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Tax Competition and the Case of Bank Secrecy Rules: New Trends in International Tax Law

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The University of Michigan Law School

**TAX COMPETITION AND THE CASE OF BANK SECRECY
RULES**

NEW TRENDS IN INTERNATIONAL TAX LAW

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SUBMITTED TO THE UNIVERSITY OF MICHIGAN LAW SCHOOL IN FULFILLMENT OF
THE REQUIREMENTS FOR THE DEGREE OF DOCTOR OF THE SCIENCE OF LAW (S.J.D.)

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TAX COMPETITION AND THE CASE OF BANK SECRECY RULES: NEW TRENDS IN
INTERNATIONAL TAX LAW

"The era of bank secrecy is over."

(G-20 Communiqué)

Abstract: The current integration of world markets has led to an increase in the competition for businesses in addition to the competition for passive investments that already existed. In addition, the current financial crisis led countries to search for additional sources of revenue in order to work within their budget constraints. As tax is an area where such competition is more visible, it has also generated an effort – mainly from industrialized countries and international organizations – to curb tax practices deemed harmful to world economy. Bank secrecy rules and lack of transparency are aspects of these "harmful" tax practices. This dissertation will focus on (i) how such rules work and how harmful they can be; (ii) jurisdiction aspects that may limit the ways countries may employ to deal with the situation; (iii) how secrecy rules affect privacy rights and how such rights may not be absolute in certain situations, and, last but not least, (iv) what bi-(multi)lateral and unilateral measures are being taken to deal with these harmful practices.

I – INTRODUCTION

This dissertation analyzes new measures aimed at curtailing tax evasion on cross-border transactions. Although tax evasion is as old as tax itself, this practice on cross-border transactions is related to the modern era, more specifically, the late 19th and 20th centuries. Cross-border transactions increased as markets became integrated, thus increasing the level of tax evasion. This, by itself, calls for new measures to deal with this problem. It is a vicious circle.

Income tax is an important source of revenue for developed countries.¹ Ever since income tax was enacted, taxpayers have been trying to avoid it; that has historically been a cat and mouse chase between the Government and taxpayers. As soon as legislators close a loophole, tax experts find another one in the legislation allowing them to create a tax shelter,² not to mention international tax shelters. Globalization has made international tax shelters extremely attractive. Also, the possibility of taking advantage of the legislation of foreign countries multiplies the opportunities for finding ways to evade the tax system.

The current economic crisis has brought to the fore the need for additional revenue, and as a consequence there have been several debates on how to increase tax revenue without losing competitiveness.³ Tax is typically an issue whose discussion, ideally, ought to be restricted to a specific society, including those countries that do not have a tax system for their revenue – usually oil producing countries.⁴ However, we are currently witnessing an intense debate within countries and within international organizations on tax issues. In fact, countries have been enacting new legislation to increase its tax revenue by trying to close legislation loopholes and tax shelters.⁵ In addition, international institutions, such as the Organization for Economic Co-operation and Development (OECD) and the G-20, have been exerting pressure on other countries to comply with requests for information in connection with tax investigations carried out by another country.

¹ As will be seen below developing countries rely more on consumption taxes, usually in the format of a value added tax, as it allows the tax to be hidden from the taxpayer.

² See, e.g., Marvin Chirelstein & Lawrence Zelenak, *A Note on Tax Shelters*, Research Paper No. 67, June 2005, Duke Law School Legal Studies, <http://ssrn.com/abstract=745385>, at 11, who understand that "...government cannot win this game".

³ Such discussions have been very intense in the United States, where a deficit budget claims for reduction of expenses and increase of revenue. On the revenue side there has been some unprecedented debate about creating a federal tax on consumption, in addition to the income tax, most likely as a value added type of tax. See, in general, *Dealing with America's fiscal hole*, The Economist November 21st - 27th 2009, 2009, at 13.

⁴ The power to tax is embedded in the sovereignty of a country. A country has no sovereignty beyond its borders and, therefore, may only levy a tax within its territory. Later in this work it will be discussed that the concept of territory may be expanded through the use of connection elements. See *infra* note 91.

⁵ See, generally, MIHIR A. DESAI & JAMES R. HINES, *Old Rules and New Realities: Corporate Tax Policy in a Global Setting* (Ross School of Business 2004), demonstrating that for reinventing United States corporate tax requires placing international considerations in the front and at the center of the debate.

The economic depression that started on the second half of 2008 has placed most industrialized countries on the same side of the playing field, i.e., in desperate need for revenue.⁶ As if the economic depression in itself was not enough, some countries like the United States are going through an unprecedented budget deficit. After all, tax is the main source of revenue for most nations, the one all governments turn to when they fall short of money.⁷

In addition to economic depression and budget deficit, the increased mobility of capital, the end of withholding taxation of capital by strong economies, and the proliferation of tax havens with secrecy rules, have all made possible for cross-border portfolio income to be earned largely free of tax.⁸ The abolition of trade barriers and exchange controls has led to market integration, which creates tax competition for businesses. In fact, tax rates on foreign direct investments have dropped in the last years mostly with the aim of attracting investors,⁹ thus generating a series of arguments both for and against tax competition.

The combination of these events makes income generated offshore¹⁰ increasingly difficult to tax. Very little tax is currently collected on cross-border portfolio investments and

⁶ The reduction of revenue not only increases borrowing (which creates all sort of economic consequences, such as increase of interest rates and submission to creditors' demands), but also inhibits public spending, necessary to boost the economy and get out of recession, i.e., if you are a liberal). In order to deal with economic depressions most conservatives prefer tax cuts because it keeps government from interfering with markets, while most liberals would prefer public spending because it expands the role of the government and can be directed to improving the welfare of the worst-off people in society. See RICHARD A. POSNER, *A Failure of Capitalism: the Crisis of '08 and the Descent Into Depression* (Harvard University Press ed., Harvard University Press First ed. 2009), at 165-166.

⁷ In some cases it may be more politically viable to raise a tax rate than to cut an expense. Also, see REUVEN S. AVI-YONAH, *The Three Goals of Taxation*, 60 *Tax Law Review* 01, (2006), at 3, arguing that besides raising revenue, tax is used to redistribute wealth and regulatory purposes.

⁸ See REUVEN S. AVI-YONAH, *Globalization, Tax Competition, and The Fiscal Crisis of the Welfare State*, 113 *Harvard Law Review* 1573, (1999-2000), at 1576. In this article the author argues that "... maintaining both globalization and social insurance will require measures that limit tax competition but preserve each democratic state's ability to determine the size of its public sector". Although the work was published in 2000, the arguments remain up to date.

⁹ See ANDREAS HAUFLE, *Taxation in a Global Economy* (Cambridge University Press First ed. 2001), at 14. See, also, JAMES R. HINES JR. & LAWRENCE H. SUMMERS, *How Globalization Affects Tax Design* (National Bureau of Economic Research 2009), Tables 3 and 4. But see OMRI Y. MARIAN, *Discursive Failure in Comparative Tax Law*, 58 *American Journal of Comparative Law* 415, (2010), for who corporate rates have not dropped in the latest years.

¹⁰ The term "abroad" is used here to mean income generated outside the country of residency of the beneficiary.

foreign direct investments, which makes it easier for tax to be levied on less mobile factors of production, such as labor, land and, ultimately, consumption. Shifting the tax burden to taxpayers less-able-to-escape has adverse effects on equity and efficiency, and tax becomes less oriented by equitable principles such as the ability-to-pay

In 2000, Prof. Avi-Yonah warned about the need for limiting tax competition in order to maintain both globalization and social security.¹¹ Although one may not agree with the solutions proposed at the time, his arguments to limit tax competition are irrefutable and the current fiscal crisis demonstrates that. The creation of production tax havens and low tax countries, such as the emerging economies of Eastern Europe who charge a flat tax, has allowed corporations seeking low tax environments to shift production to those countries.¹² In addition, since the mid-1980s, when withholding tax on portfolio income was abolished by the major economies, most of the income generated on portfolio investment by non-resident investors goes untaxed.

There are, therefore, two distinct situations that should be dealt with separately. First, countries have introduced new domestic legislation to deal with international tax evasion; such legislation has been aimed, mostly, at obtaining financial information about taxpayers outside their country of residence. Second, international organizations have been drafting model treaties and other legal documents as well as demanding from countries that they provide financial information on non-resident investors.

Tax competition plays a big role in this discussion. Furthermore, tax competition has created a world scenario where countries complain about tax relief granted by other countries just to realize that they also grant similar benefits.

There is a tax competition for direct investments, where countries are reforming their tax system in order to become more attractive - i.e., less expensive - to foreign investors - especially on production - and there are countries aiming at portfolio investments by, among other benefits, enacting secrecy rules and having low - or no - tax levied on investments

¹¹ See AVI-YONAH, *Globalization, Tax Competition and Fiscal Crisis*, supra note 6.

¹² I am assuming those countries also have good infrastructure and educated labor force. It is not being said that tax is the sole reason for deciding where to place production.

maintained by non-residents. There has been a general outcry against bank secrecy rules, especially those rules created by the latter countries. Nonetheless, bank secrecy rules have existed for over a century.¹³ Certain countries, such as Switzerland, are known for their traditional banking industry and, above all, for their "traditional" – and strict – secrecy rule regime.

What has led developed and developing nations to protest against countries that have such rules, and international organizations, such as the OECD, to start calling certain tax practices – in conjunction with secrecy rules - "harmful tax competition"? And, above all, how countries may deal with these issues? In general, when drafting tax rules, a country's legislators only care about the internal problems and difficulties of their own country - as well as the opinion of their voters - however, when domestic tax policies affect the tax system of other countries these countries voice their complaints.

This may lead us to a legitimacy issue. Do countries have a legitimate claim to demand from other sovereign nations that they amend their tax legislation and bank secrecy rules? How do secrecy rules relate to the right of privacy and what harm, if any, would come to a society that abolishes such rules? When answering such questions should we consider local or world governments? This seems to be a good case study of international relations regime, as some countries have been using their power to convince other – and generally smaller – countries with secrecy rules to enter into exchange of information agreements. However, it is not clear whether these smaller countries have such information, since a country that levies no - or almost no - tax has no incentive to collect information on the ultimate beneficiary of the income.

The application of international relation ("IR") theories with respect to tax situations has not been the subject of many studies. Prof. Diane Ring,¹⁴ applying the regime theory to

¹³ See DENNIS CAMPBELL, *International Bank Secrecy* (Sweet & Maxwell First ed. 1992), at the preface, stating that "[T]angential references in the Code of Hammurabi imply that confidentiality in banking existed more than 4,000 years ago in Babylon. Ancient Romans may have practiced banking secrecy, and it was then probably recognized as well by barbarian tribes in other parts of Europe."

¹⁴ See, generally, DIANE M. RING, *International Tax Relations: Theory and Implications*, 60 *Tax Law Review* 83, (2006 - 2007).

the phenomenon of double tax treaties, has written one of the few studies dealing with the subject. The IR theories try to explain how and where countries reach agreements or how - and why - they cooperate. The exchange of information on tax issues, among which bank information plays a central role, is definitely an area where countries should be reluctant to cooperate, since secrecy rules confer to the banking industry an unique feature that attracts a great deal of wealth - and in most cases it provides its survival.-In spite of that, countries have been entering into several Information Exchange Agreements lately,¹⁵ which raises questions about the reasons why countries with a long - history of bank secrecy rules are now agreeing to share information about non-resident bank account holders.

This dissertation will also focus on bank secrecy rules and their role in - harmful - tax competition. Bank secrecy has its justifications, especially when connected to the protection of civil rights and the right to privacy. Nevertheless, as we shall see, in spite of all justifications in favor of bank secrecy rules and the role it has played in the past, e.g. during and after the two World Wars, bank secrecy and lack of transparency can cause great harm if taken to extremes, such as, among others, when denying access to bank information about tax evaders to crime investigators.

This could not be more opportune. Since the late 1990s, the OECD has been exerting pressure on "favorable tax jurisdictions" to comply with new standards of transparency and exchange of information in tax issues.¹⁶ In Europe, certain independent organizations, such as the London based Tax Justice Network has strongly criticized the UK government for its leniency with favorable tax practices within some of the Crown's territories, especially in regard to low tax rates and lack of transparency due to secrecy rules.

¹⁵ The effectiveness of such exchange on information agreements has been questioned. See MICHAEL J. MCINTYRE, *How to End the Charade of Information Exchange*, 56 *Tax Notes International* 255, (2009).

¹⁶ The OECD has developed several studies highlighting the problems caused by lack of transparency to its member countries, and member countries have been exerting pressure on favorable tax nations to cooperate. See DIANE M. RING, *Who is Making International Tax Policy?: International Organizations as Power Players in a High Stakes World* (Boston College Law School 2010), uncovering the role of international organizations in making tax policy. The paper analyzes two case studies, specifically the inserting of the arbitration clause on Article 25 of the Model Double Tax Conventions (OECD) and the campaign that the OECD has been carrying out in regard of Information Exchange Agreements.

Moreover, the "G20: Communiqué", released as a result of the summit held on April 2, 2009, expressly stated –among other things – that "The era of bank secrecy is over".¹⁷

There has also been a lot of activity on the legislation-innovation area.

Bank secrecy rules and lack of transparency have also been of great concern in the United States lately. In 2008, the Permanent Subcommittee on Investigations of the U.S. Senate conducted several investigations on tax evasion related to the use of offshore structures in favorable tax jurisdictions with bank secrecy rules. Such investigations produced an extensive report about the harm s caused by such practices to the U.S. economy.¹⁸ Lately, the United States has been trying to pierce the veil of Swiss bank secrecy to compel UBS AG into providing financial information on all of its U.S. clients. The U.S. Federal Prosecutors Office filed a lawsuit against UBS AG demanding the bank to provide a list containing a large number of account holder who are U.S. citizens.¹⁹ In addition, on March 2, 2009, Senator Carl Levin (D-Mich) together with other Senators introduced a Bill to Congress addressing the issue.²⁰

Recently, the United States has introduced the Foreign Account Tax Compliance Act (FATCA) as part of the Hiring Incentives to Restore Employment (HIRE) Act. FATCA will have far-reaching consequences as it represents the most substantial change to the rules governing cross-border payments since the early 2000s.

¹⁷ Also, on the eve of the G-20 meeting in Pittsburgh, on September 24-25, 2009 then French President Nicolas Sarkozy stated: "Tax havens, banking secrecy, that's all over". See MCINTYRE., supra note 14, at 255.

¹⁸ See U.S. Senate, Permanent Subcommittee on Investigations, Tax Haven Banks and U.S. Tax Compliance (July 17, 2008) (the "Senate Report").

¹⁹ See generally, <http://online.wsj.com/article/SB123506522244024485.html>. The case was being tried at The United States District Court for the Southern District of Florida – Miami Division, under the Docket No. 09-20423. The parties have reached an agreement whereby UBS would provide the United States Government with the information on approximately 4,450 account holders. Nevertheless, a Swiss court has recently prohibited UBS AG to deliver any account information.

²⁰ See <http://levin.senate.gov/newsroom/supporting/2009/PSI.StopTaxHavenAbuseAct.030209.pdf>, last visited on December 3rd, 2009. Congress, instead, enacted the HIRE Act (H.R. 2847), which became law on March 2010. The HIRE includes the "Foreign Account Tax Compliance Act of 2009", dated October 26, 2009, intended to provide the U.S. Treasury Department with significant new tools to find and prosecute U.S. individuals that hide assets overseas from the Internal Revenue Service.

The OECD has also advocated more information exchange among member countries' tax administration in addition to exerting pressure on favorable tax jurisdictions to comply with such standards of information exchange.²¹ The pressure made by the OECD member countries - among which are the major industrialized nations - against bank secrecy rules has produced some results, although at present it cannot be said to have been completely successful.²²

In spite of the wish to end bank secrecy rules and to curtail tax haven practices, the statement of the G-20 is far from becoming common practice. In fact, there are powerful economic interests that benefit from tax-free jurisdictions and secrecy rules maintained by tax havens. As a consequence, it may not be that easy to abolish such practices.²³

Historically, issues related to favorable tax jurisdictions and bank secrecy rules were mainly connected with criminal activities, such as money laundering and tax evasion. Capital has always been mobile, but in the last thirty years its level of mobility has increased exponentially. In addition, other factors of production, such as labor, which used to be less mobile, have also acquired a certain degree of mobility.²⁴ This increased capital and labor mobility has generated an increase in cross-border investments and, consequently, an increase in potential tax evasion, especially due to lack of information since without information tax cannot be levied.

²¹ See, generally, OECD - Improving Access to Bank Information for Tax Purposes. pt. 119 (2000), and its 2007 "Progress Report".

²² See REUVEN S. AVI-YONAH, *The OECD Harmful Tax Competition Report: A 10th Anniversary Retrospective* (University of Michigan Law School 2008), Working Paper No. 115 – August 2008, advocating that the OECD Report was a "useful beginning", but further measures are needed, such as elimination of deferral for all CFCs, and imposing withholding tax on payments to non-treaty countries, among other things.

²³ The OECD has issued an up-dated list dated April 2nd, 2009, as a consequence of the G-20 Meeting. Such list may be obtained at <http://www.oecd.org/dataoecd/38/14/42497950.pdf>. The list appoints Costa Rica, Malaysia, Philippines and Uruguay to be the only countries not to have committed to the internationally agreed tax standard, although these countries have recently announced their adherence to the standards. But see MCINTYRE., *supra* note 14, at 255, for who the black list (as well as the "grey" list) made by the OECD has been a "sad joke".

²⁴ Several facts contributed to the increase of the mobility of capital and labor. The main facts were certainly the termination of capital flow control around the world and migration of labor (especially in the EU community), which led, as we will see below, to an exponential increase of the globalization and integration of markets, which led countries to compete for business opportunities in order to generate jobs and boost their domestic economies.

This dissertation will briefly analyze and explore the phenomenon of tax competition as a whole and certain arguments that have been raised lately both against and in favor of it. Understanding tax competition is essential to a good comprehension of the current role of bank secrecy rules in the world economy, which, in turn may help understand the new legislation being enacted and the crusade of the international organizations against lack of information.

Tax competition, in general, seems unavoidable but some of its aspects generate harmful consequences to other countries, such as incentive to non-compliance with the home country tax system. These harmful aspects of tax competition are also a by-product of globalization and market integration, but not necessarily a result of attracting businesses to boost the country's economy. Countries that are not able to attract foreign businesses and direct investments historically created other incentives to attract capital such as tax holidays (usually only for non-residents) and secrecy rules; i.e., small countries without means to attract businesses offer safe havens for wealthy investors residing elsewhere to secretly park their capital – (and more recently labor). This practice also enables capital originated from illegal activities to obtain protection from investigation. In addition, such havens offer a strong and reliable financial system, which in the majority of cases consists of strong protective legislation and local subsidiaries of solid financial institutions.

In contrast with what supporters of such rules argue, bank secrecy rules have been used nowadays to hide money from illegal activities rather than to protect people from violation of civil rights, dictators and other liberty oppressors.²⁵ Whether tax evasion should also be included in this list is a delicate issue. People oppose money laundering because is a result of (or help generate) crimes against humanity; on the other hand, there is no similar opposition in regard of tax evasion, which some do not consider a crime and others do even consider it legitimate. Perhaps that is the reason why the campaign against "harmful tax competition" (or tax havens) sponsored by the OECD has not yet been a success, or have not

²⁵ See, generally, ANITA RAMASASTRY, *Secrets and Lies? Swiss Banks and International Human Rights*, 31 *Vanderbilt Journal of Transnational Law* 325, (1998).

yet received the support people usually give to campaigns against money laundering and other crimes against individual rights.

In order to analyze secrecy rules it is also important to understand the fundamentals of the right of privacy and, more specifically, the right of privacy of financial information. Last, this paper will review international mechanisms that are being used to deal with lack of transparency. As will be seen further below, it is more efficient to focus in enacting domestic legislation to deal with such problems instead of using international legal mechanisms and diplomatic solutions. Among other arguments, the introduction of domestic legislation usually brings faster and more reliable results, avoids jurisdictional issues and creates less friction with other countries. In this light, I will also analyze the recent legislation introduced in the United States, such as QIP and FATCA, and the Brazilian legislation.

II – TAX COMPETITION AT A GLANCE

Capital has become increasingly mobile due to several factors that range from new technologies to regulatory relaxation. The increasing mobility of capital has led to an increasingly interconnected world. This generates tax competition among countries vying with each other to attract foreign businesses and boost their local economies. Also, the mobility of capital has allowed investments to be freely made around the globe. This has generated tax competition for portfolio investment as well, as some countries do not tax capital parked within its borders, as long as - most of the times - it is invested elsewhere, either off-shore or invested by non-residents. As a consequence, the combination of tax competition and capital mobility makes most of the income to go untaxed on cross-border investments, since it is hard to obtain information on such investments. This leads countries to levy tax on less mobile factors, such as labor and consumption, which are not able to escape taxation.

As an example, the Brazilian tax system has been historically dependent on consumption taxes, although this may be changing lately. Income tax plays a minor role in the overall tax revenue; in addition, most of the revenue collected from income tax comes from corporate tax, which is borne by capital owners.²⁶ Most individual income tax is collected from wages and salaries, since they are less mobile. Welfare is financed from social security taxes, which are ultimately levied on wages and salaries, company gross revenue and net profits. A possible explanation for the fact that tax revenue in Brazil is mostly derived from less mobile factors, such as wages and salaries and consumption, is that Brazil is still a developing country. In general, tax authorities of developing countries lack resources to effectively collect tax and, as a consequence, transfer the tax burden to less mobile economic factors, in theory easier to audit.²⁷ But I have no doubts that it is also a consequence of

²⁶ See, generally, ARNOLD C. HARBERGER, *The Incidence of the Corporation Income Tax*, 70 *The Journal of Political Economy* 215, (1962). As demonstrated by Professor Harberger in his seminal article, the tax levied on corporation is borne by capital owners. As a consequence, tax on corporations are borne by (i) employees, as lower wages, (ii) shareholders, as lower profits and, as a consequence, less dividends, or (iii) customers, as higher prices.

²⁷ See RICHARD M. BIRD & ERIC M. ZOLT, *Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries*, 52 *UCLA Law Review* 1627, (2005). See also HINES JR. & SUMMERS, *supra* note 7, at 18, stating that "... international evidence indicates that governments of countries with smaller and more open

globalization. In fact, Brazil cannot tax income earned locally by non-residents, without risking them investing their capital elsewhere. The after-tax return of such investment would have to compensate for the "loss" caused by the tax, which would end up being the same as the "loss" of not levying the tax, since tax revenue is off-set by higher interest payments. In addition, capital held by residents can easily flee the country as a consequence of globalization. That leaves only consumption and labor to be taxed, which are less mobile and cannot escape easily from taxation. Nowadays, this is not an exclusive problem of developing countries. Due to globalization and the increasing mobility of capital everywhere, it has become difficult to tax capital and that has been forcing developed countries to also transfer taxation to less mobile factors of production.²⁸

The European Union ("EU") member countries heavily rely on value added tax levied on consumption. One of the reasons for that, as it will be seen, is that they cannot increase their income tax rate above the level of the tax rate levied by their neighboring countries, as capital will flee to the lower tax country. That, in a nutshell, is tax competition.

(a) – Tax Competition to Attract Businesses

Tax competition is a consequence of countries' attempts to attract businesses to expand their economies. Such attempts themselves are byproducts of globalization and market integration. As the world economy becomes more interconnected, individuals and businesses have more choices of places to work and to invest their money outside their country of residence. The difficulties that prevented this to happen in the past, have been overcome due to the abolition of control barriers and, more recently, due to technological innovations as businesses became easily managed from afar. The Internet, among others,²⁹

economies rely less on personal and corporate income taxes, and more on expenditure and trade taxes, than do other governments."

²⁸ Social security taxes on wages and consumption taxes (mostly in the form of a VAT tax) have increased in the OECD member countries since the 1980s. See AVI-YONAH, *Globalization, Tax Competition and Fiscal Crisis.*, supra note 6, at 1577 and 1619.

²⁹ See, generally, THOMAS L. FRIEDMAN, *The World is Flat: A Brief History of the Twenty-First Century* (Farrar, Straus and Giroux First, revised and expanded ed. 2007), at 51-200, for a description of ten technological innovations that, as argued by the author, have made the world "flat".

and the telecommunications industry, as a whole, have connected people around the globe at a very low cost, furthering the world interconnection.

But how does globalization foster tax competition among countries? World integration and globalized markets fuel tax competition because all nations – whether they are developed or not – seek to attract investments to boost their economy. That, by itself, is not a complete answer, unless one believes that lowering tax rates is sufficient to attract business - a belief that is not completely true.

How effective tax holidays are in attracting foreign direct investments (FDI) is not only an extensive subject in itself, but an on-going debate among scholars, especially economists.³⁰ Although there are several factors that influence the choice of place of investment, some studies have concluded that the factor that businesses and very wealthy individuals care most about is the overall tax burden of the investment.³¹

In spite of the controversy surrounding the effectiveness of lowering tax rates to attract businesses, the fact remains that in the past twenty years, countries all over the world have been cutting tax rates on supply side.³² As demonstrated by some researchers in the late 1990s, more than 100 countries offer tax holidays specifically targeted to corporate investors.³³ In addition, several countries also grant tax holidays for very wealthy individuals, unhappy with the tax burden they would otherwise bear in their home country. Some authors argue that the decrease of tax rates worldwide does not mean there is a tax

³⁰ A convenient summary may be found in JAMES R. HINES JR., *Tax Policy and the Activities of Multinational Corporations*, in *Fiscal Policy: Lessons from Economic Research*, A. Auerbach, 401-45, Cambridge: MIT Press, 1997.

³¹ See, generally, HARRY GRUBERT & JOHN MUTTI, *Do Taxes Influence Where U.S. Corporations Invest?*, 53 *National Tax Journal* 825, (2000), at 825. The authors conclude that "[T]he empirical results show that average effective tax rates have a significant effect on the choice of a location and the amount of capital invested there. A lower tax rate that increases the after-tax return to capital by one percent is associated with about 3 percent more real capital invested if the country has open trade regime."

³² See KPMG's *Corporate and Indirect Tax Rate Survey 2008*, at 14, demonstrating that average corporate tax rates around the world have decreased from 34% in 1999 to 25.9% in 2008. Among the OECD member countries such reduction was from 34.8% in 1999 to 26.7% in 2008, and among the EU countries the decrease was from 34.8% in 1999 to 23.2% in 2008.

³³ See UNCTAD, *World Investment Report 1996: Investment, Trade and International Policy Arrangements* (1996).

competition,³⁴ since in several cases tax revenue has not shown a decrease on account of the reduction of the tax rate.³⁵ The fact that tax revenue has not decreased in spite of the reduction of the tax rate does not mean tax competition does not exist, it simply shows that there is room to reduce tax rates without affecting tax revenue, which is a different issue altogether.

James Hines and Lawrence Summers argue that "While evidence of growing foreign direct investment does not by itself demonstrate that tax policies influence the magnitude and performance of international investment, there is ample separate evidence that they do".³⁶ Taken altogether, the authors understand that FDI is highly responsive to local tax policies.³⁷

In their quest to penetrate profitable markets and expand global sales, businesses also search for the optimal tax burden in order to increase the after-tax return of their investments. In the global market most fixed costs are known and are also flat - except, perhaps, for labor - as suppliers tend to go global as well, following their main clients. Nowadays, tax is one of the few costs that can vary from place to place. It is undeniable that governments use their tax system to attract businesses - or to avoid local businesses to move abroad - by reducing the effective overall tax burden, aiming at generating more jobs and boost domestic economy.³⁸

³⁴ See, generally, ELAINE ABERY, *The OECD and Harmful Tax Practices*, 46 *Tax Notes International* 823, (2007), at 826, who believes that this argument alone demonstrates that tax competition doesn't exist.

³⁵ *Id.*, at 826.

³⁶ See HINES JR. & SUMMERS, *supra* note 7, at 6/7. The authors, based on several previous studies, report tax elasticity of investment around of -0.6, which means that a 10% reduction on tax rate should be associated with 6% greater inbound foreign investment.

³⁷ *Id.*, at 8

³⁸ See CHRIS EDWARDS & DANIEL J. MITCHELL, *Global Tax Revolution - The Rise of Tax Competition and the Battle to Defend It* (Cato Institute First ed. 2008), at 126-130, demonstrating that the lowering of the corporate tax rate has generated in most cases an increase in wages. In addition, the authors argue that in spite of the reduction of the average corporate tax rate in the twentieth century most industrialized economies have increased the average corporate tax revenue as a share of GDP, thus making the corporate tax play a bigger role in the overall revenue collection.

(a.1) – Tax Competition – A Product of Market Integration and Globalization

Tax competition has been broadly defined as the "... *tax-cut influence that countries exert on one another*",³⁹ and take place whenever "... *people and businesses can benefit from working and investing in other jurisdictions that have better tax policies*".⁴⁰ In other words, there will be tax competition whenever a country decreases its overall tax burden to provide incentives to the inflow of resources and/or to discourage the outflow of resources, from - or to - another country.

The reduction in tax burden may take several forms. It may decrease tax burden on production, hence increasing jobs. It may decrease tax burden on local portfolio investment, thus attracting capital and boosting local financial and capital markets. It may also decrease tax burden on local commerce and imports, boosting consumption and domestic economy.

Tax competition may have existed for a long time, but the specific form of it we see today can be traced back to the 1980s when countries started abolishing their capital and regulatory controls. Due to the abolition of capital controls and regulatory barriers, investing "offshore" became easier and less cumbersome - if not just "possible".⁴¹ In addition, in the 1990s several former socialist countries adopted market economy, and privatizations - together with the abolition of capital controls and trade barriers - soared in Latin America, Russia, and Asia, boosting FDI worldwide by big multinationals headquartered in industrialized nations.⁴² New technologies, the increasingly mobile nature of industries, and

³⁹ Id., at 3.

⁴⁰ Id., at 154. See also RACHEL GRIFFITH & ALEXANDER KLEMM, *What Has Been the Tax Competition Experience of the Last 20 Years?*, 34 *Tax Notes International* 1299, (2004), at 1300, defining tax competition as the "...*the phenomenon that countries lower their corporate income taxes to attract the real activities of firms*". The authors also claim to have a competition for taxing rights, i.e., "...*competition for having profits reported in a particular country, without any associated movement of production*."

⁴¹ Not so long ago, the suggestion that many US companies would be investing enormous resources in China, Russia and Vietnam, just to name a few, would have been unthinkable. Perhaps in the near future we will also see Cuba being part of the globalized world, outsourcing cigar manufacturing to India or Brazil.

⁴² See HINES JR. & SUMMERS, *supra* note 7, at 4, stating that the openness of world economies is reflected on a market growth of FDI. The authors also note that from 1950 to 2004 total world exports and imports grew by an average of 5.9% a year, what reflects the growth of the world economy and also the impact of reduced transportation and communications costs, falling tariff rates, and reductions in other impediments to international business.

new government policies to attract investment have been pointed out as the main engines of world integration and tax competition.⁴³ Because of new technologies, the world has become more integrated: people can instantly talk and see each other worldwide at a low cost; funds are wired around the world through a more interconnected and globalized financial industry; businesses can be easily managed from afar, and industries have become more mobile.

Cheaper transportation costs have made possible for small businesses to ship their products abroad and lowered the costs for big multinationals to establish manufacturing plants in more convenient locations, with suppliers following such new plants. Also, cheaper transportation costs helped to increase migration of educated labor, making labor more mobile and connecting different cultures.

The world has become one "flat" place as far as the manufacturing goods and the rendering of services go. Since several of the factors that drive investment decisions - such as educated labor, infrastructure, communications, etc. - may be found in more than one place, and at attractive prices, the overall tax burden on supply has become, for most of the time, the tie-break for deciding where to invest. Evidence for this can be found in the testimony before Congress of Craig Barrett, who was, at the time, the chairman of Intel Corporation, and who said, among other things, that "...[M]any nation very intent on attracting high-tech state-of-the-art factories, such as Intel's, now also have the requisite infrastructure and well-trained workforce they lacked in years past. Many countries offer very significant incentive packages and have highly favorable tax systems."⁴⁴

The influence of Globalization on the dynamics of tax competition can be easily demonstrated. It started in the early 1980s, after the United Kingdom abolished its capital control, and was shortly followed by the United States. In fact, in 1984 the United States abolished withholding tax on portfolio interest paid to foreign investors; as a consequence, every other country had to immediately follow suit and abolish their equivalent tax otherwise

⁴³ See FRIEDMAN, *supra* note 30. See, also, HINES JR. & SUMMERS, *supra* note 7, at 4.

⁴⁴ See EDWARDS & MITCHELL, *supra* note 39, at 12.

capital would fly to the United States (as it effectively happened to some extent).⁴⁵ Recently, the cases of tax competition have increased; the (successful) adoption of a flat tax by some countries at Central and Eastern Europe⁴⁶ made Germany lower its corporate income tax rate to 30% in 2008, which has historically been 50%; Hong Kong has abolished its estate tax in 2005 and lowered its corporate income tax rate in 2007 as a direct consequence of tax cuts in Singapore; the Netherlands lowered their corporate income tax rates to 26% as a consequence of lower taxes in Austria and Ireland; and the UK saw its intention to tax private equity firms go South, as a direct consequence of a campaign made by Switzerland to attract London-based financial firms.⁴⁷

The same rules apply to wealthy individuals. High-income individuals, such as very successful entrepreneurs, artists and athletes, tend to look for lower tax jurisdictions to reside.⁴⁸ Those that don't migrate from the country where they built their wealth usually use sophisticated financial structures to minimize tax burden. The revenue earned by the wealthy consists mostly of passive income (interests and dividends), which is mobile by nature, and therefore can easily be shifted worldwide. As an exotic example, all moves by the Rolling Stones is tax driven, as it can be inferred from the following statement given by Keith Richards, a member of the band: "*The whole business thing is predicated a lot on the tax laws. It's why we rehearse in Canada and not in the United States. A lot of our astute moves have been basically keeping up with tax laws; where we go, where to put it, whether to sit on it or not*".⁴⁹ Also, after Ireland changed

⁴⁵ See REUVEN S. AVI-YONAH, *Bridging the North/South Divide: International Redistribution and Tax Competition*, 26 Michigan Journal of International Law 371, (2004 - 2005). At 375/376, they state that the two recent developments that have increased the ability of earning income abroad are the (i) end of withholding taxation by developed countries, and (ii) the rise of production tax havens in developing countries.

⁴⁶ Estonia started the "club" by enacting a flat tax. The success of this tax to attract investments and increase tax revenue made other countries adopt it. Nowadays there are 25 jurisdictions levying flat-taxes at a lower rate.

⁴⁷ See EDWARDS & MITCHELL, *supra* note 39, at 4/5.

⁴⁸ E.g., singer (ex-Beatle) Ringo Star and British racecar driver Lewis Hamilton live in Monaco; Swede Ingvar Kamprad, founder of Ikea, and Brazilian former banker Jorge Paulo Lehman (currently the controlling shareholder of Inbev, the biggest brewery in the world), live in Switzerland. Several professional golfers live in Florida because of the weather and, also, because Florida doesn't levy income tax, like other states in the United States.

⁴⁹ See EDWARDS & MITCHELL, *supra* note 39, at 93.

its tax treatment of music royalties, in 2006, Bono Vox and other members of the U2 band moved their music publishing company to the Netherlands.⁵⁰

Tax competition to attract businesses has supporters and dissenters.⁵¹ In general, the arguments against tax competition is that it (i) distorts investment decisions in the private sector, which is inefficient to world economy, and (ii) creates distortions in the public sector, as reduction of revenue (when it happens) generates a "race to the bottom".⁵²

Supporters of tax competition, on the other hand, advocate that a tax cut in the supply side has demonstrated to be efficient and have helped to prevent government growth above the optimal level (whatever that may be). For example, Jack M. Mintz argued in a study that in 2005 Canadian and United States corporate taxes represented 3.5% and 2.9%, respectively, as a share of GDP, while the Irish corporate tax represented 3.4% as a share of GDP; but the Irish corporate tax rate was (and still is) around one third of the Canadian and U.S. corporate tax rate, which was 33.5%⁵³ and 40%,⁵⁴ respectively.⁵⁵ That has prompted Mintz and other scholars to advocate that there is room to reduce even more corporate tax rates without compromising tax revenue and, in addition, enhancing the economy.⁵⁶ Those who advocate in favor of tax competition argue that the argument of the "race to the bottom" is unreal, as the reduction of tax rates does not necessarily imply loss of tax revenue.

⁵⁰ See Fergal O'Brien, "Bono, Preacher on Poverty, Tarnishes Halo Irish Tax Move", October 15, 2006, Bloomberg.com, <http://bloomberg.com/apps/news?pid=20601109&refer=home&sid=ae6sR60oDgM#>.

⁵¹ See, generally, JOHN DOUGLAS WILSON, *Theories of Tax Competition*, 52 National Tax Journal 269, (1999).

⁵² The issue around the "race to the bottom" argument is controversial. Some scholars say that whether or not fiscal competition is a good thing depends on one's view of how big the public sector should be; tax competition would be good if the tendency of government is expansionary, and bad if government is welfare maximizing. See, generally, WALLACE E. OATES, *Fiscal Competition or Harmonization? Some Reflections*, 54. Also see id., at 507, (2001), at 510.

⁵³ Includes federal tax of 19.5% for 2008 plus provincial tax. Depending on the province that percentage can vary from 29.5% to 35.5%. See KPMG's Corporate and Indirect Tax Rate Survey 2008, supra note 33.

⁵⁴ The effective rate may vary depending on the place where the business is conducted. The average 40% rate is due from the 35% statutory rate plus state and local governments income taxes, which may vary from less than 1% to 12%. See KPMG's Corporate and Indirect Tax Rate Survey 2008, supra note 33.

⁵⁵ See JACK M. MINTZ, 2007 Tax Competitiveness Report: A Call for Comprehensive Tax Reform. pt. 24 (2007), at 2.

⁵⁶ Id., at 13. The author not only recommends a decrease in the Canadian corporate tax rate, but also advocates that a decrease below the revenue-maximizing rate in Canada will not affect revenue and would enable to achieve "...the highest possible standard of living".

Mintz's study suggests, among other things, that the decrease in tax rates as a consequence of global tax competition has not necessarily resulted in reduction of revenue - at least not yet. Therefore, as revenue does not decrease, public services should not be affected as Brazil's recent experience shows, although for different reasons. In light of the financial crisis that started in the middle of 2008, Brazil exempted from Federal VAT several goods manufactured in the country, such as cars and home appliances -refrigerators, laundry machines, etc. The result was a boost of consumption - and job levels - without loss of tax revenue.

The study of the relationship between taxpayer behavior and the overall level of tax revenue – expressed as a percentage of the GDP – resulting from the reduction of tax rates, and the role this relationship plays in a scenario of tax competition and tax harmonization is an aspect of tax competition that demands extensive research. Although the results of such a research would be important to determine whether tax competition is indeed a "race to the bottom", one of the main arguments against it, such research is beyond the purposes of this dissertation and does not necessarily influence further conclusions.⁵⁷

(a.2) – The Global Tax Competition and the Taxation of Capital and Consumption

Tax competition usually takes place within taxes levied on supply, i.e., taxes levied on mobile factors such as capital and, to a certain extent, labor.⁵⁸ Since the 19th century countries have relied mainly on income tax as their main source of revenue. Economists have long agreed to define income as the sum of consumption and savings. Taxable income, however, has a slightly different legal definition on account of efficiency, equity and - sometimes "especially because of" - management issues. Putting aside certain local policy choices,

⁵⁷ There is no evidence that citizens can actually determine the size of their government. In most developing countries government uses propaganda to stay in power. History has demonstrated (at least in developing countries) that people have little saying in the size of their government. Latin America, in general, and Africa are good examples. In such cases it seems to be advisable to limit the amount of tax collected by the administration. But that may be related to the level of education of the population, which is not high in Latin American and African countries. The less educated a society is, the higher is the probability of public opinion manipulation.

⁵⁸ See EDWARDS & MITCHELL, *supra* note 39, at 130, arguing that the decrease of corporate tax rates as a consequence of global tax competition has increased wages; but see AVI-YONAH, *Bridging the North/South Divide*, *supra* note 46, at 377, strongly arguing that if income from capital can escape taxation, the tax becomes levied on labor and property.

though, the definition of taxable income is reasonably similar all around the world. But tax competition has been changing the pattern that countries have been using to fund their activities in the past 100 years, as countries have started to rely more heavily on taxes levied on less mobile factors, such as consumption.⁵⁹

Indeed, except for the United States, several countries currently derive great part of their overall tax revenue from taxing both income and consumption separately.⁶⁰ There are several proposals - and this has been the subject of a lively debate for the past 30 years or so⁶¹ - for shifting taxation in the United States from income to consumption. In spite of the economic arguments supporting such shifting from income tax to a pure consumption tax, scholars recognize that taxation based only on consumption would need a very high rate and excessively broad base to raise the same amount of revenue that is obtained by an income tax.⁶² In addition, there is the debate on the regressivity of consumption taxes. A regressive tax is against equity standards currently enforced by most western world constitutions and legal systems. A progressive tax aims to levy a higher tax on those with higher ability to pay.⁶³ A regressive tax, on the other hand, falls more on those with less ability to pay.

The regressivity of consumption taxes is debatable. Some commentators argue that in order to verify whether a tax is regressive, one would need to take into account the full life cycle of the taxpayer. This is because in the beginning of her life cycle the taxpayer usually consumes less and saves more, while at the end of her life cycle the taxpayer will save less and

⁵⁹ See AVI-YONAH, *Bridging the North/South Divide*, Id., at 375.

⁶⁰ Since income is the sum of consumption and savings, to tax consumption through a separate tax in addition to an income tax means taxing consumption twice.

⁶¹ See, generally, WILLIAM D. ANDREWS, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 *Harvard Law Review* 1113, (1974), but see also ALVIN C. WARREN JR., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 *Harvard Law Review* 931, (1975).

⁶² See JOEL SLEMROD & JON BAKIJA, *Taxing Ourselves: A Citizen's Guide to the Debate over Taxes* (The MIT Press Third ed. 2008), at 239-244, analyzing at what rates a pure consumption tax would have to be levied in order to match the same levels of revenue achieved by current income tax. The authors also conclude that a revenue-neutral tax rate depends on how extensive the tax base is.

⁶³ "The case for drastic progression in taxation must be rested on the case against inequality – on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely". Henry Simons (1938, 18-19). Cited by DENNIS J. VENTRY, JR., *Equity versus Efficiency and the U.S. Tax System in Historical Perspective*, in *Tax Justice: The Ongoing Debate*, (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002), at 45.

consume more. As a consequence, a tax on consumption would not necessarily be regressive, if one would take into account the whole life cycle of the taxpayer.⁶⁴

Other commentators argue that taxing consumption will not collect revenue from the super rich. Also, the consumption/saving pattern described above doesn't necessarily apply to everybody, thus generating inequitable situations. It is true that the rich consume more than the poor, in dollar terms. But the rich consume much less than the poor if we represent their respective consumptions as a proportion of their overall incomes. This is exactly what makes a tax on consumption regressive. The poor consume most - if not all - of their income, while the rich consume only a small part of their income. As a consequence, a tax on consumption burdens the poor more than it does the rich.

Some people argue that whatever the rich do not consume is saved; and savings mean future consumption. However, it is not certain that consumption will effectively take place.

The ongoing debate on taxing income versus taxing consumption has yet another version, which proposes to tax income as well as to tax consumption through a separate tax mechanism. Indeed, there are tax-reform proposals suggesting a simplification of the current income tax and the creation of a consumption tax, in the form of a value added tax.⁶⁵ This structure with two different taxes seems more efficient under a perspective of world economy as it balances tax revenue between capital and consumption. The reason such structure seems more efficient is because consumption is much less mobile and may not escape tax - capital may be shifted abroad easily⁶⁶ - and because it combines two taxes commonly used throughout the world and, most of all, because it provides a better fit to the existing international tax and trade agreements.⁶⁷

⁶⁴ See, generally, ANDREWS, *supra* note 62.

⁶⁵ See, generally, AVI-YONAH, *The Three Goals of Taxation*, *supra* note 5, and MICHAEL GRAETZ, "A Fair and Balanced Tax System for the 21st Century", which copy may be obtained at http://www.law.yale.edu/documents/pdf/A_Fair_and_Balanced_Tax_System_for_the_21st_Century.pdf

⁶⁶ As shown by HINES JR. & SUMMERS, *supra* note 7, at 3, "... expenditures taxes do not directly tax capital returns, but do so indirectly by taxing all returns when spent on goods and services, which has the effect of taxing pure profits on capital investments while effectively exempting normal returns on savings".

⁶⁷ MICHAEL J. GRAETZ, *A Fair and Balanced Tax System for the 21st Century*, *supra* note 65, at 62.

This does not solve the problem of the regressivity of the consumption tax - in this case the value added tax. That may be dealt with by a steep progressivity of the income tax and an exemption from consumption-based tax for essential goods, which are essentially consumed by the poor, and increased rates for non-essential goods, which are more consumed by the rich.

The challenge then would be to have a simple tax system. Having a separate consumption tax brings other problems to a country, especially if the country has a federative government, where the territory is politically subdivided into smaller self-governed states.

The advanced stage of globalization and market integration has led to a decrease of tax rates levied on capital, which show that tax competition is present, in spite of not having - in certain cases - a decrease in tax revenue. Such tax competition is a product of the market and of its willingness to attract businesses. But there is another aspect of tax competition that has started long before globalization became as intense as we see it today. This second aspect of tax competition has been called "harmful" by the industrialized countries and has been under great pressure in the last decade.

Historically, tax competition to attract businesses has been a common practice, accepted by most countries. However, the increase of tax competition as a consequence of the increase of globalization has led some countries to take measures in order to reduce competition. The EU, for instance, has introduced a Code of Conduct for businesses aiming at organizing things.

(a.3) – The European Union and the Code of Conduct

The European Community targeted tax competition by introducing a Code of Conduct for business taxation. The Code of Conduct was set out in the conclusions of the Council of Economics and Finance Ministers (ECOFIN) of December 1, 1997. Even though the Code of Conduct is not legally binding it has political force.

Different from the OECD crusade, which dealt with the banking industry (as will be seen further below), the Code of Conduct introduced by the EU deals with taxation of

companies in general.⁶⁸ The criteria for identifying potentially harmful measures include: (i) an effective level of taxation that is significantly lower than the general level of taxation in the country concerned; (ii) tax benefits reserved for non-residents; (iii) tax incentives for activities that are isolated from the domestic economy and therefore have no impact on the national tax base; (iv) granting of tax advantages even in the absence of any real economic activity; (v) lack of transparency; and (vi) the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD.⁶⁹

The Code of Conduct applies to direct taxes, rather than indirect taxes. It is not certain whether it applies to social contributions and related levies. In the context of direct taxes of legal entities the measure aims to challenge harmful tax measures that may affect the decision making of where to place an investment in the European Union.

The Code of Conduct Group was subsequently created to assess the tax measures that may be within the scope of the Code of Conduct. The Group identified 66 tax measures with harmful features amongst members of the European Union. Since then, the Group has been monitoring standstill and waiting for the implementation of rollback.

The differences between the Code of Conduct and the OECD 1998 Report may be summarized as follows:

	Code of Conduct	OECD Report
Legal Nature	Political compromise	Recommendation
Scope	Taxation of legal entities	Finance services and other services which display high mobility
Geographical	European Union and territories of	OECD member countries

⁶⁸ Later, in 2003, The European Union introduced the "European Union Savings Directive" (Council Directive 2003/48/EC of June 3, 2003), providing for taxation of savings income in the form of interest payments, thus implementing the European Union withholding tax. Such Directive basically requires member states to provide other member states with information on interest paid to achieve effective taxation of the payments in the member state where the taxpayer is domiciled for tax purposes.

⁶⁹ See http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm#code_conduct, last visited on April 10, 2012.

Scope	the member countries	
Measures included	Laws, regulations and administrative practices	Laws, regulations and administrative practices not necessarily tax related
Identification of the harmful measures	<ul style="list-style-type: none"> - Level of taxation, including zero rate, significantly lower than the level to similar situation elsewhere - Ring fencing - Lack of transparency - Lack of real economic activity - Profit determination pursuant to criteria set by the OECD 	<ul style="list-style-type: none"> - Low tax level, including zero rate, on relevant income - Ring fencing - Lack of transparency - Lack of exchange of information
Other Factors to be taken into account	<ul style="list-style-type: none"> - Effective tax level of activities in the Community – Effect of the measures in other EU members - Proportionality of the measures and objectivity in case measures are destined to develop specific regions - Special attention to the specificities of regions ultra-peripheries and islands. 	<ul style="list-style-type: none"> - Artificial taxable base - Profit determination based on OECD criteria - Is income generated by foreign investment exempted? - Are there secrecy rules? - Tax is the main reason for deciding where to allocate the investment - Ratio between activities, amount of investment and the return obtained
Action	Standstill and elimination of harmful practices	Standstill and elimination of harmful practices. Brake, review and remove.

(b) – Harmful Tax Competition

Tax competition is a consequence of globalization and market integration as countries try to attract FDI and, at the same time, prevent local investments to leave. This is how most recent tax competition works and, as said above, it is a natural consequence of integrated and freely accessible markets.

There is, however, another aspect of tax competition. In this other aspect of tax competition – called "harmful" by industrialized economies – countries, or simply territories with legislative power, grant special incentives to attract mobile capital, as opposed to attract direct investments. The tools commonly used are preferential tax regimes and secrecy rules

that create a safe haven for parking mobile capital and leave it, most of the time, untaxed. In addition, strong and well-structured financial centers offer a wide variety of financial products to enable mobile capital to move around freely; in some cases capital is nominally parked at these jurisdictions without necessarily having to be physically there.

Industrialized economies have condemned such tax competition practices and are exerting pressure on countries that provide such services, to increase their exchange of tax related information. All countries have tax incentives to attract investment, which is acceptable, in principle. The creation of a tax-free environment with a secrecy regime is a different matter. The difference is that in the second scenario there is no underlying economic activity, and the tax incentives simply provide a escape route for tax evasion and crimes committed in other countries.

In fact, one of the main grounds for complaint is that such special benefits create an incentive for capital to flee from their country of residence, generating inequitable situations within that country, usually industrialized economies that rely heavily on tax revenue.⁷⁰ This constitutes a headache for both industrialized and developing economies. Indeed, developing countries also worry with capital flight as secrecy rules and tax-free environments help hiding capital derived from illegal activities - such as the product of government corruption - in addition to tax evasion.⁷¹ At this point it is important to differentiate between the capital that is connected with better rates of return, i.e. that could be related to a low tax environment, and leaves its country of origin in search for it, which in principle is legitimate, and the capital

⁷⁰ Such inequity will be even bigger when the country of residence of the taxpayer relies heavily on consumption taxes, because in that case consumption most likely will take place abroad.

⁷¹ There is plenty of evidence for that. For example, Brazil is constantly pursuing money derived from corruption and other illegal activities that is hiding in tax haven jurisdictions. A few years ago, Raul Salinas, brother of former Mexican President Carlos Salinas de Gotari was arrested for hiding money stolen from the Mexican government in a Bahamas company whose registered agent and office was a subsidiary of Citibank N.A.. In addition, the wire transfers and the bank account were held in a branch of Citibank N.A.. See ANTONIO JAQUEZ, *Follow the Money to Citibank*, at http://www.thirdworldtraveler.com/Banks/Followmoney_Citibank.html, last visited on November 17, 2010. The author makes reference to an investigative work written by Andres Oppenheimer ("Ojos Vendados" – Blindfolded), which digs deep into the role of transnational corporations (especially global banks, such as Citibank, N.A.) and the United States government in corruption scandals in Latin America.

belonging to taxpayers trying to evade the tax system and criminals trying to hide the capital derived from illegal activities, which may not be necessarily related to tax evasion.⁷²

Tax avoidance and evasion threaten government revenues. The United States estimates revenue losses from tax evasion to be around US\$100bi a year. The same happens in other countries, and all of this is attributable to tax competition and availability of secretly hiding money in tax-free jurisdictions.⁷³

"Harmful" tax competition is also a by-product of worldwide taxation. As an example, Panama, one of the first countries to become a tax haven,⁷⁴ established a tax exemption structure for local companies owned by non-resident investors and with exclusively offshore activities three years after (and as a direct consequence of) the United States enacted its worldwide base income tax.⁷⁵

Indeed, if all countries would only tax income earned within its territory probably there would be no reason for "ordinary taxpayers" to seek the services offered by tax havens and offshore financial centers (OFC).⁷⁶ This is because income earned outside the country of residency would simply not be subject to tax and, consequently, it should not matter where the investment is made, as it would not be taxed at the country of residence of the taxpayer

⁷² See JANE G. GRAVELLE, *Tax Havens: International Tax Avoidance and Evasion* (Congressional Research Service ed., CRS Report for Congress 2009), at 1. The author reminds us that the dividing line between avoidance and evasion is not entirely clear. The author also argues that multinationals firms can artificially shift profits from high-tax to low-tax jurisdictions using a variety of techniques, such as shifting debt and using transfer-pricing mechanisms. Individuals, on the other hand, in general evade taxes on passive income by not reporting income earned abroad or by sending offshore-undeclared income.

⁷³ There has been a lot of debate on how to use the tax system to enhance competitiveness in domestic economy. On October 2011 the American Tax Policy Institute has sponsored a conference on the subject, organized by Reuven Avi-Yonah and Jane Gravelle (see www.americantaxpolicyinstitute.org).

⁷⁴ See RICHARD MURPHY, *Tax Havens - Creating Turmoil* at <http://www.taxresearch.org.uk/Documents/CreatingTurmoil.pdf>, at 15/16. The Tax Justice Network lists two main characteristics of tax havens (i) "...places that create legislation designed to assist persons – real or legal – to avoid the regulatory obligations imposed upon them in the place where they undertake the substance of their economic transaction"; and (ii) places that "...create an environment of secrecy that allows the user of the structures created using its law either wholly anonymously, or largely so."

⁷⁵ But see Richard Murphy, *Id.*, at 20, stating that the first tax haven was created in the United States, when Delaware (among other States) "...offered lower taxes and relaxed regulatory environment to entice the relocation of business out of New York State in the late nineteenth century".

⁷⁶ The OECD lists as key factors for identifying tax havens the following: (i) no or nominal taxes; (ii) lack of effective exchange of information; (iii) lack of transparency; and (iv) no substantial economic activities.

anyway. Tax havens would still exist for different reasons, secrecy being one of them, but there would be less demand for the services they provide. However, with a few exceptions, all countries tax income on a worldwide basis for several reasons among which are equity and efficiency.⁷⁷

Nowadays most countries adopt worldwide taxation⁷⁸ and most arguments made to justify such policy gravitate around equity and efficiency and have capital neutrality as their instrument.⁷⁹ Countries tend to adopt the best policy for their needs and not the policies that would be more efficient - or suitable - in an international scenario.

Between equity and efficiency, the equity principle is the strongest reason for taxing income on a worldwide basis. In a globalized world domestic investors will seek bigger returns on their investments outside their country of residence. Taxing on a territorial basis will leave the income generated by offshore investments free of tax, thus creating unequal treatment between a taxpayer investing only on domestic markets and a taxpayer investing offshore.

Equity can be divided into two dimensions: horizontal and vertical. Horizontal equity is when two or more taxpayers, with equal ability to pay, have equal tax burden; vertical equity assures that two unequal taxpayers will be taxed unequally in proportion to their differences. As stated by Richard Musgrave, “[T]he call for equity in taxation is generally taken to include a rule of horizontal equity (HE), requiring equal treatment of equals, and one of vertical equity (VE), calling for an appropriate differentiation among unequals”.⁸⁰

⁷⁷ For a general discussion between territorial and worldwide tax systems, see JOINT COMMITTEE ON TAXATION, "The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and The Competitiveness of U.S. Businesses (JCX-22-06)", June 21, 2006.

⁷⁸ But see KLAUS VOGEL, *Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments*, Intertax (1988), at 217, advocating that equity and efficiency justify adoption of territorial base taxation.

⁷⁹ See MICHAEL J. GRAETZ and MICHAEL M. O'HEAR, *The "Original Intent" of U.S. International Taxation*, 46 Duke L. J. 1021, at 1076, for whom "[...] regardless of the modern economists' analysis, Thomas Sewall Adams' view that countries where income is earned will insist on taxing business income earned within their borders remains as true now as in his time."

⁸⁰ Much ink has been spent on the subject, especially between Professors Richard Musgrave and Louis Kaplow (for a list of the many work between the two scholars see LINDA M. BEALE, *Congress Fiddles While Middle America Burns: Amending the AMT (and Regular Tax)*, 6 Florida Tax Journal 811, (2004), at footnote 24). See also BRIAN GALLE, *Tax Fairness* (Florida State University College of Law, 2008) (arguing for an independent meaning of

Thus, two taxpayers earning the same amount of income should pay equal taxes irrespectively whether one of them earned its income domestically while the other earned it abroad. On the other hand, one should not have greater tax burden just because has decided to invest (and therefore earn his income) outside the country. This would hurt both horizontal and vertical equity. As a consequence, it also hurts equity when a taxpayer is able to evade tax and hide within secrecy rules of other countries, which also affects tax compliance. This does not affect the country that provides secrecy rules.

To have an equitable tax system is equally important to both developed and developing economies. A way to see the meaning of equity is interpreting it in the context of wealth redistribution. Since the middle of the last century taxation has not been just a revenue instrument. Its role in the public finance context goes farther than that, being an important tool to wealth redistribution within society. This accomplishment is generally done through expenditure programs financed by the tax revenue.

Redistribution of wealth and the achievement of social goals are in every country policymaker's mind. It is a target to be pursued regardless of being a developed or undeveloped economy, even though undeveloped economies tend to have more social gaps than developed economies, which only makes harder the work of the undeveloped country policymaker.

A justification of wealth redistribution is fairness. In principle, the concept of fairness and how the tax burden will be distributed within society must be decided by society itself. There is no clear answer for that. Nevertheless, tax burden should not be arbitrarily distributed within society and as such there is a common understanding that two requirements must be met: (i) people in equal position should pay equal amounts of tax - horizontal equity - and (ii) people in unequal position should pay different amounts proportionally to their differences - vertical equity.⁸¹

"horizontal equity" more linked to the revenue aspect of the tax). Copy available at: <http://ssrn.com/abstract=1027056>.

⁸¹ See RICHARD A. MUSGRAVE, *In Defense of an Income Concept*, 81 Harvard Law Review 44, (1967), at 45; and also SLEMROD & BAKIJA, *supra* note 63, at 59 (the latter also note that the question than is how progressive a tax should be to be called a "fair" tax).

In addition to fairness, Professor Avi-Yonah argues for two additional reasons to justify a redistributive tax system: (i) private concentration of wealth (1) confer social and political power, which ultimately could lead to the majority being governed by the minority, and (2) is against the equality concept under a liberal society standpoint; and (ii) extreme inequalities may not be sustainable over time.⁸² The discussion on each of such arguments is beyond the purpose of this dissertation; consequently we will assume that equality is desirable by society and an end that justify the means to be obtained. In addition, we will also assume that the tax system should be used as a tool to achieve equality (or, in other words, to reduce inequality) of wealth redistribution.

* . * . *

Harmful tax competition will be more common with investments that generate passive income, since they do not require a physical presence at the place of investment. Moreover, the excessive mobility of capital allows for investments to be made from anywhere in the world, thus keeping the proceeds in a jurisdiction that doesn't tax income.

Therefore, although not a justification for harmful tax competition, worldwide taxation certainly contributes to it, as countries will have an incentive to seek those offshore investments. If a given country cannot by itself attract such investments, other countries will create additional advantages and points of attraction, such as tax-free and secrecy environments.

Tax competition for passive income started with jurisdictions - not necessarily sovereign countries - enacting legislation to allow individuals and corporations to avoid regulatory obligations in their countries of residence, in addition to secrecy rules that avoid providing bank information to third parties. Lately, recent literature has stressed the harm

⁸² See AVI-YONAH, *The Three Goals of Taxation*, supra note 5, at 17; see also REUVEN S. AVI-YONAH, *Why Tax the Rich? - Efficiency, Equity, and Progressive Taxation*, 111 Yale Law Journal 1391, (2002), at 1411-1412, demonstrating that inequality in the tax system has increased since the 1980s and 1990s, and among all arguments outstanding against social inequality (therefore in favor of taxing more heavily the rich), the one that most appeals is the argument that "[t]here is something inherently undemocratic in extreme concentrations of wealth and power".

created by OFCs, by disassociating such financial centers from tax havens although they are, in some ways, related to each other.⁸³

(b.1) – When Tax Competition Becomes Harmful

It is beyond the power of any nation to forbid a sovereign state to lower its tax rates - or to grant a tax holiday - to attract a FDI.⁸⁴ The ability to tax derives from the sovereignty power of every country, which can be exercised as it pleases within its territory - preferentially as a result of the consent of its people. If we make an analogy with the private sector, it cannot be demanded from Wal-Mart to stop selling products below the price that would drive a local small store out of business. This demand would compromise the fundamentals of free market and economies of scale. As a matter of fact, several small businesses effectively go out of business after Wal-Mart opens a store nearby.⁸⁵

Although no country has the right to demand another one to raise its tax rates and no small business has the right to demand a big retail store to raise its prices, there are, or at least there should be, limits to such practices. Indeed, if Wal-Mart uses its economic power to create price cartels and monopolies it would certainly be affecting the economy in a harmful and undesirable way that would require the relevant authorities to take proper measures. Likewise, at least in a sense, countries and jurisdictions with legislation drafting power that use such power to enact rules granting safe havens for capital derived from illegal activities should also be stopped. The problem is that the second situation is not as easy to address as the first one. As we shall see, countries are sovereign and may enact legislation as they please pursuant to their domestic social contract and ideals. In addition, several countries have signed international treaties and bound themselves to recognize certain undisputable and

⁸³ See MURPHY, *supra* note 72, at 3-4. The Tax Justice Network defines OFC as "...the commercial communities hosted by tax havens which exploit the structures that can be created using the tax haven's legislation for the benefit of those resident elsewhere".

⁸⁴ Although that is beyond the power of any nation, countries may demand certain level of taxation from other countries to become a member of a trade union. The EU, for example, has demanded Portugal to terminate the tax holiday granted at Madeira Island, a well-known tax haven, and Luxembourg to terminate its holding company regime. Both tax incentive regimes terminated in 2011 and 2010, respectively. The EU has also demanded Ireland to levy some income tax on corporations, which has also been done, even though Ireland corporate tax rate remains one of the lowest among EU countries (12.5%).

⁸⁵ See MATTHEW BANDYK, *Should Small Businesses Fear Wal-Mart?*, US News August 1, 2008.

unalienable rights of the individual, such as the right of privacy, which includes the right of financial privacy.

Harmful tax practice is not just a matter of countries granting tax holidays to attract business investments, i.e., active income. What upsets developed and developing nations, - in special members of the OECD and the G-20 - is that some countries and jurisdictions grant tax holidays and secrecy rules to allow non-residents to park capital in their territory in order to escape from all sorts of compliance restrictions at their home countries and, moreover, to hide from criminal investigations.⁸⁶

Most, if not all, compliance restrictions, such as regulatory, environmental, health, etc., are created to protect rights and interests of those living in that country. Providing means to avoid such restrictions without having to bear their consequences may harm the people from highly regulated countries, as they will not have the protection afforded by such restrictive rules. For instance, let us say that a country creates certain compliance restrictions in order for a company to become public. Such restrictions are put in place to boost commitment with transparency, to increase corporate governance and other procedures targeted to protect investors from manipulation – mainly from lack of information, etc. - and other wrongdoings. Lets us say, further, that a company is incorporated in a jurisdiction that does not contain such restrictions (Country B) as long as it can issue securities only to offshore investors, probably investors from the first country (Country A), that has compliance and regulatory restrictions. The public company incorporated in Country B with no regulatory restrictions would then incorporate a wholly owned subsidiary in Country A, which would carry on its activities (Country A). As a private company, the wholly owned subsidiary (Country A) would be free from regulatory compliance restrictions created in that

⁸⁶ See MURPHY, *supra* note 72, at 34, lists some regulations that might be avoided by using tax haven financial infra-structure: (i) taxation, (ii) accounting, (iii) matrimonial, family and insolvency, and (iv) other regulations, such as those regarding financial services, health and safety, environmental issues, labor protection, etc. In addition, the author appoints tax evasion and regulatory abuse to be, by far, the most common criminal activity in tax haven, in spite of other crimes such as bribery and the purchasing of favor, hiding proceeds of corrupt activities, money laundering, etc.

country exclusively for public companies.⁸⁷ But the investors of that country would not be protected because they are investing in the parent company, which is domiciled in a jurisdiction that does not contain such restrictions (Country B).

There are several reasons for parking investments in places with secrecy rules and no taxation. These reasons can range from situations like avoiding regulatory barriers in the residence country or simply reducing tax liability by deferring payment, to escaping a criminal investigation by hiding money derived from crimes. Identifying what is permissible from what is illegal is not an easy task or math science. The result will depend on each country's policy and should be assessed on a case-by-case basis. For example, in some places tax evasion is considered to be legitimate.

Besides, the harmful tax practice is in no way harmful to the countries/jurisdictions that create such practices, as there is usually a ring-fence forbidding local taxpayers to benefit from such rules. Historically, this kind of environment was usually created as a consequence of small countries not being able to attract foreign direct investments for all sorts of reasons, among which their geographical locations and infra-structure. This tax-free and secret environment, nonetheless, generates harmful consequences to "producing" economies, both developed and developing, with well-structured markets and producing activities, which heavily depend on tax revenue.

It is a strange enough fact that a country may not survive without taxes. The main purpose of taxes, there is no secret about it, is to raise revenue to fund public services required by society, among other purposes. "Taxes are what we pay for a civilized world...".⁸⁸ Taxes also have other roles. In addition to raising revenues, taxes can have a regulatory component and, more importantly, they may have a redistributive function, to

⁸⁷ The reason for private company not be subject to regulatory restrictions would be, basically, because is not (at least in theory) being funded by the public. But as we have seen in the example given, that may not be true, as the parent company is a public company although domiciled abroad in an unregulated environment.

⁸⁸ 275 U.S. 87, at 100 (1927) (Holmes J., dissenting), cited by AVI-YONAH, *The Three Goals of Taxation*, supra note 5, at 5.

reduce inequality or, to put it in other words, to reduce unequal distribution of income and wealth generated by "... the normal operation of market-based economy".⁸⁹

The creation of safe havens allows untaxed money to flee away from its country of residence, and the existence of secrecy rules allows that capital to be kept hidden from investigators - either criminal or, simply, tax investigators.

There are two basic reasons why such tax environment becomes harmful for producing economies: (i) it allows businesses to park investments while going global and reduce tax liability by deferring its payment - thus creating all sorts of inequities in their country of residence with respect to the taxpayer that is not able to go global;⁹⁰ and (ii) it allows criminals to park their capital and hide from investigation that is taking place in the country where the crimes were committed.⁹¹

The first situation has been historically dealt with through domestic legislation enacted by countries affected by the harmful environment - and that may still be the only feasible solution. In fact, businesses, in principle, may be acting legally by using tax haven legislation to locate their investment - at least nominally - and there are no legitimate grounds to demand from tax havens that they amend their domestic legislation to prevent that, as developed economies also grant tax holidays to attract investments. On the other hand, the second situation is more complicated and usually dealt with through international legal mechanisms - such as a treaty - to make tax havens comply with more transparent information - a solution that may prove not to be effective. That may be inefficient over

⁸⁹ See AVI-YONAH, *id.*, at 3. See also RICHARD M. BIRD & ERIC M. ZOLT, *supra* note 27, at 1630 (besides raising revenue and redistribute wealth, the authors also include as purpose of taxes to "... encourage and discourage certain types of behavior, and to correct market imperfections").

⁹⁰ At some point in time deferral of tax payment was justifiable in the United States. The argument used by the Kennedy Administration to justify deferral was that it enables American companies to compete overseas. The problem is that at that time American companies were producing domestically and selling offshore, while nowadays the situation is exactly the opposite. Due to the increasingly globalization, American companies are producing overseas and escaping from tax at home by deferring the repatriation of its profits earned outside of the United States.

⁹¹ Most countries with secrecy rules argue that they do not protect criminals. In general, most tax havens do not apply secrecy rules to money derived from criminal activities. The problem is that some acts are not deemed a crime in the legal system of the country with secrecy rules. Treaties have dealt with this tension where provision is made to the effect that it is irrelevant that a crime in the host country is not considered a crime in the other country from which some action is being demanded.

time, what takes us back to the solution through domestic legislation as a more effective way to deal with this problem.

Countries have lately pressured tax havens to comply with demands for more transparent information. Pursuant to realism theory, the international order is anarchical, as there is no central authority to impose order - what may not be completely true as we can infer from the role of the European Court of Justice in the EU Community. As a consequence, a nation sets its foreign policy as a response to a hostile environment, where, as a general rule, the strong prevails,⁹² and tries to maximize its power. By doing that, a nation should not tolerate intrusions on their independence; also, it should try to be as much independent as possible.

If that is true, maybe realism does not explain why tax havens and jurisdictions with secrecy rules have accepted to enter into exchange of information agreements with (in most cases) developed countries. But although realism emphasizes the quest for independence in the international scenario, it also acknowledges that countries act - in their relations with one another - in their self-interest. Complete independence does not exist in the world scenario. For instance, take Venezuela, which in spite of all of its oil reserves - second only to Saudi Arabia - still needs to borrow heavily from China in order to deal with the isolation from the Western World created by Hugo Chavez, their current President.⁹³ Countries with weak economies depend on countries with strong economies. Also, industrialized countries - usually strong economies - with few natural resources depend on developing countries - not necessarily strong economies - with plenty of natural resources. Sometimes to accept an agreement imposed by a stronger country may be the only way a weak country will remain "independent" in the world scenario.

Liberalism, on the other hand, "... argues that harmony and order emerge from such interactions between fully informed actors who recognize the costs of conflict".⁹⁴ The theory

⁹² See ARTHUR A. STEIN, *Why Nations Cooperate: Circumstances and Choice in International Relations* (Cornell University Press First ed. 1990), at 5.

⁹³ See <http://businessweek.com/news/2010-04-17>, last visited on November 3, 2010.

⁹⁴ See STEIN, *supra* note 85, at 7.

was originally developed for understanding the interaction of private firms, but has also been applied to the interaction between sovereign nations. It states that cooperation should be natural among states.

It is hard to tell what really drives countries to co-operate with one another in regard to the subject of tax, since, in principle, a country should not care whether the money deposited within its financial industry - in most cases the main industry of that country - was sent there without being subject to tax at the country of residence of the account holder; especially if tax evasion is not considered a crime in the country where the money is "secretly" sitting. This is completely different from a situation where the money has been obtained through a clearly illegal activity, meaning acts that are condemned worldwide, such as crimes related to drug and arms trafficking, prostitution, child abuse and pornography and crimes against humanity. As a matter of fact, this may have been the reason why the campaign headed by the OCED, and about which I will expand below, has not been completely successful.⁹⁵

As we shall see, countries have been dealing with this situation both unilaterally, by enacting domestic laws to prevent capital to go untaxed, and multilaterally, through the execution of exchange of information agreements.

(b.2) – The Problem with Jurisdiction and Domestic Court Orders

The world community is dealing with this issue twofold: (i) enacting domestic legislation to address the problem, and (ii) executing bi-lateral agreements providing for exchange of information (among other international law instruments) or amending the exchange of information section of treaties already in place thus creating a standard of transparency and exchange of information for tax purposes.

⁹⁵ See STEVEN A. DEAN, *Philosopher Kings and International Tax: A New Approach to Tax Havens, Tax Flight, and International Tax Cooperation*, 58 *Hastings Law Journal* 911, (2006-2007), at 932. The author argues that tax evasion has not the same stigma of money laundering.

Before getting into that, it is necessary to elaborate briefly on the issue of jurisdiction, as domestic laws sometimes may become ineffective due to limitations of domestic courts to pursue information outside its country of residence (jurisdiction to enforce).

While introducing a new legislation, countries face limitations, as the law is bound to the country's territory. Pursuant to International Law,⁹⁶ a country exercises its sovereignty within the limits of its territory. As a consequence, the law enacted in a country will only be valid within that country's territory (jurisdiction).⁹⁷ Sovereignty is a pre-condition for jurisdiction. Without sovereignty there is no jurisdiction over a fact or person, unless there is a connection element between the fact or person and the country's territory.⁹⁸

Domestic tax laws that deal with situations subject to two or more jurisdictions are limited to its territory. The fact that these situations are subject to more than one jurisdiction is exactly what qualifies them as an international situation. Although there may be a situation subject to more than one jurisdiction, domestic law may only deal with the aspect of that situation that is connected to its territory. In order to have jurisdiction over a fact or person, the event must take place within the country's territory, or take place outside the country's territory but have a connection element with the country's territory, e.g., residence, domicile, citizenship. As a consequence, domestic laws have a certain level of limitation.⁹⁹

The power to tax may extend to the limit of sovereignty, which itself may only be exercised within the limits of the territory.¹⁰⁰ Sovereignty, on the other hand, has two aspects:

⁹⁶ International Law doctrine appoints several reasons for establishing the territory as the landmark for the exercise of sovereignty. Some of which are: (i) an element of peace; (ii) a sign of independence; and (iii) an element of safety. See generally CHARLES ROUSSEAU, *Principes de Droit International Public*, 1994, Vol. I.

⁹⁷ See CELSO DUVIVIER DE ALBUQUERQUE MELLO, *Curso de Direito Internacional Público* §2 (Editora Renovar 12^a ed. 2000), at 1038. The author quotes recent legal doctrines (Verdross and José de Arechaga) pursuant to which the State's territory is where it may exercise certain rights.

⁹⁸ See REUVEN S. AVI-YONAH, *International Tax as International Law*, 57 *Tax Law Review* 483, (2004), at 484, noting that some laws try to "expand" the territory by using certain connection elements to link the taxable event to the territory of the taxing entity, such as "nationality" and "residence".

⁹⁹ "All covenants, without swords, are but words and of no strength to secure a man at all". See Thomas Hobbes, *Leviathan*, Chapter XVII, at <http://ebooks.adelaide.edu.au/h/hobbes/thomas/h68l>, last visited November 3, 2010.

¹⁰⁰ We have recently experienced situations where bank employees in tax havens jurisdictions, which should care for the financial information of the bank customers, have been selling that information to tax authorities of

personal and territorial. Personal sovereignty is the power to legislate over persons that, on account of their citizenship (or any other connection to the territory), are part of the territory. Territorial sovereignty is the power to legislate over persons, things and facts located within the country's territory.

There are facts that take place in the territory of a country but which have consequences in the territory of another country. For example, a person located in the Canadian side of the border may fire a weapon and injure a person located in the United States side of the border. In 1889, a German court issued a decision on a prosecution for sedition of a French national who, standing on a hillside in France, shouted "Vive la France"; the basis for the prosecution was that the declaration was heard across the French/German border.¹⁰¹ There was also the case where the United States tried to levy income tax on a Mexican radio broadcasting company based on the argument that the Mexican company was doing business in the United States territory as the electromagnetic waves were captured in the United States, among other arguments.¹⁰²

What then should be the limit for a domestic law to reach situations or consequences that take place elsewhere? Countries have slowly expanded their jurisdiction while prescribing tax through their domestic laws. As argued by Avi-Yonah, the concept of residence creates an expansive view of a country's taxing jurisdiction. Also, taxing a deemed dividend¹⁰³ of a non-US corporation represents an expansion of U.S. residence tax jurisdiction, "...since taxing a deemed dividend is economically equivalent to taxing a foreign

other countries. See, generally, <http://blomberg.com//apps/news?pid=newsarchive&sid=akmacfUr7TqHs>, last visited on November 17, 2010.

¹⁰¹ See *The Case of B.*, 20 *Entscheidungen des Reichgerichts in Strafsachen* 148 (1889), 17 *Journal du Droit International Privé (Clunet)* 489 (1890), cited by DAVID J. BEDERMAN, *International Law Frameworks*, Third Edition, 2010, at 186.

¹⁰² *Commissioner v. Piedras Negras Broadcasting Co.*, 127 F. 2d 260 (1942). For further analysis, see also REUVEN AVI-YONAH, DIANE M. RING, YARIV BRAUNER, *U.S. International Taxation*, Second Edition, 2005, at 160-162.

¹⁰³ The deemed dividend rule was upheld by the Second Circuit (148 F.2d 416 (2d. Cir. 1945)).

corporation directly on foreign source income."¹⁰⁴ The examples about the expansion of taxing jurisdiction could go on and on.

To prescribe a tax on facts and acts that take place outside a country may be easier than trying to enforce the tax. Tax enforcement is not only about charging the tax. Revenue authorities also need to gather financial information held outside its territory in order to assess the tax. This may prove to be difficult. In *Sensor*,¹⁰⁵ the Dutch courts refused to defer to United States claims that required subsidiaries of U.S. companies domiciled in the Netherlands to comply with the commercial embargo against the former USSR. The same applies when tax authorities in the United States try to obtain information located outside the country by taking to court a local representative of the party holding the information outside the United States.

At first sight, the United States would be, technically, exercising its jurisdiction over persons located within its territory. But since the information required is located outside its territory, to provide such information may result in the violation of another country's law. In those cases the courts in the United States have historically applied the international comity doctrine. The United States Supreme Court has defined such doctrine as "... the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws."¹⁰⁶

The international comity doctrine is not a limitation imposed on the courts, but rather a guideline on how to behave in face of such situations. However, it may prove to be a barrier for obtaining information held outside of the United States through courts, as domestic courts should not act in a way that demeans the sovereignty of another nation.¹⁰⁷ Most of the time - if not all the time - to request financial information that is being held in a

¹⁰⁴ See AVI-YONAH, *International Tax as International Law*, supra note 91, at 487.

¹⁰⁵ *Compagnie Européenne des Pétroles, SA v. Sensor Netherland, BV*, (District Court, The Hague September 17, 1982), translated in 22 I.L.M. 99 (1983).

¹⁰⁶ *Hilton v. Guyot*, 159 US 113, 164, 16 S. Ct. 139, 2007 A.M.C. 2028 (1895).

¹⁰⁷ E.g., *Cochran Consulting, Inc. v. Unatec USA, Inc.* 102 F.3d 1224 (Fed. Cir. 1996); *Ings v. Ferguson*, 282 F.2d 149 (2d Cir.1960).

country that has - duly enacted - secrecy rules will "demean the sovereignty" of such country.¹⁰⁸

In such cases, United States courts have often looked to two related provisions of the *1987 Restatement (Third) of the Foreign Relations of the United States*: (i) Sections 403 and 422(1)(c).¹⁰⁹

These provisions identify seven factors: (i) the interest of the two states; (ii) the extent and nature of the hardship that inconsistent application of the two states' laws would place upon the relevant individual or entity; (iii) the extent to which the relevant conduct would take place in the other state; (iv) the nationality of the individual or entity; (v) whether the information originated in the United States; (vi) the degree of specificity of the request; and (vii) the availability of alternative means of securing the information.¹¹⁰

The application of international comity doctrine and the constraint of domestic rules to its territory may limit domestic legislation and courts, especially in regard to obtaining information held outside the country, necessary to assess the tax. To enforce a local rule outside the country's territory will always need the assistance of the authorities of the country where the information is located, in the light of the legal obligations the foreign individual or entity owes to their home country.¹¹¹ The case against UBS AG would be a great precedent to such discussion. However, the parties reached a deferred prosecution agreement wherein UBS AG agreed to disclose the names of certain account holders to the IRS.

This litigation is not over yet. As expected, a court in Switzerland has prohibited UBS AG to disclose any information about its account holders, in spite of the deferred

¹⁰⁸ But see *Hartford Fire Ins. Co. v. California*, 509 U.S. 764 (1993), *Cf. F. Hoffman-La Roche Ltd v. Empagran S.A.*, 542 U.S. 155 (2004). In this case the United State Supreme Court rejected the use of comity, in spite of a strong dissent.

¹⁰⁹ *Reinsurance Co. v. Administratia Asigurarilor de Stat*, 902 F2d. 1275 (7th Cir. 1990).

¹¹⁰ See BEDERMAN, *supra* note 98, at 184-185.

¹¹¹ *Hartford Fire Ins. v. California*, 509 US 764, at 798 (1993).

prosecution agreement.¹¹² In any event, the issue of unilateral court orders may not be an efficient way to obtain information held in a foreign jurisdiction.

Although unilateral court orders may not be efficient, unilateral measures remain an important instrument to deal with the subject matter. Most of the time the information needed may be obtained before the money leaves the country, or simply by enhancing the information to be disclosed in the tax return or other tax compliance mechanisms. I will elaborate more on jurisdiction when discussing FATCA rules, introduced by the United States in 2010.

(b.3) – The OECD and the Harmful Tax competition

In light of the need for tax revenue and the economic crisis of the mid-2008s, countries enhanced their fight against tax evasion mechanisms, especially tax evasion related to cross-border transactions.

The world called for a "level playing field" in the arena of bank secrecy rules and lack of transparency. The OECD started a campaign by issuing a report in 1998 condemning "harmful tax competition".¹¹³ Such Report was generated in response to a call from the G-7 in Lyon in 1996 and a result of a Ministerial Communiqué urging the OECD to "... *develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases ...*".¹¹⁴ The Report, however, was limited to geographically mobile activities and concentrated on tax practices of "*financial and other service activities*", and excluded other tax incentives "... *to attract investment in plant, building and equipment ...*".¹¹⁵

Therefore, the OECD Report did not deal with tax incentives created to attract FDI; it concentrated on incentives related to "financial and other services", as defined in the

¹¹² See CARRICK MOLLENKAMP AND LAURA SAUNDERS, *Swiss Court Muddles UBS Settlement With U.S.*, at <http://online.wsj.com/article/SB10001424052748704509704575018981732771318.html>, last visited November 22, 2011. The Swiss Parliament also rejected the settlement between UBS and the United States. See AARTI N. MAHARAJ, *Swiss Parliament Rejects UBS Tax Deal*, at <http://www.onwallstreet.com/news/swiss-ubs-irs-2667278-1.html>, last visited on November 22, 2011.

¹¹³ See OECD - *The Harmful Tax Competition: An Emerging Global Issue*. pt. 80 (1998).

¹¹⁴ *Id.*, at 7.

¹¹⁵ *Id.*, at 8.

Report. A scope that was in some ways limited, but in line with the main objective of the Report. A limitation that acknowledged the fact that all countries have, one way or another, a tax incentive designed to attract investors.

This limited scope was subject to severe criticism. It demonstrated that the OECD was going after countries with secrecy rules and not countries with tax practices supposedly harmful to equity and efficiency standards. The OECD had no alternative in limiting the scope of its campaign. In fact, challenging any and all tax incentives, including those designed to attract business investments, would affect all countries, including its members. If that had happened, probably the 1998 Report would have never seen the sunlight.

Based on these assumptions, the OECD identified six harms created by "tax havens" and "preferential tax regimes" (as classified by the Report): (i) distorting financial and, indirectly, real investment flows; (ii) undermining the integrity and fairness of tax structures; (iii) discouraging compliance by all taxpayers; (iv) re-shaping the desired level and mix of taxes and public spending; (v) causing undesired shifts of part of the tax burden to less mobile tax bases, such as labor, property and consumption; and (vi) increasing the administrative costs and compliance burdens on tax authorities and taxpayers.¹¹⁶

These harms appointed by the Report are not harms to countries that enact such tax practices. These are harms to the economy of other countries, usually industrialized economies that heavily depend on tax revenue. Except for Switzerland and Luxembourg, no other OECD member country was deemed to be a harmful tax "practitioner" under the OECD standards.

The Report had the support of the OECD members,¹¹⁷ among which are the most industrialized nations. The work was - and still is - widely criticized, mostly by those

¹¹⁶ Id., at 16.

¹¹⁷ Switzerland and Luxembourg abstained on the approval of the Report and adoption of the recommendations, and to any follow-up work undertaken since 1998. Luxembourg, since the beginning, protested that the Report was giving the impression that rather than countering harmful tax competition, it was directed to bank secrecy, which, in the end, effectively happened. The Swiss, on their part, said the Report was partial and unbalanced, mainly because it had a limited scope focused on the banking industry and did not include other practices carried out by OECD members, in what they were also right.

nations/jurisdictions that were labeled tax havens or preferential tax regimes. Some of the criticisms were the (i) exclusion of the countries targeted by the Report from most of the decision-making process; (ii) differential and favorable treatment of the OECD members; and (iii) apparent efforts to take over critical policymaking from democratically elected governments, among others.¹¹⁸ In fact, why should a country care if its domestic tax legislation, drafted to enhance its economy - in certain cases a matter of survival - is causing any, or all, of the above-mentioned "harms" to another country? That also prompts the question of why countries should co-operate.

The wide criticism was not - and could not be - ignored and prompted the OECD, since 2001, to work together with the targeted countries, which became known as "participating partners", in order to achieve a desired level playing field.

The dialogue with non-OECD economies has been carried out through the "Global Forum on Transparency and Exchange of Information for Tax Purposes" - the "Global Forum". The Global Forum is mandated to ensure that all jurisdictions adhere to the same standards of international cooperation in tax matters. Currently, the Global Forum comprises 107 member jurisdictions plus the European Union and 9 international organizations, as observers.¹¹⁹

As a measure of "relief" from the critics, all OECD members were requested to identify any domestic harmful tax practice and amend it. Eighteen preferential tax regimes were abolished since then - or are in the process of being abolished - and several others were carefully analyzed and amended, as the case may be.¹²⁰

Although the 1998 Report had several flaws, it officially started the discussion about transparency and secret rules. In the 2004 Progress Report, the OECD changed the focus of

¹¹⁸ See BRUCE ZAGARIS, *Ethical Issues in Offshore Planning*, 35 American Law Institute – American Bar Association Continuing Legal Education 213, at 245.

¹¹⁹ The observers at the Global Forum are the: (i) Asian Development Bank; (ii) Commonwealth Secretariat; (iii) European Bank for Reconstruction and Development; (iv) European Investment Bank; (v) Inter-American Development Bank; (vi) International Finance Corporation; (vii) International Monetary Fund; (viii) United Nations; (ix) World Bank.

¹²⁰ See The OECD's Project on Harmful Tax Practices: The 2004 Progress Report. pt. 18 (2004), at 9-10.

the Report and did not make any "recommendation".¹²¹ The new focus became "...the development and implementation of transparency and exchange of information standards and the establishment of a level playing field".¹²² It seems Luxembourg was right on its initial reservations to the initial work; the OECD was addressing bank secrecy rules after all and not "harmful tax practices".

It was appropriate for the OECD to shift the focus of the campaign as it was politically difficult - if not impossible - to force countries to comply with tax standards just because their tax practices were eroding the tax base of other countries. Every tax holiday granted by a country erodes the tax base of another country - in general the tax base of the country's main trading partners and, in some cases, its neighbors. That happens in Europe where countries are very much entwined, especially after they eliminated all border controls.¹²³ Also, countries are using their tax system to compete for FDI and to boost domestic economy and very little can be done to prevent that.

The new and current focus of the OECD work deals with secrecy rules and lack of transparency. This, in principle, should have greater appeal as more transparency also benefits prevention and elimination of criminal activities. Nonetheless, transparency in connection with tax matters still suffers from the fact that not everybody condemns tax evasion. The OECD crusade shifted from "harmful tax practices" to "bank secrecy rules" and "exchange of information" but that may not have solved the problems that made the campaign to be so heavily criticized. This happens, as mentioned before, because criminals do not benefit, at least in most places, from secrecy rules. Tax evaders, on the other hand, are not deemed to be criminals in many places. In fact, there are those who understand tax evasion to be justifiable. This may be the reason why the OECD campaign has not fully succeeded in

¹²¹ Id., at 4 and 17.

¹²² ZAGARIS, *supra* note 107, at 232. The author asserts that the change in the focus of the OECD work was due mainly to interventions from the Bush Administration.

¹²³ A proof of that is the fact that the EU introduced the Code of Conduct in 1997, the year before the OECD started the campaign against harmful tax competition. The Code of Conduct dealt with tax competition for businesses, which is very strong in Europe.

obtaining political support. Even among the G-20 members there is no-unanimity in regard of support to such campaign.¹²⁴

(b.4) – Towards a "Level Playing Field"

After 2004, the OECD and its members shifted the focus of their "project" against harmful tax practices to create an international standard of transparency and exchange of information. Among other things, in 2002, the OECD Global Forum Working Group on Effective Exchange of Information¹²⁵ released a *Model Convention on Exchange of Information on Tax Matters*, also known as Tax Information Exchange Agreements (TIEAs). In addition, the OECD, in 2005, amended Article 26 of its Double Tax Model Convention (DTC) as well as the commentaries to such Article in order to eliminate doubts as to its proper interpretation. Since then several countries amended their DTC to up-date the language of Article 26 and several TIEAs have been signed, mostly with deemed tax havens.¹²⁶

The key principles of transparency and information exchange for tax purposes, both found in the current version of Article 26 of the DTC and the TIEAs are (i) existence of mechanisms for exchange of information upon request; (ii) exchange of information for purposes of domestic tax law in both criminal and civil matters; (iii) no restrictions of information exchange caused by application of dual criminality principle or domestic tax interest requirement; (iv) respect for safeguards and limitations; (v) strict confidentiality rules for information exchanged; and (vi) availability of reliable information and powers to obtain and provide such information in response to a specific request.

¹²⁴ For example, Brazil has not been very active in regard of entering into transfer of information exchange agreements. It did not send any representative to the meeting in Mexico held on July 2009, about the subject matter. Apart from the United States, France and the United Kingdom, which were most affected by the economic crisis, all other countries seems to be waiting new developments.

¹²⁵ The Working Group consisted of representatives from OECD Member countries as well as delegates from Aruba, Bermuda, Bahrain, Cayman Islands, Cyprus, Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino.

¹²⁶ See OECD - Tax Co-operation Towards a Level Playing Field: 2008 Assessment by the Global Forum on Taxation. pt. 218 (2008). Since the beginning of 2007, more than 100 TIEAs have been signed. The Report covers transparency and exchange of information practices of 83 countries and their efforts to adapt to the international standards. The problem is that a jurisdiction that does not tax income usually also doesn't spend resources collecting information about income earned within its territory, especially by non-residents. That raises the question of whether such jurisdictions have any information to share.

A good example of how countries are dealing with that is the Protocol executed on September 23, 2009 amending the DTC between the United States and the Swiss Confederation to avoid double taxation signed on October 2, 1996.¹²⁷ Pursuant to Article 4 of the Protocol, new guidelines were settle for interpreting Article 26 of the DTC, which deals with exchange of information. Knowing that the Swiss have a peculiar understanding about tax evasion, both countries have agreed to set a non-comprehensive list of hypothetical situations that create the obligation to a Contracting State to provide information.

By establishing specific examples and hypothesis, countries eliminate barriers created while interpreting domestic legal rules such as the concepts of tax evasion and tax avoidance. On the other hand, exchange of information remains upon request, and that requires the illegal activity to be first identified by the requesting country.

The next section will expand on the international legal mechanisms available and being created to deal with lack of transparency, especially with Article 26 of the Model DTC and the 2002 Model TIEA.

¹²⁷ See LEXSEE 3 U.S.T. 3972

III – LACK OF TRANSPARENCY AND SECRECY RULES – NEW BI-LATERAL SOLUTIONS AND INSTRUMENTS

One of the statements made by the Leaders of the G-20 as a result of their April 2nd, 2009 summit was that the era of bank secrecy was over. This statement tells us two things: (i) there was a time when bank secrecy made sense and was also encouraged, and (ii) the reasons that justified bank secrecy rules do not exist anymore, and countries should adapt their domestic legislation to this new era.

This may be true, although not entirely.

Indeed, bank secrecy rules and the individual right of financial privacy were born in another time, when electronic wire transfers and online banking did not exist. Also, currency exchange controls did not allow for money to circulate worldwide as freely as it circulates today, and the world financial industry was not as integrated as it is nowadays. The increasing mobility of capital has made it possible not only for organized criminal syndicates to use secret offshore accounts, but also for wealthy individuals to cheat on taxes, to trade securities in violation of domestic securities law, and to fraud corporations, among others.¹²⁸

Modern bank secrecy rules were enacted as a consequence of the first two World Wars. In those times, movement of capital was restricted and totalitarian governments were attempting to curb individual civil rights all around the globe.¹²⁹ Also, extremely high income tax rates drove money to jurisdictions with secrecy rules in order to escape taxation.¹³⁰ Supporters of bank secrecy rules argue that such rules are a response to governments that over-regulate, over-tax, or impose currency exchange restrictions on their citizens.

¹²⁸ See testimony of Robert M. Morgenthau to the "Hearing on Bank Records and Foreign Transactions" before the Senate Committee on Banking and Currency, 91st Cong., 2nd Sess. (June 10, 1970).

¹²⁹ There was Ferdinand Marcos in the Philippines, Baby Doc in Haiti, several African countries became independent after the Second Great War and with that several new dictatorships were created (for the African countries, see MARTIN MEREDITH, *The Fate of Africa - A History o Fifty Years of Independence* (Public Affairs - Perseus Book Group First ed. 2005)), several Latin American countries were ruled by military governments, etc.

¹³⁰ See RICHARD T. PREISS, *Privacy of Financial Information and Civil Rights Issues: The Implications for Investigating and Prosecuting International Economic Crime*, 14 Dickinson Journal of International Law 525, (1996), at 527.

Indeed, a person's financial affairs should be a private matter between the person and her banker, and should not be of any concern to her friends and - in certain cases - family, unless such person chooses to disclose them. On the other hand, the right of privacy should not be absolute or blindly applied. That is the reason why the statement made by the Leaders of the G-20 is not entirely true. Bank secrecy has its purposes and should be harmless and preserved if limited to the privacy of an individual with respect to her personal life, as well as when the account holder is escaping a human rights oppressor.¹³¹ On the other hand, when applied to government investigating crimes (or simply wrongdoings), then "the era of secrecy rules is [*or at least should be*] over". The issue then becomes whether that should also be the case for tax investigation, as tax evasion may not be deemed to be a crime. It is difficult to draw the line between a person's right to privacy of her financial information and the government's right to pursue the individual's financial information in order to investigate crimes or simply wrongdoings committed within its territory/jurisdiction.

These questions are not difficult to answer when the bank records are located within the territory where the investigation is being carried out. In general, investigators need to request a court judge to subpoena the bank to provide the records - sometimes not even a court order is necessary. A court order is required so as to have a - disinterested - third party to evaluate whether the records being requested will contribute to the investigation or not.¹³² In such cases it is not important whether the tax evasion is a crime or not, since both the investigator and the financial institution involved in the proceedings of the "crime" are in the same jurisdiction. The court will assess the request for financial information based on local laws.

¹³¹ There may be a fine line between a country that over-taxes its residents and a country with an oppressive government that violates human rights through the tax system, as it happened in England in 1215 with the introduction of the Magna Carta, in 1776 with the Independency of the United States, in 1789 with the French Revolution, in 1917 with the Bolshevik Revolution in Russia, and probably all major social upheavals we are aware of.

¹³² Specifically in the United States, the Supreme Court in *United States v. Miller* (425 U.S. 435 (1976)) has decided that bank records have no expected privacy as "... all of the documents obtained, including financial statements and deposit slips, contain only information voluntarily conveyed to the banks and exposed to their employees in the ordinary course of business". Oddly enough, I am not sure this judgment still holds if the main reason for opening an account with a bank is its secrecy standards. Also, it is not clear whether such case remains the law, although it is often cited by commentators. See DANIEL J. SOLOVE, *Understanding Privacy* (Harvard University Press First ed. 2008), at 139/140.

It becomes – much - more complicated when the crime is committed in one country and the money, i.e., the proceeds of the crime, is wired to a bank located in another country, which has in place duly enacted legislation providing for bank secrecy. This adds a second tension to the equation, which is the tension between the need for the records desired by one country and the sovereignty concerns - local legislation - of another country where the money - and consequently the bank records - is held.¹³³ Countries usually have special procedures to deal with such requests¹³⁴ but they all take a great deal of time, which usually hampers the investigation and favors the criminal agent. Depending on the criminal act committed by the agent, some countries will not even pierce the veil of their secrecy rules, arguing that the act that took place in the other country does not constitute a crime within its legal system. This, by the way, is the reason why secrecy rules were created in the first place. Secrecy rules would be worthless if foreign governments could at any time assess bank information outside their territory.

As we saw earlier in this text, it may not be feasible or efficient to ask a Judge of the demanding country to order a person or entity of the hosting country to provide information. Mechanisms of International Law, such as treaties and conventions, are necessary to deal with the tension between the desire for documentary evidence to support the investigation of criminal acts or tax evasion and jurisdiction concerns of the country where the financial records and information are located. This, in many situations, does not guarantee, by itself, that the objective will be achieved. Much will depend on the willingness of the authorities of the host country to cooperate. And this is exactly what countries are currently trying to achieve; i.e., a higher commitment to information exchange from jurisdictions that hold proceeds from illegal activities mainly as a consequence of their secrecy rules.

Irrespective of the willingness of the authorities from the host country to co-operate, there will be legal traps that must be transposed. Basically, (i) there must be an appointed

¹³³ See PREISS, *supra* note 119, at 533.

¹³⁴ See CAMILLE STOLL-DAVEY, *Assessing the Playing Field: International Cooperation in Tax Information Exchange*, Commonwealth Secretariat (May 4, 2007), cited by Richard T. Preiss, *Id.* at 237, concluding that in virtually all countries there are: (i) mechanisms for the exchange of information under certain conditions; (ii) limitations to the manner and circumstances under which countries can provide tax information; and (iii) limitations to the information which is available to be provided in relation to tax information exchange.

authority with enough power to request the financial information needed; and (ii) a crime must have been committed and there must be a link between the requested information to the host country and the crime committed in the country of residence.

It is in this area that countries are trying to change the old rules by setting a new international standard for transparency and exchange of information for tax purposes. These standards can be primarily found in the OECD Model TIEAs and its commentaries, and in Article 26 of the OECD Model DTC, which language has also been incorporated in the UN Model DTC.

As stated by the OECD, "*The standards provide for international exchange on request of foreseeably relevant information for the administration or enforcement of the domestic tax laws of a requesting party. Fishing expeditions are not authorized but all foreseeably relevant information must be provided, including bank information and information held by fiduciary, regardless of the existence of a domestic tax interest or the application of a dual criminality standard.*"¹³⁵

In addition to the new treaty language, the members of the Global Forum met in Mexico in September 2009 and agreed that the Global Forum would (i) carry out an in-depth monitoring and peer review of the implementation of the standards of transparency and exchange of information for tax purposes; (ii) develop multilateral instruments to speed up negotiations; and (iii) ensure that developing countries benefit from the new environment of transparency.¹³⁶ The peer review process and monitoring has been a great help in implementing the standards of transparency and exchange of information for tax purposes.

The peer review process, together with the revised language of Article 26 of the Model DTC and the 2002 Model TIEA are creating an international standard of transparency and exchange of information for tax purposes. The results are not clear yet, but nowadays there are far more legal instruments dealing with exchange of information and transparency than before. That does not eliminate the need for countries to enact unilateral rules

¹³⁵ See OECD, *Implementing the Tax Transparency Standards*, 2010, at 10.

¹³⁶ *Id.*, at 11.

providing for such exchange of information, such as done by the United States with FATCA, in 2010.

(a) – The Peer Review Process

After the 2009 G-20 meeting in Mexico, it was decided to re-structure the Global Forum and to create a program of peer reviews, which was launched in 2010.¹³⁷

The peer review process is divided into two phases: (i) phase 1 consists in a review of each jurisdiction's legal and regulatory framework; and (ii) phase 2 consists on the practical implementation of phase 1, aiming at reaching the standards on transparency and exchange of information for tax purposes.

Most peer reviews until now have been directed at phase 1 only, but great progress is being made by the Global Forum. The purpose of the review is to conduct systematic examinations and assessment of the legal and regulatory frameworks as well as practical application of such framework. Also, the purpose of the peer review is to help jurisdictions to effectively implement the international standards of transparency and exchange of information for tax purposes.

In order to carry out the peer review, the Global Forum adopted the following key documents:¹³⁸ (i) Terms of Reference – sets out 10 key elements against which the legal and regulatory frameworks of each jurisdiction are assessed; (ii) Methodology for Peer Reviews and Reviews of Non-Members – the reviews are undertaken by a team that prepares a report on the reviewed jurisdiction. This team consists of two expert assessors who act in an independent capacity; (iii) Assessment Criteria – establishes the possible determinations to be attached to each element, and (iv) Schedule of Reviews – determines when the peer review will take place.

¹³⁷ At the G-20 Meeting of 2011 the Global Forum presented 59 phase 1 and combined reports, covering more than half of the members of the Global Forum (in 2012 the Global Forum has 105 jurisdictions). All peer review reports may be accessed at www.eoi-tax.org.

¹³⁸ See OECD – Global Forum on Transparency and Exchange of Information for Tax Purposes, Tax Transparency 2011: Report on Progress, 2011, at 13.

These key documents aim at verifying whether the legal framework of the jurisdiction being reviewed complies with the three components that constitute the base of the transparency standard: (i) Availability of information; (ii) Appropriate access to the information, and (iii) The existence of exchange of information mechanisms.

The "handbook" contains a good summary of the review process. The review generates a report that identifies and describes the strengths and shortcomings of the legal framework being reviewed and also provides recommendations, in case the jurisdiction has any shortcoming in its legal and regulatory framework.

The "handbook" also provides guidelines in regard of the key documents for the reviews. The terms of reference describe the standard and break them down in ten elements that should be assessed through the review process. It contains the key elements against which the jurisdiction's legal and regulatory framework is assessed.

The "methodology" sets forth detail procedures and guidelines for the reviews. By having a pre-established methodology it permits the process to be uniform and equal to all jurisdictions, both members and non-members of the Global Forum.

Finally, the assessment criteria create a system for assessing the implementation of the standards. The peer review has proven to be a good tool of assessment of the legal and regulatory framework of a jurisdiction. Currently there are 105 jurisdictions participating in the Global Forum. Until the end of 2012 it is expected to have additional 40 reports, most of which are directed solely at Phase 1. The Global Forum is exerting pressure on the jurisdictions to adapt their domestic legislation to the standards of transparency.

(b) – Article 26 of the OECD Model DTC

The new standards of transparency and exchange of information are primarily based on Article 26 of the OECD Model DTC and on the 2002 Model TIEAs. The standards provide for (i) international exchange on request of "foreseeably" relevant information for the administration or enforcement of the domestic tax laws of a requesting party, and (ii) fishing expeditions are not authorized but all foreseeably relevant information must be provided.

The "foreseeably relevant" information must be provided, including bank information, regardless of the existence of a domestic tax interest of the requested State.

The OECD made relevant changes on Article 26 of its Model DTC in 2005 in order to increase availability of information and clarify its interpretation. The current language of article 26 reads as follows:

1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2.

2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

3. In no case shall the provisions of paragraphs 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).

4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

The main purpose of the modification on Article 26 was to remove doubts in connection with its interpretation rather than to alter its substance. In order to achieve consistency with the Model TIEAs, the word "necessary" was replaced with "foreseeably relevant", the words "to the administration or enforcement" were included in Paragraph 1. Paragraphs 4 and 5 were created; the former to add new language to reflect general understanding among member countries and the latter to reflect current practices among the majority of OECD member countries. The Commentaries were also expanded, mostly to reflect the insertion of Paragraphs 4 and 5.

The main idea behind Article 26 is to provide for exchange of information in tax matters "... *to the widest possible extent...*". On the other hand, to keep the exchange of information within the scope of the DTC, a limitation was placed, so that information should be given "...*only insofar as the taxation under the domestic taxation laws concerned is not contrary to the Convention...*".¹³⁹

Pursuant to the rule set forth in Paragraph 1, information may be exchanged in 3 different ways: (i) "on request", when a contracting State has a special situation in mind and it is understood that the information available under domestic taxation procedures should be relied upon in the first place; (ii) "automatically", when contracting States—systematically provide information to each other; and (iii) "spontaneously", when a contracting State acquires information through an investigation and provides that information to another contracting State. These three forms of exchange of information may also be combined; Article 26 does not restrict contracting States to only one method of exchanging of information.

The information provided must be kept confidential and disclosed only to persons and authorities involved in the assessment of the taxes in regard of which the information was exchanged.

Paragraph 3 of Article 26 contains certain limitations to the main rule, in favor of the requested State. The requested State is not bound to go beyond its domestic laws and

¹³⁹ Id., at 86.

administrative practices, while pursuing the information requested by the treaty partner. On the other hand, tax secrecy should not be an obstacle. The information provided should not constitute a trade or business secret, i.e., "*... facts and circumstances that are of considerable economic importance and that can be exploited practically and the unauthorized use of which may lead to serious damage. Even though financial information does not, by itself, constitute a trade or business secret, it should be seeing carefully, as it may contain information that will reveal a trade or secret*".

The main purpose of the new Paragraph 4, added in 2005, is to deal with the obligation to exchange information in situations where the requested information is not needed by the requested State for domestic tax purposes. Several requested States were denying information on these grounds, since this obligation was not expressly stated in Article 26. Now, the Contracting States must use all of their information gathering measures, irrespective of whether this information is deemed necessary domestically.

The intention of the new Paragraph 5 is to ensure that the limitations of Paragraph 3 will not prevent a State from obtaining the requested information. In a sense, Paragraph 5 overrides Paragraph 3 to the extent that Paragraph 3 would allow the requested State to decline the request for information based on bank secrecy rules. In summary, pursuant to the new Paragraph 5 information requests may not be declined because the domestic law of the requested State treats the information as a trade or other secret.

The new language of Article 26 of the OECD Model DTC has been widely adopted by the OECD member countries, in spite of a few reservations. The UN Model DTC has also adopted this new and broader language. That, by itself, has increased the exchange of information between countries, for tax purposes. But it is far from representing the final solution. Nowadays there are more than 3,000 DTC entered into between countries; nonetheless, even though there are 3 ways of exchanging information, countries seldom use the "automatic" and "spontaneous" methods, and, as seen before, the method "on request" is not efficient as it depends on spotting the tax evader.

The other primary source for the international standard of exchange of information is the 2002 Model TIEA.

(c) – 2002 Model TIEA

In 2002, the Working Group developed the Model TIEA, which primary purpose was to establish an effective exchange of information standard in order to comply with the OECD's initiative on harmful tax practices, or put it another way, to "... *provide assistance through exchange of information that is foreseeably relevant to the administration and enforcement of the domestic laws of the Contracting Parties concerning taxes covered by this Agreement*".¹⁴⁰

This model agreement also provides for exchange of information that is considered to be "foreseeable relevant", such as the new language of Article 26 of the Model DTC, which intent is to provide information on tax matters "...to the widest possible extent...". At the time of writing, more than 200 TIEAs have been signed, most of them with tax haven jurisdictions.¹⁴¹

One of the most important provisions of the TIEA is found in Article 5, which deals with exchange of information upon request. Paragraph 5 of Article 5 provides some examples where information may be requested, and list the information that the requesting State must provide to the requested State in order to demonstrate the "foreseeable relevance" of the information requested. The TIEA differs from the new language of Article 26 of the Model DTC ~~is~~ mainly in that the TIEA does not provide for "automatic" or "spontaneous" information. That, however, does not prevent the contracting States to expand their co-operation by including automatic and spontaneous exchanges and simultaneous tax examinations in their agreements.

Even though the main purpose of Article 26 of the Model DTC and of the TIEAs is to regulate the exchange of information for tax purposes between countries, the TIEAs are more elaborate and explore further other - but connected - situations. For instance, Article 6 of the TIEAs provide for tax examination abroad; even though fishing expeditions are not

¹⁴⁰ See Article 1 of the Model TIEA, which text may be found at <http://www.oecd.org/dataoecd/15/43/2082215.pdf>, last visited on April 10, 2012.

¹⁴¹ For a comprehensive list of the TIEAs signed until today see http://www.oecd.org/document/7/0,3746,en_2649_33767_38312839_1_1_1_1,00.html, last visited on April 10, 2012.

allowed, contracting States may allow representatives of the requesting State to enter the requested State territory to interview individuals and to examine records.

(c) – General Comments

The 2002 Model TIEA and Article 26 of the OECD Model DTC are the primary authoritative sources of the Global Forum standards on transparency and effective exchange of information for tax purposes. Nonetheless, there are other (secondary) authoritative sources dealing with this subject matter. Secondary and complementary sources of the transparency standards are the (i) Joint Ad Hoc Group on Accounts JAHGA Report ("JAHGA"); (ii) 2006 OECD Manual on Information Exchange;¹⁴² (iii) 2004 Guidance Notes developed by the Forum on Harmful Tax Practices;¹⁴³ (iv) FATF Recommendations, Standards and Reports; (v) 2008 Note on Taking the Process Forward and The 2009 Framework Note, and (vi) Annual Assessments.¹⁴⁴

The new language of Article 26 of the DTC and the TIEAs introduced new ways to deal with the issue. For instance, it is usually difficult to have a competent authority seize a bank account and immediately demand the relevant account records. In general, it is necessary to apply for a court order in the host country as well, which takes time. The model TIEAs establish that each contracting party "shall ensure that its competent authorities for the purposes specified in Article 1 [*exchange of information*] of the Agreement, have the authority to obtain and provide upon request..." the information required as discriminated in subparagraphs "a)" and "b)".¹⁴⁵

The authority with proper powers to order the disclosure of bank records in the host country is such a key figure to an international investigation that a provision such as the one in Article 5, Paragraph 4, of the Model TIEA is also found in the Recommendation 40 of the

¹⁴² http://www.oecd.org/document/5/0,3343,en_2649_33767_36647621_1_1_1_1,00.html, last visited on April 10, 2012.

¹⁴³ <http://www.oecd.org/dataoecd/60/32/30901132.pdf>, last visited on April 10, 2012.

¹⁴⁴ The Global Forum has published annual assessments of the transparency and exchange of information regimes of many jurisdictions.

¹⁴⁵ See Article 5, Paragraph 4, of the Model TIEA which text may be found at <http://www.oecd.org/dataoecd/15/43/2082215.pdf>, last visited on April 10, 2012.

Financial Action Task Force ("FATF"). The FATF is an inter-governmental body whose purpose is the development and promotion of policies, both at national and international levels, aimed at fighting money laundering and terrorism financing.¹⁴⁶

For a country to appoint an authority to obtain financial information may not be that simple. Some countries may have to amend their Constitution to comply with such requirement. For example, there is currently a debate in Brazil about whether the tax authorities may directly request information to a financial institution without the prior consent of a judge. What makes such debate unique is that an existing law already grants that right to the tax authorities,¹⁴⁷ but some taxpayers have been challenging this law in court on Constitutional grounds.

This dispute has been recently settled. The Brazilian Supreme Court upheld the right of the revenue authorities to obtain financial information to be constitutional and, therefore, tax authorities may request information directly to financial institutions without having to obtain a court order.¹⁴⁸ This does not solve the issue entirely, because the law in question still demands that a prosecutor secures a previous court order to obtain bank information. In 2010, a prosecutor investigating a money-laundering case requested financial records from a bank in the United States based on an exchange of information agreement entered into between Brazil and the United States, but the Brazilian Superior Court of Justice denied the request under the argument that since a prosecutor must request prior court order to obtain bank information in Brazil it cannot make direct request to a private entity - irrespective of

¹⁴⁶ Pursuant to Recommendation 40, "Countries should ensure that their competent authorities provide the widest possible range of international co-operation to their foreign counterparts. There should be clear and effective gateways to facilitate the prompt and constructive exchange directly between counterparts, either spontaneously or upon request, of information relating to both money laundering and the underlying predicate offences. Exchanges should be permitted without unduly restrictive conditions." Full text of the FATF Recommendations may be found at <http://www.fatf-gafi.org/document/>.

¹⁴⁷ See Article 6 of Complementary Law No. 105, of January 10, 2001, and Decree No. 3,724, of January 10, 2001.

¹⁴⁸ See decision of the Brazilian Superior Court of Justice in "Ação Cautelar" No. 33, at www.stj.gov.br.

being domiciled - outside of Brazil, notwithstanding the exchange of information agreement in force.¹⁴⁹

The Brazilian situation is not unique. If that is the case, entering into a TIEA or updating the language of Article 26 of the DTC may not solve the problem, because the appointed authority may still need to request a court order to obtain the requested financial information. Obtaining a court order beforehand takes time, and time is always in favor of the criminal agent and tax evader, thus compromising the investigation and creating a barrier to apprehend and punish the criminal.

The new language of Article 26 constitutes a significant improvement and addresses several barriers countries were facing while trying to obtain information from their treaty-partners. Nonetheless, Article 26 of the Model DTC is far from being a complete solution for countries to obtain offshore information about their residents.

Even though the new language of Article 26 provides for automatic and spontaneous exchange of information - that seldom happens in practice, countries need wholesale information. The exchange of information based on DTCs is a good resource, but not enough; also it requires the country of residence to identify the tax evader, which is not always feasible or, to say the least, realistic.

There is no easy solution to this problem. The success of an international investigation will always be closely attached to the willingness of the host country to cooperate and provide the requested information in a timely manner. This will be directly connected to the authority that the host country has – pursuant to its domestic legal system – to request and obtain such information. Although the provisions of Article 26 of the DTC, the TIEAs and the peer review process may bring standardization to such situation, we may not be there yet in terms of solving problems of transparency and lack of information. First, it is not clear whether countries with secrecy rules are really willing to co-operate - all of them are still on Phase 1 peer review, which only evaluates the legal and regulatory framework. Second, amendment of local laws may just not be feasible, for political or practical reasons.

¹⁴⁹ See decision of the Brazilian Superior Court of Justice in "Suspensão de Segurança" No. 2.382 - SP (2010/0155667-6), at www.stj.gov.br.

In addition to the lack of authority, there is a second difficulty in trying to obtain financial information located in another country, which is whether the crime committed in the investigating country is also considered a crime in the host country; and this also applies to tax matters. The TIEA tries to deal with that by stating that the information shall be exchanged without regard to whether the conduct being investigated would constitute a crime under the laws of the requested party.¹⁵⁰ Article 26 of the DTC follows such path.

Also, there is the fact that most countries with secrecy rules may simply not have the information being requested. As noted elsewhere in this work, countries with secrecy rules don't have the means or the will to gather bank information about non-residents keeping money in the country, and as a consequence they may simply not have the information.

Both Article 26 of the DTC and the TIEAs are a proposed model language to be used by countries as guidance for negotiating the final language of a treaty.¹⁵¹ But if a country is serious about obtaining information it should seek to maintain the original language of the model treaty as much as possible.

In order to analyze bank secrecy rules in some countries, I will now draw a comparison between these countries using the legal techniques of comparative law. It is known that Legal scholars still debate and struggle to come up with a "sound theoretical framework" for comparative work.¹⁵² However, it is not the purpose of this thesis to argue whether the field of comparative tax law is a failure,¹⁵³ but to apply common comparative

¹⁵⁰ But see Testimony of MICHAEL J. MCINTYRE and ROBERT S. MCINTYRE on *Banking Secrecy Practices and Wealth American Taxpayers Before the U.S. House Committee on Ways and Means Subcommittee on Select Revenue Measures* (March 31, 2009). These two experts have a general impression that the TIEAs have been ineffective in curtailing tax evasion, although not a useless mechanism. They also find unlikely that as a practical matter the U.S. tax authorities would obtain any useful information from treaty partners with strong secrecy rules. They argue that the U.S. must be able to produce compelling evidence that one or more identified Americans are engaged in tax fraud, what may not be feasible. See, also, MCINTYRE, *supra* note **Error! Bookmark not defined.**

¹⁵¹ The Model TIEA also has a language for a multilateral convention, but the main provisions are the same.

¹⁵² See MATHIAS REIMANN, *The Progress and Failure of Comparative Law in the Second Half of the Twentieth Century*, 50 *American Journal of Comparative Law* 671, (2002), at 698, arguing that although comparative law has, on one hand, "...moved beyond merely a method and grown into a body of substantive knowledge...", on the other hand "... has made little progress as a coherent enterprise generating broader insight of general interest...", and the reason why scholarship remains random is because "... the field as a whole lacks a sound theoretical framework".

¹⁵³ See OMRI Y. MARIAN, *Discursive Failure in Comparative Tax Law*, 58 *see id.* at 415, (2010).

techniques to study the secrecy rules of different countries and their consequences. This analysis should address in particular privacy arguments occasionally raised by those in favor of secrecy rules, among other arguments.

After this comparative work, I will analyze the right of privacy and certain unilateral provisions being adopted in order to address the issue. As will be seen, an efficient way to deal with lack of financial information located outside the country may be to create enforcement mechanisms to identify the required information before it leaves the country, or to increase penalties for not disclosing information about income.

IV – SECRECY RULES – A COMPARATIVE STUDY

(a) – Comparative Tax Law

The basis of comparative legal work is to analyze and evaluate how different societies deal with similar social problems. While comparing different legal systems one will inevitably develop a better understanding of one's own legal system and, also, find different solutions that will help find new ways to improve one's own legal system. Comparative study is a source of alternative model solutions to social problems.¹⁵⁴ However, the comparison of secrecy rules has a feature, that is not necessarily present in private law rules. This feature is that secrecy rules not only affect a country internally, like most of other rules, but also generates consequences to other countries. The creation of secrecy rules, such as the criminalization of disclosure of financial information and "blocking laws", also generates consequences beyond the borders of the country from where they originate.

The solution adopted by a social group to deal with matrimonial property or contracts should not, in principle, affect other societies. One may study solutions to these legal problems and compare them with the solutions for similar situations adopted by the legal system of another country. The remedies for such problems – as well as the solutions to most social problems in private law – usually do not generate consequences beyond the borders of the country. But in the case of financial secrecy, the rules created in one country can change behavior in another country. For instance, modern secrecy rules were originally created to protect civil rights. It has been argued that by allowing residents of a country to secretly keep their wealth abroad, they would be safe from tyrants, dictators and human rights oppressors. On the other hand, in the legal system of the country of residence hiding resources abroad may constitute a crime. As a consequence, residents of the country of residence would not deposit their money abroad unless they could rest assured that the money would be secretly kept. This is what is currently happening with major economies, where a fair amount of taxpayers evade the tax system and hide the product of their tax evasion behind the secrecy rules of Switzerland, (among other places).

¹⁵⁴ See HUGH J. AULT & MARY ANN GLENDON, *The Importance of Comparative Law in Legal Education: United States and Methods of Legal Comparisons*, 27 *Journal of Legal Education* 599, (1975), at 600.

Coincidentally, this is also what happened in Germany after the Nazi party took over. As will be seen below, the Nazi government enacted a law that made keeping money abroad a crime punishable by death, thus generating the enactment of secrecy rules in Switzerland.

The analysis of financial secrecy rules needs to be discussed in several fronts. First, there must be a comparative analysis of secrecy rules in different legal systems and how they affect other societies and how different societies deal with this problem. The effects of secrecy rules in other countries lead us to the second front of analysis: the obligations of every taxpayer to comply with the tax laws of their country of residency. The third front of analysis should deal with the legal instruments that countries are proposing to solve this problem, since countries may deal with this problem either unilaterally, through domestic legislation, or bi-(multi-)laterally, through treaties and other International Law mechanisms (as seen in the last chapter).

(b) – Bank Secrecy Rules

To start with, the domestic legislation of three countries will be analyzed: United States, Switzerland and Brazil. The United States is one of the most important economies of the world and has been the most active country in exerting pressure on tax havens to adhere to the transparency standards set forth by the OECD.¹⁵⁵ The United States is the country that has felt most deeply the consequences of the economic depression of 2008/2009 and the resulting lack of tax revenue. Switzerland is the country that has, perhaps, the oldest and most strict bank secrecy rule. Brazil is a country I am familiar with, and together with Mexico, the most important country in Latin America, and currently plays a relevant role in the world economy. In addition, Brazil is a developing country, and this adds a different perspective to the comparison.

¹⁵⁵ Although the Clinton Administration gave full support to the campaign started by the OECD on tax havens, the Bush Administration acted otherwise, having the OECD back off on Caribbean tax havens. See KIMBERLY CARLSON, *When Cow Have Wings: An Analysis of the OECD's Tax Haven Work as It Relates to Globalization, Sovereignty and Privacy*, 35 J Marshall L Review 163, (2001-2002), at 164. Also, see J. C. Sharman, *Havens in a Storm, The Struggle for Global Tax Regulation*, Cornell University Press, Ithaca, New York, 2006, pursuant to which the reduction in the OCDE list of tax havens was not entirely due to cooperation, but due to the withdrawal of support from the United States in 2001.

Before we move on to any analysis of domestic laws on bank secrecy, it is important to find a common legal structure in the different tax systems so that it will be possible to compare the functions of domestic tax rules; in other words, how each country deals with a similar problem and their reasons for dealing with the problem in such a way.¹⁵⁶ The benchmark should be the function of tax rules within the tax systems. In the present case, the same problem will have different perspectives; on one side, the United States and Brazil, maybe for different reasons, will oppose secrecy rules as far as tax administration is concerned, while in Switzerland bank secrecy rules are an important feature of their banking industry, especially in regard of secrecy from tax administrations. It is also important to analyze how the secrecy rules of each country deal with residents and non-residents. It is not the purpose of this work to make a comprehensive study of bank secrecy rules in general, but only in so far as the right of tax authorities to demand from banks information about taxpayers goes.

This work will then analyze how secrecy rules in one country affect equity and efficiency in the tax system of another country. This is the reason why countries are claiming - and have been claiming for long time - for more transparency between tax authorities. This will lead to a discussion on how such transparency should be achieved and the work that has been developed since the late 1990s.

(b.1) – Swiss Bank Secrecy Rules – A Start

Bank secrecy, the way we know it today, was born in Switzerland. It is almost impossible to discuss the historical aspects of secrecy rules in the world without first going through Swiss bank secrecy regime. Bank secrecy rules were originally created to help individuals living in inflationary economies and totalitarian countries to secure their assets

¹⁵⁶ See, generally, JOHN C. REITZ, *How to Do Comparative Law*, 46 *American Journal of Comparative Law* 617, (1998). The author lists 9 basic principles of the comparative method, among which focusing on similarities and differences among legal systems together with their functional equivalence. See, also, CARLO GARBARINO, *An Evolutionary And Structural Approach to Comparative Taxation: Methods and Agenda for Research*, 57 *American Journal of Comparative Law* 677, (2009).

outside their country of residence,¹⁵⁷ as well as to protect human rights.¹⁵⁸ In addition, bank secrecy rules are generally related to the right of privacy.¹⁵⁹

Modern bank secrecy rules are fairly recent. Some commentators date modern secrecy rules to the end of the First World War, when individuals needed to keep their assets out of totalitarian countries with hyperinflationary economies and severe currency flow controls.¹⁶⁰

The right to secrecy of bank information is not embedded in the Swiss Constitution. The right of privacy - in general - is usually a fundamental right protected by the Constitutions of democratic countries, and the right to privacy of financial information could be considered as a specific case of the right of privacy in general. In fact, individual rights are hardly mentioned in the Swiss Constitution, although the Swiss Supreme Court has on several occasions considered such rights to be "unwritten fundamental rights with constitutional protection".¹⁶¹

Although the Swiss Constitution doesn't include the right of privacy among the fundamental rights of the individual, banks always had a contractual obligation to keep secret the information revealed to their employees. In that case, the duty of secrecy derives from the duty of loyalty to be observed by the bank as an agent [Code des Obligations, Article 398(2)].

Just before the Second World War, Switzerland codified bank secrecy, which until 1935 was based on customary practice and only subjected banks to civil liabilities.¹⁶² The

¹⁵⁷ See C. TODD JONES, *Compulsion Over Comity: The United States' Assault on Foreign Bank Secrecy*, 12 *Northwestern Journal of International Law & Business* 454, (1991 - 1992), at 455, for who the "[M]odern bank secrecy evolved after World War I when hyperinflation and exchange controls forced prudent individuals to hold assets outside of their home nations."

¹⁵⁸ See RAMASASTRY, *supra* nota 25, at 328, demonstrating that article 47(a) of the Swiss Federal Banking Statute, codifying bank secrecy, was enacted to protect individuals subject to government intrusion.

¹⁵⁹ *Id.*, at 339-340, stating that "*Swiss banking secrecy has a long tradition in Swiss law and is encompassed within a more general notion of a right to personal privacy, which would include one's economic holdings.*"

¹⁶⁰ But see CAMPBELL, *supra* note 11, at 663, showing that in the 17th century thousands of Huguenots from France fled to Switzerland because of religious persecution and many of them became bankers and had to maintain secrecy about their clients.

¹⁶¹ *Id.*, at 664.

¹⁶² Until then a violation of a financial secret by a Swiss banker would generate an actionable tort under Article 28 of the Civil Code and Articles 41 and 49 of the Code of Obligations.

codification of bank secrecy in Switzerland was a direct consequence of a regulation enacted by the Nazi government in 1933 requiring German nationals to declare assets held outside of Germany. Disobedience was punished by death.¹⁶³ After three Germans were executed as a direct consequence of being caught holding assets outside Germany, the Swiss government enacted Article 47(a) of the Swiss Federal Bank Statute¹⁶⁴ setting forth the following:

"(a) Whosoever discloses a secret that has been entrusted to him or of which he has received knowledge in his capacity as officer, employee, agent, liquidator or commissioner of a bank, as trustee, observer of the Federal Banking Commission or as officer or employee of a recognized auditing firm, or whosoever attempts to induce somebody else to commit such a violation of professional secrecy shall be punishable by way of imprisonment or by fine..."¹⁶⁵

Article 47 is a criminal statute and applies only to the individual that breaches the rule. In addition to this rule, Article 271 of the Swiss Penal Code (Decl. 21, 1937, SR 311.0) prohibits the collection of evidence on Swiss territory pursuant to the orders of a foreign court or performed by a party for the purpose of being used as evidence in a foreign proceeding, except with the assistance of Swiss authorities. Disclosing financial information of a Swiss bank account holder also infringes Article 273 of the Swiss Penal Code, which prohibits, among other things, the disclosure of "trade or business secrets". The financial information of an account holder has been held to constitute "business secrets". Such legal provision seeks to secure Swiss economic sovereignty, which includes individuals and legal entities in the context of their economic activity in Switzerland.

There is no legal definition of bank secrecy. "It is generally considered all types of activities performed within the framework of bank business".¹⁶⁶ Campbell (Id., at 669)

¹⁶³ See CAMPBELL, *supra* note 11, at 340; see also JONES, *supra* note 136, at 455, and PREISS, *supra* note 130, at 527.

¹⁶⁴ See *Loi fédérale sur les banques et les caisses d'épargne*, of November 8, 1934, as amended, RS 952.0, FF 1934 III 633 (Switz.).

¹⁶⁵ This Article has been amended through the years and today reads slightly different, although the main rule remains the same, i.e., it is punishable by way of imprisonment up to three years and/or by a pecuniary fine those who, intentionally, as a banker in general, or auditor of a bank, reveal a secret that was confided to ~~her~~ them, or that they become ~~s~~ aware of due to their employment.

¹⁶⁶ See CAMPBELL, *supra* note 11 at 669.

enumerates three examples: (i) The relationship between the clients and the bank; (ii) Information given by the clients to the bank concerning economic issues, even the information related to the client's relationship with other banks, and (iii) Information concerning financial operations performed by third parties. Swiss banks always have - or at least should have - full information about the ultimate beneficiary of the bank account. That also applies to accounts represented by a number or a code.

The Swiss respect the rules of other countries in connection with secrecy rules related to branches of Swiss banks located abroad. Information related to customers of such branches is not protected by Swiss bank secrecy rules and is governed by the law of the country where the branch is located.

Swiss law differentiates between tax evasion and tax fraud. Tax evasion would be simply insufficient payment of tax due to wrong information given in the tax return or the non-compliance with procedural obligations. The sanction is usually payment of the tax plus penalties and interests. Tax fraud, on the other hand, would be attempting to deceive the tax authorities by fraudulent means, such as falsifying documents and books. The sanctions are usually higher penalty charges and occasionally imprisonment. Swiss law only allows piercing the veil of bank secrecy in cases of tax fraud; in such cases bank officials must testify and furnish information.

Switzerland, like most countries, provides international judicial assistance. Foreign courts may only obtain financial information from Swiss banks with the aid of Swiss authorities, as the authority of such foreign courts cannot be extended beyond their territory. Swiss assistance is granted on the basis of an international convention or treaty.¹⁶⁷ Mutual assistance on criminal matters used to be unpredictable, as the granting of such assistance belonged to cantonal law. In 1981, the Swiss Legal Assistance Act (March 20) was enacted, governing all kinds of international legal assistance in criminal matters. As a general rule [Article 1(3)], criminal matters are those proceedings in which, pursuant to the laws of the country requesting legal assistance, a criminal court may intervene. Also as a general rule,

¹⁶⁷ E.g., on civil matters Switzerland is a signatory to the Hague Convention of July 19, 1905 - as amended in 1954. Switzerland has also entered into agreements with countries that are not parties to the Hague Convention.

political, fiscal (as long as not a fraud) and military offenses are excluded from legal assistance.

As a consequence, mutual assistance will not be forthcoming if the offense "seems to be aimed at reducing the taxes or if it violates provisions concerning currency, trade or economic policy measures" [Article 3(3)]. The origin of such deniability of mutual assistance seems to be the historical neutrality of the Swiss Federation, and the traditionally reliable banking industry, which has kept the net worth of many of the victims of human rights violations. At the same time, there is an exceptional mutual assistance in connection with tax related matters.¹⁶⁸ In other words, there will be legal assistance on tax matters if the target of the proceeding is fiscal fraud [Article 24(1)].¹⁶⁹ Fiscal fraud is defined in Article 14(2) of the federal law on administrative criminal law, which provides, basically, that tax fraud is an act of willful deceit by the taxpayer whereby "a substantial tax, contribution or other service is illegally withheld from the community or harms the latter in some other material way...". Swiss Supreme Court case law shows that "Willful deceit consists of a series of lies, especially deceitful actions or artifices". The term applies to those cases in which false or falsified documents are used for the purpose of tax evasion.¹⁷⁰

Bank secrecy in Switzerland is far from being an absolute right. On the other hand, Swiss authorities only grant international assistance to obtain bank information in cases of tax fraud, among other criminal cases unrelated to this work. Tax fraud, under Swiss law, demands a series of lies and deceitful actions or artifices made by the taxpayer to avoid paying tax in her home country. That does not include fishing expeditions or random requests. In addition, the United States and the Swiss Federation agreed to exchange information necessary to avoid tax frauds (Article 26 of the relevant DTC), although the Legal Assistance Act also covers such matters .

¹⁶⁸ See, generally, PASCAL GOSSIN, *International Mutual Legal Assistance in Switzerland*, at http://www.unafei.or.jp/english/pdf/PDF_rms/no77/08_p19-22.pdf, last visited November 23, 2011.

¹⁶⁹ Both the exception to international legal assistance and the exception of the exception may also be found in the European Convention on Legal Assistance signed in Strasbourg, in 1959, and the Swiss-America DTC which has been in force since 1977.

¹⁷⁰ See CAMPBELL, *supra* note 11, at 687.

(b.2) – United States Secrecy Rules

Bank secrecy rules in the United States apply to individuals, entities and financial institutions. Most of the legislation related to the subject matter deals with money laundering, which is different from tax evasion or avoidance. The Right to Financial Privacy Act of 1978¹⁷¹ ("Privacy Act") provides privacy rights to bank customers. In principle, the Privacy Act provides that bank customers are entitled to privacy with respect to their financial information. The Privacy Act, nevertheless, lists several situations whereby federal agencies may legally access a customer's account information. Ultimately, the right to privacy of bank information only applies to disclosure requests from non-federal agencies.

There are certain requirements to be fulfilled and some exceptions were added along the way. Bank customers may challenge a request for bank record made by a federal agency, but such challenge are limited to objections based on the relevancy of the requested information or to certain notification requirements. A grand jury may always request any information and is not limited by the Privacy Act. Also, the Privacy Act does not protect financial information of corporations.

Different from the Swiss case, privacy of financial information is far from being absolute in the United States. To start with, no secrecy of bank records may be kept from federal agencies, which may request any information, subject, of course, to certain formal requirements and legitimacy of the request. In other words, there is no substantial and legally enforceable right to financial privacy, but some procedural safeguards while requesting the information. The application of the Privacy Act is limited to federal agencies; recognition of financial privacy at state level is not included.¹⁷²

In addition to the Privacy Act, there is the Bank Secrecy Act that authorizes the Secretary of the Treasury to require financial institutions to keep specific records of certain foreign and domestic transactions and file reports that may be deemed necessary to enforce

¹⁷¹ 12 U.S.C. 3400-3422.

¹⁷² That doesn't mean there is no right of financial privacy at state level. Recognition of financial privacy at state level may flow from three sources: state constitution; state financial privacy legislation, and Common Law duty of financial confidentiality. See MELANIE ROVNER COHEN, et al., *International Bank Secrecy - United States, in International Bank Secrecy*, (Dennis Campbell ed., 1992), at 708.

or be useful in criminal, tax or regulatory matters. Federal statutes and court decisions have lately demanded from financial institutions a more pro-active role in combating both tax evasion and money laundering, by demanding from such institutions more responsibility in identifying suspicious transactions.

The rationale behind secrecy rules in the United States seems to grant such right to the individual. The right of the individual, in this specific case, seems to be limited to the right of society; as long as you have not committed any wrongdoing your financial information should be private. It is possible to see a relation of such rationale with a discussion in *Quill Corporation v. North Dakota*,¹⁷³ pursuant to which "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State'". The relation between the right to financial secrecy in the United States and that discussion in *Quill Corporation* is that the right of privacy should not prevent tax authorities to gather information to assess - or simply verify - taxes owed by those that benefit from services provided by the State. One cannot default her obligations to the State and hide behind rights of financial privacy granted to her by the same State. This rationale reflects the main purpose of a tax, which is to finance public services. Also, it makes possible carrying out public policies related to equity and efficiency, as prevents people from hiding behind secrecy rules the product with their non-compliance with the tax system.

(b.3) – Secrecy rules in Brazil

Secrecy laws in Brazil are currently similar to the rules in the United States. Basically, no information may be held back from a court of law or from tax authorities. Historically, the Banking Act¹⁷⁴ provided that all banking activities in Brazil should be kept secret, except when requested by a judge. Commentators¹⁷⁵ have argued through time that such privacy of financial information was attached to the right of privacy - in general - provided for in the three latest Brazilian Constitutions.¹⁷⁶

¹⁷³ 504 U.S. 298, 112 S. Ct. 1904, quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, at 344-345.

¹⁷⁴ Law No. 4,595, of December 31, 1964, Article 38 (currently revoked).

¹⁷⁵ See, generally, ALEXANDRE MORAIS, *Direito Constitucional* (Editora Atlas 10ª ed. 2001), at 91.

¹⁷⁶ See Article 141 of the Constitution of 1946; Article 150, paragraph 9, of the Constitution of 1967; and Article 5 of the current Constitution (1988).

The main argument has been that the latest Constitutions - including the one currently in force - have provided for the right of privacy of the intimate life of the individual, and the right of privacy of communication. Also, the current Constitution has innovated by providing for the right of secrecy of personal data, which some commentators have argued encompasses the right of financial information. Until recently bank information could only be furnished to tax authorities if requested by a court order. In order to obtain such court order, tax authorities had to demonstrate the relevance of the request, thus making very difficult to obtain bank information in Brazil.

Later, a social contribution was introduced (CPMF), which taxable event was any withdraw from bank account.¹⁷⁷ There is no way to charge the tax without having access to the taxpayer's bank information – or at least to all bank withdrawals. To prevent a legal battle under the ground of secrecy right, the law that introduced the CPMF expressly stated that the information obtained while auditing bank records for the purpose of assessing CPMF could not be used to charge any other tax (Article 11, paragraph 3). After a few years, paragraph 3 of Article 11 of Law 9,311 was revoked and the tax authorities started using bank information obtained while assessing CPMF to levy other taxes, notably income tax. That originated several legal disputes related to privacy violation, which, nevertheless, were not upheld by the Superior Court of Justice.¹⁷⁸

On January 10, 2001 Brazilian Congress introduced Complementary Law No. 105 ("Law 105") providing for bank secrecy rules. Pursuant to such law and to the extent related to tax, the revenue authorities may demand any financial information to a financial institution,¹⁷⁹ provided certain minimum requirements are met. Some of such requirements relate to what information may be provided; e.g., banks may provide only monthly cash flows without identifying the origin of the money and the destination.¹⁸⁰ Without a court order,

¹⁷⁷ See Brazilian Law No. 9,311, of October 26, 1996.

¹⁷⁸ See, generally, a decision issued by the Brazilian Superior Court of Justice on "Habeas Corpus" No. 66.128/SP (www.stj.gov.br). Such decisions stated, in summary, that such withdraw of paragraph 3° of Article 11 of Law No. 9,311 was a procedural matter and, therefore, did not violate any right of the taxpayer.

¹⁷⁹ Brazilian law defines financial institution for tax purposes as all types of banks (commercial, investment, etc.), broker dealers, insurance and leasing companies and any other business regulated by the Central Bank of Brazil.

¹⁸⁰ The main reason for such restriction is because the Brazilian Constitution provides for the right of private life and intimacy.

revenue authorities are not allowed to obtain information about payments: to whom they were made and from whom they were received. In addition, tax authorities may only verify documents, books, and registries after starting an administrative investigation proceeding where the information that is being asked is relevant to such investigation.

Taxpayers have been challenging Law 105 in court, on Constitutional grounds, under the argument that the right of privacy, as a consequence of the dignity of the human being, may only be violated by a court of law and thus subject to a due process of law. Nevertheless, the Supreme Court has upheld Law 105 as constitutional, consequently deciding that the revenue authorities may directly request information from financial institutions, provided the requirements set forth by Law 105 are met.¹⁸¹

(c) – The Three Rules - Brief Comparison

The data collected may not be enough for an extensive comparative analysis. Although not enough for an extensive comparison they provide enough information to reach some interesting conclusions.

To start with, none of the three legislations allow fishing expeditions. That is to say the revenue authorities must be investigating a specific case and the information requested must be associated to that investigation. As a consequence, random requests will not be allowed. Also, once the information is provided it must be kept secret, i.e., it is for the eyes of the requesting authority only and, in general, countries demand that the information requested is directly related and pertinent to the investigation.

The fact that fishing expeditions are not allowed favors the criminal agent, as it requires the authorities to first identify the wrongdoing. That is not the only problem. It also prevents unilateral attempts to obtain bank information outside the country of residence of the taxpayer. In fact, a country that doesn't allow fishing expeditions is not likely to accept court orders from other jurisdictions demanding random bank information not necessarily related to the investigation. That reinforces the argument that countries must focus on

¹⁸¹ See decision taken by the Brazilian Superior Court of Justice on "Ação Cautelar" No. 33 (www.stj.gov.br).

domestic legislation and international agreements to, first, prevent, and, second, identify and punish tax evasion.

Bank secrecy rules, one way or another, derives from the right of privacy, which itself originates from the unalienable rights of the individual. The protection of individual rights of the human being was consolidated throughout the 18th Century and had its zenith at the French Revolution. At the second half of the 20th Century, after the Second Great War, neo-positivism permeated legal systems of the Western World, creating more objective and clearer legal systems, as in the positivism period in the first half of the 20th Century, but still connected to moral and political philosophy, found in natural law.

After the Second World War several legal systems included in their main legislation concepts of natural law, thus creating a neo-positivism, where concepts of moral and ethics, among others, were included in codified legal systems. The principle of the dignity of the individual moved from religious and ethical grounds to legal systems, generally through Constitutions.¹⁸² The dignity of the human being is the origin of the fundamental rights of the people, such as the individual, political and social rights of the individual. The right to a dignified life originates the right to personality, which may be divided into the right to physical and moral integrity. The right to privacy is usually found along with the right to moral integrity.

All three legal systems analyzed above provide for the right of privacy, among which the right to financial privacy.

Nevertheless, the consequences adopted by the three legal systems are slightly different. The Swiss do not provide for individual rights in their Constitution, but such rights are extensively provided for in Supreme Court decisions. The United States Constitution provides for, along with other rights, in its Fourth and Fourteenth Amendments,¹⁸³ that no

¹⁸² See ROBERTO BARROSO, *Curso de Direito Constitucional Contemporâneo: Os conceitos Fundamentais e a Construção do Novo Modelo* (Editora Saraiva 1^a ed. 2009), at 251. The author argues that right to dignity was inserted into several legal documents after the Second World War, such as the Declaration of the Human Rights (1948), and in the Constitutions of several countries: Italy (1947), Germany (1949), Portugal (1976), Spain (1978), and Brazil (1988), to name a few.

¹⁸³ Most court cases related to privacy are decided based upon the Fourth Amendment, although several other Amendments are also used to deal with the subject matter, depending from what action privacy is being protected from. The criteria adopted in *United States v. Katz* (389 U.S. 347) determine what constitutes

people shall be subject to unreasonable searches and seizures, and no state shall deprive any person of life, liberty, or property, without due process of law. Among such rights is included the right of privacy, although that is not unanimous. Nevertheless, as we have seen, the right of privacy to financial information is not extended to federal agencies and grand jury with respect to bank information. Similar situation happens in Brazil.

The Swiss made bank secrecy rules the main feature of their banking industry. Although these rules have noble justifications, such as protection of civil rights, in the end they have strong economic justification. In the case of Switzerland secrecy rules helps to create the biggest wealth management industry in the world. Today bank secrecy regime has no attachment to civil rights protection; it became the core of a very powerful and large banking industry with highly economic consequences.

The legal systems of the United States and Brazil also provide for bank secrecy; but bank secrecy is not extended to criminal and tax investigations. The Swiss also pierce the veil of their secrecy rules to criminal investigations. Nevertheless, with respect to tax matters, the veil of the secrecy regime is only pierced in case of fraud, which must contain "willful deceit", meaning a series of lies, and especially deceitful actions or artifices - to be properly evidenced. The three legal systems researched differentiate between each other only with respect to regular, i.e., non-fraudulent, tax investigations. The Swiss understand that regular tax investigation is not enough to pierce the veil of secrecy rules. The United States and Brazil, on the other hand, give no protection to privacy of financial information from tax investigation.

It seems a common understanding that all three countries do not allow fishing expeditions or random investigations. The information requested to UBS by the United States Government most likely will not be provided. The same probably would happen if it were the other way around. In order to obtain private financial information there must be an ongoing investigation and the information requested must be related to the investigation. In addition, all three countries demand that the information provided must be kept secret, under the penalty of perjury.

reasonable expectation of privacy by individuals. But see AMITAI ETZIONI, *The Limits of Privacy* (Basic Books First ed. 1999), at 184, quoting a third party saying that the criteria adopted in *Katz* is "bizarre".

Switzerland needs to fund public services through tax revenue as much as any other country, notwithstanding the fact that the Swiss collect a great amount of tax from their extremely profitable banking industry. That may grant them the luxury of having a secrecy rule regime that prevents tax authorities to pierce the veil of such regime for regular, i.e., not fraudulent, tax investigation. The United States and Brazil need to derive tax revenue to fund their public services as well. The problem is that residents of the United States and Brazil are evading the tax system and hiding the proceeds of their tax evasion within the Swiss banking system. Finally, residents of other countries are using the Swiss - as well as other tax havens - secrecy rules to hide from the tax authorities of their home countries, thus affecting equity in the entire tax system.¹⁸⁴

Secret rules have been justified as a protection to unreasonable persecution. The concept of unreasonableness has been usually based on the universal rights of the individual. There is no universal right, in principle, to not to pay tax, unless such tax is depriving the individual from unalienable rights, among which the individual's dignity and right to a dignified life. If that is not the case, maybe the veil of secrecy rules should be pierced, such as when there is an ongoing tax or crime investigation.

* . * . *

It does not seem possible to create equal rules about bank secrecy within all countries.¹⁸⁵ On the other hand, there seem to be common understanding about several aspects of how secrecy rules should be treated. The international community through the OECD and its Global Forum is trying to enhance transparency standards to increase the flow of information on taxpayers in relation with their country of residency. This new trend seems to be irreversible; nevertheless, it will not be easy to obtain the level of flow of information certain countries are willing to have by only having international legal instruments. Countries

¹⁸⁴ Developing countries have extra incentive to pursue bank information abroad as such countries usually have high level of corruption of government officials.

¹⁸⁵ See ETZIONI, *supra* note 183, at 200. The author states that different "...societies define different objects and spaces as legitimate subjects of privacy – as opposed to public – ownership". For example, in the early kibbutzim all property was considered communal and the onus rested on those who sought an exception from the prevailing rule to justify the right to hold an object privately (such as a coffee mug).

will have to negotiate better exchange of information agreements and enhance domestic compliance mechanisms to obtain more information and prevent tax evasion.

V – THE RIGHT OF PRIVACY AS OPPOSED TO THE RIGHT OF OBTAINING INFORMATION

It is also important to analyze the right of privacy itself, in addition to the discussion around international mechanisms put in place by countries and multi-lateral organizations to deal with the harms bank secrecy is causing to their tax system.

The historical context of right of privacy in the United States may be divided in three distinct periods:¹⁸⁶ (i) pre-1890 - period that used principles of property right to protect privacy; (ii) 1980 to 1965 - development of right of privacy; (iii) post-1965 - expansion of privacy right based on Constitutional principles.¹⁸⁷

On 1890, the Harvard Law Review published a seminal article written by Samuel D Warren and Louis D. Brandeis¹⁸⁸ that served as basis for several cases decided by the Supreme Court. Their basic argument - and the argument used to decide the cases that followed - was that the individual has "the right to be alone".¹⁸⁹

Later, after the 1960s, privacy became decided based on constitutional principles. This third period of right of privacy in the United States started with the reproductive choice cases, such as *Griswold v. Connecticut* (381 U.S. 479 - 1965),¹⁹⁰ *Eisenstadt v. Baird* (405 U.S. 438 - 1972), and *Roe v. Wade* (410 U.S. 113 - 1973). All these three cases created an individualism

¹⁸⁶ Id., at 188/189.

¹⁸⁷ But see KEN GORMLEY, *One hundred Years of Privacy*, 1992 Wisconsin Law Review 1335, (1992), at 1340, splitting into five periods: "(i) Tort privacy (Warren and Brandeis's original privacy); (ii) Fourth Amendment privacy (relating to warrantless governmental searches and seizures); (iii) First Amendment privacy (a "quasi-constitutional" privacy which exists when one individual's free speech collides with another individual's freedom of thought and solitude); (iv) Fundamental-decision privacy (involving fundamental personal decisions protected by the Due Process Clause of the Fourteenth Amendment, often necessary to clarify and "plug gaps" in the original social contract); (v) State constitutional privacy (a mish-mash of the four species, above, but premised upon distinct state constitutional guarantees often yielding distinct hybrids)."

¹⁸⁸ See SAMUEL D. WARREN & BRANDEIS LOUIS D., *The Right to Privacy*, 4 Harvard Law Review 193, (1890-1891).

¹⁸⁹ Id., at 220. The authors end their work with the following statement: "*The common law has always recognized a man's house as his castle, impregnable, often, even to its own officers engaged in the execution of its commands. Shall the courts thus close the front entrance to constituted authority, and open wide the back door to idle or prurient curiosity?*"

¹⁹⁰ The United States Supreme Court did not treat privacy as an independent right before *Griswold*.

environment, treating the common good as second good and privacy as an unbounded good.¹⁹¹

In the 1990s, excessive individualism originated greater dedication to the common good. Communitarians started to seek balance between individual rights with social responsibilities. In other words, "privacy cannot be extended to the point where it undermines the common good; conversely, duties set to maintain social order cannot be expanded to the point where they destroy privacy."¹⁹²

A lot has been written about privacy lately, especially in light of the attempts of the Bush Administration to gain information on residents of the United States after the terrorist attacks of September 11, 2001. The Bush Administration authorized the National Security Agency (NSA) to engage in wiretapping and data mining. That created indignation in several people on one hand, but on the other hand it had the support from sectors of society that accepted it as they "had nothing to hide".

Recently, Prof. Daniel J. Solove wrote an article on the subject, arguing that the argument that privacy should not matter if you have nothing to hide misunderstands privacy.¹⁹³ Prof. Solove argues that privacy is difficult to conceptualize and do not share one element in common, but rather a plurality of different things, although resembling to each other.¹⁹⁴ As a consequence, privacy violations constitute a web of related problems.

What then should be the boundaries of privacy?¹⁹⁵ To answer that one must balance between the individual right and the underlying social good that is being protected by privacy right. Although privacy is an individual right, it is also of social interest, as it is in the interest of society that an individual should have her privacy protected, whether the individual has

¹⁹¹ See ETZIONI, *supra* note 183, at 194.

¹⁹² *Id.*, at 199.

¹⁹³ See DANIEL J. SOLOVE, *"I've Got Nothing to Hide" and Other Misunderstandings of Privacy*, 44 San Diego Law Review 745, (2007). Such article is now a chapter of the book SOLOVE, *Understanding Privacy*.

¹⁹⁴ SOLOVE, *"I've Got Nothing to Hide"*, at 756.

¹⁹⁵ Such question seem to be similar to the question made by ETZIONI, *supra* note 183, in the 1990s while arguing in favor of a balance between exacerbated individualism and communitarians.

something to hide or not. Therefore, the value of privacy will depend, most of the time, on the social harm that it tries to safeguard.

Applying those primary concepts to the present work, the question then becomes whether the taxpayer has - or not - the right to keep her financial information secret from tax authorities. The answer to such question should depend on who is requesting the information, what information will be provided and how such information will be used. When those requesting the information are the tax authorities seeking to assess taxes due by the individual, than the right of privacy should not prevail. Tax is what we pay to live in a civilized world and those that benefit from that should not have the right to get away from such duty while benefiting from life in community.¹⁹⁶

That nevertheless, must be said with caution. The problem is not only who is requesting the information. There is also the issue of what information may be provided and how the information may be used. Indeed, a person may have the right to prepare her tax return in the privacy of her home, but the information to be provided is determined by the tax authorities, so long it is relevant to assess the tax.

As mentioned before in this work, the right of privacy is, in most cases, a right granted by the Constitution of a democratic country. It is also a consequence of the neo-positivism that became reality in the second half of the 20th century - although not always expressly - where concepts of natural law were codified in Constitutions and written rules of civil law countries, as the right of integrity of the individual.

Although an unalienable right of the individual, the right of privacy is not absolute. If the right of privacy is not absolute then it can have its veil pierced in favor of an underlying social good. That creates a problem of valuation between the individual right and the social good behind it. In case it is possible to make such valuation and to conclude that is necessary

¹⁹⁶ An extensive study about the subject would have to also analyze the impact of the role ACLU has played in American social environment. ACLU has had an active role. As highlighted by Willian Donahue (in "Culture Wars Against the Boy Scout", *Society* (May-June 1994): 59-68), "[T]he ACLU is driven by an atomistic vision of liberty. It envisions solitary individuals, armed with rights and unencumbered by duties."

to violate the right of privacy it is important that violation of such right should be kept to the minimum.

For example, tax authorities have no reason, while assessing a tax, to be informed the origin of the money and its destination; that is related to the taxpayer's private life. It is not of the tax authorities business whether the taxpayer is spending her money with gambling or with meals in luxurious restaurants, or where the money came from. The tax authorities should only care whether the taxes owed by the taxpayer have been paid and should limit the information to the minimum.

Also, the financial information required must be relevant to the investigation and should be for the eyes of the tax authorities only. Any breach of that rule should be punished severely.

These requirements, one way or the other, currently exists in countries that allow tax authorities to directly request bank information of taxpayers subject to their jurisdiction. In Brazil, for example, Law 105 allows Brazilian tax authorities to request bank information provided such information is not disclosed. Also, the financial information to be provided may not identify the origin or the destination of the money; it must be provided as monthly cash flows. It is common sense that if it were not for that Law 105 would otherwise be deemed unconstitutional by the Brazilian Supreme Court.

In summary, the request of privacy should not prevail against the right to assess the tax, as long as the information demanded is relevant to the calculation of the tax; the information provide is kept secret; the intimate life of the taxpayer is not revealed to the authority requesting the information or anyone else.

To allow a taxpayer to conceal her financial information from tax authorities generates inequality. It is unequal that some people pay tax and others do not, but not as a consequence of specific tax policy, but because those not paying the tax were more cunning and able to evade the tax system and park their money under secrecy rules in another jurisdiction.

The counterargument to that has been – among others – that some countries levy so many taxes that the evasion would be justifiable, sometimes as a means of survival. But if that is true then taxes are not being levied as a result – as at least it should – of the will of the people, otherwise the same people that enabled the tax system could have disabled it, assuming they live in a democracy. That bring us to a much broader debate, which is the debate around whether a person has the right to evade the tax system, i.e., has the right to oppose to the will of the majority in a democracy.

In addition to the above argument there is also the fact that most - if not all - bank information has already been provided by the taxpayer in her tax return. The information provided in the tax return varies from one country to another. Nevertheless, it is common to request from taxpayers some bank information, such as the balance of all taxpayer's bank account on December 31st and her net worth on January 1st and December 31st of the taxable year. The argument then would be that analyzing bank information would be just a confirmation of what has been spontaneously provided in the tax return. Again, tax authorities should not have access to the origin and destination of the money, as it constitutes the taxpayer's private life and it is unrelated to the tax assessment - more publicness, less public control.

That takes us to domestic legislation enacted as unilateral measures to deal with tax evasion and the use of secrecy rules regime to prevent being caught by the tax authorities of the taxpayer's country of residence.

V – UNILATERAL MEASURES – HOW COUNTRIES DEAL WITH THE PROBLEM

Information, information, information.... It is all about information!

There are several measures being taken in order to enhance exchange of information between tax administration of industrialized countries and tax havens. Industrialized countries are pressuring tax havens to soften their bank secrecy rules and provide more information. The information required is about the income earned and kept in the jurisdiction with secrecy rules, by the resident of the industrialized country. These efforts are being made through international law mechanisms such as treaties and bi-lateral conventions. The effectiveness of such measures has not yet been proven, although a lot of work has been done.

There are several reasons for that. To start with, countries may have no incentive to comply with measures that will harm their economy (or a certain industry) in the benefit of the tax revenue of another country. Second, certain countries simply do not have the information that is being demanded from them. Since they do not collect tax over investments made by non-residents, they have no reason to spend resources collecting information about such investments and their beneficiaries. That also happens in the United States with respect to portfolio interest and certain types of capital gains earned by non-resident investors. Third, not everybody considers tax evasion a serious crime. Some societies do not even consider it a crime at all. Stopping money laundering and related crimes has a different appeal than stopping tax evasion.

Countries - sometimes including tax havens - will unite their forces to fight money laundering because of its relation to drug trafficking, prostitution, arms trade and other major crimes; but some societies do not view tax evasion something as bad, since taxation is often used to oppress the people like as we have seen in many of the social revolutions and uprisings in the 18th, 19th and 20th Centuries.

That means there may not be as much cooperation to provide information. But countries may also create unilateral legal mechanisms to deal with tax evasion problem. In

fact, there are several unilateral measures that countries may also take to reduce their exposure to the harms created on their tax base by tax havens, among which secrecy rules.

Indeed, some countries have been discussing new punitive measures against tax havens that do not cooperate with the OECD and the international transparency standard. Some of the proposed sanctions would include (i) denying deductions for business expenses when paid to a beneficiary based in a noncompliant tax haven; (ii) increasing disclosure by taxpayers and financial institutions of transactions that use such tax havens; (iii) aggravating withholding tax rate for payments made to beneficiaries domiciled in tax havens, etc.¹⁹⁷ All such unilateral measures do not directly address the problem of secrecy rules, but rather make trading with entities domiciled in tax havens or countries with secrecy rules more cumbersome and expensive.

Other countries, on the other hand, have been working specifically on the lack of information issue; for example, as reported in an article of the Wall Street Journal of April 1, 2009, Germany "*...plans legislation to increase pressure on tax havens, including measures that in some circumstances would penalize companies doing business in venues that fail to provide information needed for tax investigations*".¹⁹⁸

The United States, among all countries may be the one introducing major changes to its internal legislation. As a consequence, this research will analyze the latest legislation innovations made in the United States, as well the Brazilian rules related to the subject matter.

(a) – Domestic Legislation to Curtail Tax Evasion

(a.1) – *The United States*

As shown elsewhere in this research, globalization has enhanced capital mobility and bank secrecy rules have been aiding taxpayers to evade their home country tax system. For a long time countries have been introducing legislation to curtail tax evasion through international markets. Indeed, there are special sets of rules specifically dealing with taxation

¹⁹⁷ See <http://online.wsj.com/article/SB123851589108274129.html>

¹⁹⁸ *Id.*, at 2.

of cross-border transactions, most of which demanding the taxpayer to provide more information.

Since the beginning of the 1900s, when tax started to be levied on income wherever it may be derived, taxpayers have been using the international market to escape from their tax obligations. As a consequence, countries have been introducing domestic legislation to keep up with such schemes. The domestic legislation dealing with the issue doesn't, all the time, focus only on obtaining financial information from outside the country. There are a whole set of domestic legislation that deals with how taxpayers will comply, report and collect tax on foreign source income. The definition of "foreign source" itself, for purposes of calculating taxable income, is something taxpayers use to escape from tax in their country of residency and, as a consequence, demands a set of complicated rules.

Rules dealing with transfer pricing, thin capitalization, controlled foreign corporation, and foreign tax credit, to name a few, were created along the 20th Century aiming to attract - or connect - "income" from the place where it has been generated to the place where the beneficiary resides; such legislation also aims to prevent income to go untaxed as a consequence of international tax planning. Such rules address problems that are shared by all countries and have been adopted by most industrialized economies. In fact, major countries, for all of the G-20, levy income tax on worldwide basis and, as a consequence, have rules dealing with controlled foreign corporations, transfer pricing, foreign tax credit, thin capitalization and the like. Interesting enough, except for minor differences, the principles of such rules are the same among most countries, which makes an interesting case for comparative law study.

In the 2000s, countries have been introducing domestic legislation slightly different, targeted to obtain financial information of its taxpayers outside of their borders. The difference is that the new target is compliance and reporting, as opposed to identifying income and its place of origin. Again, the United States has taken the lead on such new focus

of domestic legislation.¹⁹⁹ The two most recent attempts to enhance information gathering and report are, in 2001, the Qualified Intermediary Program and, in 2009, the FATCA.

The QIP

In 2001, the United States made a first major attempt to obtain information outside its borders, by introducing the "Qualified Intermediary Program" (QIP).²⁰⁰ The QIP, basically, relies on certain "qualified" foreign intermediaries to enforce compliance with the United States reporting requirements.²⁰¹ As described by the Joint Committee Report:

"[T]hese foreign intermediaries agree to assume responsibility for obtaining documentation from their customers and to substantiate the status of their customers as the beneficial owners of U.S.-source income. In turn, the IRS agrees to permit the QIs to certify on behalf of their foreign customers, without revealing to the IRS or to other U.S. withholding agents the identity of those foreign customers. Moreover, the IRS agrees to rely on third-party private auditors to audit the compliance of the QIs with the QI program; this condition was viewed as a practical necessity if foreign banks were to agree to participate in the QI program, because these foreign institutions feared that their non-US customer base would not agree to allow a foreign taxing authority (the IRS) direct access (through an IRS audit) to customer account information."²⁰²

The biggest concern in enacting the QIP relates to the taxation of portfolio interest paid to - and capital gains earned by - non-resident investors. As mentioned above, the United States - as well as most developed economies - exempts from tax payments of portfolio interest paid to non-resident investors and capital gains earned by such investors

¹⁹⁹ As it has been pointed out, the United States estimates a loss in tax revenue of US\$345 billion each year as a result of offshore tax abuses, especially in connection with the use of concealed and undeclared accounts held outside of the United States. See DEAN MARSAN, *FATCA: The Global Financial System Must Now Implement a New U.S. Reporting and Withholding System for Foreign Account Tax Compliance, Which Will Create Significant New Exposures – Managing This Risk (Part 1)*, available at <http://ssrn.com/abstract=1645527> (series of four articles also published on TAXES – The Tax Magazine, July 2010).

²⁰⁰ A convenient track record of the relevant regulations can be found at JOINT COMMITTEE ON TAXATION, Tax Compliance and Enforcement Issues with Respect to Offshore Accounts and Entities (JCX-23-09), (March 30, 2009), at 22. See also, MARTIN A. SULLIVAN, *Proposals to Fight Offshore Tax Evasion*, Tax Notes April 20, 2009, at 266.

²⁰¹ *Id.*, at 22.

²⁰² *Id.*, at 23. See also subsequent pages for a description of the QIP.

upon sale of the relevant financial asset. In addition, several other payments to non-resident investors also go untaxed or are subject to low tax rates due to tax treaties.

Although that is the tax policy adopted with respect to non-resident investors, it does not apply to US investors. The QIP is a cross-border tax compliance effort enacted by the United States to prevent untaxed payments made to US investors "disguised" as non-resident investors; it relies – basically – on the bank regulatory "know-your-customer" rules.²⁰³

That means that if a non-U.S. bank - a qualified intermediary - wants to invest its clients money in the United States financial and capital markets, it has to guarantee to the IRS that the client - ultimate beneficiary of the U.S. income - is not an U.S. taxpayer; otherwise a withholding tax will be imposed on payments made to that qualified intermediary, acting on behalf of the client. The qualified intermediary is exempt from disclosing the identity of the client if it guarantees that the client/investor is not an US taxpayer.²⁰⁴

The QIP seems to be a good program but it has proven to be ineffective. The major evidence being, perhaps, the recent case of bank records obtained from a financial institution in Lichtenstein by German tax authorities and the UBS AG case. The latter started with the arrest of former UBS banker Bradley Birkenfeld, who pled guilty to conspiracy to evade U.S. taxes on June 19, 2008 in a U.S. District Court. Both cases involved qualified intermediaries that were not providing information on the ultimate beneficiary of their corporate clients, under the argument (basically) that the client was a non-U.S. corporation. Formally they were right, because the companies were not incorporated or domiciled in the United States; but on substance they were helping U.S. investors to invest tax-free in the United States markets as ultimate beneficiaries of non-US corporations. These cases are still pending, as the United States will amend and enhance its QIP, and the UBS AG situation is ongoing, which may - or

²⁰³ See MARSAN, *supra* note 183, at 41, stating that "*There are estimated to be about 5,600 financial institutions and banks that have entered into QIs with the IRS who have already developed extensive recordkeeping systems to categorize non-US customers into different tax categories and either deduct the withholding themselves or send the information on the investors to another bank.*"

²⁰⁴ The fact that the qualified intermediary does not have to disclose the identity of its client was a great incentive, as foreign institutions feared their non-US customer would not agree to allow the IRS to have information on their investments. That was changed in FATCA, as will be seen below.

may not - change the behavior of other qualifying intermediaries depending on the outcome of the lawsuit.

In addition to the QIP, new legislation was introduced in the United States dealing basically with the issue of obtaining information of financial records kept offshore.

As will be seen further below, the provisions set forth by HIRE Act's foreign tax compliance subtitle will among others things:²⁰⁵ (i) Impose a 30% withholding tax on payments either to foreign banks and trusts that fail to identify United States accounts and their owners and assets to the IRS, or to foreign corporations that do not supply the name, address, and tax identification number of United States individuals with at least 10% ownership in such corporations; (ii) Extend bearer-bond tax penalties to any such bonds marketed to offshore investors, and prevent the United States government from issuing bearer bonds; (iii) Impose penalties as high as US\$50,000 on United States taxpayers who own at least US\$50,000 in offshore accounts or assets but fail to report the accounts on their annual income tax return; (iv) Levy a 40% penalty on the amount of any understatement attributed to undisclosed foreign assets; (v) Extend to six years the statute of limitations for "substantial" omissions²⁰⁶ derived from offshore assets; (vi) Require shareholders in passive foreign investment companies to file annual returns; (vii) Require certain financial firms to file electronic returns with respect to withholding taxes; (viii) Codify that a foreign trust has United States beneficiaries if a United States person could be a current, future or contingent beneficiary; (ix) Permit the Treasury department to assume that a foreign trust has United States beneficiaries if the trust property is transferred by a United States person; (x) Establishes a US\$10,000 minimum failure-to-file penalty for certain foreign-trust-related information returns; and (xi) Subject certain dividend-equivalent payments to a 30% withholding tax similar to the tax that is levied on dividends paid to foreign investors.

FATCA is in complete contrast to the existing QIP – which, by the way, remains in place - which only collects information about investing in US securities. FATCA, on the contrary, was drafted in a way so as to allow the IRS to get information on US taxpayers

²⁰⁵ See O'TOOLE, *infra* note 208, at 01, for a convenient summary of the new provisions.

²⁰⁶ Omissions exceeding \$5,000 and 25% of reported income.

irrespective of whether these taxpayers invest in US securities or in other securities. Also, the QIP is generally limited to direct account holders, while FATCA also applies to U.S. persons who directly or indirectly control more than 10% of a foreign company. In summary, FATCA extended substantially the scope of the information required by the IRS.

FATCA

In addition to the QIP, on March 2, 2009, Senator Carl Levin (D-Mich) together with other Senators introduced a Bill to Congress (S. 506/H.R. 1265) also addressing the issue and restricting the use of offshore tax havens and abusive tax shelters to inappropriately avoid United States Federal taxation. This Bill did not go through the United States Congress,²⁰⁷ which, instead, chose to enact the Hiring Incentives to Restore Employment (HIRE) Act of 2010 (H.R. 2847), which includes the Foreign Account Tax Compliance Act of 2009 (FATCA) that increases disclosure requirements and withholding for certain payments made to offshore financial institutions.²⁰⁸ FATCA's intent is to provide the U.S. Treasury Department with significant new tools to find and prosecute United States individuals that hide assets overseas from the Internal Revenue Service.

Basically, FATCA requires most payments of income made from the United States to out of the country to be subject to a 30% withholding tax, unless the beneficiary of the payment is able to demonstrate not to be a UN-person. Since most investments are made through financial institutions through omnibus accounts, the IRS will require such institutions to enter into an agreement pursuant to which the foreign financial institution will have to provide several information on any account holder that is a US-person.

FATCA does not address the problem of multinational firms artificially shifting profits from high-tax to low-tax jurisdictions. In order to do that it would have to, among

²⁰⁷ As pointed out by Martin Sullivan, the bill's message to tax haven was basically "If you don't give us information about accounts held by U.S. citizens, we will restrict or even prohibit your use of the U.S. banking system" (see MARTIN A. SULLIVAN, *Proposals to Fight Offshore Tax Evasion, Part 3*, Tax Notes May 4, 2009, 516). Perhaps, that is why the Bill did not go through; as I am not sure the U.S. banking system can afford losing its clients from tax havens.

²⁰⁸ See CHUCK O'TOOLE, *Obama Signs HIRE-FATCA Bill Into Law Tax Notes Today at* <http://services.taxanalysts.com/taxbase/tnt3.nsf/dockey/CB8400426B2856FA852576EB00>.

other things, repeal or limit deferral, address the check-the-box regulation and somehow limit the ability of foreign tax credit to offset domestic income. FATCA, as stated elsewhere, is a reporting tool. It does that by setting several provisions enhancing reporting requirements of offshore gains and increasing enforcement, such as higher penalties.²⁰⁹ For that, one needs the participation of foreign entities. As a consequence FATCA's main objective is to force foreign financial institutions and the like to provide information about their U.S. account holders.

The Tax Section of the American Bar Association, while commenting the Bill that resulted in FATCA, stated that:

"The goal of the Bill as a whole and Section 101 of the Bill in particular, is to impede offshore tax evasion by U.S. persons. The provisions would bolster the government's arsenal in that effort and would make it more difficult for U.S. persons to hide income and assets offshore. We applaud the efforts of congress and the Administration in this endeavor.

We believe that the Bill would serve the purpose well by extending substantially the information reporting regime currently in place. Although the Bill would impose heavy costs and burdens on financial intermediaries, we believe the extend information reporting regime generally would be workable, subject to our specific comments below...".²¹⁰

These new rules are being introduced together with the task force toward obtaining more banking information with non-tax jurisdictions, through exchange of information agreements. FATCA is an improvement from the efforts being spent on this issue; the improvement lay on the fact that the legislation doesn't target countries or offshore secrecy

²⁰⁹ The effectiveness of higher penalties as an instrument to enhance compliance may be limited. See, generally, ALEX RASKOLNIKOV, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 Columbia Law Review 569, (2006).

²¹⁰ The ABA submitted comments to the Senate Finance Committee and House Ways and Means Committee on the Bill (H.R. 3933 and S. 1934).

jurisdictions.²¹¹ Also, the new legislation omits the entity classification provisions and foreign tax credit limitations, already excessively ruled.

Since it was introduced, on March 18 2010, new rules have been enacted. For example, the IRS has issued three notices outlining rules and procedures that it intends to include in regulations under FATCA provisions (Notice 2011-53, 2011-32 IRB 124 ("Notice 2011-53"); Notice 2011-34, 2011-34 IRB 765 ("Notice 2011-34"); and Notice 2010-60, 2010-37 IRB 329 ("Notice 2010-60"). More recently, on February 8, 2012, the IRS and Treasury Department issued proposed regulations. Final regulations are expected to be released on the summer of 2012.

Since the proposed regulations are still in a draft format, I will analyze the main provisions introduced by the above mentioned three Notices and, afterwards, comment on the changes suggested by the proposed regulations.

Rules and Procedures Under FATCA – Notices issued by the IRS

The IRS originally issued Notice 2010-60 (August 27, 2010), which was later supplemented by Notice 2011-34 (May 9, 2011), providing for preliminary guidance regarding priority issues and requested comments involving the implementation of chapter 4 of the Internal Revenue Code (the "Code"). Basically, Section 501(a) of the HIRE (Pub. L. 111-147 - H.R. 2847) added a new chapter 4 (sections 1471-1474) to subtitle A of the Internal Revenue Code. Such chapter 4 expands the information reporting requirements imposed on foreign financial institutions - as defined in section 1471(d)(4) with respect to certain U.S. accounts. Chapter 4 also imposes withholding, documentation, and reporting requirements with respect to certain payments made to certain foreign entities

IRS Notices – Brief Description on How it Works

Notice 2010-60 was divided in five sections; the first section dealt with how the "grandfather obligation" rules will be applied, the second section defined the term "financial

²¹¹ Section 501(a) of the HIRE (H.R. 2847) added a new chapter 4 (sections 1471-1474) to subtitle A of the Internal Revenue Code. Such chapter 4 expands the information reporting requirements imposed on foreign financial institutions (as defined in section 1471(d)(4)) with respect to certain U.S. accounts.

institution" and, for that matter, "foreign financial institution" and its interpretation; the third section dealt with collection of information and identification of persons by financial institutions under sections 1471 and 1472;²¹² the fourth section dealt with reporting U.S. accounts, describing the preliminary views of Treasury and the IRS regarding the manner and type of information reporting FFIs must provide to the IRS annually with respect to their U.S. accounts under the agreement FFI will be required to enter into with the IRS ("FFI Agreement"); and the fifth section requests for specific comments.

Notice 2010-60 did not cover provisions of the HIRE governing: (i) bearer bonds; (ii) substitute dividend and "dividend equivalent" payments; (iii) U.S. taxpayer self-disclosure of foreign assets or (iv) certain trusts.

A- Grandfathered Obligations

Section 501(d)(2) of the HIRE provides that chapter 4 shall apply to payments made under obligations outstanding on March 8, 2012, or from the gross proceeds from any disposition of such obligations.²¹³ As a consequence, payments made on such "grandfathered obligations" are exempt from the withholding provisions of the Act.

The problem here seems easy to be identified. What exactly constitutes an "obligation" for purpose of the exemption? Pursuant to Notice 2010-60, it shall not be deemed an obligation for this purpose "... *any instrument treated as equity for U.S. tax purposes, or any legal agreement that lacks a definitive expiration term.*" As a consequence, it "... *does not include brokerage, custodial and similar agreements to hold financial assets for the account of others and to make and receive payments of income and other amounts with respect to such assets.*" Notice 2011-53 provided that the term "obligation" would mean "... *any legal agreement that produces or could produce pass thru*

²¹² For example, what FFIs and U.S. FIs will need to do to identify and classify their account holders and the like.

²¹³ The proposed regulations introduced on February 8, 2012 extend the deadline for issuing obligations that are "grandfathered" from withholding under FATCA from March 8, 2012 to December 31, 2012.

payments,²¹⁴ but subject to the proviso that instruments treated as equity for U.S. tax purposes would not be "obligations" subject to grandfathering."

The proposed regulations introduced on February 8, 2012 maintained the definition of the previous Notices but added additional specific exclusions and examples of agreements that are "obligations".²¹⁵

A "material modification" of an obligation after December 31, 2012 terminates the grandfather status. This rule prevents taxpayers from circumventing the main rule by creating never-ending obligations. For example, pursuant Treas. Reg. § 1.1001-3 if a debt instrument has undergone a "significant modification" it is generally treated as if it had been retired and reissued on the day when the "significant modification" took place. In spite of the clarification, it is expected that tax planners will try to work around the concept of the obligations subject to the grandfather provision.

B – Foreign Financial Institutions (FFI) and Non-Financial Foreign Entities (NFFE)

This section perhaps contains the most difficult and important definitions of the Act. That is because, pursuant to FATCA, the withholding and information-reporting requirements apply to payments made to a payee that is an FFI. This, in itself, requires several terms to be defined in order to avoid taxpayers to play around with legal definitions. To start with, in order to be an FFI an entity must first be a "financial institution" and needs to be a non-U.S. financial institution.

Section 1471(a) of the Code requires a "withholding agent"²¹⁶ to withhold a tax equal to 30% of the amount of any "withholding payment" (also to be defined) made to an FFI that does not meet certain requirements. As will be seen, such requirements will basically

²¹⁴ Section 1471(d)(7) defines "passthru payment" to mean any withholding payment or any other payment to the extent attributable to a withholdable payment.

²¹⁵ For example, the proposed regulations state that the following are not grandfathered obligations: (i) brokerage agreements, custodial agreements, or other similar agreements to hold financial assets for the accounts of others that require the payment of income with respect to those assets, and (ii) master agreements that set forth general or standard term to apply to a series of transactions without specific term for a particular contract.

²¹⁶ A withholding agent will be any person "having the control, receipt, custody, disposal, or payment of any withholdable payment". IRC § 1474(a) makes the withholding agent personally liable for tax that is required to be withheld and is not.

comprise of entering into an agreement with the IRS whereby the FFI agrees to provide information on all U.S. account holders. By doing that the IRS aims to obtain the information it seeks on U.S. account holders. Note that the withholding applies also to payments that otherwise would not be subject to tax, such as portfolio interest and capital gains of foreign investors.

The only way an FFI may avoid the 30% withholding is by entering into a FFI Agreement with the IRS by which it undertakes to make reports to the IRS on accounts held by U.S. persons - also to be defined. Other foreign entities, which are non-financial institutions (NFFE), can avoid the withholding tax by supplying information on their U.S. owners to U.S. withholding agents.²¹⁷

An FFI is a financial institution that is a foreign entity. Pursuant to Section 1473(5), a foreign entity is any entity that is not a United States person. A financial institution,²¹⁸ is an entity that satisfies one of three categories: (i) entities that accepts deposits in the ordinary course of a banking or similar business;²¹⁹ (ii) entities that, as substantial portion of their businesses, hold financial assets for the account of others; or (iii) entities that are engaged primarily in the business of investing, reinvesting or trading in securities, partnership interests or commodities.²²⁰

The Notice provides several examples of entities in the above-mentioned situation. The Notice also lists entities that are excluded from the definition of "financial institutions" or otherwise exempt from some or all of the obligations imposed by the new legislation. For example, a foreign entity which in principle would fit into one of the three definitions of financial institution, but which sole purpose is to manage a family wealth and that all

²¹⁷ All foreign entities that are not financial institutions will have a 30% withholding tax on withholdable payments except if they either (i) certify to withholding agent they do not have any Substantial U.S.-Owner, or (ii) provide name, address and Tax Identification Number ("TIN") of each Substantial U.S.-Owner.

²¹⁸ See section 1471(d)(5).

²¹⁹ Under Section 581, a "bank" is a bank or trust company (including a building and loan association), incorporated under U.S. law, a substantial part of the business of which consists of receiving deposits, making loans and discounts, or of exercising fiduciary powers similar to those that national banks are permitted to exercise, which is supervised by a federal or state bank regulator.

²²⁰ The concept of "business" as used in section 1471(d)(5)(C) is different in scope and content from the concept of a "trade or business", as used elsewhere in the Code.

beneficiaries are ultimately identified, may be treated as "deemed compliant" FFI. That is the reason multi-billionaire George Soros is winding up his investment fund and leaving only family members as equity holders.

Insurance companies also have special treatment. Insurance companies that issue insurance and reinsurance contracts without cash value are not viewed by the IRS as implicating the concerns of FATCA rules. Again, future regulation will have to better define what exactly shall mean "insurance contract without cash value". In general, insurances that contain an investment component should be deemed as being with cash value, e.g., life insurances – other than term life insurance contracts without cash value, or annuity contracts.

The Notice also provides for special treatment of certain other classes of entities, such as (i) U.S. branches of FFIs, and (ii) Controlled Foreign Corporations. There is no exception to the definition of an FFI in the case the foreign entity has a U.S. branch. On the other hand, it shall not be included in the definition of "withholdable payment income", the effectively connected income with a U.S. trade or business [sections 871(b)(1) and 882(a)(1)]. Such exclusion does not apply to payments received by the U.S. branch of a FFI on behalf of its account holders, rather for its own account.²²¹

FFIs that are also controlled foreign corporation will not be "deemed compliant" for the purpose of FATCA. The reason for that is because the IRS and Treasury understand that existing report requirements of U.S. shareholders of CFCs are less tough than the rules prescribed by FATCA. For example, CFC reporting requirements do not demand to report certain payments made to domestic corporations, whereas FFIs are required to report information on account holders that are specified U.S. persons.

C – Collection of Information and Identification of Persons by Financial Institutions

²²¹ In summary, withholdable payment consists of: U.S. FDAP; any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the US; interest on deposits of foreign branches of domestic corporations and partnerships, (i) engaged in commercial banking business, or (ii) operating as S&Ls; does not include U.S. source ECI; exclusions for payments to foreign governments, international organizations, foreign central banks of issue, and others identified by IRS as posing "Low risk of tax evasion".

FATCA rules are about obtaining financial information of U.S. persons holding financial accounts outside of the United States. Therefore, for a FFI to receive "withholdable payments" from within the United States free of the 30% tax it must enter into a FFI Agreement with the IRS. Such FFI Agreement will basically require the FFI to, among other things, (i) identify and classify their account holders as will be necessary to determine which of such accounts are held by U.S. persons or U.S.-owned NFFEs ("U.S. Accounts");²²² (ii) comply with due diligence procedures with respect to the identification of U.S. accounts, and (iii) report certain information with respect to U.S. Accounts.²²³

An U.S. Account is a financial account - depository account, custodial account, or equity or debt interests in financial institutions not traded on an established securities market - that is held by a specified U.S. person or a U.S.-Owned Foreign entity. There is exclusion for U.S. Accounts held by natural persons with amounts lower than US\$50,000.

The Notice divides these reporting rules in four categories: (i) rules for pre-existing accounts of individuals; (ii) rules for new accounts opened by individuals; (iii) rules for pre-existing accounts held by entities; and (iv) rules for new accounts opened by entities. For the purpose of the new legislation, pre-existing accounts are financial accounts that are held as of the date the FFI Agreement becomes effective.

A specified U.S. person is any United States person other than certain types of entities that are expressly excluded ("Specified U.S. Person"). In other words, a Specified U.S. Person is generally any U.S. Person under IRS § 7701(a)(30), except for (i) publicly traded corporations and members of their expanded affiliated groups; (ii) organizations exempt under IRC § 501(a); (iii) U.S. federal, state and local government agencies; (iv) banks REITs, RIC, common trust funds; and (v) exempt trusts under IRS § 664(c), for IRC § 4947(a)(1). A U.S.-owned foreign entity is any foreign entity, which has one or more substantial U.S.

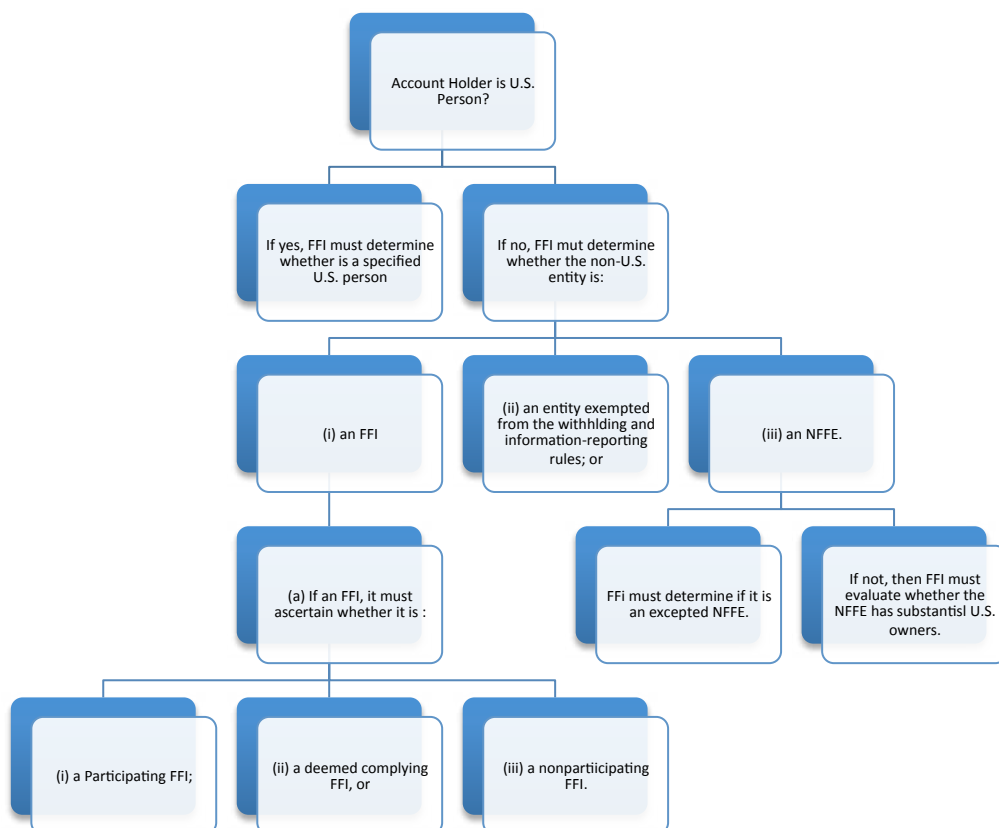
²²² See section 1471(d)(1)(A)

²²³ See section 1471(b) and (c).

owners. A substantial U.S. owner is generally defined in section 1473(2) and includes a Specified U.S. Person whose ownership interests in an entity exceed certain thresholds.²²⁴

Also, a fund engaged in business of investing, reinvesting or trading in securities, partnership interests, commodities or interests in such items is treated as U.S.-Owned foreign entity if a Specified U.S. Person has any ownership interest.

To determine whether the account holder is an entity is more complicated. Treasury and the IRS did not want to repeat the same mistake they made in the QIP, which led to situations like the UBS case, where the "qualified intermediary" held accounts of non-U.S. entities owned by U.S. entities or persons. As a consequence, the FFI will have first to establish whether the account holder is a U.S. or non-U.S. person. Below there is a chart with the procedures a FFI needs to follow in the process.



²²⁴ In the case of Corporations, 10% ownership by vote or value. For Partnerships, 10% of capital or profits interest. For Trusts, (i) any portion of grantor trust treated as owned by Specified U.S.-Owner, or (ii) 10% ownership of beneficial interest of non-grantor trust.

Similar mechanism applies to U.S. financial institutions (US-FI). Whenever a US-FI makes withholdable payment to an entity it must identify the beneficiary of the payment, i.e. it must first determine whether the recipient entity is a U.S. or non-U.S. entity. If the relevant entity is a non-U.S. person, the US-FI will be required to determine whether the beneficiary of the payment is a participating FFI, deemed-compliant FFI, non-participating FFI, entity described in section 1471(f), excepted NFFE, or other NFFE. That identification will determine whether there will be a 30% withholding payment.

D – Reporting on "U.S. Accounts"

This fourth section deals with the reporting mechanisms the FFIs will need to provide to the IRS. Treasury and IRS expect that FFIs provide to IRS, every year, several information in connection to their U.S. Accounts.

As a general rule, section 1471 provides that a Participating FFI must report to the IRS the following information:

- (i) name, address and taxpayer identification number ("TIN") of each account holder that is a Specified U.S. Person;
- (ii) in case an account holder is a U.S.-owned foreign entity, the name, address, and TIN of each substantial U.S. owner of such entity;
- (iii) the account number;
- (iv) the account balance or value; and
- (v) the gross receipts and gross withdrawals or payments from the account.

Account Value – Here lies a very delicate point about FATCA. How far can such information be disclosed without violating the right of privacy? Further comment on that will be left for the next chapter, where FATCA will be analyzed as a whole. Basically, section 1471(c)(1)(C) requires one to report to the IRS the account balance and value of each U.S. Account and gross receipts and gross withdrawals or payments from the account. Notice 2011-53 provided a phase-in scheduled for this report under which the first reports - covering

2013 - would be due September 30, 2014, and the first report would consist only of the account holder's name, address, TIN, account number and account balance.

The proposed regulation released on February 8, 2012 state that FFIs will be required to furnish annual information reports to the IRS with respect to all U.S. Accounts. The initial period for providing the reports was extended; reports covering calendar year 2015 will be required to report income - but not gross proceeds - associated with the account. On subsequent years Participating FFIs will have to provide "full report", which includes gross proceeds. The relevant information may be provided in the currency in which the account is maintained or in U.S. dollars.

Section 1471(c)(2) Election – In case the FFI does not want to inform the account balance or value, or the gross receipts and gross withdrawals or payments as required under section 1471(c)(1)(D) (let's say for reasons of domestic law of the place the FFI is domiciled), the Participating FFI may elect to report under sections 6041, 6042, 6045 and 6049 as if such FFI were a U.S. Person and each holder of an U.S. Account that is a Specified U.S. Person or U.S.-owned foreign entity were an individual and citizen of the United States. Such election basically allows a Participating FFI to elect comply with the information-reporting rules that govern U.S. financial institutions' accounts of U.S. citizens. This election does not eliminate the need to report the name, address, and TIN of each account holder that is a U.S. person or the account number.

Duplicative Report – Whenever an instrument or interest gives rise to financial accounts held by two or more FFIs, Treasury and the IRS' preference is to require the FFI that is in direct payment relationship with the account holder to be responsible for reporting. Such rule is still subject to regulations

All three Notices issued by the IRS have requested comments from the community for specific issues relating to FATCA. In light of further analysis and comments provided, IRS issued proposed regulation for FATCA on February 8, 2012. According to the timeline of events provided for by the new law, the IRS should issue regulations by the summer of 2012.

Proposed Regulations

Proposed regulations and the FATCA Notices provide a schedule for the implementation of FATCA. The obligations of the Participating FFIs increase over time. Current timeline for implementation of FATCA is the following:

- December 31st, 2012 – Ends the issuance of grandfather obligations;
- January 1st, 2013 – IRS begins accepting FFI applications;
- January 30, 2013 – FFI Agreement signing deadline to be considered a Participating FFI on Jan. 1st, 2014;
- January 1st, 2014 – Begins withholding on U.S.-source Income (FDAP);
- June 30, 2014 – Deadline for identifying and obtaining documentation of relationship managers and for documenting accounts held by "prima facie FFIs" (for agreements effective June 30, 2013);
- Sept. 30, 2014 – First FATCA reports due from FFIs (for calendar year 2013). The reports must include each U.S. Account holder's name, address, TIN and the account balance.
- January 1st, 2015 – Withholding on gross proceeds begins;
- June 30, 2015 – Deadline for responsible officer certification that due diligence on all accounts has been completed (for agreements effective June 30, 2013);
- January 1st, 2016 – Limited branch and limited FFI status expires and all members of expanded affiliated group must become Participating FFI if any member is to comply.
- March 31, 2016 – FATCA reports due from FFIs (for calendar year 2015). Must also include income associated with the account.
- January 1st, 2017 – Withholding on foreign passthru payments is schedule to begin (pending future rulemaking);
- March 31, 2017 – FATCA reports due from FFIs (for calendar year 2016). Must also begin to include gross proceeds from securities transactions. In general, FATCA reports will be due on or before March 31 of each subsequent year.

The proposed regulations made some changes on the original rules regulating FATCA.

A – Grandfathered Obligations

As seen above, the deadline for grandfathered obligations was extended from March 31 to December 31, 2012. Also, the regulation added additional specific exclusions and

examples of agreements that are deemed "obligations" for purposes of the rule. For example, debt instruments, as defined under the Code, constitute "obligations".²²⁵

B – Definitions

B.1 – Financial Accounts

The proposed regulation expanded the concept of financial account by adding "any cash value insurance contract or annuity contract issued by a financial institution". On the other hand, the regulations restricted the definition of financial account, in general, by providing that a debt - other than a deposit - or equity interest in an FFI that is a bank, broker-dealer or custodian will generally not be a "financial account". But such interest will be deemed financial accounts if "... the value of the debt or equity interest is determined, directly or indirectly, primarily by reference to assets that give rise to withholdable payments".

Equity and debt interests in other investment vehicles will also be excluded from the definition of financial account if they are regularly traded on an established securities market.

B.2 – U.S. Account

Pursuant to the FATCA Code provisions, a "U.S. Account" is any financial account held by a U.S. Person or U.S.-Owned Foreign Entity, unless the amount is less than US\$50,000. For the proposed regulations, the "Holder" of a U.S. Account is the person or entity listed or identified as the Holder of the account with the FFI, and flow-through entities can be listed as the Holder.

B.2.1 – Specified U.S. Person

Specified U.S. Person includes any U.S. person that does not belong to an exempted class. The following will not be considered a Specified U.S. Person: publicly traded corporations, tax-exempt organizations, individual retirement plans, U.S. government units, banks, real estate investment trusts, regulated investment companies, common trust funds, and certain tax-exempt trusts.

²²⁵ Regulations define debt instrument by reference to Section 1275(a)(1) of the Code.

B.2.2 – U.S.-Owned Foreign Entity

U.S.-Owned Foreign Entity will include any foreign entity which has one or more Specified U.S. Person with greater than 10% direct or indirect interest in a non-US entity. There is a special rule for investment vehicles. The proposed regulations elaborate on the concept, such as including the owner of an option to acquire stock, a partnership interest or a beneficial interest in a trust.

B.3 – Foreign Financial Institutions

The proposed regulations state that the following are FFIs: (i) entities engaged in a banking or similar business; (ii) entities holding financial assets as a substantial portion of its business; (iii) entities in the business of investing, reinvesting and trading, and (iv) any insurance company - or holding company of an insurance company - that issues or is obligated to make payments with respect to a financial account as defined above.

B.4 - Affiliated Groups

Pursuant to Notice 2011-34, every member of an Expanded Affiliated Group (as defined in the Notice) must be a participating FFI in order for any member of the group to become a participating FFI. The proposed regulations provide a transition period, as certain domestic laws may limit the ability of certain FFIs to become participating FFI. During such transition period the existence, within a corporate group, of a non-participating FFI due to local restrictions will not prevent other members of the corporate group to become participating FFI. A specific registration with the IRS will be required together with certain compliance measures. The grace period expires January 1st, 2016.

D – Deemed Compliant

The proposed regulations provide for two general types of deemed-compliant FFIs: (i) registered deemed-compliant FFIs and (ii) certified deemed-compliant FFI. To qualify as registered deemed-compliant FFI the FFI will be required to register with the IRS and certify that certain procedural requirements will be followed. On the other hand, a certified deemed-

compliant FFI will not be required to register with the IRS but will be required to certify to a withholding agent on a Form W-8 that they meet the applicable requirements.

E – Participating FFIs

E.1 – FFI Agreement

IRS intends to release a draft of the agreement early 2012 - it does not come out until end of March, 2012 - and finalize the required FFI Agreement in the autumn of 2012.

E.2 – Due Diligence ("DD")

Key changes made to the DD procedures as provided for in the IRS Notices include - but they are not limited to - the following: (i) a Participating FFI that complies with the FFI Agreement will not be held liable for failure to identify a U.S. Account; (ii) FFIs will be permitted to rely on an electronic review of their records, in case of pre-existing accounts that does not exceed US\$1 million; (iii) modify the DD steps to require Participating FFIs to identify entity accounts held by certain "prima facie" FFIs,²²⁶ which must be documented within one year of the effective date of the FFI Agreement.

(a.2) – Critics and Comments to FATCA

FATCA is without doubt groundbreaking, maybe similar to the Controlled Foreign Corporations legislation when it was introduced. No other country has tried that before, at least not yet.

Because of its complexity and far-reaching rules, FATCA has been criticized. Every time new and innovative legislation is introduced lots of comments are expected, especially when such legislation affects the pockets of millions of individuals. This is inevitable.

Let's take, for example, the harsh criticism made by the Americans Citizens Abroad ("ACA"), the voice of Americans overseas, which is a non-partisan, non-profit association of

²²⁶ Entities with respect to which either (i) the withholding agent has a designation that the account holder is a qualified intermediary or a NOI in its electronically searchable records or (ii) in the case of accounts maintained in the United States, the account holder is either documented or presumed to be a foreign entity.

volunteers with worldwide membership.²²⁷ This association wrote an open letter to several Government Officials criticizing FATCA and demanding its repeal. Some of their arguments were good and some not so much. I will make an analysis of what FATCA is and whether it respects jurisdictions or has the United States overreached.²²⁸

FATCA in a Nutshell

As seen above, FATCA is about reporting and obtaining financial information of American taxpayer on resources held outside of the United States. It does not mean that such information was optional before;²²⁹ on the contrary, the IRS has always required such information. As a matter of fact, in principle, it is absolutely legitimate to search for that information, as no country may be prevented to go after those taxpayers evading the tax system and hiding their assets behind the curtains of secrecy regimes. Nevertheless, like everywhere in the world, the information on assets - and their underlying income - held outside of the country's territory is in all cases self-assessed by the taxpayer and that creates great chances of underreporting income. Countries do not have jurisdiction to search for information outside of their territory and, as a consequence, before FATCA all countries had to rely on self-assessed information. That has proven not to work well, especially when there is a variety of tax havens with a strong financial industry and secrecy regime.²³⁰

In order to deal with such need for information, countries have developed all sorts of mechanisms, as seen elsewhere in this work. Countries have entered into bi-lateral treaties, exchange of information agreements etc. etc., all proven to be insufficient. The reason for

²²⁷ The ACA has headquarters in Geneva, Switzerland. I am not sure whether that is for tax reasons.

²²⁸ See, generally, SCOTT D. MICHEL & H. DAVID ROSENBLUM, *Fatca and Foreign Bank Accounts: Has the U.S. Overreached?*, May 30, 2011, *Tax Analysis 2011*.

²²⁹ FATCA will exist alongside and in addition to (i) withholding at source rules (IRC § 6041 et. Seq.), (ii) withholding at source on foreign persons (IRC § 1441 – 1444), (iii) FIRPTA withholding (IRC § 1445), (iv) withholding on foreign partner's share of ECI (IRC § 1446), (v) backup withholding (IRC § 3406) and QI rules. In Brazil, a list of all assets and liabilities held anywhere in the world must be disclosed in the regular tax return. In addition, those holding assets outside of Brazil must report to the Central Bank of Brazil the type of asset and any relevant information in connection with it (e.g., amount, term, interest, etc. etc.)

²³⁰ The evidence that the self assessed mechanisms doesn't work well is the great amount of financial information disclosed by unhappy employees of financial institutions in Switzerland and Lichtenstein, and also the great amount of taxpayers that adhered to a tax amnesty program introduced by the IRS. It has been reported that more than 16,000 individuals adhered to such tax amnesty program.

such failure has been, perhaps, the fact that those mechanisms have never provided for an automatic and comprehensive level of information, allowing the Revenue Service to match it with the information provided by the taxpayer. Rather, the mechanisms that existed before FATCA required countries to identify the evader and request the information, which took a great deal of time – and that always works in favor of the evader - and was ineffective; the flow of information was not automatic or comprehensive. It is not being said that those mechanisms were pointless. Even though they are not useless, the mechanisms that existed in the past were clearly insufficient; they did not satisfy the countries' demand for information.

The goal of FATCA is to stop offshore tax evasion. That is to say, to stop offshore tax evasion by U.S. person who hide income and assets offshore, thus leveling the playing field among American taxpayers. The United States may have overreached in some points, but that is normal in such an aggressive and innovative legislation. The excesses should be dealt with along the way.

The basic principle under which lies FATCA is fairly simple. What makes it complex is putting it in place, trying to close as much loopholes as possible, based on past experience of evading mechanisms and failures. Basically, the United States will require all payors - withholding agents - of income generated in the United States and paid to certain entities domiciled outside the country - whether a direct beneficiary of the payment or merely acting as agent - to withhold a tax at a rate of 30%, including payment of interest, dividends and royalties, as well as the proceeds of the sales of items producing interest or dividends from U.S. sources. The withholding will not apply in case the entity domiciled outside the United States complies with certain requirements, among these, entering into an agreement with the IRS pursuant to which the foreign entity agrees to provide comprehensive financial information on U.S. account holders.

On a first look, what FATCA does, at the end of the day, is to create a mechanism to guarantee that only the country of residence taxes passive income, as the group of experts gathered by the League of Nations found to be the best solution for double tax treaties. In the present case, that is not completely true, as the United States also taxes its citizens. As a

consequence, although an American may be residing outside of the United States, she will also have to be reported for FATCA purposes. If it has stopped here perhaps FATCA would have much less criticism.

FATCA levies a withholding tax - or penalty, one can also call it that way - on certain payments made to financial institutions outside of the United States in exchange for information that the country cannot obtain on the normal course of business. The new legislation does not analyze, first, whether the beneficiary of the payment is a non-U.S. person. In fact, if a Brazilian bank does not enter into an agreement with the IRS and acts as agent in an investment for a Brazilian citizen and resident, payments of income made on such investment from U.S. source, made to the Brazilian Bank A will be subject to tax irrespective the fact that the ultimate beneficiary of such payment is Brazilian citizen and resident.

The difference is very subtle. To levy income tax on payments made within the United States to U.S. taxpayers is different from levying a withholding tax at a rate of 30% to every payment made to outside the United States, except if the beneficiary - if a legal entity - enters into an agreement with the IRS pursuant to which several information on U.S. Persons will have to be provided. The harshness of this new rule is generating severe criticism.²³¹

Several new definitions were put in place and in some cases are still being developed. For example, FATCA must define what is "withholdable payment", "withholding agent", "foreign financial institution", "nonfinancial foreign entity", "specified U.S. person", "U.S.-owned foreign entity", "financial account", "U.S. accounts", "affiliated groups", and so on and so forth. Also, the IRS must draft the agreement it wants the foreign entities to enter into with, and the information it wants to be reported, the means of reporting, the frequency and other ancillary information for the entities to comply with in order not to have levied the 30% withholding tax.

²³¹ As said by the American Citizens Abroad ("ACA") in its open letter to the Secretary of the Treasury, "FATCA is using a bulldozer to go after an ant hill."

Jurisdiction

One argument being made against FATCA is that the United States is unilaterally extending its law worldwide, and that FATCA will "... *provoke a serious backlash from foreign governments who find it unacceptable ...*", to conclude that "[T]his is financial imperialism".²³² That may or may not be true. Whether foreign governments will react is yet to be seen. I have heard from the Commissioner of the Mexican revenue service, Alfredo Gutierrez Mena, that not only they like FATCA, but also are thinking of taking the opportunity to introduce similar rules in Mexico themselves, in order to obtain the information they need to levy their own income tax on Mexican taxpayers. In fact, all countries need information of their taxpayers abroad in order to deal with tax evaders. In the case of developing countries, such as Brazil and Mexico, there is an additional component, which is to stop corruption - and other crimes for that matter - as obtaining financial information of its residents abroad will also enable such countries to pursue corrupt money hiding behind secrecy laws in tax havens.

The same - or a similar - argument was made when the United States introduced the Controlled Foreign Corporations rule. In the case of the CFCs rules was even worse, as such rules overruled the double tax treaties in place. Nowadays several countries have CFC rules, and tax the deemed dividend that would have been paid to the parent company by the controlled foreign subsidiary. As will be mentioned below, Brazil does not segregate between active and passive income, thus taxing all profits earned by the controlled foreign subsidiary, therefore having a much harsher position than the United States.

It may be financial imperialism, but the fact remains that it takes harsh measures to deal with this problem, especially if one takes into account that nowadays evaders have at their disposal a very well structured and solid financial industry, and domestic secrecy laws consolidated in case law.

What strikes most those who read the critics before reading the rule is that the rule is not as imperialist as its critics make it out to be. Also, it does not seem a bulldozer after an "*antbill*". Well, it may be a bulldozer, but what people tend to forget is that the target is

²³² See the ACA letter, which can be found at <http://www.aca.ch/fatcapp.pdf>.

definitely not an "*antbill*". The problem with tax evasion and corruption is serious and big, and it must be addressed accordingly.

FATCA, as a whole, is a law addressed to Americans. It is not addressed to people outside the United States, with no tax obligation to the American Government. Indeed, the main rule provides that every withholding agent (which is an entity domiciled in the United States) will be required to withhold tax at a rate of 30% on certain payments made to certain foreign entities domiciled outside the United States. In case the American entities do not withhold the 30% tax they will have to pay it from their own pockets. And, in case the foreign entities do not want to have the tax withheld, they should obtain, with the IRS, a taxpayer identification number (TIN). To obtain the TIN the foreign entities will have to comply with several requirements, which have never before been demanded by a country. The main requirement is to enter into an agreement with the IRS pursuant to which the foreign entity will provide financial information solely on U.S.-Persons. In case such U.S.-Person has paid her tax obligations properly nothing else will be demanded from her. Note that it has not been said those foreign entities must obtain the TIN in order to trade in the United States financial and capital markets.

Like all taxes, that will generate an economic behavior. What that behavior will be will depend on what will be the reaction from other countries. Will other big economies seize the opportunity and enact a FATCA like legislation? In case that happens, the economic behavior will probably be minor. This is because if several other countries introduce a FATCA-like legislation, this will create a standardization of procedures that will strengthen the legitimacy for requesting financial information, by the residence country, of assets held abroad. That would also be a mass blowout to corruption, as foreign financial institutions would have to report the balance and gross revenue – in addition to other information a country may find useful to have - on the accounts of the other country taxpayer.

In spite of such good perspectives, we are still far from seeing it happen. FATCA still needs to be tested. It is not sure whether it will take off, as there are several barriers to be overcome. At this moment, the United States runs the risk of having major disinvestment out of the United States by foreigners. In 1984, when the United States abolished

withholding tax on interest payments to foreign investors, trillions of dollars migrated from other economies to the United States financial and capital markets. Now the same may happen, the other way around. Can the U.S. banking industry take such a blow?

FATCA may also create a tier level of financial institutions: (a) the financial institution that has entered into an agreement with the IRS (Bank A), and, as a consequence, all its account holders may invest in the United States financial and capital markets free of withholding tax; and, (b) the financial institution that has not entered into an agreement with the IRS (Bank B). Bank A, even though it will not have the tax, will have to report information on accounts held by U.S. persons. Bank B will not be a good option to have an account in case the account holder intends to invest in the United States financial and capital markets. On the other hand, Bank B will be a perfect place for a U.S. Person to hold an account, in case she does not want her financial information to be reported back to the IRS.

That brings to an interesting situation. Let us say that all the financial institutions of a certain country decide not to enter into a FFI Agreement. That country will be a perfect place for a U.S. Person to hide her assets, assuming she does not care about investing in the United States financial and capital markets. It is impossible to predict how the market will react. For example, George Soros has winded-up his investment fund in order not to be required to enter into a FFI Agreement. That may be an isolated case or a trend.

Also, the United States financial and capital markets will have to become more attractive to foreign capital. With globalization and market integration other financial and capital markets around the world constitute an option for those searching for investment opportunities outside the United States. For the time being, while Europe is going through a major economic and financial crisis, FATCA may not be at risk. But after Europe gets out of trouble and the BRICs offer more investment opportunities, some foreign financial institutions may decide to cancel the FFI Agreement and convince its account holders not to invest in the United States. All is yet to be seen.

Another interesting situation will be if other countries decide to adopt a FATCA-like legislation. This will demand from United States financial institutions to comply with the reporting requirements imposed by the other country FATCA rules. The question then

becomes: are the United States financial institutions ready to provide such information about non-U.S. account holders? Some people think they are not. Not being ready to provide such information on non-U.S. account holder does not mean that the United States financial institution cannot prepare itself for that. Most of the FFIs will have to adapt their information gathering mechanisms to be able to provide the IRS with the information it will request under the FFI Agreement anyway. That brings us to another argument against FATCA; who will bear the burden of the compliance cost FATCA will inevitably generate?

It is too early to risk an answer to this question. Probably the FFI account holders or the U.S. Person account holders, or the FFI itself.²³³ The compliance cost associated to FATCA will exist and will be significant. How the market will distribute that is also something to keep an eye on.

Another criticism made to FATCA is that the United States is extending its law worldwide. What exactly is the outer limit of a State's exercise of the various kinds of jurisdiction? There are three different kinds of jurisdiction: (i) jurisdiction to prescribe, which is the power of a nation to legislate, to make rules binding on persons, transactions, and relationships that have some connection with that State; (ii) jurisdiction to adjudicate, that is the power of a tribunal to decide a particular dispute or to hear a certain case; and (iii) jurisdiction to enforce, which is the power of a State to enforce both its rules and its judgments.²³⁴

In principle, it doesn't seem FATCA has disregarded any of these aspects of jurisdiction. FATCA is a rule targeted to Americans, especially "withholdable agents", as defined by the law. In case the withholdable agent does not withhold the 30% tax on certain payments made to certain foreign entities, they will have to pay such tax out of their own pockets. It is within the power of the United States to introduce such legislation, as much as to adjudicate a case involving such rule and enforce such adjudication. It does not seem to have any conflict between FATCA and any law of a foreign State.

²³³ Remember HARBERGER, *supra* note 26.

²³⁴ See DAVID J. BEDERMAN, *International Law Frameworks* (Thomson Reuters/Foundation Press Ed.), Third Ed., 2010, at 182/181.

There are though, certain situations that may create some apparent conflicts. Let's take, for example, the case of Switzerland and its domestic law that prohibits bankers from disclosing financial information of account holders. Scene 1, a Swiss bank - such as UBS - acts as agent for several thousand clients that invest in the United States markets; some of those clients are U.S. Persons. Scene 2, an American bank has a subsidiary in Switzerland, which holds accounts for clients from all around the world and also acts as agent of investments of its clients in the United States markets. Both financial institutions will have to comply with FATCA in case they want to be able to invest their client's money in the United States markets without paying 30% withholding tax. That implies providing the IRS with substantial financial information on all U.S. Persons that holds an account with the financial institution. But to provide such information means committing a crime in Switzerland.

In the first situation, FATCA apparently does demand the Swiss bank to provide financial information of its account holders. What it says is that in case the financial institution does not do that all investments made in the United States will be subject to withholding tax at a rate of 30%. I do not see any conflict of laws in this specific situation.

In the second situation, on the other hand, things may be slightly different, because the Swiss bank is a subsidiary of an American bank. There are certain principles and rules of international law that delimitates the outer limits of a State to prescribe, adjudicate and enforce. There are the territoriality and effects principle; the nationality; universality; protective; and passive personality. The United States, in fact, routinely tries to extend its jurisdiction over persons, facts and transactions occurred outside of its territory.

There are several examples of that. For example, the United States has tried to enforce its antitrust laws outside of its territory.²³⁵ At the end the Court ruled that the Sherman Act would only penalize an anti-competitive conduct, which had actual effects in the United States. The same applies for the embargo to Cuba. A subsidiary of an American company incorporated outside the United States cannot trade with Cuba, in spite of the place of incorporation permits such trade. Also, the Foreign Corrupt Practice Act applies to all Americans - and subsidiaries of American companies – irrespective of where they are located.

²³⁵ See *United States v. Aluminum Co. of America (Alcoa)*, 148 F.2d 416 (2d Cir. 1945).

That creates difficult situations where a subsidiary of an American corporation is forced to decide whether to comply with U.S. law or to obey the law of the State where it is domiciled. It gets even harder if the law of the State of domicile criminalizes the act, since this will imply that by complying with U.S. law the subsidiary will necessarily be committing a crime abroad. That would be the situation of the financial institution in our Scene 2 above.

FATCA does contain a component of extraterritoriality. For example, when the FFI is not the ultimate beneficiary of a withholdable payment, the IRS requires the FFI to withhold the 30% tax in case the payment is made to a recalcitrant account holder or to a FFI that is not a Qualified FFI - also called "passthru payments".

FATCA, no doubt, is groundbreaking and there are lot variables that need to be explored. Its actual results may only be felt after it gets in place. Pursuant to the proposed regulations, information will be demanded on obligations contracted after December 31st, 2012.

(b) – Brazil

Brazil has no legislation as innovative and complex as FATCA. On the other hand, Brazil has a simpler legislation also targeting compliance and tax havens, even though not as sophisticated as the American legislation.

It is useful to have an overview of another country's legislation on how to deal tax evasion and use of tax havens and secrecy rules. Brazil is a developing country, has a revenue service that is not as sophisticated as the developed economies. As a consequence, legislators have smartly introduced simple legislation that does not differentiate taxpayers as much as more sophisticated legislations do. In spite of being a developing country, Brazil is also a big economy that was even said to have surpassed Great Britain's position to become the 6th largest economy in the world.

Like all other countries, Brazil struggles with tax evasion, especially with obtaining financial information on the assets and income generated by its taxpayers outside of its borders. Several reporting mechanisms have been put in place, together with a new legislation.

To start with, Brazil - as surprising as it may seem - has been one of the first countries to introduce comprehensive electronic filing for individuals; nowadays individuals have to file one tax return a year, but legal entities are subject to several electronic filings during the calendar year. Most of the filings a legal entity must file relates to withholdable payments²³⁶ and to social contribution payments.²³⁷ In fact, the Federal Government is discussing whether it should eliminate the regular income tax return as all the necessary information is already provided in the hundreds other returns that must be filed along the calendar year.

In the regular annual tax return, both individuals and legal entities must report all their assets and income held/derived abroad. Individuals have a section in their tax return where they must inform all assets held on December 31st of the previous year and December 31st of the year before. The amount informed for December 31st of the year before cannot change, as it must coincide with the information provided in the previous year. Therefore, the individual net worth cannot grow from one year to the other in an amount higher than the income earned during that year. If that happens, the computers at the revenue services will red flag that specific tax return for further analysis.

In addition to the tax return, Central Bank of Brazil (the "Central Bank") demands all individuals and legal entities resident of Brazil to inform through an electronic filing all assets held outside of the country. The Central Bank nowadays uses that information for statistical purposes only, but that information is shared with the revenue authorities.²³⁸

The two reporting mechanisms are very strong and interconnected. Their electronic format allows powerful computers to match the information provided and check any inconsistencies. Nevertheless, and this might be reason why thousands of Americans have undeclared bank accounts offshore, such mechanisms are inefficient. The main reason for

²³⁶ All payments made by a legal entity to an individual are subject to withholding. That reduces non-compliance from the self-employed individuals, and makes easier to the tax authorities to audit.

²³⁷ Most of the tax revenue collected by the Federal Government comes from social contributions levied on several different facts, most unrelated to any measure of ability-to-pay. That makes the Brazilian tax system extremely regressive and overborne by legal entities, which, at the end of the, we all know doesn't bear the burden of the tax. There is a historical reason for that, which I will not get into, as it is not related to the present research.

²³⁸ Unnecessary to mention that underreporting generates all sorts of penalties.

their ineffectiveness is the fact that information must be provided by the taxpayer. That is exactly what FATCA tries to avoid.

It is proven that depending on the taxpayer to bring her financial information to the system by herself is not efficient. That has a strong appeal in Brazil. As a developing country Brazil experiences several practices linked to corrupt activities. Money derived from such activities will never surface, irrespective of any amnesty program.

Even though tax compliance relies heavily on self-reporting mechanisms, Brazil has been able to collect some tax revenue from Brazilian taxpayer investing in Brazil through undeclared account disguised as foreign legal entities. Like in the United States and most other countries, a non-resident - and, as a consequence, a non-Brazilian taxpayer - investing in Brazil has several tax exemptions on income derived in the Brazilian markets. Even when non-resident investor is subject to tax, the tax rate is lower than the tax rate a Brazilian resident will pay on the same income.

In fact, since 1999 Brazil has been penalizing payments made to tax havens jurisdictions. In 1999, Brazil took measures against the use of tax havens (where, at the end of the day, most undeclared money sits), perhaps already as a consequence of the 1998 Report issued by the OECD. Basically, all payments of income to beneficiaries domiciled in tax havens have an aggravated rate of withholding tax of 25% (the usual rate is 15% or, as in some cases, 0%, provided a lower rate is not set forth by a DTC). In addition, any transaction with a beneficiary domiciled in a tax haven is automatically subject to transfer pricing rules. There is currently a Bill going through the Brazilian Congress that grandfathers all money currently being secretly held outside the country. The proposal is to allow taxpayers to bring their money that is secretly hidden offshore without paying tax - or paying a minimal amount - and criminal prosecution, except for cases where the money held offshore derives from criminal activities, such as drug trafficking among other activities. The United States tax authorities did a similar program aiming at repatriating ~~to~~ the money hidden on Swiss bank accounts. The results were impressive.

The aggravated tax rate for income paid to beneficiaries domiciled in tax havens captures some of the lost tax revenue. More legislation has been introduced to catch schemes

build to circumvent such higher taxation. For example, foreign investors domiciled in tax haven have been investing in Brazil through limited liability companies incorporated in the State of Delaware, as the United States is not deemed a tax haven - at least not in principle. Since the Delaware LLC is a pass-thru entity for purposes of US tax and the Brazilian legislation did not look through to the ultimate beneficiary, the objective of the scheme is achieved.

As seen above, Brazil has aggravated the tax rate to any payment of income²³⁹ made to a beneficiary domiciled in a tax haven. The question then is what constitutes "tax haven".²⁴⁰ The term "tax haven" was first introduced in the Brazilian legislation through Law No. 9,430/96, dealing with transfer pricing. Any trade with a beneficiary domiciled in a tax haven will be subject to transfer pricing rules and, as a consequence, deemed an intercompany trade. Article 24 of Law No. 9,430/96 states that a *tax haven* is, in general, any country that does not tax income, or taxes income at a rate lower than 20%. Later, another requirement was added to Article 24 to say that will also be deemed tax haven any country or jurisdiction with favorable tax regime which legislation does not allow access to information with respect to capital ownership of legal entities, or the identify of its ultimate beneficiary.²⁴¹

In spite of the definition of *tax haven* provided by the law, the revenue authorities issued a black list containing 65 countries and/or jurisdictions.²⁴² Even though a law is deemed to be hierarchically superior to a revenue ruling, the revenue authorities have been considering the black list comprehensive and the sole source of *tax haven* definition.

Later, in 2008, Brazil enacted another legislation creating the concept of "privileged fiscal regime", in addition to the already existing *tax haven* concept.²⁴³ A "privileged fiscal

²³⁹ Any payment of income to a beneficiary domiciled outside of Brazil is a "withholdable payment".

²⁴⁰ See, generally, WALTER H. DIAMOND & D. B. DIAMOND, *Tax havens of the World*, New York, 1974, and MARSHALL J. LANGER, *How to Use Foreign Tax Havens*, 1975. Some say that the biggest tax havens in the world are located on islands, more specific the Island of Manhattan, in NY-EUA, and London, which is the capital of an island (Great Britain itself).

²⁴¹ See Law No. 11.727/08.

²⁴² See Normative Instruction No. 1,037, of June 4, 2010.

²⁴³ See Law No. 11.727/08.

regime" is considered a fiscal regime that presents any of the following characteristics:²⁴⁴ (i) does not tax income or taxes it at a maximum rate of 20%;²⁴⁵ (ii) grants a tax benefit to non-residents (a) without any requirement of having economic substance in the country, (b) subject or not to having economic substance in the country; (iii) does not tax, or taxes it at a maximum rate lower than 20%, any income earned outside of its territory; or (iv) does not grant access to information related the equity ownership of a legal entity and to the ownership of assets and rights or financial transactions.²⁴⁶

Currently, the concept of "privileged fiscal regime" is applied only to transfer pricing and thin capitalization²⁴⁷ purposes. There are also some requirements for individuals to lose their resident status when transferring their residency to *tax havens* and "privileged tax regimes", and tax deductions of certain payments made to beneficiaries domiciled in those places. This last aspect of the "privileged tax regime" legislation is perhaps the most interesting.

A company, in Brazil, may only deduct as expense payments made to a beneficiary domiciled in a "privileged tax regime" if the following are met: (i) the effective beneficiary of the payment is identified and (a) it has not been incorporated for the sole purpose of generating tax savings; (b) is earning the income for its own profit, and not as agent, fiduciary manager, attorney-in-fact for third parties; (ii) the effective beneficiary must demonstrate to have substance; and (iii) in the case of trade, the price must be effectively paid and the goods delivered or the services used.²⁴⁸ As a consequence, the Brazilian payor, in order to deduct the payment as expense, must demonstrate that the payment of the income has substance and is being made to an identified beneficiary.

²⁴⁴ See Law No. 11,941, of May 27, 2009.

²⁴⁵ Note that there is a difference from the *tax havens* concept. The taxation threshold is not of the country where the beneficiary is domiciled, but the taxation of the transaction itself. Therefore, if the country taxes income at a rate higher than 20%, it may still be considered a "privileged fiscal regime" if the transaction itself is not.

²⁴⁶ Similar concepts may also be found in the OECD report on Harmful Tax Competition, and the European Union Code of Conduct.

²⁴⁷ See Law No. 12,249, of June 11, 2010.

²⁴⁸ See Law No. 12,249/2010, Article 26.

As can be seen from the analysis above, unilateral measures – on certain United States and Brazilian legislations – are more effective and allow countries to immediately prevent the problem. Although more effective, they prevent some evasion but do not completely solve the problem. Also, domestic legislation of countries may have to overreach in order to achieve the expected results. As seen elsewhere in this work, information revealed by an employee of a bank in Lichtenstein has demonstrated that several residents of the United States, as well as residents of many other countries hide untaxed money under secrecy regimes.

VII – CONCLUSION

The world is going through an unprecedented globalization process. The end of regulatory barriers and new technological instruments has increased the pace of globalization. In light of such globalization process, countries have been battling to attract new businesses in order to enhance their domestic economy. Reduced tax rates have been a common tool used by countries to attract new businesses.

Also, certain jurisdictions have specialized themselves in attracting mobile capital by creating a tax-free environment with secrecy rules and a strong banking industry.

Both competition for foreign investment, either business investment or simply investment capital, generate capital flight from developed economies, which generate less tax revenue, inequities and erosion of their domestic tax base. That has led certain countries - most of them developed economies that heavily rely on tax revenue - to challenge such practices.

In the first case, where a country reduces its tax rates to attract foreign direct investment, there is not much a country can do unilaterally, except for also reducing its tax rates to prevent businesses to leave. The European Union, where such competition can be strongly felt, enacted a Code of Conduct, which tries to create minimum rules that a country should follow in order to use its tax system to attract foreign direct investment.

On the other hand, a bigger battle was created against jurisdictions that create a tax-free environment with secrecy rules. Several international organizations, such as the G-20 and the OECD, have been criticizing such jurisdictions and trying to enact legal instruments aiming at increasing exchange of information between government authorities. The OECD has improved the language of Article 26 of its model treaty against double taxation, and its Global Forum has drafted a model exchange of information agreement. Both legal instruments have been widely used by several countries.

In addition to international legal mechanisms, countries have been introducing new legislation aiming at enhancing exchange of information, or simply forcing foreign financial institutions to provide information on the taxpayers outside of their country of residence.

The combination of international treaties and domestic legislation will improve exchange of information between countries, and prevent tax evasion. Ultimately, the path to success in curtailing tax evasion is to have access to the necessary information.

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