COMMITTEE INSIGHTS

International Tax Law*

This short report discusses issues in international tax law that will impact on the practice of international tax and international law practitioners generally: the growing enforcement and penalization tendencies in international tax compliance; the growing interaction between international tax and international trade; and the emerging importance of public international law and international tax law.

I. The Growing Enforcement and Penalization Tendencies

One clear trend in the last decade, and especially in the last few years, has been the proclivity of governments around the world to emphasize tax compliance in transnational tax matters. The United States Government has indeed been a leader in the compliance effort. Behind the new initiative in international tax compliance is the belief that the United States Government is losing substantial revenue in intercompany pricing manipulations by multinational companies.

Starting with the indictment of Marc Rich and Marc Rich & Co. for intercompany pricing violations in the mid-1970s,[1] the U.S. has increasingly penalized foreign-owned U.S. companies for failing to keep proper books and records and for failing to respond to requests for information. Foreign-owned corporations have been the subject of investigation by Congress and the IRS due to a concern that such corporations have been understating their tax liability through

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1. Marc Rich & Co., A.G. v. United States, 707 F.2d 663 (2d Cir.), *cert. denied*, 463 U.S. 1215 (1983); *In re* Grand Jury Subpoena Duces Tecum Dated Sept. 15, 1983, Marc Rich & Co., A.G. v. United States, 731 F.2d 1032 (2d Cir. 1984); *In re* Marc Rich & Co., A.G., 736 F.2d 864 (2d Cir. 1984); *In re* Marc Rich & Co., A.G., 739 F.2d 384 (2d Cir. 1984); *see also* Rosen, *Marc Rich Firms Plead Guilty to Tax Evasion Charges*, 25 TAX NOTES 203 (1984); Zagaris, *Marc Rich Caves In*, 46 TAXES INT'L 55 (Aug. 1983).

inappropriate intercompany pricing.[2] As a result, section 6038A of the Internal Revenue Code has been amended to strengthen the IRS's enforcement efforts in this area.

The laws have increasingly tightened, so that now even 25-percent-foreign-owned U.S. companies are within the new record-keeping requirements. (Before the Revenue Reconciliation Act of 1989 (RRA 89) only foreign persons with a majority of the vote or value of the stock of a U.S. company were subjected to the requirements). In addition, the RRA 89 requires the reporting corporation to obtain authorizations from foreign related parties to act as their agent for summons enforcement purposes. Simultaneous with the broadening of the scope of the law has come an increase in penalization. In particular, the monetary penalties for noncompliance have increased tenfold with RRA 89. In addition, a nonmonetary penalty is provided under which the IRS could reduce deductions, even to zero, for amounts paid to foreign related parties or the cost of property transferred in transactions with related parties.

Another reason for the increase in international tax compliance is because the IRS and its foreign counterparts have been allocating resources and prioritizing this element of tax administration. The IRS reallocated most of the manpower of the agents working on tax shelters into the international area. During the last five years, the IRS has continued to strengthen its international compliance resources. For instance, on August 28, 1991, it announced the establishment of a Compliance Analysis Division within the Office of the Assistant Commissioner (International) to identify global economic trends and target market segments for closer attention. It will have a trends and forecast team, which will identify worldwide economic and investment patterns and spot emerging tax issues; a workload identification team, which will use the findings of the forecasting team to identify tax returns in targeted market segments for closer review by the international examiners of the IRS; and a training team to instruct international examiners.[3]

Another procedural development in the drive towards tax compliance has been the conclusion of tax information exchange agreements (TIEAs) since the Caribbean Basin Economic Recovery Act of 1983.[4] At present eight CBI countries have concluded such TIEAs. Three other TIEAs have been concluded, but are not yet in effect.[5] Other TIEAs have been concluded with U.S. territories. Still another new mechanism to strengthen the international compliance efforts has

2. Testimony of Hon. Fred T. Goldberg before House Ways and Means Subcomm. on Oversight on July 10, 1990; *see also* DAILY TAX REP. L-5 (July 11, 1990).

3. For additional background on the establishment of a Compliance Analysis Division, see *IRS Starts International Compliance Analysis Division*, 7 INT'L ENFORCEMENT LAW REP. 357 (Sept. 1991).

4. The Caribbean Basin Initiative [CBI], Pub. L. No. 98-67, 97 Stat. 384 (1983) (codified at 19 U.S.C. §§ 2701 *et seq.*); for a discussion of the tax information exchange provisions, see Zagaris, *The Caribbean Basin Initiative*, 28 TAX NOTES 102 (1985).

5. For a recent discussion of the TIEA program, see Zagaris, *Selected Developments of New Tax Information Exchange Agreements and Their Relatives*, 1 9TH ANNUAL INT'L TAX CONF. 1.1-69 (Florida Bar CLE Comm., Jan. 17–18, 1991).

been the Council of Europe and the Organization of Economic Cooperation and Development Convention on Mutual Administrative Assistance in Tax Matters, a multilateral convention that provides new forms of administrative assistance with respect to income, capital (wealth), social security, and other taxes.[6] Administrative assistance will include exchanges of information, simultaneous tax examinations, assistance in collection, and service of documents. It should eventually result in standardized procedures for information exchanges and enhanced worldwide cooperation in tax matters.

In spite of the increased resources towards international tax compliance, the IRS has not achieved a successful record of litigating intercompany pricing methods. One potential move is to criminalize some cases and raise the stakes for taxpayers who lose or want to fight audits vigorously.

Another method for the IRS to achieve greater compliance is to apply new mechanisms of information gathering, such as the use of the John Doe summons, whereby the IRS issues a summons on a U.S. bank, requesting all records for a period of years for certain types of transactions (for example, over a threshold of $10,000) with so-called tax haven jurisdictions. Such a mechanism has been utilized and is now under litigation. The result could have far-reaching implications.[7]

The international compliance efforts of the United States have been emulated in countries such as Mexico, Argentina, and Korea. For instance, on May 15, 1990, the Mexican Ministry of Finance announced that it would enforce its law taxing earnings abroad of Mexican taxpayers.[8] In addition, on December 28, 1989, the Mexican Government enacted as part of its federal tax code article 115b, which criminalizes money laundering.[9] The Mexican Government also recently has enacted laws on asset forfeiture. To strengthen its ability to enforce these laws, the Mexican Government has sent its officials to take the financial investigative courses run by the IRS. Informally, U.S. officials have reported that the Mexican Government is making use of the TIEA with the United States.

II. Interaction of International Trade and Tax Law

One phenomenon that has significantly impacted international tax practice has been the developments in international trade and tax law.

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6. Convention on Mutual Administrative Assistance in Tax Matters, *opened for signature* Jan. 25, 1988, 27 I.L.M. 1160 (1988), *reprinted in* 5 R. RHOADES & M. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTION ch. 55 (1989).

7. For a discussion of the case, see Zagaris, *Former Assistant Attorney General Upholds John Doe IRS Summons Pertaining to All Transactions for 2 Years with 5 Tax Havens*, 7 INT'L ENFORCEMENT LAW REP. 223 (June 1991); Zagaris, *U.K. Government Intervenes on Behalf of Hong Kong in the John Does Case*, 7 INT'L ENFORCEMENT LAW REP. 329 (Aug. 1991).

8. For additional discussion of the Mexican Regulation, see Zagaris, *Mexican Finance Regulation on Expatriate Compliance*, 6 INT'L ENFORCEMENT LAW REP. 222 (June 1990).

9. For a discussion of the new law, see Zagaris, *Mexican Government Criminalizes Money Laundering*, 6 INT'L ENFORCEMENT LAW REP. 220 (June 1990).

The importance of international trade to international tax was demonstrated in the early 1980s when a GATT panel ruled that the domestic international sales companies (DISCs) were contrary to GATT.[10] As a result the United States enacted the foreign sales corporation law. To benefit from the tax deferral, the U.S. corporation must have a subsidiary outside the United States.[11]

Economic integration demonstrates how trade has increasingly determined the course of international tax developments. An example is the European Community.[12] Until 1990, much of the progress on harmonization or approximation of tax rules within the European Community (EC) occurred in indirect taxation. Progress has also occurred in the area of excise duties on tobacco products, alcoholic beverages, and mineral oils and fats. Capital duties have been harmonized within narrow bands that have constantly moved downwards. The rates are now between zero and 1 percent.

1990 was an important year, with progress occurring in direct corporate taxation. On July 23, the ECOFIN Council passed a package of three corporate tax directives. The Parent-Subsidiary Tax Directive will exempt dividends from EC-based subsidiaries owned 25 percent or more by an EC Member State company from withholding tax, as well as from 95 or 100 percent of the corporate tax otherwise due in the hands of that corporate shareholder, unless the recipient is instead accorded a tax credit in its home country for underlying mainstream taxes.

The main principles for a convention that would provide for the mandatory resolution of transfer pricing disputes between EC Member States have been reached.

The Mergers (Taxation) Directive will permit a deferral of taxation on the cross-border transfer of assets occurring as a part of a qualified merger, division (split-up), or contribution of a branch of activities. The three directives have motivated the introduction of tax bills in this session of Congress to enable U.S. corporations for purposes of Subpart F of the Code (the antideferral tax provisions) to treat the EC as one country. This proposal is designed to help U.S. corporations compete.

So important are the EC directives that jurisdictions such as the Netherlands Antilles are claiming that the Treaty of Rome allows the Antilles to qualify for

10. For a discussion of the GATT decision and the threatened retaliation by U.S. trading partners unless the United States complied with the decision of the GATT panel, see Zagaris & Papavizas, *Senate takes tentative step toward DISC replacement*, 52 TAXES INT'L 3 (Feb. 1984); *The DISC/GATT dispute*, 25 TAXES INT'L 1, 2–12, 46 (Nov. 1981); *The GATT Council adopts the DISC panel report*, 26 TAXES INT'L 46 (Dec. 1981); *Canada plans to launch the next round of the DISC/GATT dispute on 28 April 1982 and the U.S. view of the GATT council decision on DISC*, 29 TAXES INT'L 46–47 (Mar. 1982).

11. I.R.C. §§ 921 *et seq.*

12. For additional background, see Liebman, *Recent Developments in European Corporate Taxation*, 18 TAX PLANNING INT'L REV. 36 (Feb. 1991); Liebman & Patton, *Finance Ministers Adopt Three Corporate Tax Measures*, 17 TAX PLANNING INT'L REV. 28 (Aug. 1990).

the directives. Meanwhile, current and prospective EC directives will impact on a wide range of territories that have international financial sectors, including Gibraltar, Malta, Madeira, Jersey, Guernsey, Liechtenstein, the Caribbean dependencies (the Cayman Islands, Anguilla, Monserrat, Turks & Caicos, and the British Virgin Islands), and the other Dutch Antilles (Aruba and St. Maarten).

An example of the importance of the power of the EC is the challenge within the EC to the U.S.-German income tax treaty. In particular, the contention is that the limitation of benefits provisions, whereby the treaty tries to limit the persons allowed to benefit from the treaty so as to prevent treaty abuse, are contrary to the Treaty of Rome.[13] The resolution may have an important impact on the future of U.S. tax treaty policy with EC countries.

The Enterprise for Americas Initiative has led to new positive policies in taxation. On the one hand, many countries are liberalizing their taxation of foreign investment. On the other hand, countries that have had a long-standing policy against tax treaties have been actively negotiating treaties. Mexico has concluded treaties with Canada, France, and the Netherlands. It needs only one more round with the United States before reaching agreement. Already it has a tax attaché in the United States. Similarly, Venezuela has begun negotiating tax treaties. Brazil and the United States are seriously negotiating a tax treaty.

The Lomé IV Convention,[14] a trade, financing, and technical assistance convention between the 12 EC members and 68 countries in Africa, the Caribbean, and the Pacific (ACP countries), contains specific technical and financial assistance provisions to support the effort to develop services sectors in the ACP countries.

Within the Caribbean Common Market and Community, the Secretariat and the Caribbean Law Institute are beginning to reevaluate the tax treaties that were adopted at the initiation of the integration effort, but have become antiquated.

III. Public International Law

In the interaction of international tax law with both enforcement/criminal law and international trade law, public international law has and will play an increasingly important role. Diplomats and lawyers are having to become more creative and find ways to resolve disputes between governments. In this connection the U.S. Government has shown an interest in arbitration. Threats to utilize the International Court of Justice or to retaliate against treaty overrides by the United

13. For a discussion of the controversy on art. 28 of the new German-U.S. Tax Treaty, see Becker & Thömmes, *Treaty Shopping and EC Law—Critical Notes to Article 28 of the New German-U.S. Double Taxation Convention*, BULL. FOR INT'L FISCAL DOCUMENTATION 173 (June 1991).

14. For a discussion of the provisions of the Lomé IV Convention to international financial sectors, see Zagaris, *Application of the Lomé IV Convention to Services and the Potential Opportunities for the Barbados International Financial Sector*, 45 BULL. FOR INT'L FISCAL DOCUMENTATION 289–302 (June 1991).

States are becoming commonplace. Creative solutions to strengthen intergovernmental cooperation in tax matters, such as simultaneous audits and coordinated intercompany advance pricing agreements, are becoming common. Tax lawyers and policymakers are and will need increasingly to identify and apply public international law to international tax issues.