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The Original Intent of the Single Tax Principle: from Theory to Practice

By

Gianluca Mazzoni

A dissertation submitted in satisfaction
of the requirements for the degree of
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I would first like to dedicate this dissertation to Professor Reuven Avi-Yonah. I consider myself privileged for having the opportunity to spend almost four years under your guidance and mentorship at The University of Michigan Law School. I still remember the first time we met in Italy after I graduated from law school at University of Milan – Bicocca. It has been an absolute honor to attend your classes, discuss various tax issues, and co-author many articles with you. I never would have imagined that I would have been mentored by such an inspiring and talented professor and will always be thankful to God for giving me this opportunity.

Secondly, this dissertation is dedicated to my grandfather, Livio, who passed away on September 20th, 2018. He always used to ask me when I would present my dissertation. I hope that, wherever you are now, you saw me present it this year and that it brought you happiness.

Thirdly, this dissertation is dedicated to my mother and all the sacrifices she made raising a child alone. No words can express or describe the unconditional love I have for you and how thankful I am for all the sacrifices you have made for me.

Fourthly, this dissertation is dedicated to my other grandparents: Maria, Lola, and Jeannot. You are the best grandparents I could have ever wished for and am thankful each and every day for having you all in my life.

Finally, this dissertation is dedicated to some people who are not among us anymore but have had a profound and positive impact on my life: Achille Campagna, Dean of my High School, thank you for letting me study one year abroad. It was a life changing experience for me and I will always be grateful. Professor Francesco Tesauro, my law school thesis co-supervisor, thanks for writing my letter of recommendation. All of this would not have been possible without your help. Marco Pantani, Franco Ballerini, and Kobe Bryant, my childhood heroes and legends, you taught me to never give up and give the best I could possibly give in every situation.

Without any offense to the people who have not been explicitly mentioned in this thank you note, I conclude with one my favorite phrases: *Per aspera ad veritatem.*

New York, Wednesday, February 19, 2020

Gianluca Mazzoni

ET 9/2019 – WGOI

Italy

The Italian Patent Box Regime and the Foreign Tax Credit

Gianluca Mazzoni*

In this note, the author discusses recent clarifications released by the Italian tax authorities on the determination of foreign tax credits under the Italy-United States Income Tax Treaty (1999) and article 165(10) of the TUIR.

1. Factual Background

On 29 May 2019, the Italian tax authorities (ITA) issued clarifications on how to correctly determine the amount of the foreign tax credit based on the provisions of article 23(1) of the Italy-United States Income Tax Treaty (1999) (the Treaty)[1] and article 165(10) of the Italian Income Tax Consolidation Act (*Testo Unico Delle Imposte Sui Redditi* - TUIR).[2]

The facts of the case were as follows. Company Alfa asked the ITA how to correctly apply treaty provisions regarding the calculation of the amount of the foreign tax credit in a cross-border royalty payment situation in which, on the one hand, the United States, as the licensee's residence state, levies a withholding tax on outbound royalties and, on the other hand, Italy, as the licensor's residence state, provides for a partial exemption of income arising from qualifying intellectual property rights because the qualifying taxpayer has opted for the preferential patent box regime.[3]

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[1] *Convention between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion* (25 Aug. 1999), Treaties & Models IBFD.

[2] IT: Income Tax Consolidation Act, Presidential Decree No. 917/1986 (*Testo Unico delle Imposte sui Redditi*), Primary Sources IBFD.

[3] *See, Comprehensive Tax Reform for 2015 and Beyond By Republican Staff Committee on Finance United States Senate* pp. 271-273 (Dec. 2014, available at https://www.finance.senate.gov/imo/media/doc/Comprehensive%20Tax%20Reform%20for%202015%20and%20Beyond%20(C).pdf: "A patent box is a tax incentive granted for certain income arising from the exploitation of intellectual property. Generally, the incentive is a reduction in the corporate income tax with respect to the income of the intellectual property ... A patent box can be viewed as providing a back end tax benefit with respect to

In particular, company Alfa wanted to know whether it should have calculated the foreign tax credit for its US source income based on the provisions of the Treaty, without applying the domestic limitation of article 165(10) of the TUIR, pursuant to which if foreign source income is only partially included in the taxpayers' worldwide income, the foreign tax must be reduced accordingly. Company Alfa's argument was that the Treaty did not include such a similar provision.

2. Relevant Law: Domestic and Treaty Provisions

The method chosen by Italy and United States to provide relief in respect of juridical double taxation is the credit method provided by article 23(3) of their Treaty. Based on that method, Italy, as the residence state, calculates its income taxes by taking into account the taxpayers' worldwide income, which includes income produced in the source state, i.e. the United States, where it has already been subject to tax. Subsequently, Italy deducts from the taxes so calculated the tax on income paid to the United States.[4] On the basis of the Technical Explanation to the Treaty, the ITA stated that there is a *nexus* between the inclusion of foreign source income in worldwide income taxable in the residence state and recognition of a credit for foreign taxes paid.

The ITA also illustrated how, domestically, the Italian legislator chose to provide relief for double taxation by allowing for a foreign tax credit. In particular, according to article 165(1) of the TUIR, the tax credit is only granted when the foreign source income is included in the taxpayers' worldwide income [limited to the lesser of the foreign tax paid or the Italian tax that relates (based on a ratio of foreign income to total income) to such amount of income]. Unlike the United States, the foreign tax credit limitation is determined on a per-country basis.

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intellectual property. Front end tax benefits would include the research and development tax credit and expensing for research and experimental expenses. These are tax incentives provided at the front end of the innovation chain or process". For a general discussion of the new Italian patent box regime introduced in 2015, *see* S. Zucchetti & A. Pallotta, *Italian Patent Box Regime: Thinking Outside the Box or Just More Harmful Tax Competition?*, 23 Intl. Transfer Pricing J. 1 (2016), Journal Articles & Papers IBFD.

[4] *See* art. 23(3) of the Treaty: "If a resident of Italy derives items of income which are taxable in the United States under the Convention (without regard to paragraph 2(b) of Article 1 (Personal scope)), Italy may, in determining its income taxes specified in Article 2 of this Convention, include in the basis upon which such taxes are imposed the said items of income (unless specified provisions of this Convention otherwise provide). In such case, Italy shall deduct from the taxes so calculated the tax on income paid to the United States, but in an amount not exceeding that proportion of the aforesaid Italian tax which such items of income bear to the entire income. However, no deduction will be granted if the item of income is subjected in Italy to a final withholding tax by request of the recipient of the said income in accordance with Italian law. For purposes of applying the Italian credit in relation to tax paid to the United States the taxes referred to in paragraphs 2(a) and 3 of Article 2 (Taxes covered) shall be considered to be income taxes".

Thereby, both article 23(3) of the Treaty, on the one hand, and article 165(1) of the TUIR, on the other, as well as article 23 B of the OECD Model (2017),[5] require the inclusion of foreign source income in the taxpayers' total taxable income in order to benefit from the foreign tax credit. Given that the principles underlying both the treaty and domestic provisions are substantially the same, the ITA held that the inclusion of foreign source income in the taxpayers' total income taxable in Italy is a necessary requirement for the purposes of deducting from Italian tax liability taxes paid abroad.

Thus, a failure to include foreign source income in the residence state's tax base does not allow taxpayers to credit the foreign income taxes that they paid against Italian tax imposed on such items of income. According to the ITA, such a "principle of law" holds true even where the foreign source income is partially included in the taxpayers' worldwide income and, thus, even where a preferential tax regime, such as a patent box regime, applies, providing for a partial exemption of qualifying income.

3. Numerical Example

A numerical example may be helpful. Assume that, in 2018, the Italian parent company granted the right to use some intangible assets to its US subsidiary in exchange for a USD 30 royalty. The US subsidiary used those patents to manufacture industrial products and equipment, from which it generated USD 100 of income. Total taxable income is 100 – 30 = 70, in respect of which USD 14.7 is remitted to the US federal government. A further withholding tax is levied on the outbound royalty paid from the US subsidiary to its Italian parent company in the amount of USD 2.4 (30 times 0.08). Assuming that USD 30 of royalty is qualifying income for the purposes of the Italian patent box regime and USD 10 is a qualifying expenditure in relation to research and development of the patent, only USD 10 (30 – 10 divided by 2) will be subject to corporate income tax in Italy, thus, USD 2.4 should be remitted to the Italian government before applying the foreign tax credit for taxes paid to the US government. In applying principle of law no. 15 issued by the ITA on 29 May 2019, the foreign tax credit for the Italian taxpayers should be reduced by half of USD 2.4, thus USD 1.2 for a total amount remitted to the Italian government of USD 1.2. The total tax burden borne by the company would be USD 14.7 of corporate income tax remitted to the US government plus USD 1.2 remitted to the Italian government for a total of USD 15.90.

4. Uncertainties

[5] *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Treaties & Models IBFD.

The question, however, is not entirely clear. For example, business community indicated a different possible solution for redetermining the amount of the foreign tax credit in light of the limitation of article 165(10) of the TUIR, based on the effective tax benefit derived from the preferential tax regime. In the case at hand, the effective tax reduction benefit derived from the application of the patent box regime is 10/30, i.e. one third, thus Italian taxpayers should be allowed to credit up to two thirds of 2.4 for a total amount remitted to the Italian government of USD 0.8. According to the business community, the application of article 165(10) of the TUIR substantially undermines the preferential treatment provided by the patent box regime. In its opinion, the impact of this distortionary effect can be mitigated, to a certain extent, if the foreign tax credit is redetermined based on the effective corporate tax rate on royalties and not based on their statutory tax rate. In this regard, the Tax WG was hoping that the ITA will, in the future, provide additional nuance as to the methods of redetermining the foreign tax credit.

5. Conclusions and Open Questions

The author agrees with the clarifications issued by the ITA. Indeed, with regard to foreign income or gains that are only partially included in the resident company's IRES (*Imposta sul reddito delle societa*, corporate income tax) tax base (for example, foreign dividends), the foreign tax creditable is reduced accordingly. For example, 95% of the amount of qualifying foreign dividends are not included in the corporate tax base. Thus, only 5% of these dividends is subject to IRES. Because only 5% of the dividends is included in the tax base and subject to IRES, Italy grants a foreign tax credit for that portion of the foreign withholding tax that was levied on 5% of the dividends.[6]

In the author's opinion, as 50% of net royalty income is exempt from taxation due to the application of the patent box regime, granting 100% of the foreign tax credit, i.e. USD 2.4, would constitute an undue tax benefit, as only USD 1.2 will be remitted to the Italian government.

In addition, this case raises an interesting question. Should the United States apply the lower treaty rate of 8% given that the US source royalty will be subject to a favourable tax regime in the residence state, which provides for a 50% exemption? In the author's opinion, the answer is no. The United States should apply its domestic withholding tax rate of 30%, as only 50% of the net royalty will be subject to corporate income tax in Italy.[7] Consequently, a withholding tax of USD

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[6] C. Silvani, *Italy – Corporate Taxation – Country Analyses* sec. 7., Country Guides IBFD.

[7] Some scholars have argued that, "Italy's tax treaty practice is to maintain the reduced right to tax (or the exemption if applicable) in the source state under article 12 regardless of the existence of a favourable regime in the residence state. Note that a recent judgment of the Regional Tax Court of Milan (March 22, 2017, Decision no. 1254) has confirmed that application of the treaty with Switzerland to a beneficial owner who is a Swiss-resident holding company exempted from the municipal and cantonal taxes by virtue of a ruling concluded with the Swiss tax authorities". *See* A. Brazzalotto, *Chapter 16: Italy in Taxation of Intellectual Property under Domestic Law, EU Law and Tax Treaties* (G. Maisto ed., IBFD 2018), Books IBFD. The author has repeatedly argued that Italy should

9 (30 times 0.3) should be levied on the outbound royalty payment from the US subsidiary to its Italian parent company. Thus, even though the Italian tax liability would be entirely wiped out, total tax burden borne by the company would nonetheless be higher because of the excess credit of USD 7.8. Compared to the above scenario, where the United States applied its treaty withholding rate of 0.08%, by applying instead the domestic withholding rate of 0.3%, the total tax burden borne by the company would be USD 14.7 of corporate income tax remitted to the US government plus USD 7.8 of non-creditable foreign taxes, for a total amount of USD 22.5. This also appears to be the result based on the wording of the new US Model Income Tax Convention (2016).[8] Indeed, according to article 12(2)(a) of the new US Model (2016):[9]

a royalty arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is a connected person with respect to the payor of the royalty may be taxed in the first-mentioned Contracting State (United States) in accordance with domestic law if such resident benefits from a special tax regime with respect to the royalty in its Contracting State of residence (Italy).

The question is whether the Treaty will ever be amended through a protocol along the lines of the US Model (2016) and if the Italian patent box regime meets all of the conditions of article 3(1)(l) of that Model to be considered as a special tax regime. In the meantime, it could be argued that the ITA, by issuing principle of law no. 15 on 29 May 2019, correctly applied the single tax principle to prevent double non-taxation.

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not abandon its taxing rights in respect of favourable tax regimes applicable to the beneficial owner of passive income in its residence state; *see* R.S. Avi-Yonah & G. Mazzoni, *Complete Distributive Rules and the Single Tax Principle: A Review of Recent Italian Case Law*, 73 Bull. Intl. Taxn. 4 (2019), Journal Articles & Papers IBFD.

[8] *US Model Income Tax Convention* (17 Feb. 2016), Treaties & Models IBFD.

[9] *See also Convention between the Government of the Italian Republic and the Government of Barbados for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion* (24 Aug. 2015), art. 29(1), Treaties & Models IBFD, "[t]he benefits of this Convention shall not apply to a person entitled to a tax benefit under a special tax regime in either Contracting State".

The Italian Supreme Court's Decision in the ITW case (No. 32840): The Beneficial Ownership Requirement and Double Non-Taxation?

Gianluca Mazzoni

Introduction

On December 19th, 2018, the so-called "*Corte Suprema di Cassazione*", the Italian Supreme Court, (hereinafter "ISC") issued an interesting decision as to the scope of the notion of beneficial ownership and its relationship with double non-taxation. In its decision no. 32840, the V chamber of the ISC held that only the beneficial owner, which has the actual economic and juridical availability of the relevant item of income and is subject to the taxing powers of the other contracting state, may benefit from source tax limitation. Otherwise, an improper shifting of tax treaty benefits or a phenomenon of double non-taxation would arise.

In the case at hands, the ISC excluded that the German company could be the beneficial owner of royalties paid by the Italian subsidiary. According to the Court, the German company was just a mere intermediary of the U.S. parent company – the real owner of trademarks and patents, whose right to use had been granted to the Italian company. Indeed, the Germany company collected royalties from various EU companies and largely transferred them to the U.S. parent company, with the consequence that only a de-minimis amount was subject to tax in Germany (representing commission for the activity carried out).

Facts of the case

The facts of the case are the following. In 2007, ITW Italy Holding SRL (hereinafter "ITW IT" or "petitioner") – the Italian subsidiary – was subject to a tax audit by the so-called, *Guardia di Finanza* (hereinafter "GdF"), the national tax police.

Illinois Tool Works, Inc., (hereinafter "ITW US"), the U.S. parent company, was the owner of the intangible assets (e.g., trademarks, patents, know-how, business consulting, marketing support, technology etc.) from which royalties originated. Until 2002, an agreement for the right to use intangibles was in force between ITW US and petitioner, ITW IT. Royalties were paid directly by ITW IT to ITW US after applying withholding rate of 10 percent provided by the tax treaty between Italy and the U.S. Starting from 2002, ITW US granted the right to use its intangibles to another U.S. company, ITW Finance LLC. This, in turn, assigned to a German company (CSE Germany GmbH e Co KG subsequently merged with incorporation into ITW Befestigungssysteme GmbH, i.e. ITW DE) the task to manage the relationships with all the EU group companies, among which, ITW IT. Consequently, the previous agreement in force between ITW U.S. and ITW IT was revoked and substituted by a new agreement signed between ITW IT and ITW DE to which royalties were paid after applying the withholding rate of 5 percent. The tax authorities had interpreted all this sort of group restructuring as a mere interposition of the German company in an economic transaction where it was clear ITW DE was not the beneficial owner as the legal ownership of the intangible assets still remained within ITW U.S. All of this was done in order to benefit from the most favored tax treatment of 5 percent provided by the treaty between Italy and Germany compared to that of 10 percent provided by the treaty between Italy and the U.S.

At the end of the tax audit, the GdF charged ITW for failing to withhold taxes, on royalties, on the one hand and, on interest, on the other hand, paid to foreign companies. Thus, on November 24th, 2008, tax authorities issued and notified ITW five notices of deficiency (relating to fiscal years from 2002 to 2006) for submitting an "unfaithful" tax return due to the erroneous determination of withholding on royalties paid to the Germany company (ITW Deutschland GmbH hereinafter "ITW DE") and failing to withhold taxes on interest paid to the Luxembourg company CS Finance Europe SARL.

Opposing parties' views

ITW IT appealed those notices of deficiency before the Provincial Tax Commission of Turin. On the one hand, the Provincial Tax Commission of Turin assigned the notices of deficiency relating to fiscal years 2002-03 to its VII chamber, which issued decision no. 14 on February 11th, 2010. On the other hand, the notices of deficiency relating to the remaining fiscal years (2004-05 and 2006) were assigned to the IX chamber, which issued two different decisions no. 77 and 78 on June 14th, 2010.

In particular, tax authorities issued the notices of deficiency relating to fiscal years 2002-03 because ITW erroneously determined the amount withheld on royalties paid to ITW DE for EUR 562.706,00 in 2002 and 1.906.547,00 in 2003 and failed to withhold taxes on interest paid to the Lux company CS for EUR 9.819,66 in 2003.

Tax authorities argued that ITW Italy applied the lower withholding rate of 5 percent provided by the double tax treaty with Germany[10] in lieu of the domestic rate of 30 percent provided by Art. 25(4) of Presidential Decree no. 600/1973.[11] According to the tax authorities, ITW DE could not be considered the beneficial owner of royalties paid by ITW IT, as only the U.S. parent company, the legal and economic owner of the intangible assets, was entitled to.

Regarding the second issue – failure to withhold taxes on interest paid to the Lux company CS., tax authorities argued that the application of domestic rate of 12.5 percent[12] instead of the reduced tax treaty rate of 10 percent[13] was due to the fact that the necessary documentation was submitted in 2007 well beyond the deadline.

[10] Italy – Germany Income and Capital Tax Treaty (1989), Art. 12, 'Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the recipient of the royalties is the beneficial owner thereof, the tax so charged shall not exceed 5% of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.'

[11] Royalties paid to non-resident companies are subject to a 30% withholding tax, which is generally applied to 75% of the gross amount of the payment, resulting in an effective rate of 22.5% (article 25 of DPR 600/1973). G. Gallo, Italy – Corporate Taxation sec. 6., Country Surveys IBFD.

[12] See Art. 26(5) of Presidential Decree 600/1973.

[13] Italy – Luxembourg Income and Capital Tax Treaty (1981), Art. 11, 'Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. However, such interest may also be taxed in the Contracting State in which it arises and according to the law of that State but, if the recipient is the beneficial owner of the interest, the tax so charged shall not exceed 10% of the gross amount of the interest.'

According to ITW IT, the notice of deficiency was exclusively based on the erroneous belief that ITW DE was not the beneficial owner of the income attributable to it as it was a conduit company, which operated as a mere intermediary in the economic transaction between ITW IT and the U.S. parent company, with the exclusive aim of benefitting from the most favored tax treatment provided by the double tax treaty between Italy and Germany.

In order to demonstrate instead that ITW DE was the beneficial owner of the royalties paid to it, ITW IT submitted an official letterhead of the Germany company dated July 25th, 2007, from which it emerged that ITW DE was operative and was the beneficial owner of the royalties received from ITW IT. In addition, in order to support its arguments, ITW IT also made reference to Directive 2003/49/CE, on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, which at art. 1(4) considers as beneficial owner of interest or royalties any company of a Member State *if it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorised signatory, for some other person*;[14] and to the OECD Commentary on Art. 12 of the Model Tax Convention on Income and on Capital in order to state that, concerning the case at hand a license agreement, ITW DE should be identified as the beneficial owner.

Finally, ITW IT also made reference to a factual circumstance according to which, on December 18, 2002 the U.S. parent company granted the rights to use its intangible assets to another U.S. company which, the following day, on December 19, 2002 negotiated with ITW DE a one-time payment for royalties due by the latter for the economic exploitation of intangible assets until October 31st, 2005 in the amount of EUR 140.000.000.

In conclusion, with regard to the above-mentioned second issue, ITW IT contested the application of 12.5 percent domestic tax rate due to the delayed submission of the necessary documentation (certificate stating fiscal residence in Luxembourg and absence of any permanent establishment (hereinafter "PE")). ITW IT thus asked the Provincial Tax Commission of Turin to apply the reduced tax treaty rate of 10 percent as the deadline was only imposed and provided by treasury regulations and was not included in any statutory provision (domestic or conventional).

ITW IT asked the Provincial Tax Commission of Turin to declare the notices of deficiency void for being groundless and/or lack of evidence. Alternatively, to apply the lower withholding rate of 5 percent provided by the tax treaty between Italy and Germany. Had the ITW DE not been recognized as the beneficial owner of the royalties, petitioner asked to apply the higher withholding rate of 10 percent provided by the tax treaty between Italy and the U.S.[15]

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[14] See L. Banfi & F. Mantegazza, An Update on the Concept of Beneficial Ownership from an Italian Perspective, 52 Eur. Taxn. 2/3 (2012), Journals IBFD, 'Italian tax law does not provide a comprehensive, generally applicable, definition of a "beneficial owner." A specific beneficial ownership definition was introduced in the Italian tax law upon implementation of the Interest and Royalties Directive (2003). The provision stipulates that a company may be regarded as the beneficial owner of the income if it receives the payment, "as final beneficiary and not as an intermediary, such as an agent, trustee or authorised signatory, for some other person.'

[15] Italy – United States Income Tax Treaty (1984), Art. 12, 'Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial

First-tier judgment

The case was heard before the Provincial Tax Commission of Turin on January 12th, 2010.

The question was whether ITW DE was the beneficial owner of the royalties and whether the requirements to enjoy the application of the most favored regime provided by the treaty between Italy and Germany were fulfilled. More generally, the question was whether the double tax treaty between Italy and Germany had been abused by the interposition of a conduit company such as ITW DE as it did not only provide for a more favorable regime on royalties taxation compared to the Italian domestic one provided by Art. 25(4) of Presidential Decree no. 600/73 but also compared to that provided by the treaty between and Italy and U.S., residence country of the company, which, according to the tax authorities, was the real beneficial owner.

The Provincial Tax Commission of Turin noted that the concept of beneficial ownership had been included in the passive income articles of the OECD Model since 1977 without positively explicating its meaning. As such, the Provincial Tax Commission of Turin believed to share the "negative" definition given by scholars, according to which, in addition to agents and nominees, any other *conduit* person, whose powers in relation to the relevant item of income are so limited to render them a mere fiduciary or administrator on behalf of third parties, is excluded from the notion of beneficial owners. As a consequence, for purposes of recognizing the status of beneficial owner the mere legal / formal ownership of the income as well as the attribution to the recipient for tax purposes is not sufficient. It is also necessary that the recipient has the actual and concrete availability of that income, i.e. the power to economically dispose of it according to their wishes.

The Provincial Tax Commission also noted that the tax treaty rate of 5 percent constitutes an exception to the ordinary domestic regime and, as such, the burden of proof in relation to the existence of its prerequisites lies upon the taxpayer. In this regard, petitioner submitted three documents in order to demonstrate that tax authorities erroneously qualified ITW DE as a conduit company: (i) a certificate issued by the German tax authorities stating that ITW DE had been fiscally resident in Germany from 2002 to 2006 and recognized the Italian source royalties as revenue in its financial statements and thus was the real beneficial owner; (ii) an official letter dated July 25th 2007 from ITW DE stating that the latter was operative and owned the royalties it

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owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed: (a) 5 percent of the gross amount of the royalties in respect of payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work; (b) 8% of the gross amount of the royalties in respect of payments of any kind received as a consideration for the use of, or the right to use, motion pictures and films, tapes or other means of reproduction used for radio or television broadcasting; (c) 10% of the gross amount of the royalties in all other cases.
The case at hands concerns royalty payments occurred during the 2002-06 fiscal years when the old 1984 treaty was still in force. The 1984 treaty was replaced only on March 3rd, 2009 when the Italian Parliament approved the new Italy-U.S. income tax treaty, which had been signed on August 25th, 1999. The new treaty eliminates the tax for the use of any literary, artistic, or scientific copyright and reduces the rate to 5 percent for the use of computer software or industrial, commercial, or scientific equipment, and to 8 percent for all other royalty payments. See, Kristen Burmester, The New U.S.-Italy Treaty: A U.S. Perspective, *Diritto E Pratica Tributaria Internazionale*, August 2009, available at:
http://www.mondaq.com/unitedstates/x/86158/Corporate+Tax/The+New+USItaly+Treaty+A+US+Perspective See also, Art. 12(2) of the 1999 Italy-U.S. treaty.

received both legally and economically; and (iii) a statement from Deloitte & Touche according to which ITW DE, after replacing in 2002 the U.S. parent company in managing 40 sub-license agreements with EU group companies, entered into additional 60 new agreements with several EU companies and had received in the 2002-06 period EUR 277.5 million compared to EUR 228.3 million paid to its U.S. parent company, more than 80 percent, i.e. 82,27 percent; had a 610 square meter office and 11 employees to perform its licensee activities.

However, the Provincial Tax Commission held that those three documents could not be ranked as evidence as the first certificate – supposedly issued by the German tax authorities – was made of only two pages, both unnumbered, without a heading from which it could be inferred who the issuer was, with an illegible signature, thus lacking any necessary element as to the identification of the subject who issued it. The same held true for the letter issued by ITW DE as it was not supported by any other evidence.

The Provincial Tax Commission further noted that ITW DE's financial statements relating to the fiscal years under consideration (2002-3) were absent; there was no evidence as to the full availability of royalties received in those years; no functional analysis as to ITW DE's activities or its decision making process had been carried out.

For these reasons, the Provincial Tax Commission rejected the first argument raised by petitioner aiming at declaring notices of deficiency void for being groundless and/or lacking any supporting evidence. In addition, based on the fact that ITW DE was controlled by ITW US, (the real beneficial owner according to the tax authorities) and the economic transaction actually occurred between ITW IT and ITW U.S., art. 12 of the tax treaty between Italy and the U.S. should be applied in determining the withholding rate (10 percent) and not that of the tax treaty between Italy and Germany (5 percent).

Ultimately, the Provincial Tax Commission of Turin partially accepted the third argument raised by petitioner as it levied the withholding both on royalties paid to ITW DE and on interest paid to the Lux company CS at the rate of 10 percent (accepting petitioner's argument that the 12-month term to submit the residence certificate issued by Lux tax authorities was only imposed by a ministerial circular and was not included in any statutory or conventional provision).

Second-tier judgment

Both petitioner and respondent appealed the Provincial Tax Commission's decision (14/07/2010) before the Regional Tax Commission of Piedmont, which issued its decision no. 34 on June 20th, 2012.

On the one hand, petitioner complained that the Provincial Tax Commission of Turin disregarded ITW DE as beneficial owner. Instead the Provincial Tax Commission considered ITW DE a conduit company, i.e. a mere holding whose income was mainly passive lacking any economic substance.

On the other hand, tax authorities argued that the U.S. parent company was not the real beneficial owner of the royalties as, despite the fact it held the licenses for the right to use the intangibles, its functions were merely limited to that of an intermediary. Therefore, the domestic tax rate of 30

percent should be applied in lieu of the lower rate (10 percent) provided by art. 12 of the tax treaty between Italy and the U.S.

The Regional Tax Commission of Piedmont in its decision no. 34 of June 20th, 2012 made reference to artt. 10 and 11 of the double tax treaty between Italy and Germany and, in particular, to art. 9 of the Protocol, according to which, '*the recipient of the dividends, interest and royalties is the beneficial owner within the meaning of Articles 10, 11 and 12 if he is entitled to the right upon which the payments are based and the income derived therefrom is attributable to him under the tax laws of both States*.' Based on this wording, the Regional Tax Commission did not believe that ITW DE was acting as a conduit for ITW U.S. channeling income back to the residence country of its parent company. In addition, the Regional Tax Commission referred to two Ministerial Circulars (22/E of May 26th, 2011 and 32/E of July 8th, 2011) concerning the tax treatment of outbound dividends paid to EU resident companies, which clarified the requirements to benefit from the reduced withholding at source. According to these two Circulars, tax authorities should assess the fulfillment of all necessary requirements based on certificates showed by withholding agents (issued and validated by the tax authorities of the beneficial owner's residence country) and also through the activation of cross-border mutual assistance procedures by the relevant competent authorities provided by Directive 77/799/EEC. Thus, the Regional Tax Commission stated that any taxpayer should be able, without unduly administrative burdens, to prove the sound business reasons behind the acquisition, maintenance and establishment of a foreign corporation in order to overcome the presumption that such corporation is a wholly artificial arrangement. What this means in practice, according to the Regional Tax Commission, is that the Italian withholding agent can rely on the residence certificate issued and validated by the other contracting state as valid evidence in order to apply the reduced treaty rate. In the case at hands, petitioner provided the residence certificate issued by the German tax authorities, which undoubtedly had evidential value. Thus, the Regional Tax Commission rejected tax authorities' arguments and accepted those of petitioners. Accordingly, royalties paid to ITW DE were subject to 5 percent withholding tax at source.

On the other hand, the Regional Tax Commission also overturned the Provincial Tax Commission's decision regarding withholding on interest paid to the Lux company CS but, in this case, in favor of tax authorities. Indeed, at that time, petitioner did not have a certificate as to CS's fiscal residence in Luxembourg and absence of any PE in Italy as such certificate had only been issued by the relevant Lux competent authority on March 2nd 2007, i.e. two years after the deadline to submit form 770. According to the Regional Tax Commission, it is a generally recognized principle that who wants to enforce a right should prove its existence even though that obligation is not explicitly provided by a statutory provision. Consequently, the Regional Tax Commission held that interest paid to Lux company should be subject to 12,50 percent withholding tax at source.

ISC judgment

Thus, tax authorities proposed appeal against the Regional Tax Commission's decision before the ISC, which issued its decision no. 32840 on December 19th, 2018. One of the main arguments of the tax authorities was that the Regional Tax Commission omitted to verify whether ITW DE was the beneficial owner from a substantial perspective when it held that the residence certificate issued

by the German tax authorities had undoubtedly evidential value, ignoring completely a decisive document, i.e. Deloitte & Touche's statement, according to which only a minority share of the royalties remained subject to tax in Germany. Deloitte & Touche's statement showed that ITW DE was a mere sub-licensee of its U.S. parent company, with the exclusive aim to centralize trademark's ownership in Europe and, in turn, sub-license it to the various EU associated companies. ITW DE retained for its own benefit just 17,73 percent of the royalties received and transfer the rest of them to its U.S. parent company. Thus, ITW DE had a typical holding structure whose income was mainly passive and its core business was to sub-license to its EU sister companies the right to use intangible assets owned by the U.S. parent company. According to the tax authorities, if the Regional Tax Commission had better considered those elements, it should have concluded that ITW DE was not the beneficial owner of the royalties and the entire transaction resembled more an intermediary activity.

The ISC, after referring to art. 12(2) and (4)[16] of the Italy – Germany Income and Capital Tax Treaty (1989) and art. 9 of the Protocol, stated that, at the international level, the concept of beneficial owner has been elaborated to counteract those practices aimed at exploiting the self-restraint of taxing powers. In particular, the beneficial ownership's clause has been included, for the first time, in 1977, in the passive income articles of the OECD MTC and ever since in the various bilateral treaties signed by Italy.[17] This clause of the international tax regime aims at preventing taxpayers from improperly taking advantage of tax treaties through "treaty-shopping" practices whose purpose is to obtain treaty benefits in cases where taxpayers would not be entitled to or would be subject to a less generous tax treatment. As such, taxpayers may be entitled to treaty benefits only if subject to the taxing jurisdiction of the other contracting state and have the actual economic and juridical availability of the relevant item of income received. Otherwise, tax treaty benefits would be improperly shifted or double non-taxation would occur. Having said that, the ISC held that the logical/juridical reasoning behind the Regional Tax Commission's decision was weak and incomplete as did not take into consideration tax authorities' argument at all, according to which Deloitte & Touche's statement clearly demonstrated that ITW DE was not the beneficial owner of the royalties, but just a mere intermediary of its U.S. parent company, to which it transfers the bulk of royalties received from the various EU associated companies, leaving only a de-minimis amount (representing commission for the financial activity performed) subject to tax in Germany. In conclusion, had this factual circumstance been better appreciated and not completely disregarded, the Regional Tax Commission's decision making process would have probably been oriented otherwise. For those reasons, the ISC accepted tax authorities' arguments and remitted

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[16] Italy – Germany Income and Capital Tax Treaty (1989), Art. 12(4), 'The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films and films or tapes for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.'

[17] The ISC referred to its previous case law (no. 25281 of December 16th, 2015) on the compatibility of controlled foreign company (CFC) rules with EU law and tax treaties. For a comment, see F. Avella & V. Mollica, Italian Supreme Court Holds that CFC Rules Are Compatible with EU Law and Tax Treaties, 56 Eur. Taxn. 7 (2016), Journals IBFD.

the case back to the Regional Tax Commission of Piedmont (different composition) to decide its merits.

Comments

The facts and circumstances of this case are particularly helpful to the extent they shed some light and provide some guidance on the definition of beneficial owner. In the author's opinion, the ISC seems to have taken a closer look at the "economics" of the transaction focusing on a "decisive" document, which had been left out in the Regional Tax Commission's reasoning, i.e. Deloitte & Touche's statement. From the ISC's decision it could be inferred that ITW DE did not have an appropriate organizational structure and was unable to assume the managing risk of EU sub-license activity. Are 11 employees and offices of 610 square meter sufficient to manage almost 100 sub-license agreements in the EU, which in the four-year period from 2002 to 2006 generated 277,5 million of royalties? Could it be argued that ITW DE was acting autonomously from ITW Finance LLC? Apparently not. But the most important aspect taken into consideration by the ISC seems to be the amount of royalties remitted back to the U.S., which almost wiped-out entirely taxable income in Germany. Indeed, ITW DE distributed back to ITW Finance LLC more than 80 percent of the royalties received, retaining only 17,73 percent as a commission.

Should Italy give up its power to tax in this situation? A numerical example can be helpful. Suppose that the Italian Sub in 2002 had gross pre-tax profits of EUR 100 and is required to pay EUR 30 to ITW DE as royalty for the right to use intangible assets. Net taxable income is thus 70, to which the .36 statutory corporate income tax rate applies. The Italian Sub remits then EUR 25,2 to the Italian Government as corporate income tax. Upon the distribution of royalties to ITW DE a .05 WHT is further levied = EUR 1,5. Let us assume that ITW DE's only income is just EUR 30 of Italian source royalties and is constrained by a contractual or legal obligation to pass 80 percent of the royalties received to ITW Finance LLC, thus EUR 24. The net taxable income in Germany would then be EUR 30 – 24 = 6 upon which the .25 statutory corporate income tax applies. ITW DE remits then EUR 1,5 to German government but has EUR 1,5 of foreign tax credit for wht levied by Italy on the outbound royalty distribution to Germany. The net German tax liability would then be 0. Moreover, the further outbound distribution of royalties to ITW Finance LLC is exempt from source taxation, thus no wht will be levied upon the remittance of EUR 24 to the U.S., according to Art. 12(1) of the Germany – United States Income and Capital Tax Treaty (1989).[18] For purposes of applying the treaty wht rate of .05 should Italy take into consideration the nil or de-minimis taxation of royalties in Germany due to the contractual obligation to pass the bulk of them to the U.S.? Yes. Although it is the author's opinion that Italy should not apply its domestic tax rate of 30 percent on the 75% of EUR 30, i.e. EUR 6,75. In this case, as it is clear that ITW U.S. is the beneficial owner of the royalties, as legal and economic owner of the intangible assets, in the author's opinion the .1 wht rate provided by the Italy – U.S. treaty should be applied, i.e. EUR 3. In the author's opinion, this case example shows how the tax base in Germany is so depleted, even without reliance on preferential measures, but through an excessive back-to-back

[18] Germany – United States Income and Capital Tax Treaty (1989), Art. 12(1), 'Royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State.'

royalty payment to the U.S., that the Italy – Germany convention can be said to be improperly employed.[19]

Should Italy find this situation undesirable from a policy perspective, it could renegotiate the Italy – Germany Income and Capital Tax Treaty (1989) and insert a specific provision relating to conduit companies along the lines of Article 23 of the German-Swiss tax treaty (1971), according to which, 'A company which is a resident of a Contracting State (Germany), and in which persons who are not residents of that State (U.S.) have, directly or indirectly, a substantial interest in the form of a participation, or otherwise, may only claim the tax reductions provided for in Articles 10 through 12 with respect to dividends, interest, and royalties, derived from sources in the other State (Italy), as provided for in Articles 10 through 12, where: ... (c) *Not more than 50 per cent* of the relevant income derived from sources in the other Contracting State (Italy) is used to satisfy claims (interest, royalties, development, advertising, initial and travel expenses, depreciation on any kind of business asset including on immaterial goods, processes, etc.) by non-residents (U.S.) of the first-mentioned State (Germany).[20] Based on this treaty article as more than 80 percent of the royalties derived from sources in Italy was used to satisfy claims by U.S. residents, the German company should not be entitled to the tax reductions provided for in Art. 12 of the Italy – Germany

[19] See OECD WP No. 1 of the Committee on Fiscal Affairs on Double Taxation, DAF/CFA/WP1/79.9, Paris, September 11th, 1979, Working Group No. 21, 'The Improper Use and Abuse of Tax Conventions,' para. 37, at p. 15.
[20] Art. 23 of the Germany – Switzerland Income and Capital Tax Treaty (1971).

tax treaty. A similar treaty clause can be found in art. 23 of the Swiss treaty with Italy[21] and, finally, in art. 14 of the Swiss treaty with France[22] and art. 22 of the Swiss treaty with Belgium.[23]

Historically, these treaty provisions were the result of the considerable political pressure that Switzerland was subject to in the early sixties by high-tax jurisdictions, such as France, Germany and the United States,[24] which were concerned that Switzerland was somehow encouraging tax

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[21] Art. 23 of the Italy – Switzerland Income and Capital Tax Treaty (1976) (as amended through 2015). This article's wording is almost identical to its corresponding one of the Swiss treaty with Germany, the few exceptions being the definition of normal interest rate which, in art. 23 of the Swiss treaty with Italy, means, 'in Italy: the legal rate of interest plus *three* percentage points; in Switzerland: the average interest rate on debentures issued by the Swiss Confederation plus two percentage points. On the other hand, in art. 23 of the Swiss treaty with Germany, the normal interest rate means with respect to the Federal Republic of Germany: the rate of the current yield of interest-bearing securities from inland issuers plus *two* percentage points.' The second and last difference is the addition of para. 4 to Art. 23 of the Swiss treaty with Italy, according to which, 'The supervision, investigation and corroboration necessitated by the application of paragraphs 1 and 2 shall be carried out by the competent authorities of the Contracting State in which the recipient of the relevant income is resident.'

[22] Art. 14 of the France – Switzerland Income and Capital Tax Treaty (1966) (as amended through 2014). This treaty provision is unique compared to the other three, not only because is shorter (only three paragraphs compared to the usual five) but also because its bona fide provision of para. 2(ii) resembles what the OECD was referring to as, '*Alternative relief provision*,' which, in the author's opinion, is the predecessor to '*derivative benefits test*' included in current LOBs: 'The provisions of paragraph 1 of this Article shall not apply where the person who claims the benefits of the Convention demonstrates that the operations in question were not primarily designed to take advantage of this Convention. This condition shall be assumed to be satisfied where the item of income would be subject to a *treatment* under the Convention which is *similar or more favorable* had it been directly received by the person to whom it is transferred.' Compare it to para. 42(v) of the OECD Committee on Fiscal Affairs, DAFFE/CFA/83.3, Paris, May 27th, 1983, The Improper Use of Tax Conventions through "Conduit Companies" by Persons not Entitled to their Benefits, at p. 18, 'In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that such expression "shall not be deemed to included residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation *not less* than the relief from taxation claimed under this Convention.' Finally, Art. 14(2)(i) states that this condition is also satisfied where the item of income is transferred by the resident of a Contracting State to any person or entity which is not associated to it. Thus excluding payments to unrelated parties from being counted toward the excessiveness of the 50 percent figure, implicitly assuming that those payments are more likely to involve normal and genuine business transactions. See OECD WP No. 1 of the Committee on Fiscal Affairs on Double Taxation, DAF/CFA/WP1/79.9, Paris, September 11th, 1979, Working Group No. 21, 'The Improper Use and Abuse of Tax Conventions,' para. 39, at p. 16, 'A third difficulty concerns whether any payment in satisfaction of claims should be counted toward the "excessiveness" figure; or whether, instead, only payments to related parties should be counted. Arguably, *cases of payments to unrelated parties not otherwise entitled to the benefits of a convention are less likely to involve abuse cases, and more likely to involve cases of legitimate international business transactions, than are cases where the payments to non-entitled persons are to related parties.*'

[23] Art. 22 of the Belgium – Switzerland Income and Capital Tax Treaty (1978) titled 'Prevention of abuse of the Convention.'

[24] See Alan R. Rado, Switzerland establishes new measures to prevent tax haven abuses, The Journal of Taxation, April 1963, at pp. 222 – 223, 'In recent years, Switzerland became one of the most popular European countries for establishing so-called base companies. This fact, for instance, was repeatedly pointed out by Treasury Secretary Dillon when he testified in support of the President's tax proposals leading to the enactment of the Revenue Act of 1962. From one of the numerous exhibits presented by him, it appears that as of March 1, 1961 there were more than 500 U.S.-owned corporations in Switzerland, out of which 170 were organized in the period between March 31, 1960 and March 31, 1961. The Swiss Federal Tax Administration has watched with growing apprehension the great number of Swiss corporations controlled by foreign capital. No wonder then that it has been considering

evasion through the use of conduit companies aimed at taking advantage of both low or non-existent taxation at the cantonal level and the benefits deriving from the network of conventions concluded by Switzerland. Thus, on the one hand, Switzerland thought it desirable to take steps to protect its partners and enacted unilateral measures aimed at limiting the improper use of treaties, i.e., the Decree of the Swiss Federal Council of December 14th, 1962, implemented by the Administrative Circular of the Federal Tax Administration of December 31st, 1962. The underlying purpose of this domestic anti-abuse legislation was to prevent persons not entitled to the benefits of a tax convention to benefit, directly or indirectly, from a reduction of, or exemption from, taxes in another State (source State) provided by a tax convention concluded between Switzerland (residence State of the conduit company) and the source State. Therefore, a Swiss company which acted as a conduit company through which the income in question flowed to persons not entitled to the benefits of a tax convention, as well as a foreign owned company which did not distribute an appropriate portion of the income in question to the shareholders, were excluded from reliefs from foreign taxes on such income.

On the other hand, on the impulse of the U.S.[25] and German Delegates,[26] the general principles included in the Swiss Abuse Decree were also implemented at the treaty level through bilateral negotiations. According to the report prepared by the U.S. Delegate and submitted to the OECD WP No. 1 for consideration at its meeting on September 25th-28th, 1979 those treaty provisions are aimed generally at "*unjustified*" claims to the benefits of double taxation conventions. An "*unjustified claim*" or a "*claim without legitimate cause*" arises when the benefits of a relief from tax of source *inure,* directly or indirectly, to the substantial benefit of persons not in their own right entitled to the benefits of a convention. The benefits of a convention are deemed to inure to the substantial benefit of persons not otherwise entitled to the benefits of the convention in four different cases: (i) an *excessive proportion* of the treaty income is used to satisfy claims of nonentitled persons; (ii) the benefited amounts inure to the benefit of a Swiss corporation in which nonentitled persons hold a substantial interest, and where the recipient does not distribute a minimum amount of its income, thereby exploiting opportunities created by Swiss law to avoid a tax on accumulated profits by accumulating income and distributing it upon liquidation from assets

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appropriate measures to insure that the great number of foreign-owned Swiss holding and domiciliary companies will not "abuse" the Swiss tax conventions.'

[25] Paris, February 13th, 1963, FC/M (63)2, OECD Fiscal Committee, Minutes of the 8th Session held at Chateau de la Muette, Paris on Tuesday 22nd, Wednesday 23rd, Thursday 24th, and Friday 25th January, 1963, at p. 3, 'The Delegate for the United States thought that a bilateral solution was necessary because, in the case of abuse, the Contracting State which had relinquished its right to tax in the Convention should be able to levy its tax.'

[26] Paris, March 28th, 1963, FC/M (63)3, Part I, OECD Fiscal Committee, Minutes of the 9th Session held at Chateau de la Muette, Paris on Tuesday 12th, Wednesday 13th, Thursday 14th and Friday 15th March 1963, at p. 4, 'The Delegate for Germany stressed the difficulty of defining and establishing abuses of the conventions and thought it would be necessary to envisage a system of reciprocal assistance and information to prevent such abuse. *He wondered, moreover, if it would not be necessary to insert a clause in the conventions to the effect that none of their provisions prevented a Contracting State from applying internal measures to counteract abuse of the conventions, such as those introduced by Switzerland under the Federal Council Order of* 14th *December*, 1962.' That is probably the reason why the following paragraph, 'Additional measures already taken, or to be taken by one of the Contracting States, against abuse of the use of tax relief relating to withholding tax levied at source in the other Contracting State, are not prejudiced hereby,' was included in Art. 23(1) of the German treaty with Switzerland.

not subject to taxation in Switzerland; (iii) the income inures to the benefits of a fiduciary, holding property or income for the benefit of a nonentitled person; or (iv) the income inures to the benefit of a family foundation founded by, or established for the benefit of, persons not otherwise entitled to the convention.

In case Italy wants to go down this road and decides to renegotiate the treaty with Germany and include a similar provision, there are however two fundamental issues. Firstly, what proportion of benefited income should be considered "*excessive*?" In other words, where should the threshold be set in order to disallow treaty benefits? In the author's opinion, a mere numerical figure is arbitrary because on the one hand, a lower figure may deny benefits to legitimate transactions while, on the other hand a higher figure might create too many abuse cases.[27] Secondly, as argued by Ryser,[28] a brutal and blind use of a percentage criterion without regard to *economic realities*, without any possibility of bringing counter-evidence of the *absence of abuse*, is difficult to accept and infringes fundamental principles of the administration of justice in a state subject to the *rule of law*.

Therefore, while the so-called "*channel*" approach adopted by those treaty provisions appears to be the most effective in counteracting *stepping-stone* strategies or cases where income is merely transmitted through conduit companies with a view to minimizing taxes, in 1983 the OECD thought it necessary to supplement it by a bona fide clause, as it may cover normal and genuine business activities.[29] The OECD Committee suggested five different bona fide provisions which, in the author's opinion, resemble the safe harbors provided by U.S. Limitation on Benefits Tests. Indeed, the first bona fide provision at para. 42(i) titled '*general bona fide provision*' lays in an area between the *discretionary determination* and the *principal purpose* test proposed by BEPS action item no. 6, 'The foregoing provisions do not apply where the company establishes that the *principal purpose* of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by *sound business reasons* and thus do not have as *primary purpose* the obtaining of any such benefits.'[30] In addition, in order to avoid the denial of treaty benefits solely because the

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[27] The U.S. – Netherlands tax treaty is very generous as provides an high threshold when defining conduit company, see Art. 26(8)(m), '... the term "conduit company" means a company that makes payments of interest, royalties and any other payments included in the definition of deductible payments ... in a taxable year in an amount *equal to or greater than 90 percent* of its aggregate receipts of such item's during the same taxable year.'
[28] See Walter Ryser (Switzerland) in Ellis, Maarten J. [et al.] Recourse to tax havens: use and abuse, IFA congress seminar series; Vol. 5, Proceedings of a seminar held in Paris in 1980 during the 34th congress of the International Fiscal Association, Kluwer Law and Taxation, at pp. 131 and 133 – 134.
[29] See OECD Committee on Fiscal Affairs, DAFFE/CFA/83.3, Paris, May 27th, 1983, The Improper Use of Tax Conventions through "Conduit Companies" by Persons not Entitled to their Benefits, at pp. 17 – 18, para. 42.
[30] See OECD Committee on Fiscal Affairs, DAFFE/CFA/83.3, Paris, May 27th, 1983, The Improper Use of Tax Conventions through "Conduit Companies" by Persons not Entitled to their Benefits, at p. 18, para. 42(i). Compare it to Art. 26(7), Netherlands – United States Income Tax Treaty (1992) (as amended through 2004), 'A person resident of one of the States, who is not entitled to some or all of the benefits of this Convention because of the foregoing paragraphs, may, nevertheless, be granted benefits of this Convention if the competent authority of the State in which the income in question arises so determines. If making such determination, the competent authority shall take into account as its guidelines whether the establishment, acquisition or maintenance of such person or the conduct of its operations has or had as *one of its principal purposes* the obtaining of benefits under this

intermediary company engages in a disproportionate and excessive back-to-back payment out of its residence country, Italy may alternatively supplement this "*channel*" provision with an "*activity provision*," the predecessor to the current *active trade or business* test, which reads as follows, 'The foregoing provisions shall not apply where the company is engaged in *substantive business operations* in the Contracting State of which it is a resident (Germany) and the relief from taxation claimed from the other Contracting State (Italy) is with respect to income which is connected with such operations.'[31]

Conclusions

ITW IT's case decided by the ISC on December 19th, 2018, resembles to some extent the famous 1996 U.S. Tax Court case, involving the Dutch company SDI. The SDI case involved three related entities: SDI Bermuda, SDI Netherlands, and SDI USA. The only differences are that in the SDI case, the resident country of the parent company, Bermuda, does not have a treaty with the U.S., while in the ITW case, the resident country of the parent company, U.S. does have a treaty with Italy providing for 10 percent withholding tax on royalty. On the other hand, in the SDI case, the treaty between the resident country of the intermediary Dutch company and source country (the U.S.-Netherlands tax treaty) provides for zero withholding, while in the ITW case, the treaty between the resident country of the intermediary Germany company and source country (the Italy-Germany tax treaty) provides for 5 percent withholding tax. SDI Bermuda licensed software to SDI Netherlands, which then licensed it to its wholly owned U.S. subsidiary and the rest of the world. Royalties were thus paid at 6 percent from the U.S. to The Netherlands and at 5.5 percent from The Netherlands to Bermuda.[32] The U.S. to Netherlands royalty was not subject to tax by virtue of Art. 13 of the U.S.-Netherlands tax treaty.[33] As to the character of the royalty paid by

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Convention. The competent authority of the State in which the income arises will consult with the competent authority of the other State before denying benefits of the Convention under this paragraph.'

[31] See OECD Committee on Fiscal Affairs, DAFFE/CFA/83.3, Paris, May 27th, 1983, The Improper Use of Tax Conventions through "Conduit Companies" by Persons not Entitled to their Benefits, at p. 18, para. 42(ii). Compare it to Art. 26(4)(a) of the Netherlands – United States Income Tax Treaty (1992) (as amended through 2004), 'Notwithstanding that a resident of a State may not be a qualified person, it shall be entitled to all the benefits of this Convention otherwise accorded to residents of a State with respect to an item of income derived from the other State, if the resident is engaged in the *active conduct of a trade or business* in the first-mentioned State (other than the activities of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities dealing carried on by a bank, insurance company or registered securities dealer), the income derived from the other State is derived in connection with, or is incidental to, that trade or business and that resident satisfied any other specified conditions for the obtaining of such benefits.'

[32] The Bermuda license agreement fixed royalties payable to SDI Bermuda by SDI Netherlands at ninety-three percent of the net amount of all royalties due to SDI Netherlands by all sublicensees after the deduction of the withholding tax on royalties. SDI Netherlands licensed the exclusive rights to use and licensing of the software within the United States to SDI USA in return for annual royalty of fifty percent of the gross billable or invoiced revenues of SDI USA. During the years in dispute, SDI Netherlands paid ninety-three to ninety-six percent of its royalties from SDI USA to SDI Bermuda in accordance with the Bermuda license agreement. See, Michael W. King, Royalty Payments from U.S. Source to Foreign Corporation Did Not Retain Character: SDI Netherlands v. Commissioner, 50 Tax Law. 863 (1997), at p. 864. As above mentioned, the amount paid back by ITW DE to its U.S. parent company was lower, i.e. 82,27 percent of all royalties received from the various EU sublicensee companies.

[33] United States – Netherlands Income Tax Treaty (1992) (as amended through 2004), Art. 13, 'Royalties arising in one of the States and beneficially owned by a resident of the other State shall be taxable only in that other State.'

SDI Netherlands to its parent licensor SDI Bermuda, the IRS, supported by Rev. Rul. 80-362, argued that royalties were sourced at the location of use. Thus, according to the IRS, as the place of use was in the U.S. because the software was being used there, the royalty income from SDI Netherlands to SDI Bermuda represented U.S. source income and should be subject to withholding tax there.

The Tax Court disagreed with the IRS. The Court found that SDI Netherlands was not a conduit company as to the royalty payments between itself and its Bermuda parent company based on two "questionable" arguments. Firstly, the Court found that the Netherlands-Bermuda royalty also included royalties from countries other than the U.S. and refused to calculate how much of this royalty came from SDI USA.[34] The Court's second argument, the so-called 'cascading royalty problem,' was, according the some scholars,[35] the most important. Assuming no income tax treaty was in force between the U.S. and The Netherlands, accepting IRS's argument would have led to multiple withholding taxes being paid throughout the group chain, wiping out entirely all royalties generated.[36]

Most tax practitioners, experts and scholars agree that the position of the IRS was well founded and was correct[37] in using the substantive rule of sections 861(a)(4) and 862(a)(4) as well as Rev. Rul. 80-362, which is restated in example 11[38] of treasury regulations 1.881-3(e) and Art. 12(8) of

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[34] Even if X [SDI Netherlands] had not received any royalties but had used the licensed U.S. intangible to manufacture and sell the product, an unrelated person who had licensed only the U.S. rights would certainly have determined how much of X's income was attributable to that license. Public corporations like GE and IBM do this both internally and in their financial statements. See Charles I Kingson, The Source of Royalty Income, Tax Notes, May 5, 2008, 499 – 500, footnote no. 5.

[35] Reuven S. Avi-Yonah, International Tax as International Law, An Analysis of the International Tax Regime, Cambridge Tax Law Series, (2007), at pp. 46 – 47, 73, and 172 – 173.

[36] SDI Netherlands argued ... that application of Revenue Ruling 80-362 would lead to "absurd consequences" that would not be consistent with congressional intent. Specifically, SDI Netherlands posited that under the ruling, a chain of licenses and sublicenses between several foreign persons of the right to use property within the United States would lead to U.S. tax on the gross royalty payment at each step in the chain. Indeed, SDI Netherlands claimed that with enough sublicenses, the total U.S. tax imposed could exceed one-hundred percent of the gross royalties generated. See, Michael W. King, Royalty Payments from U.S. Source to Foreign Corporation Did Not Retain Character: SDI Netherlands v. Commissioner, 50 Tax Law. 863 (1997), at pp. 864 – 865.

[37] For example, Sidney Roberts told Charles Kingson that he had had correspondence with his law school's colleague Judge Tannenwald complaining about his arguments in SDI, which accepted the Norther Indiana decision (Northern Indiana Public Service Co. v. Commissioner, 115 F.3d 506, Doc 97-16951, 97 TNT 111-17 (7th Cir. 1997). See Charles I. Kingson, The Source of Royalty Income, Tax Notes, May 5, 2008, at p. 499, footnote no. 4.

[38] Treas. Regs. § 1.881-3(e), 'Example 11. Reduction of tax. (i) On January 1, 1995, FP licenses to FS the rights to use a patent in the United States to manufacture product A. FS agrees to pay FP a fixed amount in royalties each year under the license. On January 1, 1996, FS sublicenses to DS the rights to use the patent in the United States. Under the sublicense, DS agrees to pay FS royalties based upon the units of product A manufactured by DS each year. Although the formula for computing the amount of royalties paid by DS to FS differs from the formula for computing the amount of royalties paid by FS to FP, each represents an arm's length rate. (ii) Although the royalties paid by DS to FS are exempt from U.S. withholding tax, the royalty payments between FS and FP are income from U.S. sources under section 861(a)(4) subject to the 30 percent gross tax imposed by § 1.881-2(b) and subject to withholding under § 1.1441-2(a).'

the Canada-U.S. tax treaty.[39] Indeed, the IRS was just seeking to enforce one level of withholding tax, in other words, applying the single tax principle where royalties were deductible at source and exempt at residence.

The same purpose can be said to be behind ISC decision no. 32840, which implicitly and indirectly, based on Deloitte's statement, prescribes taxpayers how to structure their intermediary as to the level of business activity (and the amount of earnings) it should engage in order to get treaty benefits and avoid falling under the conduit treatment.

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[39] Canada – United States Income and Capital Tax Treaty (1980) (as amended through 2007), Art. 12(8), 'Where a resident of a Contracting State pays royalties to a person other than a resident of the other Contracting State, that other State may not impose any tax on such royalties except insofar as they arise in that other State or insofar as the right or property in respect of which the royalties are paid is effectively connected with a permanent establishment situated in that other State.'

Present at the Creation:

Archival research and evidence on the origins of the Single tax principle

Gianluca Mazzoni*

1. Introduction

Since 1997, Avi-Yonah has argued that the core of the 'international tax regime' (hereinafter: "ITR") is two norms, which he calls the *benefits principle*, i.e. active business income should be taxed primarily at source, while passive investment income primarily at residence, and the *single tax principle* (hereinafter: "STP"), i.e. cross-border income should be taxed once – that is not more and but also not less than once.[40] What this means in practice is that if the jurisdiction that has the primary right to tax refrains from doing so, the other jurisdiction should tax instead to prevent double non-taxation. This thesis has been quite controversial. While most commentators would agree that the benefits principle is clearly embodied in the text of the over 3,000 tax treaties, several prominent international tax academics and practitioners in the US and elsewhere deny the validity of the STP and some doubt its coherence.[41]

The aim of this article is not to re-affirm the validity of the STP or dispel any doubts regarding its consistency, but rather to identify with relative certainty its origins. The purpose is to give a systematic and historical interpretation of the STP by looking at the context during which it was purportedly invented. The scope of this article is limited to two dimensions of the STP: First, its original theoretical acknowledgment at international level, which is contained in the commentary to the draft of the first League of Nations model tax treaty of 1927; and second, its original practical implementation at both the cross-border and the domestic levels. In this regard, the author will focus on Thomas Adams' failed attempt to actually implement the STP at the international level by assigning the right to tax interest from securities exempt from tax at source to the creditor's country domicile. While recent scholarship shows that Stanley Surrey implemented the STP in the early sixties with the enactment of the first controlled foreign corporation (CFC) legislation and the introduction of predecessor provisions to Limitation on Benefits articles (hereinafter: "LOB")[42]

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[40] R.S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 Tax L. Rev. 507 (1997), 517-523. See more recently, R.S. Avi-Yonah , *Who Invented the Single Tax Principle?: An Essay on the History of US Treaty Policy,* 59 N.Y.L. Sch. L. Rev. 2 (2015), 305-315.

[41] On this position see, e.g., H. D. Rosenbloom, *International Tax Arbitrage and the "International Tax System",* 53 Tax L. Rev. 137 (2000); M. J. Graetz, *Taxing International Income - Inadequate Principles, Outdated Concepts, and Untasatisfactory Policy,* 54 Tax L. Rev. 261 (2001); J. Roin, *Taxation Without Coordination,* 31 The Journal of Legal Studies S1 (2002),; M. A. Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage,* 53 Emory L.J. 89 (2004); A. H. Rosenzweig, *Harnessing the Costs of International Tax Arbitrage,* 26 Va. Tax Rev. 555 (2006). For the contrary position see, e.g., R. S. Avi-Yonah, *Commentary on Rosenbloom*, 53 Tax L. Rev. 167 (2000); Y. Brauner, *An International Tax Regime in Crystallization*, 56 Tax L. Rev. 259 (2002); F. B. Brown, *An Equity-Based, Multilateral Approach for Sourcing Income Among Nations*, 11 Fla. Tax Rev. 565 (2001); E. Farah, *Mandatory Arbitration of International Tax Disputes: A Solution in Search of a Problem,* 9 Fla. Tax Rev. 757 (2008); V. Thuronyi, International Tax Cooperation and a Multilateral Treaty, 26 Brooklyn J. Int'l L. 1641 (2000).

[42] Back then those provisions were commonly referred to as investment and holding companies articles. See, N. Fishbien From Switzerland with Love: Surrey's Papers and the Original Intent(s) of Subpart-F, 38 Virginia Tax Review, 1 (2018), p. 1.

in the treaties with Luxembourg and the Netherlands Antilles, in this article the author argues that Thomas Adams was the first person who tried to practically implement the STP at both cross-border and the domestic level. Indeed, his goal when he proposed the foreign tax credit in 1918 was actually (as argued by other scholars as well) the prevention of double non-taxation.[43]

This article draws extensively on unpublished archival material of the League of Nations and on published writings of one of the main architects of both U.S. international tax rules and the ITR, Thomas Adams. The purpose is to contextualize and provide an historical background for the STP by guiding the readers through the unpublished minutes of the League of Nations.

This article is divided in four parts. Part II seeks to identify who actually drafted the third sentence of the first paragraph of the commentary to the 1927 draft model convention, usually quoted by Avi-Yonah as the original theoretical acknowledgment of the STP at international level.[44] Part III argues that Adams attempted to implement the STP, also at the international level, when he proposed amendments to the 1927 draft treaty, which would have allowed for residence-based taxation in case of tax-exempt bonds (the original practical implementation of the STP at the cross-border level). Part IV argues that the STP was the underlying idea when Adams proposed (and Congress adopted) the foreign tax credit in 1918, limited the personal exemption allowable to foreigners investing in the US in 1921, and made some recommendations concerning state inheritance taxation of intangible property transfers by nonresidents in 1932 (the original practical implementation of the STP at the domestic level). Part V concludes.

2. The single tax principle theorized at the international level: The Minutes of Meetings on the draft bilateral convention on administrative assistance.

In order to justify the existence of the STP, Avi-Yonah usually quotes the following excerpt from the commentary to the draft of the first League of Nations model tax treaty of 1927:

From the very outset, the Committee realized the necessity of dealing with the questions of tax evasion and double taxation in co-ordination with each other. It is highly desirable that States should come to an agreement with a view of ensuring that a taxpayer shall not be taxed on the same income by a number of different countries, and it seems equally desirable that such international co-operation should prevent certain incomes from escaping taxation altogether. *The most elementary and undisputed principles of fiscal justice, therefore, required that the experts should devise a scheme whereby all incomes would be taxed once and once only.*' (emphasis added).[45]

To the author's knowledge, none has ever asked themselves before who actually drafted that last sentence or where it originates from. This first section of this article intends to answer those questions by analyzing the minutes of the League of Nations meetings.

[43] See *supra* n. 1, at p. 309.
[44] See *supra* n. 1, at p. 310.
[45] See, League of Nations, Financial Committee, *Committee of Technical Experts on Double Taxation and Tax Evasion Report,* Doc. C. 216. M. 85, (12 April 1927), at p. 23.

On 18 May 1926 at 3:30pm, during the fourth meeting held at Geneva of the Committee of double taxation and fiscal evasion,[46] chaired by Mr. d'Aroma (Italy), it was decided to set up the following three Sub-Committees: A, B, and C. Sub-Committee A would study the question of double taxation and would prepare a draft model of international conventions on the basis of Dr. Dorn's (Germany) and Mr. Clavier's (Belgium) proposals. Sub-Committee B would study the question of legal assistance. Finally, Sub-Committee C would study the question of fiscal and administrative evasion. It was composed of the following four members: Mr. Blau (Switzerland); Mr. Borduge (France); Mr. Van der Waals (Netherlands) and Mr. Zaleski (Poland).

The following day, on 19 May 1926, d'Aroma started the fifth meeting[47] by explaining that the seven experts – those who drafted the 1925 Report – had examined the question of fiscal evasion from two angles: the point of view of the basis of taxation, i.e. the information required for tax assessment and the collection of taxes, and providing administrative and judicial assistance to the other state for the recovery of taxes. After a long discussion, the seven experts had agreed on resolutions which resulted in a compromise between the different perspectives of the parties in the Committee. D'Aroma then read paragraph I of the resolution on tax evasion according to which, 'Unlike double taxation, in connection with which any problems arising between two States can be settled appropriately by means of bilateral conventions, the question of tax evasion can only be solved in a satisfactory manner if the international agreements on this matter are adhered to by most of the States and if they are concluded simultaneously. Otherwise, the interests of the minority of States, which would alone have signed the conventions, might be seriously prejudiced.' In this regard, d'Aroma recalled the fact that during the morning meeting Sub-Committee C had investigated whether it was possible to simultaneously conclude international conventions on tax evasion. Professor Zaleski, as a new member of the Committee, gave his own personal perspective on the topic of tax evasion. He entirely agreed with the underlying purpose which had led the seven experts to recommend measures aiming at, '... prevent[ing] honest men from paying the taxes of those who shirked their fiscal duties.' In particular, he agreed with the seven experts on the following two points: (i) the close connection existing between the two problems of tax evasion and double taxation; and (ii) the necessity of simultaneous conclusion of international agreements on tax evasion by most States. However, he was skeptical regarding this last point. He did not believe it was possible at that time to draft efficient measures for curbing tax evasion primarily for two reasons: (i) it would have been politically difficult to persuade the great majority of States willing to sign on such conventions, and (ii) the risk of weakening the financial market and/or disorganizing the banking system had countries enforced a control mechanism on movable securities, deposits and current accounts. Finally, it should also be noted that the seven experts had themselves assigned little room within which a complete and effective convention on tax evasion could be drafted. Indeed, the third sentence included in paragraph II of the resolution on tax evasion stated that, 'Nevertheless, having regard to circumstances of different kinds, the experts recognize that this exchange should be limited actually to the information which is in the possession of States

[46] See, League of Nations, *Minutes of the Fourth Meeting of the Sixth Session of the Committee on Double Taxation and Fiscal Evasion,* D.T./6th Session/P.V.4.(1), (18 May 1926),pp. 1 – 2.
[47] See, League of Nations, *Minutes of the Fifth Meeting of the Sixth Session of the Committee on Double Taxation and Fiscal Evasion,* D.T./6th Session/P.V.5(1), (19 May 1926), pp. 1 – 2.

or which the States can obtain in the course of their fiscal administrations,'[48] thus removing from information to be supplied that concerning movable securities. Since the United States was, at that time, the only country which exercised an effective control over movable securities, it was clear that no country would enforce similar measures with the only effect of encouraging the flight of capital to other countries. In the author's opinion, Dr. Dorn (Germany) appeared to be the most pragmatic among those who attended the fifth meeting, since he recommended, as a first step to be taken, the conclusion of bilateral treaties limited to the exchange of information on request. That was indeed something easily achievable.

Mr. Clavier (Belgium) highlighted how the agreement in force between the Netherlands and Belgium provided for the exchange of information on income from immovable securities and mortgages. In his opinion, information regarding profits from industrial, commercial and agricultural undertakings could be supplied as well, since such information was already available to Treasury and did not violate any bank secrecy rules. The issue became more sensitive regarding information from movable securities. Clavier was of the opinion of rendering paragraph I of the resolution on tax evasion less categoric by inserting after the words '*the question of fiscal evasion can only be solved in a satisfactory manner*' the phrase '*at least as regards movable securities.*' For the other four classes of income, i.e. immovable property; mortgages; industrial, commercial or agricultural undertakings and earned income, including directors' fees, the conclusion of bilateral treaties would be enough. On the other hand, Mr. Borduge (France) raised the objection that in France the Treasury knew only the amount of directors' fees at the macro- rather than the micro-level, thus the total sum paid to directors and not the individual salary earned by each one of them. Clavier replied that in Belgium, on the contrary, the salary of each administrator had to be reflected in the accounting statements of any companies. Thus, nothing prevented Treasury from exchanging such information if necessary and based on reciprocity. Mr. Blau (Switzerland) did not share Clavier's view. In his opinion, the conclusion of *general* and *simultaneous* conventions was necessary also for the four remaining classes of income, otherwise taxpayers would invest their capital in countries which had not signed a bilateral convention.

Mr. Damste (Netherlands) agreed with Clavier. Since 1843, experience in both Belgium and the Netherlands showed that the investment in immovable property located in the two countries did not decrease to a remarkable extent as a result of the exchange of information on income derived from immovable property.

Mr. Yamaji (Japan) agreed with Dorn. Clavier believed it was just a question of drafting. He did not oppose the insertion of the phrase '*administrative and legal assistance*' at the beginning of the resolution on tax evasion, regarding assessment of tax. He agreed with what Damste had previously said. In his opinion, the reason why Dutch and Belgian taxpayers continued, despite the exchange of information, to invest in immovable property situated in the two countries was the need for any taxpayers to supervise the underlying investment. Therefore, Blau's concerns were groundless. Blau actually realized that the issue for immovable property and mortgages was not so paramount, since the cadastral was a public register. However, it could become more

[48] See, League of Nations, Financial Committee, *Committee of Technical Experts on Double Taxation and Tax Evasion, Report and Resolutions*, Doc. C. 115 M. 55. (7 Feb. 1925), at p. 35.

problematic with regard to profits deriving from commercial and industrial undertakings, because in that case it was more likely for taxpayers to invest in countries which did not undertake to supply such information. He entirely agreed with Dorn that any proposed measures should be limited to provisions similar to those contained in bilateral treaties between Germany and Czech Republic, Germany and Italy, etc. In his opinion, administrative and legal assistance should be limited to concrete cases of taxation, keeping in mind that that does not mean establishing an automatic exchange of information operating without any request from the requesting State.

Dr. Valnicek (Czech Republic) put emphasis on the great difficulties raised by the question of bank secrecy. Based on a mutual agreement concluded with Germany, the Czech Republic exchanged information regarding commercial or industrial activities held by German taxpayers in Czech Republic. On the other hand, that was not possible with Switzerland absent any similar provision in the Czech – Swiss tax treaty. Therefore, it would be useful to determine which states, according to their domestic law, were allowed to examine the accounting statements of companies and send information to the other contracting state. Even though he agreed with Dorn, Valnicek pointed out that the 1925 experts initially had provided for an automatic exchange of information.

D'Aroma noted that his colleagues had different opinions. Was it necessary to conclude general and simultaneous conventions? Or was the conclusion of bilateral treaties sufficient? What was the scope of the information to be given? Was it limited to specific classes of income? And what was the method? On request or automatic? As shown by the minutes of meeting, the opinions of Clavier and Damste differed from those of Blau, Dorn, Valnicek and Yamaji. Consequently, d'Aroma proposed the postponement of Committee's decision on paragraph I until paragraph II had been examined.[49]

In addition, d'Aroma, while referring to a previous remark of Clavier regarding the insertion of the phrase '*administrative and legal assistance*' at the beginning of the resolution on tax evasion, thought that it was merely a question of drafting as well. However, Dorn had proposed to limit the exchange of information to specific requests, thus avoiding a systematic transmission of information from one contracting state to the other. In this regard, it should be noted that the 1925 experts had not expressly chosen between the exchange of information on request or automatic. Dorn's intention was not to restrict the scope of 1925 experts' proposals. Rather, his suggestion was that the Committee should temporarily put aside the question whether it was possible to recommend the automatic exchange of information and focus, instead, on the conclusion of bilateral treaties providing for an exchange of information on demand.

In response to d'Aroma, Blau stated that, according to Swiss domestic legislation in force, it was impossible to send abroad information regarding commercial or industrial activities owned by foreigner taxpayers in Switzerland.[50] His agreement with the 1925 experts' proposals just reflected

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[49] See, League of Nations, supra n. 9, at p. 34, '... The experts consider that the effective method of avoiding tax evasion is for the revenue authorities to undertake to supply on a basis of reciprocity to other countries, in respect of persons or companies domiciled in those countries, such information as may be required for tax assessment, for which purpose it is necessary to ascertain both the income and capital value of: ...'

[50] See, League of Nations, supra n. 8, pp. 7 – 9, 'M. Blau thought that a country might legitimately hesitate to give information on the profits obtained by a foreigner on its territory. He would ... point out that if, for example, it was a question of a Company with its seat in Belgium and a branch in Switzerland, when it submitted its balance-sheet in

his own personal views on the matter and did not officially bind his government. He accepted their proposals based on the condition that international agreements should have been simultaneously concluded.

D'Aroma highlighted that states were free to conclude among themselves bilateral treaties which provided for an automatic exchange of information as under the 1907 convention between France and England with regard to succession duties.

As it can be shown from the above, the Committee on Double Taxation and Tax Evasion, during its fifth meeting, examined in great details the 1925 Experts' resolutions. Some of its members, probably, in the author's opinion, wasted time in proposing amendments which were either described as 'a question of drafting' or 'useless.' Few of them, e.g. Blau or Mr. Oria (Argentina), adopted a practical approach. According to them, the Committee should have adopted immediately the 1925 Experts' resolutions without any change since they resulted from long deliberations.[51] In any case, d'Aroma stated that before the Committee there were three amendments aiming at modifying the text of paragraph I of the resolution on tax evasion: the first one proposed by Borduge, 'The question of fiscal evasion can only be completely solved, if international arrangements include the majority of States or if, at least for certain classes of income, bilateral arrangements are concluded simultaneously;'[52] the second one proposed by Clavier, who thought that paragraph I did not take bilateral conventions so much in consideration. Accordingly, 'In the meanwhile bilateral conventions might cover under the above conditions the furnishing by a State of information requested from it at least so far as concerns certain classes of taxable assets.'[53] Finally, the third one proposed by Dorn according to which, 'The resolutions of this article do not exclude the conclusion of bi-lateral treaties confined to the regulation of administrative assistance on demand in concrete cases of taxation.'[54] Both Clavier and Dorn pressed for their own amendments, considering them necessary, thus leading to a bargaining impasse. For this purpose, Borduge, who had previously withdrew his amendment to support that of Clavier, in order to solve this deadlocked situation and reconcile the conflicting views of his colleagues, proposed to adopt a slightly modified version of Dorn's amendment, which read as follows, 'The resolutions of this article do not exclude the conclusion of bi-lateral treaties which are confined to the regulation of reciprocal assistance between two fiscal administrations as regards the exchange of information on certain classes of income.'[55] D'Aroma then read another different text according to which, 'The resolutions of this article do not exclude the conclusion of bi-lateral treaties confined to regulating administrative assistance on demand in concrete cases of taxation which have as their object the production by a State of information which may be required of it, at any rate regarding one or

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Belgium, that Company would have to add a statement of its profits obtained in Switzerland, – that was to say, it would have to furnish inclusive figures ... concerning its turnover, its customers, etc.'

[51] See, League of Nations, supra n. 8, pp. 9 and 17, '... M. Blau asked that there should be no change in the resolutions adopted by the seven experts, which were the result of long deliberations. He himself had ... supported without difficulty the final formula which had been adopted as reconciling the various points of view. The original resolutions should be retained for formal and material reasons ...'

[52] See, League of Nations, supra n. 8, at 4pm, pp. 10 – 11.

[53] See, League of Nations, supra n. 8, at p. 18, '... M. Clavier pressed his amendment, which appeared to him to be necessary, since the terms of paragraph I absolutely excluded bi-lateral conventions ...'

[54] See, League of Nations, supra n. 8, at p. 16.

[55] See, League of Nations, supra n. 8, at 4pm, at p. 18.

several classes of taxable assets.'[56] After a brief exchange of views, he ended the meeting by asking his colleagues to meet as a Sub-Committee in order to reach an agreement on concrete texts, either in the form of a new paragraph to be added to the existing resolutions or a slight amendment to them with clarifying purposes.

The 6th Meeting of the Committee on Double Taxation and Fiscal Evasion had as the main purpose the examination of the text of the amendment to the penultimate paragraph [of paragraph II of the resolution on tax evasion] proposed by Blau, Borduge and Dorn, which read as follows, 'Just as bilateral agreements concerning certain of the categories above mentioned, as well as other treaties regulating administrative assistance, have already been concluded in the past, similar agreements may, pending the conclusion of a general convention, be concluded in the future, within the limits of the information in the possession of States, or of that which the States may procure under their present fiscal practice.'[57]

Blau agreed to the text as a gesture of reconciliation even though he believed it would be better to retain the original text, which was the result of difficult negotiations in terms of the concessions made.[58] However, he was very surprised in realizing that some of the 1925 experts now refused to accept the above compromise. He believed that the text of the 1925 experts' resolutions formed the basis upon which newly Committee members, such as Dr. Alvarez Feo (Venezuela), Borduge, Mr. Mori (Japan), Oria, and Zaleski had the opportunity to give their opinions. According to Blau, the above compromise represented the first step in the fight against tax evasion, where no effective measure had been taken yet. The fight against tax evasion should have been conducted wisely and without any rush along the principles indicated by the 1922 Genoa Conference[59] and the recent statement of the International Chamber of Commerce.[60] Clavier did not like Blau's statements and wanted to rectify them. D'Aroma intervened to tone down the discussion by observing that Blau just wished to obtain newly Committee members views. As such, d'Aroma asked for the new members opinions. Dr. Alvarez Feo stated that Venezuela did not have any capital invested abroad and thus was not very much interested in tax evasion. Oria and Zaleski preferred the original text.[61] On the other hand, Borduge, Damste, Mori, and Sir Percy Thompson supported the new text.

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[56] See, League of Nations, supra n. 8, at p. 19.

[57] See, League of Nations, *Minutes of the Sixth Meeting of the Sixth Session of the Committee on Double Taxation and Fiscal Evasion* D.T./6th Session/P.V. 6.(1) (20 May 1926), at p. 1.

[58] Blau was of the opinion of retaining the original text of the 1925 experts' resolutions not only because they resulted from long deliberations but also for formal and substantial reasons. In his opinion, the amendments of Clavier and Dorn were both covered under the text of the resolutions. However, had the Committee members majority deemed an amendment necessary, he would have supported that of Dorn.

[59] See, League of Nations, supra n. 9, at p. 25, '... It will be remembered ... that the Genoa Conference of 1922, when it requested the League of Nations "to study the question of measures for international co-operation to prevent tax evasion," made a reservation to the effect that "*any proposal to interfere with the freedom of the market for exchange or to violate the secrecy of bankers' relations with their customers is to be condemned.*"'

[60] See, Statement of Mr. Julliard, Delegate of the International Chamber of Commerce contained in League of Nations, supra n. 8, at p. 12, '... *It was very necessary to avoid the danger that international legislation, intended to restrain fiscal evasion, might result in affecting the freedom of the exchange market and the movement of capital, or to inspire in countries taking such measures still more suspicion, thereby making the removal of capital still more rapid – the very think it was trying to avoid.* Such precautions would also have the effect – directly counter to the principal aim in view – of increasing the frequency of cases of double taxation.'

[61] League of Nations, supra n. 18, at p. 5, 'M. Zaleski, after closer examination of the text ... agreed to [it].'

Van der Waals, the Dutch delegate for colonial questions, stated that for debtor countries, such as the Dutch Indies, the question of tax evasion had to be examined from two different perspectives. As a residence country, due to its geographical location and its being a capital *importing* country rather than a capital *exporting* country, tax evasion was unlikely to occur. Like Venezuela, Dutch Indies did not have any resident taxpayers with capital invested abroad. As a source country, Dutch Indies did not have any advantages in concluding an agreement on tax evasion. It would have been strategically unwise for the Dutch Indies to sign on a convention which would have only unduly overburdened its Treasury in sending information abroad without getting anything in return. In the author's opinion, Van der Waal's proposal of adopting a general convention on tax evasion, to which all debtor countries should have participated, was not influenced by the '*immoral character of fraudulent evasion*' but by merely hypocritical and selfish considerations. He simply did not want that capital *exporting* countries would have invested elsewhere had Dutch Indies been the only debtor country belonging to the convention. On the other hand, Oria appeared to be one of the few with genuine interests having in mind only the best solution for a problem which affected the majority of States.[62]

In conclusion, a new text amended by Borduge was adopted in the following form, 'Just as bilateral agreements concerning certain of the categories above mentioned, as well as other treaties regulating administrative assistance, have already been concluded in the past, similar agreements may, pending the conclusion of a general convention, be concluded in the future, within the limits of the information in the possession of States, or of that which the States may procure under their present fiscal practice.' The word 'nevertheless' was added at the beginning of the last paragraph.[63]

The 7th meeting of the Committee on Double Taxation and Fiscal Evasion took place on Friday, 21 May 1926 at 3pm.[64]

Borduge, Chairman of Sub-Committee C, which was in charge of studying the question of fiscal and administrative evasion, explained that the draft prepared was divided in two parts: the first was a sort of explanatory statement, while the second expressed some principles which could be helpful for drafters of future conventions. Sub-Committee C had only prepared a model for future bilateral conventions, which could have been tailored to specific individual cases.

D'Aroma stated that a decision on the substance of Sub-Committee C's report would not have been taken until the next meeting. Therefore, he invited the other members to give their opinions on the following two points: (i) Did they consider that a collective/general convention was impossible, and therefore, would they advocate for bilateral treaties? (ii) did they intend to submit

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[62] Compared for example to Blau who thought that, '*the suppression of banking secrecy was a grave economic mistake.*' See, League of Nations, supra n. 18, at p. 6, '... All reservations having been made, *he thought that as the experts were League of Nations experts rather than Government delegates they should work in a spirit of complete neutrality towards finding the best solution of the problem which was of concern to most countries*, and those most developed economically, with a view to preparing the way for the conclusion of general conventions ...'

[63] See, League of Nations, supra n. 18, , at p. 6.

[64] See, League of Nations, *Minutes of the Seventh Meeting of the Sixth Session of the Committee on Double Taxation and Fiscal Evasion* D.T./6th Session/P.V.7.(2) (21 May 1926).

to the Financial Committee their project in the form of a statement of principles or in the form of a draft convention as was done by Sub-Committee B?

Blau explained that Sub-Committee C did not examine the question as to whether a collective convention was possible or not. Undoubtedly the Committee advocated for bilateral conventions rather than a collective convention, but the idea of a collective convention had not been expressly set aside, which would of course have been in opposition to the experts' resolutions. At that moment, the two options were on the table but he did not want to pick up sides on the matter.

Borduge highlighted that actually three possible solutions existed: (i) collective convention; (ii) bilateral treaties; and (iii) simultaneous bilateral treaties. From Sub-Committee C deliberations it emerged that the conclusion of simultaneous bilateral treaties would have allowed to reach results more easily and quickly.

Considering that Clavier,[65] Damste[66] and Dorn were straying from the point with their comments, d'Aroma reminded the other members that decisions on the substance of Sub-Committee C's report would be postponed until the next meeting. The question he asked was purely formal. The text prepared by Sub-Committee B was in the form of a draft convention, while that of Sub-Committee C contained only statements of general principles. Should the texts for the three conventions be submitted in similar or different forms?

Blau stated that the problem under discussion was so delicate that it would have been strategically better for the Committee to keep the current draft in the form of a statement of principles. Zaleski was of the same opinion.[67] Mori as well accepted the draft in the form of general principles, as the problem would again be discussed in October.[68]

On the other hand, Clavier and Damste believed that the Sub-Committee experts should have exhibited less timidity in addressing the issue of tax evasion. In particular, according to Clavier, the technical experts should have tackled the issue more firmly. They were dissatisfied with the advancement of Committee's work and hoped that more definite results would be reached by October.

D'Aroma was glad that such exchange of views had taken place which should allow Committee members to reach an agreement at the next session in October.

However, documents made available to the author show that the Committee on Double Taxation and Fiscal Evasion did not review the report of Sub-Committee C and the draft convention on

[65] Clavier imagined the following scenario. On the one hand, the conclusion of a collective convention on double taxation, tax evasion and exchange of information covering all points which did not raise discussions among states. On the other hand, for all questions where states disagreed, complete freedom should be granted in concluding bilateral treaties, while leaving the door open for a collective convention. See, League of Nations, supra n. 25, at p. 6.

[66] Damste did not support Dorn's suggestion to mix in the same convention the ideas of administrative (Sub-Committee C) and legal (Sub-Committee B) assistance. He thought that by doing so the resulting text would have been less clear. See, League of Nations, supra n. 25, p. 7.

[67] See, League of Nations, supra n. 25, at p. 9, '... *the problem of fiscal evasion from the standpoint of the basis of taxation was particularly delicate. In the course of the present sitting it was better to leave this latter subject in the state of a definition of principle ...*'

[68] See, League of Nations, supra n. 25, at p. 10.

fiscal evasion (DOC. D.T. 52) until January 1927, during the 8th meeting of the 7th session. During this 7-month period, there had been two developments: the replacement of d'Aroma by Clavier as Chairman[69] and the death of Valnicek.

Thus, on 10 January 1927, Clavier submitted for discussion Chapter I of the draft convention of fiscal evasion, which originally contained only ... articles. In this section, the author's intention is not to review this convention article-by-article as done by the technical experts. The author will only focus on those articles strictly connected with the STP included in the commentary to the draft convention on administrative assistance.

In the author's opinion, one of the two closest articles to the STP is Art. 1, which originally read as follows, '*With a view to obtaining a better yield from taxes*, the Contracting Parties undertake, subject to reciprocity, to give each other administrative assistance. Such assistance may consist: a) the exchange of fiscal information available in one of the contracting countries and required by the services of the other country. Such an exchange may take place following a request concerning a concrete case, or, without any special request, for a whole class of particulars defined in a special agreement. b) co-operation between the administrative services of the two countries in carrying out certain procedural measures and in preparing certain records of information.' Zaleski highlighted the need of substantially modifying this paragraph. According to his opinion, the purpose of the convention on administrative assistance was not only to ensure the best yield from taxation, but also to, '*achieve a more equitable distribution of fiscal charges*.' It was therefore important for him that this objective was expressly mentioned in Art. 1. Following an exchange of views, the Committee adopted the following text, '*With a view to obtaining a better apportionment of fiscal charges both in the interest of the States and in the interest of the taxpayers* the contracting parties, etc.'

Sir Percy Thompson then asked what the meaning of the expression, '*subject to reciprocity*' was. Assuming the following scenario where a convention is in force between Belgium and Great Britain. If Great Britain were unable to provide, under its domestic law,[70] information on immovable property held by Belgian taxpayers within its borders, would Belgium provide that information the other way round? Since the nature of information varied considerably from country to country, he suggested that each contracting state should prepare a list with the various items of income needed, and the other contracting state should indicate what information it was able to provide. Clavier noted that in Thompson's example Belgium, whose domestic law enabled the collection of extremely detailed information over British taxpayers, might be obliged to send over that information while getting in return something of relatively small importance. In his opinion, reciprocity meant something of the same nature and quality. For these reasons, he proposed the insertion of the following footnote to Art. 1, 'The exchange may be limited between the States according to circumstances.' Mr. Bolaffi (Italy) and Sir Percy Thompson had a similar discussion

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[69] D'Aroma was unable to attend Geneva meetings due to the fulfillment of his new duties in Italy. See, League of Nations, *Provisional Minutes of the First Meeting of the Seventh Session of the Committee on Double Taxation and Fiscal Evasion*, (5 Jan. 1927), at p. 1.

[70] See, League of Nations, supra n. 8, at p. 10(a), '... Great Britain, unlike other continental countries, was unable to furnish information concerning immovable property and mortgages inasmuch as no register of the ownership of land or mortgages existed ...'

while commenting Art. 2(3) ex Art. 6(3). According to Bolaffi, it was impossible to restrict the list of exchangeable information as this varied according to states' domestic legislation. On the other hand, Thompson insisted in narrowing as much as possible that list as, '*public opinion would never tolerate the British Government being obliged to furnish to a foreign Government information enabling that Government to tax a British citizen.*'[71]

For reasons that will be better explained later, the second closest article to the STP is Art. 6(4), according to which, 'the exchange of information as contemplated in paragraph (a) of Article 1 may have reference to: ... transferable securities, deposits and current accounts (capital value and income); *any information collected by an administration, more especially in connection with exemption or relief granted by that authority by reason of the taxpayer's domicile or nationality.*' In the final version of the draft convention on administrative assistance, based on Clavier's suggestion, Art. 6(4) became Art. 2(5). The analysis of the minutes of meetings shows that Clavier wanted to retain in this article many of the ideas from the 1925 experts' resolutions, such as limiting the information to, '*the fiscal and moral persons domiciled or resident in one of the two contracting countries,*'[72] and '*... what was necessary in order to assess taxation, or, ... for the purpose of tax assessment.*'

For the purposes of this section, it should be noted that the STP appeared for the first time in Chapter II on the draft bilateral Convention on administrative assistance in matters of taxation submitted to the Committee on April 8th, 1927.[73] According to the text, which became after some slight verbal amendments the commentary to the convention on administrative assistance, '*As soon as its work began,*[74] the Committee realized the necessity of dealing with the questions of tax evasion and double taxation *together.*[75] It is highly desirable for States to come to an agreement with a view to ensuring that a tax-payer shall not be taxed on the same income by a number of different countries, and *it would also seem desirable*[76] that such international cooperation should prevent certain incomes from escaping taxation altogether. The most elementary and undisputed principles of fiscal justice, therefore, required that the experts should devise a scheme whereby all incomes would be taxed once and once only.'

In the documents under author's possession there is no discussion as to the actual drafter of Chapter II or where it originates from. Thus, in the first place, the paternity of STP should be attributed to Sub-Committee C as a whole. All Sub-Committee C members, Blau, Borduge, Van der Waals and Zaleski can therefore claim its paternity. However, the analysis of the minutes of the meetings

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[71] See, League of Nations, *Minutes of the Eight Meeting of the Seventh Session of the Committee of Experts on Double Taxation and Fiscal Evasion,* , held at 10am on Monday, D.T./7th Session/P.V.8.(1), (10 Jan. 1927), at p. 6.

[72] Clavier assumed the following scenario. There were three countries: Belgium, France and Italy; and two conventions, one between BE and FR and the other between FR and IT, thus no convention between BE and IT. Assuming that information exchange covered all those who were subject to taxation without any distinction of nationality, BE would be obliged to provide IT information about italian taxpayers earning Belgian source income without getting anything in return. See, League of Nations, supra n. 32, at p. 4.

[73] See, League of Nations, *Double Taxation and Tax Evasion, Draft Report,* D.T. 107(2), (8 April 1927), Chapter II on the draft bilateral Convention on administrative assistance in matters of taxation, at p. 1.

[74] From the very outset.

[75] In co-ordination with each other.

[76] It seems equally desirable.

shows that the basic principles of the 1925 experts' resolutions highly influenced Sub-Committee C in carrying out its work, to the extent that the paternity of the STP might even be attributed, with relative certainty, to one individual in particular: Clavier.

Firstly, many of the 1925 experts also attended the above meetings held from May 1926 to April 1927, which led to the 1927 report and the draft of four different bilateral conventions: (i) for the prevention of double taxation; (ii) for the prevention of double taxation in the special matter of succession duties; (iii) on administrative assistance in matters of taxation; and (iv) on judicial assistance in the collection of taxes. Therefore, it was logical to expect that the 1927 experts would have largely focused their discussions on the examination of the 1925 experts' resolutions.

Secondly, textual analysis reveals that there is a high degree of similarity between the 1925 report and the commentary to the 1927 draft convention on administrative assistance. The first paragraph of the latter states that from the very beginning it was necessary for the Committee to consider the questions of tax evasion and double taxation as if they were coordinated between each other. This first paragraph clearly derives from the conclusions of the 1925 report on tax evasion where the 1925 experts thought it desirable to, '*draw attention to the connection which exists between the two problems of tax evasion and double taxation.*'[77] This point was also reiterated by Zaleski on May 19th, 1926 during the fifth meeting when he argued that the purpose underlying the existing close connection between tax evasion and double taxation was to *prevent honest men from paying the taxes of those who shirked their fiscal duties.*

This close connection is also highlighted in paragraph 2 of the commentary to the 1927 draft convention on administrative assistance when it is stated that the purpose of international co-operation is to avoid both double taxation (... *a taxpayer shall not be taxed on the same income by a number of different countries* ...) and double non-taxation (... *prevent certain incomes from escaping taxation altogether* ...). Also paragraph 2 of the commentary, especially its second part concerning administrative assistance and double non-taxation, comes from the 1925 report. The 1925 experts had imagined the following scenario. Assuming an individual taxpayer was domiciled in country A and held shares in a company domiciled in country B which paid dividends. If he wanted to be reimbursed for or be exempted from country B's schedular tax on dividends distribution, he needed to produce an affidavit or proper evidence proving his nationality and that he was domiciled abroad. The competent authorities of country B received the affidavit, but if they had not sent it back to country A declaring the amount of dividends exempt from source taxation, the competent authorities of country A would have been totally unaware of the fact that its resident taxpayer had received exempt foreign-source income. As the 1925 experts stated, [*t*]*hus, the taxpayer may wholly avoid taxation.* That is the reason why Art. 2(5) ex Art. 6(4) was included in the 1927 draft convention on administrative assistance, according to which the exchange of

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[77] See League of Nations, supra n. 9, at pp. 25 and 27, '... The first criticism passed on the existing convention between France and England is that it increases the mischievous consequences of double taxation on account of the conflict of laws in respect of domicile. "The mutual interchange of information may thus, in some cases, bring, quite correctly under existing law, the whole of a personal estate under liability to taxation in both countries." To this objection, which may be made both in respect of income-tax and succession duties, it may be replied that the proposed resolutions form an indivisible whole, and that their object is to prevent both double taxation and tax evasion. *The foregoing criticism will be seen to furnish a fresh proof of the close connection between these two problems.*'

information may cover *any information collected by an administration, more especially in connection with exemption or relief granted by that authority by reason of the taxpayer's domicile or nationality.* Paragraph 4 of the commentary to Art. 2(5) stated that, 'In some cases, e.g. in cases where relief is sought, the assistance which it may be possible for the relieving State to afford may be considerable. For instance, tax-payers may apply to a given country on grounds of domicile for exemption or abatement as regards certain taxes on stocks and shares. *In that case, it should be held*[78] *that the preferential treatment claimed by such persons cannot, in all fairness, be extended to them unless their circumstances are precisely those which warrant such treatment*;[79] since, moreover, they are applying for relief in respect of taxes levied in one country, on the ground that they are already taxed on that same income by another country, it is *but*[80] natural that the latter should be informed that certain of its *nationals*[81] have advanced the plea of *nationality*,[82] and that it should be enabled to verify *the taxation imposed upon them.*[83] In such cases, the tax-payer can always *enforce his rights under*[84] ordinary law; by *the very fact that the claims the benefit of special exemption, as* provided *for the avoidance of*[85] double taxation, he agrees to abide by the consequences of his choice and cannot object to the accuracy of his statement being subsequently checked.'[86] In the author's opinion, the highlighted sentence is the prelude to the STP. That sentence suggests that reduction from source-based taxation should be contingent upon taxation at residence. In other words, a source country should not grant relief to foreign taxpayers from its schedular tax, if the latter were not subject to the general income tax in their residence countries. After all, as the 1927 experts stated it was a matter of *fairness*. If a foreign taxpayer seeks relief from source country schedular tax by stating that has already been (or will be) taxed in his residence country, then the source country has the duty to assist and inform taxpayer's residence country.

Finally, paragraph 3 of the commentary to the 1927 draft convention on administrative assistance states that, '... The most elementary and undisputed principles of *fiscal justice*, therefore, *required that the experts should devise a scheme whereby all incomes would be taxed once and once only ...*' Again, the documents available to the author do not show who originally drafted that sentence. However, by analyzing the text of the 1925 experts' report as well as minutes of meetings, and based on the previous work of other scholars, there is enough evidence to claim that its paternity might be attributed to Clavier. *Justice*, *fairness* and *equity* were all interchangeably concepts used by both 1925 experts and those who took part at the meetings from May 1926 to April 1927. Firstly, the word *justice* was used *twice* in the 1925 experts' report with regard to both double taxation and tax evasion. On the one hand, the 1925 experts based on *justice* considerations sought to prevent an improper use of tax treaty provisions. Back then, wealthy taxpayers were investing their capital in easily transferable securities, moving from one country to another, staying only temporarily in

[78] It must be admitted.
[79] Really entitle them to such treatment.
[80] Only.
[81] Citizens.
[82] Domicile.
[83] That they are duly taxed.
[84] Obtain the application of.
[85] His action in seeking to benefit by the exemption which has been ... in order to avoid.
[86] See, League of Nations, supra n. 34, at p. 4.

each and without owning any real property in their own name. By evading all treaty provisions, they were able to achieve double non-taxation. In order to frustrate the aims of these taxable persons, the last paragraph of the 1925 experts' resolutions on double taxation states that, '*States shall always be free to tax their nationals on that part of their total income, wealth or capital not taxed under the terms of the previous paragraph.*' On the other hand, the word *justice* was also used in arguing that the two problems of tax evasion and double taxation were closely and *morally* connected.[87]

But it was Clavier in his role of 1927 expert who used for the first time the concept of *fiscal justice* in relation to international co-operation and administrative assistance. On May 21st, 1926, during the 7th meeting of the 6th session, while agreeing with Sir Percy Thompson on the need of a draft bilateral convention capable of adaptation to each specific situation he argued that, '*a great step would have been taken towards fiscal justice ... if an international understanding was arrived at, for example, on immovable property and mortgages, as several countries had already done for more than a century.*'[88] Basically, he was advocating for a draft bilateral convention along the lines of the conventions from 1843 and 1845 that Belgium concluded with France and the Netherlands. As mentioned above, that system worked well in practice without significantly reducing cross-border investment in immovable property in those countries. Also in 1923, Clavier had said that the question of tax evasion was significant from the perspective of both *public morality* and *international solidarity*.[89] Among the experts he emerged as the one who proposed measures which might have largely contributed to the achievement of *justice* in matters of taxation.

Secondly, as above mentioned, it was *unfair* if foreign taxpayers had claimed relief from source country schedular tax in cases where they were not really entitled to it, i.e. they were not subject to general income tax in their residence countries. This second characteristic of the STP means that a reduction from source-based taxation is allowed only to the extent that there is taxation at residence, i.e. at least one level of tax is levied and remitted to a government.

In conclusion, the last feature of the STP is the allocation of a particular item of income to the right jurisdiction entitled to tax it. Considering that income should be taxed *once and once only*, the question then becomes, where should cross-border income be subject to tax once? In which jurisdiction? How can the right jurisdiction be identified? In the author's opinion, all those questions were in the minds of Damste and Zaleski when they argued that cross-border fiscal

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[87] League of Nations, supra n. 9, at p. 28, '... Essentially, however, the connection between the two problems is much more a *moral* than a material one; the idea of *justice* in the distribution of taxes is the predominating consideration in all the investigations which we have concluded, both in regard to double taxation and evasion.' See also, at Societe des Nations, TITLE, E.F.S. D.T./4th Session/P.V.4 (1), (DATE), at p. 10, '... Mr. Clavier se félicite d'avoir soulevé la question de la liaison entre la double imposition et l'évasion fiscale. Les déclarations des orateurs précédents montrent que les membres du Comité n'ont pas exactement les mêmes vues à cet égard. Si on ne lie pas étroitement les deux questions, chaque pays accordera aux contribuables riches, seuls frappés par la double imposition, des restitutions d'impôts alors que par ailleurs ces contribuables auront fraude peut-être le fisc. *Il y a là una question de moralité publique*. L'orateur reste donc d'avis de lier les deux questions. Ce serait le moyen de se concilier l'opinion publique, car la plupart des victimes de la double imposition se feront aussi les défenseurs d'un système tendant à réprimer l'évasion fiscale mais Mr. Clavier n'insiste pas au sujet de sa proposition; il lui suffit qu'elle soit mentionnée dans le rapport. Il n'insiste pas non plus, dans un désir de conciliation, sur les amendements qu'il a proposés.'

[88] See, League of Nations, supra n. 25, at p. 11.

[89] Societe des Nations, TITLE, E.F.S./D.T./P.V.10(1), (8 June 1923), at p. 6.

burdens should be distributed more *equitably*. As the author has showed above, Zaleski pressed and was successful in modifying para. 1 of Art. 1 by expressly stating that administrative assistance through information exchange has also the purpose of achieving a more *equitable* distribution of fiscal charges. A better apportionment of fiscal charges between states allows a more efficient allocation of resources.

By April 1927 then, the two features of the STP, one single level of tax and the allocation of tax revenue to the specific jurisdiction for equity and efficiency purposes, had been definitely theorized by Sub-Committee C in relation to the draft convention on administrative assistance. The fingerprints of the 1925 experts and in particular those of Clavier were clearly evident in many articles of the convention and in its commentary.

3. The **single tax principle applied at international level: Adams' proposal on tax-exempt securities**

The STP has also a third feature, which is the most controversial and causes considerable debate among tax scholars. The STP provides that if the jurisdiction that has the primary right to tax refrains from doing so, the other jurisdiction should tax in order to prevent double non-taxation. Thus, if for example the *source jurisdiction* that has the primary right to tax *active income* refrains from doing so, the *residence jurisdiction* should tax, in order to prevent double non-taxation. The same holds true also for *passive income*. If it is not taxed by the *residence jurisdiction*, it is up to the *source jurisdiction* to avoid double non-taxation. Subpart F-type legislation and limitation on benefits (hereinafter: "LOB") provisions can be viewed as the practical implementation of the STP. On the one hand, the former puts a significant limit on double non-taxation for controlled foreign corporations by subjecting both passive and active income not taxed at source to current tax at residence. On the other hand, LOB provisions seek to ensure that a source country will not abandon or reduce its withholding tax on passive income when no tax is levied at residence. These are the intellectual ancestors of today's GLOBE proposal for minimum residence and source based taxes.

This section of the article argues that Thomas Adams was the first person who tried to implement in practice this feature of the STP. Before going into the details of his proposal, it should be noted that Adams participated in only one session, of the Committee on Double Taxation and Fiscal Evasion, the 8th, at a very late stage when the draft bilateral convention regarding double taxation (D.T.54.(3)) was almost finalized.[90] Nonetheless, his participation was still influential and his proposal, as will be explained below, caused a long debate among the members of the Committee.

[90] Documents under author's availability state that, '... On July 7th, 1925 the Secretary General invited the Government of the United States of America to designate an expert to serve on the Committee of experts which was studying the problems of double taxation and tax evasion. By letter of September 2nd, 1925 the American Government replied that it was not desirous of designating such an expert. On December 22nd 1926, the Secretariat was unofficially informed by wire that the American Government was ready and willing to designate an expert if the invitation was repeated. Consequently an invitation was dispatched that same night. According to information received and also published in the press, the American Government desired to designate Prof. Adams as expert. Unfortunately Prof. Adams could not leave the States before January 15th 1927'. See, League of Nations, Note by the Secretariat, Double Taxation and Tax Evasion, D.T. 84. (4 Jan. 1927), pp. 1 – 2. See also, League of Nations, supra n. 30, at p. 2. To be more precise, it was Mr. Robinson a member of the International Chamber of Commerce who expressed his desire to include an American expert in the Committee's works. He thought it was important to have an American representative not only

During the third meeting of the eighth session, held in London on April 6th, 1927 at 3:30pm, the Committee was discussing the draft bilateral convention regarding double taxation article-by-article. While discussing Art. 3, which assigned the primary right to tax income from public funds, bonds, loans and non-professional deposits or current accounts to the debtor country, Adams suggested the following amendment, 'Nevertheless, by special agreement between the Contracting States, the *interest* referred to in the present Article *being exempted from taxation at the source may be taxed* in whole or in part *in the country of domicile.*' In that situation, States might have preferred to tax a portion of the income at the domicile of the creditor and the text Adams suggested would have allowed for that possibility. According to Thompson a reference to special agreements would have been made in the report and there would also have been a provision in the Convention dealing with the point.[91]

In the author's opinion, Adams' proposal represents the practical implementation of the third STP feature. In that case, income from public funds was sourced to the *debtors residence state* under Art. 3(1). However, if interest had been exempt from taxation at source, the *creditors residence state* may tax it.

From the minutes of the fourth meeting, it emerged that the Sub-Committee as a consequence of Prof. Adams' suggestion had decided, without abandoning the principle of paragraph 1 (primary jurisdiction to tax assigned to the debtors' residence country), to insert a new second paragraph in the following terms, 'Nevertheless, if *a special agreement*, under conditions of reciprocity, exempts in the country of origin interest covered by the present article, this interest may be taxed in the country in which the creditors have their domicile.' This provision, although purely optional, was justified by *equity*, administrative and economic reasons.

Borduge thought it would have been better to simply refer to the situation of fact instead of providing the requirement of a special agreement to allow taxation in the creditors country. Therefore, he suggested the following terms, 'If, *owing to its legislation*, a country failed to levy the tax on interest, etc ...'

Adams, without insisting on his original proposal, thought it was necessary to render the provision as flexible as possible. If bilateral treaties were contemplated, states would have been completely free to apply or not apply that provision.

Damste said that the question whether the creditor residence state was entitled to levy a general tax on the interest income in case of exemption from source tax should have been discussed later. That was the reason why the Committee had deleted Adams's proposal.

Thompson noted that if country A had issued a loan free of tax with a quite low interest rate, and country B taxed the interest, the conditions under which the holders, nationals of country B had

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because the US was an economic and financial power but also because US had adopted a reciprocal exemption system for foreign shipping companies. However, the question was procedurally difficult since the US was not a member of the League of Nations. See, Societe des Nations, Comite de la Double Imposition et de l'Évasion Fiscale, 3ème Session. Procès-verbal de la 13ème Séance, E.F.S./D.T./3e.Session/P.V.13.(1), (6 Apr. 1924), pp. 1 – 2.

[91] See, League of Nations, Minutes of the Third Meeting of the Eight Session of the Committee on Double Taxation and Fiscal Evasion, DT/8th Session, P.V.3.(1), (6 April 1927) at p. 7.

subscribed the loan would have been modified to the extent of a breach of contract. Adams observed that in any case the interest income would have been subject to tax in England had an English investor subscribed the loan. The application of Art. 3(2) would not have modified the subscription conditions for an English holder. Thompson replied that the same did not hold true for a French investor.

Clavier, in replying to Damste, explained that the Sub-Committee's proposal did not help solving the question of the general tax, which would have come later. The real problem was the schedular tax. He also observed that in Thompson's example the foreign holder would have received the interest income without being subject to the source-country schedular tax. Therefore, Art. 3(2) would not have created double taxation. In his opinion, country B was not bound by any promise of exemption made by country A (the issuing country), thereby it was free to tax the interest of country-A bond subscribed by its resident investors without any breach of contract.

Dorn agreed with Clavier. There would have not been any double taxation in case the creditor residence state had taxed the interest income exempt from source country tax. The creditor residence state would have retained its jurisdiction to tax the income from foreign loans exempt at source, unless a bilateral treaty provided otherwise. In any case, the creditor residence state would not have exercised its taxing powers, as this would have been an *economic mistake*.

Julliard noted that Art. 3(2) would have been a *useless complication* and in contradiction with the general source principle of Art. 3(1), as the exemption from source tax was counter-balanced by the low interest rate.

In the author's opinion, Borduge appeared to be the one who most joined Adams' cause. He referred to Adams when he argued that, '*exempted securities in the debtor country must nevertheless pay a tax in the creditor country*' and '[*i*]*t was essential that there should not be any income which escaped the tax.*'[92] This last sentence clearly demonstrates that the purpose behind Adams and Borduge proposals was the avoidance of double non-taxation.[93]

Adams said that in the US there were thousands of securities exempt from taxation. Accordingly, his knowledge of the problem was fairly wide. Indeed, it should be noted that he already discussed the topic in 1922 during the Annual Conference on Taxation of the National Tax Association. His concerns against the spread of tax-exempt securities over the international capital market were purely based on equity and economic considerations. Firstly, he thought that a dangerous element of social discontent could arise if, '... *the wealthiest men – the men most able to bear taxation – get themselves, by reason of the existence of these tax-free bonds, into an isle of safety, in which*

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[92] See, League of Nations, *Minutes of the Fourth Meeting of the Eight Session of the Committee on Double Taxation and Fiscal Evasion,* D.T./8th Session/P.V.4.(1), (7 April 1927), at p. 6.

[93] The author notes that there was a lot of misunderstanding among the Committee's members. For example, some were examining income from loans free of tax (Julliard, Thompson, Vlasak, and Zaleski) while others (Clavier) were focusing their discussion on items of income provided by Art. 3(1), such as income from public funds, bonds, including mortgages, loans, deposits and current accounts. According to the former, if a debtor country had issued a loan free of tax, it would still have levied implicitly and indirectly a tax in the amount of a lower interest rate. Therefore, if the creditor residence state sought to impose a tax, economically then double taxation would still have occurred. On the other hand, committee's members were also mixing the questions of imposing a personal general tax with that of imposing a real schedular tax.

they are absolutely sheltered from the burden of supporting government, to which, as Justice Holmes … has said, they owe their protection and in some senses their lives.'[94] In his opinion, it was necessary that the richest class paid taxes and be known and seen to pay taxes. To show how serious this social problem was, he quoted some numbers. In 1916, those belonging to the richest group of taxpayers (people having an annual income of $300K or more) reported $993m of net income. By 1919, after years of economic prosperity, the reported taxable income of that group had shrunk to $440m, a reduction of almost 56%. In his opinion the reason of this reduction had to be primarily attributed to the fact that the wealthier members of society were investing increasing amounts of their wealth in tax-free securities. Secondly, the tax-exemption feature of state and local bonds violated the principle of neutrality by exercising influence on taxpayers' economic choices creating a pervert mechanism whereby the richest taxpayers were turning from the riskiest investments to invest in tax-free securities.[95] Back then it was calculated that those belonging to the richest group of taxpayers had 2/3 of their investments in tax-free securities. Thirdly, Adams demonstrated how, under any system of progressive tax, the costs for public bodies in terms of foregone revenue were much higher than the benefits deriving from borrowing at lower interest rates.[96] The above considerations, coupled with the fact that US has a citizenship-based tax system, showed that Adams was not advocating for any particular interest except for equity, efficiency and neutrality. In any case, US citizens would have been subject to tax in the US regardless of whether the interest had been exempt in the issuing country. The same held true for British citizens. In case the attachment to the rule laid down in paragraph one was of great value

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[94] T.S. Adams, *Proceedings of the Annual Conference on Taxation under the Auspices of the National Tax Association,* 15 JSTOR (1922), at p. 262, available at: https://www.jstor.org/stable/23399745 (accessed 17 June 2019).

[95] Adams, supra n. 55, at p. 264, '… Municipal and state and public securities of this country … offer the best security, the nearest approach to absolute safety that we have. They ought to be investments of those persons who have small amounts to invest, in which safety is paramount. Now, what happens is that under the existing situation the very rich become the principal owners of these bonds; the men who ought to be taking the grave industrial chances – who ought to be investing in the hazardous things – who ought to be supplying the money for those dangerous investments which are legitimate and necessary, but which ought to be invested in and be supported by the people who can afford to lose. The oil schemes, the dangerous mining ventures, are getting in increasing degree the investments of the poor, and the rich, who ought to carry those grave risks, are turning from them to invest in tax-free securities. *Thus the normal habits of investment have been perverted.*'

[96] Adams, supra n. 55, at pp. 264 – 265, '… let us take a very wealthy man, subject to a 50 per cent tax, and then take another man less wealthy, subject to a 25 per cent tax; let us suppose, just for the purposes of convenience, that the rate on absolutely secure taxable investments is five per cent. Now then, the man paying a 50 per cent tax, if he invests in taxable securities, is going to net two and one-half per cent. That is all he is going to get. He is going to pay fifty per cent in taxes, half of his interest. He could then afford, if necessary, to lend to states and cities and to the federal government, on tax-exempt federal securities, at two and one-half per cent. It would net him just as much as a five per cent taxable bond. But, the important point is that there are very few, relatively speaking, of those men who are paying the fifty per cent tax, and if the states and cities want to float all the bonds that is necessary for them to float, they take to seek classes of taxpayers that are paying a smaller tax. They have to come down and get into the market of the people who are subject to twenty-five per cent taxes. But to the man who is subject to only a twenty-five per cent tax, this exemption is worth one-quarter of five per cent, which is one and one-quarter per cent. All he will bid for this privilege of exemption is one and one-quarter per cent; and if you go down to the man subject to only twenty per cent income tax, the exemption feature is worth only one per cent, and that is all he will pay for it … In other words, all you are going to get for your exemption privilege is one per cent, but *every taxpayer subject to more than twenty per cent tax is going to save more in taxes than he loses in taking the smaller interest rate. That is the reason why under any system of progressive taxation, an exemption feature must cost the government more in taxes than it saves them in reduced interest payment.*'

for the Committee, then the contracting states should have undertaken once and for all not to tax certain items of income. He was not sure whether contracting states would have accepted such a clause.

Thompson said that France would not have acted in bad faith had it decided to impose a schedular tax upon income arising from a Belgian security exempt at source. On the contrary, if the two countries had decided to reciprocally restrict their domestic taxing rights through a convention, Belgium's negotiation position would have been weaker as it would not have anything to yield in case of a loan free of tax.[97]

Dorn noted that Committees' members agreed with the principle of Art. 3(1) and recognized the fact that the creditor residence state retained the right to impose the general tax on such income. On the other hand, they disagreed as to whether the creditor residence state was entitled to levy a schedular tax on such income. The explanation given by Clavier showed that the actual question was that of personal tax, which should have been made effective by information exchange. As a large number of countries did not have their tax system structured in the two categories of real and personal taxes, he proposed to leave the draft text as such to cover the case of personal tax and merely mentioning in the commentary the possibility of agreements between countries to deal with the case of real tax.

Damste approved all these suggestions and recognized that the measure proposed by Clavier, '*might contribute to a large extent to the achievement of justice in regard to taxation.*'[98]

D'Aroma submitted to the Committee the following text, 'Income from public funds, bonds, including mortgages, loans, deposits and current accounts, shall be taxable in the State in which the debtors of such income are at the time resident. Nevertheless, if, following a special agreement and subject to conditions of reciprocity, the country of origin exempts the interest covered by the present article from the application of an existing tax, this interest may be taxed in the country in which the creditors have their domicile.'

Dorn wanted to better define the scope of paragraph two by specifying that the interest might have been subject to real tax in the creditor residence state. Clavier thought this proposal to be useless as Art. 3 was included in the chapter on real tax. A reference might have been made in the commentary. Julliard reiterated his point that the creditor residence state should not have been allowed to levy real tax. In his opinion, in order to prevent double non-taxation, it would have been

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[97] The minutes of meetings show a discussion between Vlasak and Clavier. In the author's opinion, the former seemed to embrace a very conservative approach re tax evasion, which remembers arguments laid down in some recent case laws on double non-taxation. Vlasak observed that Art. 3(1) provided a complete distributive rule by allocating exclusive taxing rights over income from public funds etc. to debtor residence state. The way in which the debtor residence state had exercised its taxing powers was exclusively a matter of fiscal sovereignty and in the case it had decided to exempt it, as it was free to do, the creditor residence state should not have been entitled to tax that income. A totally different approach was taken by Clavier, according to which, in order to prevent double non-taxation, the holder of securities should have been subject to tax at source (in the debtor issuing state) without being granted a relief in light of the tax rules existing in his residence state. Indeed, Clavier made the example of a debtor issuing residence state having the schedular tax but not the general tax and the creditor residence state having the general tax but not the schedular tax.

[98] See, League of Nations, supra n. 53, at p. 13.

sufficient that, '*the country in which the income originated granted no exemption for no taxpayer* ...'[99] Also Zaleski thought it illogical to allow the creditor residence state to levy real tax. D'Aroma reminded the other members that the measure he proposed was in conformity with the 1925 experts' resolutions on double taxation according to which, the reimbursement of, or exemption from, source country schedular tax would be allowed only to extent had a tax been levied in the residence country.[100] At the end, the Committee adopted the text submitted by d'Aroma.

In conclusion, even though Adams' attempts to amend Draft Convention No. I*a* were unsuccessful, according to Graetz and O'Hear, the allocation rule for interest provided by Draft Convention No. I*b* may partially have reflected Adams' efforts to preserve a safeguard against tax-exempt securities.[101] In addition, it should be recognized that Adams's proposal sparked one of the longest debates within the Committee on Double Taxation and Tax Evasion and many of subsequent proposals such as those of Borduge and Clavier, although different, had nonetheless as objective the avoidance of double non-taxation and the achievement of justice in taxation, thus the actual enforcement of the STP.

4. The Single tax principle applied at the state level: The US as a residence state

Some scholars have argued that the rejection of double non-taxation was already implicit when Congress enacted the Revenue Act of 1918 introducing the foreign tax credit mechanism, according to which U.S. citizens (or residents) and domestic corporations may take as a credit against the tax due to the U.S. government the amount of any income tax paid or accrued during the same taxable year to any foreign country.[102] Driven by concerns about tax evasion, which he

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[99] See, League of Nations, supra n. 53, at p. 15.

[100] League of Nations, supra n. 9, at p. 32, '... As regards interest on (1) Public funds and bonds issued by companies or other legal persons; (2) deposits and current accounts: the State in which the debtor is domiciled shall, as a rule, be entitled to levy the schedular tax, but the experts recommended the conclusion of agreements whereby (particularly by means of affidavits and subject to proper precautions against fraud) *reimbursement of, or exemption from, this tax would be allowed* in the case of securities, deposits or current accounts of persons domiciled abroad, or *whereby the tax would be levied either wholly or in part by the State in which the creditors are domicile*.'

[101] See, M. J. Graetz & M. M. O'Hear, *The "Original Intent" of U.S. International Taxation,* 46 Duke Law Journal 5 (1997) at p. 1099, footnote no. 307, available at: https://scholarship.law.duke.edu/dlj/vol46/iss5/2/ (accessed 17 June 2019).

[102] Adams also tried to impose the foreign tax credit at international level in his work with the International Chamber of Commerce and the League of Nations. See, J. G. Herndon, *Relief from International Income Taxation: the development of international reciprocity for the prevention of double income taxation.,* (Callaghan and Company, 1932), at pp. 20 – 22 – 23 – 25 and 31, 'One of the Resolutions adopted by the Organization Meeting of the International Chamber of Commerce was as follows: "... *in order to prevent individuals or companies from being compelled to pay a tax on the same income in more than one country, taking into consideration that the country to which such individual or company belongs has* [*a*] *right to claim the difference between the tax paid and the home*;"' See, League of Nations, *Minutes of the Tenth Meeting of the Eight Session of the Committee of Experts on Double Taxation and Fiscal Evasion,* D.T./8th Session/P.V.10(1), (12 April 1927). See, League of Nations, *Double Taxation and Tax Evasion, General Principles to serve as a Basis of Discussion in Drafting a Convention to prevent Double Taxation in the Sphere of National Income Taxes, Submitted by Prof. T.S. Adams*, D.T. 141 (27 Oct. 1928), at p. 3, 'Art. III.A. – Where under the foregoing Articles a State agrees to exempt any income from sources in another State received by a national or resident or a corporation organized under its laws or having its real centre of management within its territory, it may require such taxpayer to report his or its total income from all sources and effect the exemption by *deducting* from its tax on total income, *the lesser of the two following amounts*: 1) *the tax which is*

considered as unjust and problematic as double taxation, Thomas Adams designed the credit system in a way to ensure that foreign-source income not taxed abroad is captured and subject to tax by the United States as residence jurisdiction. Since the foreign tax credit itself is a cost to the U.S., because the U.S. Treasury foregoes collection in favor of the foreign treasury so as not to subject US citizens and domestic corporations to two taxes,[103] Adams thought residence-based taxation should only defer to source-based taxation when tax is actually paid, therefore when the source state effectively exercises its jurisdiction to tax.[104] Many scholars have argued that in order to justify the foreign tax credit, Adams wrote, '*... the state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax.*' While the underlying principle is substantially the same, it should be noted that Adams, when he wrote that sentence in 1932, was actually referring to the U.S. domestic movement to reduce double taxation in the field of inheritance taxes. Indeed, Adams was referring to the so-called *reciprocal exemption laws* and a series of U.S. Supreme Court decisions. According to these reciprocal exemption laws, which were adopted during the 20's by 2/3 of the states containing more than 90 per cent of the population of the country, states agreed not to tax intangibles of non-residents, provided that the state of the decedent's domicile either did not tax intangibles of non-residents or granted a similar reciprocal exemption. On the other hand, the U.S. Supreme Court decisions cited by Adams held that the due process clause of the Fourteenth Amendment forbids double taxation of testamentary transfers of both *tangible* and *intangible* property.[105] Back then thus, ignoring the federal estate tax, property was subject to

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imposed by the other Contracting State on such income, or 2) *that proportion of the total tax which the income taxed in the other State bears to the total income.*'.

[103] See E.R.A. Seligman, *Double Taxation and International Fiscal Cooperation,* being A series of Lectures delivered at the Académie de Droit International de La Haye, (The Macmillan Company 1928), at p. 135, 'In all these cases the committee express their doubts as to the first principle, that of deduction. This is actually followed in the United States which permits a credit for taxes levied abroad. The committee point out that this is indeed generous, and quite possible for a wealthy country like the United States. *But inasmuch as it may happen that the foreign tax is higher than the domestic one, it would follow that the country permitting the credit or deduction would, if it did not limit the credit as in the United States, get no revenue at all.* This may indeed be endurable or even desirable for a country which is anxious to favor the business enterprises carried on abroad by its own nationals; and which is ready to make sacrifices for that end. But in the ordinary run of cases the sacrifice would be too great. *With the gradual lowering of taxes in the United States, synchronously with the maintenance of higher taxes abroad, it means that the United States is making a present of the revenue to other countries.* In a country which already has many foreign investments or where much business is already carried on abroad, *this would put its exchequer at the complete mercy of the foreign country.* For the ordinary country that finds some difficulty in balancing its budget such a situation would be unfortunate. It is an over-generous and one-sided arrangement.'

[104] In 1921 a limitation was imposed on the amount of this credit in order to, '*ensure that U.S. companies and individuals could not use foreign taxes to reduce or eliminate U.S. taxes on U.S. source income.*' See, See, Graetz & O'Hear, supra n. 62, pp. 1022 – 1023, footnote no. 4.

[105] See, US: Supreme Court, Frick v. Com. of Pennsylvania, 268 U.S. 473, 488-92 (1925), '... it must be held that the *Pennsylvania statute, in so far as it attempts to tax the transfer of tangible personality having an actual situs in the other states, contravenes the due process of law clause of the Fourteenth Amendment and is invalid;*' US: Supreme Court, Farmers Loan Co. v. Minnesota, 280 U.S. 204 (1930) (State could not assess inheritance tax on transfer of *public securities* owned by nonresident decedent, and kept in state of his domicile). After Farmers Loan immunity from multiple taxation was extended to other forms of intangible property: US: Supreme Court, Baldwin v. Missouri, 281 U.S. 586 (1930) (State's inheritance tax on transfer of *credits*, *bonds* and *notes*, physically within state, but owned by nonresident, held unauthorized and unconstitutional); and US: Supreme Court, First Nat'l Bank v. Maine, 284 U.S. 312 (1932) (Shares of stock in Maine corporation, belonging to estate of decedent domiciled in Massachusetts, held not subject to Maine inheritance tax).

inheritance tax only once: (i) at *situs* in the case of *real property* and *tangible personalty* which had acquired an *actual situs* other than the domicile of the decedent; (ii) at *domicile* in the case of *intangible property*. In realty Adams was concerned that had those reciprocal statutes been read in conjunction with the possibility for securities and other intangible personalty to acquire a '*business situs*' other than the domicile of the decedent, as mentioned by the Supreme Court, taxation would have been avoided altogether. Adams observed that, '... If the Court eventually decides that *such personalty* [shares of stock and other intangibles] may be taxed only at its "*business situs*," then under many of the reciprocal statutes it *will escape altogether*; it *will be exempt at situs under the reciprocal statutes as now framed and will be exempt at domicile under the assumed court decision*.'[106] For these reasons, Adams made four important conclusions based on his wide experience: (i) for purposes of avoiding double taxation, tax should be assigned to a jurisdiction which can effectively administer and collect it; (ii) sometimes it may happen that the residence jurisdiction does not have greater administrative power and control than the source jurisdiction; (iii) allocation of tax sources should not be fixed for indefinite periods by rigid constitutional rules. In the author's opinion, however, the most important conclusion is the fourth one according to which, '... *the jurisdiction of domicile should usually grant an exemption only through the tax credit, by which the taxpayer is exempted at domicile only when he has proved payment of the tax in some other jurisdiction. The modern habit of living or incorporating in one jurisdiction and holding property or doing business in other jurisdictions has led to much unjust double taxation, but it has also led to a large volume of tax evasion, and the state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax*.' Therefore, it is the author's opinion that Adams, when he wrote the above-mentioned sentence, was advocating for the STP at interstate level in the field of inheritance tax on testamentary transfers of intangible property owned by nonresidents.[107] But given Adams' role in drafting the foreign tax credit and rejecting the common practice of exempting foreign source income, it is hard not to believe that he also had the international aspects of the STP in mind.

Finally, in the author's opinion tax evasion concerns might have also played a role when Adams structured the tax system for non-resident aliens who derive income from sources within the US. On September 3rd, 1921 in a hearing before the Senate Finance Committee on H.R. 8245, Adams was discussing with Senators Smoot, Simmons and Watson the high complexities and difficulties in applying the old § 216(e) to foreign investors in the US. The question was whether foreigners doing business in the US should have been entitled to personal exemptions. Adams thought that

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[106] See, US: Nebraska Supreme Court, Mackiewicz v. Douglas County, 246 Neb. 50, 54, 516 N.W.2d 608, 611 (1994), 'It may be true, as the district court found, that *in general the intent of reciprocal exemption laws is not to avoid taxation altogether*, but to avoid double or multiple taxation. *To prevent nonresidents from avoiding taxation completely, at least one state has limited the exemption provided for in its reciprocal transfer tax law to cases in which the decedent's resident state has imposed a tax on the transfer of the property exempted*. See US: Wis. Stat. Ann. 72.11 (West 1989).'

[107] See, T. S. Adams, *Interstate and International Double Taxation*: in *Lectures on Taxation* (R. Magill ed., Chicago Commerce clearing House 1932) at p. 113, '... *The decisions under discussion* [Frick; Farmers Loan Co; Baldwin; and First Nat'l Bank] *embody a general principle of single jurisdiction or single taxation and a specific allocation of particular tax sources to the jurisdictions favored*.'

old § 216(e)[108] was a highly difficult provision as, '... We have to follow the foreign law, and *sometimes the foreign country has no income tax*, and it is changing its laws. Also it seems to me we are very generous to say that a foreign citizen, although he may be receiving only one one-hundredth of his income in this country, shall have his personal exemptions in this country ...'[109] The simplification of administrative challenges were not, as other scholars argued, the only reason why Adams was against providing personal exemptions to foreigners making money in the US. In the author's opinion, tax evasion concerns were important as well. Indeed, as the minutes of the 1921 Hearing Act show, '... [The House adopted ... new § 216(e)] *in order to* simplify it and *do more justice*.'[110] According to Adams, therefore, it was preferable for the US Treasury not to grant a personal exemption to foreigners deriving US source income since it could not know whether they had been taxed in their residence country. If by the foreign tax credit Adams wanted to preserve residence-based taxation absent any taxation at source, by denying *tout court* personal exemptions to nonresident individuals and foreign traders, Adams wished to retain source-based taxation in the absence of any taxation at residence. Again, this episode is another clear and practical implementation of the STP by Adams.

5. Conclusion

The historical and systematic analysis of the League of Nations minutes of meetings carried out above allows the author to draw meaningful conclusions in relation to the STP and its father[s]. On the one hand, at the international level, it is undisputed that by April 1927 Sub-Committee C's members had theorized the STP in their work on the draft bilateral convention on administrative assistance in matters of taxation. The minutes of meetings show that Sub-Committee C's members drew extensively from the 1925 Experts' resolutions and their continuous references to the principles of *justice*, *fairness* and *equity*. Firstly, the 1925 Experts used considerations of justice to condemn the abuse of tax treaty provisions which enabled wealthy taxpayers to escape taxation altogether. Secondly, the idea of justice was used by Clavier in arguing that tax evasion was a problem of *public morality*. Here, the smoking gun is represented by his 1924 memorandum on the resolution adopted by the Committee on Double Taxation and the Evasion of Taxation concerning the possibility for states to exchange information on income from movable securities etc. There, Clavier, by making reference to statements of finance ministers of various European governments, such as Delacroix (Belgium), Lastevrie (France) and Baldwin (United Kingdom)

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[108] See, old § 216(e) IRC: 'In the case of a nonresident alien individual who is a citizen or subject of a country which imposes an income tax the credits allowed in subdivisions (c) and (d) shall be allowed only if such country allows a similar credit to citizens of the United States not residing in such country.' in US: Internal Revenue: Hearings Before the Committee on Finance of the United States Senate on H.R. 8245, 67th Cong. 256 (1921), reprinted in 95A Internal Revenue Acts of the United States 1909-1950: Legislative Histories, Laws, and Administrative Documents (Bernard D. Reams, Jr. ed., 1979), at p. 63.

[109] See Internal Revenue, supra n. 69, at p. 63, '... We have to follow it into the foreign country. Maybe the foreign country has no income tax, although it has some tax which is somewhat similar. We have no test of the veracity of the foreign citizen. We can not tell whether he has 10 children or 4 children, or whether he is unmarried or living with his wife. It also means, if you want to administer it with any care and accuracy, that we have to convert the foreign income into dollars in this country. The situation is not important enough to warrant so much meticulous care.'

[110] See § 216(e) IRC: 'In the case of a nonresident alien individual or foreign trader, the personal exemption shall be only $1,000, and he shall not be entitled to the credits provided in subdivision (d).' in Internal Revenue, supra n. 69, at p. 63.

stated that, '... [I]t is contrary to equity and morality that persons whose fortune consists solely of immovable property or mortgages, and persons who live by their own labor and whose income is known ... should pay taxes on the whole of their income while so many holders of transferable securities, who have nothing to do but detach their dividend coupons, escape almost entirely, leaving it to those who are conscientious to pay in their stead.'[111] In the author's opinion, it seems that the lack of information exchange on income from movable securities might have violated the principle of horizontal equity. Assuming individual taxpayers, A and B were both residents of country R. Taxpayer A was exercising his profession of lawyer in his resident country while taxpayer B held shares in a company domiciled in country S, which paid dividends. Both taxpayers had an annual taxable income of $100. If country S did not exchange information with country R that taxpayer B had received a coupon from SCo and asked to be reimbursed from source withholding tax, taxpayer B may wholly avoid taxation in his resident country leading thus to a discrimination. Thirdly, and most importantly, Clavier also argued that a great step towards *fiscal justice* would have been taken if countries had come to an agreement to bilaterally exchange information on certain items of income along the lines of the 1843 treaty between Belgium and Netherlands on immovable property. Fourthly, it was *unfair* if source country had abandoned or reduced its schedular taxes absent any actual taxation at residence. Finally, as argued by Zaleski, administrative assistance would have also served the purpose to better apportion and *more equitably distribute* fiscal burdens in the interests of both taxpayers and States. Exchange of information was not only necessary to prevent double non-taxation but also to allocate tax bases to the best jurisdiction in terms of administrative efficiency in controlling taxpayers, collecting taxes etc. Therefore, if *prima facie* the paternity of the STP should be attributed to all Sub-Committee C's members, a closer examination of the minutes of the meetings reveals that Clavier was its actual father, at least from its theoretical perspective. Clavier's hand can be detected in three out of four statements over justice. Clavier, the Belgian representative, was one of the 1925 Experts and, although he was not a Sub-Committee C member, he actively participated in the discussion of all provisions of the draft bilateral convention on administrative assistance. The minutes of the meetings also show that many of the instruments that have been enacted in the last nine years, such the US Foreign Account Tax Compliance ACT (hereinafter: "FATCA"), the 2011 OECD Multilateral Agreement for Administrative Assistance in Tax Matters (hereinafter: "MAATM"), or the 2014 OECD Common Reporting Standard (hereinafter: "CRS"), which provide for an automatic exchange of financial account information, are not something entirely new. Sub-Committee C discussed at great length whether conventions should be multilateral, thus covering as many states as possible, or just bilateral; whether information should be exchanged automatically or by specific requests; and whether should be limited to specific items of income or not. The 1907 treaty concluded by France with Great Britain was one of the first agreements under which the taxing authorities of the two countries automatically exchanged information with

[111] See, League of Nations, Financial Committee Evasion of Taxation, F. 192., (20 Oct. 1924), at p. 18. It is also interesting to read the parts where Clavier was commenting the recent rejection in Switzerland by way of a popular referendum of the abolition of bank secrecy, *Id.*, at p. 25, '... When the electors are asked: do you want fresh taxation to be imposed on several millions among you in order to spare a few thousand wealthy and unscrupulous individuals, there can be no doubt as to the reply they will make in every country. The vaunted secrecy of the banks will be swept away by a wave of general indignation. That day will see the dawn of an era of fiscal justice and of higher public morality.' (Emphasis was already present in Clavier's memorandum).

a view to counteracting the evasion of death duties. The history of the League of Nations' minutes thus leads the author to conclude that the current fight against international tax avoidance and evasion is nothing new, as recently proposed solutions do not differ at all from what was already proposed one century ago. Serious political willingness is what is missing. Thus, Santayana's famous quote, '*Those who cannot remember the past are condemned to repeat it*' holds true even in the fight against international tax avoidance and evasion. Indeed, one century of hypocrisies and nationalistic egoism led to a world where, according to Zucman's data, $7.6 trillion. equivalent to 8% of the global financial assets of households, is held in accounts located in tax havens.[112] Out of this total, Zucman estimates that $6.1 trillion (80%) of offshore funds is undeclared to tax authorities. This amounts to a global reduction in tax revenues of about $200 billion annually.[113]

On the other hand, at the international level, the practical implementation of the STP, the idea that if the primary jurisdiction refrains from exercising its taxing powers, it is incumbent on the other jurisdiction to tax in order to prevent double non-taxation, was due to Thomas Adams and his 1927 proposed amendment on Art. 3(2) concerning tax-exempt securities, based on equity (vertical), efficiency and neutrality reasons. At the state level, for the US as a residence state, the above analysis demonstrates that the rejection of double non-taxation was already implicit in 1918 when Adams adopted the foreign tax credit; in 1921 when he wanted to deny and/or limit personal exemptions to foreigners investing US. since the US Treasury could not know whether any residence tax had been levied on their US source income; and in 1932, when he criticized to some extent the double exemption that could have been achieved through the reciprocal exemption laws and some favorable US Supreme Court decisions in the field of inheritance taxes.

In conclusion, it could be argued that, by 1927, Clavier and Adams had given birth to the STP from a theoretic and practical perspective. One interesting question is to what extent the STP was driven primarily by issues of tax evasion (i.e. deliberate and voluntary defiance of the law by taxpayers) rather than tax avoidance (i.e. income that is legally not subject to tax anywhere due to a literal compliance with the law but not with its spirit). *Prima facie*, it seems that Clavier may have thought more of evasion and Adams more of avoidance. On the one hand, indeed, in the case of internationally mobile wealthy taxpayers without any fixed residence, Clavier referred to the *evasion* of all treaty provisions, implicitly assuming that taxpayers were intentionally defying all treaty provisions by being internationally mobile – making only a short stay in each country without having any permanent home at their disposal – in order to have their transferable securities not subject to tax anywhere. On the other hand, Adams's opposition to tax-exempt securities seemed to be driven primarily by tax avoidance concerns. He did not want richest taxpayers diverting their capital to inefficient and unproductive investments, such as tax-exempt bonds.

[112] G. Zucman, *The Hidden Wealth of Nations, The Scourge of Tax Havens*, (The University of Chicago Press, 2015), p. 35.

[113] G. Zucman, *Taxing across Borders: Tracking Personal Wealth and Corporate Profits*, 28 Journal of Economic Perspectives 4 (2014), p. 141.

However, a closer examination of the cases they cited reveals that neither Clavier nor Adams had entirely separated the issues of tax avoidance and tax evasion in justifying the STP.

In conclusion, in the author's opinion, the STP originated by 1927 but only reached its maturity during the six years 1957-1963, when Stanley Surrey firstly was successful in persuading Senate not to ratify Art. XV(I) of the Pakistan – United States Income Tax Treaty (1957)[114] and secondly adopted the first anti-deferral regime in the world, the so-called Subpart F, and introduced the first LOB provision in Art. XV of the treaty with Luxembourg. It is the author's opinion, indeed, that Surrey wanted to close the loopholes of US international tax rules by adopting both a '*top-down*' (introducing Subpart F legislation dealing with the issue of *base companies* from the perspective of residence jurisdiction) and a '*bottom-up*' approach (introducing LOB provisions dealing with the issue of *conduit companies* from the perspective of source jurisdiction).[115] At the international level (OECD), the STP reached its maturity only 12 years later, in 1975, when the Committee on Fiscal Affairs discussed the US proposal to abolish withholding tax on portfolio dividends and interest paid to non-residents. One of the arguments in favor of source withholding taxes was indeed tax avoidance and international co-operation:

'... Tax avoidance considerations have always been part of the discussion of withholding tax. *The levying of a withholding tax at source* is often presented as a "minimum tax" on the income paid abroad which, if it does not induce the investor to declare his income in his home country, *does at least ensure that some tax is paid somewhere*. In principle, the deduction of withholding tax generates information which should be of use in identifying taxpayers in their country of residence, at any rate, if such information is exchanged regularly and duly exploited.'[116]

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[114] US: Hearing before the Committee on Foreign Relations United States Senate, 85th Congress, 1st Session on Income Tax Convention with Pakistan (1957), at p. 3, '... This treaty distorts the whole foreign tax credit procedure. It gives a credit for a foreign tax *not paid*. In effect this is what has happened;' and p. 25, '... *The analogy here is that the Congress should be asked to grant a tax deduction for State property taxes not paid to Louisiana*. That is exactly what this treaty does.' See also, S.S. Surrey, *The United States Taxation of Foreign Income*, 1 The Journal of Law & Economics, (1958), pp. 72 – 96.

[115] See US: Official explanation proposed by the US Treasury Department on article XV of the Luxembourg-United States Income and Capital Tax Treaty (1962), 'Inasmuch as these laws allow investment income from domestic and foreign sources to be accumulated by these holding companies and distributed to nonresident individuals and foreign corporations without the imposition of Luxembourg tax, it was deemed appropriate not to grant any of the exemptions from, or reductions in the rate of U.S. tax otherwise available under this convention with respect to such income ... Although this approach adopted for the purpose of excluding so-called "tax-haven" income from the scope of the convention is not found in any income tax convention concluded by the United States, other than the Netherlands Antilles Protocol [1963], certain precedent may be found in some of the relief provisions contained in the conventions with the United Kingdom, Ireland, Australia, and Pakistan requiring that the recipient of treaty income "be subject to tax" on such income in the country of residence in order to qualify for exemption from, or reduction in the rate of, the tax of the country of source. *Moreover, this new provision is consistent with the spirit of the provisions of section 12 of the Revenue Act of 1962 relating to the taxation of certain "tax-haven" income of controlled foreign corporations to U.S. shareholders*.'

[116] See, OECD, CFA, Fiscal Issues Pertaining to Withholding Taxes on Portfolio Dividends and Interest (Note by the Secretariat), CFA (75)4 Scale 2 (12 May 1975), at p. 11. According to Avi-Yonah, the portfolio interest exemption was always regarded as a necessary evil rather than a positive step. See, R. S. Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (Cambridge University Press 2007), at pp. 70-71.

But this is a research hypothesis that will be investigated in a future paper.

A comparison of the U.S. economic substance doctrine with Italy's new abuse of law rules: Gravitation towards similar outcomes?

Gianluca Mazzoni

summary: 1. Introduction – 2. Drawing the line between tax evasion, tax avoidance and legitimate tax planning: general definitions – 3. The Italian experience: an example of hybrid solution – 3.1. Art. 37*bis*, a GAAR or a semi-general statutory GAAR? – 3.2. The judicial anti-abuse of law doctrine from 2000 to nowadays – 3.3. The relationship between the Commission Recommendation on aggressive tax planning and the *Delega Fiscale* – 3.4. A new definition of "abuse of law" – 4. The development of the US economic substance doctrine: from its origins to the 2010 codification – 5. Conclusion.

1. Introduction.

The aim of this article is straightforward: try to demonstrate that there is a convergence between the different approaches adopted by Italy and the USA with regard to the concept of tax avoidance. This issue has been traditionally treated differently: a substance-over-form doctrine developed by courts in common law countries and an abuse of law rule provided by statutes in civil law countries. However, it seems that many countries preferred hybrid solutions. On one side, common law countries are trying to codify a general anti-avoidance rule (hereinafter GAAR). On the other side, courts of civil law countries are trying to develop some sort of the substance-over-form doctrine. Does this statement still hold true nowadays? The economic substance doctrine has been codified by Congress with the Health Care and Education Reconciliation Act of 2010 while, starting from December 2008, the Italian Supreme Court (hereinafter ISC) has been trying to apply a GAAR based on the ability to principle of Art. 53 of the Constitution. Surprisingly, a legal definition of abuse of law has been recently introduced in Italy with Legislative Decree No. 128 of August 5th 2015. Accordingly, abuse of law exists when one or more transactions lack economic substance and, despite being formally in compliance with tax law, are essentially aimed at obtaining undue tax savings. Consequently, it could be argued that the economic substance doctrine successfully circulated among the USA and Italy and has been similarly implemented, in the sense that both countries adopted a statutory GAAR. After all, the reasons behind the adoption of a statutory

GAAR were, also, the same in both countries: ensure a higher level of legal certainty and foreseeability[117].

This article is divided into three sections. In section two, the author will try to define the concepts of tax evasion, tax avoidance and licit savings and briefly introduced the different approaches adopted by the USA and Italy to counter tax avoidance. In section three, the author will go back over the Italian experience of abuse of law while in section four the author will describe the US doctrine of economic substance.

2. Drawing the line between tax evasion, tax avoidance and legitimate tax planning: general definitions.

As Avi-Yonah et al. have argued, there is no universal legal or academic definition of these concepts and it is very difficult to distinguish between legal tax behaviours and the illegal forms of tax avoidance.[118]

For example, the concept of tax evasion seems to be clear and simple: the taxpayer avoids the payment without avoiding the tax liability and consequently escapes the payment of tax – which is unquestionably due according to the law of the taxing jurisdiction – and even breaks the letter of the law. However, this definition is not shared by all countries and according to a more refined and precise approach, evasion is the direct violation of a tax provision, and the detrimental financial effect on the revenue is by itself immaterial[119].

On the other hand, tax avoidance identifies illegitimate behaviours aimed at reducing, removing or postponing the tax liability under which the taxpayer complies with the literal letter of the law but frustrates its spirit[120]. Some jurisdictions do not recognize the legal concept of tax avoidance

[117] See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress 378, JCS-2-11 (March 2011) where it is stated that: "The Congress believes it is still desirable to provide greater clarity and uniformity in the application of the economic substance doctrine in order to improve its effectiveness at deterring unintended consequences". From the Italian perspective, Legislative Decree No. 128 of August 5th 2015, which entirely reviews the set of anti-avoidance rules and introduces a definition of "abuse of law" is labelled "Certainty Decree".

[118] Avi-Yonah, Sartori and Marian, Global Perspectives on Income Taxation Law, Oxford University Press, 2011, at p. 151.

[119] See also IBFD Tax Glossary: Tax evasion, in contrast to tax avoidance, may be characterized as intentional illegal behaviour, or as behaviour involving a direct violation of tax law, in order to escape payment of tax. Tax evasion is generally accompanied by penalties that may be, but are not always, criminal in nature. Deliberate underreporting of taxable income would generally be considered an example of tax evasion. The term "evasion" tends to be used in French-speaking countries to refer to the concept of tax avoidance, while "tax fraud" is used to refer to the concept of tax evasion.

[120] See also IBFD Tax Glossary: For tax purposes, avoidance is a term used to describe taxpayer behaviour aimed at reducing tax liability that falls short of tax evasion. While the expression may be used to refer to "acceptable" forms of behaviour, such as tax planning, or even abstention from consumption, it is more often used in a pejorative sense to refer to something considered "unacceptable", or "illegitimate" (but not in general "illegal"). In other words, tax avoidance is often within the letter of the law but against of the spirit of the law. It generally contains elements of artificiality, e.g. as to the legal form adopted, and may often be considered to be contrary to the spirit of the law.

on the grounds either that the behaviour is legitimate[121], or, if illegitimate, that it constitutes evasion[122]. A clear example of tax avoidance is the conversion of income to non- or lower-taxed gains.

Licit tax saving or legitimate tax planning can be defined as an arrangement of a person's business and/or private affairs which does not contradict neither the law nor its spirit and whose intent is to minimize tax liability.

The difference between tax avoidance and tax saving is less clear and often questioned than the difference between tax evasion and tax avoidance where is there is substantial consensus among scholars. However, according to Uckmar, the decisive criterion is the legislative intent. Tax saving is the reduction of the tax liability by means which the legislator did not wish to regulate or to consider fiscally relevant[123], whereas tax avoidance is the exploitation of areas which the legislator intended to cover but for one reason or another did not. Thus, the distinction is made between "fiscally free areas" and "legislative loopholes".

According to economists, taxpayers can reduce their tax liabilities in a wide variety of ways. The legal ways, such as using legitimate itemized deductions or some forms of tax arbitrage, are called tax avoidance.[124] The illegal ways, such as failing to report income or overstating deductions, are called tax evasion. In their opinion, taxpayers will undertake behaviour that reduces tax liability up to the point that the marginal cost equals the marginal tax savings. With avoidance, the cost may be expenditures on professional assistance. With evasion, the cost may be exposure to the uncertainty on an audit and any attendant penalties for detected evasion. Therefore, they do not accept the tri-partition used by legal academics.

As hereinbefore mentioned, the attempts to drawn the line between legitimate tax minimization and abusive tax avoidance vary from country to country.

2.1. An overview of US judicial doctrines addressing tax avoidance: the *business purpose* and *substance over form* doctrines.

[121] Where only direct violation of tax law is punishable, indirect violations of tax provisions are fully legitimate and the term "avoidance" is thus legally immaterial, IFA Cahiers 1983 – Vol. 68a. Tax Avoidance/Tax Evasion, General Report, V. Uckmar, at p. 23.

[122] In some countries where indirect violations of tax law may be penalised, the term "avoidance" may be deemed to be immaterial because an "illicit avoidance" would be legally labelled as "evasion" which in the legal tax code includes all violations of tax laws, IFA Cahiers 1983 – Vol. 68a. Tax Avoidance/Tax Evasion, General Report, V. Uckmar, at p. 24.

[123] An extreme example is that of the individual who refrains from consumption of a certain product (and thus avoids payment of purchase tax), or deliberately slows down his work in order to avoid having a larger income which would be mainly absorbed by taxes, IFA Cahiers 1983 – Vol. 68a. Tax Avoidance/Tax Evasion, General Report, V. Uckmar, at p. 20.

[124] Joel Slemrod and Jon Bakija, Taxing Ourselves, A Citizen's Guide to the Debate over Taxes, The MIT Press Cambridge, fourth edition, at pp. 144 – 146.

In scrutinizing taxpayer behaviour, the US courts formulated a set of doctrines among which the most important are: the sham transaction doctrine, the economic substance doctrine, the substance over form, the business purpose and the step transaction doctrine. All these judicial doctrines try to answer the following question: have the taxpayers actually done what they, and their documents, represent, or are the economic realities of the transaction – and the attendant tax consequences – other than what the taxpayers purport them to be?[125]

In particular, according to the *business purpose* doctrine, great emphasis is placed on the motive[126] of the transaction. Transactions are distinguished between those motivated by a business purpose[127] and those that have no substance, purpose or utility apart from tax avoidance. An effective and valid business motive is considered as a prerequisite for a certain tax treatment. As originally formulated in the landmark case *Gregory v. Helvering*[128], the business purpose doctrine was applied to deny tax-free treatment to a transaction that would not have been consummated but for tax savings that would result if its form were respected. Indeed, the sole purpose why the taxpayer, Evelyn Gregory, created and liquidated Averill corporation was the avoidance of two levels of tax[129]. The Supreme Court concluded that the operation had no business or corporate purpose but was rather a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character[130].

Another relevant case where the business purpose doctrine was applied is *ACM Partnership v. Commissioner*. Here, Merrill Lynch presented a proposal to Colgate-Palmolive (Colgate) in order

[125] This is the reason why it was argued that: "The tests used to resolve this question bear many labels which are often used interchangeably". See S. Schwarz & D. J. Lathrope, *Fundamentals of Corporate Taxation*, 2012, THOMSON REUTERS, p. 11; see also p. 619 where the two authors argue that: "These common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts, the IRS, and litigants"; for a discussion about the relationship between the economic substance and sham transaction doctrines see Y. Keinan, *The COLI Cases Through the Looking Glass of the Sham Transaction Doctrine*, 111 TAX NOTES 327, 330-31.

[126] See Walter J. Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 *U. Chi. L. Rev.* 3 (1967), pp. 485-544.

[127] With regard to corporate divisions, Reg. § 1.355-2(b)(2) defines a corporate business purpose as a real and substantial non Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group to which the distributing corporation belongs; see also Rev. Proc. 96-30, App. A, 1996-1, C.B. 696, which provided detailed guidelines to be used for ruling purposes in evaluating whether a distribution satisfies the business purpose requirement. However, it should be noted that, in 2003, the Service announced a "pilot program" under which it would no longer issue advance rulings on the business purpose requirement and the device limitation. See, S. Schwarz & D. J. Lathrope, *Fundamentals of Corporate Taxation*, 2012, THOMSON REUTERS, pp. 484-487.

[128] See J. S. Seidman, *The Gregory Reorganization Case*, 13 *Tax Magazine* 3 (1935), pp. 130-172.

[129] See Faber, Peter L., *Business Purpose and Section* 355, 43 *Tax Law*. 1989-1990, p. 863: "Mrs. Gregory owned all the stock of United Mortgage Corporation (United), which included among its assets 1,000 shares of the stock of Monitor Securities Corporation (Monitor). Mrs. Gregory wanted United to distribute the Monitor stock to her, but she did not want to be taxed on a dividend. Instead, she caused United to form a new corporation, Averill Corporation (Averill), and to transfer the Monitor shares to Averill in exchange for which all of the Averill stock was issued directly to Mrs. Gregory, who immediately liquidated it, received the Monitor shares in liquidation, and sold them. Mrs. Gregory argued that the transaction was a reorganization under section 112(i)(1)(B) of the Revenue Act of 1928 (the predecessor to section 368(a)(1)(D) of the Internal Revenue Code of 1986) because it met the literal requirements of that provision. She said that she should be treated as if she had received a liquidating distribution from Averill, that her basis in the Averill shares should be the proportion of her cost in the United shares that the Monitor shares bore to the total assets of United, and that she should pay tax at capital gains rates on the difference. She treated the Monitor shares as if they had received a stepped-up basis in the liquidation of Averill, and she reported no gain on the sale".

[130] *Gregory v. Helvering*, 55 S. Ct. 266, 267, 293 U.S. 465, 469 (U.S. 1935).

to reduce Colgate's tax liability arising from long-term capital gains which were attributable in significant part to the sale of its wholly owned subsidiary The Kendall Company (Kendall). Merrill Lynch proposed an investment partnership that would generate capital losses which Colgate could use to offset some of its capital gains. The US Court of Appeals, 3rd Cir., concluded that the transactions were not intended to serve any "useful non-tax purpose" and were not reasonably expected to generate a pre-tax profit and thus constituted the type of scheme with "no purpose other than avoidance" that lacks the economic substance necessary to give rise to a deductible loss.

US courts also developed the so-called *substance over form*[131] doctrine in order to counter tax avoidance. Under this theory, a court may not accept the form in which a taxpayer casts a transaction, but instead, will examine the transaction for substance or net economic effect in determining its tax treatment. Facts have to assessed according to their economic substance as opposed to the formal content. An example is whether a business arrangement is properly classified as a sale or a lease. In *Frank Lyon Co. v. United States*, the Supreme Court held that where there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honour the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties govern for tax purposes[132].

Finally, *Kimbell-Diamond Milling Co. v. Commissioner* can be seen as an example of a step transaction doctrine[133] – that the court can apply tax law to the end result of a series of transactions rather than have to take each step in turn. The background of the case was the following: in August, 1942, petitioner's milling plant was destroyed by fire and in November, 1942, petitioner collected insurance as a reimbursement for its loss. On December 26, 1942, using the insurance proceeds ($120,000) and additional funds ($90,000) petitioner acquired 100% of the stock of Whaley Mill & Elevator Co. of Gainesville, Texas. His sole intention in purchasing Whaley's stock was to

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[131] Consider the following case: Target Corporation ("T") has assets with an aggregate fair market value of $600k, an aggregate adjusted basis of $300k, and a $100k liability. Acquiring Corporation ("P") transfers $600k of its voting stock to T in exchange for all of T's assets and does not assume T's liability. T then sells $100k of P voting stock and uses the proceeds to pay off the liability. T then distributes the remaining P stock to its shareholders in complete liquidation. According to Prof. Adams, if T had transferred $100k worth of the P stock to its creditors in payment of the debt, T would have complete nonrecognition, under §§ 361(c)(1) and (c)(3). Indeed, the current version of § 361 provides that only transfers of "qualified property" (i.e., stock or obligations of the acquiring corporation) or boot directly to creditors will qualify for nonrecognition because they are treated as "distributions" to the shareholders pursuant to the reorganization plan. According to Prof. Adams, it seems inappropriate to have a different result because T sold $100k worth of the P stock and transferred the proceeds to the creditor. However, this is a case in which form appears to take precedence over substance. Thus, sales of property to third parties are fully taxable events even if they were necessary to raise money to pay off creditors. T would take a § 358(a)(1) basis in the P stock of $300k, 1/6th of which, or $50k, would be the basis of the stock T sold for $100k, so T would recognize $50k of gain. No gain recognized to T on the distribution of the remaining P stock in liquidation, it's "qualified property" § 361(c). T's e&p is increased by the recognized gain of $50k, and those e&p would carry over to A under § 381. See Schwarz, Stephen & Lathrope, Daniel J., Fundamentals of Corporation Taxation (8th ed. 2012), pp. 446 – 450.
[132] *Frank Lyon Co. v. U.S.*, 98 S. Ct. 1291, 1303-4, 435 U.S. 561, 583-84 (U.S. Ark., 1978).
[133] However, it should be noted that the step transaction doctrine was born in 1938 with *Minnesota Tea Co. v. Helvering*, 302. U.S. 609 (U.S. 1938); see Yoram Keinan, It Is Time for the Supreme Court to Voice Its Opinion on Economic Substance, 7 Hous. Bus. & Tax L.J. 93, 101 & n. 45 (2006) pp. 6 – 7.

acquire Whaley's assets and liquidate Whaley as soon as practicable. On December 31, 1942, Whaley was dissolved and its assets distributed to petitioner. Since the taxpayer's acquisition of the Whaley stock qualified under § 1033, its was $110,000 (the sum of the $20,000 adjusted basis of the destroyed assets and the $90,000 of additional funds that were paid in addition to the insurance proceeds). The assets of Whaley acquired by the taxpayer in the liquidation had an adjusted basis to Whaley of more than $300,000; the depreciable assets represented about $140,000 of this total. The central dispute in the case was over the taxpayer's basis for depreciation in the assets acquired in the Whaley liquidation. The court held that: "the purchase of Whaley's stock and its subsequent liquidation must be considered as one transaction, namely, the purchase of Whaley's assets which was petitioner's sole intention ... petitioner's basis in the assets, both depreciable and nondepreciable, is, therefore, its cost ...". As it has been noted, if the stock purchase and subsequent liquidation of the target subsidiary in Kimbell-Diamond had been treated as separate transactions, the buyer would have taken a (higher) transferred basis in the target's assets under § 334(b)(1). The court looked to the buyer's intent, however, in holding that the stock purchase was merely a transitory step in a transaction that was properly characterized as a purchase of assets. Under this application of the step transaction doctrine, the liquidation was disregarded, and the buyer took a cost basis in the assets.

2.2. An overview of the civil law doctrine of abuse of law.

On the other hand, the civil law doctrine, broadly equivalent to the substance over form doctrine, is the abuse of law. According to this theory, historically developed in the private law[134] field, no one can exercise his rights in conflict with the function to which the right was attributed. The rationale is straightforward: protect other individuals' rights. Over the years, this theory has been developed and extended to the tax field. Indeed, the taxpayer is free to adopt the contractual scheme which is least burdensome from the tax standpoint, but if the sole or predominant purpose of a certain transaction is the avoidance of tax, the form of the transaction may be ignored, on the grounds that the taxpayer has abused his right to use such a form, and substituted by another that

[134] See the definition of abuse of law given by Gérard Cornu in his legal vocabulary: "In civil law, mistake consisting of exerting one's right with no self-interest and with the only aim of being prejudicial to others". One example of prohibition of abuse of rights in Italy may be represented by art. 42 of the Constitution where it is stated that the right to property is not unlimited. Specifically, art. 42 states: "Property is publicly or privately owned. Economic assets belong to the State, to entities or private persons. Private property is recognised and guaranteed by the law, which prescribes the way it is acquired, enjoyed and its limitations so as to ensure its social function and make it accessible to all. Private property may, in the cases provided for by the law and with provisions for compensation, be expropriated for reasons of general interest. The law establishes the regulations and limits of legitimate and testamentary inheritance and the rights of the State in matters of inheritance"; see also P. Rosenblatt, *General Anti-avoidance Rules for Major Developing Countries*, Vol. 49 Series on International Taxation, Kluwer, The Netherlands, p. 82: "The concept of abuse of law is widespread in civil law countries, where it is often regarded as a doctrine of statutory construction. It was initially imported from private law into tax law through judicial development and later codified. Generally, it means the action exceeds the limits of what is reasonable, often when the person acts with an improper motive or purpose. There are two main types of abuse: social abuse – when the action is deliberately driven to circumvent the law in order to achieve a result that the legislature did not intend – and intentional abuse to harm a third party".

is more consistent with economic realty. Compared with the private law, the rationale of abuse of law in tax law is different because it is used to protect the interest of the State vis-à-vis the freedom of the taxpayer to use the legal forms of his choice for the operation of his income-producing activities.

In the next sections, the author will analyse the Italian and US experiences in order to argue that both countries are converging on the idea that the adoption of a GAAR is necessary to effectively counter tax avoidance.

3. The Italian experience: an example of hybrid solution.

As Avi-Yonah et al. have argued, the Italian experience can be described as hybrid in the sense that in addition to specific anti-avoidance rules (hereinafter SAAR), there is a GAAR[135], which is limited in its application to certain transactions (mainly reorganizations). This section will be divided into three subsections: subsection one will be dedicated to the analysis of art. 37*bis*, Presidential Decree No. 600 of September 29th 1973 Income Tax Assessment Act (hereinafter ITAA); subsection two will discuss the abuse of law doctrine developed by the ISC and, finally, subsection three will review the recent codification of abuse of law by Legislative Decree No. 128 of August 5th 2015.

3.1. Art. 37*bis*, a GAAR or a semi-general statutory GAAR?

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[135] See, Avi-Yonah, Sartori and Marian, Global Perspectives on Income Taxation Law, Oxford University Press, 2011, at p. 153; see also R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD where it is stated that: "Despite its wide application, this is not a general anti-avoidance rule (*Generalklausel*), since its application is limited to the specific list of transactions in Para. 3 of Art. 37*bis*. Art. 37*bis* of the ITAA essentially falls in between a specific anti-avoidance provision and a general anti-avoidance rule". In this sense also, A. Fantozzi & G. Mameli, *The Italian Abuse of Law Doctrine for Taxation Purposes*, 64 Bull. Intl. Taxn. 8/9 (2010), Journals IBFD: "For the purposes of this article, it should be noted that the anti-avoidance rule in Art. 37-bis of the ITAC is not a general rule in the full meaning of the term and would be better described as a "semi-general rule". In particular, the rule does not, in fact, apply in general, but, rather, only to certain operations specifically listed in the law. The list was variously augmented in the 10 years following the adoption of Art. 37-bis of the ITAC, thereby widening the scope of the rule. Notwithstanding the widening of the scope of the rule, it should still not be regarded as a "general" rule"; C. Innamorato, *An Unwritten Anti-Abuse Principle in the Italian Tax System*, Eur. Taxn. (2008) Journals IBFD: "Art. 37*bis* of Ministerial Decree 600/1973, albeit with quite a broad scope and giving the tax authorities the power to disregard transactions used without sound business reasons that were intended to circumvent tax obligations, is not formulated as a general anti-avoidance rule. Indeed, the fact that, in the third paragraph, specific transactions are positively listed makes its general application uncertain"; A. Lupo, in *Cahiers de droit fiscal international*, Vol. 87a, Kluwer, The Netherlands, p. 370: "As far as income taxes are concerned, article 37-bis ITAC represents a quasi-general anti-avoidance provision which has been recently introduced and which is assuming a growing importance for business enterprises"; C. Silvani, *Italy - Corporate Taxation* sec. 10., Country Analyses IBFD (accessed 12 Nov. 2015): "Although Italy did not have true statutory GAAR before DLgs 128/2015, the Italian tax authorities have however relied on (i) an extensive range of specific anti-avoidance rules aimed at tackling specific transactions or practices, (ii) a sort of semi-general statutory GAAR (article 37-bis of DPR 600/1973) and (iii) the overarching abuse of law doctrine".

Italian law regulates tax avoidance through two main tools. On the hand, there are specific provision that prohibit the unlawful saving of taxes. On the other hand, the battle against tax avoidance is tackled through the application of art. 37*bis*, Presidential Decree No. 600 of September 29th 1973 ITAA[136].

The origin of art. 37*bis* can be tracked back to the beginning of the 1990s, when the Italian Parliament finally approved art. 10 of Law 408/1990, which gave the Italian tax authorities the power to disallow the tax advantages that derived from certain specifically listed corporate restructuring operations – i.e. mergers, demergers, transformations and capital reductions – performed without economical reason and with the sole reason of fraudulently obtaining a tax saving. By way of, first, Law 724/1994[137] and, later, Law 662/1996, the list of potentially abusive operations was extended to specifically include the sale of securities, thereby making the anti-abuse provision applicable to dividend stripping operations. The next legislative development was the addition to the ITAC, by art. 7 of Legislative Decree 358 of October 8th 1997, of art. 37-bis, entitled "the anti-avoidance rule"[138]. According to art. 37*bis*, paragraph one, the tax authorities may disregard the tax effects of any transaction or series of transactions carried out without valid economic reasons, aimed at circumventing obligations or prohibitions by the tax system and aimed at obtaining tax reductions or refunds to which the taxpayer would not otherwise entitled[139]. The existence of an abusive transaction is, thus, determined on the basis of three conditions: (i) the lack of a business purpose; (ii) the circumvention of obligations/prohibitions; (iii) the result of obtaining tax reductions/refunds otherwise not due. If all these conditions are met, the tax authority may ignore the private law form of a transaction and apply the law that is avoided, thereby negating the tax savings realized[140].

Art. 37*bis*, paragraph three, contains the specific list of transactions to which the anti-avoidance rule may apply. When Art. 37*bis* was introduced in October 1997, its application was limited to only six transactions[141]. Since then, the list has been greatly expanded and the following transactions are now included[142]: (a) transformations, mergers, divisions, liquidations and

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[136] R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD.
[137] For a description of the provisions on tax avoidance that were introduced into Italian law by Law 408/1990 and amended by Law 724/1994, see P. Valente, *Development of Anti-Avoidance Rules with respect to Corporate Reorganizations*, Eur. Taxn., 1998, pp. 32 – 37.
[138] A. Fantozzi & G. Mameli, *The Italian Abuse of Law Doctrine for Taxation Purposes*, 64 Bull. Intl. Taxn. 8/9 (2010), Journals IBFD.
[139] A. Lupo, in *Cahiers de droit fiscal international*, Vol. 87a, 2002, Kluwer, The Netherlands, p. 370.
[140] See art. 37*bis*, paragraph two, Presidential Decree No. 600 of September 29th 1973 ITAA; A. Fantozzi & G. Mameli, *The Italian Abuse of Law Doctrine for Taxation Purposes*, 64 Bull. Intl. Taxn. 8/9 (2010), Journals IBFD.
[141] See G. Marino, *The Reform of the Italian Tax System*, 25 Int'l Tax J. (1999), p. 78: "According to Article 37-*bis*(3), the new regime operates with regard to tax benefits achieved only through (a) transformations, mergers, divisions, liquidations, distributions to shareholders of income other than profits; (b) transfer of going concerns; (c) sale of credits; (d) assignment of tax claims; (e) EU mergers, divisions, transfer of assets, exchange of shares; (f) other operations including valuation of participations, valuation of securities, and valuation of other financial derivatives.
[142] R. Avi-Yonah, N. Sartori & O. Marian, *Global Perspectives on Income Taxation Law*, Oxford University Press, 2011, pp. 107-108.

distributions to shareholders of reserves not consisting of profits; (b) contributions to companies and transactions for the transfer or utilization of business assets; (c) transfer of debt claims; (d) transfer of tax credits; (e) EU mergers, divisions, transfers of assets and exchange of shares; (f) transactions concerning securities and financial instruments; (f-bis) transfers of assets between companies within the same consolidated tax group; (f-ter) payments of interest and royalties eligible for the exemption under the EC Interest and Royalties Directive, if made to a person directly or indirectly controlled by one or more persons established outside of the European Union; (f-quarter) transactions between resident entities and their affiliates resident in tax havens and concerning the payment of an amount under a penalty clause.

The following paragraphs provide some procedural guarantees to taxpayers. Firstly, the assessment notice must be issued, *sub sanctione nullitatis*, after a preliminary request[143] for clarification is sent to the taxpayer who shall answer within 60 days from the receipt of such request. Secondly, the assessment notice must take into consideration the clarifications provided by the taxpayer and be fully justified[144]. Thirdly, taxes assessed under the provisions of this anti-avoidance rule shall be collected only after the judgment of the Provincial Tax Court[145]. Moreover, persons other than the taxpayer may, within one year, ask for reimbursement of taxes paid in relation to transactions disregarded by the tax authority[146]. Finally, taxpayers may apply for an advance ruling with the Italian tax authorities in order to claim the non-application of such an anti-avoidance provision[147].

If the reason behind the introduction of art. 37*bis* was to draw a clear line between legitimate tax planning and tax avoidance, the author does not believe that art. 37*bis* achieved this result due to the several interpretative issues it gave rise. Apart from the uncertainty related to its general application due to the positive list of transactions of paragraph three, there are some other questions which did not find a clear answer. For example, art. 37*bis*, paragraph one, simultaneously refers to both valid economic reasons and circumvention of obligations/prohibitions. The Provincial Tax Court of Milan in its judgment No. 278 of December 13rd 2006 held that when there are no valid economic reasons, the transaction can be considered elusive without the need to identify the circumvented obligations. Legal scholars do not agree on this statement. On one hand, some argue that the absence of valid economic reasons does not automatically identify a transaction as abusive because the circumvention of tax law principles should be primarily considered in applying art.

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[143] In this request, the tax authority must indicate the reasons why it considers that paragraphs one and two of art. 37*bis* are applicable to the specific case. See Art. 37*bis*, paragraph four, Presidential Decree No. 600 of September 29th 1973.

[144] See Art. 37*bis*, paragraph five, Presidential Decree No. 600 of September 29th 1973.

[145] See Art. 37*bis*, paragraph six, Presidential Decree No. 600 of September 29th 1973.

[146] See Art. 37*bis*, paragraph seven, Presidential Decree No. 600 of September 29th 1973.

[147] See Art. 37*bis*, paragraph eight, Presidential Decree No. 600 of September 29th 1973; C. Silvani, *Italy - Corporate Taxation* sec. 10., Country Analyses IBFD (accessed 14 Nov. 2015); P. Valente & I. Caraccioli, *Criminal Relevance of Avoidance Transactions in Italy: Lessons from the Dolce & Gabbana Case*, 52 Eur. Taxn. 10 (2012), Journals IBFD, p. 519: "This provision gives the taxpayer an opportunity to make a special request for a tax ruling from the regional director of the competent tax authority instead of the specific anti-avoidance rule being applied, as provided for by article 37-*bis* (8) of Presidential Decree No. 600/1973.

37*bis*[148]. On the other hand, some believe that, in evaluating the presence of an abusive transaction, both elements should be equally relevant[149]. In addition, since its inclusion within Presidential Decree No. 600/1973 which deals with assessment of income taxes, can art. 37*bis* also be applied with regard to indirect taxes?

In conclusion, these open questions suggest the author that the distinction between licit tax saving and tax avoidance after the introduction of art. 37*bis* was still far from being clear. Probably, these were the reasons which led the ISC to develop some sort of the substance over form doctrine. Nevertheless, it can be argued that with art. 37*bis* the Italian legal system started to converge towards the US legal system. The economic substance and business purpose doctrines inspired the Italian legislator in the introduction of art. 37*bis*[150].

3.2. The judicial anti-abuse of law doctrine from 2000 to nowadays.

Since the early 2000s, the ISC began to elaborate its doctrine on abuse of law. Cases under its examination primarily involved dividend stripping/dividend washing transactions[151]. In three judgments No. 3979 of April 3rd 2000, No. 11351 of September 3rd 2001[152] and No. 3345 March

[148] See D. Stevanato, L. Para & R. Lupi, *Ancora sul concetto di elusione tributaria e sulla sua non punibilità*, 3 *Dialoghi di Diritto Tributario* (2007), pp. 373 – 407; D. Stevanato, *Uso e abuso della clausola antielusiva*, 24 *Corr. Trib.* (2007), pp. 1962 – 1966.

[149] G. Falsitta, *Manuale di Diritto Tributario – Parte Generale*, 2003, CEDAM, Padova, pp. 193-195; P. Pistone, in *Diritto Tributario Internazionale*, 2005, CEDAM, Padova, pp. 813-872.

[150] See G. Chiametti, *Il concetto di elusione fiscale*, 17 *Il Fisco* (2007), p. 2542.

[151] See IBFD Tax Glossary: "In general terms dividend stripping refers to a transaction whereby corporate profits are extracted to shareholders in a tax beneficial form, generally by converting taxable dividend income into tax-free or low taxed capital gain. The most common form of dividend stripping involves the sale of shares to an intermediary party shortly before a dividend is paid on the shares followed by a resale to the original shareholder once the dividend has been paid, the difference in purchase and resale price (less a service fee for the intermediary) representing the dividend amount. The original shareholder typically realizes a tax-free capital gain (instead of taxable income) while the intermediary can generally shelter the dividend by, e.g. claiming a tax credit, and/or a loss on resale. Dividend stripping takes place in both a domestic and a cross-border context. A typical example of the latter is a shareholder in one country selling shares in a company resident in another country to an intermediary in a third country (which may be the same as that of the distributing company) that, by virtue of a more beneficial tax treaty, can obtain the benefit of a lower withholding tax or, under domestic law, can obtain the benefit of an imputation credit. This benefit would typically be shared between the original owner and the intermediary. The term is also used to describe the converse situation where a (tax-free) dividend is paid shortly before a taxable sale of shares in order to reduce the subsequent gain. Many countries have anti-avoidance legislation to neutralize the tax advantages". In the USA, an example of anti-avoidance provision is § 1059 which provides that a corporate shareholder receiving an "extraordinary dividend" must reduce its basis in the underlying stock (but not below zero) by the amount of the nontaxed (i.e. deductible) portion of the dividend if the corporation has not held the stock for more than two years before the "dividend announcement date"–i.e., the earliest date when the distributing corporation declares, announces or agrees to the amount or payment of the dividend. See S. Schwarz & D. J. Lathrope, *Fundamentals of Corporate Taxation*, 2012, THOMSON REUTERS, p. 176.

[152] A. Lupo, in *Cahiers de droit fiscal international*, vol. 87a, 2002, Kluwer, The Netherlands, pp. 363 – 364: "The judgment of the Court of Cassation concerned a claim of the tax administration which recharacterised a leasing contract for VAT purposes. In the appeal, the tax administration maintained that the leasing contract had to be recharacterised due to ancillary obligations undertaken by a third party to the leasing contract. According to the tax

7th 2002, the ISC rejected the argument of the tax authorities that the transactions carried out would have violated art. 1344 of the Civil Code since the obtaining of tax saving did not constitute per se a violation in the absence of any specific provision. A transaction could be considered as illegitimate only if was expressly defined by a legislative provision[153]. The attempt to fight tax motivated transactions through the principle of *fraude à la loi* set forth by art. 1344 of the Civil Code was not something new of that years. Since 1970s there had been a debate among legal scholars about its application to tax law. Some scholars supported its application[154], others considered it not applicable[155]. However, this theory had been rejected both by the ISC[156] and lower Tax Courts[157].

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administration, the contract represented an abuse of law, which could be recharacterised in light of article 1344. In contrast, the Court of Cassation held that article 1344 was not applicable to tax law, which was not a mandatory law within the meaning of article 1344; in any event, article 1344 could not be utilised to recharacterise a contract: this provision could only be utilised to declare a contract null and void. According to the Court of Cassation, the recharacterisation requires an ad hoc provision such as article 10, Law no. 408, of 29 December 1990. However, this provision was not applicable as the notice of assessment had been served on the taxpayer in 1988 (i.e. prior to the entry into force of article 10).

[153] See R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD: "Initially, the ISC considered some transactions to be legitimate provided they were not expressly identified by the law as constituting tax avoidance behaviour, since the contractual autonomy of parties can only be limited by specific provisions. In the absence of specific provisions such transactions would merely fall under the "gap", in the tax legislation. According to this interpretation, taxpayers, were absolutely free to put into practice tax saving structures – such as "dividend washing" transactions – and benefitting from a reduced tax burden, as long as there was no explicit prohibition that could be relied upon by the tax authorities".

[154] See F. Gallo, *Elusione, risparmio d'imposta*, in *Giur. comm.*, 1989, I, 377; U. Morello, *Il problema della frode alla legge: trasformazioni, fusione e concentrazioni di comodo*, in Atti del convegno dicembre 1988 di Madonna di Campiglio, 1990, Milano; Santonastaso, *I negozi in frode alla legge fiscale*, in *Dir. Prat. Trib.*, 1970, I, 503.

[155] See G. Maisto, *The abuse of rights under Italian tax law: an outline*, (1991) 19 *Intertax*, Issue 2, p. 94: "The applicability to tax law of the principle of *fraude à la loi* set forth by Art. 1344 of the Civil Code has been rejected by the case-law and by prevailing literature: the denial is based on the circumstance that the liability arises as a result of the assessment by the tax office (i.e., an administrative act). Consequently, any fraud committed by the taxpayer would not qualify as fraud to the law but as fraud to the fisc. In addition, Art. 1344 of the Civil Code refers to the avoidance of legislative provisions which prohibit a given course of action. On the contrary, a legislative tax provision simply sets forth a tax regime for a given factual situation. The tax provision therefore does not contain any prohibition".

[156] See G. Maisto, *The abuse of rights under Italian tax law: an outline* (1991) 19 *Intertax*, Issue 2, p. 94, note n. 7.

[157] See A. Lupo, in *Cahiers de droit fiscal international*, vol. 87a, Kluwer, The Netherlands, p. 363: "The inapplicability of article 1344 was held by the First Instance Tax Court of Milan, judgment no. 336, of 10 February 1998. In that case, the tax administration utilised article 1344 to recharacterise a sale of shares as a sale of assets. The tax administration maintained that the sale of the shares should be characterised as a sale of assets because the company, whose shares were sold, owned one asset only. The claim regarded the application of VAT: the sale of shares is VAT exempt, the sale of assets (in particular, land) is subject to VAT".

Surprisingly, three years later, the ISC completely changed its opinion[158]. The ISC in its judgments No. 20398 of October 21st 2005[159] and No. 22932 of November 14th 2005[160] stated that transaction lacked – from its inception – any economic justification, as the parties simply wished to obtain a fiscal advantage and there was no economic motivation other than that. On this basis, the Court stated that the lack of economic justification renders the transactions void under Italian civil law. As a result, no tax consequences could arise from the agreement[161].

In reasonable opposition to the previous judgments, the ISC clarified that the principle according to which, before the introduction of art. 37*bis*, there was no GAAR in the Italian tax legal system should have been reviewed on the basis of the European Court of Justice (hereinafter ECJ) jurisprudence. Indeed, the ISC emphasized the case-law of the ECJ[162], on the abusive exercise of a right arising from a provision of Community law. Even though the existence of a GAAR had not been expressly affirmed by the ECJ in the field of tax law, according to ISC[163] it could not be disputed the emergence of a principle which should have driven the legal scholars in finding appropriate solutions to counter the abuse of law. In other words, the ISC was implying the existence of a general anti-avoidance principle under the Italian legal system[164].

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[158] See R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD: "From 2005 onwards the judicial approach became more flexible and it was considered acceptable for the tax authorities to declare the tax advantages of certain transactions ineffective on the basis of civil law instruments", C. Innamorato, *An Unwritten Anti-Abuse Principle in the Italian Tax System*, Eur. Taxn. (2008) Journals IBFD: "Whereas between 2000/02, the ISC held that fiscal benefits may be denied only if so provided under a tax provision in force at the time a transaction is put in place, in 2005, it disregarded the agreements of the taxpayers by considering these to be void from a civil law perspective".

[159] See F. Camerlingo, *Supreme Court decisions on dividend washing and abuse of rights in tax matters*, 8 Derivs. & Fin. Instrums. 4, (2006) Journals IBFD, p. 209: "In 1992, a resident company entered into an agreement with a resident investment fund (the Fund) under which the former purchased from the latter a quantity of shares held in resident companies. Immediately after that, the shareholders' meeting resolved to distribute dividends (so-called shares *cum cedola*). One day after having paid the dividends, the company resold the shares to the Fund for an overall consideration less than the purchase price paid to acquire them".

[160] See F. Camerlingo, *Supreme Court decisions on dividend washing and abuse of rights in tax matters*, 8 Derivs. & Fin. Instrums. 4, (2006) Journals IBFD, p. 209: "A resident company entered into an agreement with several non-resident companies under which the former purchased from the latter the usufruct right related to shares held in resident companies by the non-resident companies. Therefore, the resident company was entitled to receive the dividends paid by the resident companies on the shares owned by the non-resident companies".

[161] See F. Camerlingo, *Supreme Court decisions on dividend washing and abuse of rights in tax matters*, 8 Derivs. & Fin. Instrums. 4, (2006) Journals IBFD, p. 211.

[162] Community law cannot relied on for abusive or fraudulent ends: Case C-206/94 *Brennet v Paletta* [1996] ECR I-2357, paragraph 24; Case C-8/92 *General Milk Products v Hauptzollamt Hamburg-Jonas* [1993] ECR I-779, paragraph 21; Case C-367/96 *Kefalas and Others v Greek State and OAE* [1998] ECR I-02843, paragraph 20.

[163] See ISC judgments No. 20398 of October 21st 2005 and No. 22932 of November 14th 2005, paragraph 3.3 and 3.4 respectively.

[164] See F. Camerlingo, *Supreme Court decisions on dividend washing and abuse of rights in tax matters*, 8 Derivs. & Fin. Instrums. 4, (2006) Journals IBFD, p. 211; C. Innamorato, *An Unwritten Anti-Abuse Principle in the Italian Tax System*, Eur. Taxn. (2008) Journals IBFD, p. 452: "In the latter case, however, the ISC had already affirmed that, in the light of a general anti-abuse principle established by the ECJ in respect of non-tax issues, fiscal benefits that derive from transactions having the sole aim of obtaining a tax advantage had to be denied. The ISC also submitted that, had the ECJ defined an anti-abuse principle for tax purposes, this principle could have also been applied to the (non-harmonized) direct tax field.

In the author's view, this last statement of the ISC, together with *Halifax*[165], played a great role in the next judgments. Indeed, less than half a year after the application of civil abuse of law doctrine, the ISC changed again and affirmed that operations effected only for the purpose of obtaining a tax advantage constitute an abuse of rights and it is for the taxpayer to prove the existence of sound business reasons. Accordingly, the concept of abuse of rights is independent from the fictitious or fraudulent nature of a transaction[166]. Specifically, ISC derived the existence in the Italian tax system of an anti-abuse clause as a direct consequence of the prohibition of abuse of law elaborated at the EU level[167]. This position was confirmed in a series of judgments[168]. Particularly, in judgment No. 8772 of April 4th 2008, the ISC held that the notion of abuse of law rooted in the EC law, as defined in *Halifax*, shall be applied in the field of direct taxation, since such a doctrine is inherent to the domestic tax system[169]. Finally, in judgment No. 25374 of October 17th 2008, held that the notion of abuse of law based on EC law, as implemented under the Italian tax system, had the rank of a general anti-avoidance rule applicable to all fields of taxation beyond the "harmonized" or "Community" taxes, such as VAT, excise and custom duties[170]. The ISC's application of the

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[165] See Case C-255/02 *Halifax plc, Leeds Permanent Development Services Ltd and County Wide Property Investments Ltd v Commissioners of Customs & Excise* [2006] ECR I-01609, paragraph 86: "For it to be found that an abusive practice exists, it is necessary, first, that the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and of national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage".

[166] See ISC judgment No. 21221 of September 29th 2006; C. Innamorato, *An Unwritten Anti-Abuse Principle in the Italian Tax System*, Eur. Taxn. (2008) Journals IBFD, p. 449.

[167] See R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD, p. 512: "the ISC held that in determining the business income of an undertaking, transactions should be assessed in light of the abuse of law principle elaborated on by the ECJ, which does not conflict with the principle of legality"; A. Fantozzi & G. Mameli, *The Italian Abuse of Law Doctrine for Taxation Purposes*, 64 Bull. Intl. Taxn. 8/9 (2010), Journals IBFD.

[168] See judgments No. 22023 of October 13rd 2006; No. 25612 of December 1st 2006; No. 10273 of May 4th 2007; No. 8772 of April 4th 2008; No. 10257 of April 21st 2008 and No. 25374 of October 17th 2008.

[169] See R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD, p. 512; C. Innamorato, *An Unwritten Anti-Abuse Principle in the Italian Tax System*, Eur. Taxn. (2008) Journals IBFD, p. 452: "What must be stressed is the fact that the ISC not only applies the *Halifax* doctrine to the direct tax field, but goes further, stating that such doctrine is *immanent* in the Italian legal system. In other words, the ISC envisages the existence of an anti-abuse principle at the EC level, which, without the need for any legislative interventions, directly applies at the domestic level. The internal specific anti-avoidance rules are, in the ISC's view, nothing but evidence of the existence of the supranational, general anti-abuse principle"; M. Beghin, *L'inesistente confine tra pianificazione, elusione e <<abuso del diritto>>*, 22 *Corr. Trib.* (2008), p. 1777; M. Procopio, *Elusione (od abuso del diritto): la Corte di Cassazione si allinea all'orientamento comunitario*, 5 *Dir. Prat. Trib.* (2008), p. 10919; S. Orsini, *L'abuso del diritto rende l'atto inefficace: sul contribuente* l'onere *della prova contraria*, 8 *Riv. Giur. Trib.* (2008), p. 695; P. Turis, *Pratiche elusive e abuso di diritto*, 17 *Il Fisco* (2008), p. 3095; G. Stancati, *Il dogma comunitario dell'abuso della norma tributaria*, 3 *Rass. Trib.* (2008), p. 784.

[170] See P. Centore, *Abuso del diritto generalmente applicabile nell'IVA e nell'imposizione diretta*, 48 *Corr. Trib.* (2008), p. 3866, G. Corasaniti, *Abuso del diritto*, 12 *Obb. e Contr.* (2008), p. 1048; R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD, p. 513. According to EC settled case-law, although direct taxation falls within the competence of the Member States, the latter must none the less exercise that competence consistently with Community law (Case C-279/93 *Schumacker* [1995] ECR I-225, paragraphs 21 and 26; Case C-80/94 *Wielockx* [1995] ECR I-2493, paragraph 16; Case C-107/94 *Asscher* [1996] ECR I-3089, paragraph 36; Case C-250/95 *Futura Participations SA* [1997] ECR I-2492, paragraph 19.

EC law-abused of law doctrine to the field of direct taxation was not convincing, since the ECJ had limited its use to harmonized taxes. Therefore, the ISC devised new arguments to justify its full application to all areas of tax law[171].

As hereinbefore argued, in December 2008, the ISC justified the application of the abuse of law concept to direct taxes on constitutional grounds (the ability to pay principle)[172]. This latest

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[171] See R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD, p. 513; P. Valente & I. Caraccioli, *Criminal Relevance of Avoidance Transactions in Italy: Lessons from the Dolce & Gabbana Case*, 52 Eur. Taxn. 10 (2012), Journals IBFD, p. 515: "The application of the EU abuse of law principle has been largely criticized by scholars and experts mainly for two reasons: first, the principle of abuse of law based on EU law took shape within a VAT context, which is a tax that is subject to harmonization; hence, such a principle should not be applied to tax on income that is not subject to harmonization; and second, assessing whether a transaction is elusive or not based on economic reasons alone does not allow for an analysis that examines the difference between a solution that is fiscally less burdensome and an authentic avoidance scheme".

[172] See Judgments No. 30055, No. 30056 and No. 30057 of December 23rd 2008; G. Corasaniti, *Sul generale divieto di abuso del diritto nell'ordinamento tributario*, 2 *Dir. Prat. Trib.* (2009), p. 20213; R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD, p. 513: "the recent decisions make it clear that the source of that principle, in the field of non-harmonized taxes – such as direct taxes – is not found in ECJ case law, but in the constitutional principles. The ISC identifies the ability to pay principles as the basis of all tax provisions and exemptions and, consequently, finds the existence, within the system, of a principle according to which a taxpayer cannot benefit from undue tax advantages deriving from the misuse of legal instruments, even if no specific provision is infringed, in the absence of an economic purpose that is capable of justifying the transactions"; A. Fantozzi & G. Mameli, *The Italian Abuse of Law Doctrine for Taxation Purposes*, 64 Bull. Intl. Taxn. 8/9 (2010), Journals IBFD, p. 448: "These important decisions, although confirming the existence of a general anti-avoidance principle, supplanted the previous positions of the Supreme Court in affirming that, as far as the non-harmonized taxes are concerned, the source of the anti-abuse principle is to be found in the defining tax principles of the Italian Constitution, i.e. the principles of ability to pay and progressivity. Consequently, the Supreme Court has clearly affirmed that it considers the principle that a taxpayer cannot unduly benefit, for tax purposes, from the distorted use of legal structures (those which, although not in violation of a specific rule, lack any economically sound reason, except for that of tax saving) to be direct and essential consequences of Art. 53 of the Constitution"; A. Lovisolo, *L'art.* 53 *Cost. come fonte della clausola generale antielusiva ed il ruolo delle <<valide ragioni economiche>> tra abuso del diritto, elusione fiscale ed antieconomicità delle scelte imprenditioriali*, 3 *Riv. Giur. Trib.* (2009), p. 216; R. Lupi & D. Stevanato, *Tecniche interpretative e pretesa immanenza di una norma generale antielusiva*, 6 *Corr. Trib.* (2009), p. 403; C. Silvani, *Italy - Corporate Taxation* sec. 10., Country Analyses IBFD (accessed 14 Nov. 2015): "In three landmark decisions handed down at the end of 2008, the Supreme Court recognized the existence of an overarching abuse of law principle in the tax system, which is grounded on the Italian constitution. In particular, the Supreme Court held that tax savings obtained via transactions or arrangements not supported by valid economic reasons are contrary to the constitutional principles of the ability to pay and of graduated taxation"; P. Valente & I. Caraccioli, *Criminal Relevance of Avoidance Transactions in Italy: Lessons from the Dolce & Gabbana Case*, 52 Eur. Taxn. 10 (2012), Journals IBFD, p. 515: "The application of such a principle in the area of non-harmonized tax (income tax in this case), is based on constitutional principles relating to taxpaying capacity (article 51, paragraph 1 of the Constitution), as well as on tax progression (article 53, paragraph 2 of the Constitution) and does not conflict with the principle of legality (article 23 of the Constitution). The application of such a concept should not be construed as the imposition of obligations that do not derive from the law, but rather as the rejection of the illegal effects of transactions carried out for the sole purpose of avoiding the application of tax rules. Therefore, the legal basis for the general anti-avoidance rule in regard to tax matters must be found in constitutional principles rather than ECJ case law"; G. Zizzo, *Clausola antielusione e capacità contributiva*, 2 *Rass. Trib.* (2009), p. 487. However, A. Lupo, in *Cahiers de droit international*, vol. 87a, Kluwer, the Netherlands, pp. 368 e 371, noted that: "the tax administration had already made reference to article 53 in order to clarify the purport of the anti-avoidance provision of article 37-bis ITAC. In particular, according to the Ministry of Finance, tax savings are illegitimate when they are contrary to the ability to pay principle (article 53 of the Italian Constitution Law)". See Ministry of Finance, Circular Letter No. 320 of December 19th 1997, p. 23 available at http://def.finanze.it/DocTribFrontend/RS2_HomePage.jsp.

position has been widely criticised primarily because the ISC has re-interpreted the ability to pay principle as a substantive provision capable of justifying almost any kind of assessment of the tax authorities based on abuse of law[173]. This result is clearly inconsistent with other Constitutional provisions such as art. 3[174]; art. 23[175]; art. 41[176] and art. 97[177]. Nevertheless, this position has been repeatedly confirmed by the ISC since then[178]. Particularly interesting was judgment No. 1465 of January 21st 2009 where the ISC held that the tax authorities must prove the facts and the main elements of the tax claim, as well as the circumstances showing the objective nature of the transaction. The taxpayer, however, must demonstrate the existence of economic reasons for its transactions[179].

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[173] See R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD, p. 514.

[174] Art. 3: "All citizens have equal social dignity and are equal before the law, without distinction of sex, race, language, religion, political opinion, personal and social conditions. It is the duty of the Republic to remove the economic and social obstacles which by limiting the freedom and equality of citizens, prevent the full development of the human person and the effective participation of all workers in the political, economic and social organisation of the country".

[175] Art. 23: "No obligations of a personal or a financial nature may be imposed on any person except by law". R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD, p. 517: "The judicial creation of an unwritten general anti-avoidance rule by the ISC is not only an obvious violation of the saving clause contained in Art. 23 of the Constitution, but it goes beyond the powers of statutory interpretation entrusted to judges in common law jurisdictions".

[176] Art. 41: "Private-sector economic initiative is freely exercised. It cannot be conducted in conflict with social usefulness or in such a manner that could damage safety, liberty and human dignity. The law shall provide for appropriate programmes and controls so that public and private-sector economic activity may be oriented and co-ordinated for social purposes"; see R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD, p. 516: "the recognition of a generalized power of the tax authorities to find that a transaction is an avoidance transaction also leads to an infringement of the freedom of economic initiative of taxpayers. In particular, taxpayers, in making economic choices will now have to take into account not only the commercial risks, but also the risk of unpredictable assessments of the tax authorities if certain transactions are "suspected" to be avoidance transactions. This could undoubtedly have negative consequences for the economy if Italian undertakings decide to transfer abroad and foreign ones avoid establishing their seat in Italy".

[177] Art. 97, paragraph two: "Public administration offices shall be organised according to the provisions of law, so as to ensure the efficiency and impartiality of the administration".

[178] C. Silvani, *Italy - Corporate Taxation* sec. 10., Country Analyses IBFD (accessed 14 Nov. 2015). See decisions No. 1465 of January 21st 2009; No. 8481 of April 8th 2009, No. 2193 of February 16th 2012; M. Basilavecchia, *Surrogati interpretativi in difetto di norma antielusiva*? 7 *Riv. giur. trib.* (2009), p. 593; M. Beghin, *L'abuso del diritto tra capacità contributiva e certezza dei rapporti fisco-contribuente*, 11 *Corr. Trib.* (2009), p. 823; *Id.*, *L'abuso del diritto e l'elusione fiscale tra regole <<scritte>>, giustizia tributaria e certezza del diritto*, 17 *Corr. Trib.* (2012), p. 1298; A. Borgoglio, *Dottrina dell'abuso del diritto e disciplina antielusiva*, 10 *Il Fisco* (2012), p. 1492; G. Corasaniti, *Abuso del diritto*, 5 *Obbl.* e *Contr.* (2009), p. 473; S. Donatelli, *Aspetti problematici della motivazione degli accertamenti antielusivi*, 6 *Riv. Giur. Trib.* (2012), p. 491; M. Procopio, *L'irrisolto problema dell'elusione fiscale e la necessità di un intervento del legislatore*, 2 *Dir. Prat. Trib.* (2009), p. 10357.

[179] See R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD, p. 515; C. Silvani, *Italy - Corporate Taxation* sec. 10., Country Analyses IBFD (accessed 14 Nov. 2015): "The Supreme Court also specified that it is the tax authorities' duty to explain (also in the notice of deficiency) why the legal form chosen by the taxpayer is not normal and not appropriate to carry out the envisaged transaction".

In conclusion, if, after the introduction of art. 37*bis*, the distinction between licit tax saving and tax avoidance was still far from being clear, now it seems to have disappeared into thin hair[180]. Some argued to broaden the scope of Art. 37-bis of the ITAC and ensure that its list of cases is more comprehensive, thereby transforming it into a truly general anti-abuse clause[181]. The Italian Government responded to this by introducing, with Legislative Decree No. 128 of August 5th 2015, a legal definition of abuse law.

3.3. The relationship between the Commission Recommendation on aggressive tax planning and the *Delega Fiscale.*

Before analysing in details the new definition of abuse of law, the author wishes to say a few words about the framework which led to its introduction[182].

The starting point is Law No. 23 of March 11th 2014, entered into force on March 27th 2014, which delegated powers to the Government to lay down legal provisions for a more equal, transparent and growth-oriented tax system.

Article 5, paragraph one, states that: "the Government will revise the current anti-avoidance rules in light of the general principle of prohibition of abuse of law and according to the criteria included in the Commission Recommendation of December 6th 2012 on aggressive tax planning>>". In particular, it is provided that the abusive conduct shall be defined as "distorted use of legal instruments suitable to get a tax saving although such conduct does not infringe any specific provision". Moreover, in order to guarantee the taxpayer's freedom of choice between different optional regimes leading to a different tax burden, the aim of getting undue tax advantages shall be considered as the main reason of the abusive operation. On the other hand, the existence of an abusive conduct is excluded if the operation is justified for relevant reasons unrelated to taxation.

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[180] See R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), Journals IBFD, p. 515: "What is objectionable is that, based on the abuse of law doctrine, the ISC is giving the tax authorities and judges the power to determine the legal characterization of transactions that may be an expression of tax avoidance, entrusting them with a "non-conventional weapon" that substantially erases any difference between tax avoidance and lawful tax saving".

[181] See A. Fantozzi & G. Mameli, *The Italian Abuse of Law Doctrine for Taxation Purposes*, 64 Bull. Intl. Taxn. 8/9 (2010), Journals IBFD, p. 449, in the same line M. Scuffi, *Il sindacato antiabuso del giudice tra elusione, frode e oneri probatori*, 20 *Corr. Trib.* (2009), p. 1580 who believes that time is ripe to implement Art. 37bis ITAA beyond limitations imposed by paragraph three.

[182] International Monetary Fund, *Italy: Technical Assistance Report* – The *Delega Fiscale and the strategic orientation of tax reform*, Country Report 12/280 (2012), p. 23: "It seems widely agreed that recent jurisprudence has increased uncertainty as to – and widened the range of – the circumstances in which tax schemes will be struck down. Article 37-*bis* sets out a general principle of artificiality in tax arrangements, though limiting its application to specified transactions. More recently, however, a series of Supreme Court decisions, based on constitutional principles, appear to have widened and muddied the circumstances in which tax schemes may be overturned. Adoption of a GAAR, as envisaged in the DF and as done in many though by no means all countries, can ease this uncertainty – for both taxpayers and tax authorities. Details vary, but the essence of a GAAR is to allow tax authorities to disregard arrangements that have no clear business rationale other than to reduce tax liability. They thus at least make clear to all concerned what the basic test will be".

From a brief overview, it clearly emerges that the legislator, in drafting these criteria, took inspiration from the position expressed by the ISC in the three well-known judgments of December 2008[183]. However, as it has been argued[184], these principles raise some doubts. Firstly, it is hard to decode the notion of misuse or distorted use of legal instruments on which the identification of abusive transactions relies. Secondly, the relationship between undue tax savings and economic reasons is not clear. On one hand, it is stated that abuse of law takes shape when the former prevail over the latter. On the other hand, abuse of law is excluded when the economic reasons are not marginal.

To this extent it might be useful to look at principles included in the Commission recommendation on aggressive tax planning of December 6th 2012 in which Member States were encouraged to adopt a common GAAR. Indeed, it is recommended the adoption by Member States of the following clause: "An artificial arrangement or an artificial series of arrangements which has been put into place for the essential purpose of avoiding taxation and leads to a tax benefit shall be ignored. National authorities shall treat these arrangements for tax purposes by reference to their *economic substance*"[185] (emphasis added). Accordingly, an arrangement is artificial where it lacks commercial substance and has been essentially put into place for the purpose of obtaining a tax benefit. The purpose of obtaining a tax benefit shall be considered essential where any other purpose that is or could be attributed to the arrangement or series of arrangements appears at most negligible, in view of all the circumstances of the case[186]. Consequently, as someone has argued[187], the Commission Recommendation seems to leave the door open to the case when, even though there is no economic substance, the arrangement has been put into place for reasons other than tax savings. Therefore, the abusive conduct is identified when these other purposes are irrelevant, marginal, tenuous, ostensible. However, the most interesting aspect is when the Commission Recommendation emphasises the relationship between obtaining a tax advantage and the spirit of law involved. Indeed, it is specified that: "the purpose of an arrangement or series of arrangements consists in avoiding taxation where, regardless of any subjective intention of the taxpayer, it defeats the object, spirit and purpose of the tax provisions that would otherwise apply"[188]. If there is no contrast between the obtaining of a tax benefit and the *ratio* of the tax provisions that would otherwise apply, no abuse can be identified[189].

In conclusion, the Commission Recommendation provides us with very useful insight to overcoming the uncertainties related to the guidelines of article 5 of Law No. 23 of March 11th

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[183] See *supra* note n. 54; A. Carinci & A. Deotto, *D.lgs.* 5 Agosto 2015, N. 128 – *Abuso del diritto ed effettiva utilità della novella: MUCH ADO ABOUT NOTHING?*, 32-33 *Il fisco* (2015), p. 3107; A. Contrino & A. Marcheselli, *Luci e ombre nella struttura dell'abuso fiscale riformato*, 37 *Corr. Trib.* (2015), p. 3787; G. Zizzo, *L'abuso del diritto tra incertezze della delega e raccomandazioni europee*, 39 *Corr. Trib.* (2014), p. 2997.

[184] See G. Zizzo, *L'abuso del diritto tra incertezze della Delega e raccomandazioni europee*, 39 *Corr. Trib.* (2014), p. 2997.

[185] See point 4.2 of the Recommendation 2012-772-EU on aggressive tax planning, EU Law IBFD.

[186] See point 4.6 of the Recommendation 2012-772-EU on aggressive tax planning, EU Law IBFD.

[187] See G. Zizzo, *L'abuso del diritto tra incertezze della Delega e raccomandazioni europee*, 39 *Corr. Trib.* (2014), p. 2997.

[188] See point 4.5 of the Recommendation 2012-772-EU on aggressive tax planning, EU Law IBFD.

[189] See A. Contrino & A. Marcheselli, *Luci e ombre nella struttura dell'abuso fiscale "riformato"*, 37 *Corr. Trib.* (2015), p. 3787.

2014[190]. Firstly, in distinguishing between (acceptable) tax planning and (unacceptable) aggressive tax planning, the less burdensome tax solution does not per se constitute abuse of law. Therefore, the notion of misuse or distorted use of legal instruments shall be related to the concept of artificiality, the use of legal instruments is distorted in the sense that no economic substance is created. Secondly, the Commission Recommendation states that the abuse of law takes form when there are no economic reasons or in the case when these reasons are marginal, trifling. Thus, there is no need to establish which of the two (economic reasons or tax advantages) prevails. In this line, the Commission Recommendation seems to prefer the second criterion of article 5, according to which the abuse is excluded whether the arrangement or series of arrangements is justified by not marginal economic reasons instead of the first one which considers the purpose of obtaining undue tax benefits as the essential cause of the abusive transaction. Finally, the mere presence of a tax saving is not sufficient, because it is required its contrast with the *ratio* of the tax provisions that would otherwise apply.

3.4. A new definition of "abuse of law".

Now, the question is whether and to what extent these doubts have been confirmed or overcome by Legislative Decree No. 128 of August 5th 2015. Someone has argued that the outcome is certainly a lot better than was expected[191]. The definition of abuse of law has been, particularly, appreciated for its terse style, something very unusual for the modern legislative technique. One or more transactions constitute abuse of law where they lack economic substance and, despite being formally in compliance with tax law, are essentially aimed at obtaining undue advantages[192]. The constitutive elements of abuse of law are the following four: (a) the formal compliance with the law but matched with (b) the substantial frustration of its spirit; (c) the use of legal instruments with no economic substance and, finally, (d) the essentiality of the aim to achieve undue tax benefits. As it has been argued[193], the first two elements follow the roman law definition of *fraude à la loi*[194] and the Commission Recommendation which focused its attention on the contrast with the object, spirit and purpose of the tax provisions that would otherwise apply[195]. This position is

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[190] See G. Zizzo, *L'abuso del diritto tra incertezze della Delega e raccomandazioni europee*, 39 *Corr. Trib.* (2014), p. 2997.

[191] See A. Contrino & A. Marcheselli, *Luci e ombre nella struttura dell'abuso fiscale riformato*, 37 *Corr. Trib.* (2015), p. 3787.

[192] See Art. 10*bis*, paragraph 1, of Law No. 212 of July 27th 2000; V. Salvadori di Wiesenhoff, *Italian Tax Reform: New Legislation on Abuse of Law and Statute of Limitations*, 17 European Tax Services 10 (2015), Bloomberg BNA, p. 2.

[193] See A. Contrino & A. Marcheselli, *Luci e ombre nella struttura dell'abuso fiscale riformato*, 37 *Corr. Trib.* (2015), p. 3787.

[194] See R. Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition*, 1996, Oxford University Press, p. 702: "The type of behaviour described in this paragraph was known as *agere in fraudem legis*: conclusion of a transaction which, whilst respecting the words of a specific statute, was designed to thwart its purpose. The Digest contains the following elegant definition taken from a work of Paulus: *Contra legem facit, quid id facit quod lex prohibit, in fraudem vero, qui salvis verbis legis sententiam eius circumvenit*".

[195] See *supra* note n. 62.

also strengthened by art. 10*bis*, paragraph 2, lett. b) of Law No. 212/2000 where it is stated that: "the undue tax advantages consist in benefits, even incurred in the long run, obtained in contrast with the purpose of the tax rules or with the principles of the tax legal system"[196].

With regard to the third element of the definition of abuse, art. 10*bis*, paragraph 2, lett. a) of Law No. 212/2000 states that: "transactions are deemed to be lacking any economic substance when they consist of facts, acts and contracts, even interconnected, that are not able to generate economic effects other than the tax advantages. The inconsistency between the individual transactions and the underlying juridical rationale of their aggregation or between the legal instruments that have been adopted and standard market practices can be regarded as being evidence of a lack of economic substance"[197]. The Commission Recommendation is still more detailed. Indeed, it states that: "In determining whether the arrangement or series of arrangements is artificial, national authorities are invited to consider whether they involve one or more of the following situations: (a) the legal characterisation of the individual steps which an arrangement consists of is inconsistent with the legal substance of the arrangement as a whole; (b) the arrangement or series of arrangements is carried out in a manner which would not ordinarily be employed in what is expected to be a reasonable business conduct; (c) the arrangement or series of arrangements includes elements which have the effect of offsetting or cancelling each other; (d) transactions concluded are circular in nature; (e) the arrangement or series of arrangements results in a significant tax benefit but this is not reflected by the taxpayer or its cash flows; (f) the expected pre-tax profit is insignificant in comparison to the amount of the expected tax benefit"[198]. On this matter, someone has argued[199] that the Legislative Decree has been timorous because it only refers to the first two situations. In addition, this choice does not seem to be appropriate since it sacrifices one of the most significant and useful aspects of the Commission Recommendation: an analytical and complete enumeration of situations where an arrangement or a series of arrangements lack commercial substance. Indeed, this choice seems to be a compendium of the Commission Recommendation which, on one hand, sacrifices certainty and, on the other hand, does not have any remarkable justifications. However, these criticisms can be overcome through a systematic reading of art. 10*bis*, paragraph 2, lett. a). As someone has argued the character of situations listed therein is illustrative, not comprehensive[200]. Therefore, the risk of drafting an internal definition of abuse other than that recommended has been avoided. Art. 10*bis* is perfectly aligned with the EU definition of abuse of law.

Finally, as herein before mentioned, art. 5 of Law No. 23 of March 11th 2014 raised some doubts when it referred to the aim of getting undue tax advantages as *main* reason of the abusive

[196] See Maisto e Associati, Tax Alert 04/2015 available at http://www.maisto.it/it/su-di-noi/tax-alert/item/tax-alert-2015-04.html.
[197] See, V. Salvadori di Wiesenhoff, *Italian Tax Reform: New Legislation on Abuse of Law and Statute of Limitations*, 17 European Tax Services 10 (2015), Bloomberg BNA, p. 3.
[198] See point 4.4 of the Recommendation 2012-772-EU on aggressive tax planning, EU Law IBFD.
[199] See A. Contrino & A. Marcheselli, *Luci e ombre nella struttura dell'abuso fiscale riformato*, 37 *Corr. Trib.* (2015), p. 3787.
[200] See A. Contrino & A. Marcheselli, *Luci e ombre nella struttura dell'abuso fiscale riformato*, 37 *Corr. Trib.* (2015), p. 3787.

operation[201]. Someone has argued[202] that art. 5 was improper due to the presence of the adjective *main* for the following reasons: (i) it would have paved the way for an unmanageable discretionary assessment; (ii) it would have constituted a violation of the principle of legal certainty recognized by the ECJ[203]; (iii) it clearly shows that the Italian legislator did not learn any lessons from judgment No. 685 of December 29th 2013 of the French Constitutional Council in which the new definition of abuse of law was rejected[204]; (iv) it would have been in contrast with the Commission Recommendation[205]. *Prima facie*, art. 10*bis*, paragraph 3, of Law No. 212/2000 seems to have overcome these uncertainties since it provides that: "there is no abuse when a transaction is justified by sound and non-marginal non-tax reasons, including managerial and organizational ones, being aimed at improving the structure or the functionality of the business"[206].

In conclusion, with regard to the burden of proof, it is further specified that tax authorities shall provide evidence of the alleged abuse of law[207], as defined above, while the taxpayer may invoke and demonstrate the existence of non-tax reasons supporting the transaction that is being challenged[208]. In addition, tax authorities can resort to the statutory GAAR only if the tax benefits cannot be challenged based on other specific tax provisions (e.g. specific anti-avoidance rules)[209]. Moreover, it is now specifically ruled that abusive transactions that are challenged under the GAAR do not amount to tax crimes. These transactions shall be sanctioned with the imposition of

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[201] See *supra* note n. 58.

[202] See A. Contrino & A. Marcheselli, *Luci e ombre nella struttura dell'abuso fiscale riformato*, 37 *Corr. Trib.* (2015), p. 3787.

[203] See Taxand responds to the OECD invitation for public comments on the proposals produced with respect to Action 6 (Prevent Treaty Abuse) of the BEPS Action plan, available at http://www.taxand.com/sites/default/files/taxand/documents/Taxand%20responds%20to%20the%20OECD%20BEPS%20Action%20Plan%206%20-%20Treaty%20Abuse.pdf, p. 11 where the main issues arising from incorporating a treaty GAAR into the OECD Model were reviewed.

[204] See Deloitte, *World Tax Advisor*, January 10th 2014, available at http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dtt_tax_worldtaxadvisor_140110.pdf, p. 6 where it is stated that: "The finance law for 2014 contained a provision that would have expanded the definition of abuse of law. Current rules allow the French tax authorities to disregard an arrangement that is artificial and/or that aims to benefit from the tax law in a manner that circumvents the intent of the legislature where the *sole* purpose of the arrangement is to mitigate or avoid tax. The budget law would have replaced the word *sole* with *main*, but without any further clarification as to scope of the term. In its decision, the Constitutional Court noted that, in addition to the reassessment of unpaid tax and the imposition of late payment interest, a severe penalty is imposed for abuse of law (a fine equal to 80% of the unpaid tax). Taking these penalties into account, the Court found that the proposed definition of abuse of law was too broad, and it therefore invalidated the new definition".

[205] See *supra* note n. 60.

[206] See V. Salvadori di Wiesenhoff, *Italian Tax Reform: New Legislation on Abuse of Law and Statute of Limitations*, 17 European Tax Services 10 (2015), Bloomberg BNA, p. 3.

[207] In particular, tax authorities must give evidence of the lack of economic substance and prove that just tax benefits were obtained, see C. Silvani, *Italy - Corporate Taxation* sec. 10., Country Analyses IBFD (accessed 28 Nov. 2015).

[208] See Art. 10*bis*, paragraph 9, of Law No. 212/2000; V. Salvadori di Wiesenhoff, *Italian Tax Reform: New Legislation on Abuse of Law and Statute of Limitations*, 17 European Tax Services 10 (2015), Bloomberg BNA, p. 3.

[209] See Art. 10*bis*, paragraph 12, of Law No. 212/2000; C. Silvani, *Italy - Corporate Taxation* sec. 10., Country Analyses IBFD (accessed 28 Nov. 2015).

the ordinary administrative tax penalties[210]. As someone has argued[211], this is a noteworthy development since it eliminates the uncertainty which has led to conflicting case law in the past[212].

4. The development of the US economic substance doctrine: from its origins to the 2010 codification.

This last section will be dedicated to the analysis of the judicial economic substance doctrine which Congress finally codified in 2010 with the Health Care and Education Reconciliation Act.

4.1. Origins and evaluation of the evolution of the economic substance doctrine in the US.

Generally, under this common law doctrine, a court may deny tax benefit arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in Federal income tax[213]. There is an alleged disagreement about the origins of the

[210] See Art. 10*bis*, paragraph 13, of Law No. 212/2000; V. Salvadori di Wiesenhoff, *Italian Tax Reform*: *New Legislation on Abuse of Law and Statute of Limitations*, 17 European Tax Services 10 (2015), Bloomberg BNA, pp. 3-4.

[211] See C. Silvani, *Italy - Corporate Taxation* sec. 10., Country Analyses IBFD (accessed 28 Nov. 2015).

[212] See P. Valente & I. Caraccioli, *Criminal Relevance of Avoidance Transactions in Italy: Lessons from the Dolce & Gabbana Case*, 52 Eur. Taxn. 10 (2012), Journals IBFD, pp. 515-516: "The position of Italian judges in regard to the criminal relevance of tax avoidance has been rather contradictory over the years. In particular, in the following decisions of the Supreme Court the transactions were deemed not criminally relevant: (i) Decision No. 23730 (2006) establishes that violation of anti-avoidance rules, by and large, does not involve criminal consequences; (ii) Decision No. 14486 (2008-2009) establishes that tax presumptions have no evidentiary value in the criminal area ... In contrast, however, in the following decisions, the Supreme Court was in favour of attributing criminal relevance to certain tax avoidance transactions: (i) Decision No. 26723 of 18 March 2011, according to which the criminal offence under article 4 of Law Decree No. 74/2000 was also found to be applicable in regard to avoidance behaviours listed under article 37-*bis* of Presidential Decree No. 600/73, when such behaviours, consisting of deeds and transactions that do not create any conflicts with the tax authorities, involve a failure to disclose accurate amounts in a tax return; (ii) Decision No. 29724 (2010) ...".

[213] See General Explanation of Tax Legislation Enacted in the 111th Congress prepared by the staff of the Joint Committee on Taxation, March 2011, p. 369.

economic substance doctrine. On one hand, Avi-Yonah[214], Alves Alvarrenga[215], Lederman[216], Lampreave[217], believe that the economic substance doctrine can be attributed to the Supreme Court cases of *Gregory v. Helvering, Knetsch v. United States* and *Frank Lyon Co. v. United States*. On the other hand, Zoë Prebble and John Prebble[218] believe that the first case on whether the anti-avoidance judicial safeguards apply to tax products was *ACM Partnership v. Commissioner*. Instead, Schwarz and Lathrope consider *Gregory v. Helvering* and *Frank Lyon Co. v. United States* as examples of the business purpose and the substance over form doctrine respectively. Finally, according to their opinion, in *ACM Partnership v. Commissioner*, the court has been receptive to the economic substance doctrine[219]. In the author's view, neither of them is wrong since, as it has been argued: "closely related doctrines also applied by the courts (*sometimes interchangeable with the economic substance doctrine*)[emphasis added] include the <<sham transaction doctrine>> and the <<business purpose>> ... Certain <<substance over form>> cases involving tax-indifferent parties, in which courts have found that the substance of the transaction did not comport with the form asserted by the taxpayer, have also involved examination of whether the change in economic position that occurred, if any, was consistent with the form asserted, and whether the claimed business purpose supported the particular tax benefits that were claimed"[220]. However, a clarification has to be made. Even though the economic substance and the business purpose are closely related and sometimes interchangeable doctrine, a difference might still exist between the former and the latter. On one hand, the doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, *unintended by Congress* (emphasis added), by means of transactions that serve no economic purpose other than tax savings. On the other hand, the business purpose doctrine involves an inquiry into the *subjective motives of*

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[214] See Avi-Yonah, Reuven S. and Pichhadze, Amir, GAARs and the Nexus between Statutory Interpretation and Legislative Drafting: Lessons for the U.S. from Abroad (September 28, 2015), p. 7: "In the years following Gregory, the Supreme Court decided a series of economic substance cases. In most of them, it followed *Gregory* in ruling that a transaction lacked economic substance if the taxpayer could not establish a non-tax business purpose. A good example is *Knetsch* (1960), in which the taxpayer borrowed at 3.5% to invest in an annuity paying 2.5%, because he could deduct the interest on the loan at a tax rate of over 90%, converting a before tax loss to an after-tax profit. The <<modern>> economic substance doctrine is based on the Supreme Court's opinion in *Frank Lyon* (1978) ..." Available at SSRN: http://ssrn.com/abstract=2666716.

[215] See C. Alves Alvarrenga, *Preventing Tax Avoidance: Is There Convergence in the Way Countries Counter Tax Avoidance?*, 67 Bull. Intl. Taxn. 7 (2013), p. 350: "The economic substance or sham transaction doctrine can be attributed to the Supreme Court case of *Knetsch v. United States* (1960) ... Another important case related to the origin of the economic substance doctrine is *Frank Lyon Co. v. United States* (1978)". Journals IBFD.

[216] See Lederman, Leandra, W(h)ither Economic Substance? Iowa Law Review, Vol. 95, p. 389, 2010; Indiana Legal Studies Research Paper No. 128, p. 402: "The origins of the economic substance doctrine lie in several transactions in which taxpayers applied the literal terms of the Code to reach results at arguably inconsistent with its intent. *Gregory v. Helvering, Knetsch v. United States*, and *Frank Lyon Co. v. United States* are typically identified as developing what became the economic substance doctrine". Available at SSRN: http://ssrn.com/abstract=1345388

[217] See P. Lampreave, *An Assessment of the Anti-Tax Avoidance Doctrines in the United States and the European Union*, 66 Bull. Intl. Taxn. 3 (2012), p. 156: "The <<economic substance>> doctrine has been enshrined in common law for some time. This doctrine states that tax-motivated transactions must have an effective business purpose. The principal case on which is based is the decision reached by the courts in *Gregory v. Helvering*". Journals IBFD.

[218] See Z. Prebble – J. Prebble, Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law, 62 Bull. Intl. Taxn. 4 (2008), p. 165.

[219] See S. Schwarz & D. J. Lathrope, *Fundamentals of Corporate Taxation*, 2012, THOMSON REUTERS, pp. 12-13.

[220] See General Explanation of Tax Legislation Enacted in the 111th Congress prepared by the staff of the Joint Committee on Taxation, March 2011, p. 369, note n. 990.

the taxpayer – that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. However, as it has been argued[221], in the modern economic substance doctrine established on *the most quoted (and risk-disregarding) sentence in recent tax history*[222], there is no reference at all to Congressional intent, the entire emphasis shifts to the taxpayer's purpose. As Leandra Lederman has pointed out[223], one important drawback of the shift from a focus on congressional intent to a focus on the taxpayer's intent and the prospect of pre-tax profit is a doctrine that is much easier for taxpayers to manipulate. The result is a test that does little to distinguish tax shelters and other abusive transactions from legitimate ones. Therefore, the modern economic substance doctrine should be abandoned and replaced with a direct inquiry into congressional intent. According to Avi-Yonah[224], if the focus were instead on Congressional motivation, it is hard to see how transactions like the tax shelter upheld by the Court of Appeal in *Compaq* and *IES* could survive an IRS challenge.

As hereinbefore mentioned[225], *Frank Lyon Co. v. U.S.* has been construed to create the two-prong test for determining whether a transaction lacks economic substance. This test was subsequently developed by *Rice's Toyota World, Inc. v. C.I.R*[226] where it was held that to treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction (i.e., the subjective component), and that the transaction has no economic substance because no reasonable possibility of a profit exists (i.e. the objective component). In particular, the business purpose inquiry simply concerns the motives of the taxpayer in entering the transaction, *i.e.* were tax benefits a significant aspect of the transaction?[227] while the second prong, the economic substance inquiry, requires an objective

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[221] See Avi-Yonah, Reuven S. and Pichhadze, Amir, GAARs and the Nexus between Statutory Interpretation and Legislative Drafting: Lessons for the U.S. from Abroad (September 28, 2015), p. 7; see also Lederman, Leandra, W(h)ither Economic Substance? Iowa Law Review, Vol. 95, p. 389, 2010; Indiana Legal Studies Research Paper No. 128, pp. 414-415: "Where the Supreme Court went astray in Frank Lyon is that, unlike in the Gregory and Knetsch cases, the Court did not consider Congress's intent. The Court's different approach in Frank Lyon may reflect larger societal changes, changes in approaches to statutory interpretation, the parties' litigation strategies, or even the complexity of the facts. Regardless of the reasons, the Court simply did not question whether Congress's intent with respect to the depreciation and interest provisions was to allow deductions to a taxpayer who held legal title but lacked any upside potential in the property – that is, a taxpayer who was in the same economic position as a lender. Instead, the Court, shifted the focus from Congress to the parties".

[222] This is the way Charles I. Kingson, The Confusion over Tax Ownership, 93 Tax Notes 409, p. 410 called Court's holding in *Frank Lyon Co. v. United States*: "Where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honour the allocation of rights and duties effectuated by the parties"; see also Yoram Keinan, It Is Time for the Supreme Court to Voice Its Opinion on Economic Substance, 7 Hous. Bus. & Tax L.J. 93, 101 & n. 45 (2006) p. 8: "The Supreme Court established the foundation for the two prongs of the economic substance test: objective economic substance and subjective business purpose".

[223] See Lederman, Leandra, W(h)ither Economic Substance? Iowa Law Review, Vol. 95, p. 389, 2010; Indiana Legal Studies Research Paper No. 128, p. 389.

[224] See Avi-Yonah, Reuven S. and Pichhadze, Amir, GAARs and the Nexus between Statutory Interpretation and Legislative Drafting: Lessons for the U.S. from Abroad (September 28, 2015), p. 10.

[225] See Y. Keinan, *supra* note n. 103.

[226] See *Rice's Toyota World, Inc. v. C.I.R.*, 752 F.2d 89 (C.A. 4, 1985).

[227] See *Friedman v. C.I.R.*, 869 F.2d 785, 792 (C.A.4, 1989) where the United States Court of Appeals, Fourth Circuit held that: "The first prong of this test, <<the business purpose>> prong, concerns the subjective intent of the taxpayer, and is similar to the <<primarily for profit>> standard of §§ 165 and 108 ... Unlike §§ 108 and 165, this prong requires

determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits, *i.e.* did the investment provide a realistic opportunity for economic profit apart from tax benefits?[228] As Avi-Yonah noted, neither prong depended on Congressional purpose[229]. Some courts have applied a "conjunctive test", which requires a taxpayer to establish the presence of both economic substance and business purpose in order for the transaction to survive judicial scrutiny[230]. A familiar example of this is *Pasternak v. C.I.R.* where it was held that: "to be valid, asserted business expense deduction or tax credit on depreciable property that has a useful life of more than three years must satisfy both components of two-part test; threshold question is whether transaction has economic substance, and if answer is yes, question becomes whether taxpayer was motivated by profit to participate in transaction"[231]. A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction[232]. *Sanderson v. C.I.R.*[233] can be regarded as an example of the "disjunctive test". There, the United States Tax Court held that: "... the transaction must either satisfy a subjective <<business purpose>> test, or satisfy an objective <<economic substance>> test". In the same

a showing that the *only* purpose for entering into the transaction was the tax consequences"; see also *Shriver v. C.I.R.*, 899 F.2d 724, 726 (C.A.8, 1990) where the United States Court of Appeals, Eight Circuit held that: "The business purpose inquiry examines whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved. The determination of whether the taxpayer had a legitimate business purpose in entering into the transaction involves a subjective analysis of the taxpayer's intent"; see also *ACM Partnership v. C.I.R.*, 1997 WL 93314, at*39 (U.S. Tax Ct., 1997) where the United States Tax Court held that: "Whether a transaction has economic substance is a factual determination. *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451, 456 (1950). Key to this determination is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. *Cherin v. Commissioner*, 89 T.C. 986, 993-994 (1987). A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs". Finally, see *Andantech L.L.C.* v. C.I.R., T.C. Memo. 2002-97 (U.S. Tax Ct., 2002) where the US Tax Court held that: "In analysing whether taxpayer was subjectively motivated to enter transaction by legitimate profit motive, rather purely tax benefits, as would support disregarding the transaction, significant factors include: (1) presence or absence of arm's-length price negotiations, (2) relationship between selling price and fair market value, (3) structure of financing, (4) degree of adherence to contractual terms, (5) reasonableness of the income and residual value projections, and (6) insertion of other entities into transaction".

[228] See *In re CM Holdings, Inc.*, 301 F.3d 96, 103 (C.A.3 (Del.), 2002) where the United States Court of Appeals held that: "There are several different formulations of the objective portion of the economic substance inquiry. Knetsch voided a transaction because it <<did not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax>>. 364 U.S. at 366, 81 S.Ct. 132. In *United States v. Wexler* we held that <<[w]here a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes>>. 31 F.3d 117, 122 (3d Cir. 1994). In ACM Partnership we required a <<net economic effect on the taxpayer's economic position>>. 157 F.3d at 249. *The main question these different formulations address is a simple one: absent the tax benefits, whether the transaction affected the taxpayer's financial position in any way*".

[229] See Avi-Yonah, Reuven S. and Pichhadze, Amir, GAARs and the Nexus between Statutory Interpretation and Legislative Drafting: Lessons for the U.S. from Abroad (September 28, 2015), p. 7.

[230] See P. Lampreave, *An Assessment of the Anti-Tax Avoidance Doctrines in the United States and the European Union*, 66 Bull. Intl. Taxn. 3 (2012), p. 157.

[231] *Pasternak v. C.I.R.*, 990 F.2d 893 (C.A.6, 1993).

[232] See P. Lampreave, *An Assessment of the Anti-Tax Avoidance Doctrines in the United States and the European Union*, 66 Bull. Intl. Taxn. 3 (2012), p. 157.

[233] *Sanderson v. C.I.R.*, T.C. Memo. 1985-477 (Tax Court 1985), see note n. 4: "The Fourth Circuit, where an appeal in the instant case would lie, has confirmed the use of this test".

vein, *Torres v. C.I.R.*[234] where it was held that: "... a finding of lack of economic substance is inappropriate if either a business purpose or a reasonable possibility of profit apart from expected tax benefits is found to have been present". Finally, in *Black & Decker Corp. v. U.S.* it was held that: "The court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes"[235]. As Lampreave argued, this interpretation is more flexible than the conjunctive test as it allows the taxpayer to prove either economic substance or business purpose for the IRS to accept the transaction[236].

4.2. Codification of the economic substance doctrine in 2010.

On March 30th, 2010, Congress codified the economic substance doctrine and added a strict penalty regime in the Health Care and Education Reconciliation Act of 2010. According to section 7701(o) of the Internal Revenue Code, in the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if (a) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (b) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. As Cuff argued[237], the decision of Congress to pass § 7701(o) to clarify the economic substance reflects a series of concerns: (i) Section 7701(o) is intended to resolve certain conflicts in the courts in interpreting the tests of economic substance? (ii) The increased Section 6662 penalty for nondisclosed noneconomic substance transaction is

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[234] *Edward Torres, Et Al., Petitioners v. Commissioner of Internal Revenue*, Respondent, 88 T.C. 702, 718 (Tax Court, 1987), see also *Packard v. C.I.R.*, 85 T.C. 397, 417 (Tax Court 1985): "A taxpayer's failure to establish that a transaction was motivated by a business purpose rather than by tax-avoidance is not conclusive, however, that the transaction was a sham. Rather, if an objective analysis of the transaction indicates that a reasonable possibility of profit existed apart from tax benefits, the transaction will not be classified as a sham".

[235] *Black & Decker Corp. v. U.S.*, 340 F.Supp.2d 621, 624 (D.Md., 2004). Interestingly, the United States District Court, D. Maryland also held that: "The second prong of the *Rice's Toyota* test examines the objective reasonableness of the transaction to determine whether it contained economic substance aside from tax benefits. A corporation and its transactions are objectively reasonable, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions". For a comment, see also Karen C. Burke, Black & Decker's Contingent Liability Shelter: "A Thing Of Grace And Beauty? Tax Notes, January 31, 2005, p. 385: "On October 20, 2004, without a hearing, the court granted B&D's refund claim and dismissed the government's counterclaim. According to the court, the government argued that: <<the BDHMI transaction was a tax avoidance vehicle that must be disregarded for tax purposes>>. Based on the Fourth Circuit's two-pronged test for determining whether a transaction will be treated as a <<sham>>, the court held that the BDHMI transaction must be respected because it had economic substance". In particular, see note n. 55: "B&D argued that, under the Fourth Circuit's economic substance analysis, either business purpose or economic substance suffices to overcome a challenge that an entity should be disregarded as a sham".

[236] See P. Lampreave, *An Assessment of the Anti-Tax Avoidance Doctrines in the United States and the European Union*, 66 Bull. Intl. Taxn. 3 (2012), p. 157; see also Y. Keinan, *The Many Faces of the Economic Substances Two-Prong Test: Time for Reconciliation*? 1 NYU J. Bus. & L., Spring, p. 372 (2005). On the other hand, the conjunctive two-prong test is the judicially developed form of economic substance most favourable to the IRS, see Mark A. Luscombe, *Codification of Economic Substance*, Taxes – The Tax Magazine, July 2010, p. 4.

[237] See Terence F. Cuff, *Economic Substance*, 70th NYU IFT, Volume 2, 2012, § 13.02. See also *supra* note n. 1 where it was argued that Congress finally codified the economic substance doctrine to clarify how and when that doctrine should be applied.

supposed to increase the taxpayer sakes and to make transactions lacking economic substance less attractive to taxpayers; (iii) The codification of the economic substance doctrine and particularly the extension of the Section 6662 penalty to transactions that lack economic substance was intended to raise $4.5 billion in revenue; (iv) The statutory economic substance doctrine was designed to make it appear that the Administration is getting tough on tax shelters. From the new version of § 7701(o), it emerges that Congress chose the more rigorous conjunctive test under which a transaction must satisfy both standards, objective and subjective[238]. Failure to meet either one of them will cause the transaction under scrutiny to lack economic substance. Although this new provision tries to provide greater clarity and uniformity in the application of the economic substance doctrine, some questions are still left unanswered[239]. For example, there is no specific definition of what constitutes a "change in a meaningful way" of the taxpayer's economic position[240]. Secondly, what does a substantial nontax purpose constitute?

With regard to the first question, it seems to me that the codification supports the taxpayer's argument that was rejected in *Long Term Capital Holding v. U.S.*[241] and *Gilman*[242] according to which objective economic substance is present where a transaction causes change in the economic positions/rights of the parties (other than tax savings). However, the JCT report discusses the type of non-tax economic benefit a taxpayer must establish in order to demonstrate that a transaction has economic substance arguing that there is a lack of uniformity. Thus, as Keinan argued[243] while it appears from the codification that a broader approach is applicable, the focus would be on the benefits from the transaction mainly profit potential[244]. Here, the problem is the following: must

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[238] See Y. Keinan, *The Economic Substance Doctrine* (Portfolio 508), p. 127; see also Avi-Yonah, Reuven S. and Pichhadze, Amir, GAARs and the Nexus between Statutory Interpretation and Legislative Drafting: Lessons for the U.S. from Abroad (September 28, 2015), p. 10: "The main change in the codified version was that it mandated following the conjunctive version of the doctrine in all the Circuits, and imposed stiff penalties for transactions lacking economic substance"; see also P. Lampreave, *An Assessment of the Anti-Tax Avoidance Doctrines in the United States and the European Union*, 66 Bull. Intl. Taxn. 3 (2012), p. 158: "From this definition, it can be concluded that a conjunctive analysis is required. Accordingly, there must be an inquiry regarding the objective effects of the transaction on the taxpayer's financial position as well as an inquiry regarding the taxpayer's subjective motives for engaging in the transaction".

[239] See C. Alves Alvarrenga, *Preventing Tax Avoidance: Is There Convergence in the Way Countries Counter Tax Avoidance?* 67 Bull. Intl. Taxn. 7 (2013), p. 352.

[240] See P. Lampreave, *An Assessment of the Anti-Tax Avoidance Doctrines in the United States and the European Union*, 66 Bull. Intl. Taxn. 3 (2012), p. 158.

[241] *Long Term Capital Holdings v. U.S.*, 330 F. Supp. 2d 122, 172 (D. Conn., 2004).

[242] *Gilman v. C.I.R.*, 933 F.2d 143, 147 (C.A.2, 1991).

[243] See Y. Keinan, *The Economic Substance Doctrine* (Portfolio 508), p. 122.

[244] See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress 378, JCS-2-11 (March 2011), p. 381: "Under the provision, a taxpayer may rely on factors *other than profit potential* to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial non-Federal-income-tax purpose for entering into such transaction. *The provision does not require or establish a minimum return that will satisfy the profit potential test*. However, if a taxpayer relies on a profit potential, the present value of the *reasonably expected* pre-tax profit must be *substantial* in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected". According to Lampreave, the term <<reasonable expectations>> imposes a hypothetical analysis at the date of the arrangement and not the real result. In other words, at the date of the transaction, there must be a pre-tax expectation of benefits and not a real benefit, which ... is a positive approach, as many business expectations do not always ultimately have a real result. See P. Lampreave, *An Assessment of the Anti-Tax Avoidance Doctrines in the United States and the European Union*, 66 Bull. Intl. Taxn. 3 (2012), p. 159.

taxpayer's profit potential be more than nominal *or* might it be sufficient if there is a nominal amount of pre-tax profit as measured against expected tax benefits? In the author's view, a comparison has to be made between the profit potential and the tax benefits and conclude whether the former is *infinitesimally nominal* and *vastly insignificant*[245]. In such a case, clearly the economic substance doctrine has to be applied to disallow the tax benefits.

With regard to the second question, i.e. the substantial nontax purpose, the Joint Committee explanation on an earlier version of a bill to codify the economic substance doctrine stated: "The proposal provides that a taxpayer's non-tax purpose for entering into an applicable transaction must be <<substantial>>. It is intended that the nontax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities. In determining whether a taxpayer has a *substantial nontax business purpose*, a purpose of achieving a financial accounting benefit shall *not* be taken into account if the origin of such benefit is a reduction of income tax. Under this rule, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (*i.e.*, a permanent book-tax difference) would *not* be considered to have a *substantial non-tax purpose* unless such a purpose exists apart from the financial accounting benefits"[246]. This was held in *American Elec. Power, Inc. v. U.S.*[247] and *Wells Fargo & Co. and Subsidiaries v. U.S.*[248] and now is clearly codified in section 7701(o)(4). In this regard, The JCT report on an earlier version of the codification of economic substance doctrine stated that: "by requiring a substantial non-tax purpose, it is intended that more than a mere showing that a transaction was not motivated solely by tax considerations would be needed to satisfy this

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[245] See *Goldstein v. C.I.R.*, 364 F.2d 734 (C.A.2, 1966) disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills: "The Tax Court found as an ultimate fact that petitioner's purpose in entering into the Jersey City Bank and Royal State Bank transactions <<was not to derive any economic gain or to improve here beneficial interest; but was solely an attempt to obtain an interest deduction as an offset to her sweepstake winnings>>. This finding of ultimate fact was based in part on a set of computations ... These computations indicated that petitioner and her financial advisors then estimated that the transactions would produce an economic loss in excess of $18,500 inasmuch as petitioner was out of pocket the 4% interest she had prepaid and could expect to receive 1 ½% interest on the Treasury obligations she had just purchased plus a *modest capital gain when the obligations were sold*"; See *Sheldon v. C.I.R.*, 94 T.C. 738, 768 (Tax Court, 1990) where the US Tax Court held that: "the potential for <<gain>> ... is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions".

[246] Options to improve tax compliance and reform tax expenditures, prepared by the Staff of the Joint Committee on Taxation, January 27th, 2005, JCS-02-05, pp. 21 – 22. With regard to the meaningful change in the taxpayer's economic position, the JCT further stated: "As one example, a transaction is suspect under this standard if money (or any other asset or liability) moves in a circular manner, such that the taxpayer's or another party's apparent financial outlay is largely protected from risk and is reasonably expected to be returned to that party or a related party when the transaction is complete".

[247] See *American Elec. Power, Inc. v. U.S.*, 136 F. Supp. 2d 762 (S.D. Ohio, 2001) where the United States District Court of S.D. Ohio Eastern Division held that: "AEP's intended use of the cash flows generated by the MBL COLI VIII plan is *irrelevant to the subjective prong of the economic substance analysis*. If a legitimate business purpose for the use of the tax savings <<were sufficient to breathe substance into a transaction whose only purpose is to reduce taxes, [then] every sham tax-shelter device might succeed>>. *Winn-Dixie*, 113 T.C. at 287.

[248] See *Wells Fargo & Co. and Subsidiaries v. U.S.*, 91 Fed.Cl. 35 (Fed.Cl., 2010).

standard"[249]. As it has been argued[250], this prong, although it is really nothing new, concerns many tax practitioners, because read literally, it can be applied to many common tax planning transactions that do not involve what are commonly considered to be "tax shelters". For example, it easily could apply to a cross-border loan between related parties that serves no purpose other than to shift income from a high jurisdiction (the borrower's) to a low tax jurisdiction (the lender's)[251]. Guidance on the second prong of the test is offered by Reg. § 1.355-2(b) with regard corporate divisions. As hereinbefore mentioned[252], a corporate business purpose is defined as "a real and substantial non Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group to which the distributing corporation belongs". Valid business purpose include compliance with antitrust divestiture orders, amicable separations to permit shareholders to devote their attention to the business in which they are more interested and more proficient[253]. Over the years, the courts and the Service ruled that the business purpose requirement was met in: a pro rata distribution of a controlled corporation's stock by the parent to the parent's shareholders in order to increase the amount of commercial credit that would be available to the corporations if they continued to exist in a parent-subsidiary relationship[254]; avoiding the development of further differences and conflicts between stockholders of a corporation as to the conduct of the business of the corporation[255]; containing labour difficulties[256], a distribution of the stock of a controlled corporation in order to enable that corporation to hire a

[249] See Technical Explanation of H.R. 5095 (The "American Competitiveness Act of 2002"), prepared by the Staff of the Joint Committee on Taxation, July 19th, 2002, JCX-78-02, p. 8.

[250] See McMahon, Martin J., Living with (and Dying by) the Codified Economic Substance Doctrine (June 11, 2010). University of Florida Levin College of Law Research Paper No. 2010-13, p. 21. Available at SSRN: http://ssrn.com/abstract=1623822

[251] See McMahon, Martin J., Living with (and Dying by) the Codified Economic Substance Doctrine (June 11, 2010). University of Florida Levin College of Law Research Paper No. 2010-13, p. 21. Available at SSRN: http://ssrn.com/abstract=1623822

[252] See *supra* note n. 9.

[253] Reg. § 1.355-2(b)(5) Examples (1) and (2); S. Schwarz & D. J. Lathrope, *Fundamentals of Corporate Taxation*, 2012, THOMSON REUTERS, p. 484.

[254] See Rev. Rul. 77-22, 1977-1 C.B. 91; Rev. Rul. 85-122, 1985-2 C.B. 118: the case involved the separation of an unprofitable ski resort from a profitable golf and tennis resort in order to meet the recommendation of the securities underwriter who planned to market debentures of the profitable golf and tennis report.

[255] See *Badanes v. C.I.R.*, 39 T.C. 410, 415 (Tax Court 1962) where it was held: "Here, as in the *Coady* case, the principal purpose of the transaction was to enable two businessmen, who could no longer agree between themselves as to the proper means for advancing their common business interests, to separate their interests and thereafter conduct through two corporations the businesses which they had theretofore conducted through the use of a single corporate entity. We believe that such purpose was a *sound and valid business purpose*; and that the clear implication of the *Coady* case is that Congress, in enacting section 355, intended to provide a means whereby a separation motivated by such a purpose could be accomplished without the deterrent effect of being subjected to tax. Moreover, there is no evidence herein that the principal purpose of the transaction involved was other than the business purpose above mentioned; and respondent has presented no argument to the contrary".

[256] See *Olson v. Commissioner*, 48 T.C. 855, 868 (Tax Court 1967) where the Tax Court held that: "... Cleveland's distribution to its stockholders of its stock in Buffalo, in order to avoid to the extent possible the development of further differences and conflicts between Buffalo and its employees and a union representing them, ... constituted a *valid business purpose* for the distribution".

key employee who also wishes to acquire a direct interest in that corporation[257] and, finally, in warding off corporate raiders[258].

As hereinbefore mentioned[259], in order to get taxpayers' attention and strengthen enforcement, Congress imposed stiff penalties for transactions lacking economic substance. The penalty rate is 20%, increased to 40% if the relevant facts affecting the tax treatment are not adequately disclosed by the taxpayer in the return or a statement attached to the return. In this regard, amended returns, filed after the taxpayer has been contacted for audit, are not taken into consideration. Unlike most other civil penalties, the reasonable cause and good faith exceptions are not applicable to noneconomic substance transactions, with the result that outside opinions or in-house analysis would not protect a taxpayer from imposition of the penalty[260].

4.3. Concerns raised with the codification of the economic substance doctrine.

Interestingly, this provision has been criticized as either removing too much flexibility from the courts or potentially applying too broadly to many non-tax-shelter transactions[261]. On one hand, Silverman, West, Nocjar[262] and Wolfman[263] have argued with persuasive lucidity that Congress

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[257] See Rev. Rul. 88-34, 1988-1 C.B. 115, 1988-20 I.R.B. 21; see also Rev. Rul. 69-460, 1969-2 C.B. 51, which held that the distribution of subsidiary stock to enable key employees to buy stock in the subsidiary was undertaken for a valid business purpose; see also Rev. Rul. 85-127, 1985-2 C.B. 119, which held that a valid business purpose exists where a corporation transferred one of its businesses to a new corporation and distributed the stock of the new corporation to retain a key employee and to permit the employee to purchase a majority of stock in the new corporation.

[258] See Mark J. Silverman, Corporate Divisions Under Section 355, Practising Law Institute, 2013, pp. 155 – 156: "Under certain circumstances, a section 355 distribution to ward off corporate raiders may constitute a valid business purpose. In P.L.R. 88190705 (Feb. 17th, 1988), the corporation's investment banker had advised the corporation (1) that it was currently vulnerable to a takeover attempt, (2) that the takeover price may be inadequate, and (3) that several subsidiaries might be sold, thereby causing harm to the corporation and its shareholders. A Schedule 13D filing recently had been made by a person or entity with a history of takeover participation, suggesting that a takeover was imminent. The Service approved of a distribution that allegedly would make Distributing less vulnerable to such a takeover attempt".

[259] See *supra* note n. 118.

[260] See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress 378, JCS-2-11 (March 2011), p. 382.

[261] See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress 378, JCS-2-11 (March 2011), p. 1.

[262] See Mark J. Silverman – Philip R. West – Aaron P. Nocjar, The Case Against Economic Substance Codification, Letter to the Editor, *Tax Notes*, July 19th, 2004, p. 316: "The economic substance doctrine has evolved since the Supreme Court decided Gregory v. Helvering, 293 U.S. 465 (1935), and has become far more significant in all areas of tax law. The longstanding application of the doctrine to an almost unending array of different circumstances confirms its strength and flexibility. And *there is no reason to believe that, in the hands of the courts, this strength and flexibility will diminish.* Although flexibility can be frustrating at times, to both taxpayers and the government, *a doctrine of equity such as the economic substance doctrine should remain flexible to respond to current issues*".

[263] See Bernard Wolfman, Why Economic Substance Is Better Left Uncodified, *Tax Notes*, July 26th, 2004, p. 445: "The words, the holding, and the breadth of Gregory v. Helvering, 293 U.S. 465 (1935), which courts, practitioners, and the government seek to capture in that doctrine, would lose their strength and much of their purpose if they were reduced to a rigid or formulaic legislative Rx". On the other hand, see Monte A. Jackel, For Better or For Worse: Codification of Economic Substance, *Tax Notes*, May 24th, 2004, p. 1070: "... despite its defects, the economic

should not have codified the economic substance doctrine. In addition, Avi-Yonah's main concern is that: "the codified version, even more than the judicial version, provides a road map to successful avoidance. What is needed is (a) a credible taxpayer bolstered by contemporaneous documentation to satisfy the subjective prong and (b) a reasonable chance of making a profit built into the transaction"[264].

On the other hand, as hereinbefore mentioned[265], a major concern was that it would have been extended to well-accepted tax planning techniques that had never been targeted. In this regard, the JCT report stated[266] that: "The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied". However, as Jackel argued: "The angel list is provided only in the legislative history; it is not part of the statutory text. Treasury and the IRS should thus issue regulations explaining what transactions are eligible for inclusion on the angel list"[267]. Therefore, the IRS released Notice 2010-62 in order to provide interim guidance regarding the codification of the economic substance doctrine under section 7701(o) and the related amendments to the penalties. Practitioners criticized it as *profoundly disappointing*[268] since (i) it confirmed that Treasury and the IRS did not intend to issue a so-called angel list of transactions that would not be subject to the doctrine or a list of those that would be subject to it[269]; (ii) it also confirmed that the IRS will not issue private letter rulings on whether the doctrine is relevant to a particular transaction; (iii) it made no mention of whether

substance codification proposal should be enacted into law because it will force practitioners to do some hard thinking about proposed transactions before advising a client to go forward with the transaction".

[264] See Avi-Yonah, Reuven S. and Pichhadze, Amir, GAARs and the Nexus between Statutory Interpretation and Legislative Drafting: Lessons for the U.S. from Abroad (September 28, 2015), p. 10.

[265] See *supra* note nn. 132 and 142.

[266] See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress 378, JCS-2-11 (March 2011), p. 379.

[267] See Monte A. Jackel, Dawn of a New Era: Congress Codifies Economic Substance, *Tax Notes*, April 19th, 2010, pp. 296 – 297.

[268] See Amy S. Elliott, Practitioners Blast Economic Substance Guidance, *Tax Notes*, September 20th, 2010, p. 1212.

[269] See Amy S. Elliott, Economic Substance 'Angel List' Unlikely, Says Treasury Official, *Tax Notes*, May 3rd, 2010, p. 521: "The Treasury Department is reluctant to issue guidance identifying which transactions would not be subject to the economic substance doctrine – like the so-called angel list contained in the legislative history for the Senate bill – said Donald Bakke, attorney-adviser in Treasury's Office of Tax Legislative Counsel. <<We are reluctant to go down that road because, for one, it would take a tremendous amount of resource to try to figure out what should be on the list>> ... creating an angel list would run afoul of that statutory directive because there is no angel list in the circuits applying the conjunctive test"; see also Amy S. Elliott, Practitioners Skeptical of IRS Stance on Economic Substance, Tax Notes, July 19th, 2010, p. 259: "... IRS and Treasury officials remain opposed to issuing an <<angel list>> of transactions that would generally not be subject to an economic substance inquiry ... IRS Associate Chief Counsel William Alexander reiterated that he has no intention of issuing rulings that explicitly address either the doctrine or the associated penalties".

and how the IRS would implement a uniform penalty procedure for assertions of the harsh strict liability. As Schwarz and Lathrope argued: "In declining to provide more specific guidance, the IRS appears to have concluded that codification of the economic substance doctrine would have more clout if its contours were as fuzzy as the common law doctrines that preceded it so that only the most adventuresome (or ignorant) tax planners would risk the heightened penalty exposure"[270].

5. Conclusion.

Although Italy and the United States have historically countered tax avoidance differently, from this article, it emerges that these countries converged on the implementation of a GAAR. As hereinbefore mentioned, the economic substance doctrine has inspired the Italian legislator in the introduction of Art. 37*bis* and, following the U.S. experience of 2010, has been recently codified. In addition, the analysis of Legislative Decree No. 128 of August 5th 2015, which introduced a new definition of abuse of law and repealed Art. 37*bis*, together with that of section 7701(o), also tried to demonstrate that the structure of the GAARs is almost similar. One important difference between Italy and the United States is the focus on the taxpayer's motivation. While in Italy, the attention is focused on the contrast with the *object*, *spirit* and *purpose* of the tax provisions, in the United States, since *Frank Lyon*, there has been a shift from congressional to taxpayer's intent. Apparently, this makes the Italian GAAR superior to 7701(o). Therefore, in the author's view, Congress should seriously take into account the possibility to repeal 7701(o) and draft a GAAR based, this time, on a *purposive inquiry* as suggested by Lederman[271]. After all, already in 2004, Wolfman argued: "We must ask, and ask in every case, whether the transaction as consummated fits the language and the purpose of the statutory provisions in question. There is no escape from looking to statutory purpose as it has been described in precedent and legislative history and as it can be sensibly understood in the context of the transaction in question. The cheap, easy way out that codification of the economic purpose doctrine might seem to offer is no way out at all"[272].

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[270] See S. Schwarz & D. J. Lathrope, *Fundamentals of Corporate Taxation*, 2012, THOMSON REUTERS, p. 625.
[271] See Lederman, Leandra, W(h)ither Economic Substance? Iowa Law Review, Vol. 95, p. 389, 2010; Indiana Legal Studies Research Paper No. 128, p. 443.
[272] See B. Wolfman, Why Economic Substance Is Better Left Uncodified, Tax Notes, July 26th, 2004, p. 445.

(Re)defining the balance between tax transparency and tax privacy in the Big data analytics

summary: 1. Introduction – 2. Traditional audit selection – 3. Defining Big data: legal, social and technical perspectives – 4. Big data in tax: an analysis of best practices around the world – 5. Big data and tax privacy: a preliminary assessment.

1. Introduction

145 countries that represent 98 percent of the world's GDP see €2.4 trillion lost every year through fraud and tax evasion. Ian Pretty, Head of Tax & Welfare, Global Sectors at Capgemini Group, in a three-minute video posted on YouTube explains why Big data is important to tax agencies. Now, a big challenge for tax agencies in Western Europe and Northern America is to find the revenues necessary to fund public services in an efficient way since, over the last decade, their budget has been cut and their workforce consequently reduced despite an increased workload. Thus, tax agencies are forced to do more with less. Big data in combination with analytics can provide significant opportunities in several areas: (1) perform Customer Due Diligence (CDD) by creating a single view of compliance; (2) predicting tax liabilities more accurately; and (3) preventing tax fraud and errors from occurring by improving risk detection. Big data can enhance the ability of tax agencies to select the most effective collection and audit cases, allowing their staff to focus only on the taxpayers that truly need intervention. This could improve outcomes by 10-25 percent or more and generating tens (or hundreds) of millions of euro in increased revenue. While Big data undoubtedly presents Big opportunities for tax agencies, it also raises Big challenges to taxpayers' privacy. In particular, the key defining characteristics of Big Data, the three or five V's, volume, variety, velocity, veracity and validity appear to starkly contrast with two of the most prominent data protection principles, namely purpose limitation and data minimization. This Article examines the clashes between Big data and data protection principles in the field of taxation. By looking at the most recent judgments of the Court of Justice of the European Union as well as those of some domestic courts, this Article intends to circumscribe tax authorities' powers and delineate clearer taxpayers' rights in the field of Big data.

2. Traditional audit selection

Tax agency is a transactional business. It deals with large amount of data and large amount of cash. Traditionally, information available to tax agencies was that filed by the taxpayers themselves through tax returns, or through third parties, e.g. employers required to send information reports (such as W-2s) on wages and salaries for all their employees. Then, tax agencies chose tax returns to audit based on discrepancies detected between those third party reports and tax returns. If information does not match up, IRS computers automatically generate and send out a notice to taxpayers asking them to explain and eventually pay up.

Secondly, and most importantly, tax returns are selected for audit on the basis of computer scoring. In Publication 556, the IRS states that it uses a computer program, called the Discriminant Inventory Function System (DIF), which calculates a numeric score for each individual and some corporate tax returns after they been processed. Receiving a high score under the DIF system significantly increases the likelihood that an examination of your return will result in a change to your income tax liability. Thus, the DIF has a two-fold purpose: *identify and select* tax returns for

audit utilizing a carefully developed secret formula. There are several items on a tax return, such as large charitable contributions, home office deductions, large travel and entertainment expense or large automobile expense that may raise serious concern and constitute red flag indicators. Once a tax return is selected, then IRS personnel manually review it by evaluating attachments and related data.

The IRS uses an additional tool, namely the Unreported Income Discriminant Index Formula (UI DIF) for two purposes: (1) rate the probability that information provided is inaccurate; and (2) rate the probability that income has been omitted. For example, if a taxpayer files the very simple Form 1040EZ, reporting wage and salary income from a W-2 only, then it is unlikely that the tax return will be selected for audit, this is because earnings reported on the three forms: 1040EZ, W-2 and social security number match up. Conversely, if a taxpayer has various sources of income: labor compensation, capital income, or engages in pass-through activities that might include tax shelters, the establishment of trust, and related taxation shielding options, or is a self-employee but fails to provide supporting documentation to justify his deductions, then is more likely to be audited.

Finally, tax returns are selected as a result of information received from other sources, such as newspapers, public records, and individuals (whistleblowers). Before starting an examination or investigation, however, IRS evaluates whether that information is reliable and accurate.

But, as argued by Jeff Buttler, Director of Research Databases at IRS, in an era of persistently reduced budgets, the use of Big data analytics has become more important than ever to drive innovation, risk management, and decision making across the agency. In a 2013 presentation, he outlined seven areas where Big data might be useful: (i) identify patterns of filing and payment non-compliance; (ii) predict and prevent ID theft and refund fraud; (iii) estimate U.S. tax gap; (iv) measure taxpayer burden; (v) optimize case inventories and treatment strategies; (vi) simulate effects of tax changes on taxpayer behavior; and (vii) analyze criminal networks.

3. Defining Big Data: legal, social and technical perspectives

What does the term "Big data" mean? When people hear it, they often associate it with the internet and the so-called FANG companies, Facebook, Amazon, Netflix and Google (now Alphabet, Inc.). Facebook, the world's most popular social media network with more than two billion monthly active users worldwide, stores every day enormous amounts of user data. It has been calculated that every 60 seconds, 136,000 phots are uploaded, 510,000 comments are posted, and 293,000 status are updated. Facebook knows who our friends are, where we are, what we are doing, what we look like or dislike. This massive amount of data is collected, stored, and analyzed in order to determine user behavior, which represents a gold mine for advertisers, marketers, political analysts, etc. Netflix, the American over-the-top media services provider, which revolutionized the entertainment industry, uses Big data to provide consumers with relevant and personalized content. Viewing habits, such as time of day a movie or TV show was watched, time spent selecting movies, and how often playback was stopped, are analyzed in order to create targeted suggestions, with customized lists of titles. Thus, if you watched, for example, NARCOS TV show, Netflix will more likely recommend you titles like Cocaine Coast, OZARK, EL CHAPO, violent TV Dramas, International TV Thriller etc.

As argued by Arthur J. Cockfield, the definition of the term Big data remains unsettled within social science perspectives partly because the concept is relatively new and partly because different academic disciplines such as law, accounting and economics appear to have different conceptions of Big data.

From a legal perspective, four different definitions of Big data are frequently cited.

In an Opinion adopted on April 2, 2013, on purpose limitation, Article 29 Data Protection Working Party gave the following definition, 'Big data refers to the exponential growth in availability and automated use of information: it refers to *gigantic digital datasets* held by corporations, governments and other large organizations, which are then *extensively analyzed* using computer algorithms. Big data relies on the increasing ability of technology to support the collection and storage of large amounts of data, but also to analyze, understand and take advantage of the full value of data (in particular using analytics applications). The expectation from big data is that it may ultimately lead to better and more informed decisions. There are numerous applications of big data in various sectors, including healthcare, mobile communications, smart grid, traffic management, fraud detection, marketing and retail, both on and offline. Big data can be used *to identify general trends and correlations* but its processing can also directly affect individuals. For example, in the field of marketing and advertisement, big data can be used to analyze or predict the personal preferences, behavior and attitudes of individual customers and subsequently inform "measures or decisions" that are taken with regard to those customers such as personalized discounts, special offers and targeted advertisements based on the customer's profile.'

Subsequently, the International Working Group on Data Protection in Telecommunications, in one of its 2014 working papers on Big data and Privacy, built on that definition (and White, 2012),[273] 'Big Data is a term which refers to the enormous increase in access to and automated use of information. It refers to the *gigantic amounts of digital data* controlled by companies, authorities and other large organizations *which are subject to extensive analysis* based on the use of algorithms.'

Moreover, the European Data Protection Supervisor, in its reference library available online, refers to Big data as, '*large amounts of different types of data produced at high speed from multiple sources*, requiring new and more powerful processors and algorithms to process and to analyse. These practices and technologies could offer major benefits for economic growth and various sectors including energy transportation and health. Not all of this information is personal, but businesses and governments are more and more using big data to understand, predict and shape human behavior. Big data is therefore a long term strategic concern for data protection and privacy regulators. It puts strain on not only privacy and data protection, but other fundamental rights including freedom of expression and non-discrimination.' It should be noted that the EDPS has been developing the concept of Big data protection since March 2014 when it issued a Preliminary Opinion on Privacy and competitiveness in the age of big data. There, Big data was used as

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[273] Cf. White (2012). Big data is the term for a collection of data sets so large and complex that it becomes difficult to process using on-hand databases management tools or traditional data processing applications.

shorthand for the combination of *massive personal data collection and analytics on high variety, high volume datasets*.[274]

At national level, the most prominent definitions of Big data are the two used in Germany and the United States.

Germany defines Big data as, 'synonymous with the intelligent use of large or heterogeneous datasets.'

On the other hand, the US definition of Big data can be found in the 2014 Podesta report, who was at that time Counselor to President Barack Obama. According to the Podesta report, 'there are many definitions of "big data" which may differ depending on whether you are a computer scientist, a financial analyst, or an entrepreneur pitching an idea to a venture capitalist. Most definitions reflect the growing technological ability to capture, aggregate and process an ever-*greater volume, velocity, and variety of data*. In other words, "data is now available faster, has greater coverage and scope, and includes new types of observations and measurements that previously were not available." More precisely, big datasets are "large, diverse, complex, longitudinal, and/or distributed datasets generated from instruments, sensors, Internet transactions, email, video, click streams, and/or all other digital sources available today and in the future.' As we can see, the Podesta report is clearly based on the 'technical'[275] definition of Big data appeared for the first time in a research note drafted by Doug Laney and published on February 6, 2001 entitled *3-D Data Management*: *Controlling Data Volume, Velocity and Variety*, better known as the Gartner report. Accordingly, Big data is, '*high-volume, high-velocity and/or high-variety information assets* that demand cost-effective, innovative forms of information processing that enable enhanced insight, decision making, and process automation.'

To summarize, those different definitions of Big data – legal, social, and technical – regularly mention a number of components, which relate to three stages of Big data, namely collection, analysis and use of data. When it comes to *collecting*, Big data is about collecting gigantic, large, massive amounts of data (the V of *Volume* describes the size of a data set, usually terabytes or petabytes) from different data structures and format due to multiple sources [the V of *Variety* refers to structured data (i.e. 3rd party data, external data via APIs and internal data) and unstructured data (i.e. web pages, social media, books/documents, audio and video)]. Regarding the analysis of data collected, Big data hinges on the speed of the analyses and the use of new and powerful processors, such as computer algorithms. The V of *Velocity* thus has to do with the speed at which data is created, processed and analyzed, which continues to tremendously accelerate. According to a collaborative research survey conducted by the IBM Institute for Business Value and the Saïd

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[274] Interestingly, also the EDPS cited the above-mentioned definition of Big data given by Article 29 WP as well as that of McKinsey Global Institute (June, 2011), 'big data means datasets whose size is beyond the ability of typical database software tools to capture, store, manage, and analyze.' See footnote no. 1.

[275] It should be noted that some legal scholars seem to prefer instead a 'social' definition of Big data that looks at the broader societal impact Big data will have. In doing so, they refer to the definition given by Mayer-Schönberger and Cukier. See, Neil M. Richards; Jonathan H. King, Big Data Ethics, 49 Wake Forest L. Rev. 393, 432 (2014), at. p. 394, footnote no. 5.

Business School at the University of Oxford, most organizations expect data will be available within 24 hours of being captured and processed.

The results of those three parameters are often two-fold: on the one hand, results are *prescriptive*, i.e. they provide *insight*, they look more closely at the data that has already been gathered in order to extract better business value and develop a more accurate and complete picture, on the other hand, results might also be *predictive* in nature, i.e. they provide *foresight* by predicting a future possible outcome based on a systematic examination of the historic information.

4. Big data in tax: an analysis of best practices around the world

Big data analytics is an extremely valuable tool for improving efficiency and effectiveness in tax agencies. One area in which tax agencies might use this '*growing gush of data*,' as defined by Hatfield, is in support of taxpayer services, such as providing 'pre-filled' or 'pre-populated' returns in order to save costs to tax preparation, including out-of-pocket expenses and time individuals spend on their tax affairs. For example, in Italy, since April 15, 2015 a pre-filled tax in relation to employment and pension income is made available online to qualifying individual taxpayers or to their tax representatives. Taxpayers are able to accept the information automatically included by the Agency on the return[276] or make modifications. If accepted, the pre-filled tax return becomes final and will not be selected for audit. In this case, automatically assessed tax refunds will also be paid without further examination. Alternatively, taxpayers have the possibility to submit an amended return. Despite the significant benefits associated with the provision of pre-filled returns, such as substantially reduced compliance burden for taxpayers, faster processing of tax return information and faster refund payouts, Tax Foundation highlighted how a 'return-free' filing system has also significant costs of its own, namely surrendering a great deal of privacy. For example, the Italian Revenue Agency, in a note published online last year, stated that in a three-year period, from 2015 to 2017 (pilot phase of pre-filled tax returns introduction), has collected over 800 million information.[277] Implications for taxpayers' privacy are clearly evident, not only for the vast *quantity* of sensitive information that has been collected – 800 million information compared to pre-filled returns actually submitted – but also for the *quality* of that information,

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[276] The Italian Revenue Agency uses information from its tax database from previous filing years, information provided by third parties, such as forms completed by the employers containing the details of employees' wages and salaries, banks, insurance companies, and pension funds. Since 2016, pre-filled tax returns also include information on purchases of medicine and other health services, which is collected from the public health billing system.

[277] Beyond information collected by tax database and from previous filing years, in the forms taxpayers can find data from third parties, such as banks, insurance companies, pension funds, universities, pharmacies, healthcare facilities or other health services. From this year, more pre-filled data has been added to income tax returns: now pre-compiled tax returns include many information on health services provided by psychologists, nurses, optician, obstetricians and radiologists. Furthermore, pre-filled data interest expenses for the renovation of apartment buildings. Overall, this process will allow to collect more than 800 million information. Specifically, 690 million of information will concern tax documents on health costs, included prescription and over-the-counter drugs; about 94 million involves insurance premiums; over 8 million are related to interest expense on mortgage banking; over 4 million are the information about supplementary personal protections; more than 3,4 million affect university costs and other 3,3 million concern social security contributions for domestic workers; finally, about 5,6 million data are tax documents for the renovation of apartment buildings.

which may reveal, among other things, information about income, spending and savings, employment status, disability status, associations and club memberships, mortgage costs, child support and alimony.

In addition, Big data might be useful in the enforcement area, especially during the audit stage, where tax officials are required to apply many complex code sections whose tax treatment usually depends on facts and circumstances. For example, tax agencies might use phone tracking technologies, such as Stingray, in order to determine the likelihood that a particular residence is the taxpayer's principal residence.[278]

In the author's opinion, audit case selection is the area where Big data might express its full potential. Indeed, of the 16 tax agencies that responded to a survey carried out by the OECD in late 2015, 15 indicated that they had deployed analytics to prioritize cases for investigation, audit, or other compliance intervention. The same survey indicated that several tax agencies, including Ireland, Malaysia, the Netherlands, New Zealand and Singapore are carrying out social network analysis (SNA) to help detect VAT carousel fraud and other group-level risks. SNA help tax agencies to identify risky groups in situations where individual-level assessments may fail to detect anything of concern. It identifies links between individuals (for instance, through company directorships, joint bank accounts, or shared telephone numbers), and assembles connected individuals into easily visualized networks. Tax officials can then browse these networks to profile individual risks. Equally, the networks can be scored for risk using either a rules-based assessment or a statistical model trained on historical data. For example, the Armenian Revenue Agency, in a 2018 presentation on the impact of digitalization on the transformation of tax administration, explained how it uses Big data to find out interconnected taxpayers. Basically, it uses three methods to identify links between taxpayers: (1) by importers; (2) by sellers; and (3) by employees. If different taxpayers import the same goods from the same country (Single Administrative Document field 11, SAD), store imported goods in the same storage (invoice), or purchase the same goods from the same exporter enterprise (SAD fields 32, 33), then it is highly likely that they might have the same owner. By sellers, the Armenian Revenue Agency looks at and combines different information, including addresses, invoices, registration data, and if different taxpayers have cashier machines in the same places, sell the goods from the same storage or have the same founders, it increases the likelihood that they might share the same owner.

Big data have the potential to dramatically change the way audits are conducted and cases selected. For example, information disclosed by taxpayers on social media platforms can be relevant for tax purposes in many ways. A taxpayer's Instagram feed might show whether a trip was really for business purposes and thus deductible, rather than for personal purposes – nondeductible. In addition, a Facebook feed might show a lifestyle that is inconsistent with reported income.[279] Tax agencies from the United States, Canada, India, Italy, and United Kingdom are among those said to be data mining Facebook, Instagram, Twitter, and other social networks for signs of tax evasion.

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[278] Kay Bell, IRS Using Cellphone Scrapers to Gather Data, Bankrate (Oct. 27, 2015), https://www.bankrate.com/financing/taxes/irs-using-cell-phone-scrapers-to-gather-data/#ixzz4JhlKj7p5

[279] Adam B. Thimmesch, Tax Privacy, 90 Temp. L. Rev. 375 (2018) at p. 386, footnote no. 56.

In the United States, data mined from social media is added to the information the tax agency (Internal Revenue Service, IRS) already has on people, its proprietary databases, such as Social Security numbers (SSNs), health records, bank statements, and belongings. Then, sophisticated pattern recognition algorithms are run to identify potential non-compliant taxpayers. An IRS training document, 'Guidance on Using Internet Tools,' mentions social networking sites as sources to gather taxpayer information. It is extremely useful because it discusses what tax officials are allowed to do while conducting Internet researches for taxpayer information. For example, tax officials are not permitted to misrepresent their identity or obtain information from a website using a fictitious identity to register.[280] In a much publicized 2014 case, *U.S. v. Wilson*, Rashia Wilson filed more than 220 fraudulent tax returns claiming $1.9 million in refunds between 2009 and 2012. According to court documents, the IRS conducted searches of Wilson's Facebook account where she had referred to herself as, '*THE QUEEN OF IRS TAX FRAUD*.' Consequently, Wilson received 21 years in federal prison and was ordered to forfeit more than $2 million. So, the lesson that can be drawn is that taxpayers should keep a tight privacy lock on their accounts. As we saw, the IRS is reportedly only looking at information that is public.

In Private Letter Ruling 201313031, IRS's examiners used photos of a property obtained through Google Maps as evidence in revoking the 501(c)(4) status of a homeowner's association.[281] That map was extremely helpful to support IRS's argument that the organization operated to restrict the general public from access to its facilities, thereby failing to confer a benefit onto the community. In particular, it showed how security gates were added after the organization applied for, and was granted, tax-exempt status. Indeed, according to the IRS, 'the addition of the security gates are a significant change to the organization's operations because they serve to exclude the general public from entering the property. Excluding the public does not conform to the definition of a § 501 (c)(4) organization.'

In addition, according to a 2010 Wall Street Journal article, Riverhead town officials used Google Earth images to detect some 250 illegal swimming pools in and around the town.[282] Google Earth's

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[280] See Example 1, at p. 3, 'Access to social networking sites is controlled by the individual or business that set up the site. For individuals, access is usually limited to "friends." Anyone wanting to become a friend must first provide information about themselves. *Employees may not use either their correct identification information or false identification information to become "friends" to gain access to the taxpayer's social network site*.'

[281] A homeowner's association is a membership organization formed by a real estate developer to own and maintain common green areas, streets, and sidewalks and to enforce covenants to preserve the appearance of the development may be exempt as a social welfare organization if it is operated for the benefit of all the residents of the community ... The association should include with its exemption application evidence that areas such as roadways and park land that it owns and maintains are open to the general public and not just its own members. It also must show that it does not engage in exterior maintenance of private homes. See also, Private Letter Ruling, PLR 201313031, March 2013, 'The ORG owns and maintains the portion of the property not owned by ORG (the CO-1) or the residents, which includes the roads and common areas. The entire property is enclosed with fencing. The property contains 426 houses and condominiums, which surround a golf course. The golf course is owned and maintained by the CO-1. The road consists of a two-mile loop around the inside of the property. It does not have any sidewalks or bicycle lanes. *The examining agent printed and copied a map from Google Maps* (www.google.com) *into this report*.'

[282] https://blogs.wsj.com/metropolis/2010/08/03/google-earth-used-to-bust-illegal-pools-on-long-island/

satellite images have also been used to detect illegal home constructions, additions built without proper permits, marijuana fields etc.[283]

IRS investigators can also access websites, such as eBay and PayPal to weed out regular traders. In a 2010 U.S. Tax Court, *Orellana v. C.I.R.*,[284] taxpayer Andrea Fabiana Orellana was found to have unreported income from eBay sales in 2004 and 2005. Between 2000 and 2005 she was involved in over 7,000 eBay transactions but did not report any income or expenses from her eBay transactions on her Federal income tax returns for the years at issue. Because taxpayer failed to maintain records of her purchases and sales of items on eBay, IRS determined taxpayer's gross income using combination of bank deposits method and analysis of records of her online-auction-site sales.[285] Thus, for 2004 IRS determined a total of $30,663.13 of unreported income, while for 2005 a total of $11,179.29 of unreported income. The U.S. Tax Court sustained IRS's determination holding that in view of the large number of transactions in 2004 (1,200) and 2005 (600), she should have realized have that her activity might be subject to question, and, despite her subjective belief she was not engaged in a 'business,' she was responsible to report gains from property sales.[286]

In the author's opinion, however, U.K. and Indian tax agencies are those where a structured digital model has been (at least) adopted. According to a Financial Times article, at the heart of HM Revenue & Customs' (HMRC) counter-evasion efforts lies a powerful computer software program called *Connect*. Made up of 22 billion lines of data, and 500 million documents, *Connect* uses information spontaneously available in government departments, such as land registry records, UK and overseas bank accounts, internal tax documents (VAT registration, previous tax investigations and tax returns), earnings from any employer, including those of temporary and ad-hoc basis jobs, as well as from online marketplaces, financial service companies, social media, peer-to-peer lenders, rental platforms, web browsing and email records and makes connections between them in order to delineate a more comprehensive picture of taxpayers. Launched in 2010, with the general objective to improve tax compliance across all activities and sectors of the economy, last data published shows a long-term reduction in the tax gap from 8.3% in 2005-06 to the latest figure of 6.5% in 2014-15.

HMRC employs also a number of other analytical methods, such as *Dynamic Benchmarking* and the above-mentioned *Predictive Analytics*. Dynamic Benchmarking is used to allow the data collected in specific sectors of the economy to tell what the norm is with regard to tax revenues. This method serves to identify outliers to whom notification letters are sent. Predictive Analytics

[283] Tax agencies in Estonia, Greece, Lithuania and United Kingdom use satellite pictures captured by Google Earth to find undeclared country villas and swimming pools as well as images provided by Google Map Street View to spot lavish spending on property renovations and building extensions.
[284] Orellana v. C.I.R., United States Tax Court, April 20, 2010, T.C. Summ. Op. 2010-51, 2010 WL 1568447.
[285] IRS subpoenaed records pertaining to taxpayer from eBay/PayPal. The examination of those records showed that taxpayer had approximately 1,200 eBay sales in 2004 and 600 in 2005.
[286] See § 61(a)(3) and Treas. Regs. § 1.61-6. In order to determine whether she had gains from property sales, taxpayer would have had to keep track of her cost or other basis in the property sold and the amount realized upon sale. But, as the Tax Court stated, 'there was no reduction in gross receipts to account for taxpayer's basis, if any, because there was no evidence with which to tie petitioner's purchases to her sales.'

is used to identify the riskiest cases that need intervention from VAT traders. It collects and combines data from trader characteristics, returns, debt information, audit visit outcomes and, through mostly econometric multivariate models of analysis, predicts those riskiest cases that need a 'targeted surveillance.'

Following United Kingdom's experience, in 2017 Indian tax agency began to amass a warehouse of virtual information collected not just from traditional existing sources like bank disclosure but also from social networking sites to help assess taxpayers' spending patterns with reported income. Built over seven years at a cost of about $156 million, '*Project Insight*' will increase tax compliance by 30%-40% in its first implementation stage, officials said.

5. Big data and tax privacy: a preliminary assessment

Some scholars pointed out that there is a difference between searching publicly available information online about a taxpayer who is being audited or subject to a criminal investigation and using data mining on social media or other websites to locate potential noncompliant activity, before taxpayer has even been selected for an audit. While the former seems to be implicitly acceptable, the same cannot be said for the latter. Houser and Sanders believe it would, at minimum, violate the consent requirement of Fair Information Practices (FIPs).[287] Başaran Yavaşlar goes even further and argues that, by doing so, all taxpayers are presumed to be potential tax evaders[288] or, as argued by Hatfield, subject to a *taxation surveillance system.*[289]

Moreover, according to the author, the key defining characteristics of Big data appear to be in stark contrast with two of the most prominent data protection principles, namely *purpose limitation* and *data minimization*. The definition of Big data given by the Dutch Data Protection Authority clearly summarizes that contrast, '*Big data is all about collecting as much information as possible*; storing it in ever larger databases; *combining data that is collected for different purposes*; and applying algorithms to find correlations and unexpected new information.' That definition is obviously incompatible with a literal interpretation of Article 5(1)(b) of the General Data Protection

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[287] Kimberly A. Houser and Debra Sanders, The Use of Big Data Analytics by the IRS: Efficient Solutions or the End of Privacy as We Know It? (March 29, 2017). Vanderbilt Journal of Entertainment & Technology Law, Vol. 19, No. 4, 2017. Available at SSRN: https//ssrn.com/abstract=2943002

[288] The information which is to be verified is the information received from taxpayer. If there has not yet been any information received from the taxpayer, there is nothing to be verified by the tax administration. Thus, the tax administration should not capture information from third parties at any time. It can be argued that if there is no verification, then there should a revelation of the unknown taxable elements as the second function of the controlling system. However, contacting the third persons and / or other sources at any time prior to receiving the taxpayers returns, and thus determining the taxable elements which should be declared, is based on the assumption that *all taxpayers are potential tax evaders* in an self-assessment taxation system. If we consider that all individuals are not terrorists, and all taxpayers are not tax evaders, that assumption would require a criminal investigation of all taxpayers. Even in an ex officio taxation system in which the tax administration can use tax procedural tools to discover taxable events, taxpayer and tax base, it should have minimum standards for contacting third parties and other resources for information. See Funda Başaran Yavaşlar, Tax Transparency – Preparatory materials, EATLP 2018. Available at http://www.eatlp.org/uploads/EATLP%202018-%20Panels%202%20and%204.pdf

[289] Hatfield predicted that over the next twenty-five years, the IRS will increasingly rely on surveillance technologies to reduce the compliance burden and compliance gap. See Michael Hatfield, Taxation and Surveillance: An Agenda, 17 Yale J.L. & Tech. 319 (2015).

Regulation (GDPR), which as of May 25, 2018 replaced the 1995 Data Protection Directive (DPD). According to Article 5(1)(b), personal shall be collected for specified, explicit and legitimate purposes and not further processed in a manner that is incompatible with those purposes; further processing for archiving purposes in the public interest, scientific or historical research purposes or statistical purposes shall, in accordance with Article 89(1), not be considered to be incompatible with the initial purposes ('purpose limitation').

A practical example is the March 2015 judgment by the Court of Appeal in Den Bosch which ruled that information gathered by the police with road surveillance cameras, installed for safety purposes, may be used by tax authorities to monitor compliance with the law on road vehicle tax.

Regarding data minimization principle, Article 5(1)(c) states that personal data shall be adequate, relevant and limited to what is necessary in relation to the purposes for which they are processed. In this regard, Marino adopted a highly effective neologism, '*datafication*.' Gigantic amounts of digital data are captured, communicated, aggregated, stored and analyzed regardless of their accuracy and quality. The risk is that this massive amount of data might be unnecessary and irrelevant in assessing taxpayers' liabilities.

The principles of data quality and accuracy,[290] as well as the issue of profiling,[291] have been addressed by the Italian Data Protection Authority in November 2013 in relation to a particular presumptive method of reconstructing income,[292] the so-called '*redditometro*.' The *Redditometro*, whose literal translation is income meter, evaluates the consistency of the expenses of individuals to their income.[293] The idea behind is that a certain amount of expenditure 'must' correspond to a certain amount of income. So if tax authorities can calculate the total of a taxpayer's expenditures, they can tell whether and to what extent he was cheating on his tax return. This risk-assessment

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[290] Article 5(d), 'Personal data shall be accurate, and where necessary, kept up to date; every reasonable step must be taken to ensure that personal data that are inaccurate, having regard to the purposes for which they are processed, are erased or rectified without delay ('accuracy').'

[291] Article 4(4), 'For the purposes of this Regulation, profiling means any form of automated processing of personal data consisting of the use of personal data to evaluate certain personal aspects relating to a natural person, in particular to analyze or predict aspects concerning that natural person's performance at work, economic situation, health, personal preferences, interests, reliability, behavior, location or movements.'

[292] See Tax Law Design and Drafting (volume 1; International Monetary Fund: 1996; Victor Thuronyi, ed.) *Chapter 12, Presumptive Taxation*, at p. 1, 'Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts. The term "presumptive" is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method.'

[293] To understand how the tool operates in practice, see http://ec.europa.eu/social/ajax/BlobServlet?docId=18476&langId=en, 'The tool juxtaposes data from households' income declarations, purchases of certain goods, and pre-defined standard of living household groups to assess whether a household is likely to have evaded taxes by declaring lower income. The household expenditures are controlled through data available in the tax register on purchases of large-scale items and the average expenditure for this type of family unit. If the identified discrepancy is too high, this triggers a financial inspection. The controlled items of expenditure include larger items, like houses, cars, and investments but also any kind of expenditure, which defines the lifestyle of the whole family involved such as clothes, beverages, groceries, power consumptions, health costs, entertainment, education, insurance, and major expenses of various kinds such as art, gifts, jewelry and other valuables. The items have to be matched with the whole family income.'

tool flags tax returns where the declared income differs from the taxpayer's estimated spending by more than 1/5 or 20 percent. Those who fail the test are asked to justify their returns. Taxpayers can challenge its application by proving that the estimated personal consumption expenses have been funded with exempt income; income subject to withholding tax; or income that has been legally excluded from the determination of the tax base.

In its Opinion of November 21, 2013,[294] the Italian DPA found several criticalities related to, among the others, the quality and accuracy of the data used by the Italian Revenue Agency, the estimated expenses incurred by each taxpayer depending on multifarious life-style components, as well as the information to be provided to the taxpayers. Firstly, the Italian DPA stated that the national statistics should not be used to determine the amount of recurring costs, such as clothing, grocery, hotel for which unequivocal evidence is missing. Such data relating to the average monthly expenditure per household cannot be properly attributed to any individual expect with significant error margins. Secondly, the so-called imputed rent (attributed to the taxpayer in the absence of home ownership or lease agreements in his municipality of residence) should be attributed only after the exact household composition has been confirmed. This in order to avoid

[294] It should be noted that nine months before the Italian DPA issued its opinion, the Court of Naples reviewed the Treasury Decree that established the *Redditometro* and declared it void as against the right to privacy and data protection, protected by Articles 2 and 13 of the Italian Constitution, and by Articles 1, 7 and 8 of the European Charter of Fundamental Rights. Consequently, the Court of Naples ordered the Revenue Agency to not engage in any identification, storage, or any activity of knowledge or use of data in relation to what is provided by Article 38(4) and (5) of the Presidential Decree no. 600/1973; to stop, where started, any activity of access, analysis and collection of any kind of data related to petitioner's position; and to destroy all related archives. This decision has been much debated and occasionally criticized by some tax scholars. See, Enrico Manzon, Giuseppe Citarella, Dario Stevanato & Raffaello Lupi, Redditometro, accertamento in base alla spesa e tutela della "privacy" in *Dialoghi Tributari* n. 1/2013, at p. 16. In their opinion, the Treasury Decree of December 24, 2012 did not expand Revenue Agency's knowledge of taxpayers' expenses. Such knowledge derives from reporting obligations imposed on several third parties (public and private) and tax audit powers of the Revenue Agency, as provided by provisions of primary source. Without such disclosure of information, taxpayers are unable to claim deductions for the most sensitive and social expenses, such as medical expenses, purchases of pharmaceutical drugs, etc. The administration of the individual income tax system will be practically impossible. Moreover, rather than declaring the Treasury Decree void, the Court of Naples should have remitted the question (whether or not Article 38(4) of the Presidential Decree no. 600/1973 complies with Articles 2 and 13 of the Italian Constitution) to the Constitutional Court so that we could have known its opinion on the balance between tax audits and taxpayers' right to privacy. Finally, rather than criticizing the *Redditometro* for its invasiveness or interference with the private and family life of taxpayers, it should have been criticized for its inefficiency in determining taxpayers' income. This argument proved right. According to a 2017 Il Sole 24 ORE article, as of December 31, 2016 there have been only 2.812 assessments with a 52% reduction from 2015 (5.827) and more than 92% reduction from 2012. The amount of tax recovered dramatically decreased from 207,6 million to just 2 million in the 2012/16 period (-99%). It should be noted that the first civil section of the Italian Supreme Court, by order 17485 filed on July 4, 2018, upheld the appeal of the Revenue Agency and overturned the judgment of first instance, which ruled in favor of petitioner. The Supreme Court highlighted how the rights provided by Article 7 of the Privacy Code concern the unlawful processing of specifically identified data and not generically the processing of all data concerning a data subject and indistinctly indicated. Otherwise, the initiative would result in an inadmissible opposition by the taxpayer to the investigation of the Revenue Agency, based on legal provisions, so as to prevent the administration to exercise its powers attributed by law. In other words, *Redditometro* constitutes an interference with taxpayers' right to privacy but such interference is justified since is in accordance with the law (it is based on specific provisions of the income tax code whose purpose is the exact collection of tax and the prevention of fraud and tax evasion) and is necessary in a democratic society in the interests of the economic well-being of the country.

those discrepancies that automatically attributed the imputed rent to two million of minor. In this regard, the Italian DPA noticed that from 2009 ISTAT data, as well as those from 2011 census, almost 25 million of households emerged compared to the 34 million identified by the Italian Revenue Agency. The Italian Revenue Agency should therefore focus in particular on the quality and accuracy of data in order to prevent and correct the anomalies detected in the databases or the mismatches between the different concepts of 'family' for civil and tax purposes. The exact household composition is indeed relevant in order to determine household income, identify the household type or attribute the imputed rent. Thirdly, taxpayers should be informed, through a form attached to their income tax returns, that their personal data will be also used for purposes of indirectly ascertaining their income through the *Redditometro*. Finally, during the consultation stage, the Revenue Agency should make clear whether the request of submitting additional information is compulsory or optional and what the consequences will be in case taxpayers will (even partially) refuse to comply with. National statistics and average spending patterns should not be used neither for audit selection purposes nor during the consultation stage. And this because the request of those data that relate to all aspects of everyday life conflicts with the right to privacy and data protection guaranteed by the European Convention on Human Rights. Thus, the Revenue Agency accepted the Italian DPA's observations with Circular no. 6/E of March 11, 2014.

Another relevant GDPR provision is Article 23(e), according to which Union or Member State law to which the data controller or processor is subject *may* restrict by way of a legislative measure the scope of the obligations and rights provided for in Articles 12 to 22 and Article 34, as well as Article 5 in so far as its provisions correspond to the rights and obligations provided for in Articles 12 to 22, when such a restriction respects the essence of the fundamental rights and freedoms and is a necessary and proportionate measure in a democratic society to safeguard … other important objectives of general public interest of the Union or of a Member State, in particular an important economic or financial interest of the Union or of a Member State, including monetary, budgetary and *taxation* matters, public health and social security.

In addition to Article 23(e), the word '*tax*' is cited three additional times, specifically in recitals (31); (71); and (112). Recital (31) generally refers to the fact that public authorities, such as *tax and custom authorities*, to which personal data are disclosed in accordance with a legal obligation for the exercise of their official mission, should not be regarded as *recipients* if they receive personal data which are necessary to carry out a particular inquiry in the general interest, in accordance with Union or Member State law. The GDPR restates then this principle in Article 4(9), which defines the term '*recipient.*' However, in the author's opinion, Big data practices by tax agencies are directly impacted by recital (71), according to which, '*The data subject should have the right not to be subject to a decision, which may include a measure*, evaluating personal aspects relating to him or her *which is based solely on automated processing* and which produces legal effects concerning him or her or similarly significantly affects him or her, such as automatic refusal of an online credit application or e-recruiting practices *without any human intervention*. Such processing includes 'profiling' that consists of any form of automated processing of personal data evaluating the personal aspects relating to a natural person, in particular to analyze or predict aspects concerning the data subject's performance at work, economic situation, health, personal preferences or interests, reliability or behavior, location or movements, where it produces legal

effects concerning him or her or similarly significantly affects him or her. *However, decision-making based on such processing, including profiling, should be allowed where expressly authorized by Union or Member State law to which the controller is subject, including for fraud and tax-evasion monitoring and prevention purposes* conducted in accordance with the regulations, standards and recommendations of Union institutions or national oversight bodies and to ensure the security and reliability of a service provided by the controller, or necessary for the entering or performance of a contract between the data subject and a controller, or when the data subject has given his or her explicit consent. *In any case, such processing should be subject to suitable safeguards, which should include* specific information to the data subject and *the right to obtain human intervention*, to express his or her point of view, to obtain an explanation of the decision reached after such assessment and to challenge the decision. Such measure should not concern a child.' Here, recital (71) in combination with Article 22 seems to allow the use of Big data analytics by tax agencies. Therefore, a taxpayer might be subject to an automated decision as long as it complies with regulations, standards, recommendations of Union institution or national oversight bodies and 'suitable measures' that safeguard his or her interests are provided including, as a minimum, the right to obtain human intervention, to express his or her point of view and contest the decision involved. In this regard, it should always be borne in mind that Big data gives its best results in decision supporting systems, complementing human knowledge.

Finally, recital (112) provides derogations to the general principle that personal data should not be transferred to a third country that does not ensure an adequate level of data protection, an assessment that is made by the Commission. It states that those derogations should in particular apply to data transfers required and necessary for important reasons of public interest, for example in cases of international data exchange between ... *tax or customs administrations*.

It seems to be definitively an improvement compared to the '95 DPD where the word *tax* appeared only twice. However, clashes between Big data analytics and purpose limitation and data minimization principles are still there and seem to be insurmountable. Some early commentators argued whether GDPR is made of boastful words, without any practical and relevant meaning or whether GDPR will make Big data analytics inefficient, by limiting its utility.[295] The author does not believe any of these perspectives is necessarily true. The advent of Big data does not mean the end of privacy as we mean it, because, first of all, what do we mean when we refer to the right to privacy? And, has the concept ever been defined in the tax context? As the author argued in the first chapter of his SJD dissertation, the notion of privacy as a *fundamental*, but not *absolute* human right appears to be grounded on three central ideas: (i) *the right to be let alone* (Cooley, 1888 and Warren and Brandeis, 1890) also known as *tort privacy*; (ii) the right of the individual to be free from unwanted and unwarranted governmental intrusion in matters affecting fundamental rights (*Griswold v. Connecticut* and *Eisenstadt v. Baird*) also known as *constitutional privacy*; and (iii) the claim of individuals, groups, or institutions to determine for themselves when, *how*, and to what extent information about them is communicated to others (Fried, 1968 and Miller, 1971) also known as *informational privacy*. One might thus think that individuals have the ability, freedom or right to keep confidential or secret information concerning their income, expenditures,

[295] Tal. Z. Zarsky, Incompatible: The GDPR in the Age of Big Data, 47 Seton Hall L. Rev. 995 (2017).

investments and wealth. But this view of privacy is both incorrect and utopian from a tax perspective. The right to privacy does not share the same scope of protection between tax and non-tax context. The notion of privacy in tax law is not as broad as in tort law or in constitutional law. Taxpayers cannot claim the right to be let alone or be free from unwarranted governmental intrusion. The reason is that, at stake, there is also the country's economic wellbeing to be protected. As Justice Roberts argued in *Bull v. U.S.*, taxes are the '*lifeblood*' of government. Therefore, an appropriate balance between societal and individual interest is required. As long as individuals have procedural safeguards, their tax privacy is guaranteed. Providing those safeguards does not mean that Big data analysis in Europe will be inefficient or limited, it just means focusing on *how* information about individuals is collected, processed, analyzed and used. In conclusion, in the author's opinion, the rise of Big data represents the beginning of a new era[296] where the collection, processing, analysis and use of personal data should be made in an elegant and ethical way. Far West situations where personal data are traded like any other commodity or abused like in the past should not be tolerated anymore. That certainly applies to businesses but also to tax agencies, which must always bear in mind that not all taxpayers are potential tax evaders.

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[296] Ira S. Rubinstein, Big Data: The End of Privacy or a New Beginning, Vol. 3 International Data Privacy Law, No. 2 (2013) 74-87.

Abuse and Aggressive Tax Planning between OECD and EU initiatives: Between the new challenges of FATCA and data protection

Gianluca Mazzoni

1. Introduction

Starting from the G-20 meeting in London on April 2nd 2009, where it was held that: "*the era of banking secrecy is over*," the rules of the international exchange of information have been subject to a radical change. On the one hand, new instruments have been issued by the United States (US), European Union (EU) and the Organisation for Economic Co-operation and Development (OECD) in an attempt to reduce the possibility of tax evasion and recover what Zucman has called the '*hidden wealth of Nations*' which, according to his estimates, amounts to about 8% of the financial wealth of households or $7.6 trillion. On the other hand, little attention has been paid to the protection of taxpayer's basic rights, namely the right to privacy or data protection. This dissertation aims to answer the following question: what is the scope of protection of the right to privacy in the context of automatic exchange of information? Before answering this question, it is necessary to give an overview of the different concepts of privacy. Therefore, firstly, the author will discuss the three central ideas on which the notion of privacy as a fundamental right is founded. As it will be explained below, in the US, privacy has been defined as: (i) the right to be let alone; (ii) the right to be free from unwarranted governmental intrusion; and (iii) the claim of individuals, groups, or institutions, to determine for themselves how, when, and to what extent, information about them is communicated to others. However, for the purposes of this dissertation, the author believes that the most relevant concept of privacy is the third one, also known as *informational privacy*. The question is not whether the taxpayer has the right to be let alone or is free from unwarranted governmental intrusion. These two definitions are too broad and cannot be accepted in the tax field since, at stake, are the important economic interest of governments, their "*lifeblood*," to be safeguarded. The right question should be whether the individual has the ability to control the circulation of personal tax information. Tax information, in particular, can reveal much about of a person's religion, ideology, opinions and interests. For this reason, individuals may be very reluctant to share their tax information with any third party, other than their government. As it will be shown in the second part, this definition of privacy as control over one's personal information has strongly influenced the way privacy is perceived in the EU. *Informational privacy* can be conceptually linked to the right of *informational self-determination*[297] introduced by the *Bundesverfassungsgericht* in its symbolic decision of 1984 regarding the Population Census Act and subsequently recognized, at the EU level, by Article 8 of the Charter of Fundamental Rights of the European Union and Directive 95/46/EC on the protection of individuals with regard to the

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[297] Alexander Rust, *Data Protection as a Fundamental Right*, in *Exchange of Information and Bank Secrecy* (A. Rust & E. Fort eds.), Kluwer Law International, (2012), pp. 177 – 178; Harald Schaumburg & Stefan Schlossmacher, *Article 26 of the OECD Model in Light of the Right to Informational Self- Determination*, Bulletin – Tax Treaty Monitor, October 2000, p. 522.

processing of personal data and on the free movement of such data. The third part will be dedicated to the compatibility of obligations under the US Foreign Account Tax Compliance Act (FATCA) and the OECD Common Reporting Standard (CRS) with the harmonized framework on data protection principles laid down in particular by Directive 95/46EC. The author will assess whether, according to the provisions contained within FATCA and CRS, personal data is (a) processed fairly and lawfully; (b) collected for specified, explicit and legitimate purposes and not further processed in a way incompatible with those purposes; (c) adequate, relevant and not excessive in relation to the purposes for which they are collected and/or further processed; (d) accurate and, where necessary, kept up to date; (e) kept in a form which permits identification of data subjects for no longer than is necessary for the purposes for which the data were collected or for which they are further processed. Particular attention will also be given to whether taxpayers have the right of access to data and how to correct them in case of any inaccuracies. As it will be demonstrated, in the light of the principles of necessity and proportionality stated by the ECJ in the judgment of April 8th 2014 (Joined Cases C-293/12 and C-594/12), where the Data Retention Directive was declared to be invalid,[298] under neither FATCA nor CRS, is the right to privacy as adequately and sufficiently guaranteed as it should be. Therefore, in the last part, the author will formulate a series of suggestions that should be taken into account in order to avoid the negative consequences of further invalidations.

2. The right to privacy in the US

Prior to addressing the new challenges of FATCA to taxpayers' privacy, it may be helpful to discuss some deep scholarly views on what is meant by the term "privacy" and how differently it is perceived in the United States and the European Union.

As it has been argued[299], the word *privacy* stems from the words *privation* and *deprivation.* Originally, to be private was to be deprived. Thus, the term *privacy* initially had unfavourable connotations: isolation meant loneliness; seclusion was an effective method of punishment. Eventually, individuals discovered the value of occasional isolation – to ponder without interruption and to conceal selected aspects of one's thoughts and activities, so as to enjoy the confidences of others. Today, however, privacy means much more than physical isolation[300]. The words which are normally associated with privacy are independence, freedom, autonomy, liberty, individuality, dignity, seclusion, and the absence of intrusion[301].

2.1. *Tort privacy: the right to be let alone* and its impact on subsequent theories

[298] ECJ, 08 April 2014, Joined Cases C-293/12 and C-594/12 *Digital Rights Ireland and Others* § 51.
[299] Richard A. Glenn, *The Right to Privacy: Rights and Liberties Under the Law*, pp. 3 – 4 (2003).
[300] See *supra* note n. 3, p. 4.
[301] Jon L. Mills, *Privacy: The Lost Right*, Oxford Scholarship Online: January 2009, DOI: 10.1093/acprof:oso/9780195367355.001.0001.

The first attempt to define privacy was made by Thomas Cooley in 1880.[302] In his treatise on the law of torts, Judge Cooley defined privacy as a *right of complete immunity*: *to be let alone*.[303] Ten years later, this phrase was adopted by Samuel D. Warren and Louis D. Brandeis in their noted article *The Right to Privacy* published in the *Harvard Law Review*.[304] Their purpose was to consider whether the existing law afforded a principle which could properly be invoked to protect the privacy of the individual; and, if it did, what the nature and extent of such protection was.[305] According to their opinion, the principle which protects personal writings and all other personal productions, not against theft and physical appropriation, but against publication in any form, is in reality not the principle of private property,[306] but that of an *inviolate personality*.[307] Warren and Brandeis also considered in what circumstances the right to privacy could be limited. For example, they noted that: (I) the right to privacy does not prohibit any publication of matter which is of public or general interest;[308] (II) the right to privacy does not prohibit the communication of any matter, though in its nature private, when the publication is made under circumstances which would render it a privileged communication according to the law of slander and libel;[309] (III) the law would probably not grant any redress for the invasion of privacy by oral publication in the absence of special damage;[310] (IV) the right to privacy ceases upon the publication of the facts by the individual, or with his consent;[311] (V) the truth of the matter published does not afford a defence;[312] (VI) the absence of 'malice' in the publisher does not afford a defence.[313] The remedies suggested for the enforcement of this right were twofold: (1) an action of tort for damages in all cases and (2) an injunction in a very limited number of types.[314]

Almost forty years after this article, which had a profound impact on the law of privacy and on subsequent theories of privacy,[315] Brandeis wrote his famous dissenting opinion in *Olmstead v.*

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[302] However, according to Solove: "Cooley's right to be let alone was, in fact, a way of explaining that attempted physical touching was a tort injury; he was not defining a right to privacy". See Daniel J. Solove, *Conceptualizing Privacy*, 90 Cal. L. Rev. (2002), p. 1100, note n. 48 quoting Robert Ellis Smith, *Ben Franklin's Web Site*: *Privacy and Curiosity from Plymouth Rock to the Internet* 128 (2000).

[303] Thomas M. Cooley, *A treaties on the law of torts, or, The wrongs which arise independent of contract*, p. 29.

[304] Samuel D. Warren and Louis D. Brandeis, *The Right to Privacy*, Vol. IV Harv. L. Rev. No. 5, 1890, p. 194.

[305] See *supra* note n. 8, p. 197.

[306] No difficulty arises in accepting this view, so long as we have only to deal with the reproduction of literary and artistic compositions. They certainly possess many of the attributes of ordinary property: they are transferable; they have a value; and publication or reproduction is a use by which that value is realized. *But where the value of the production is found* not in the right to take the profits arising from publication, but *in the peace of mind or the relief afforded by the ability to prevent any publication at all, it is difficult to regard the right as one of property, in the common acceptation of that term*. See *supra* note n. 8, pp. 200-201.

[307] See *supra* note n. 8, p. 205.

[308] See *supra* note n. 8, p. 214.

[309] See *supra* note n. 8, p. 216.

[310] See *supra* note n. 8, p. 217.

[311] See *supra* note n. 8, p. 218.

[312] See *supra* note n. 8, p. 218.

[313] See *supra* note n. 8, p. 218.

[314] See *supra* note n. 8, p. 219.

[315] Daniel J. Solove, *Conceptualizing Privacy*, 90 Cal. L. Rev. (2002), p. 1101. Available at: http://scholarship.law.berkeley.edu/californialawreview/vol90/iss4/2; Richard C. Turkington, *Legacy of the Warren and Brandeis Article*: *The Emerging Unencumbered Constitutional Right to Informational Privacy*, 10 N. III. U. L. Rev. (1990) pp. 481 – 482.

United States.[316] In *Olmstead*, the Supreme Court held that wiretapping did not violate the Fourth Amendment because no trespass was committed upon any property of the defendants[317] (the tapping connections were made in the basement of a large office building and on public streets). In dissent, Justice Brandeis argued that: "the protection guaranteed by the amendments is much broader in scope. The makers of our Constitution undertook to secure conditions favourable to the pursuit of happiness. They recognized the significance of man's spiritual nature, of his feelings and of his intellect. They knew that only a part of the pain, pleasure and satisfactions of life are to be found in material things. They sought to protect Americans in their beliefs, their thoughts, their emotions and their sensations. They conferred, as against the government, *the right to be let alone – the most comprehensive of rights and the right most valued by civilized men. To protect, that right, every unjustifiable intrusion by the government upon the privacy of the individual, whatever the means employed, must be deemed a violation of the Fourth Amendment*. And the use, as evidence in a criminal proceeding, of facts ascertained by such intrusion must be deemed a violation of the Fifth. Applying to the Fourth and Fifth Amendments the established rule of construction, the defendants' objections to the evidence obtained by wiretapping must, in my opinion, be sustained. *It is, of course, immaterial where the physical connection with the telephone wires leading into the defendants' premises was made. And it is also immaterial that the intrusion was in aid of law enforcement*."[318]

Brandeis's formulation was subsequently invoked by the Supreme Court in several cases. For instance, in *Time, Inc. v. Hill*, Justice Fortas observed, "A distinct right of privacy is now recognized, either a 'common-law' right or by statute in at least 35 States. Its exact scope varies in the respective jurisdictions. It is, simply stated, *the right to be let alone*; *to live one's life as one chooses, free from assault, intrusion or invasion except as they can be justified by the clear needs of community living under a government of law*."[319]

In *Katz v. United States*,[320] the Court adopted Brandeis's view, overruling *Olmstead*. Indeed, the Court concluded that: "the underpinnings of *Olmstead* and *Goldman* have been so eroded by our subsequent decisions that the 'trespass' doctrine there enunciated can no longer be regarded as controlling.[321] *The Government's activities in electronically listening to and recording the*

[316] *Olmstead v. U.S.*, 48 S. Ct. 564, 568, 277 U.S. 438, 466 (U.S., 1928).
[317] Neither the cases we have cited nor any of the many federal decisions brought to our attention hold the Fourth Amendment to have been violated as against a defendant, unless there has been an official search and seizure of his person or such a seizure of his papers or his tangible material effects or an actual physical invasion of his house 'or curtilage' for the purpose of making a seizure. We think, therefore, that the wire tapping here disclosed did not amount to a search or seizure within the meaning of the Fourth Amendment. See *supra* note n. 20.
[318] See *supra* note n. 20.
[319] *Time, Inc. v. Hill*, 87 S.Ct. 534, 555, 385 U.S. 374, 413 (U.S.N.Y. 1967).
[320] *Katz v. U.S.*, 88 S. Ct. 507, 512, 389 U.S. 347, 353 (U.S. Cal. 1967).
[321] It is true that the absence of such penetration was at one time thought to foreclose further Fourth Amendment inquiry, for that Amendment was thought to limit only searches and seizures of tangible property. But the premise that property interests control the right of the Government to search and seize has been discredited. Thus, although a closely divided Court supposed in *Olmstead* that surveillance without any trespass and without the seizure of any material object fell outside the ambit of the Constitution, we have since departed from the narrow view on which that decision rested. Indeed, *we have expressly held that the Fourth Amendment governs not only the seizure of tangible items, but extends as well to the recording of oral statements overheard without any 'technical trespass under local property law'*. See *supra* note n. 22.

petitioner's words violated the privacy upon which he justifiably relied while using the telephone booth and thus constituted a 'search and seizure' within the meaning of the Fourth Amendment. The fact that the electronic device employed to achieve that end did not happen to penetrate the wall of the booth can have no constitutional significance."[322]

Brandeis's dissenting was also quoted in *Stanley v. Georgia*.[323] Under authority of a warrant to search an appellant's home, federal and state agents found three reels of eight-millimetre film. Officers viewed the films and concluded that they were obscene. Appellant was placed under arrest for their possession. He was later indicted, tried and convicted for 'knowingly hav(ing) possession of obscene matter' in violation of Georgia law. The Supreme Court of Georgia affirmed, holding that, "*it is not essential to an indictment charging one with possession of obscene matter that it be alleged that such possession was 'with intent to sell, expose or circulate the same'*."[324] Before the Supreme Court, appellant argued that the Georgia obscenity statute, insofar as it punishes mere private possession of obscene matter, violated the First Amendment, as made applicable to the States by the Fourteenth Amendment. On the other hand, Georgia contended that since 'obscenity is not within the area of constitutionally protected speech or press', the States were free, subject to the limits of other provisions of the Constitution, to deal with it any way deemed necessary, just as they might deal with possession of other things thought to be detrimental to the welfare of their citizens. The Supreme Court held that: "mere categorization of these films as 'obscene' is insufficient justification for such a drastic invasion of personal liberties guaranteed by the First and Fourteenth Amendments. *Whatever may be the justifications for other statues regulating obscenity, we do not think they reach into the privacy of one's own home*. If the First Amendment means anything, it means that a State has no business telling a man, sitting alone in his own house, what books he may read or what films he may watch. Our whole constitutional heritage rebels at the thought of giving government the power to control men's minds."[325] Accordingly, the judgment of Georgia's Supreme Court was reversed and remanded.

Finally, Brandeis's opinion was also cited in *Doe v. Bolton*.[326] In this case, Mr. Justice Douglas, who wrote a concurring opinion, stated that, "the right '*to be let alone*' includes the privilege of an individual to plan his own affairs, for, 'outside areas of plainly harmful conduct, every American is left to shape his own life as he thinks best, do what he pleases, go where he pleases'."[327]

Despite the fact that it highly influenced subsequent judgments, many scholars observed that this idea of privacy was too broad.[328] For instance, Solove argued that: "the formulation of privacy as

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[322] See *supra* note n. 23.
[323] *Stanley v. Georgia*, 89 S.Ct. 1243, 1248, 394 U.S. 557, 565 (U.S. Ga. 1969).
[324] *Stanley v. State*, 161, S.E.2d 309, 311, 224 Ga. 259, 261 (Ga. 1968).
[325] See *supra* note n. 24.
[326] *Doe v. Bolton*, 410 U.S. 179 (U.S.Ga. 1973).
[327] See *supra* note n. 28. Douglas, J., *Concurring Opinion*, quoting *Kent v. Dulles*, 357 U.S. 116, 126.
[328] Anita L. Allen, *Uneasy Access: Privacy for Women in a Free Society*, Rowman & Littlefield, Publishers (1988), p. 7; Tom Gerety, *Redefining Privacy*, 12 Harv. C.R.-C.L. L. Rev. (1977), p. 263: "Warren and Brandeis began all this by singling out for favour Cooley's 'right to be let alone'. But any such evocation leaves us with an all-embracing and all-elusive background concept related to, and indeed inclusive of, all that we mean by privacy, but of little or no help in excluding other related concepts at the important juncture of finding rights and remedies"; Richard A. Glenn, *The*

the right to be let alone merely describes an attribute of privacy. Understanding privacy as being let alone fails to provide much guidance about how privacy should be valued vis-à-vis other interests, such as free speech, effective law enforcement, and other important values. Being let alone does not inform us about the matters in which we should be let alone."[329]

2.2. *Constitutional privacy*: freedom from unwarranted governmental intrusion

The notion of privacy as a fundamental but not *absolute*[330] human/personal right also appears to be grounded in another central idea: the ability to engage in certain conduct free from governmental regulation or the invasion of one's dignity. In particular, this idea was first developed in *Griswold v. Connecticut.*[331] In *Griswold*, the appellant, the Executive Director of the Planned Parenthood League of Connecticut and its medical director, a licensed physician and professor at Yale Medical School, were found guilty as accessories for giving information, instruction and medical advice to *married persons* as a means of preventing conception. They examined the wife and prescribed the best contraceptive device or material for her use. Sections 53-32 of the General Statutes of Connecticut made it a crime for any person to use any drug, medicinal article or instrument for the purpose of preventing conception. Appellants claimed that the accessory statute[332] violated the Fourteenth Amendment. The Appellate Division of the Circuit Court and the Supreme Court of Errors affirmed that judgment. The Supreme Court reversed the case holding that: "Connecticut law forbidding use of contraceptives unconstitutionally intrudes upon the right of *marital privacy*."[333]

This idea of privacy was better defined in *Eisenstadt v. Baird* where it was held that a Massachusetts statute permitting married persons to obtain contraceptives to prevent pregnancy but prohibiting the distribution of contraceptives to single persons for that purpose violated the equal protection clause.[334] Justice Douglas, in his concurring opinion, argued that, "If under Griswold the distribution of contraceptives to married persons cannot be prohibited, a ban on distribution to unmarried persons would be equally impermissible. It is true that in Griswold the right of privacy in question inhered in the marital relationship. Yet the marital couple is not an independent entity with a mind and heart of its own, but an association of two individuals each with a separate intellectual and emotional make up. *If the right of privacy means anything, it is the right of the individual, married or single, to be free from unwarranted governmental intrusion into*

Right to Privacy: *Rights and Liberties Under the Law*, p. 5; David M. O'Brien, *Privacy, Law, and Public Policy*, (1979), p. 5.

[329] Daniel J. Solove, *Conceptualizing Privacy*, 90 Cal. L. Rev. (2002), p. 1101. Available at: http://scholarship.law.berkeley.edu/californialawreview/vol90/iss4/2.

[330] See the six limitations set out by Brandeis and Warren in their article, *supra* note nn. 9 – 14.

[331] *Griswold v. Connecticut*, 85 S. Ct. 1678, 1679, 381 U.S. 479, 480 (*U.S.*Conn., 1965).

[332] Section 54-196 of the General Statutes of Connecticut (1958 rev.) provided: "Any person who assists, abets, counsels, causes, hires or commands another to commit any offense may be prosecuted and punished as if he were the principal offender".

[333] See *supra* note n. 33.

[334] *Eisenstadt v. Baird*, 405 U.S. 438 (U.S.Mass. 1972).

matters so fundamentally affecting a person as the decision whether to bear or beget a child. On the other hand, if Griswold is no bar to a prohibition on the distribution of contraceptives, the State could not, consistently with the Equal Protection Clause, outlaw distribution to unmarried but not to married persons. In each case the evil, as perceived by the State, would be identical, and the underinclusion would be invidious."[335]

In conclusion, these cases demonstrate that categorically, two types of privacy exist. The first type of privacy encroachment, which stems from the actions of private individuals, has been called *tort privacy*.[336] As mentioned, the development of a tort remedy for an invasion of privacy traces its lineage back to the law review article of Warren & Brandeis.[337] In their article, Warren and Brandeis pointed out that, "Instantaneous photographs and newspaper enterprise have invaded the sacred precincts of private and domestic life."[338] According to Prosser, Warren and Brandeis were inspired to write the article because reporters overstepped the bounds of propriety and decency in covering what was intended as a private wedding ceremony (the wedding of Warren's daughter).[339] However, according to Barron, this could not have been the reason because when the article was published, Warren's oldest daughter was no more than seven-years old.[340] According to Solove and Schwartz, the most likely impetus for writing the article was Warren's displeasure about a number of stories in the *Gazette* about his dinner parties.[341]

The second type of privacy encroachment is called *constitutional privacy*. It is the right of an individual to be *free* from unwanted and unwarranted governmental intrusion in matters affecting fundamental rights and to not have certain private information gathered, preserved, or disseminated by government.[342] As written above, examples of this second category of privacy are *Griswold, Eisenstadt* and *Roe v. Wade*. In addition to these landmark cases, the concept of privacy as an aspect of liberty has also been highlighted by Post[343] and Whitman. In particular, according to Whitman, the American right to privacy is oriented toward values of liberty, and especially

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335 See *supra* note n. 35. In this regard, see also *Roe v. Wade*, 410 U.S. 113 (U.S.Tex., 1973) in which the Supreme Court held that: "*Constitutional right of privacy is broad enough to encompass woman's decision whether or not to terminate her pregnancy, but the woman's right to terminate pregnancy is not absolute* since state may properly asset important interests in safeguarding health, in maintaining medical standards and in protecting potential life, and at some point in pregnancy these respective interests become sufficiently compelling to sustain regulation of factors that govern the abortion decision".

336 Richard A. Glenn, *The Right to Privacy: Rights and Liberties Under the Law* (2003), p. 6. See William L. Prosser, *Privacy*, 48 Cal. L. Rev. (1960), p. 389.

337 Harry Kalven Jr., *Privacy in Tort Law – Were Warren and Brandeis Wrong*? 31 *Law and Contemporary Problems* (1966). However, according to Solove and Schwartz, Brandeis's dissent [in *Olmstead v. United States*] demonstrated that the 'right to be let alone' ... also had constitutional roots in the Fourth Amendment. See Daniel J. Solove & Paul M. Schwartz, *Information Privacy Law*, Wolters Kluwer, 5th edition, 2015, pp. 35 – 36.

338 See *supra* note n. 6.

339 William L. Prosser, *Privacy*, 48 Cal. L. Rev. (1960), p. 383.

340 James H. Barron, Warren and Brandeis, *The Right to Privacy*, 4 Harv. L. 193 (1890): *Demystifying a Landmark Citation*, XIII Suffolk L. Rev. 4 (1979), p. 893.

341 Daniel J. Solove & Paul M. Schwartz, *Information Privacy Law*, Wolters Kluwer, 5th edition, 2015, p. 13, in particular note n. 20.

342 Richard A. Glenn, *The Right to Privacy: Rights and Liberties Under the Law* (2003), pp. 6 – 7: "Thus, constitutional privacy involves at least two separate kinds of interests – one in independence in making certain kinds of important decisions, the other in avoiding disclosure by government of personal matters".

343 Robert C. Post, *Three Concepts of Privacy*, 89 Geo. L.J. (2000-2001), p. 2096.

liberty against the state; it is the right to freedom from intrusions by the state, especially in one's own home.[344]

2.3. A tailor-made definition for '*tax exceptionalism*': *informational privacy* and the cases of *Miller* and *Yeong Yae Yun*

For the purposes of this dissertation, the author believes that the most relevant concept of privacy is what has been defined by Fried,[345] Miller[346] and Westin as *informational privacy*, a form of control over personal information. In particular, according to Westin, privacy is "the claim of individuals, groups, or institutions to determine for themselves when, how, and to what extent information about them is communicated to others."[347]

As it has been argued, tax information, which includes a taxpayer's income and an individual's personal circumstances (e.g. to support a claim for a disability tax credit), is a particularly sensitive form of personal information, and may be used to construct a detailed profile of an individual's identity, including religious and political beliefs,[348] For this reason, individuals may be very reluctant to share their tax information with third parties other than their government.[349]

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[344] James Q. Whitman, *The Two Western Cultures of Privacy*: *Dignity Versus Liberty*, 113 Yale L.J. (2003-2004), p. 1161.

[345] Charles Fried, *Privacy*, 77 Yale L.J. (1967-1968), pp. 482-483.

[346] Arthur R. Miller, *The Assault on Privacy, Computers, Data Banks, and Dossiers*, The University of Michigan Press, 1971, p. 25.

[347] Alan Westin, *Privacy and Freedom*, Atheneum ed., (1967), p. 7. In this regard, see also Randall P. Bezanson, *The Right to Privacy* Revisited: Privacy, News, and Social Change, 1890-1990, 80 Cal. L. Rev. 5, (1992) p. 1135.

[348] Arthur J. Cockfield, *Protecting Taxpayer Privacy Rights Under Enhanced Cross-Border Tax Information Exchange*: *Toward a Multilateral Taxpayer Bill of Rights*, 42 U.B.C. L. Rev. 2, pp. 420 and 437; see also Mr. Justice Powell (concurring) in *California Bankers Ass'n v. Shultz*, 94 S.Ct. 1494, 1526, 416 U.S. 21, 78-79 (U.S.Cal. 1974): "A significant extension of the regulations' reporting requirements, however, would pose substantial and difficult constitutional questions for me. In their full reach, the reports apparently authorized by the open-ended language of the Act touch upon intimate areas of an individual's personal affairs. *Financial transactions can reveal much about a person's activities, associations, and beliefs*. At some point, governmental intrusion upon these areas would implicate legitimate expectations of privacy. Moreover, the potential for abuse is particularly acute where, as here, the legislative scheme permits access to this information without invocation of the judicial process. In such instances, the important responsibility for balancing societal and individual interests is left to unreviewed executive discretion, rather than the scrutiny of a neutral magistrate"; see also Mr. Justice Douglas (dissenting) in *California Bankers Ass'n v. Shultz*, 94 S.Ct. 1494, 1529, 416 U.S. 21, 85-86 (U.S.Cal. 1974).

[349] See *supra* note n. 50, p. 438; In this regard, Cynthia Blum argued that some people may avoid revealing facts about their financial condition out of a desire to avoid: "(I) blatant comparisons (favourable or unfavourable) with others; (II) interference with, or scrutiny of, their decisions so as to protect creativity and autonomy; (III) that political or other enemies will make public revelation in a manner designed to humiliate or embarrass; (IV) requests for donations , or gifts to friends or family or raises for employees; (V) commercial solicitations, e.g. by purveyors of luxury goods or investment management; (VI) being a target of thieves, scam artists, or other criminals, including kidnappers seeking a ransom; (VII) identity theft or advantage to business competitors; and (VIII) enforcement of monetary obligations, such as contractual debts, tax liability, obligations of support, tort liability or criminal fines. See Cynthia Blum, *Sharing Bank Deposit Information With Other Countries*: *Should Tax Compliance or Privacy Claims Prevail*? 6 Fla. Tax Rev. 6 (2004) pp. 604 – 605.

Therefore, if, as mentioned,[350] one central idea of privacy is the ability to engage in certain conduct free from governmental regulation, do individuals have the ability, freedom or right to keep confidential or secret information concerning their income, expenditures, investments and wealth? Or better yet, do individuals have control over their financial information? In other words, does the right to privacy share the same scope of protection between tax and non-tax content? As argued by Olson, "our Supreme Court ruled very early on that the traditional due process protections of having a hearing before you seize property doesn't apply in the tax world because '*taxes are the lifeblood of government*'[351] and therefore government should be able to proceed to have that lifeblood immediately, and then we can figure out the correct answer later."[352]

In *United States v. Miller*, the respondent, who had been charged with various federal offenses, made a pretrial motion to suppress microfilm of checks, deposit slips, and other records relating to his accounts at two banks, which had maintained the records pursuant to the Bank Secrecy Act of 1970 (Act).[353] He contended that the subpoenas duces tecum, pursuant to which the material had been produced by the banks, were defective and that the records had thus been illegally seized in violation of the Fourth Amendment. Following the denial of his motion, respondent was tried and convicted. The Court of Appeals reversed, having concluded that the subpoenaed documents fell within a constitutionality protected zone of privacy.[354] The United States Supreme Court reversed the judgment of Court of Appeals holding that, "there is no legitimate '*expectation of privacy*' in the contents of the original checks and deposit slips, since the checks are not confidential communications but negotiable instruments to be used in commercial transactions, and all the documents obtained contain only information voluntarily conveyed to the banks and exposed to their employees in the ordinary course of business. The Fourth Amendment does not prohibit the obtaining of information revealed to a third party and conveyed by him to government authorities. The Act's recordkeeping requirements do not alter these considerations so as to create a protectable Fourth Amendment interest of a bank depositor in the bank's records of his account."[355]

As argued by Solove and Schwartz,[356] the Court followed the doctrine that has become known as the third party doctrine,[357] which holds that when data is maintained by third parties, there is no reasonable expectation of privacy – and no Fourth Amendment protection.

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[350] See *supra* note n. 33.
[351] *Bull v. U.S.*, 55 S.Ct. 695, 699, 295 U.S. 247, 259 (U.S. 1935).
[352] Conversations: Jeffrey Owens, Nina Olson, and Philip Baker, *Tax Notes Int'l.*, Feb. 15, 2016, p. 595.
[353] The Bank Secrecy Act of 1970, 31 U.S.C. § 1081, requires the retention of bank records and creation of reports that would be useful in criminal tax, and regulatory investigations and proceedings. The Act requires that federally insured banks record the identities of account holders as well as copies of each check, draft, or other financial instrument. See Daniel J. Solove & Paul M. Schwartz, *Information Privacy Law*, Wolters Kluwer, 5th edition, 2015, p. 780.
[354] *U.S. v. Miller*, 500 F.2d 751 (C.A.Ga. 1974).
[355] *U.S. v. Miller*, 96 S.Ct. 1619, 1620, 425 U.S. 435, 435 (U.S.Ga., 1976).
[356] Daniel J. Solove & Paul M. Schwartz, *Information Privacy Law*, Wolters Kluwer, 5th edition, 2015, p. 781.
[357] *Katz v. U.S.*, 88 S.Ct. 507, 511, 389 U.S. 347, 351 (U.S.Cal. 1967): "What a person knowingly exposes to the public, even in his own home or office, is not a subject of Fourth Amendment protection"; *U.S. v. White*, 91 S.Ct. 1122, 1125, 401 U.S. 745, 749 (U.S.Ill., 1971): "*Hoffa v. United States*, 385 U.S. 293, 87 S.Ct. 408, 17 L.Ed.2d 374 (1966), which was left undisturbed by Katz, held that however strongly a defendant may trust an apparent colleague, his expectations in this respect are not protected by the Fourth Amendment when it turns out that the colleague is a

Two years after *Miller*, Congress passed the Right to Financial Privacy Act (hereinafter RFPA), Pub. L. No. 95-630. The RFPA prohibits federal agencies from obtaining access from a financial institution to records concerning customers except through procedures set forth in the law.[358] As the Ninth Circuit, Court of Appeals held in *U.S. v. Mann*, the statutory rights granted by Congress, however, apply only to financial institutions within the United States. The rule of *Miller*, then, is in full force with respect to foreign banks.[359] The term 'financial institution' includes banks, savings banks, card issuers, industrial loan companies, trust companies, savings associations, building and loans, homestead association (including cooperative banks), credit unions and consumer finance institution.[360] Customers are limited to individuals or partnerships of five or fewer individuals.[361] Corporations, associations, larger partnerships, or other entities are not covered.[362] Access to financial records is prohibited unless either permitted by one of the exceptions to the Act, *e.g.*, grand jury subpoena or procedures; customer authorization, administrative summons or subpoena, search warrants under the Federal Rules of Criminal Procedure, judicial subpoena, or 'formal written requests', where no administrative summons or

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government agent regularly communicating with the authorities. In these circumstances, 'no interest legitimately protected by the Fourth Amendment is involved,' for that amendment affords no protection to 'a wrongdoer's misplaced belief that a person to whom he voluntarily confides his wrongdoing will not reveal it'. *Hoffa v. United States*, at 302, 87 S.Ct., at 413. No warrant to 'search and seize' is required in such circumstances, nor is it when the Government sends to defendant's home a secret agent who conceals his identity and makes a purchase of narcotics from the accused, *Lewis v. United States*, 385 U.S. 206, 87 S.Ct. 424, 17 L.Ed.2d 312 (1966), or when the same agent, unbeknown to the defendant, carries electronic equipment to record the defendant's words and the evidence so gathered is later offered in evidence. *Lopez v. United States*, 373 U.S. 427, 83 S.Ct. 1381, 10 L.Ed.2d 462 (1963)"; *Couch v. U.S.*, 409 U.S. 322 (U.S.Va. 1973): "where taxpayer hired an independent accountant to whom she had delivered regularly over a period of years various business and tax records which remained in his continuous possession and accountant worked in his own office, taxpayer's divestment of possession of such records was of such character as to disqualify her entirely as object of any impermissible Fifth Amendment compulsion, and she was not entitled to invoke such privilege to prevent the production of her business and tax records in possession of accountant pursuant to subpoena of special agent served on accountant in connection with investigation of tax liability".

[358] For a comment see Nancy M. Kirschner, *The Right to Financial Privacy Act of 1978 – The Congressional Response to United States v. Miller: a Procedural Right to Challenge Government Access to Financial Records*, 13 U. Mich. J.L. Reform (1979-1980), p. 32.

[359] *U.S. v. Mann*, 829 F.2d 849, 851 (C.A.9 (Or.), 1987); see also *In re Grand Jury Proceedings*, 40 F.3d 959 (C.A.9 (Ariz.), 1994) where it was held that an Austrian citizen residing in the United States who was targeted by federal grand jury for possible offenses stemming from claimed tax liabilities did not have protected Fourth Amendment interest in his foreign bank records. These two cases referred to *U.S. v. Payner*, 447 U.S. 727 (U.S.Ohio, 1980) where the Supreme Court, Mr. Justice Powell, held that: "(1) defendant, charged with falsifying a federal income tax return by denying that he maintained a foreign bank account, lacked standing under Fourth Amendment to suppress documents illegally seized from briefcase of officer of Bahamian bank, which documents led to loan guaranty in which defendant pledged bank account as security for a loan as defendant possessed no privacy interest in the seized document, notwithstanding suggestion that Bahamian law of bank secrecy created an expectation of privacy".

[360] § 3401(1) Definitions, 12 USCA § 3401.

[361] § 3401(4)(5) Definitions, 12 USCA § 3401.

[362] *California Bankers Ass'n v. Shultz*, 94 S.Ct. 1494, 1519-20, 416 U.S. 21, 65-66 (U.S.Cal. 1974): "While they may and should have protection from unlawful demands made in the name of public investigation, *corporations can claim no equality with individuals in the enjoyment of a right to privacy*. They are endowed with public attributes. They have a collective impact upon society, from which they derive the privilege of acting as artificial entities. The Federal Government allows them the privilege of engaging in interstate commerce. Favours from government often carry with them an enhanced measure of regulation. Even if one were to regard the request for information in this case as caused by nothing more than official curiosity, nevertheless law-enforcing agencies have a legitimate right to satisfy themselves that corporate behaviour is consistent with the law and the public interest".

subpoena authority reasonably appears available.[363] However, as argued by Kirschner, Title XI is a decidedly pro-government statute which fails to give customers adequate privacy protection. What is required is a better balance between the three separate interests affected by the Act, namely, those of the customer, those of the financial institution, and those of government law enforcement officials.[364]

The holding of *United States v. Miller* was reaffirmed in *Yeong Yae Yun v. U.S.* a case involving the international exchange of taxpayer information. In 1999, the Korean taxing authorities issued requests to the IRS for information related to certain Korean taxpayers because they believed the taxpayers had failed to report all their taxable income or to pay their tax liabilities for the years 1995 through 1998. The IRS' Manager of International Programs reviewed the Korean government's requests, determined that they were proper under the Convention, and concluded that it was appropriate for the United States to honour them. At the time the summons were issued, neither the IRS nor the Korean authorities had access to the requested information. In June 2000, the International Examiner issued and served summonses on the banks, requiring that witnesses appear before him and produce documents. Petitioners (the Korean taxpayers) contended (1) the summons were not related to an ongoing tax investigation by the IRS; (2) that they constituted an invasion of petitioners' right to privacy; and (3) that they were vague, ambiguous, and overbroad. The United States District Court, for the Central District of California held that, "*Petitioners have no legitimate expectation of privacy in their bank accounts*."[365] In this case, the court referred to *United States v. Miller* ("The depositor takes the risk, in revealing his affairs to another, that the information will be conveyed by that person to the Government")[366] and to *United States v. Aguilar* ("a person has no legitimate expectation of privacy in information he voluntarily turns over to third parties").[367]

In the author's view, *Yeong Yae Yun v. U.S.* demonstrates that, even though, in 1978, Congress passed the RFPA, the right to privacy does not have the same scope of protection when in the context of taxation. Individuals only have procedural safeguards, not a substantive right to privacy. However, one interesting aspect of *Yeong Yae Yun v. U.S.*, as compared to the *Sabou*[368] case where it was held that the taxpayer had no right to be informed or to participate in any way in the process of information exchange, was that the IRS International Examiner also sent copies of the summons to petitioners by certified mail. All administrative steps necessary for the issuance of a proper summons were thus fulfilled.[369] In this regard, the Ninth Circuit, Court of Appeals, in *Fortney v. U.S.* held that, "Issuance of third-party summonses is governed by 26 U.S.C. § 7609. That statute provides that when a summons is served on a 'third-party recordkeeper' and that summons identifies a person about whom information is requested, 'notice of the summons shall be given to

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[363] See *supra* note n. 60, p. 33.
[364] See *supra* note n. 60, pp. 41 – 42.
[365] *Yeong Yae Yun v. U.S.*, 2000 WL 33267334, at *4 (C.D.Cal., 2000).
[366] See *supra* note n. 57.
[367] *U.S. v. Aguilar*, 883 F.2d 662, 699 (C.A.9 (Ariz.), 1989).
[368] CZ: ECJ, 22 Oct. 2013, Case C-276/12 *Jiří Sabou v. Finanční ředitelství pro hlavní město Prahu*. For a comment see, J.M. Calderón & A. Quintas Seara, *The Taxpayer's Right of Defence in Cross-Border Exchange-of-Information Procedures*, 68 Bull. Intl. Taxn. 9 (2014), Journals IBFD.
[369] See *supra* note n. 66; see also *Villarreal v. U.S.*, 2011 WL 7575002, at *3 (D.Colo., 2011).

any person so identified.' The statute indicates that '[s]uch notice *shall be accompanied by a copy of the summons which has been served* and shall contain an explanation of the right under subsection (b)(2) to bring a proceeding to quash the summons."[370] Therefore, it could be argued that the RFPA and § 7609, compared to the old mutual assistance directive 77/799/EC, provided, at minimum, procedural safeguards to taxpayers.

3. The right to privacy in the EU: Art. 8(1) of the ECHR and Art. 7 of the CFREU

While the US Constitution does not explicitly mention privacy, a right to privacy is explicitly established at the constitutional level in Europe: in additional to national constitutions, both the Convention for the Protection of Human Rights and Fundamental Freedoms, better known as the European Convention on Human Rights (hereinafter ECHR), and the Charter of Fundamental Rights of the European Union both have provisions on privacy (hereinafter CFREU).

Article 8(1) of the ECHR and similarly Article 7 of the CFREU[371] provide that, "Everyone has the right to respect for his private and family life, his home and his correspondence."

According to case law of the European Court of Human Rights (hereinafter ECtHR), the term "private life" must not be interpreted in a restrictive manner. In particular, the ECtHR recognised that a person's interactions with others may also fall within the scope of private life. Furthermore, there is no reason or principle that justifies excluding activities of a professional or business nature from the notion of "private life."[372]

As regards to the word 'home', the ECtHR observed that in certain contracting states, notably Germany,[373] it has been accepted as extending to business premises. Such an interpretation is fully consistent with the French text, since the word 'domicile' has a broader connotation than the word 'home' and may extend, for example, to a professional person's office. In this context also, it may not always be possible to draw precise distinctions, since activities which are related to a profession or business may well be conducted from a person's private residence and activities which are not so related may well be carried on in an office or commercial premises.[374]

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[370] *Fortney v. U.S.*, 59 F.3d 117, 120 (C.A.9 (Nev.), 1995).

[371] Art. 7 CFREU: "*Everyone has the right to respect for his or her private and family life, home and communications*". Thus, Article 7 of the charter almost exactly corresponds with Article 8 of the ECHR, the only difference being the replacement of 'correspondence' in the ECHR with 'communications'. See European Data Protection Supervisor, *Guidelines on data protection in EU financial services regulation*, p. 7.

[372] ECtHR 16 December 1992, *Niemietz v. Germany*, (Application no. 13710/88) § 29; ECtHR 25 June 1997, *Halford v. The United Kingdom*, Application no. 20605/92 § 42; ECtHR 16 February 2000, *Amann v. Switzerland*, Application no. 27798/95 § 65.

[373] Article 13 para. 1 of the Basic Law (*Grundgesetz*) guarantees the inviolability of the home (*Wohnung*); this provision has been consistently interpreted by the German courts in a wide sense, to include business premises (see, in particular, the Federal Constitutional Court's judgment of 13 October 1971 - *Entscheidungssammlung des Bundesverfassungsgerichts*, vol. 32, p. 54.

[374] ECtHR 16 December 1992, *Niemietz v. Germany*, (Application no. 13710/88) § 30; ECtHR 16 July 2002 *Société Colas Est and Others v. France*, (Application no. 37971/97) § 41. The issue in *Peev v. Bulgaria* (ECtHR 26 October

Art. 8(2) provides that, "There shall be no interference by a public authority with the exercise of this right except such as is *in accordance with the law* and is *necessary in a democratic society in the interests of* national security, public safety or *the economic well-being of the country*, for the prevention of disorder or crime, for the protection of health or morals, or for the protection of the rights and freedoms of others." Therefore, such interference gives rise to a breach of Article 8 unless it can be shown that it was "*in accordance with the law*," pursued one or more legitimate aims as defined in paragraphs 2 and was "*necessary in a democratic society*" to attain. A central requirement of Article 8 is the "the rule of law." The ECtHR explained this concept in *Sunday Times v. United Kingdom*, "*Firstly, the law must be adequately accessible*: the citizen must be able to have an indication that is adequate in the circumstances of the legal rules applicable to a given case. *Secondly, a norm cannot be regarded as a 'law' unless it is formulated with sufficient precision to enable the citizen to regulate his conduct*: he must be able – if need be with appropriate advice – to foresee, to a degree that is reasonable in the circumstances, the consequences which a given action may entail. Those consequences need not be foreseeable with absolute certainty: experience shows this to be unattainable. Again, whilst certainty is highly desirable, it may bring in its train excessive rigidity and the law must be able to keep pace with changing circumstances. Accordingly, many laws are inevitably couched in terms which, to a greater or lesser extent, are vague and whose interpretation and application are questions of practice."[375] In the same vein, in *Kopp v. Switzerland* the ECtHR held that, "The expression 'in accordance with the law', within the meaning of Article 8 § 2, requires firstly that the impugned measure should have some basis in domestic law; it also refers to the quality of the law in question, requiring that it should be accessible to the person concerned [second requirement – the accessibility of the law], who must moreover be able to foresee its consequences for him, and compatible with the rule of law [third requirement – the law's "foreseeability" as to the meaning and nature of the applicable measures]."[376] In this case, which concerned the monitoring of the applicant's law firm's telephone lines under orders of the Federal Public Prosecutor, the Court held that there had been a breach of Article 8 since domestic law did not indicate with sufficient clarity the scope and manner of the

2007, Application no. 64209/01) was whether the search in the applicant's office, which was located on the premises of a public authority, also amounted to an interference with the right to respect for the private life. The ECtHR examined whether the search affected the applicant's private life under the 'reasonable expectation of privacy' test. The Court, in § 39, concluded that: "*the applicant did have such an expectation*, if not in respect of the entirety of his office, *at least in respect of his desk and his filing cabinets. This is shown by the great number of personal belongings that he kept there.* Moreover, such an arrangement is implicit in habitual employer-employee relations and there is nothing in the particular circumstances of the case – such as a regulation or stated policy of the applicant's employer discouraging employees from storing personal papers and effects in their desks or filing cabinets – to suggest that the applicant's expectation was unwarranted or unreasonable. *The fact that he was employed by a public authority and that his office was located on government premises does not of itself alter this conclusion, especially considering that the applicant was not a prosecutor, but a criminology expert employed by the Prosecutor's Office. Therefore, a search which extended to the applicant's desk and filing cabinets must be regarded as an interference with his private life*". Whether such a search also amounted to an interference with the individual's right to respect for his home was left open; ECtHR 3 June 2008, *Steeg and Wenger v. Germany*, (Application np. 9676/05): "*As to the searches of the second applicant's office at the University of Würzburg, a public authority, the second applicant could reasonably expect that his office would not be liable to an inspection by the authorities extending to the contents of documents or electronic storage media kept therein. Therefore, the searches interfered at least with his right to respect for his private life*".

[375] ECtHR 26 April 1979, *Sunday Times v. United Kingdom* (Application no. 6538/74) § 49.

[376] ECtHR 25 March 1998, *Kopp v. Switzerland*, (Application no. 23224/94) § 55.

exercise of the authorities' discretion in the matter. Consequently, the applicant, as a lawyer, had not enjoyed the minimum degree of protection required by the rule of law in a democratic society.[377]

As to the requirement, to be necessary in a democratic society, the Court pointed out that an interference must be founded on a pressing social need and, in particular, be proportionate to the legitimate aim pursued.[378]

3.1. Art. 8(2) of the ECHR: is the interference of revenue authorities with the right to privacy justified?

Also here, the question is, according to case law of the ECtHR, what is the scope of the protection provided under the right to privacy in the context of taxation? In other words, is the interference of revenue authorities to the right to privacy of an individual justified on the basis of Article 8(2)? The answer is not as clear as it has been argued in US case law. In the author's opinion, it depends on an analysis of all the factual circumstances of each case.

Here, the leading case is *Hardy-Spirlet v. Belgium*. The tax authorities requested the applicant give information as to how he had used the money he had obtained from the sale of various properties. When they found the information insufficient, the tax authorities asked the applicant for a detailed explanation about his private investments. The applicant contended that an obligation to give further details would compel him to reveal the most intimate aspects of private life. In particular, he alleged that the obligation to provide tax authorities with a list, including receipts, of all his private expenditure amounts to an unjustified interference in his private affairs. In this regard, the ECnHR held without hesitation that: "the fact that a tax authority is entitled to require the applicant to produce a list of his private expenditure, subject to the risk of a tax assessment measure, constitutes an interference with his private life."[379] However, was this interference in compliance with paragraph 2 of Article 8? Yes. The ECnHR held that the interference was in accordance with the law since it was based on specific provisions of the income tax code whose purpose was the exact collection of tax and the prevention of fraud and tax evasion. In determining whether the tax control measure complained of was proportionate to the objective of the legislation, the ECnHR took account of the fact that the cash sum, which the applicant was unable or unwilling to prove that he had spent, was a considerable one. Accordingly, the procedure adopted by the tax authority was in proportion to the pursued objective.[380]

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[377] ECtHR 25 March 1998, *Kopp v. Switzerland,* (Application no. 23224/94) § 75.

[378] ECtHR 24 March 1988, *Olsson v. Sweden,* (Application no. 10465/83) § 67; ECtHR, 20 June 1988, *Schönenberger and Durmaz v. Switzerland* (Application no. 11368/85) § 27.

[379] ECnHR 7 December 1982, *X. v. Belgium,* (Application no. 9804/82), p. 235. For a comment see Philip Baker, *Taxation and the European Convention on Human Rights*, British Tax Review (2000), p.; *Id., Taxation and Human Rights*, I GITC Review 1, November 2001, pp. 9 – 10.

[380] ECnHR 7 December 1982, *X. v. Belgium,* (Application no. 9804/82), p. 236.

As Baker argued, there are very few cases where a breach of Article 8 has been found.[381] In particular, during the period from 1959 to 2000, Article 8 was raised in 26 cases, and the taxpayer being successful under Article 8 in two of those cases: both cases involving information-seeking by revenue authorities where there were inadequate judicial safeguards.[382] The first case in which the taxpayer was successful on a complaint under Article 8 was that of *Funke v. France*. In January 1980, three French custom officers went to the house of the applicant to obtain the particulars of his assets abroad. During the house search, they discovered statements and check-books from foreign banks. They seized all the items found and drew up a report. The ECtHR held, "Undoubtedly, in the field under consideration – the prevention of capital outflows and tax evasion – *States* encounter serious difficulties owing to the scale and complexity of banking systems and financial channels and to the immense scope for international investment, made all the easier by the relative porousness of national borders. The Court therefore recognises that they *may consider it necessary to have recourse to measures as house searches and seizures in order to obtain physical evidence of exchange-control offences* and, where appropriate, to prosecute those responsible. Nevertheless, the relevant legislation and practice must afford adequate and effective safeguards against abuse."[383] This was not so in *Funke*. The ECtHR held that the customs authorities had very *wide powers*; in particular, they had exclusive competence to assess the expediency, number, length and scale of inspections and, in the absence of any requirement of a judicial warrant, the restrictions and conditions provided for in *law appeared too lax and full of loopholes* for the interferences with the applicant's rights to have been strictly proportionate to the legitimate aim pursued[384]. Accordingly, there was a breach of Article 8. The same conclusion was reached in *Crémieux v. France*[385] and in *Miailhe v. France*. In this last case, the Court criticised that the seizures made at the applicants' premises were wholesale and indiscriminate, to such an extent that customs considered several thousand documents to be of no relevance to their inquiries and returned them to the applicants.[386]

Another case in which an applicant was successful under Article 8 was the case of *Huvig v. France*. In that case, as the taxpayers were suspected of tax evasion, an investigating judge ordered the monitoring and the transcription of all their telephone calls. The applicants alleged that the telephone tapping had contravened Article 8. The government did not dispute that the telephone tapping amounted to an 'interference by a public authority' with the exercise of the applicants' right to respect for their 'correspondence' and their 'private life.' They sought to justify the interference under Article 8(2). However, the ECtHR held that French law regulating telephone-tapping was not in conformity with the foreseeability requirement of Article 8(2) since it did not indicate with reasonable clarity the scope and manner of exercise of the relevant discretion conferred on the public authorities. This was truer still at the material time, so that Mr and Mrs

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[381] Philip Baker, *Taxation and Human Rights*, I GITC Review 1, November 2001, p. 10.
[382] Philip Baker, *Taxation and the European Convention on Human Rights*, British Tax Review (2000), p.
[383] ECtHR, 25 February 1993, *Funke v. France*, (Application no. 10828/84), § 56.
[384] ECtHR, 25 February 1993, *Funke v. France*, (Application no. 10828/84), § 57.
[385] ECtHR, 25 February 1993, *Crémieux v. France*, (Application no. 11471/85), §§ 39, 40 and 41.
[386] ECtHR, 25 February 1993, *Miailhe v. France*, (Application no. 12661/87), §§ 39 and 7.

Huvig did not enjoy the minimum degree of protection to which citizens are entitled under the rule of law in a democratic society.[387]

With regard to the exchange of information between revenue authorities, article 8 was raised in the case of *F.S. v. Germany.*[388] There, the applicant, a Dutch national and resident in the Netherlands, complained that the transmission of information concerning his assets and capital income by the German Federal Ministry of Finance to the Dutch authorities violated his right to respect for his private life under Article 8 of the Convention. The ECnHR after having found that the disclosure of information on the applicant's assets and capital income to the Dutch tax authorities amounted to an interference with his right under Article 8 para. 1, concluded that the interference could be justified under Article 8 para. 2. Firstly, the ECnHR noted that the interference was in accordance with German law. In particular, the transmission of information was based upon S. 2 para. 1 of the EC Mutual Administrative Assistance Act whose lawfulness had been confirmed both by the Cologne and Federal Tax Court and, moreover, the applicant's submissions did not disclose any non-observance of the relevant legal provisions. Secondly, the transmission of information was taken in the interest of the economic well-being of the country, and also aimed at the prevention of crime. Thirdly, this measure was proportionate[389] to the legitimate aims pursued. As Baker argued: "it seems that in virtually all cases the countries concerned could justify any prima facie infringement of privacy arising from the passing on of information relating to a taxpayer by reliance on the provisions of Art. 8(2). In particular, in many cases the exchange of information would be necessary, being probably the only effective way to combat international tax avoidance. In all cases the information would have also been collected by one of the revenue authorities prior to exchange: if that collection of information could be justified under Art. 8(2), then it is hard to think that the transmission of the information to another state would constitute an infringement of the ECHR."[390]

3.2. The importance of procedural guarantees: the right to be *informed*

Despite the fact that the application was declared inadmissible, it should be noted that, at least, in *F.S. v. Germany*, the Federal Ministry of Finance informed the applicant that it intended to submit information and documents to the Dutch tax authorities. The applicant was also able to file an interim injunction[391] before the Cologne Tax Court prohibiting the Tax Office from disclosing the

[387] ECtHR, 24 April 1990, *Huvig v. France*, (Application no. 11105/84), § 35.
[388] ECnHR, 27 November 1996, *F.S. v. Germany*, (Application no. 30128/96).
[389] ECnHR, 27 November 1996, *F.S. v. Germany*, (Application no. 30128/96).
[390] Philip Baker, *Double Taxation Conventions and Human Rights*, in *Tax Polymath: A Life in International Taxation*, p. 70 (P. Baker & C. Bobbett eds., IBFD 2010).
[391] Klaus-Dieter Drüen & Isabel Gabert, *Germany Report*, in *Mutual assistance and information exchange*, 2009 EATLP Congress, Santiago de Compostela, 4-6 June 2009, (R. Seer and I. Gabert eds., IBFD 2010), p. 283; Daniel Dürrschmidt & Karin Kopp, *Germany Report*, in *The practical protection of taxpayers*' fundamental rights, Cahiers de droit fiscal international, vol. 100b, Kluwer, The Netherlands, (2015), p. 424: "Taxpayers – including non-resident taxpayers – may file a preventive appeal (vorbeugende Unterlassungsklage) with tax courts to prevent exchange of

information in question to the Dutch authorities. However, the Court dismissed the applicant's request finding that the German authorities were entitled to forward the information in question pursuant to S. 2 para. 2 of the EC Mutual Administrative Assistance Act. The notification and the subsequent ability to challenge the transmission of information through an interim injunction have to be positively considered since as it had already been argued in the *Sabou* case, the ECJ observed that, "*Directive 77/799 does not address the taxpayer's right to challenge the accuracy of the information conveyed, and it does not impose any particular obligation with regard to the content of the information conveyed. In those circumstances, only national laws can lay down the relevant rules.*"[392] In this regard, twelve years before *Sabou*, Baker rightfully argued that, "The only point one might make with respect to exchange of information relates to the question of whether there is adequate judicial supervision of exchange under the E.C. Directive or under a DTC. Though practice varies from country to country, in most countries a taxpayer is not informed that information which has been gathered by one revenue authority is being exchanged with the authorities of another country. In the absence of notification, the taxpayer is in no position to challenge the exchange of information. Bearing in mind the decision in Funke with respect to the importance of judicial safeguards on infringements of the right of privacy, one wonders whether the absence of any opportunity to challenge an exchange of information might constitute an actual breach of the Convention."[393]

Article 8 has also been raised in the recent case of *G.S.B. v. Switzerland* which concerned the transmission to the US tax authorities of the applicant's bank account details in connection with a mutual assistance agreement between Switzerland and the United States. In 2007, the IRS and the Department of Justice had discovered, through the information provided by Bradley Birkenfeld, a former employee of Swiss UBS AG, that the latter bank, an IRS Qualified Intermediate (QI) agent, encouraged American citizens to transfer their capital to tax havens via shell companies, so as to dodge their tax liabilities.[394] Following an agreement which, in its consolidated version with a protocol, was referred to as 'Convention 10', the Swiss federal tax authority ordered UBS to forward the requested documents in the context of that authority's cooperation with the IRS. The applicant appealed the decision to the Federal Administrative Court. The latter Court dismissed the applicant's appeal finding that 'Convention 10' was binding upon the Swiss authorities, which did not have to verify the conformity of that text to Federal law or previous conventions. The applicant lodged a public appeal against this judgment before the Federal Court on the ground that the considerations of the Federal Administrative Court were relevant to criminal law but not to administrative cooperation. The Federal Court declared the appeal inadmissible and, consequently, the applicant's bank account details were transmitted to the US tax authorities. Before the ECtHR, the applicant complained that the disclosure of his bank details amounted to a violation of his right to respect for his private life. However, the ECtHR held that there had been no violation of Article

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information. Taxpayers may also apply for an interim order (einstweilige Anordnung) since a regular court proceeding may take some time".

[392] CZ: ECJ, 22 Oct. 2013, Case C-276/12 Jiří Sabou v. Finanční ředitelství pro hlavní město Prahu §§ 48 and 49.

[393] Philip Baker, *Taxation and the European Convention on Human Rights*, British Tax Review (2000), p.

[394] Reuven S. Avi-Yonah and Gil Savir, Find It and Tax It: From TIEAs to IGAs (February 20, 2015). U of Michigan Public Law Research Paper No. 443. Available at SSRN: http://ssrn.com/abstract=2567646 or http://dx.doi.org/10.2139/ssrn.2567646.

8. In particular, the Court noted that: "only his bank account details, that is to say purely financial information, had been disclosed. No private details or data closely linked to his identity, which would have deserved enhanced protection, had been transmitted."[395] The author does not agree with the Court's observations since, as Justice Douglas argued in his dissenting opinion in *California Bankers Ass'n v. Schultz*, financial records are a '*virtual biography*'. That is, a person is defined by the checks he writes; banking transactions can indicate a person's '*religion, ideology, opinions, and interest.*'[396] Therefore, in the author's opinion, the Court should not have minimised the value of applicant's bank account details.[397] On the other hand, what should be recognized is that: "the applicant had benefited from several effective and genuine procedural guarantees to challenge the disclosure of his bank details and obtain protection against the arbitrary implementation of agreements concluded between Switzerland and the United States."[398] Thus, the applicant's right to be heard had been respected.

In conclusion, on the basis of *F.S. v. Germany*, *Sabou* and *G.S.B. v. Switzerland*, if the transmission of information amounts to an interference with the right to privacy of individuals concerned that can be justified under Art. 8(2), the importance of judicial safeguards should not be underestimated. In particular, *F.S. v. Germany* and *G.S.B. v. Switzerland* concerned difficult situations, where the requested States, Germany and Switzerland, needed to obtain the information from a third party. Here, does the requested State need to inform the taxpayer and give him the right to challenge the collection of the information or its transmission? According to Baker and Pistone, only 22% (21.95 – 9 out of 41 branches) of countries examined provide the taxpayer the right to be informed before information is sought from third parties in response to a specific request for exchange of information.[399] Moreover, only 17% (17.07 – 7 out of 41 branches) provide the taxpayer the right to be heard by the tax authorities before information related to him is exchanged with another country.[400] Surprisingly, 51% (51.21 – 21 out of 41) of countries provide the taxpayer the right to challenge before the judiciary the exchange of information related to him with another country.[401] In these situations, a balance between the different interests at stake can be found. On the one hand, the requesting State might be afraid that if taxpayer is informed, he will launch a series of legal moves to prevent any information from being supplied: if these moves are drawn out, it may prevent the exchange of information from taking place for months, years, or may even prevent it

[395] ECtHR, 22 December 2015, *G.S.B. v. Switzerland*, (Application no. 28601/11).
[396] See *supra* note n. 50.
[397] The value of bank account details was also minimised in a decision of 30 November 2010 (2 BvR 2101/09) of the German Federal Constitutional Court regarding the use of stolen bank data of Liechtenstein banks purchased by German tax authorities in 2008; see Germany – Federal Constitutional Court rules on use of stolen bank data (06 Dec. 2010), News IBFD; this holding was reiterated in a decision of the Financial Court of Cologne of 15 December 2010 (14 K 2484/10) see Germany – Financial Court of Cologne rules on use of stolen bank data (24 May 2011), News IBFD and in a decision (VGH B 26/13) of 24 February 2014 of the Constitutional Court of the Federal State of Rhineland-Palatinate, see Germany – Constitutional Court of Rhineland-Palatinate rules on use of stolen bank data (06 Mar. 2014), News IBFD.
[398] ECtHR, 22 December 2015, *G.S.B. v. Switzerland*, (Application no. 28601/11).
[399] Philip Baker and Pasquale Pistone, *General Report*, in *The practical protection of taxpayers' fundamental rights*, *Cahiers de droit fiscal international*, vol. 100b, Kluwer, The Netherlands, (2015), p. 60, note n. 220.
[400] See *supra* note n. 99, note n. 221.
[401] See *supra* note n. 99, p. 61, note n. 223.

completely.[402] This was true in *G.S.B. v. Switzerland.* The applicant appealed the AFC's decision to the Federal Administrative Court on December 8th 2010. The applicant's bank account details were transmitted to the US tax authorities two years later, on December 14th 2012. On the other hand, as it has been argued, if taxpayers have no notification rights, they would not be entitled to bar the requested State from giving tax information concerning them to another Member State. Only in cases where the taxpayer is somehow made aware of the request, it could be seen as a kind of legal protection. But most important, as mentioned before, the absence of any opportunity to challenge the exchange of information might constitute an actual breach of Article 8 of ECHR.[403] On the basis of these considerations, the author agrees with Baker and Pistone when they considered that, "where the requested state either supplies information it already has in its possession or has to seek information from a third party, the taxpayer concerned should be notified unless there is a specific and reasoned request from the requesting State that the taxpayer should not be informed on grounds that there would be prejudice to the investigation."[404] In the author's view, EU Member States should also take into consideration the enactment of a provision similar to 26 U.S.C. § 7609 regarding the issuance of third-party summons. Also, in the case of information to be obtained from a third party, if the taxpayer denies authorisation, then it would be necessary to obtain a judicial authorisation prior to any exchange of information.

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4. The right to privacy and to data protection: two distinct and specific rights?

Before turning to the analysis of Article 8 CFREU, it should be noted that the CFREU is unique in recognising a specific provision of data protection separate from that of privacy. Such a distinction cannot be found in the ECHR. As a consequence, there is a debate in the legal literature whether or not there is a difference between the right to data protection and the right to privacy. Is data protection a particular part of the right to respect for private life? Is the distinction between both rights in CFREU purely symbolic? Or does the right to protection of personal data create a specific and reinforced system of protection? The answer is not clear since both the jurisprudence and legal literature are divided.

On the one hand, some see the right to data protection as a particular expression of the right to privacy. Both rights were conceptually linked through the development of the concept of

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[402] See *supra* note n. 99, p. 61.

[403] See *supra* note n. 93. In the author's view, it should be clear that the aim of notification rights is not to prevent information reaching the requesting State, but rather to enforce taxpayer's safeguards (confidentiality and privacy) at all stages both *investigation* and *contentious.*

[404] See *supra* note n. 98, p. 62.

[405] See *supra* note p. 62; Robin Williamson and Ian Young, *United Kingdom Report*, in *The practical protection of taxpayers' fundamental rights, Cahiers de droit fiscal international*, vol. 100b, Kluwer, The Netherlands, (2015), p. 864; Ignacio Gepp, *Chile Report*, in *The practical protection of taxpayers' fundamental rights, Cahiers de droit fiscal international*, vol. 100b, Kluwer, The Netherlands, (2015), pp. 254 – 255.

informational self-determination[406] which can be described as the right to determine the disclosure and use of one's own personal data.

On the other hand, according to Kranenborg,[407] Kokott and Sobotta, even though privacy and the protection of personal data are closely linked, they should not be considered identical. In particular, according to Kokott and Sobotta, a first distinction lies in the substantive scope, meaning the information covered by the respective rights. In their opinion, data protection includes all information on identified or identifiable persons while private life does not. As a consequence, the scope of data protection is broader than the scope of privacy.[408] However, as regards the personal scope, data protection is limited to natural persons while legal persons can rely on the right to privacy.[409] Thirdly, the requirements that personal data must be processed fairly and for a specified purpose cover many instances where an interference with privacy would have to be justified.[410]

However, the jurisprudence of both the ECtHR and the ECJ tends to treat data protection as an expression of the right to privacy. For instance, the ECtHR reiterated that both the storing of information relating to an individual's private life and the release of such information come within the scope of Article 8(1).[411]

On the other hand, the ECJ in *Österreichischer Rundfunk* ascertained for the purpose of applying Directive 95/46 whether legislation such as that at issue in the main proceedings provided for an interference with private life, and if so, whether that interference is justified from the point of view of Article 8 of the Convention.[412] In particular, under paragraph 8 of the *Bundesverfassungsgesetz über die Begrenzung von Bezügen öffentlicher Funktionäre* (hereinafter BezBegrBVG), public bodies, such as *Österreichischer Rundfunk*, were obligated to communicate to the *Rechnungshof* (Court of Audit) the salaries and pensions exceeding a certain level paid by them to their employees and pensioners together with the names of the recipients, for the purpose of drawing up an annual report to be transmitted to the *Nationalrat*, the *Bundesrat* and the *Landtage* (the lower and upper chambers of the Federal Parliament and the provincial assemblies) and made available to the

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[406] Herke Kranenborg, Art 8 – *Protection of Personal Data*, in *The EU Charter of Fundamental Rights: A Commentary* (S. Peers – T. Hervey – J. Kenner and A. Ward eds., Hart 2014), p. 229; *Contra* Paul Schwartz, *The Computer in German and American Constitutional Law: Towards an American Right of Informational Self-Determination*, 37 Am. J. Comp. L. (1989); for the historical development of the concept of informational self-determination, see Gerrit Hornung & Christoph Schnabel, *Data protection in Germany I: The population census decision and the right to informational self-determination*, 25 Computer Law & Security Report 1, 2009, pp. 84 – 85.

[407] Herke Kranenborg, Art 8 – *Protection of Personal Data*, in *The EU Charter of Fundamental Rights: A Commentary* (S. Peers – T. Hervey – J. Kenner and A. Ward eds., Hart 2014), p. 229.

[408] Juliane Kokott and Christoph Sobotta, *The distinction between privacy and data protection in the jurisprudence of the CJEU and the ECtHR*, 3 International Data Privacy Law 4, p. 225.

[409] See *supra* note n. 108, in particular footnotes nn. 29 and 30. However, as the ECJ held in *Volker und Markus Schecke GBR and Hartmut Eifert v. Land Hessen*, § 53.

[410] See *supra* note n. 108, p. 226.

[411] ECtHR 26 March 1987, *Leander v. Sweden* (Application no. 9248/81) § 48; ECtHR 16 February 2000, *Amann v. Switzerland*, (Application no. 27798/95) §§ 65 and 69-70; ECtHR, 4 May 2000, *Rotaru v. Romania* (Application 28341/95), § 43; ECtHR 4 December 2008, *S. and Marper v. The United Kingdom*, (Application no. 30562/04 and 30566/04), § 67; ECtHR 18 October 2011, *Khelili v. Switzerland*, (Application no. 16188/07), § 55; ECtHR 13 November 2012, *M.M. v. The United Kingdom*, (Application no. 24029/07) § 187.

[412] AU: ECJ 20 May 2003, *Rechnungshof* (C-465/00) *v. Österreichischer Rundfunk and Others and Christa Neukomm* (C-138/01) *and Joseph Lauermann* (C-139/01) *v. Österreichischer Rundfunk*, § 72.

general public. The Luxembourg Court held that: "the collection of data by name relating to an individual's professional income, with a view to communicating it to third parties, falls within the scope of Article 8 of the Convention ... It necessarily follows that, while the mere recording by an employer of data by name relating to the remuneration paid to this employees cannot as such constitute an interference with private life, the communication of that data to third parties, in the present case a public authority, infringes the right of the persons concerned to respect for private life, whatever the subsequent use of the information thus communicated, and constitutes an interference within the meaning of Article 8 of the Convention."[413] In addition, the ECJ held that, "If the national courts conclude that the national legislation at issue is incompatible with Article 8 of the Convention, that legislation is also incapable of satisfying the requirement of proportionality in Articles 6(1)(c) and 7(c) or (e) of Directive 95/46."[414] Thus, the ECJ confirmed that the right to data protection is only a subset of the right to privacy.

The right to privacy and the right to data protection were also considered in *Volker und Markus Schecke GBR and Hartmut Eifert v. Land Hessen*. This concerned the validity of the provisions of European law providing for publication of information on beneficiaries of agricultural aid. In particular, it concerned the publication on the internet site of the Federal Office for Agriculture and Food (the *Bundesanstalt*) of personal data relating to the applicants as recipients of funds from the European Agricultural Guarantee Fund (hereinafter EAGF) or the European Agricultural Fund for Rural Development (hereinafter EAFRD). The Luxembourg Court held, "It is not disputed that the amounts which the beneficiaries concerned receive from the EAGF and the EAFRD represent part of their income, often a considerable part. *Because the information becomes available to third parties, publication on a website of data naming those beneficiaries and indicating the precise amounts received by them thus constitutes an interference with their private life within the meaning of Article 7 of the Charter*."[415] As noted by Kranenborg, the ECJ repeatedly mentioned Articles 7 and 8 of the Charter together, seeming to disregard the different nature of both rights.[416] This was particularly apparent in § 52 where the Court held, "... *it must be considered that the right to respect for private life with regard to the processing of personal data, recognised by Articles 7 and 8 of the Charter, concerns any information relating to an identified or identifiable individual and the limitations which may lawfully be imposed on the right to the protection of personal data correspond to those tolerated in relation to Article 8 of the Convention*"[417] and in § 64 where it was held that, "Since the publication of data by name relating to the beneficiaries concerned and the precise amounts received by them from the EAGF and the EAFRD constitutes an interference,

[413] AU: ECJ 20 May 2003, *Rechnungshof* (C-465/00) *v. Österreichischer Rundfunk and Others and Christa Neukomm* (C-138/01) *and Joseph Lauermann* (C-139/01) *v. Österreichischer Rundfunk*, §§ 73 and 74.

[414] AU: ECJ 20 May 2003, *Rechnungshof* (C-465/00) *v. Österreichischer Rundfunk and Others and Christa Neukomm* (C-138/01) *and Joseph Lauermann* (C-139/01) *v. Österreichischer Rundfunk*, § 91; Herke Kranenborg, Art 8 – *Protection of Personal Data*, in *The EU Charter of Fundamental Rights: A Commentary* (S. Peers – T. Hervey – J. Kenner and A. Ward eds., Hart 2014), p. 230: "However, the Court did not clarify what should be done if the conclusion was reached that Article 8 ECHR would not be breached. Should an additional assessment still follow under the specific data protection rules?"

[415] DE: ECJ 9 November 2010, *Volker und Markus Schecke GBR and Hartmut Eifert v. Land Hessen*, § 58.

[416] Herke Kranenborg, Art 8 – *Protection of Personal Data*, in *The EU Charter of Fundamental Rights: A Commentary* (S. Peers – T. Hervey – J. Kenner and A. Ward eds., Hart 2014), p. 230.

[417] DE: ECJ 9 November 2010, *Volker und Markus Schecke GBR and Hartmut Eifert v. Land Hessen*, § 52.

as regards those beneficiaries, with the rights recognised by Articles 7 and 8 of the Charter, and since such processing of personal data is not based on the consent of those beneficiaries, it is necessary to examine whether the interference is justified having regard to Article 52(1) of the Charter."[418]

4.1. The EU framework on data protection: Art. 8 of the CFREU and Directive 95/46/EC

Having said that, Article 8 of the Charter states: "(1) Everyone has the right to the protection of personal data concerning him or her. (2) Such data must be processed fairly for specified purposes and on the basis of the consent of the person concerned or some other legitimate basis laid down by law. Everyone has the right of access to data which has been collected concerning him or her, and the right to have it rectified. (3) Compliance with these rules shall be subject to control by an independent authority". Thus, Article 8 of the Charter requires the processing of personal information to be: (i) fair, (ii) for specified purposes, (iii) transparent to the individual, and (iv) lawful. In addition, the individual is entitled to access and rectification of his/her information, and his/her rights must be subject to control by an independent authority. Only if these essential requirements are fulfilled, personal data will be processed.

Even though the rights to respect for private and family life and to protection of personal data can be described as fundamental rights, they are derogable and not absolute. The exercise of these rights might possibly be limited. According to Article 52(1) of the Charter: "Any limitation on the exercise of the rights and freedoms recognised by this Charter must be provided for by law and respect the essence of those rights and freedoms. Subject to the principle of proportionality, limitations may be made only if they are necessary and genuinely meet objectives of general interest recognised by the Union or the need to protect the rights and freedoms of others." Thus, if the processing of personal data is not based on the consent of the person concerned, as specified in Article 8(2), it should be justified in accordance with Article 52(1).

The essential conditions laid down in Art. 8(2) and (3) of the Charter are based on some, though not all, of the principles in Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data (hereinafter the "Data Protection Directive").[419] In particular, according to Article 6(1) of the Data Protection Directive,[420] personal data must be: (a)

[418] DE: ECJ 9 November 2010, *Volker und Markus Schecke GBR and Hartmut Eifert v. Land Hessen*, § 64.
[419] European Data Protection Supervisor, *Guidelines on data protection in EU financial services regulation*, p. 8. It should be noted that the protection of personal data is also enshrined in the Treaty on the Functioning of the European Union (Art. 16) as well as in the Treaty on European Union (Art. 39) and in the Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data, Strasbourg, 28.I.1981, (hereinafter Convention 108/1981).
[420] See also Art. 5 Convention 108/1981: "Personal data undergoing automatic processing shall be: (a) obtained and processed fairly and lawfully; (b) stored for specified and legitimate purposes and not used in a way incompatible with those purposes; (c) adequate, relevant and not excessive in relation to the purposes for which they are stored; (d)

processed fairly and lawfully (*legal basis*); (b) collected for specified, explicit and legitimate purposes and not further processed in a way incompatible with those purposes (*purpose limitation*); (c) adequate, relevant and not excessive in relation to the purposes for which they are collected and/or further processed (*necessity and proportionality*); (d) accurate and, where necessary, kept up to date; (e) kept in a form which permits identification of data subjects for no longer than is necessary for the purposes for which the data were collected or for which they are further processed (*data retention*). In addition, personal data may be processed only if the data subject has unambiguously given his consent.[421] The data subject's consent means "any freely given specific and informed indication of his wishes by which the data subject signifies his agreement to personal data relating to him being processed."[422] In its opinion no. 15/2011, Article 29 Working Party thoroughly analysed the concept of consent as currently used in the Data Protection Directive. It clarified the meaning of "unambiguous" consent and explained that: "For consent to be unambiguous, the procedure to seek and give consent must leave *no doubt* as to the data subject's intention to deliver consent. In other words, the indication by which the data subject signifies his agreement must leave no room for ambiguity regarding his/her intent. If there is a reasonable doubt about the individual's intention, there is ambiguity."[423]

The reference to "... *any* ... *indication of his wishes* ... *signifying* ..." point in the direction of an action being needed (as opposed to a situation where consent could be inferred from a lack of action).[424] In addition, consent must be freely given which means that, "the data subject is able to exercise a real choice, and there is no risk of deception, intimidation, coercion or significant negative consequences if he/she does not consent. If the consequences of consenting undermine individuals' freedom of choice, consent would not be free."[425] Moreover, to be valid, consent must be specific. In other words, blanket consent without specifying the exact purpose of the processing is not acceptable.[426] To be specific, consent must be intelligible: it should refer clearly and precisely to the scope and consequences of the data processing. It cannot apply to an open-ended

accurate and, where necessary, kept up to date; (e) preserved in a form which permits identification of the data subjects for no longer than is required for the purpose for which those data are stored".

[421] Art. 7(a) Data Protection Directive. The ECJ in *ASNEF and FECEMD v. Administración del Estado* (Joined Cases C-468/10 and C-469/10) § 30 held that: "Article 7 of Directive 95/46 sets out an *exhaustive and restrictive list of cases* in which the processing of personal data can be regarded as being lawful". For all grounds, except for the consent of the data subject, it is explicitly stated that data processing should be *necessary* ... Convention 108 does not contain a similar list of legitimate grounds for processing. Even the consent of the data subject is not mentioned as ground for legitimate processing ... The notion of consent only appears in Art. 15 (3) of the Convention in relation to the provision of assistance to data subjects resident abroad ... In the current revision process of Convention 108, the intention is to include a reference to the consent given by the data subject and to list other possible legitimate grounds for processing. See Herke Kranenborg, Art 8 – *Protection of Personal Data*, in *The EU Charter of Fundamental Rights: A Commentary* (S. Peers – T. Hervey – J. Kenner and A. Ward eds., Hart 2014), p. 250.

[422] Art. 2(h) Data Protection Directive.

[423] Article 29 DATA PROTECTION WORKING PARTY, Opinion 15/2011 on the definition of consent, Adopted on 13 July 2011, (01197/11/EN WP187), p.

[424] See *supra* note n. 123, p. 11 and 12; p. 24; p. 35.

[425] See *supra* note n. 123, p. 12. See also ARTICLE 29 Data Protection Working Party, Working Document on the processing of personal data relating to health in electronic health records (EHR) Adopted on 15 February 2007 (00323/07/EN WP 131), p. 8: "Consent must be given freely: 'Free' consent means a voluntary decision, by an individual in possession of all of his faculties, taken in the absence of coercion of any kind, be it social, financial, psychological or other".

[426] See *supra* note n. 123, p. 17.

set of processing activities. In other words, the context in which consent applies is limited.[427] Finally, consent must be informed. As argued by Article 29 Working Party, the need for consent to be "informed" translates into two additional requirements. First, the way in which the information is given must ensure the use of appropriate language so that data subjects understand what they are consenting to and for what purposes. Second, the information provided to users should be clear and sufficiently conspicuous so that users cannot overlook it. The information must be provided directly to individuals. It is not enough for it to be merely available somewhere.[428]

Moreover, according to Art. 12 of the Data Protection Directive, the data subject has the right of access to their own data and to have the data rectified, erased or blocked when the processing does not comply with the provisions of the Directive, especially because of the incomplete or inaccurate nature of the data.[429]

4.2. Data protection and *tax exceptionalism*: a comparison between Art. 13(1) of Directive 94/46/EC and Art. 25(1) of Directive 2011/16/EU

However, according to Art. 13(1) of the Data Protection Directive,[430] Member States *may* adopt legislative measures to restrict the scope of the obligations and rights provided for in Articles 6 (1), 10, 11 (1), 12 and 21 when such a restriction constitutes a necessary measure to safeguard: (a) national security; (b) defence; (c) public security; (d) the prevention, investigation, detection and prosecution of criminal offences, or of breaches of ethics for regulated professions; (e) *an important economic or financial interest of a Member State or of the European Union, including monetary, budgetary and taxation matters*; (f) a monitoring, inspection or regulatory function connected, even occasionally, with the exercise of official authority in cases referred to in (c), (d) and (e); (g) the protection of the data subject or of the rights and freedoms of others. Does Art. 13(1) impose an obligation on the Member States to provide for exemptions and restrictions or does it offer Member States the option? In this regard, the ECJ in *Institut professionnel des agents immobiliers v. Geoffrey Englebert* held that, "As regards Article 13(1) of Directive 95/46, it is clear from its wording, and in particular from the use of the words 'Member States may' that that provision does not oblige the Member States to lay down in their national law exceptions for the purposes listed in Article 13(1)(a) to (g) but, on the contrary, the legislature intended to give them the freedom to decide whether, and if so for what purposes, they wish to take legislative measures aimed at limiting, inter alia, the extent of the obligations to inform the data subject. Furthermore, it is also apparent from the wording of Article 13(1) that the Member States may lay down such measures only when they are necessary. The requirement that the measures be 'necessary' is thus a precondition for the application of the option granted to Member States by Article 13(1), and does not mean that they are required to adopt the exceptions at issue in all cases where that

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[427] *Ibidem.*
[428] See *supra* note n. 123, p. 35.
[429] Art. 12(b) Data Protection Directive.
[430] Art. 13(1) Data Protection Directive.

condition is satisfied."[431] Firstly, that interpretation is supported by the wording of recital 43 of Directive 95/46: "Whereas restrictions on the rights of access and information and on certain obligations of the controller *may similarly be imposed* by Member States in so far as they are necessary to safeguard, for example, national security, defence, public safety, or important economic or financial interests of a Member State or the Union, as well as criminal investigations and prosecutions and action in respect of breaches of ethics in the regulated professions ...."[432] Secondly, that interpretation is confirmed by a comparison of, on the one hand, the wording of Article 13(1) of Directive 95/46 and, on the other hand, Article 9 and recital 37 of the directive, which for their part clearly impose an obligation[433] on the Member States to provide for exceptions and derogations for the processing of personal data carried out solely for journalistic purposes or the purpose of artistic or literary expression in so far as they are necessary to reconcile the right to privacy with the rules governing freedom of expression.[434] Thirdly, that interpretation is also confirmed in *Promusicae* where the ECJ found that Article 15(1) of the directive on privacy and electronic communications gives Member States the possibility of providing for exceptions to the obligation of principle, imposed on them by Article 5 of that directive, to ensure the confidentiality of personal data[435] and, consequently, held that Article 15(1) cannot be interpreted as compelling the Member States, in the situations it sets out, to lay down an obligation to disclose personal data in the context of civil proceedings.[436]

Nevertheless, according to Art. 25 of Directive 2011/16/EU, Member States *shall*, for purposes of correct application of the Directive, restrict the scope of the rights and obligations provided for in Article 10, Article 11(1), Articles 12 and 21 of Directive 95/46/EC to the extent required in order to safeguard the interests referred to in Article 13(1)(e) of that Directive. Consequently, according to the wording of Art. 25 of Directive 2011/16/EU, Member States are compelled to limit the scope of these rights and obligations provided by Directive 95/46/EC to the extent required in order to safeguard the important economic or financial interest of a Member State or of the European Union including ... taxation matters.[437] For example, the data controller (financial institutions or competent authorities of each Member State) should be exempted from the obligation to inform

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[431] ECJ, 7 Nov. 2013, Case C-473/12, *Institut professionnel des agents immobiliers (IPI) v. Geoffrey Englebert, Immo 9 SPRL, Grégory Francotte*, § 32.
[432] Recital 43 Data Protection Directive.
[433] Art. 9 Data Protection Directive: "Member States *shall* provide for exemptions or derogations from the provisions of this Chapter, Chapter IV and Chapter VI for the processing of personal data carried out solely for journalistic purposes or the purpose of artistic or literary expression only if they are necessary to reconcile the right to privacy with the rules governing freedom of expression"; Recital 37 Data Protection Directive: "... whereas Member States *should* therefore lay down exemptions and derogations necessary for the purpose of balance between fundamental rights as regards general measures on the legitimacy of data processing ..."
[434] ECJ, 7 Nov. 2013, Case C-473/12, *Institut professionnel des agents immobiliers (IPI) v. Geoffrey Englebert, Immo 9 SPRL, Grégory Francotte*, § 33.
[435] ECJ, 29 Jan. 2008, Case C-275/06, *Productores de Música de España (Promusicae) v. Telefónica de España SAU*, § 50.
[436] ECJ, 29 Jan. 2008, Case C-275/06, *Productores de Música de España (Promusicae) v. Telefónica de España SAU*, § 54 and 55; ECJ, 7 Nov. 2013, Case C-473/12, *Institut professionnel des agents immobiliers (IPI) v. Geoffrey Englebert, Immo 9 SPRL, Grégory Francotte*, § 37: "It must, therefore, be considered that Article 13(1) of Directive 95/46 offers Member States the option to provide for one or more of the exceptions that it sets out, but they are not compelled to do so".
[437] Art. 13(1)(e) Data Protection Directive.

the data subject (*e.g.*, the taxpayer). In addition, the taxpayer's right of access to data and right to have data rectified in case of inaccuracies should be restricted. In this regard, it should be noted that the text of Art. 25 was amended by Council Directive 2014/107/EU which expanded the scope of the automatic exchange of information within the European Union in line with international developments of FATCA and CRS. According to Art. 1(5)(b) of Directive 2014/107/EU, the following paragraphs are inserted in the text of Article 25, "2. Reporting Financial Institutions and the competent authorities of each Member State shall be considered to be data controllers for the purposes of Directive 95/46/EC. 3. Notwithstanding paragraph 1, *each Member State* shall ensure that each Reporting Financial Institution under its jurisdiction informs each individual Reportable Person concerned that the information relating to him referred to in Article 8(3a) will be collected and transferred in accordance with this Directive and *shall ensure that the Reporting Financial Institution provides to that individual all information that he is entitled to under its domestic legislation implementing Directive* 95/46/EC *in sufficient time for the individual to exercise his data protection rights and, in any case, before the Reporting Financial Institution concerned reports the information referred to in Article* 8(3a) *to the competent authority of its Member State of residence*. 4. Information processed in accordance with this Directive shall be retained for no longer than necessary to achieve the purposes of this Directive, and in any case in accordance with each data controller's domestic rules on statute of limitations."[438] The Author already argued that if the text of Article 25 had not been amended, Directive 2011/16/EU would have borne the risk of being challenged before the ECJ.[439] However, the author believes that, if the verb '*shall*' included in Article 25 had been replaced by the verb '*may*', the outcome would have been even clearer. In that event, Article 25 would have offered Member States the *option* to restrict the scope of the obligations and rights provided for by Directive 95/46/EC to the extent required in order to safeguards the economic or financial interests referred to in Article 13(1)(e) of that Directive.

In the next part of the dissertation, the author will analyse how the provisions contained within FATCA and CRS interact with the right to privacy and to protection of personal recognised by CFREU and, in particular, with the principles laid down by Directive 95/46/EC.

5. The interaction between automatic exchange of information (AEoI) and data protection

Over the last few years, the WP29 has dealt with the impact of the automatic exchange of information as pertaining to the right to the protection of personal data in the following documents:

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[438] Art. 1(5)(b) of Council Directive 2014/107/EU of 9 December 2014 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation; see also recital 17: "This Directive respects the fundamental rights and observes the principles which are recognised in particular by the Charter of Fundamental Rights of the European Union, including the right to the protection of personal data".

[439] G. Mazzoni, *The interaction between FATCA and the right to privacy and data protection*, Michigan Journal of International Law, (forthcoming); see also European Commission, *First Report of the Commission AEFI expert group on the implementation of Directive* 2014/107/EU *for automatic exchange of financial account information*, March 2015, p. 7.

(i) two letters, respectively adopted on June 21st 2012[440] and October 1st 2012[441] concerning the compatibility of obligations under the US Foreign Account Tax Compliance Act (hereinafter FATCA) and Directive 95/46/EC; (ii) a letter on the OECD Common Reporting Standard adopted on 18 September 2014;[442] (iii) a statement on automatic inter-state exchanges of personal data for tax purposes adopted on February 4th 2015;[443] and (iv) Guidelines for Member States on the criteria to ensure compliance with data protection requirements in the context of the automatic exchange of personal data for tax purposes adopted on December 16th 2015.[444]

The implications for protection of the data used in the increasing number of automatic inter-state exchanges of tax information were also considered, at the Council of Europe level, in an opinion by the Consultative Committee of the Convention for the protection of individuals with regard to the automatic processing of personal data (T-PD), adopted on June 4th 2014.[445]

More recently, on March 2015, the Commission's Expert Group on the Automatic Exchange of Financial Account Information for Direct Taxation Purposes (hereinafter AEFI Group) adopted its first Report on the implementation of Directive 2014/107/EU.[446]

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[440] 06/12/2012, Letter from the Article 29 Working Party addressed to Mr. Zourek, Director General of Taxation and Customs Union regarding Foreign Account Tax Compliance Act (FATCA), available at http://ec.europa.eu/justice/data-protection/article-29/documentation/other-document/files/2012/20120621_letter_to_taxud_fatca_en.pdf.

[441] 06/21/2012, Letter from the Article 29 Working Party addressed to Mr. Zourek, Director General of Taxation and Customs Union regarding Foreign Account Tax Compliance Act (FATCA), available at http://ec.europa.eu/justice/data-protection/article-29/documentation/other-document/files/2012/20120621_letter_to_taxud_fatca_en.pdf.

[442] 09/18/2014, Letter from the Article 29 Working Party to OECD, G20, European Commission, European Parliament, Council of the European Union on OECD Common Reporting Standard, available at http://ec.europa.eu/justice/data-protection/article-29/documentation/other-document/files/2014/20140918_letter_on_oecd_common_reporting_standard.pdf.pdf; see also the Annex on Specific issues identified in respect of CRS available at http://ec.europa.eu/justice/data-protection/article-29/documentation/other-document/files/2014/20140918_annex_oecd_common_reporting_standard.pdf.pdf.

[443] Article 29 DATA PROTECTION WORKING PARTY, Statement of the WP29 on automatic inter-state exchanges of personal data for tax purposes Adopted on 4 February 2015 (14/EN WP 230), available at http://ec.europa.eu/justice/data-protection/article-29/documentation/opinion-recommendation/files/2015/wp230_en.pdf.

[444] Article 29 DATA PROTECTION WORKING PARTY, Guidelines for Member States on the criteria to ensure compliance with data protection requirements in the context of the automatic exchange of personal data for tax purposes Adopted on 16 December 2015 (175/16/EN WP 234), available at http://ec.europa.eu/justice/data-protection/article-29/documentation/opinion-recommendation/files/2015/wp234_en.pdf.

[445] Opinion on the implications for data protection of mechanisms for automatic inter-state exchanges of data for administrative and tax purposes [T-PD(2014)05] available at http://www.coe.int/t/dghl/standardsetting/dataprotection/TPD_documents/T-PD(2014)05_En_Opinion%20tax%20(final).pdf; see also Report on the implications for data protection of the growing use of mechanisms for automatic inter-state exchanges of personal data for administrative and tax purposes, as well as in connection with money laundering, financing of terrorism and corruption [T-PD-BUR(2014)01] available at http://www.coe.int/t/dghl/standardsetting/dataprotection/TPD_documents/T-PD-BUR(2014)01%20-%20Rapport%20CE%202013%20(final)%20C%20%20Porasso_En.pdf.

[446] European Commission, First Report of the Commission AEFI expert group on the implementation of Directive 2014/107/EU for automatic exchange of financial account information, March 2015, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_cooperation/mutual_assistance/financial_account/first_report_expert_group_automatic_exchange_financial_information.pdf.

Finally, data protection implications were also considered by the European Data Protection Supervisor in its opinion on the EU-Switzerland agreement regarding the automatic exchange of tax information adopted on July 8th 2015.[447]

On the basis of these documents, the author will try to answer the question whether the automatic exchange of financial account information and, in particular, FATCA, guarantees EU privacy standards.

5.1. AEoI and legal basis

As hereinbefore mentioned, according to Article 8(2) of the CFREU, personal data must be processed *fairly* for specified purposes and *on ... some other legitimate basis laid down by law*. The requirement for a legal basis is also reiterated in Article 6(1)(a) of Directive 95/46/EC, which states that personal data must be processed *fairly and lawfully*. In this regard, the WP29 pointed out that, "The exchange of personal data shall be regulated by a clear legal basis, whether a legislative act or an international agreement. It is essential that any law or agreement is accessible by citizens and foreseeable in its application, in accordance with the requirements of Article 8 ECHR. *Such instruments shall contain substantive provisions that implement (and not just merely refer to) the Directive* and/or the national data protection law that implement it. It is also important that national procedures, providing for the involvement of respective Parliaments – and eventually DPAs – are fully respected in order to create a democratic, clear and foreseeable legal basis."[448] In particular, the WP29, in its letter adopted on June 21st 2012 with regard to FATCA and Directive 95/46/EC, concluded that, "Without an appropriate legal basis justifying both sets of obligations imposed on European FFIs would result in the unlawful processing of personal data."[449] As the author already argued,[450] this negative conclusion derives from the fact that, when the WP29 adopted its letter, a common solution to the FATCA implementation was still under discussion between the US Treasury Department and the tax administrations of some EU Member States. The intergovernmental approach was first announced in a Joint Statement issued on February 7th 2012 by the US Treasury Department and five EU countries (France, Germany, Italy, Spain and United

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[447] Opinion of 8 July 2015 on the EU-Switzerland agreement on the automatic exchange of tax information, available at https://secure.edps.europa.eu/EDPSWEB/webdav/site/mySite/shared/Documents/Consultation/Opinions/2015/15-07-08_EU_Switzerland_EN.pdf.

[448] Annex on Specific issues identified in respect of CRS available at http://ec.europa.eu/justice/data-protection/article-29/documentation/other-document/files/2014/20140918_annex_oecd_common_reporting_standard.pdf.pdf; see also *supra* note n. 146, pp. 5 – 6; see also Giuseppe Busia, *Automatic inter-state exchange of data: Safeguarding data protection and fundamental rights*, Joint EBF – FBF Tax Conference 2014 – Paris, 22 September 2014, p. 6: "Multilateral/bilateral agreements should contain substantive data protection provisions (not a mere reference to DP tools). Moreover, national procedures (involvement of Parliament, DPA) should be respected to create adequate, clear and foreseeable legal basis (Article 6a of Directive 95/46)".

[449] See *supra* note n. 142, p. 11 § 16.1; p. 6 § 8.4 and § 10.1; p. 7 § 10.5.

[450] Gianluca Mazzoni, *The interaction between FATCA and the right to privacy and data protection*, Michigan Journal of International Law, (forthcoming), p.

Kingdom). In this sense, the first intergovernmental agreement[451] (hereinafter IGA) to improve tax compliance, combat offshore tax evasion and implement FATCA was signed by the US Treasury Department with the United Kingdom on September 12th 2012, followed by the Kingdom of Denmark on November 15th 2012. Now, with 54 jurisdictions whose IGA is in force, the question is whether such instruments include substantive data protection safeguards and not just merely refer to Directive 95/46/EC. In the author's opinion, IGAs lack adequate data protection safeguards. For example, in the IGA between the United States and Italy signed on January 10th 2014 and entered into force on August 17th 2015, the words 'privacy' and 'data protection' do not appear a single time in the text, while the term 'confidentiality' only appears twice.[452]

The same conclusions were reached by the WP29 in its letter on OECD Common Reporting Standard adopted on September 18th 2014 where it held that, "the mere act of adopting a national law and/or European law (under Directive 2011/16/EU) or international tax agreements providing for the possibility to use an automatic exchange of personal data under systems such as FATCA or CRS, would not be enough to ensure adequate data protection. *It is on the contrary necessary to provide in such laws for substantive provisions that put in place adequate data protection safeguards.*"[453]

5.2. AEoI and limitation of purpose

Secondly, according to Article 6(1)(b) of Directive 95/46/EC, personal data must be collected for specified, explicit and legitimate purposes and not further processed in a way incompatible with those purposes. As it can be shown from an analysis of IGAs' recitals, the underlying policy goal of FATCA is to improve international tax compliance and to prevent fraud or fiscal evasion

[451] On the legal nature and the characteristics of the IGAs see Allison Christians, *The Dubious Legal Pedigree of IGAs (And Why It Matters)*, 69 *Tax Notes Int'l* 6, p. 567 arguing that IGAs must be 'sole' executive agreements – agreements undertaken by the president without congressional authorization of any kind; L. Parada, *Intergovernmental Agreements and the Implementation of FATCA in Europe*, 7 World Tax J. (2015), Journals IBFD.

[452] See last recital of Italy – United States FATCA Model 1A Agreement (2014): "Whereas, the Parties desire to conclude an agreement to improve international tax compliance and provide for the implementation of FATCA based on domestic reporting and reciprocal automatic exchange pursuant to the Convention and subject to the *confidentiality* and other protections provided for therein, including the provisions limiting the use of the information exchanged under the Convention"; see also Article 3(7) Italy – United States FATCA Model 1A Agreement (2014): "All information exchanged shall be subject to the *confidentiality* and other protections provided for in the Convention, including the provisions limiting the use of the information exchanged". In this regard, see Alberto G. Soriano, *Toward an Automatic but Asymmetric Exchange of Tax Information: the US Foreign Account Tax Compliance Act (FATCA) as Inflection Point*, 40 *Intertax* 10, p. 552: "*The cons are many: First, the agreement does not end up with the legal problems faced, especially in the field of data protection*".

[453] See *supra* note n. 144, p. 4; see also p. 3: "*The practical roll-out of CRS in Europe based on existing FATCA IT solutions currently lacks adequate data protection safeguards*, notwithstanding the EU proposed to amend the *Directive 2011/16/EU* regarding mandatory automatic exchange of information in the field of taxation. This Directive – which could be considered as transposition of the US FATCA and CRS in EU law – *so far falls short of data protection safeguards*". For a comment, see Maryte Somare & Viktoria Wöhrer, *Automatic Exchange of Financial Information under the Directive on Administrative Cooperation in the Light of the Global Movement towards Transparency*, *Intertax* 12, (2015), p. 813.

through certain accounts maintained by foreign financial institutions held by residents of the United States. In this regard, the WP29 stressed that, "In accordance with Article 6 of the Directive, any international agreement should clearly identify the purposes for which data are collected and validly used. *The wording on the purpose ('tax evasion'/'improvement of tax compliance') for example may appear vague and insufficiently clear, allowing too much flexibility* to the competent authority. *It is not clear whether such purposes include, for example, legal acts of tax evasion, illegal acts of tax evasion or (serious) financial crimes. Citizens shall be always aware of the exact purpose behind the processing of their data* and such purpose shall be used as a parameter for assessing the necessity and proportionality (and thus the legality) of the data exchange."[454] According to the WP29, the problem is that alternative uses become possible in receiving jurisdiction, in a way which is potentially harmful to individual rights.[455] The more flexible the purpose is, the more the right to protection of personal data is restricted. Here, the author recognizes that IGAs seek to limit the possibility that information exchanged is used for additional purposes. For instance, according to art. 3(7) Italy – United States FATCA Model 1A agreement, all information exchanged shall be subject to the confidentiality and other protections provided for in the Convention, including the provisions limiting the use of the information exchanged. In this regard, art. 26(1) of Italy – United States Income Tax Treaty (1999) states that, "Any information received 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) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. *Such persons or authorities shall use the information only for such purposes*." However, the exact purpose behind the processing of personal data under FATCA is

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[454] See Annex on Specific issues identified in respect of CRS available at http://ec.europa.eu/justice/data-protection/article-29/documentation/other-document/files/2014/20140918_annex_oecd_common_reporting_standard.pdf.pdf; see also *supra* note 146, p. 6; see also Giuseppe Busia, *Automatic inter-state exchange of data: Safeguarding data protection and fundamental rights*, Joint EBF – FBF Tax Conference 2014 – Paris, 22 September 2014, p. 6: "Any inter-state agreement should clearly identify the purposes for which data are collected and validly used (Article 6b of Directive 95/46). What's 'tax evasion'? (legal acts, illegal acts, serious financial crimes?). In this regard, Avi-Yonah argues that: "There are three categories of strategic tax behaviours: tax evasion, tax avoidance, and licit tax savings. The definition of these behaviours is debated by academics, and it is not clear where the distinguishing lines should be drawn (i.e., when tax avoidance crosses the line and becomes tax evasion, for example)"; see Reuven S. Avi-Yonah, Nicola Sartori, Omri Marian, *Global Perspectives on Income Taxation*, Oxford University Press, 2011, p. 101.

[455] See *supra* note 146, p. 8; see also the Opinion of European Data Protection Supervisor on Art. 6(3) of EU – Switzerland agreement on the automatic exchange of tax information *supra* note 149, pp. 5 and 6. According to that Article, information received by a jurisdiction (being a Member State or Switzerland) *may be used for other purposes when such information may so be used under the laws of the supplying jurisdiction* (being, respectively, Switzerland or a Member State) *and the Competent Authority of that jurisdiction authorises such use*. As it clearly emerges, Article 6(3) of EU – Switzerland agreement follows the structure of Article 26(2) last sentence OECD Model Tax Convention as recently amended by the OECD Council on July 17th 2012. As a result of the modification, the competent authorities are allowed to use information received for purposes other than the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to all taxes provided such use is allowed under the laws of both States and the competent authority of the supplying State authorises such use. Prior to the amendment, this was an option included in paragraphs 12.3 of the Commentary on Article 26(2) OECD MTC. The author believes that the Opinion of EDPS on Art. 6(3) of EU – Switzerland agreement holds true also with regard to the amended version of Article 26(2) OECD MTC.

still not clear. As the author suggested,[456] the primary purpose of processing personal data under FATCA is not to fight the evasion of US taxes through the use of foreign accounts and investment vehicles, but rather to enforce citizenship-based taxation.[457] From the Joint Statement of July 7th 2012, it was evident that the policy objective of FATCA was to achieve reporting of a significant and disproportionate amount of personal data which would have given IRS the possibility to administer the taxation of non-resident citizens. Indeed, as argued by Christians,[458] Blum and Singer,[459] up until 2010, taxing non-resident citizens was unadministrable. As argued by Avi-Yonah, attempting to tax them imposed a burden on the IRS that it was unable to meet.[460] However, after the enactment of FATCA, even though the burden is imposed on banks, the situation did not change in terms of costs and benefits.[461] In addition, *due diligence* obligations for identifying and reporting on U.S. *Reportable Accounts* mainly consists of an electronic record search of some U.S. indicia which are not incontrovertible evidence of tax evasion. In this regard, the EDPS in its opinion dated July 8th 2015 considered that, "the EU – Switzerland agreement on automatic exchange of tax information should have included provisions and criteria that explicitly link the reporting of personal data concerning financial accounts to possible tax evasion and that exempt low-risk accounts from reporting. In this respect, such criteria should be applicable *ex ante* to determine which accounts (and which information) would need to be reported. Only at that stage – once the relevance (or irrelevance) of the reporting for the purpose of countering tax evasion has been established – the electronic search might help determining the residence of the account holder."[462] In the author's view, the EDPS's Opinion on EU – Switzerland agreement on AEoI is also valid with regard to FATCA since due diligence exercises under both agreements are almost the same.[463] Finally, in a survey carried out on July 2014 by the deVere Group of 414 American expat clients, 79% said they had 'actively considered', 'are thinking about', or 'have explored the options of' renouncing their US passport due to the implications of FATCA.[464] As argued by Ruth Mason, many factors motivate expatriations, and FATCA has clearly pushed some people who

[456] Gianluca Mazzoni, *The interaction between FATCA and the right to privacy and data protection*, Michigan Journal of International Law, (forthcoming); see also Allison Christians, *Uncle Sam Wants … Who? A Global Perspective on Citizenship Taxation*, (January 18th 2016) p. 1; p. 2; p. 5.

[457] *Contra* Michael Kirsch, *Revisiting the Tax Treatment of Citizens Abroad: Reconciling Principle and Practice*, 16 Florida Tax Review 3 (2014), p. 161.

[458] Allison Christians, Allison Christians, *Uncle Sam Wants … Who? A Global Perspective on Citizenship Taxation*, (January 18th 2016) p. 5.

[459] Cynthia Blum & Paula N. Singer, *A Coherent Policy Proposal U.S. Residence-Based Taxation of Individuals*, 41 Vand. J. Transnat'l L. 3 (2008), p. 713: "The IRS is at a serious disadvantage in monitoring compliance by U.S. citizens overseas because of the lack of many of its usual sources of information …"

[460] Reuven S. Avi-Yonah, *The Case against Taxing Citizens* (2010), Law & Economics Working Papers. Papers 12. http://repository.law.umich.edu/law_econ_current/art12, p. 10.

[461] According to Mark Matthews, a former deputy commissioner of the IRS, the amount of additional tax revenue generated by FATCA is very small. In this regard, see Reuven S. Avi-Yonah and Gil Savir, Find It and Tax It: From TIEAs to IGAs (February 20, 2015). U of Michigan Public Law Research Paper No. 443. Available at SSRN: http://ssrn.com/abstract=2567646 or http://dx.doi.org/10.2139/ssrn.2567646, p. 8.

[462] See *supra* note n. 149, p. 5.

[463] Compare, for instance, Italy – United States FATCA Model 1A Agreement, Annex I, section II(B)(1) with EU – Switzerland agreement on AEoI, Annex I, section III(B)(2) both regarding due diligence for pre-existing individual accounts.

[464] https://www.devere-group.com/news/American-expats-passport-FATCA-deVere.aspx.

were on the fence into expatriating.[465] On February 5th 2016, the U.S. Department of Treasury published the names of individuals who renounced their U.S. citizenship or terminated their long-term U.S. residency during the fourth quarter of 2015. As the graph created by Andrew Mitchel and Ryan E. Dunn shows,[466] the number of expatriates for 2015 (4,279) is a 25.30% increase over 2014 (3,415) when FATCA became effective and a 178.94% increase over 2010 (1,534) when FATCA was enacted.

5.3. Necessity and proportionality of AEoI after the *Digital Rights Ireland* case

Thirdly, according to Article 6(1)(c) of Directive 95/46/EC personal data must be adequate, relevant and not excessive in relation to the purposes for which they are collected and/or further processed. The WP29 stated that, "FATCA must be mutually recognised as *necessary* from an EU perspective. This requires … [a] careful assessment of how FATCA's goals balance with that of … Article 8 of the Charter of Fundamental Rights …, i.e. *by demonstrating necessity by proving that the required data are the minimum necessary in relation to the purpose*." According to 26 U.S. Code § 1471(c) the foreign financial institution, with respect to each United States account maintained by such institution, shall report the following information: (A) the name, address, and TIN of each account holder which is a specified United States person and, in the case of any account holder which is a United States owned foreign entity, the name, address, and TIN of each substantial United States owner of such entity; (B) the account number; (C) the account balance; (D) the gross receipts and gross withdrawals or payments from the account. Thus, it appears that there is a significant amount of personal data collected from financial institutions and transferred to the IRS under FATCA. Therefore, on the basis of WP29's analysis the question is whether FATCA's goals can be achieved through other mechanisms which are less intrusive. In other words, can FATCA's goals be met through narrower measures which would result in processing less personal data?

With regard to Directive 2011/16/EU of February 15th 2011 on administrative cooperation in the field of taxation as amended by Directive 2014/107/EU of December 9th 2014, Somare and Wöhrer argued that, "in the light of the criteria that have been laid down by the CJEU [in the *Digital Right Ireland* case] it is highly questionable whether the significant amount of personal data required to be exchanged … is the minimum necessary to reach the goal of fighting cross-border tax fraud and tax evasion."[467] Somare and Wöhrer accurately compared the massive amount of data collected

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[465] Ruth Mason, Citizenship Taxation (February 10th, 2016), *Southern California Law Review*, Vol. 89, *Forthcoming*, pp. 148 – 149, J. Richard (Dick) Harvey, Jr. *Worldwide Taxation of U.S. Citizens Living Abroad: Impact of FATCA and Two Proposals*, Villanova University School of Law, Public Law and Legal Theory, Working Paper No. 2013-3057, available at http://ssrn.com/abstract=2318463 discussing whether the additional financial issues created by FATCA for U.S. citizens living abroad justify a change by the United States from a worldwide to a residence-based tax system, p. 6.

[466] http://intltax.typepad.com/intltax_blog/2016/02/new-expatriate-record-2015-nearly-4300-expatriations.html.

[467] Maryte Somare & Viktoria Wöhrer, *Automatic Exchange of Financial Information under the Directive on Administrative Cooperation in the Light of the Global Movement towards Transparency*, *Intertax* 12, (2015), p. 813.

from financial institutions and transferred to tax administrations of other Member States with the data collection under the Data Retention Directive which has been declared invalid due to disproportionality.

In particular, according to Article 1(1) of Directive 2006/24/EC, providers of publicly available electronic communications services and public communications networks were obliged to retain certain data for the purpose of investigation, detection and the prosecution of serious crimes. The types of data which had to be retained were traffic data, location data, and data necessary to identify the subscriber or registered user. The Directive excluded the content of electronic communications from its scope.[468] Interestingly, Directive 2006/24/EC gave significant leeway to Member States regarding the determination of the content of several key provisions. According to Article 6, Member States could require data to be retained for periods of not less than six months and not more than two years from the date of communication. In addition, the definition of serious crime was left to the discretion of each Member State. Moreover, according to Article 4, the procedures to be followed and the conditions to be fulfilled in order to gain access to the retained data were defined by the Member States. The national laws were, however, subject to the relevant provisions of European Union law or public international law, and in particular the ECHR as interpreted by the ECtHR.

In the *Digital Right Ireland* case,[469] the ECJ examined the validity of Directive 2006/24 in light of Articles 7, 8 and 11 of the CFREU. It held that, "The retention of data for the purpose of possible access to them by the competent national authorities, as provided for by Directive 2006/24, directly and specifically affects private life and, consequently, the rights guaranteed by Article 7 of the Charter. Furthermore, such a retention of data also falls under Article 8 of the Charter because it constitutes the processing of personal data within the meaning of that article and, therefore, necessarily has to satisfy the data protection requirements arising from that article."[470] In this regard the Court held that the obligations imposed by the Directive to retain, for a certain period, data relating to a person's private life and to his communications, and to allow competent national authorities to access that data, constitute an interference with the fundamental rights to privacy and to the protection of personal data as guaranteed by Articles 7 and 8 of the Charter and Article 8 of the ECHR.[471] The Court pointed out that these interferences were wide-ranging and particularly

[468] According to Article 5(1), the categories of data to be retained were: (a) data necessary to trace and identify the source of a communication; (b) data necessary to identify the destination of a communication; (c) data necessary to identify the date, time and duration of a communication; (d) data necessary to identify the type of communication; (e) data necessary to identify users' communication equipment or what purports to be their equipment; (f) data necessary to identify the location of mobile communication equipment. Those data consist, *inter alia*, of the calling telephone number, the name and address of the subscriber or registered user, the telephone number called, the IP address allocated by the Internet access service provider to a communication. See ECJ in *Digital Rights Ireland* § 26 and § 27.

[469] For a comment on the case see The Data Retention Directive is incompatible with the rights to privacy and data protection and is invalid in its entirety: *Digital Rights Ireland, Common Market Law Review* 51, (2014), pp. 1789 – 1812; see also David Eisendle, *Data Retention: Directive invalid – Limits imposed by the Principle of Proportionality exceeded*, 8 Vienna J. on Int'l Const. L. 458 (2014).

[470] ECJ, 08 April 2014, Joined Cases C-293/12 and C-594/12 *Digital Rights Ireland and Others* § 29.

[471] ECJ, 08 April 2014, Joined Cases C-293/12 and C-594/12 *Digital Rights Ireland and Others* §§ 34, 35 and 36.

serious.[472] Were these interferences with the right to privacy and data protection justified? According to Article 52(1), any limitation on the exercise of the rights and freedoms recognised by the Charter must: (i) be provided for by law; (ii) respect the essence of those rights and freedoms; and (iii) be necessary and genuinely meet objectives of general interest. With regard to the second condition of Article 52(1), the ECJ held that the retention of data did not adversely affect the essence of those rights because firstly, the Directive did not permit the acquisition of knowledge of the content of the electronic communications[473] and, secondly, the Directive required Member States to adopt appropriate technical and organisational measures against accidental or unlawful destruction, accidental loss or alteration of the data.[474] With regard to the third condition of Article 52(1), the Court observed that, whilst the aim of the Directive was to harmonise Member States' provisions concerning data retention obligations, the material objective of the Directive was to contribute to the fight against serious crime[475] and thus, ultimately, to public security.[476] Consequently, the Court held that the retention of data for the purpose of allowing the competent national authorities to have possible access to that data genuinely satisfied an objective of general interest.[477] But was this interference proportionate? In other words, was the retention of data appropriate for attaining the objective pursued by Directive 2006/24? Did the retention of data exceed the limits of what was appropriate and necessary in order to achieve the objectives pursued by Directive 2006/24? Was the interference caused by Directive 2006/24 limited to what is strictly necessary? No, because the Court held Directive 2006/24 did not lay down clear and precise rules governing the extent of the interference with the fundamental rights to respect for private and family life and to the protection of personal data.[478]

In the author's view, the same yardstick used by the ECJ in relation to the *Digital Right Ireland* case should also apply to the automatic exchange of tax information, in particular to FATCA, CRS and DAC 2. Interestingly, the ECJ held that: "Directive 2006/24 affects, in a comprehensive manner, all persons using electronic communications services, *but without the persons whose data are retained being, even indirectly, in a situation which is liable to give rise to criminal prosecutions. It therefore applies even to persons for whom there is no evidence capable of suggesting that their conduct might have a link, even an indirect or remote one, with serious crime ....*"[479] This is also true in regard to FATCA. *Inter alia*, FATCA reporting requirements also

[472] ECJ, 08 April 2014, Joined Cases C-293/12 and C-594/12 *Digital Rights Ireland and Others* § 37, see also Advocate General Opinion, §§ 77 and 80.
[473] ECJ, 08 April 2014, Joined Cases C-293/12 and C-594/12 *Digital Rights Ireland and Others* § 39.
[474] ECJ, 08 April 2014, Joined Cases C-293/12 and C-594/12 *Digital Rights Ireland and Others* § 40.
[475] The fight against serious crime in order to ensure public security constitutes an objective of general interest as well as the fight against international terrorism in order to maintain international peace and security. See to that effect, ECJ 03 September 2008, Joined Cases C-402/05 P and C-415/05 P, *Yassin Abdullah Kadi and Al Barakaat International Foundation v. Council of the European Union and Commission of the European Communities*, § 363; ECJ 23 Nov. 2010, C-145/09 *Land Baden-Württemberg v. Panagiotis Tsakouridis* §§ 46 and 47; ECJ 15 Nov. 2012, Joined Cases C-539/10 P and C-550/10 P *Stichting Al-Aqsa v. Council of the European Union* § 130.
[476] ECJ, 08 April 2014, Joined Cases C-293/12 and C-594/12 *Digital Rights Ireland and Others* § 41.
[477] ECJ, 08 April 2014, Joined Cases C-293/12 and C-594/12 *Digital Rights Ireland and Others* § 44.
[478] ECJ, 08 April 2014, Joined Cases C-293/12 and C-594/12 *Digital Rights Ireland and Others* § 65.
[479] ECJ, 08 April 2014, Joined Cases C-293/12 and C-594/12 *Digital Rights Ireland and Others* § 58.

apply to bank accounts with no signal of tax evasion or intent to launder money,[480] *i.e.* those of non-resident citizens who need them to conduct day-to-day business in their residence state and own them for perfectly innocent reasons.[481] For this reason, Christians proposed a so-called "*same-country exception*" from FATCA for those US citizens who have bank accounts or other investments in the same country in which they are resident.[482] The idea of a same-country exception was also encouraged by the National Taxpayer Advocate in its report to Congress in order to mitigate the unintended negative consequences of FATCA.[483]

5.4. AEoI and data retention

Fourthly, according to Article 6(1)(e) of Directive 95/46/EC, personal data must be kept in a form which permits identification of data subjects *for no longer than is necessary* for the purposes for which the data were collected or for which they are further processed (*data retention*). The WP29 reiterated that proportionality should also guide data retention.[484] In the *Digital Rights Ireland* case, the ECJ, as concerned the data retention period, held that, "Article 6 of Directive 2006/24 requires that those data be retained for a period of at least six months, *without any distinction* being made between the categories of data set out in Article 5 of that directive on the basis of their possible usefulness for the purposes of the objective pursued or according to the persons concerned. Furthermore, that period is set at between a minimum of 6 months and a maximum of 24 months, but *it is not stated that the determination of the period of retention must be based on objective criteria in order to ensure that is limited to what is strictly necessary.*"[485] As a consequence of this

[480] The Commission AEFI expert group held that: "*In its current version, DAC 2 might be challenged because it does not respect the principle of sufficient cause, i.e. the verification of indicia for a non-compliant behaviour of taxpayers*". See European Commission, *First Report of the Commission AEFI expert group on the implementation of Directive* 2014/107/EU *for automatic exchange of financial account information*, March 2015, p. 8.

[481] Ruth Mason, Citizenship Taxation (February 10th, 2016), *Southern California Law Review*, Vol. 89, *Forthcoming*, pp. 147 and 168; see also Reuven S. Avi-Yonah & Gil Savir, *IGAs vs. MAATM: Has Tax Bilateralism Outlived Its Usefulness*? (February 8, 2014). U of Michigan Public Law Research Paper No. 384; U of Michigan Law & Econ Research Paper No. 14-002, available at SSRN: http://ssrn.com/abstract=2392702 or http://dx.doi.org/10.2139/ssrn.2392702: "the fundamental problem stems from the fact that the U.S. has, since 1861, taxed its citizens living permanently overseas, and as a result, *FATCA applies to many such expatriates who have no intention of hiding their income from the IRS* (*in fact, most of them do not owe any taxes to the U.S. because of the earned income exclusion of IRC section 911 and the foreign tax credit of IRC section 901*).

[482] Allison Christians, *Could a Same-Country Exception Help Focus FATCA And FBAR*? July 9th, 2012, p. 158.

[483] *The IRS's Implementation of FATCA Has in Some Cases Imposed Unnecessary Burdens and Failed to Protect the Rights of Affected Taxpayers*, p. 50 available at http://www.taxpayeradvocate.irs.gov/Media/Default/Documents/2016-JRC/Area_of_Focus_4_Implementation_of_FATCA.pdf; in the same vein, see also American Citizens Abroad, "*Same Country*" *Exemption for Accounts of US Taxpayers Residing Abroad: Relaxation of FATCA Rules to Mitigate "Lock-Out" and Unnecessarily Burdensome Reporting Problems*, available at https://www.americansabroad.org/media/files/files/feffd7bf/same-country-exemption-2015-04-06.pdf.

[484] See the Annex on Specific issues identified in respect of CRS available at http://ec.europa.eu/justice/data-protection/article-29/documentation/other-document/files/2014/20140918_annex_oecd_common_reporting_standard.pdf.pdf.

[485] ECJ, 08 April 2014, Joined Cases C-293/12 and C-594/12 *Digital Rights Ireland and Others* §§ 63 and 64.

judgment, the WP29 explicitly stated that, "The indication of an explicit retention period for the personal data collected and exchanged ensures that data are retained for the time strictly necessary to pursue legitimate policy goals and, once this is achieved, they are deleted, restoring in full individual rights. *Should this not be the case, the massive and continuous exchange of tax information concerning citizens would result in a large archive difficult to control and potentially harmful to the citizens.* Tax cooperation agreements, therefore, should clearly indicate for how much time tax information should be retained, in order to counter tax evasion. They shall also explicitly provide for the deletion of such information once the retention period has expired."[486] However, the author notes that in both FATCA[487] and the OECD CRS[488] there are a lack of clear rules concerning the data retention period. In addition, the EU – Switzerland agreement does not say anything of what happens once tax information is collected and exchanged.[489] The only instrument of the international exchange of information which provides a similar provision is DAC 2. *Inter alia*, an additional paragraph was inserted by Article 1(5)(b) of Directive 2014/107/EU in the text of Article 25 of Directive 2011/16/EU. According to the new version of Article 25(4), information processed in accordance with this Directive shall be retained *for no longer than necessary* to achieve the purposes of this Directive, and in any case in accordance with each data controller's domestic rules. This provision should have ensured the respect of proportionality principle as concerns the data retention period. However, as argued by Somare and Wöhrer, "due to the lack of clear deadlines this provision does not substantially enhance data protection and is most certainly not enough to ensure the proportionality of data retention."[490] In the author's view, this provision does not take into consideration the ECJ ruling in *Digital Rights Ireland*. Article 25(4) is formulated in a way which does not allow one to objectively determine the data retention period. The text of Article 25(4) merely refers to Article 6(1)(e) of Directive 95/46/EC without explicitly indicating a clear limited period for the retention of personal data collected and exchanged. In the author's opinion, Article 25(4) gives Member States much leeway especially when it states that the maximum retention period should be set according to the timeframe provided by each data controller's domestic rules and in particular the statute of limitations provided therein. Therefore, using the ECJ's words, it could be argued that, also in DAC 2, data retention period is not *limited to what is strictly necessary.*

5.5. AEoI and taxpayer's consent: the 30 percent withholding tax under FATCA

486 See *supra* note 146, p. 7.
487 26 C.F.R. § 1.1471-4(c)(iv)
488 Commentaries on the Common Reporting Standard, Section IX, paragraph 7.
489 See *supra* note 149, pp. 7 – 8.
490 Maryte Somare & Viktoria Wöhrer, *Automatic Exchange of Financial Information under the Directive on Administrative Cooperation in the Light of the Global Movement towards Transparency*, *Intertax* 12, (2015), p. 812.

In addition, according to Article 7(a) of Directive 95/46/EC, personal data may be processed only if the data subject has *unambiguously* given his consent.[491] The WP29 underlined the fact that Member States attempting to obtain a waiver from data subjects from any domestic or EU law which would prevent the reporting of any information required under FATCA via consent *is not a valid criterion* for processing given the imbalance between the position of the data subject and the data controller, and the improbability that consent could be withdrawn. Furthermore, it is highly questionable whether data subjects are able to exercise a real choice given the imposition of a sanction such as a 30% withholding tax or closure of their account if they fail to provide a valid and effective waiver or the required documentation within a reasonable period of time. These significant negative consequences undermine the data subject's freedom of choice. The individual's consent is obtained by threat of imposing a 30% withholding tax or the closure of his account. It could be argued that the individual is *forced* to consent against his will. Therefore, his consent is not '*freely*' and '*unambiguously*' given as defined by Article 2(h) or 7(a) of Directive 95/46/EC.

5.6. AEoI and taxpayers' rights

Moreover, another element of criticism is shown by the fact that under FATCA Model 1 IGAs, little attention has been paid to the protection of data subjects' rights. In particular, it is not clear whether data subjects have: (i) the right to be *informed* of the identity of the controller, the purposes of the processing, the recipients or categories of recipients of the data; (ii) the right of *access* to data; and (iii) the right to have data *rectified* in case of inaccuracies. In this regard a slightly better approach has been adopted by the OECD CRS. According to section 5(1) of the OECD Model Competent Authority Agreement (hereinafter "MCAA"), all information exchanged is ... to the extent needed to ensure the necessary level of protection of personal data, in accordance with the safeguards which *may* be specified by the supplying Competent Authority as required under its domestic law. Therefore, as stated by Commentary on Section 5(1) of OECD MCAA: "The Competent Authority receiving the information must ensure the practical implementation and the observance of any safeguarding specified. The Competent Authority receiving the information shall treat the information in compliance not only with its own domestic law, but also with additional safeguards that may be required to ensure data protection under the domestic law of the supplying Competent Authority. *Such additional safeguards*, as specified by the supplying Competent Authority, *may for example relate to individual access to the data*."[492] Nevertheless, this provision simply provides for option for the supplying Competent Authority to specify in the MCAA the particular safeguards that must be respected without placing any concrete obligation. Secondly, according to the Commentary on Section 5(1), the specification of the safeguards may not be necessary if the supplying Competent Authority is satisfied that the receiving Competent

[491] For a definition see Art. 2(h) of Directive 95/46/EC: 'the data subject's consent shall mean any *freely* given specific and informed indication of his wishes by which the data subject signifies his agreement to personal data relating to him being processed.

[492] Commentary on Section 5(1) of OECD MCAA, p. 80.

Authority ensures the necessary level of data protection with respect to the data being supplied.[493] In the author's view, this provision will be problematic in the case of an information exchange between an EU Member State and a third country. In that case, the decision whether a third country ensures an adequate level of protection shall be adopted by the EU Commission on the basis of Article 25(6)[494] of Directive 95/46/EC and not by the supplying Competent Authority. For all these reasons, the WP29 in its guidelines of last December stated that, "Tax cooperation agreements should specify that the data subject shall be informed on data exchanges with a reasonable delay before the actual exchange of the data takes place (so that the individual concerned gets time to defend himself if relevant). The information provided should at the minimum inform the data subjects of the fact that their personal data will be sent to a competent authority for the purpose of fighting tax evasion, include a list of the category of data sent, a list of the receiving authorities in various countries and the contact of the controller in their country of residence and inform them of their right to object and their right of redress".

The right to be *informed* about the data processing and the transfer of data has been recently examined by the ECJ in *Smaranda Bara and Others*. Ms. Smaranda Bara and numerous other Romanian citizens (the applicants) were all self-employed. The Romanian tax authority ('ANAF') transferred data relating to their declared income to the National Health Insurance Fund ('CNAS'), which then required the payment of arrears of contributions to the health insurance regime. The applicants brought an appeal before the Court of Appeal, in which they contested the lawfulness of that transfer in the light of Directive 95/46. They submitted that their data were, on the basis of a single international protocol, transferred and used: (i) for purposes other than those for which it had initially been communicated to the ANAF; (ii) without their prior explicit consent; and (iii) without them having previously been informed.[495] Law no. 95/2006 empowers public bodies to transfer personal data to the health insurance funds so that the latter may determine whether an individual qualifies as an insured person. The data concern the identification of persons (surname, first name, personal identity card number, address) but does not include data relating to income received.[496] The Court of Appeal asked the ECJ to determine whether Articles 10, 11 and 13 of Directive 95/46 must be interpreted as precluding a public administrative body to transfer personal

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[493] See *supra* note 195.

[494] The adoption of a (comitology) Commission decision based on Article 25(6) of the Directive involves: (i) a proposal from the Commission; (ii) an opinion by Member States' data protection authorities and the EDPS, in the framework of the Article 29 Working Party; (iii) an approval from the 'Article 31 Committee', composed of representatives of Member States, under the comitology 'examination procedure'; (iv) the adoption of the decision by the College of Commissioners; (v) at any time, the European Parliament and the Council may request the Commission to maintain, amend or withdraw the adequacy decision on the grounds that its act exceeds the implementing powers provided for in the Directive. The effect of such a decision is that personal data can flow from the 28 EU countries and three EEA member countries (Norway, Liechtenstein and Iceland) to that third country without any further safeguard being necessary. See http://ec.europa.eu/justice/data-protection/international-transfers/adequacy/index_en.htm.

[495] RO: ECJ, 1 Oct. 2015, Case C-201/14, *Smaranda Bara and Others v. Preşedintele Casei Naţionale de Asigurări de Sănătate, Casa Naţională de Asigurări de Sănătate and Agenţia Naţională de Administrare Fiscală (ANAF)*, ECJ Case Law IBFD, § 15.

[496] RO: ECJ, 1 Oct. 2015, Case C-201/14, *Smaranda Bara and Others v. Preşedintele Casei Naţionale de Asigurări de Sănătate, Casa Naţională de Asigurări de Sănătate and Agenţia Naţională de Administrare Fiscală (ANAF)*, ECJ Case Law IBFD, § 16.

data to another public administrative body and their subsequent processing, without the data subjects being informed of that transfer and processing.[497] In its judgment of October 1st 2015, the ECJ held that the requirement of fair processing of personal data laid down in Article 6 of Directive 95/46 requires a public administrative body to inform[498] the data subjects of the transfer of those data to another public administrative body for the purpose of their processing by the latter in its capacity as recipient of those data.[499] In addition, the ECJ has clarified that the rights of the data subjects may be restricted for certain purposes, including tax reasons, but the restriction shall be provided by law, not being sufficient as an administrative measure, such as a protocol concluded between the national tax authority and another State institution.[500] In the author's view, the principle elaborated by the ECJ in *Bara* should also apply to FATCA and OECD CRS.

In conclusion, on the basis of all aforementioned considerations, it could be argued that neither FATCA nor OECD CRS guarantee EU privacy standards.

6. Conclusion

As hereinbefore mentioned, neither FATCA nor CRS or DAC2 are fully compliant with the fundamental rights of privacy and data protection. On the basis of the ECJ decision in the *Digital Rights Ireland* case, it could be argued that such instruments constitute a disproportionate harm to the fundamental rights to privacy and to the protection of personal data. Borrowing the words of the German Constitutional Court, in the population census judgment, or of the ECJ in the *Digital Rights Ireland* case, such instruments *go beyond what is strictly necessary* to achieve the goal of fighting against offshore tax evasion. In particular, the reporting obligations apply even to persons for whom there is no evidence capable of suggesting that their conduct might have a link, even an indirect or remote one, with tax evasion. In the author's opinion, low-risk accounts should be exempted from reporting. Here, the question is how to identify those financial institutions and accounts that present a low risk of being used to evade taxes in order to exclude them from the scope of reporting obligations. As indicated in one of the recitals of the EU-Switzerland agreement on the automatic exchange of tax information, thresholds should not be generally included as they could easily be circumvented by splitting accounts into different financial institutions. In the

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[497] RO: ECJ, 1 Oct. 2015, Case C-201/14, *Smaranda Bara and Others v. Preşedintele Casei Naţionale de Asigurări de Sănătate, Casa Naţională de Asigurări de Sănătate and Agenţia Naţională de Administrare Fiscală (ANAF)*, ECJ Case Law IBFD, § 28.

[498] The Advocate General Cruz Villalón pointed out in his opinion that: "*the requirement to inform the data subjects about the processing of their personal data*, which guarantees transparency of all processing, *is all the more important since it affects the exercise by the data subjects of their right of access to the data being processed*, referred to in Article 12 of Directive 95/46, *and their right to object to the processing of those data*, set out in Article 14 of that directive"; see Opinion of Advocate General Cruz Villalón delivered on July 9th 2015, § 74.

[499] RO: ECJ, 1 Oct. 2015, Case C-201/14, *Smaranda Bara and Others v. Preşedintele Casei Naţionale de Asigurări de Sănătate, Casa Naţională de Asigurări de Sănătate and Agenţia Naţională de Administrare Fiscală (ANAF)*, ECJ Case Law IBFD, § 34.

[500] RO: ECJ, 1 Oct. 2015, Case C-201/14, *Smaranda Bara and Others v. Preşedintele Casei Naţionale de Asigurări de Sănătate, Casa Naţională de Asigurări de Sănătate and Agenţia Naţională de Administrare Fiscală (ANAF)*, ECJ Case Law IBFD, §§ 39 & 40.

author's opinion, due diligence procedures should be enhanced. Currently, reportable accounts are identified through a due diligence exercise which consists mainly of an electronic record search of all electronically searchable data – performed in relation to account holders whose residence information is missing – looking for evidence of the residence of such account holders in one of the jurisdictions where reporting and tax information exchange apply. In the author's opinion, as under the anti-money laundering legislation, a list of subjective and objective "*anomaly indicators*" should be elaborated and proposed in order to facilitate the detection of those accounts that present a high risk of tax evasion.

As already stated, in the light of the principle of necessity stated by the ECJ in the *Digital Ireland* case, it is highly controversial whether the significant amount of personal data (*e.g.*, name, address and place of birth of the account holder, balance of the account, amount of interests, dividends and/or other income obtained from the account), required to be exchanged under those instruments, is the minimum necessary for attaining the purpose of combating fraud and tax evasion. If States do not prove the necessity of those instruments, in other words, if the goal of fighting against tax evasion cannot be achieved through less privacy-intrusive means, the massive and indiscriminate collection of data would be considered to be disproportionate.

In addition, in those instruments, there is a lack of clear rules regarding the fundamental principle of purpose limitation as enshrined in Art. 6(1)(b) of Directive 95/46/EC. Thus, there is a risk that information exchanged may be used for other purposes in the receiving jurisdiction, in a way which is potentially harmful to individual rights.

Moreover, except for DAC2, neither FATCA nor CRS provide for any kind of "participation rights" for taxpayers such as: (i) the right to be informed that their personal data will be collected and transferred to the competent authorities for the purpose of fighting tax evasion, including a list of the categories of data sent and the contact of the data controller; or (ii) the right of access to data in order to correct any inaccuracies as required by Articles 10, 11(1) and 12 of Directive 95/46/EC. The benefits deriving from the involvement of taxpayers in the exchange of information have been highlighted by the OECD Commentary on Art. 26, para. 14.1 where it was held that: "notification procedures ... can help prevent mistakes (*e.g.* in cases of mistaken identity) and facilitate exchange (by allowing taxpayers who are notified to cooperate voluntarily with the tax authorities in the requesting State)."[501] In the same vein, Art. 4(3) of the Convention on Mutual Administrative Assistance in Tax Matters states that, "Any Party may ... indicate that, according to its internal legislation, its authorities may inform its resident or national before transmitting information

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[501] OECD Commentary to Article 26 of the OECD Model Tax Convention, para. 14.1: "Notification procedures should not, however, be applied in a manner that, in the particular circumstances of the request, would frustrate the efforts of the requesting State. In other words, they should not prevent or unduly delay effective exchange of information. For instance, notification procedures should permit exceptions from prior notification, *e.g.* in cases in which the information request if of a very urgent nature or the notification is likely to undermine the chance of success of the investigation conducted by the requesting State".

concerning him, in conformity with Articles 5 (exchange of information on request) and 7 (spontaneous exchange of information)."[502]

Finally, none of the instruments which were discussed above, use the objective criteria in the determination of retention period for the personal data collected and exchanged in order to ensure that it is limited to what is necessary. Comparing their retention period (six and five years for FATCA and CRS, respectively), with that of Directive 2006/24 (between a minimum of six months and a maximum of 24 months), the proportionality of those instruments is highly questionable.

Therefore, what should be done? Professor Christians proposed the so-called "*Same-Country Exception*" which would exclude, from FATCA coverage, financial accounts held in the country in which a U.S. taxpayer is a *bona fide* resident. In the author's opinion, this regulatory change would also be helpful to minimize the number of Americans renouncing their U.S. citizenship which, since FATCA was enacted, has increased almost 180 percent. Under the current conditions Congress should re-examine whether there is still a need to tax citizens who live permanently overseas. In this regard, Blum and Singer propose that the United States abandon its imposition of income tax based on citizenship and institute a new system for taxing individuals based solely on residence.

In addition to these proposals, in the author's opinion, the actual effectiveness of the automatic exchange of tax information should also be assessed from an economic perspective. According to Zucman's estimate, offshore wealth has increased 28 percent from end-2008 to end-2013.[503] Thus, the new standard for the automatic exchange of tax information is far away from having reached its goal of fighting against tax evasion.

Whichever proposal will be adopted, it must always be borne in mind that, however legitimate and fundamental it may be, the objective of combating tax evasion should be pursued with due respect for an individual's fundamental rights, in particular, the right to privacy and the protection of their personal data.

[502] However, it should be noted that, since Art. 6 is not expressly mentioned by Art. 4(3), in the case of automatic exchange of information, the competent authorities are not required to inform individuals that data concerning them will be collected and transferred.

[503] G. Zucman, Taxing across Borders: Tracking Personal Wealth and Corporate Profits, *Journal of Economic Perspectives* – Volume 28, Number 4 – Fall 2014 – pages 121 – 148.