Due Diligence in International Tax Law

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1. Introduction: Is There a Due Diligence Obligation in International Tax Law?

In international tax law prior to the financial crisis of 2008–2009, there was no due diligence concept that imposed on states, and derivatively on their financial institutions, an obligation not to harm other states by aiding and abetting tax evasion by residents of these other states. This was in part the result of a legal rule, the ‘revenue rule’, which stemmed from the eighteenth-century declaration of Lord Mansfield pronouncing that ‘no country ever takes notice of the revenue laws of another [country]’:\footnote{Court of King’s Bench, *Holman v. Johnson*, 1775, English Reports 98 (1378–1865), 1120–1122, at 1121.} In other words, states cannot be expected to aid other sovereign states in the collection of their taxes. In addition, as we will discuss in section 2, from the enactment of the portfolio interest exemption by the US in 1984 and the subsequent abolition of withholding taxes by EU member states, it was the clear policy of both the US and the EU to actively aid and abet tax evasion by each other’s residents by allowing the payment of interest to foreign individuals and legal entities without either a withholding tax or the collection of any information about the identity of the beneficial owner of the interest that could be shared with the residence jurisdiction under tax treaties. This mutual race to the bottom culminated when the US adopted the ‘qualified intermediary’ regime in 2000, which affirmatively shielded the required information from the Internal Revenue Service (IRS), and the EU adopted the Saving Directive in 2003, which exempted payments to non-EU residents. The total lack of any due diligence obligation can be seen from the statement by UBS Group AG during the US Senate hearing on the ‘UBS scandal’ in 2009: that it was perfectly acceptable for the Swiss bank to rely on W8-BEN forms that indicated that the owner of an account was a tax-haven corporation when UBS had itself set up that corporation for a US resident and knew the identity of that resident.\footnote{US Senate, Permanent Subcommittee on Investigations, Staff Report, Tax Haven Banks and US Tax Compliance, 17 July 2008, available at: www.hsgac.senate.gov/imo/media/doc/REPORTTaxHavenBanksJuly1708FINALwPatEliseChgs92608.pdf (accessed 14 July 2019). On this and related discussions, see *Seeing Tax Law - Understanding Tax Law*, Cambridge University Press (2019).}
This all changed in the wake of the UBS scandal and the 2008–2009 financial crisis. Both the US and the EU became aware that aiding and abetting tax evasion by each other’s residents could lead to Americans pretending to be Europeans and Europeans pretending to be Americans in order to evade their tax obligations: in both the US and the EU, there was no withholding tax imposed on payments to non-residents, so if a resident of either the US or the EU could pretend to be a resident of the other, she could evade the withholding tax. In addition, the revenue pressure from the financial crisis and the subsequent public outrage at the banks that caused it first led to the enactment in the US of the Foreign Accounts Tax Compliance Act (FATCA) of 2010, then to the negotiation of Intergovernmental Agreements (IGAs) between the US and over a hundred other countries, and finally to the development by the Organisation for Economic Co-operation and Development (OECD) of the Common Reporting Standards (CRS) for the Automatic Exchange of Information (AEoI) under the Multilateral Agreement on Administrative Assistance in Tax Matters. The CRS have as of June 2018 been adopted by 123 jurisdictions (though not by the US).

2. Origins: Before 2010

In 1987 the US terminated its tax treaty with the Netherlands Antilles. The reason was that the treaty (technically an extension of the US-Netherlands treaty) had become a ‘treaty with the world’ (that is, allowing any non-resident to achieve treaty benefits without residing in a treaty jurisdiction): every US multinational could set up a finance subsidiary in the Antilles and use it to borrow funds from investors regardless of their country of residence, secure in the knowledge that there would be no withholding tax levied on the interest payments under Article 11 of the treaty. The US became concerned that no country would be interested in negotiating tax treaties with it if their residents could use the Antilles treaty.
However, the termination of the treaty also caused concerns: how would the US itself (which was running a large budget deficit) and US corporations continue to borrow from overseas investors if the interests were subject to a 30% withholding tax? When a US corporation borrowed money from a foreign individual, any interest payments by the corporation to that individual would be subject to the 30% withholding tax. One answer was that those investors from treaty countries already benefitted from a lower rate of withholding tax (typically 10%, or even 0%). However, if the lower rate depended on a treaty, the investors would potentially be subject to the exchange of information provision (Article 26), which could mean that they would have to declare the US-source interest income to their country of residence.

The solution was to adopt the portfolio interest exemption, Internal Revenue Code §871(h), under which interest paid by US persons (the US treasury and US corporations, as well as US banks and other financial institutions) to lenders that do not own at least 10% of the stock of the borrowing corporation is unilaterally exempt from the withholding tax. This enabled US persons to borrow without paying the withholding tax (which is typically shifted to the borrower, as interest rates are set in the global market) and also without jeopardising tax evasion by the lender, since the exemption does not depend on a treaty and therefore no information needs to be collected by the payors and no information was available for exchanging with residence countries.

The result was astonishing: over $300 billion were invested in the US from Latin America alone—a sum exceeding all official aid received by Latin American countries during the entire 1980s. As the Deputy Assistant Secretary for Tax Analysis Charles McLure admitted, this was not foreseen by the Treasury and caused

5 Reuven S. Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (Cambridge: CUP 2007), 70: ‘This exemption specifies that all payments of U.S.-source interest to foreigners are exempt from the withholding tax as long as they are ‘portfolio interest.’ This exemption covers interest on deposits in banks (which is actually an even older exception), interest on bonds issued by the government, and interest on all bonds issued by private corporations; basically all interest is exempt from tax as long as it is so-called portfolio interest. Portfolio interest is interest that is paid to non-shareholders. The test is whether the shareholder owns 10% of the stock—that is, interest paid to foreign parents or to large foreign shareholders does not qualify for the portfolio interest exemption.’

6 Ibid., at 71: ‘The portfolio interest exception has had a dramatic effect. It is estimated that the first few years after 1984, more than $300 billion moved from Latin America to bank accounts in Miami. This money transfer was illegal from the Latin American countries’ perspective because of local capital restrictions, but was attracted by the availability of interest free from withholding in bank accounts. In addition, deposits in American banks are guaranteed by the U.S. government and insured by the Federal Deposit Insurance Corporation, so it is a low-risk location. This quantity of money is large even by American standards, but by Latin American standards it is tremendously large: it was much more than all the World Bank and even private investment in Latin America at the time. The money went into Latin America and went back out to the U.S. bank accounts without benefiting Latin America. The attractiveness of American banks in the 1980s was one factor in why the 1980s were the ‘lost decade’ for
massive damage to Latin American countries. In addition, tax competition has ensured that since 1984 no developed country has been able to collect a withholding tax on interest paid by its banks or corporations to non-residents, because if it tried to do so the funds would be shifted to the US. For example, when Germany tried to impose a withholding tax on interest paid to non-residents because the Federal Constitutional Court held that it was a violation of equality requirements to withhold tax on wages but not on interest, the result was a massive flight of capital to Luxembourg that forced the German government to change course. The US and other OECD member countries have since benefitted from massive inflows of portfolio investment that is exempt from taxation ‘at source’ and that is generally not declared ‘at residence’, resulting in trillions of dollars of untaxed income.

However, from the beginning the US was concerned that the portfolio interest exemption could be used by US citizens and residents to move funds out of the US and then reinvest in US bonds via a secrecy jurisdiction. Because of this, the US took several steps to combat potential tax evasion by Americans: it severely restricted ‘bearer bonds’ that are not in a registered form; and it required that bonds issued by US corporations in Europe bear a legend that states they are not intended for sale to US citizens. In addition, the portfolio interest exemption itself contains

Latin America in terms of development, because money given to them was transferred back into the United States.


9 New York State Bar Association Tax Section, Report on Issues Relating to Restrictions Imposed on Offers and Sales of Bearer Bonds by the Tax Equity and Fiscal Responsibility Act of 1982, 1 October 2007, at 3–4: ‘In 1982, Congress adopted restrictions on the issuance of debt instruments in bearer form, principally to enhance tax compliance by U.S. taxpayers and to restrict access to easily negotiable financial instruments that could be used to facilitate the ‘laundering’ of funds derived from illegal activities. Under these restrictions, issuers of debt instruments in bearer form generally are denied deductions for interest paid in respect of such instruments and are subject to an excise tax. Holders of bearer-form debt instruments also generally are subject to sanctions—a denial of capital gains treatment in respect of gains realized, and a denial of deductions for losses realized, on disposition of such instruments—unless the instruments are held in a manner that allows the instruments to satisfy information reporting requirements. In adopting these restrictions, however, Congress also recognized the importance of not unduly restricting liquidity in the financial markets and allowing U.S. issuers to issue securities in the international capital markets in an efficient manner. Thus, Congress reconciled these differing objectives by restricting the issuance of bearer-form debt instruments generally, but permitting their issuance outside the United States—i.e., under circumstances in which the instruments were unlikely to be sold to United States persons. The basic compromise adopted pursuant to Tax Equity and Fiscal Responsibility Act of 1982 and the Deficit Reduction Act of 1984 created a system pursuant to
a provision allowing the Treasury to suspend its application to countries that do not participate in information exchange.\textsuperscript{10}

These steps, however, proved insufficient. Bearer bonds survived on the Eurobond market, and the legend was insufficient as it did not apply to the secondary sales of the bonds. Nor was the exchange-of-information limitation to the portfolio interest exemption ever applied.

To improve its policing of the withholding tax, the US in the early 2000s adopted the ‘qualified intermediary’ (QI) programme. Under the QI programme, banks could qualify to be QIs by signing an agreement to validate the identity of their customers. They would then pass on the information to the US withholding agents, but only in aggregate form without revealing the actual identities of the beneficial owners to anyone in the US. The reason for this latter provision, of course, was to ensure that the information was not available to the IRS to exchange in accordance with its obligation under the US tax treaties and therefore could not be used by other countries to combat tax evasion by their residents.\textsuperscript{11}

The UBS scandal, which broke in 2009, showed that the QI programme was also insufficient to prevent ‘round tripping’ by US citizens. UBS sent representatives to visit locations in the US where the rich congregate and persuade them to set up corporations in tax havens like the Caymans. The tax-haven corporations then deposited funds into UBS (based in Zurich), which in turn invested them in the US. UBS claimed that the QI agreement it signed did not require it to disclose any of this information to the IRS as long as the accounts were in the name of the tax-haven corporations, even though it knew the corporations were beneficially owned by US citizens.\textsuperscript{12}

which U.S. issuers were given a fundamental choice: (1) obtain the ability to issue securities globally by issuing them in registered form, subject to holder documentation requirements necessary to establish the identity of U.S. holders and the eligibility of non-U.S. holders for the portfolio interest exemption from U.S. withholding tax; or (2) minimize the need for holders to provide documentation by issuing the securities in bearer form, at the cost of not being able to issue those securities to U.S. investors.\textsuperscript{10}

11 US, Internal Revenue Code, Tax on Nonresident Alien Individuals, 26 USC §871(h)(6): ‘If the Secretary determines that the exchange of information between the United States and a foreign country is inadequate to prevent evasion of the United States income tax by United States persons, the Secretary may provide in writing (and publish a statement) that the provisions of this subsection shall not apply to payments of interest to any person within such foreign country (or payments addressed to, or for the account of, persons within such foreign country).’

12 US Senate, Tax Haven Banks and US Tax Compliance, 2008 (n. 2), at 87–88: ‘UBS (…) took steps to assist its U.S. clients to structure their Swiss accounts in ways that avoided U.S. reporting rules under
3. The Rise of Tax Due Diligence: From 2010 Onwards

The result of the UBS scandal was the enactment in 2010 of FATCA, under which any 'foreign financial institutions' (FFI) must take affirmative steps to discover who among its depositors is a US citizen or resident and disclose that information to the IRS. The penalty for not doing so is a hefty 30% withholding tax on any US-source income earned by the FFI in question. Since most FFIs are exposed to the US market in some way, this penalty has real teeth. To lighten the compliance burden, the US negotiated IGAs with several foreign governments under its tax treaties, according to which the foreign government collects the requisite information from its FFIs and shares it with the US either indirectly through local tax authorities (Model 1 Agreements) or directly to the IRS (Model 2 Agreements).13

As the first author has argued elsewhere, FATCA is the most spectacular and impressive recent example of the power of US leadership—or of constructive unilateralism—in international taxation. Indeed, the negotiation of IGAs by the US Treasury with foreign countries led to the development of standard information

the QI Program. UBS informed the Subcommittee that, after it joined the QI program in 2001, and informed its U.S. clients about its QI disclosure obligations, many of its U.S. clients elected to sell U.S. securities or open new accounts to avoid the QI reporting obligations attached ( . . . ) UBS also told the Subcommittee that, in 2001, about 250 of its U.S. clients with Swiss accounts took action to establish corporations, trusts, foundations, or other entities in non-U.S. countries, open new UBS accounts in the names of those foreign entities, and then, in a number of instances, transfer U.S. securities from the clients' personal accounts to those new accounts. The offshore entities included corporations, trusts, and foundations set up in the British Virgin Islands, Hong Kong, Liechtenstein, Panama, and Switzerland. UBS then accepted W-8BEN Forms from these offshore entities in which they claimed ownership of the assets had been transferred from the U.S. clients' personal accounts. UBS treated the new accounts as held by non-U.S. persons whose identities did not have to be disclosed to the IRS, even though UBS knew that the true beneficial owners were U.S. persons.'

13 For a comparison of FATCA Model 1A and Model IGAs, see Maryte Somare/Viktoria Wöhrer, 'Two Different FATCA Model Intergovernmental Agreements: Which Is Preferable?: A Comparison of FATCA Model 1A and Model 2 Intergovernmental Agreements,' Bulletin for International Taxation 68 (2014), 395–403. See, on the legal nature and the characteristics of IGAs, Allison Christians, 'The Dubious Legal Pedigree of IGAs (And Why It Matters),' Tax Notes International 69 (2013), 565–568, at 567, which argues that IGAs must be the 'sole' executive agreements—agreements undertaken by the president without congressional authorisation of any kind; Carol Tello, 'FATCA: Catalyst for Global Cooperation on Exchange of Tax Information,' Bulletin for International Taxation 68 (2014), 88–102, at 93: 'For US purposes, the Treasury Department has adopted the position that an IGA, like a TIEA, is considered an executive agreement and not a treaty. A treaty requires the advice and consent of the Senate under art. 2(2), clause of the US Constitution'; Leopold Parada, 'Intergovernmental Agreements and the Implementation of FATCA in Europe,' World Tax Journal 7 (2015), 201–240, at 209: 'Nonetheless, since the IGAs are not regarded as international agreements (at least not for both parties in the agreement), it is logical to have doubts regarding the rules that must be applied to interpret their provisions. A simple answer would be to affirm that the IGAs are instruments that depend on the existence of other instruments (i.e., DTCs or TIEAs); therefore, the interpretation rules must be in accordance to these instruments. In other words, when the exchange of information under the IGA is made in accordance to articles 26 or 27 of the OECD Model, the interpretation of the IGAs should be in accordance to this tax treaty. However, the reference to the DTCs and the IGAs is made only in terms of how the exchange of information must be made, but what about the interpretation of other provisions in the IGAs? Must they be interpreted independently in each contracting state? Can the rules of the Vienna Convention be applicable?'
exchange rules that culminated in the Multilateral Agreement on Administrative Assistance in Tax Matters, which has now been signed by over eighty countries and which provides for AEoI with no bank secrecy or dual criminality exceptions.\textsuperscript{14}

On 15 July 2014, the OECD Council approved CRS, which calls on jurisdictions to obtain information from financial institutions and automatically exchange that information with other jurisdictions on an annual basis. CRS sets out the financial account information to be exchanged, namely all types of investment income (including interest, dividends, income from certain insurance contracts, and other similar types of income) but also account balances and sales proceeds from financial assets; the financial institutions required to provide a report, namely banks and custodians but also other financial institutions such as brokers, certain collective investment vehicles, and certain insurance companies; the different types of accounts and taxpayers covered, namely individuals and entities (including trusts and foundations) with the requirement to look through passive entities and report on the individuals that ultimately control these entities; as well as common due diligence procedures to be followed by financial institutions.

Reportable accounts are identified through a due diligence exercise, which consists mainly of an electronic record search (or a paper record search where the only indicia found is a ‘hold mail’ or ‘in-care-of’ address) of all electronically searchable data—performed in relation to account holders whose residence information is missing—for evidence (for example mailing address, fixed or mobile phone numbers, power of attorney granted) of the residence of such account holders in one of the jurisdictions where reporting and tax information exchanges apply. Borrowing the words of the Court of Justice of the European Union in \textit{Digital Rights Ireland}, AEoI 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 tax evasion.\textsuperscript{15} Therefore, in its current version, AEoI might be challenged because it does not respect the principle of sufficient cause, namely the verification of indicia for the non-compliant behaviour of taxpayers. In other words, AEoI could be considered disproportionate since it fails to narrow down reporting obligations to individuals suspected of tax evasion. In this regard, the European Data Protection Supervisor in its opinion of 8 July 2015 proposed a ‘true’ due diligence risk evaluation approach:


\textsuperscript{15} CJEU, \textit{Digital Rights Ireland}, Grand Chamber Judgment of 8 April 2014, Joined Cases C-293/12 and C-594/12, para. 58.
the [EU–Switzerland agreement on the 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 \textit{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.\footnote{European Data Protection Supervisor, Opinion 2/2015 on the EU-Switzerland agreement on the automatic exchange of tax information, 8 July 2015, para. 14, available at: https://edps.europa.eu/sites/edp/files/publication/15-07-08_eu_switzerland_en.pdf (accessed 14 July 2019). For the compatibility of reporting obligations under FATCA and CRS with the EU framework on privacy and data protection, see Reuven S. Avi-Yonah/Gianluca Mazzoni, ‘Taxation and Human Rights: A Delicate Balance’, 5 September 2016, University of Michigan Public Law Research Paper No. 520, available at SSRN: https://ssrn.com/abstract=2834883 (last accessed 14 July 2019).}


But FATCA and CRS also have significant built-in loopholes. On the one hand, FATCA can be avoided by using a bank with no US assets and therefore no US source income exposure. In addition, FATCA’s disclosure requirements have been limited and weakened by its implementing regulations that provide a set of high dollar reporting thresholds and require the aggregation of account balances in different accounts only when the accounts are at the same financial institution. Thus, a US taxpayer can easily open multiple accounts at multiple banks and maintain account balances below the FATCA reporting thresholds.\footnote{US Senate, Permanent Subcommittee on Investigations, Offshore Tax Evasion: The Effort to Collect Unpaid Taxes on Billions in Hidden Offshore Accounts, 26 February 2014, at 171–173.} On the other hand, on 19 February 2018, the OECD released a consultation document that assesses how
‘residence by investment’ (RBI) or ‘citizenship by investment’ (CBI) schemes can potentially be exploited to avoid CRS reporting requirements.\textsuperscript{21} Example 1 in the consultation document demonstrates how current CRS due diligence procedures are insufficient to effectively counter a case where an account holder falsely self-certifies their tax residency and omits to include all tax residence jurisdictions.\textsuperscript{22} Practitioners suggested the following amendment to the current due diligence procedures so as to introduce a risk-based approach to the process of verifying tax residence status:

Where an account holder seeks to rely on recently issued Documentary Evidence then a Financial Institution ought to treat the account as high risk and require supporting evidence of previous tax residence status, perhaps over the last 5 years. Recently Issued Documentary Evidence may be such documents relied on as may have been issued on or after 29 October 2014, to align with the proposed effective date of the MDR.\textsuperscript{23}

The recent release of the Paradise Papers in late 2017, as well as the Panama Papers released the preceding year, demonstrates that the current regime is vulnerable to continuing evasion since it requires the cooperation of too many countries in order to be effective. Every tax haven has to sign on, otherwise money can be transferred to the non-cooperating tax havens. For instance, Panama had not yet confirmed its commitment to implement AEoI under the new standard. This aspect was also highlighted by OECD Secretary-General Angel Gurría when he stated, soon

\begin{itemize}
\item \textsuperscript{21} RBI or CBI are schemes that allow foreign individuals to obtain citizenship or temporary or permanent residence rights in exchange for local investments or against a flat fee. See Allison Christians, ‘Buying In: Residence and Citizenship by Investment’, \textit{St. Louis University Law Journal} 62 (2017), 51–72.
\item \textsuperscript{22} OECD, Consultation Document: Preventing Abuse of Residence by Investment Schemes to Circumvent the CRS, 19 February 2018, available at: \url{www.oecd.org/tax/exchange-of-tax-information/consultation-document-preventing-abuse-of-residence-by-investment-schemes.pdf}, at 3: ‘X is an individual resident in jurisdiction F. In order to circumvent reporting under the CRS, X applies for ‘residency status’ in jurisdiction M under its RBI program. This status requires X to purchase a property in jurisdiction M worth at least 500,000 Euro or to rent a property for a minimum of 40,000 Euro per year. It allows X to obtain tax residency in jurisdiction M without being taxed on any income that is not sourced in or remitted to jurisdiction M. X opens a New Account with a Bank B in jurisdiction B and self-certifies to be resident for tax purposes in country M (including by presenting his tax residency certificate to Bank B in the on-boarding process). Although the CRS requires X to include all jurisdictions of residence for tax purposes in his self-certification, he omits to self-certify his tax residence in jurisdiction F. In addition, the AML/KYC documentation provided by X does not show any connection to jurisdiction F. Bank B will identify X as a resident of country M and report the income and other information about the account to the tax authorities of jurisdiction B that will exchange the CRS information with country M, in compliance with the CRS. However, X is not taxed on the income in jurisdiction M. X continues to be a resident of jurisdiction F but jurisdiction B does not exchange X’s information with jurisdiction F, as a consequence of the outcome of the due diligence procedures applies by Bank B.’ (accessed 14 July 2019).
\end{itemize}
after the giant leak of more than 11.5 million financial and legal records, that ‘our standards on tax transparency are robust; they need to be effectively implemented worldwide, by everyone, with no exceptions, so there’s nowhere left to hide’.

4. Conclusion: From Rules to Standards

As we have seen, due diligence in international tax law is currently embodied in a specific set of rules imposed on FFIs by FATCA, CRS, and the EU Directives. The problem is that in the absence of an overarching standard of due diligence, these rules can be avoided, as exemplified by the RBI or CBI schemes outlined in section 3. For example, FATCA can be avoided by either using a bank with no US exposure, using several banks and dividing up the funds to avoid hitting the reporting limits, or by being born outside the US and self-certifying a non-US status. In the absence of a due diligence standard, FFIs can claim they have met their obligation in these cases even if they have reasons for suspicion. Similarly, CRS can be avoided by CBI and RBI schemes, if not too many questions are asked by the FFI. In addition, as explained above in the discussion of CRS, reliance on specific rules can lead to violations of privacy because the mechanical application of the rules ignores the specific circumstances of the taxpayer and whether the taxpayer poses an actual risk of tax evasion.

The solution is to create a due diligence standard over and above the specific rules and to hold those FFIs and states that regulate them to that standard. The OECD is the most likely institution to adopt this standard, perhaps as a preamble to CRS. Such a standard, like any due diligence standard, is based on the degree of risk in any particular situation. If an FFI is found to have neglected to ask the right questions despite a reason to be suspicious, the state that regulates the FFI should have an affirmative obligation to intervene, or else be held liable for violating its due diligence obligations. Only by openly adhering to such a due diligence standard can we avoid a repetition of the UBS scandal and achieve the goal of CRS: that every resident of every country that is liable to pay income tax be forced to do so. Otherwise, we risk undermining confidence in the income tax system, which for most countries is the main line of defence against rising inequality.