part of the aforementioned holistic approach and whether exchange of information can be or should be dissociated from taking part in the BEPS Action Plan.

The first issue is whether a developing country (a low income country) should participate in the international standard of exchange of information upon request, as it has been carried out by the Global Forum, since 2009; or, furthermore, should participate in the international standard on automatic and multilateral exchange of information or in a model similar to a TIEA; the second issue is whether a developing country should participate in the BEPS actions and, if the answer is positive, to what extent.

13. OECD, *OECD Standard for Automatic Exchange of Financial Account Information, Common Reporting Standard* (13 Feb. 2014); *id.*, *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (21 Jul. 2014).

14. Bilick, K. & Fuest, C., ‘With Which Countries do Tax Havens Share Information?’, 6 *EUI Working Papers, RSCAS* (2012).

15. Johanssen, N., ‘Taxing Hidden Wealth: Lessons for Policy Making’, *EUI Working Papers, 25 EUI Working Papers, RSCAS* (2012).

16. Dharmapala, D. & Hines, J.R. Jr fn. 6; See also Johanssen, N. & Zucman, G., ‘The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown’, *WP No. 2012-04, Paris School of Economics* pp. 1-50; Johanssen, N., fn. 15.

17. Hines, J., ‘Treasure Islands’, 24 *Journal of Economic Perspectives* 123-124 (2010).

In a chapter of a book on Tax, Law and Development, I refer to a Hercules legislator in the context of technical assistance provided by an international organization (and an external draft legislator). It is assumed that the external drafter is requested to draft and discuss with local officials, parliamentary members, and members of the public, a whole or partial tax reform in a developing country. The external drafter is expected to play the Hercules legislator¹⁸ and is well aware that a consistent and coherent tax regime is not independent from its validity.¹⁹ Validity requires that the rules be the product of genuine argumentative interaction among the representatives of different legalities in a legal system (facticities in the Habermasian sense²⁰).

A Hercules legislator is constrained by the fact that he is not democratically elected – he does not represent the majority in parliament, and that is a major flaw. Comparing my Hercules legislator to Dworkin’s Hercules judge, the latter is in an advantageous position, since he is not, by definition, elected and his or her role is to determine a right answer as a result of interpretation of what has been decided by the law.

My question is therefore whether a Hercules legislator would propose exchange of information on tax matters (including tax crimes) and BEPS as international standards, in the sense that they would be the best legal solution for every state in the world and, if so, without jeopardizing the taxpayers’ fundamental rights as acknowledged in rule-of-law states. It is herein further contended that every tax principle and rule demanded by the rule-of-law and the rule-of-law itself is an international standard and therefore, international standards exist and can be proposed universally. However, to propose a standard as universally valid implies a previous assessment of utmost responsibility, especially when it is proposed by international organizations powerful enough to lead their members to adopt such standards. The success of tax reforms and tax standards also depends on their validity.

The G20, the OECD, the Global Forum, and the EU are currently engaged in proposing global standards without questioning their validity: neither their international validity nor their state (or local) validity. Legitimacy and validity result from communication and equality (absence of corruption, equal information) which will only occur in rule-of-law States. These conditions will often not apply in developing countries.

It is clear that this international trend to propose and adopt global standards is a response to global aggressive tax planning and to the awareness that states are not capable of reacting efficiently on a unilateral basis. However, globalization has also brought with it the awareness that jurisdictions have to accommodate plural legalities.

18. In analogy to Dworkin’s Hercules judge: *Taking Rights Seriously*, Harvard University Press, Cambridge, Massachusetts, 1978 (1977), 105-107; Fontana Masterguides, *Law’s Empire*, ed. Frank Kermodé, 1986, Glasgow, e.g., Chapters V and VI.

19. Dourado A.P. ‘Is this is a pipe? Validity of a tax reform for a developing country’, in: *Tax Law and Development* (ed. by Brauner Y. & Stewart M.), Elgar, 2013, at 127 et seq.

20. These concepts are therefore used here in the Habermasian sense and further discussed below: See Habermas J., *Faktizität und Geltung, Beiträge zur Diskurstheorie des Rechts und des demokratischen Rechtsstaats*, Frankfurt-am-Main, 1992, 2. Auflage 32-55.

Legal pluralism can be described as the coexistence of two or more legal systems in the same social field.²¹ I have already contended that validity of a tax reform implies taking into account the plural legalities in force in a given jurisdiction, including non-state legalities that have been recognized as binding by tax officials and courts.²² By plural legalities I mean horizontal legalities (within the same jurisdiction) (legal personality versus partnerships, trusts, accounting obligations) and vertical legalities (implying multiple fiscal levels of decision, as it occurs at a national, municipal, and supra national level. In tax law, horizontal legalities may interact in the case of qualification of persons (a taxpayer being granted legal personality in the residence jurisdiction whereas it is qualified as a partnership in the source state); or in the case of qualification of income (hybrid income, for example, being qualified as interest in the source country and as a dividend in the residence country).²³

In turn, vertical legalities take place in regional integration areas or resulting from best practice recommendations by international organizations such as the OECD or the UN. These legalities can include overlapping of taxes resulting in double taxation, different procedural tax rules, adoption of different accounting rules and languages in tax compliance duties, and also transfer pricing and anti abuse rules applicable to multinationals, and exchange of information.

In respect of migration movements of persons or capital, there is a risk of reciprocal ignorance of the incoming persons or capital and the state legalities involved. This reciprocal ignorance will affect recognition of rules and their binding character (I call these cases blind legalities) and contribute to tax evasion and avoidance (or aggressive tax planning). Hybrid mismatch arrangements as identified in OECD/G20 BEPS Action 2, illustrate the consequences of blind legalities. The latter can occur in the case of a state A income tax that adopts a legal concept of taxpayer that corresponds to the dominant legal culture, and does not recognize any tax consequences to an entity that is treated as opaque in another jurisdiction B (in other words, State A will consider the entity to be transparent). Thus, blind legalities will very often play a role in cross-border situations and may be connected to cross-border mismatches that either result in double taxation, double non-taxation or double deduction. An example of double deduction concerning hybrid entities is identified in OECD/G20 Action:

21. Facchi A., *I Diritti nell' Europa Multiculturale, Pluralismo Normativo e Immigrazione*, Editori Laterza, 4^a ed., Roma-Bari, 2008, 38; Pospisil L., *The Anthropology of Law: A Comparative Theory of Law*, Harper and Row, New York, 1971; Griffiths J., 'What is Legal Pluralism?', *Journal of Legal Pluralism and Unofficial Law*, 1986, n. 24, 1-50; Moore S.F., 'Law and Social Change: The Semi-Autonomous Social Field as an Appropriate Subject of Study', *Law & Society Review*, n. 7, 1973, 719 et seq.; Merry S.E., 'Legal Pluralism', *Law & Society Review*, 1988, vol. 22, n.º 5, 870 (869-901).

22. Supra note 19, at 130-133: as a reference to Hart's rules of recognition (secondary rules). Hart's concept of law covers primary and secondary rules, accommodates sources of law that do not necessarily emanate from the state, since law exists and is valid if there are commonly accepted rules of recognition. Hart H.L.A., 'The Concept of Law', Clarendon Law Series, Oxford University Press, Oxford, 1961, at 138-140.

23. See *Action Plan on Base Erosion and Profit Shifting – Report: 2013* (OECD 2013), p. 13. OECD/G20 Base Erosion and Profit Shifting Project, *Neutralising the Effects of Hybrid Mismatch Arrangements* (2014).

A company set up in country A (A Co) may set up a subsidiary in a country B (B Co) that is treated as transparent under the laws of country A and as opaque under the laws of country B. A Co holds all the shares of B Co. B Co borrows from a bank and pays interest on the loan. B Co derives no other income. B Co will deduct interest in country B. Because B Co is disregarded in A, A Co is treated as the borrower for the purposes of country A's laws. The arrangement results in double deduction of interest under the laws of both country B and A.²⁴

It can be assumed for the purposes of this chapter, that A is a developing country and the same (double deduction) consequences will occur.

The current globalization movement and aggressive tax planning by multinationals can also operate through vertical legalities.

Plural legalities in force in a given state are facts for my purposes and they refer to legalities that are recognized as binding by the authorities that apply the law (and I am adopting the Habermasian meaning of facts and facticities²⁵). Recognition that plural legalities are in force is therefore insufficient: my concerns are related to the validity of law and by it I mean legal rules that are the product of genuine argumentative interaction among the representatives of different legalities (again in the Habermasian sense²⁶) both within a state and at an inter-state level, the latter being either bilateral or multilateral. The concept of validity of law adopted herein covers tax reforms and any global rules and standards applicable in cross-border situations and resulting from a compromise assumed under international law.²⁷

The validity of international standards – exchange of information, tax treatment of trusts and transparency, CFC rules, transfer pricing documentation, elimination of double taxation – is often not discussed by national parliaments – it is not the product of argumentative interaction – and that implies ignorance of their scope and consequences for the country (in a perspective of efficiency, taxpayers' equity, and equity between States).

§7.07 THE GLOBAL STANDARD ON AUTOMATIC EXCHANGE OF INFORMATION, TAXPAYERS RIGHTS AND DEVELOPING COUNTRIES

The global standard on exchange of information goes beyond exchange of information related to the correct application of the provisions of the Convention (or 'minor information clause'), since it also covers exchange of information for the administration or enforcement of the domestic law ('major information clause').

Exchange of information is instrumental to the correct allocation of taxing rights according to the provisions of a tax treaty (the so-called 'minor information clause') and to the administration or enforcement of the domestic law (the so-called 'major

24. OECD/G20 BEPS, *Neutralising the Effects...*, supra note 9, pp. 51-52.

25. These concepts are therefore used here in the Habermasian sense and further discussed below: See Jürgen Habermas, supra note 20, at 32-55.

26. Habermas J., *Faktizität ...*, supra note 20, at 32-55.

27. As a consequence, it is herein contended that the rules of recognition also have to be valid in the Habermasian sense: id. at 32-55.

information clause'). This used to be primarily so in respect of the residence State²⁸ (taxing worldwide income), until the current move of OECD Member States to territorial taxation in respect of companies.

Taking into account the mismatches resulting from tax treaties, the transfer pricing issues, the meaning of permanent establishment, and the location of intangibles and dematerialized services, all of which are mentioned or identified in the BEPS Action Plan, as well as the difficulty in locating both the residence and source of companies, exchange of information is also relevant to settle any dispute over the source of income or to ground the application of an anti abuse rule. In the OECD Manual on Exchange of Information some examples, regarding the residence and the source countries, as well as transfer pricing issues, are enumerated as justifying exchange of information upon request.²⁹

Exchange of information is neither limited to information relating to the affairs of residents of the Contracting Parties nor to the taxes covered by the Convention. It therefore has a broader scope than other provisions in a Convention and it is ultimately aimed at fulfilling the national revenue interest, even though instrumental to the correct allocation of taxing rights and to avoiding double taxation and double non-taxation.

Since 2009, the OECD pressure on States previously classified as tax havens has led to the widespread conclusion of TIEAs. TIEAs are an additional argument to demonstrate that exchange of information has a broader purpose than the correct implementation of bilateral tax conventions and their limitation of the taxing rights of the Contracting States.

Article 26 paragraph 2 envisages the possibility for persons authorized to use the information to disclose it to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. The OECD MC 2012 foresees the possibility that the tax authorities of the receiving State share tax information with other law

28. Lighthard, K. *Vogel Commentary on DTC* 3rd ed., (2004) at 6; Engelschalk, DBA Kommentar (5th edn, Munich, C.H. Beck, 2008), at 21.

29. '...for the application of Article 12 of the Model Convention (royalty payments), the country of residence may ask the source country the amount of royalties transmitted to one of its residents, the source country may ask the country of the recipient of the royalties whether he is a resident and whether he is the beneficial owner of the royalties in order to exempt them from withholding. Furthermore, for the application of Articles 7, 9, 23 A and 23 B, information may also be needed for the proper allocation of profits between associated enterprises in different states or between a head office in one State and a permanent establishment in another State. Information necessary for the application of Article 9 also includes information on ownership and control in a foreign person for purposes of establishing whether or not enterprises are associated within the meaning of Article 9. Here, countries A and B may exchange information regarding transactions with the company in country C for the correct taxation of their resident companies; prices in general, necessary to check the prices charged by their taxpayers even if there are no business contacts between the taxpayers. For instance, country A may wish to check prices charged by its taxpayers by reference to transfer pricing information on similar transactions in country B, even if there are no business contacts between the respective taxpayers in countries A and B (see paragraph 8, sub-paragraph c of the Commentary on Article 26 of the Model Convention.'

enforcement agencies and judicial authorities in that State on high priority matters (e.g., to combat money laundering, corruption, terrorism financing). Law enforcement agencies and judicial authorities receiving information under the last sentence of paragraph 2 must treat that information as confidential consistent with the principles of paragraph 2.³⁰

In respect of disclosure in public court proceedings or in judicial decisions, this means cases dealt with by tax courts or in administrative or penal proceedings for tax offences. Once information has been disclosed, it becomes common knowledge. However, the MC does not allow any disclosure outside court proceedings or for reasons other than those listed in Article 26. Information treated as confidential or secret under Article 26 or similar provisions of DTCs cannot be granted to other entities³¹ even if it does not relate to individual taxpayers.³²

The obligation of a Contracting State to fulfil an information request is limited by paragraph 3. This limitation can result from domestic law and administrative practice of one or both of the Contracting States as well as confidentiality related to the activity of the taxpayer or if exchange of information would be contrary to public order.

Disclosure of information upon request by one Contracting State to another Contracting State implies that the latter treats the information received as secret. Under the OECD MC 1963 secrecy was a treaty obligation to be interpreted autonomously from domestic law, and requiring an absolute protection.³³

The OECD MC 1977 partially introduced a non-discrimination or equivalence principle: the Contracting State must treat the information obtained from the other Contracting State in the same manner as it treats such information domestically. The equivalence principle implies that different procedural rules and different levels of protection will be applicable in the various Contracting States, within the framework of the MC limits.³⁴

This cross-reference to domestic law is not complete, since the MC includes parameters of secrecy, namely those regarding the persons to whom information may be disclosed and the purposes for which it may be used: the information can only be

30. No. 12.3 Commentary.

31. For example, if the documents sought include Technical Assistance (TA) memoranda prepared by an authority in connection with information requested by tax treaty partners specific to particular taxpayers: US District Court for District of Columbia, of 26 Mar. 2001, Case n.º 96-2285 (CKK), 152 F. Supp 2d 13 87 AFTR 2d (RIA) 2001-726; *Tax Analysts v. Internal Revenue Service*. ‘The District Court held further that the exemption from disclosure applies to an entire TA document that contains taxpayer-specific information, and that the IRS was not required to segregate and disclose the portions of a TA memorandum that included legal analysis of a tax treaty or US or foreign tax law since such portions constituted tax convention information that was exempt from disclosure’.

32. US District Court for District of Columbia, of 5 Aug. 2002, Docket n.º 99-0372, *Tax Analysts v. U.S.*

33. Engelschalk, in: Vogel/Lehner (eds), fn. 28, Art. 26 mnos. 78 and 87. According to the 1963 version of Art. 26, para. 2, ‘Any information so exchanged shall be treated as secret and shall not be disclosed to any persons or authorities other than those concerned with the assessment or collection of the taxes which are the subject of the Convention’.

34. Rust, A., ‘Data Protection as a Fundamental Right’, in: Rust, A. & Fort, E. (eds), fn. 12, at 180-181.

disclosed to a certain group of persons and used for purposes of assessment or collection of taxes under paragraph 1, and for the enforcement or prosecution or the determination of appeals regarding the mentioned taxes (the purpose limitation principle).³⁵

However, as mentioned above, the 2012 amendment to paragraph 2 allows the Contracting States to share information received for non-tax purposes, provided two conditions are met: first, the information may be used for other purposes under the laws of both States (e.g., in case of a non-fiscal crime, a treaty concerning judicial assistance); and, second, the competent authority of the supplying State authorizes such use (see commentary 12.3).

Thus, the tax authorities of the receiving State may wish to share the information with other law enforcement agencies and judicial authorities in that State on certain high priority matters (such as to combat money laundering, corruption, or terrorism financing). When a receiving State desires to use the information for an additional purpose (i.e., a non-tax purpose), the receiving State should specify to the supplying State the other purpose for which it wishes to use the information and confirm that the receiving State can use the information for such other purpose under its laws.

Since the supplying State has to authorize such use, protection of secrecy is still achieved. In turn, the supplying State is expected to authorize such use, if it has concluded international agreements or other arrangements with the requesting State on mutual assistance between other law enforcement agencies and judicial authorities. These law enforcement agencies and judicial authorities receiving information under the last sentence of paragraph 2 must treat that information as confidential consistent with the principles of paragraph 2 (in this sense, commentary 12.3).³⁶

If the supply of information is contrary to paragraph 3, the requested State can refuse to supply that information and in that manner it is protecting the interests of the taxpayer.³⁷ The supplying State therefore has a duty of care to protect the taxpayer's interest. However, that decision is discretionary and therefore there is no guarantee that the requested State will refuse that supply. Most importantly, consequences – sanctions – to the violation of the confidentiality obligations are neither foreseen in Article 26 OECD MC nor in the TIEAs.

35. See, however, the views of the US Senate on the *USA-Norway* Income Tax Treaty and the *USA-Germany* Treaty on Inheritance Tax, according to which information received should also be made available to 'the appropriate Congressional committees and to the US General Accounting Office', 22 *ET* 35 (1982).

36. See, previously to the 2012 update of the OECD MC and commentary, Rust, A., fn. 34 at 181-182.

37. According to para. 3 of the OECD MC, in no case shall the provisions of paras 1 and 2 be construed so as to impose on a Contracting State the obligation:

- a. To carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
- b. To supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
- c. To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (*ordre public*).

All of the described elements have led to the common understanding that the taxpayer's position under this duty of secrecy by the requesting State is not sufficiently protected.³⁸

The compatibility of national law with the MC in grey areas is also disputable, such as the case where a Contracting State publishes lists of debtors. The issue is whether under paragraph 2 those lists can include any domestic taxes due on residents' income with sources abroad, the amount of which results from information supplied by the other Contracting State. The DTC rule of secrecy prevails over any domestic obligations of the receiving State to reveal information.³⁹ Thus, the issue is whether the aforementioned publication is compatible with any of the purposes mentioned in Article 26 paragraph 2. The same reasoning applies to the example of disregarding secrecy in tax matters for the purpose of combating illegal employment (paragraph 31a AO) in connection with information received by the German tax authorities under Article 26.⁴⁰ In contrast, extreme cases would ultimately be protected under paragraph 3 c. (public policy).

Taking into account the current international rules, it is herein claimed that a developing country should not participate in the movement of international standards on exchange of information, unless the administrative organization is sophisticated enough to guarantee the confidentiality of the data exchanged.

It is herein also contended and proposed, that the peer-review tests carried out by the Global Forum require the observance of rules connected with taxpayer rights.

This is necessary, because taking into account the previous paragraphs, both Article 26 of the OECD Model Convention and Article 1 of the TIEAs MC do not sufficiently protect taxpayer rights.

The EU directive on personal data protection⁴¹ could be adopted by the Global Forum as a best practice in this respect.

It foresees detailed protection of data as well as sanctions in case of violation of confidentiality: (a) 'the receiving agency may use such data only for the stated purpose and shall be subject to the conditions prescribed by the supplying agency; such use is also permitted, subject to written consent..., for the prevention and prosecution of serious crimes and for the purpose of addressing serious threats to public security; (b) The receiving agency shall on request inform the supplying agency about the use of the supplied data and the results achieved thereby; (c) Personal data may be supplied only to the responsible agencies. Any subsequent supply to other agencies may be effected only with the prior approval of the supplying agency; (d) The supplying

38. Schenk-Geers T., 'International Exchange of Information and the Protection of the Taxpayer' in: Seer R. & Gabert I. (eds.) *Mutual Assistance and Information Exchange*, The Netherlands, 2010, at 107-108; Vegh P. G., *European Taxation*, 391, 399 et seq. (2002); Oberson X., *Bulletin for International Fiscal Documentation*, 14 (17) (2003); Calderón J.M., *Intertax* 462 (2000); García Prats F.A., *Bulletin – Tax Treaty Monitor* 541-547 (1999). Malherbe P. & Beynsberger M., fn. 12 at 132-133.

39. Rust A., "Data Protection as a Fundamental Right", in: Rust, A. & Fort, E. (eds), fn. 12, at 181-182.

40. See Engelschalk, in: Vogel & Lehner, *DBA Kommentar*, 5th ed, Munich (2008) at m.no 85.

41. Directive 95/46/EC of the European Parliament and of the Council of 24 Oct. 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data.

agency shall be obliged to ensure that the data to be supplied are accurate, necessary and proportionate for the purpose for which they are supplied; (e) Upon application the person concerned shall be informed of the supplied data relating to him and of the use to which such data are to be put. There shall be no obligation to furnish this information if on balance it turns out that the public interest in withholding it outweighs the interest of the person concerned in receiving it. In all other respects the right of the person concerned to be informed of the existing data relating to him shall be governed by the law of the Contracting Party in whose sovereign territory the application for the information is made; (f) The receiving agency shall bear liability in accordance with the law applicable to it in relation to any person suffering unlawful damage in connection with the supply of data.’ Protocols to TIEAs signed by Germany, e.g., the Protocol to the Agreement between Germany and Jersey, ensure the protection of personal data at a level that is equivalent to that of the aforementioned EU Directive.

In the Protocol to the Austria-Slovenia tax treaty, violation of confidentiality by the requesting State implies sanctions in that requesting State:

Where information is exchanged it is subject to strict confidentiality rules. It is expressly provided in Article 26 that information communicated shall be treated as secret. It can only be used for the purposes provided for in the convention. Sanctions for the violation of such secrecy are governed by administrative and penal laws in all states. Typically, unauthorised disclosure of tax related information received from another country is a criminal offence punishable by a jail sentence.

However, if the requested State has grounds to suspect that the requesting State will not respect confidentiality of the information provided, namely because in previous exchange of information situations it has not respected confidentiality or because its domestic legislation does not respect it, sanctions can be applicable in the requested State (See the *Aloe Vera of America* case⁴²).

§7.08 THE MEANING OF ‘INFORMATION’ FOR THE PURPOSES OF EXCHANGE OF INFORMATION AND BEPS ACTION PLAN 10

One aspect of exchange of information that can interact with Action Plan 10 regards the object of exchange of information. The term ‘information’ under Article 26 OECD MC and Article 1 of the TIEA MC is not only limited to facts protected by legal secrecy but also covers publicly known facts.

The market price of a product or publicly quoted shares is not covered by secrecy, and domestic rules of the State obtaining the information will logically not include them under confidentiality, but it is not for the tax authorities of that State to reveal that information: it will be revealed if they need to do so, for the purposes mentioned in Article 26, paragraph 2. Nothing in paragraph 2 requires that such publicly available information be treated in the same manner as domestic non-confidential information,

42. US District Court for District of Arizona, of 2 Feb. 2007, fn. 29; *Aloe Vera of America v. United States*, (D. Ariz., Feb. 11, 2015).

and a different treatment of publicly available information would not raise an issue under Article 26, paragraph 3, namely paragraph 3 c.

The domestic rules on secrecy in tax matters are designed to safeguard information on facts and taxpayer's rights. Those rights are not connected with a tax interest, but with informational, business, or professional interests.⁴³

Whereas violation of secrecy obligations by the Contracting State receiving the information involves a violation of the bilateral treaty from the viewpoint of the Contracting States, from the point of view of the taxpayer he is entitled by the treaty to a non-discriminatory domestic tax regime and has legal rights under the domestic law of the Contracting State receiving the information.⁴⁴

Action 10 under the BEPS Action Plan will require specific data collection and targeted information related to transfer pricing agreements. Business or professional interests will be protected under Article 26 OECD MC and TIEAs by a non-discrimination clause and this will also probably prove to be insufficient at a global bilateral and multilateral level. Combination of Article 10 with information exchange may also raise difficult issues in developing countries. Data collection and targeted information regarding transfer pricing agreements requires a considerable amount of technical and financial resources. Developing countries often do not have enough resources to collect the aforementioned data and targeted information, to interpret those data and information, and to make sure that they will be safely stored.

§7.09 INFORMATION EXCHANGE AND BEPS AS VALID INTERNATIONAL STANDARDS: SOME PROPOSALS

Automatic and multilateral exchange of information should be dependent upon consistent and periodical verification of the existence of domestic rules on taxpayer rights, departing from Article 26, but stronger. The standard should not be limited to verifying the equivalence principle or the non-discrimination between resident and non-resident taxpayers. International standards on the protection of personal data and explicit sanctions regarding the countries that did not comply with those rules should be foreseen in an international legal instrument (i.e., binding).

The basic argument lies in taxpayer rights and in the fact that the principle of separation of powers and the corresponding existence of independent courts is not guaranteed. Moreover, the European Court of Human Rights has limited jurisdiction and will not function as a Court of Appeal.

International standards should not be put forward without democratic legitimacy of standards and without an international court or international arbitral tribunal that can check the legality of the administrative actions resulting from cross-border actions and whether taxpayer rights are guaranteed.

The described legal situation does not recommend application of exchange of information without first considering whether taxpayer rights are observed in a given

43. Schenk-Geers T., fn. 38 at 108.

44. Ligthard, K., fn. 28.

jurisdiction. For the sake of simplicity, it is now assumed that the Global Forum, the EU, and other international organizations will in the near future implement some of the proposals put forward in the previous paragraphs. Even in that case, exchange of information primarily serves the interests of the residence State, corresponding in most cases to capital exporting countries or OECD countries. Because in many cases developing countries will have difficulty in implementing the necessary rules regarding protection of taxpayer rights in case of information exchange (especially confidentiality, observance of the statute of limitations, and efficient access to courts in case of illegal actions by the tax authorities) it is herein proposed that a transitional period with a withholding tax on passive income from capital should be introduced. This proposal will grant revenue to the developing State acting as source State and assures that passive income is taxed at least once (therefore avoiding double non-taxation). In case the residence State taxes worldwide income and applies the ordinary credit method, tax rates could be agreed upon bilaterally, so that the residence country still gets some revenue. In case the residence State of the individual or the ultimate parent company adopts the principle of territoriality, the withholding rate should correspond to the tax rate of the residence State. A withholding tax in the source State will avoid the interposition of conduit companies. In case tax treaties have been concluded, switch-over clauses should be foreseen.

A step-by-step approach could be taken in developing countries: information exchange could be introduced in some developing countries, in respect of one or some industries, and simultaneously with some BEPS Actions, namely those regarding transfer pricing issues (e.g., Action 10). The industry-wide exchange of information concerns an economic sector as a whole, for instance, the pharmaceutical industry or the oil industry, and has been considered a good practice (it is foreseen in the OECD Manual on the Implementation of Exchange of Information⁴⁵).

A transitional approach combined with a step-by-step approach would contribute to include developing countries in the current international movement, without forcing them to adopt an international standard, for which they will not in many cases be prepared.

45. OECD Manual on the Implementation of Exchange of Information, para. 27.