"EXTRATERRITORIAL ENFORCEMENT OF TAX LAWS"

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1- ABSTRACT

Extraterritorial enforcement of tax laws refers to the attempt of states to collect revenue beyond their territories. It is a source of international tension since according to accepted international tax principles jurisdiction to enforce taxes cannot extend further than sovereignty. Against this background, cooperation is crucial at the enforcement level since it reduces international tension over the use of extraterritorial jurisdiction and States rely heavily on foreign enforcement agencies to investigate and prosecute.

Increasing cross-border trade and investment and fast technological changes reduced the ability of national governments to effectively enforce their tax laws. This is a major concern as Governments face obstacles to collect taxes on cross-border transactions and this raises several concerns: 1) Loss of tax revenue; 2) Lack of enforcement jurisdiction discriminates against domestic companies vis-à-vis non-resident companies; 3) Governments tend to impose taxation on less mobile factors such as labor and property, with repercussion for democratic wealth redistribution efforts; 4) compliance costs raises the cost of doing business and make companies reluctant to expand their business into foreign markets.[1]

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[1] A. Cockfield, Jurisdiction to Tax: A Law and Technology Perspective", 38 Georgia Law Review, pp. 85-118 (2003), at 89

2 – SOVEREIGNTY AND FISCAL JURISDICTION

2.1. Public international law

The ability of a State to enforce its laws beyond its territory is, in its essence, a question of public international law. In *Burnet v. Brooks*[2], the US Supreme Court stated: "*We determine national power in relation to other countries and their subjects by applying the principles of jurisdiction recognized in international relations*".

International law does not recognize States any sort of extraterritorial jurisdiction to enforce tax laws. Several theories have been put forward to explain the basis of the jurisdiction to tax, but today it is commonly accepted that jurisdiction to tax is a manifestation of sovereignty.[3] One of the principles which is a corollary of the independence and sovereignty of States is the duty to refrain from intervening in the internal or external affairs of other States – the so called "principle of non-intervention in the reserved domain of domestic jurisdiction".[4] In international tax matters, this principle is known as "revenue rule". In general terms, it is a common law doctrine that allows domestic courts to decline enforcing foreign tax judgments or foreign revenue laws.[5]

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[2] 288 US 3387.
[3] R.J. Jeffery, "The Impact of State Sovereignty on Global Trade and International Taxation" (The Hague, Kluwer Law International, 1999), at 26.
[4] R.J. Jeffery, "The Impact of State Sovereignty on Global Trade and International Taxation" (The Hague, Kluwer Law International, 1999), at 37.
[5] The earliest reported case referencing the revenue rule was decided in 1729: *Attorney General v. Lutwydge.*

Against this background, cooperation between States is essential to ensure no objection to the extraterritorial enforcement of tax law. This cooperation can take different forms: from international treaties to non-binding instruments (soft law). These have proved to be important to develop greater consistency in both policy and regulatory approaches.

2.2. Jurisdiction to tax

Hellerstein distinguishes between jurisdiction to tax (or "substantive jurisdiction") and jurisdiction to compel the collection of tax (or enforcement jurisdiction).[6] The latter refers to the "*power of a State to compel collection of the tax over which it has "substantive" tax jurisdiction*".[7] As a result, jurisdiction to enforce presupposes substantive jurisdiction to tax income on the basis of either residence or source.

Under customary international law, direct assertions of jurisdiction must be justified according to one internationally recognized basis of jurisdiction. One of the most commonly referred in territoriality – each state has jurisdiction over actors and activities taking place within its territory. The majority of countries in the world taxes domestic source income, regardless of whether it is derived by residents or non-residents. One variant of the principle of territorially is the "effects doctrine", under which States have jurisdiction over foreign actors and conduct on the basis of "effects" (usually, economic effects) produced within their territorial boundaries, provided that those effects are substantial and a direct effect of a foreign conduct.

[6] W. Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective, Georgia Law Review*, Vol 38, No. 1 (2003), pp. 1-70.
[7] W. Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective, Georgia Law Review*, Vol 38, No. 1 (2003), pp. 1-70, at 3.

Another base of jurisdiction is nationality – states may exercise jurisdiction over their own nationals, wherever they are in the world.

The main limit on enforcement jurisdiction is practicality. In the absence of an effective enforcement mechanism in practice may determine that the tax collection is administratively or economically impractical. Generally, if the state has personal jurisdiction on the basis of residence over the earner, there is not problem in collecting taxes. In this case, it is likely that the State has sufficient legal relationship with the taxpayer or the latter has assets in the state´s territory which makes the risk of a default payment a serious disincentive to ignoring a tax obligation. This risk is also real for non-residents with a permanent establishment whose substantive tax obligation is based on the source principle.

Non-residents with no assets constitute the real problem to enforce taxes. One of the main questions is whether a State has the power to enforce the collection of tax on income earned by a nonresident from domestic sources. In this case, the State has substantive jurisdiction to tax on basis of source but does not have personal jurisdiction over the earner of the income. Generally, States impose withholding taxes at source, at least when direct enforcement of the substantive tax obligation may be problematic (e.g. passive investments).

2.3. Mismatch between substantive jurisdiction and enforcement jurisdiction

Hellerstein identifies as one of the main issues related to the jurisdiction to tax the need to align enforcement jurisdiction with substantive jurisdiction.[8] The difference in principles governing substantive ad enforcement jurisdiction make the harmonization more difficult. Also, other events (such as the electronic commerce) accentuate the misalignment between source of income and physical presence. Another explanation might be the understanding of the source principle that is not connected with the geographic localization of identifiable physical activities.

Some States my see this mismatch as an argument to adopt a residence-base rule of substantive jurisdiction (instead of a source-based rule). However, this would contravene the established principles of international tax according to which the source jurisdiction has the primary right to tax business profits. Also, the shift to a residence-based rule raises questions of international tax equity because it favors capital exporting countries. At an international level, progress toward realigning enforcement jurisdiction with substantive jurisdiction is more likely, as international organizations will try to accommodate diverse interest and reach practical compromises

A different approach is to promote mutual assistance between States and allow extraterritorial enforcement of tax laws. This seems to be the solution adopted internationally to solve the gap between substantive jurisdiction and enforcement jurisdiction.

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[8] W. Hellerstein, Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective, Georgia Law Review, Vol 38, No. 1 (2003), pp. 1-70, at 37.

3 - INSTRUMENTS ON ASSISTANCE IN TAX COLLECTION

3.1. Bilateral conventions

As mentioned above, under the principle of international tax law known as "revenue rule", countries do not assist other countries in the enforcement of tax claims. In the absence of a tax treaty, tax authorities are not allowed to collect taxes in foreign countries´ territory. For this reason, and considering the increasing possibilities of tax avoidance and tax evasion, States are increasingly willing to enter into conventional instruments allowing cooperation in tax collection.

Today it is commonly accepted that one of the main purposes of tax treaties is to allow tax authorities to collect taxes beyond the boundaries of their country with the assistance of other country. In the past decades, the expansion of conventional instruments allowing assistance in the collection of taxes revels that the traditional attitude toward tax recovery has changed and a new co-operative environment in this field has emerged.

The articles providing for assistance in the collection of taxes in tax treaties should be consistent with those related to exchange of information so that the tax authorities can freely communicate information with respect to the taxes to be collected. [9]

[9] Commentary on Article 27 concerning the assistance in the collection of taxes of the 2010 OEDC Model Tax Convention on Income and on Capital, para 13.

Article 27 on assistance in the collection of taxes was added to the OECD Model Tax Convention in 2003. It enables contracting states to negotiate whether and to what extend assistance should be given in the collection of taxes.[10] Contracting states may agree to a comprehensive or a limited type of collection (for instance, assistance only in cases where the benefits of the convention are claimed by persons not entitled to them).[11] The contracting states have discretion decide the following aspects:

- *Personal scope*: The contracting states define if the assistance must be provided with respect to a revenue claim owned by any person (whether or not a resident of the contracting states), or if the assistance is limited to taxes owed by resident of either contracting states.[12]

- *Taxes covered*: This mechanism may be used to assist in the collection of all kinds of taxes imposed by the contracting states or it may be limited to the taxes that are covered by the convention.[13] It also covers interest, administrative penalties and costs of collection or conservancy related to those taxes.[14]

- *Requirements*: The request for assistance in collection can only be made when the requesting state has the right, under its internal law, to collect the revenue

[10] Commentary on Article 27 concerning the assistance in the collection of taxes of the 2010 OEDC Model Tax Convention on Income and on Capital, para 1.
[11] Commentary on Article 27 concerning the assistance in the collection of taxes of the 2010 OEDC Model Tax Convention on Income and on Capital, para 2.
[12] Commentary on Article 27 concerning the assistance in the collection of taxes of the 2010 OEDC Model Tax Convention on Income and on Capital, para 4.
[13] Commentary on Article 27 concerning the assistance in the collection of taxes of the 2010 OEDC Model Tax Convention on Income and on Capital, para 10-12.
[14] Article 27(2) of the 2010 OEDC Model Tax Convention on Income and on Capital.

claim and the taxpayer has no right to prevent such collection.[15] According to article 27(3), the requested state has to collect the revenue claim "*in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes*".[16] Regarding this requirement, the Commentary makes clear that the contracting states may agree that the requested state is obliged to collect the revenue claim regardless of the provisions of its internal law applicable the collection of its own taxes.[17]

- *Measures of conservancy*: The contracting states may agree that the requested state must act in accordance with the provisions of its laws even if, at the time when such measures are applied, the revenue claim is not enforceable in the requesting state or the taxpayer has a right to prevent its collection.[18]

- *Time-limits*: In general, only the time-limits established in the requesting state for the enforcement of a claim are relevant. It is for the contracting states to decide whether the time-limits contained in the requested state´s internal law constitute an obstacle to the collection of revenue claims. [19]

- *Legal or administrative proceedings*: Considering their constitutional and legal background, the contracting states decide whether the requested state´s courts and administrative bodies should have jurisdiction to decide on the

[15] Article 27 (3) of the 2010 OEDC Model Tax Convention on Income and on Capital.
[16] Article 27 (3) of the 2010 OEDC Model Tax Convention on Income and on Capital.
[17] Commentary on Article 27 concerning the assistance in the collection of taxes of the 2010 OEDC Model Tax Convention on Income and on Capital, para 16.
[18] Article 27 (4) of the 2010 OEDC Model Tax Convention on Income and on Capital.
[19] Commentary on Article 27 concerning the assistance in the collection of taxes of the 2010 OEDC Model Tax Convention on Income and on Capital, para 23-24.

existence, validity or the amount of a tax revenue claim of the requesting state.[20]

- *Limits to the requested state´s obligations*: The states may agree on different limitations to their obligation to provide assistance in the collection of taxes. The 2010 OEDC Model Tax Convention and the Commentary refer that the request state may not be required: (a) to go beyond its own internal law and administrative practice to fulfil its obligations under the article; (b) to carry out measures which would be contrary to the public policy; (c) to provide assistance when the requesting state did not apply all reasonable measures available under its internal law to collect taxes; (d) to provide assistance when it is not practical to do so (e.g., the costs of collecting a revenue claim would exceed the amount of the claim); (e) to provide assistance when it considers that the taxes at stake are contrary to the generally accepted taxation principles.[21]

On 26th January 2007, the OECD Committee on Fiscal Affairs approved a document under the title "Manual on the Implementation of Assistance in Tax Collection" to help tax administrations dealing with the operation of assistance in tax collection provisions and to provide technical and practical guidance to improve the efficiency of such assistance.

[20] Commentary on Article 27 concerning the assistance in the collection of taxes of the 2010 OEDC Model Tax Convention on Income and on Capital, para 28.

[21] Article 27 (8) of the 2010 OEDC Model Tax Convention on Income and on Capital and Commentary on Article 27 concerning the assistance in the collection of taxes of the 2010 OEDC Model Tax Convention on Income and on Capital, para 30-37.

3.2. Multilateral conventions:

The Convention on Mutual Administrative Assistance in Tax Matters entered into force on 1st April of 1995 and it is currently in force in seventeen states: Azerbaijan (2004), Belgium (2000), Denmark (1995), Finland (1995), France (2005), Georgia (2011), Iceland (1996), Italy (2006), Netherlands (1997), Norway (1995), Poland (1997), Slovenia (2011), Spain (2010), Sweden (1995), Ukraine (2009), United Kingdom (2008) and United States (1995).

It is the most comprehensive multilateral instrument available for tax co-operation between states with the purpose of combating tax avoidance and tax evasion. Until the 1st June 2011, it was only open for signature by the member States of the Council of Europe and the Member countries of OECD. After that date, it is open to all countries allowing them to benefit from cross border tax co-operation and information sharing.

This convention includes provisions on administrative assistance in direct tax matters[22], including exchange of information, assistance in recovery, and service of documents[23].

Regarding the recovery of tax claims, the convention's scope is significant:

[22] Article 1(1) of the Convention on Mutual Administrative Assistance in Tax Matters (1988).
[23] Article 1(2) of the Convention on Mutual Administrative Assistance in Tax Matters (1988).

- *Personal scope*: Assistance must be provided whether the person affected is a resident or national of a state or of any other state.[24]

- *Taxes covered*: This mechanism may be used to assist in the collection of taxes on income, capital gains, net wealth; compulsory social security contributions; estate, inheritance and gift taxes; taxes on immovable property; general consumption taxes, such as VAT; and any other taxes, except customs duties.[25]

Several other aspects distinguish this multilateral instrument from article 27 of the OEDC Model Tax Convention on Income and on Capital. One of them is the time-limit beyond which a tax claim cannot be enforced. According to article 14 (1), "*the requested State is not obliged to comply with a request for assistance which is submitted after a period of 15 years from the date of the original instrument permitting enforcement*".[26]

The Nordic Mutual Assistance Convention on Mutual Administrative Assistance in Tax Matters (1989) is another multilateral convention by which the contracting states undertake to provide administrative assistance to each other in tax matters. The contracting states to this convention are: Denmark, Finland, Iceland, Norway and Sweden.

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[24] Article 1(3) of the Convention on Mutual Administrative Assistance in Tax Matters (1988).
[25] Article 2 of the Convention on Mutual Administrative Assistance in Tax Matters (1988).
[26] Article 14(1) of the Convention on Mutual Administrative Assistance in Tax Matters (1988).

3.3. Tax Collection Directive[27]

The purpose of "Tax Collection Directive" is to ensure the recovery in each Member State of tax claims arising in another Member State (article 1). The directive is applicable to claims relating to taxes on income and capital (article 2 (g)). Under this directive, the tax authorities of one Member State (requested authorities) shall provide any information which is foreseeably relevant to the tax authorities of another Member State (applicant authority) in the recovery of its claim. (article 5/1) Under article 6, Member States can exchange information without prior request when they refund taxes to taxpayers resident in other Member State. At the request of the applicant authority, the requested authority shall (i) notify the taxpayers of the relevant documents (including court decisions) emanating from the applicant Member (article 8/1) and (ii) recover the claims covered by an instrument permitting their enforcement in the applicant Member State (article 10/1). If the applicant authority and the requested authority agree, officials authorised by the applicant authority may be present during administrative enquiries carried out in the territory of the requested Member State and assist the competent officials of the requested Member State during court proceedings in that Member State (article 7/1).

[27] Council Directive 2008/55/EC, of 26 May 2008, on mutual assistance for the recovery of claims relating to certain levies, duties, taxes and other measures was repealed by the Council Directive 2010/24/EU, of 16 March 2010, concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures. This directive entered into force in 20 April 2010 and has to be transposed by the Member States by 31 December 2011. For practical reasons, this article refers to the Council Directive 2010/24/EU, of 16 March 2010.

4. CONCLUSION

The growing international movement of persons, capital, goods and services increased the possibilities of international tax avoidance and tax evasion. The awareness of this phenomenon led sovereign states to adopt bilateral and multilateral instruments to promote international cooperation in tax administration matters, including assistance in tax collection.

The need to protect tax revenues against tax avoidance and tax evasion is forcing states to change their traditional attitude towards assistance in tax collection. In view of the revenue rule, the cooperation between tax administrations has to be based on a international agreement providing for such cooperation.