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Exchange of Information: A Train Smash waiting to happen?

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On 11 February 2015 a US District Court found that the US Internal Revenue Service disclosed false tax return information to the Japanese National Tax Administration contrary to the Japan-US tax treaty in *Aloe Vera of America Incorporated, et al. v. United States of America* (Case No. CV-99-01794-PHX-JAT). The IRS had supplied information showing a significant shortfall in the taxpayer's reported income although they had no basis for this. Both competent authorities ultimately agreed that there was no unreported income but the matter appeared in the Japanese media. Nominal statutory damages were awarded against the IRS but the taxpayer failed to prove further damage that would warrant a more extensive award.

In the 21st Century, international transparency has become the mantra of tax administration. The explosion of legal instruments aimed at securing information from foreign sources, such as TIEAs, the OECD multilateral mutual assistance convention, FATCA and FATCA type of arrangements as well as considerable investment in administrative activity demonstrate that this has become one of the major preoccupations of tax administrators and lawmakers.

Why is this the case? Increased mobility of persons and capital is certainly a contributing factor. These have made cross-border situations commonplace. However, underlying this is the fact that taxes on income, profits and capital gains by their nature, require vast amounts of data in order to be administered. The amount of data needed has increased as these taxes have become more complex. These taxes are also inherently difficult to administer. This combination of increased international activity and taxes that are dependent on information for effective compliance, means that the need for foreign-based information will not go away.

Some 85 states (including the dependent territories to which it has been extended) have signed the OECD Mutual Assistance Convention, and some 61 have proposed to participate in the mutual agreement on automatic exchange of information made pursuant to that convention. This is in addition to enhanced exchange of information provided in article 26 of bilateral treaties patterned on the OECD Model. Even territories that do not themselves impose taxes on income have been pressured into concluding tax information exchange agreements with territories who do impose such taxes in order to supply an information to them.

Implicit in this emerging institutional framework for cross-border supply of information is the legal notion of equality of states. All states have the same character in international law. Other than ensuring that states have the internal legal framework to supply information undertaken through the Global Forum on Transparency and Exchange of Information Peer Reviews, notions of

sovereignty dictate that states do not interfere in the domestic affairs or internal law is of others, including respect for the rule of law, institutional framework or administrative probity.

Thus, subject to the limited safeguards in treaties, information exchange takes place within the framework of the legal notions of the equality of states and of their sovereignty, ignoring the real political, economic and legal inequality that exists. At one end of the scale, tax administration may be highly politicised as illustrated by *Yukos Universal Limited (Isle of Man) v The Russian Federation* (PCA Case No. AA 227, Final Award 18 July 2014). Where, the Permanent Court of Arbitration found that the treatment of Yukos by Russian tax authorities showed "the primary objective of the Russian Federation was not to collect taxes but rather to bankrupt Yukos and appropriate its valuable assets" (Decision para 756).

The OECD Global Forum on Transparency and Exchange of Information Peer Reviews, Phase 2 Review (as of October 2014) rates Russia as "largely compliant" in respect of rights and safeguards. What is the obligation of a competent authority in a state with a treaty in line with global exchange of information standards in such circumstances? Legal costs in the Yukos case were around US$80 million (Decision para 1887). How are ordinary citizens to give effect to their rights?

Even in states with substantial adherence to the rule of law and highly professional tax administrations, breaches of duty relating to confidential information by tax administrations can occur (See for example, in the United Kingdom in November 2007 HM Revenue and Customs lost computer disks containing confidential details of 25 million child benefit recipients.)

The task of competent authorities charged with assessing the appropriateness of an exchange of information in the context of widely ranging domestic standards is immense. Where the exchange is automatic, then there is no opportunity to make such an assessment in advance of the exchange. The impact of such information in the receiving state falls on both compliant and non-compliant taxpayers. This is illustrated by UK investigations into Swiss bank accounts as a result of the receipt of stolen data. HMRC report that of 3,600 cases, 2000 accounts were found to be held by compliant taxpayers, although these continue to be monitored. (HMRC press release, 14 February 2015). There is no indication of the extent to which compliant taxpayers were compelled to demonstrate their compliance or the cost they may have incurred in doing so. There are few other areas of public law where the cost of innocence is born in this way.

Clearly, exchange of information between tax administrations is necessary in order to an administer tax systems, particularly taxes on income. As the global economy becomes more integrated, collaboration among tax administrations is essential. This should not, however, mean that the protection of individual rights should become of secondary importance. Nor does it mean that individuals should bear the consequences and costs of unresolved rough edges in the emerging system. At the same time, global standards for the protection of these rights should be developed and implemented. Administrators may be well equipped to undertake peer reviews of information gathering and exchange mechanisms, they are poorly equipped, and by reason of their role, poorly positioned to undertake peer reviews of rights and safeguards. This should be left to independent parties. NGOs such as Transparency International and governmental bodies such as human rights commissions may be better placed in this respect.

Although the trend in the first part of this Century has been to sign up as many countries as possible to the global standard in exchange of information, perhaps the time has come to limit

participation in it to states with a high adherence to the rule of law and strict governance standards. Peer reviews would be necessary to ensure continued participation. This would create the necessary incentive to create the conditions of human existence that both tax systems and the rule of law should aim for.

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