

# Antiabuse Rules and Policy: Coherence or Tower of Babel?

by Philip R. West

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# SPECIAL REPORTS

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## Antiabuse Rules and Policy: Coherence or Tower of Babel?

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And they said: "Come, let us build us a city, and a tower, with its top in heaven, and let us make us a name; lest we be scattered abroad upon the face of the whole earth." And God came down to see the city and the tower, which the children of men built. And God said: "Behold, they are one people, and they have all one language; and this is what they begin to do; and now nothing which they propose to do will be unattainable for them. Come, let us go down, and there confound their language, that they may not understand one another's speech." So God scattered them abroad from thence upon the face of all the earth; and they left off to build the city. Therefore was the name of it called Babel; because God did there confound the language of all the earth; and from thence did God scatter them abroad upon the face of all the earth.<sup>1</sup>

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<sup>1</sup>Genesis 11: 4-9.

### I. Introduction

There has been no shortage of recent work on international tax antiabuse rules,<sup>2</sup> and a learned scholar has

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<sup>2</sup>These articles have addressed economic substance in the international context (*see, e.g.*, James M. Peaslee, "Creditable Foreign Taxes and the Economic Substance Profit Test," *Tax Notes Int'l*, Feb. 12, 2007, p. 595, *Doc 2007-32, 2007 WTD 38-12*; David P. Hariton, "The *Compaq* Case, Notice 98-5 and Tax Shelters: The Theory Is All Wrong," *Tax Notes*, Jan. 28, 2002, p. 501, *Doc 2002-2090, 2002 TNT 19-30*); the application of section 269 in the international context (Peter M. Daub, "Section 269(a) Across the Border: An Appraisal," 159 *Journal of Int'l Taxation* 22 (Sept. 2004)); Daniel M. Berman and John L. Hynes, "Limitation on Benefits Clauses in U.S. Income Tax Treaties," 29 *Tax Mgmt Int'l J.* 692 (2000)); international tax arbitration (Gregory May, "Getting Realistic About International Tax Arbitrage," 85 *Taxes* 37 (Mar. 2007); Daniel N. Shaviro, "Money on the Table?: Responding to Cross-Border Tax Arbitrage," 3 *Chi. J. Int'l L.* 317 (2002); H. David Rosenbloom, "International Tax Arbitrage and the International Tax System, David R. Tillinghast Lecture on International Taxation," 53 *Tax Law Rev.* 137 (2000)); and U.S.

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recently published a book on whether a coherent international tax regime exists.<sup>3</sup> Faced with this impressive precedent, a more cautious observer might think twice before writing on whether there is a coherent international antiabuse tax regime applicable internationally.<sup>4</sup> But because several countries have recently imported or proposed to import our least taxpayer-friendly product, U.S. antiabuse tax policy, it might be worth revisiting the subject, reviewing selected foreign and domestic developments, and asking whether we can connect any dots and observe any trends.<sup>5</sup> If we can, the hard part will then be to distill meaning from the trends and make predictions about the future. That is, admittedly, an ambitious goal, but even if we fall short, my working hypothesis (if you will excuse the inside joke) is that the exploration will have been worth the effort, barring divine wrath of the sort described above.

## II. Discussion

This discussion section, the main portion of this report, consists of a (mostly) objective exposition of developments followed by a brief subjective analysis. The section on developments, immediately below, considers unilateral U.S. developments first and other developments second. The U.S. developments include recent legislation enacted or proposed to deal with perceived aggressive tax planning, as well as recently decided cases involving tax-driven structures.<sup>6</sup> The foreign

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and U.K. tax shelter rules (Alan Granwell and Sarah McGonigle, "U.S. Tax Shelters: A U.K. Reprise?" [2006] *BTR* No. 2, pp. 170-208). Many other articles have, of course, addressed international tax enforcement policy and antiabuse rules more generally. See, e.g., Diane M. Ring, "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage," 44 *B.C. L. Rev.* 79 (2002-2003); and Joseph Bankman, "The Economic Substance Doctrine," 74 *S. Cal. L. Rev.* 5 (2000-2001).

<sup>3</sup>Reuven Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (2007).

<sup>4</sup>And a more hardened observer might question the importance of the inquiry in the first place, or at least the possibility of an answer. See, e.g., Daniel N. Shaviro, "Money on the Table: Responding to Cross-Border Tax Arbitrage," 3 *Chi. J. Int'l L.* 317 (2002) (observing, regarding the relative merits of tax competition versus tax harmonization, "one might as well ask whether government is good or bad").

<sup>5</sup>A brief recent attempt to do so solely with respect to administrative and enforcement developments can be found at Ernst & Young, "Tax Administration Goes Global: Complexity, Risks, Opportunities," available at [http://www.ey.com/global/content.nsf/International/Tax\\_-\\_Tax\\_Administration\\_Goes\\_Global](http://www.ey.com/global/content.nsf/International/Tax_-_Tax_Administration_Goes_Global).

<sup>6</sup>The selection of developments for this and the other sections was obviously subjective; some developments were included that different observers might well have omitted, and others, such as Financial Accounting Standards Board Interpretation No. 48, *Textron v. United States*, 507 F. Supp.2d 138, *Doc 2007-20046*, 2007

developments include recent legislation enacted or proposed in the U.K. and Germany to deal with perceived aggressive tax planning, as well as recently decided Canadian and French cases involving tax-driven structures. The foreign developments reviewed also include some bilateral and multilateral developments, most notably the so-called intermediaries project under the auspices of the OECD.

### A. Developments

#### 1. U.S. Developments

##### a. Current law

##### i. Tax shelter registration/disclosure rules

(a) **In general.** Long in gestation and repeatedly amended, rules relating to the disclosure and registration of transactions perceived by the IRS as being over-aggressive or potentially so were finalized by Treasury and the IRS on July 31 of last year.<sup>7</sup> In brief, the rules require participants in reportable transactions to file a form containing details of the transaction with their tax returns and with the Office of Tax Shelter Analysis. Reportable transactions include listed transactions, some transactions entered into under conditions of confidentiality, some transactions involving fees that are refundable or contingent, some transactions involving significant losses, and some other transactions of interest to the government.<sup>8</sup> One knows transactions in the first and last categories because the IRS describes them in published guidance, although transactions must also be reported if they are substantially similar<sup>9</sup> to those transactions.<sup>10</sup>

The rules also require material advisers to report their involvement with a reportable transaction to the

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*TNT 169-1* (D.R.I. 2007), and other developments involving accounting standards and practices, EU harmonization, and U.S. criminal prosecutions for tax shelter promotion, were omitted even though different observers might have included them.

<sup>7</sup>See 72 *Fed. Reg.* 43146 (Aug. 3, 2007); 72 *Fed. Reg.* 43154 (Aug. 3, 2007); 72 *Fed. Reg.* 43157 (Aug. 3, 2007).

<sup>8</sup>Treasury and the IRS recently issued proposed regulations that would treat some patented transactions as a reportable transaction. See 72 *Fed. Reg.* 54615 (Sept. 26, 2007). The final regulations issued in August 2007 reduced the class of reportable transactions by removing transactions that had a significant book-tax difference and transactions involving brief asset holding periods during which the asset generates tax credits. See 72 *Fed. Reg.* 43146 (Aug. 3, 2007).

<sup>9</sup>The regulations define down the term "substantially similar" to mean just "similar." See reg. section 1.6011-4(c)(4); reg. section 1.6011-3(c)(5).

<sup>10</sup>Transactions of interest are simply transactions the IRS wants to know more about, and wants to treat as reportable transactions, but do not fall into any other reportable transaction category.

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IRS by the end of the month after the calendar quarter in which they become material advisers.<sup>11</sup> After reporting, the material adviser is given a reportable transaction number, which he must provide to every person for whom he acts as a material adviser. The number must be used in the reporting described in the previous paragraph.

The rules also require that each material adviser prepare and maintain a list of all persons for whom he has acted as a material adviser.<sup>12</sup> The list must include specified information regarding the identities of those persons and their participation in the reportable transaction, and it must include all written materials that are material to an understanding of the tax aspects of the transaction and that have been shown to any potential participant by the material adviser or any related party or agent.

**(b) Tax arbitrage.** From March 2000 until August 2001, in an earlier proposed version of the regulations discussed above, tax arbitrage was included as one of several “filters” that would have required transactions featuring arbitrage to be disclosed and reported to the IRS.<sup>13</sup> Although arbitrage has not reappeared in subsequent iterations of that regulation, a superficial look at recent U.S. developments might lead us to conclude that there is currently an emerging U.S. policy against cross-border arbitrage.

For example, on July 11, 2007, the IRS Large and Midsize Business Division issued an industry directive stating that cross-border hybrid instrument transactions have been designated as a “Tier I” compliance concern and a mandatory examination issue.<sup>14</sup> Similarly, in re-

cent proposed regulations addressing so-called foreign tax credit generator transactions, arbitrage is identified as one of the elements leading to a denial of foreign tax credits.<sup>15</sup> And despite the assurances of current and former government officials,<sup>16</sup> companies involved in audits of those transactions know that arbitrage is more than just a minor factor in the government’s evaluation of the deals.<sup>17</sup>

Three things appear clear, however, from the history of how arbitrage has been treated in U.S. tax law.<sup>18</sup> First, there have been few instances in which the government has taken the position that arbitrage is a relevant consideration weighing against the ability of a taxpayer to achieve the otherwise applicable tax consequences it seeks. Second, in the few instances in which it has taken that position, it has done so in published guidance, strongly supporting the commonly held view that there is no general common law or self-executing policy against arbitrage.<sup>19</sup> And third, in each such instance, either the rule has been very detailed regarding

<sup>15</sup>See 72 *Fed. Reg.* 15081 (Mar. 30, 2007) (the proposed regulations would deny foreign tax credits with respect to specific highly structured financing arrangements in which “the parties exploit differences between U.S. and foreign law in order to permit the U.S. taxpayer to claim a credit for the purported foreign tax payments while also allowing the foreign counterparty to claim a foreign tax benefit”). For an analysis of the transactions that were the subject of the regulations, see Yaron Reich, “International Arbitrage Transactions Involving Creditable Taxes,” 85 *Taxes* 53 (Mar. 2007).

<sup>16</sup>See statements made by Hal Hicks, Treasury’s then-international tax counsel, *Tax Notes Int’l*, Jan. 30, 2006, p. 326, *Doc 2006-1511*, 2006 *WTD* 17-1, and *BNA Daily Tax Report Supplement Tax Administration* (Jan. 17, 2006) ISSN 1522-8800.

<sup>17</sup>Some IRS personnel may have been encouraged in this view by then-IRS Commissioner Mark Everson’s comment to a large Tax Executives Institute audience on Oct. 23, 2006, that he is “concerned about tax arbitrage . . . about technical compliance with the rules but achieving results that are not intended. . . . For example, it is not intended that a company can do business in two countries that are not tax havens and pay tax in neither through the use of hybrid instruments.”

<sup>18</sup>For a broader discussion of the history of cross-border arbitrage, a proposed standard for evaluating whether it is objectionable, and a conclusion that most arbitrage is not objectionable, see West, “Foreign Law in U.S. International Taxation: The Search for Standards,” 3 *Fl. Tax Rev.* 147 (1996). See also articles on arbitrage cited at note 2 *supra*.

<sup>19</sup>The IRS has implicitly recognized this. See TAM 9748005, *Doc 97-32355*, 97 *TNT* 230-10 (in analyzing an inbound sale-and-leaseback transaction, “dual tax ownership will not be a concern in the United States when it is solely the result of differing U.S. and foreign legal standards of tax ownership being applied to the same facts because tax ownership is determined under U.S. legal standards without regard to the tax ownership treatment obtained under foreign law”). Even though it holds against the taxpayer in a double-dip case, *Coleman v. Commissioner*, 87 T.C. 178 (1986) is not to the contrary. In that case, Judge Tannenwald held that the taxpayer had not met the high standard of “strong proof” needed in the judicial circuit in which the taxpayer did

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<sup>11</sup>See reg. section 301.6111-3(e). The definition of material adviser is broad and includes any person who “provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction” and who derives at least \$250,000 in fees for the advice and/or the implementation of the transaction. Material aid, assistance, or advice is defined in the regulations, and the fee threshold is or may be reduced in the case of advice exclusively to natural persons, advice regarding a listed transaction, and advice regarding a transaction of interest. See reg. section 301.6111-3(b).

<sup>12</sup>See reg. section 301.6112-1.

<sup>13</sup>See, e.g., temp. reg. section 1.6011-4T(b)(3)(i)(F), T.D. 8877, 2001-1 C.B. 747, *Doc 2000-5714*, 2000 *WTD* 41-52 (Mar. 13, 2000), withdrawn and superseded by T.D. 8961, 2001-2 C.B. 144, *Doc 2001-20881*, 2001 *WTD* 166-18 (Aug. 27, 2001).

<sup>14</sup>A Tier I issue is an issue that the LMSB has identified as having high strategic importance, compared to other issues identified by LMSB. These issues involve a high level of compliance risk and are typically prevalent across industry lines. The identification of certain issues as Tier I issues is part of the LMSB industry issue focus (IIF) initiative. The IIF approach is designed to centralize the identification and resolution of technical tax issues and to focus enforcement efforts on those issues, such as Tier I issues, that are of high strategic importance to LMSB.

the specifics of the arbitrage that is the government's concern,<sup>20</sup> or the rule has been withdrawn.<sup>21</sup> As such, in the United States, although the revenue officials appear interested in arbitrage, there is no general policy against it, and rules addressing it have been few and far between.

**ii. New tax return preparer rules.** Last May amendments to the tax return preparer penalty rules of section 6694 were enacted.<sup>22</sup> The amendments extend the penalty rules to all federal tax returns, not just income tax returns, and increase the penalties for violations. Most significantly, however, the amendments

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business to disavow the form of a transaction. The transaction was a double-dip lease in which the transaction documents and the U.K. treated one party as the owner of the property, and the taxpayer asserted that another party was the owner. The case more concerns the taxpayer's failure to meet the standard necessary to disavow the form of its transaction than it does any principle regarding cross-border arbitrage.

That there are not more authorities in which arbitrage has been challenged by the IRS is perhaps a reflection of the extent to which it is embedded in U.S. tax law that foreign rules do not control domestic outcomes. As such, ordinarily it would be illogical to challenge a transaction on the basis that some other sovereign has a different view of it.

<sup>20</sup>See, e.g., prop. reg. section 1.901-2(e)(5) (Mar. 29, 2007); see also section 1503(d) and implementing regulations issued thereunder (concerning dual consolidated losses); section 894(c) and reg. section 1.894-1.

<sup>21</sup>See, e.g., prop. reg. section 1.6011-4T(b)(3)(i)(F), T.D. 8877, 2001-1 C.B. 747 (Mar. 13, 2000), *withdrawn and superseded by* T.D. 8961, 2001-2 C.B. 144 (Aug. 27, 2001). See also Notice 98-5, 1998-1 C.B. 334, *Doc 98-175, 97 TNI 248-16, withdrawn by* Notice 2004-19, *Doc 2004-3291, 2004 TNT 32-7*.

Treaties might be viewed as a special case because, by their terms, they are reciprocal contracts that may be viewed as being predicated on shared assumptions of the contracting parties and one of their fundamental purposes is to address inconsistencies between tax systems. In general, however, and as a constitutional matter in the United States, treaties cannot impose tax burdens; they can only relieve tax burdens. As such, the inconsistencies that treaties address are those that increase tax burdens, so they cannot be said broadly to be antiarbitrage tools. For example, in the recent U.K.-U.S. treaty, there are four provisions limiting treaty benefits when arbitrage planning reduces taxation not only below double taxation, but also below a single level of taxation. See article 18 (resolving issues created by the U.K.'s remittance system of taxation for cross-border pension contributions); article 1(8) (addressing items of income, profit, or gain derived through fiscally transparent entities); article 24 (eliminating double non-taxation of repurchase arrangements); and article 4 (addressing dual resident taxpayers).

<sup>22</sup>As enacted, the new standards are effective for returns prepared after May 25, 2007. In Notice 2007-54, *Doc 2007-13936, 2007 TNT 113-14*, the IRS provided transitional relief, responding to practitioner concerns that the provision effectively applied retroactively. The notice provides that tax preparers can generally rely on prior law for returns, amended returns, and refund claims due on or before Dec. 31, 2007. The IRS recently issued Notice 2008-11, *Doc 2007-28348, 2008 TNT 1-4*, to address some questions arising under Notice 2007-54.

raise the standards return preparers must meet to a level that is both too high and inconsistent with the standards the return filers themselves must meet.<sup>23</sup>

Until the recent amendments, the preparer statute and regulations, Circular 230,<sup>24</sup> the American Bar Association professional standards,<sup>25</sup> and the American Institute of Certified Public Accountants professional standards<sup>26</sup> all required that an adviser meet a "realistic possibility of success on the merits" standard for undisclosed return positions. Perhaps most significantly, that standard is the one applicable to taxpayers themselves for undisclosed return positions resulting in a substantial understatement of tax.<sup>27</sup> Now the penalty rules penalize return preparation advice unless it meets a "more likely than not" standard. And one does not need to sign a tax return to be a return preparer.<sup>28</sup>

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<sup>23</sup>For a concise critique of the current rules and discussion of their predecessors, see Brenner, "New Standard for Tax Return Positions Is Inappropriate," *Tax Notes*, Aug. 14, 2007, p. 559, *Doc 2007-16822, 2007 TNT 157-31*; New York State Bar Association Tax Section report on the definition of tax return preparer and other issues under code sections 6694, 6695, and 7701(a)(36), available at <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/Report1139.PDF>.

<sup>24</sup>Reg. section 10.34 (Cir. 230 section 10.34). Treasury and the IRS issued proposed regulations on Sept. 24, 2007, that would amend the tax return preparation standard in Circular 230 to be consistent with the statutory change made under section 6694.

<sup>25</sup>ABA Formal Opinion 85-352.

<sup>26</sup>AICPA Statements on Standards for Tax Services No. 1, Tax Return Positions.

<sup>27</sup>See reg. section 1.6662-4(d)(2) (requiring a taxpayer to have "substantial authority" for a return position to avoid the substantial understatement penalty under section 6662(d), and explicitly defining the substantial authority standard to be less stringent than the "more likely than not" standard but more stringent than the "reasonable basis" standard); reg. section 1.6694-2(b) (providing that the "realistic possibility" standard of old section 6694 was consistent with the "substantial authority" standard); see also reg. section 1.6662-3(b)(3) (providing that the negligence penalty of section 6662(c) is avoided if there is a "reasonable basis" for a return position).

<sup>28</sup>A return preparer can include one who merely gives advice on a specific issue of law, as long as the advice is given with respect to events that have occurred at the time the advice is rendered and not with respect to the consequences of contemplated actions; the advice is directly relevant to the determination of the existence, characterization, or amount of and entry on a return or a claim for refund; and the preparer's advice constitutes the "preparation" of all or a substantial portion of the return. See reg. section 301.7701-15(a)(2). Moreover, even if advice is provided by one who is not then acting as a preparer, the taxpayer will likely take that advice to its return preparer. As such, in practical effect, most tax advice may well be judged against the return preparer standard. However, recent interim guidance indicates that the IRS may not apply the new preparer standards to nonsigning preparers as aggressively as it might. Notice 2008-13, *Doc 2007-28351, 2008 TNT 1-6*, provides an example that suggests that an attorney only advising a taxpayer regarding a proposed

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Although the provision is broadly viewed as a response to a perceived increase in tax avoidance abetted by aggressive tax practice, nothing in the legislative history reveals an analysis of whether this is the correct response, or any consideration of the inconsistency between the new preparer penalty standard and the other cited standards.<sup>29</sup> The practical effect of the rules is that in the case of an issue on which there are conflicting authorities in equipoise, or no controlling authorities at all, one cannot advise a favorable undisclosed return position even though the taxpayer itself could take the undisclosed position.

#### b. Proposed legislation<sup>30</sup>

**i. Doggett bill.** The proposed antiabuse legislation that has received the most attention recently is Rep. Lloyd Doggett's, D-Texas, override of the limitation on benefits provision of our treaties.<sup>31</sup> His proposal would apply to deductible payments from a U.S. entity to a foreign entity when both are controlled by a common parent in a 50-percent-owned controlled group. Under the bill, those deductible payments would be treated as subject to withholding no less than that which would be imposed if the payment were made directly to the common parent.

The proposal is remarkable not only for its breadth,<sup>32</sup> but also because it has already passed one

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transaction does not prepare a substantial portion of the tax return on which the benefits of the transaction are claimed, provided the attorney does not provide any posttransaction advice and does not otherwise prepare the tax return. Notice 2008-13 also clarifies that an attorney will not be treated as preparing a substantial portion of a return if the attorney advises the taxpayer about a single entry on the tax return, provided that entry does not constitute a significant portion of the taxpayer's tax liability as a whole.

<sup>29</sup>In fact, IRS Chief Counsel Donald Korb said in a recent conference that the IRS was "blindsided" by the legislative change. See Sheppard, "Government Officials Discuss Partnership, Shelter Issues," *Tax Notes*, June 11, 2007, p. 1011, *Doc 2007-13305*, 2007 TNT 107-1.

<sup>30</sup>For a more detailed discussion of several of the proposals discussed here, see Bruce Zagaris, "U.S. International Tax Policy: Protectionism Disguised as Enforcement," *Tax Notes Int'l*, Sept. 24, 2007, p. 1181, *Doc 2007-19694*, 2007 WTD 186-7.

<sup>31</sup>H.R. 3160, passed by the House on July 26 as part of H.R. 2419, the agriculture subsidy reauthorization bill. Doggett's proposal was used in the farm bill to pay for a provision that House Ways and Means Chair Charles B. Rangel, D-N.Y., said was needed "so 26 million people would not lose their food stamps." *BNA Daily Tax Report* at G-8 (July 27, 2007). A tempered version of the proposal also was incorporated into Rangel's omnibus corporate tax reform bill, H.R. 3970, the Tax Reduction and Reform Act of 2007.

<sup>32</sup>Among other obvious problems with the bill, it erodes our credibility at the treaty negotiating table, treats all deductible outbound related-party payments as tax motivated, and ignores a long history of extraordinarily nuanced work attempting to define more specifically the kind of abuse it targets.

house of Congress, and did so with amazing speed and significant support as a free-standing measure. Ironically, Doggett drew more support on introduction for his most substantively radical legislative proposal than he has for almost any other antiabuse measure he has proposed.<sup>33</sup> However, in light of the significant opposition to the provision, not only from the private sector, but also from the chair and ranking member of the Senate Finance Committee<sup>34</sup> and the Bush administration,<sup>35</sup> enactment is at best uncertain.

#### ii. Levin bill: The Stop Tax Haven Abuse Act (including codification of the economic substance doctrine): S. 681, H.R. 2136

**(a) In general.** As chair of the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Government Affairs, Sen. Carl Levin, D-Mich., has spent far more time examining tax avoidance, evasion, and abuse than have most members of the Finance Committee. The most recent product of his work<sup>36</sup> is the Stop Tax Haven Abuse Act, introduced on February 17, 2007, and cosponsored on introduction by Sen. Norm Coleman,

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<sup>33</sup>The measure had 61 cosponsors on introduction as a free-standing bill. *Compare, e.g.*, H.R. 2136, 110th Congress (2007) (the Stop Tax Haven Abuse Act, which had 40 cosponsors on introduction); H.R. 2345, 110th Congress (2007) (the Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2007, which had 52 cosponsors on introduction); H.R. 2625, 109th Congress (2005) (the Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2005, which had 51 cosponsors on introduction); H.R. 1234, 109th Congress (2005) (the Corporate Accountability Tax Gap Act of 2005, which had 29 cosponsors on introduction); H.R. 2184, 108th Congress (2003) (the Fairness and Accountability in International Taxation Act of 2003, which had 30 cosponsors on introduction); H.R. 1556, 108th Congress (2003) (bill referred to as the Corporate Accountability Tax Gap Act of 2003, which had 25 cosponsors on introduction); H.R. 1555, 108th Congress (2003) (bill referred to as the Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2003, which had 27 cosponsors on introduction); H.R. 2520, 107th Congress (2001) (the Abusive Tax Shelter Shutdown Act of 2001, which had 22 cosponsors on introduction); H.R. 3197, 106th Congress (1999) (bill to prevent abuse of the charitable deduction, which had 55 cosponsors on introduction); H.R. 2255, 106th Congress (1999) (the Abusive Tax Shelter Shutdown Act of 1999, which had 7 cosponsors on introduction).

<sup>34</sup>See *BNA Daily Tax Report* at G-5 (Aug. 2, 2007).

<sup>35</sup>See "White House Opposes Proposed Offset in House Farm Bill," *Doc 2007-17346*, 2007 TNT 144-1.

<sup>36</sup>Perhaps foreshadowing his next project, it has been reported that Levin sent a letter on Aug. 23 to large multinationals asking detailed questions about their worldwide businesses, tax positions, and bilateral or multilateral advance pricing agreements the recipient corporation may have entered into, and seeking responses by Sept. 20, 2007. See Allison Bennett, "Multinational Corporations: Senate Subcommittee on Investigations Seeking Information on Overseas Activities," *BNA Daily Tax Report* at G-1 (Aug. 28, 2007).

R-Minn., the ranking minority member of the subcommittee, and presidential candidate Sen. Barack Obama, D-Ill.<sup>37</sup>

At least two provisions in Levin's bill will interest anyone concerned about the inconsistent standards for tax advice discussed above. Section 106 of the bill provides that taxpayers can no longer rely on legal opinions to protect them from penalties under the reasonable cause standard of section 6664 to the extent that the portion of any underpayment to which the opinion relates is attributable to a transaction "any part of which involves an entity or financial account in an offshore secrecy jurisdiction."<sup>38</sup> Treasury is given the authority to exempt a legal opinion from this rule if it "substantially exceeds the 'more likely than not' confidence level." Treasury is also given authority to exempt classes of transactions from the rule, and the statute mentions corporate reorganizations as one such possible class.<sup>39</sup>

A related provision, section 308 of the bill, directs Treasury to impose standards applicable to the render-

<sup>37</sup>See S. 681, 110th Congress (2007). Sens. Ken Salazar, D-Colo., and Sheldon Whitehouse, D-R.I., have since signed on as cosponsors. The companion bill in the House was introduced by Doggett on May 3, 2007, and has 44 cosponsors, all but 4 of whom were original cosponsors. See H.R. 2136, 110th Congress (2007).

<sup>38</sup>The bill provides a list of 34 such jurisdictions that were identified by the IRS in a 2005 proceeding to enforce a John Doe summons against Pay Pal Inc., and it grants Treasury the authority to add or remove jurisdictions. The list includes Switzerland, Hong Kong, Singapore, Luxembourg, and Bermuda.

<sup>39</sup>Although one must admire Levin's tenacity in pursuing tax abuse, and his use of the Permanent Subcommittee on Investigations as a forum for the prosecution of causes on behalf of the taxpaying everyman, one potential danger of this zealous prosecution is an underappreciation of the differences between violating the law and tax planning around the language Congress has written, and between criminal tax evasion facilitated by tax haven secrecy and tax neutral structuring facilitated by tax haven income tax policy. A detailed examination of the Levin bill would suggest that the senator frequently does appreciate those differences, but the introductory statement accompanying his bill follows a discussion of a tax haven intellectual property holding company structure with the pronouncement that his subcommittee's "most recent investigation into offshore abuses highlighted the extent to which offshore secrecy rules make it possible for taxpayers to participate in illicit activity with little fear of getting caught." 153 *Cong. Rec.* S2208 (daily ed. Feb. 17, 2007) (Levin statement).

Of course, even commonplace deferral planning may be of concern to revenue authorities for reasons unrelated to their interest in tax haven secrecy. For example, cost sharing and foreign affiliate ownership of intangibles, often effectuated through the use of tax havens, are issues that have been designated by LMSB as Tier 1 audit issues and have been repeatedly identified by senior IRS officials to Congress as high-priority areas of concern. See *supra* note 14. And, as will be discussed below, standard deferral planning has come under increased scrutiny in Europe as well.

ing of legal advice regarding any transaction that has the potential for tax avoidance. The standards are to address numerous items addressed by Circular 230 today, and, according to Levin, the provision "would provide express statutory authority for these and even clearer regulations."<sup>40</sup>

Other provisions include giving Treasury authority to impose requirements similar to those authorized by the PATRIOT Act regarding financial institutions that deal with other institutions or jurisdictions that are of primary money laundering concern. The Levin bill would authorize Treasury to impose similar restrictions when foreign institutions or jurisdictions impede U.S. tax enforcement. And other provisions extend the time for audits when information is needed from a secrecy jurisdiction, provide for increased disclosure of offshore accounts and entities, and close perceived loopholes in the foreign trust laws.<sup>41</sup>

Levin's bill contains numerous provisions that can be viewed as independent of the tax haven provisions. One prohibits patents for tax minimization ideas. Others penalize contingent fees in tax matters and increase the penalties for promoting abusive tax shelters or aiding or abetting an understatement of tax. And one directs the Securities and Exchange Commission and banking agencies to develop and implement examination techniques to detect potential violations of the rules relating to such promotion, and aiding and abetting.<sup>42</sup>

#### (b) Codification of economic substance.

Levin's bill contains a codification of the economic substance doctrine similar to codifications that have been proposed before.<sup>43</sup> The substance of the proposal is beyond the scope of this report, but it is relevant to

<sup>40</sup>See 153 *Cong. Rec.* S2215 (daily ed. Feb. 17, 2007) (Levin statement).

<sup>41</sup>See sections 103, 104, 105, and 201 of the Levin bill. The Levin bill also contains civil evidentiary rebuttable presumptions regarding U.S. taxpayers who deal with tax haven entities. The presumptions reasonably require taxpayers to prove that they are not in control of tax haven entities that they form or to which they transfer money, that funds they receive from or transfer to such entities have not yet been taxed, and that foreign accounts controlled by U.S. taxpayers contain enough money (\$10,000) to trigger reporting of foreign account ownership. The presumptions are subject to numerous limitations. For example, they do not apply for purposes of tax return preparation, but only in the case of a formal tax proceeding. (There are also two related presumptions, relating to beneficial ownership and control of offshore entities, applicable to securities enforcement proceedings.)

<sup>42</sup>See section 305 of the Levin bill. Other provisions require withholding agents and financial institutions to report certain information regarding offshore financial accounts, and permit increased sharing between governmental agencies of return information under section 6103. See sections 104, 306, and 307 of the Levin bill.

<sup>43</sup>See sections 401 to 403 of the Levin bill.

note that, with a Democratic Congress and a greater perceived need for revenue, the chances of the provision being enacted, irrespective of the chances for the remainder of the Levin bill, may be significantly greater than they have been in the past.<sup>44</sup>

**iii. Neal bill.** Corporate inversions have been in the tax news for years. With the enactment of relatively bright-line legislation designed to restrict the ability of corporations to expatriate,<sup>45</sup> some have said it would now constitute professional malpractice not to advise corporate clients regarding their options for expatriation under the statute. Rep. Richard E. Neal, D-Mass., who has long held a different view, has said that corporate expatriation is not only objectionable, it is unpatriotic. And he has tried to make it tax-prohibitive as well.

His latest legislative effort would exclude management, administrative, and headquarters activities from being taken into account in determining whether a corporation has sufficient business activities in a foreign jurisdiction for purposes of section 7874.<sup>46</sup> That provision does not apply if the entity under consideration has substantial business activities in the foreign country in which, or under the law of which, it is created or organized, when compared with the total business activities of the affiliated group of which it is a part (as defined).<sup>47</sup>

The effort is narrow and is widely believed to be aimed at Halliburton Corp., which announced shortly before Neal's proposal that it was moving its headquarters to Dubai, but not for tax purposes.<sup>48</sup> The entire area is instructive, however, in evaluating the extent to which our rule-based system is overlaid with a requirement to go beyond what the rules require and allow.<sup>49</sup>

### c. Judicial developments

**i. In general.** Studying antiabuse cases frequently leaves one skeptical. Whether a lawyer is drafting a legal opinion or a judge is drafting a judicial opinion,

the result should follow the analysis, not the other way around. Conclusions are reached based on an application of the law to the facts, not on whether we can articulate some theory supporting a transaction if it is "a deal in search of a structure" and condemning it if it is "a structure in search of a deal." But the purposive decision-making sanctioned by *Gregory*<sup>50</sup> and its progeny blurs the line between strict construction and results-driven opinions, allowing judges to determine whether they think a transaction should work and to write their opinions accordingly. In fact, at least one respected judge who writes detailed analytical opinions has acknowledged that a smell test is precisely how he decides cases of the sort we are concerned with.<sup>51</sup>

Against this backdrop, it is hard to accurately assess how concerned we should be about any particular bit of analysis in any particular case, but one bit of analysis in one recent case has rightly received significant attention. Carried to its logical extreme, the portion of *Coltec*<sup>52</sup> dealing with the scope for application of the economic substance doctrine can have very far-reaching consequences.

*Coltec* states that the transaction to be tested under the economic substance doctrine is the "one that gave rise to the alleged tax benefit."<sup>53</sup> In the easy case, this means that you cannot bolt a profitable transaction onto a pretax loser to cleanse the latter's economic substance taint. In the hard case, this means that even if an overall transaction is conceived and driven for business purposes, rather than tax purposes, any portion that is structured to reduce taxes must be isolated and itself tested for economic substance.<sup>54</sup> If the doctrine were to be aggressively applied this way, few tax reduction strategies would survive.

<sup>50</sup>293 U.S. 465 (1935).

<sup>51</sup>In a famous 1985 speech, years before much of the public reached a similar conclusion in the wake of *Bush v. Gore*, 531 U.S. 98 (2000), Justice William Brennan pulled the curtain back on the notion that even the Supreme Court can dispense objective truth. Justice William J. Brennan Jr., speech given at the Text and Teaching Symposium, Georgetown University, Washington, Oct. 12, 1985, (stating that the doctrine of strict construction of the Constitution is little more than "arrogance cloaked as humility").

<sup>52</sup>454 F.3d 1340, *Doc 2004-21316*, 2004 TNT 214-16 (Fed. Cir. 2004).

<sup>53</sup>*Id.*

<sup>54</sup>A tax-motivated transaction may be disregarded under a conjunctive test for economic substance, which requires the taxpayer to establish both a business purpose for the transaction and that the transaction has economic reality. In contrast, a transaction may satisfy the economic substance standard even if there is no business purpose for the transaction, provided that a disjunctive test is applied and the taxpayer can show that a transaction has economic reality. The court in *Coltec* explicitly rejected the disjunctive test to evaluate whether a transaction has economic substance, suggesting that the *Coltec* court adopted a conjunctive test.

<sup>44</sup>For a critique of the proposal in one of its previous incarnations, see Silverman, West, and Nocjar, letter to Thomas, Grassley, Rangel, and Baucus, Nov. 15, 2005, *Doc 2005-23306*, 2005 TNT 220-20.

Other incarnations of economic substance codification have appeared in more recent legislative proposals by Rangel. See H.R. 4351 (the AMT Relief Act of 2007); H.R. 3970 (the Tax Reduction and Reform Act of 2007). H.R. 4351 passed the House on Dec. 12, 2007.

<sup>45</sup>Section 7874.

<sup>46</sup>See H.R. 2937, 110th Congress (2007).

<sup>47</sup>Section 7874(a)(2)(B)(iii).

<sup>48</sup>Halliburton press release, *Doc 2007-6268*, 2007 TNT 49-34 (Mar. 11, 2007).

<sup>49</sup>For a compelling analysis of this issue, see Kleinbard, "Corporate Tax Shelters and Corporate Tax Management," 51 *Tax Executive* 235 (May-June 1999).

But I believe the alarm may be overstated. First, most would agree that the appellate court decision in *Coltec* was, at least in part, a strong reaction to, shall we say politely, an unusual view of the law by the trial court. The Court of Federal Claims held that the economic substance doctrine violated the separation of powers and was therefore unconstitutional.<sup>55</sup> But perhaps more importantly, it is doubtful that the IRS will pursue a radical view of the law that would invalidate, for example, either a reorganization because the use of a transitory merger subsidiary had no purpose in the transaction other than to qualify the deal under section 368, or the use of a foreign corporation rather than a branch for an outbound expansion because it had no purpose other than to qualify for deferral, although both might in theory be attacked under this aspect of the *Coltec* decision.<sup>56</sup>

Therefore, it is this lawyer's view that future decisions will not generally use *Coltec* in ways that shock the conscience. Rather, *Coltec*, like other recent IRS victories, is perhaps best understood as a judicial warning. Clearly, the courts are saying that tax planning has gone too far when they are presented with deals like those at issue in *Coltec*, *Black & Decker*, *Castle Harbour*, and *Heinz*.<sup>57</sup> But taxpayers are also losing cases like *Times Mirror* and *Merrill Lynch*, which are rich in tax planning but are clearly deals in search of a structure, not structures in search of a deal.<sup>58</sup> And taxpayers are winning cases like *Falconwood*, which easily could have gone the other way under judicial doctrines but landed the taxpayers in court because of an apparent absence of tax planning, not an excess of tax planning.<sup>59</sup> In this environment, the courts and the IRS may be interpreted as simply trying to brush back taxpayers from

the often-present large gray area in tax planning when they proceed in a manner not sufficiently deferential to the rules and the system.<sup>60</sup>

## ii. Enforcement and administrative developments.

A full discussion of international enforcement and administrative issues is beyond the scope of this report,<sup>61</sup> but several items are noteworthy for these purposes. First, it is relevant to mention the utility to the IRS of the Joint International Tax Shelter Information Center (JITSIC). JITSIC was formed in May 2004 to enhance enforcement efforts of the United States, the U.K., Canada, and Australia through information sharing. It is widely viewed as being the source of information leading to the audit and regulatory efforts concerning so-called foreign tax generator transactions,<sup>62</sup> as well as other enforcement initiatives. JITSIC's success for the IRS can be evaluated by the recent announcement that it is opening a second office, that Japan is joining the group, and that it is broadening the focus of its activities.<sup>63</sup>

Another noteworthy enforcement development is the Supreme Court's 2005 decision in *Pasquantino*.<sup>64</sup> Despite the majority's rhetoric to the contrary, that case appears to have allowed the enforcement of another country's revenue laws by the U.S. courts, contrary to the long-standing revenue rule. This has two primary effects. First, it deprives Treasury of a bargaining chip if other countries think they can get U.S. courts to enforce their tax laws without a treaty provision to that effect. Of potentially greater significance, however, is that the case may suggest the erosion of the revenue rule, so that countries will enforce other countries' tax laws in cases of perceived abuse.<sup>65</sup>

<sup>55</sup>Nevertheless, the court then went on to decide that the *Coltec* transaction indeed passed the economic substance test.

<sup>56</sup>In materials prepared for a Jan. 23, 2007, speech, available at *Tax Notes*, Jan. 29, 2007, p. 390, *Doc 2007-1895*, 2007 *TNT* 16-6, Korb said that the "economic substance doctrine will not be asserted to challenge routine business restructurings."

<sup>57</sup>*Black & Decker Corp. v. United States*, 436 F.3d 431, *Doc 2006-2133*, 2006 *TNT* 23-8 (4th Cir. 2006), *TIFD III-E Inc. (Castle Harbour) v. United States*, 459 F.3d 220, *Doc 2006-14691*, 2006 *TNT* 150-8 (2d Cir. 2006); *H. J. Heinz Company and Subsidiaries v. United States*, Court of Federal Claims, No. 03-2847T, *Doc 2007-12834*, 2007 *TNT* 103-16 (May 24, 2007).

<sup>58</sup>*Times Mirror v. Commissioner*, 125 T.C. 110, *Doc 2005-19801*, 2005 *TNT* 187-12 (2005); *Merrill Lynch v. Commissioner*, 386 F.3d 464, *Doc 2004-19204*, 2004 *TNT* 190-14 (2d Cir. 2004), *aff'g* 120 T.C. 12, *Doc 2003-1506*, 2003 *TNT* 11-5 (2003).

<sup>59</sup>*The Falconwood Corp. v. United States*, 422 F.3d 1339, *Doc 2005-18305*, 2005 *TNT* 171-52 (Fed. Cir. 2005). See also LTR 200427011, *Doc 2004-13611*, 2004 *TNT* 129-24, which also could have easily gone the other way under judicial doctrines, but in which the taxpayer was given a favorable ruling after disclosing all elements of the transaction to the IRS for review.

<sup>60</sup>Compare *Jade Trading, LLC v. United States*, Ct. Fed. Cl. No. 03-2164T, *Doc 2007-28072*, 2007 *TNT* 248-5 (Dec. 21, 2007), with *Countryside Limited Partnership, et al. v. Commissioner*, T.C. Memo. 2008-3, *Doc 2008-61*, 2008 *TNT* 2-15 (Jan. 2, 2008).

<sup>61</sup>For a broader, albeit brief review of developments as of early 2007, see Ernst & Young, "Tax Administration Goes Global," *supra* note 5.

<sup>62</sup>Prop. reg. section 1.901-2(e)(5) (Mar. 29, 2007).

<sup>63</sup>See IRS news release IR-2007-104, May 23, 2007, *Doc 2007-12517*, 2007 *TNT* 101-11. The original office is in Washington. The new office is in London.

<sup>64</sup>*Pasquantino v. United States*, 544 U.S. 349, *Doc 2005-8734*, 2005 *TNT* 80-9 (2005).

<sup>65</sup>There are numerous fascinating issues that arise in considering the relationship of one country's laws to another in the enforcement context. For example, to what extent should practitioners be concerned about other countries' laws when giving advice? And to what extent should taxpayers be concerned about the possibility that a foreign country will perceive its laws to have been violated by a U.S. taxpayer and seek enforcement of those laws in the United States?

## 2. Foreign Developments

### a. Unilateral

i. **U.K.** Three U.K. developments of relevance will be discussed here.<sup>66</sup> They are the 2004 transaction reporting rules, as modified later (most significantly in 2006 but also in 2007),<sup>67</sup> the 2005 antiarbitrage rules,<sup>68</sup> and the 2007 consultation document suggesting changes to the U.K. controlled foreign corporation rules.<sup>69</sup>

(a) **Transaction reporting rules.** In 2004 the U.K. enacted legislation requiring disclosure by promoters<sup>70</sup> of some arrangements involving certain financial products and employment schemes if a main benefit of the arrangement was obtaining a U.K. tax advantage. The rules focus on the supply side of the tax planning business and do not require promoters to disclose the identity of taxpayers investing in their transactions, although taxpayer reporting may be required.<sup>71</sup>

<sup>66</sup>Other significant and relevant developments will be left for treatment by others. These include recent U.K. judicial developments involving the *Ramsay* doctrine, including the recent decision by Special Commissioner John Avery Jones in *Astall v. HMRC*, in which the U.K.'s judicial antiabuse principles were applied against the taxpayer in furtherance of a purposive interpretation of the statutory law. *John Astall and Graham Edwards v. Revenue & Customs*, [2007] UKSPC SPC00628 (Aug. 14, 2007). Note that the U.K. considered, but did not adopt, a statutory antiabuse rule in the 1990s. See generally the presentation on U.K. developments by Mark Baldwin of Macfarlanes at the Foreign Lawyers Forum panel on comparative antiavoidance developments, ABA Tax Section Mid-Year Meeting, Las Vegas, January 18, 2008.

<sup>67</sup>Part 7 (sections 306 to 319) of Finance Act 2004, SI 2004/1863, SI 2004/1864, and SI 2006/1543 and SI 2007/785 (dealing with National Insurance Contribution avoidance schemes).

<sup>68</sup>Part 2, Chapter 4 (sections 24 to 31) of Finance (No. 2) Act 2005.

<sup>69</sup>Available at [http://www.hm-treasury.gov.uk/consultations\\_and\\_legislation/foreign\\_profits/consult\\_foreign\\_profits.cfm](http://www.hm-treasury.gov.uk/consultations_and_legislation/foreign_profits/consult_foreign_profits.cfm).

<sup>70</sup>There are four groups of persons on whom these obligations are imposed: U.K.-based promoters of schemes; persons dealing with non-U.K.-based promoters; parties to transactions where there is no promoter (that is, in-house-developed schemes); and the users of the schemes when the promoter is otherwise prevented from disclosing the scheme because of legal professional privilege (that is, when lawyers are the promoters). (Observers have expressed doubts about the legality of the fourth group under U.K. and EC law.)

<sup>71</sup>The regime works as follows: Promoters notify HMRC of a scheme within 5 days of the scheme being available for implementation; HMRC may issue a reference number to the promoter within 30 days of being notified; if the promoter is issued a number by HMRC, the promoter must notify its client of that number within 30 days of issue; and the client must state that number in its tax return to HMRC. (A slightly different regime applies to stamp duty land tax and national insurance contribution avoidance schemes.)

Under the applicable regulations, disclosure generally must be made within five days of the date the transaction is made available to taxpayers. The regulations as originally enacted specified classes of financial product and employment schemes subject to the disclosure rules. Those transactions, referred to as "notifiable arrangements," included some financial products (for example, loans, repos, and share loans) under which the promoter includes a fee tied to the tax benefits, expects the transaction to remain confidential, or has terms that are non-arm's-length, if the promoter is a party to the financial product. As such, under the regulations, a transaction that met none of these three filters was outside the scope of the rules. Also, if the transaction did not involve a financial product or employment arrangement, it was outside the scope of the rules.

Effective August 1, 2006, the rules were broadened. The three filters described above were expanded and three new ones added (relating to mass-marketed schemes, loss schemes (for which the standard under the main purpose test is elevated from "a" main purpose of tax avoidance to "the" main purpose in the eyes of an "informed observer"<sup>72</sup>), and some leasing arrangements).<sup>73</sup> Also, the 2006 changes broadened the rules so that they no longer apply only to employment schemes and financial products. They now apply to any arrangement that results in the avoidance of income tax, corporation tax, capital gains tax, national insurance contributions, and stamp duty land tax. The new rules retain the requirement that the transaction have a main benefit (or, for loss transactions, "the" main benefit) of tax avoidance.

(b) **Arbitrage.** In 2005 the U.K. enacted legislation empowering HM Revenue & Customs to deny tax benefits associated with some arbitrage transactions.<sup>74</sup> Of ostensibly great, but perhaps only minor practical, significance, the legislation is not self-executing and

<sup>72</sup>The text reads "the arrangements are such that an informed observer (having studied them) could reasonably conclude that the main benefit of those arrangements which could be expected to accrue to some or all of the individuals participating in them is the provision of losses." The court may take a view that "an informed observer" is a special commissioner, in which case few loss schemes would be nondisclosable.

<sup>73</sup>These filters are now called hallmarks.

<sup>74</sup>Part 2, Chapter 4 (sections 24 to 31) of Finance (No. 2) Act 2005. The legislation was first proposed in a 2005 finance bill that was to be enacted into law before parliamentary elections that year. Because it was thought that the arbitrage provisions might engender debate delaying enactment until after the elections, the arbitrage provisions were stripped out of the bill, which then passed promptly. The arbitrage provisions were included in a second finance bill that same year, introduced after the elections, and were at that time enacted into law.

HMRC has recently issued a consultation paper on draft clauses to amend the 2005 arbitrage provisions. The draft clauses  
(Footnote continued on next page.)

applies to a transaction only if HMRC issues a notice to a taxpayer applying the rules. A transaction becomes noticeable under the rules if it involves a hybrid entity or instrument,<sup>75</sup> a deduction is claimed as a result of the arrangement, a main purpose of the arrangement is to obtain a U.K. tax advantage, and the amount of the advantage is not minimal. A separate class of transactions is notifiable under the rules even if it does not involve a deduction in the U.K. (the “receipt rules”), as long as it involves a receipt that is not taxable in the U.K. (such as a capital contribution) and a deduction elsewhere.

If the notice is issued, it announces the position of HMRC that deductions are denied to the extent that the deduction may also be claimed by another person (for U.K. or foreign tax purposes). If the sole purpose of the scheme is to obtain an overseas tax advantage (for example, the recipient of a payment made under a qualifying scheme is not subject to tax on that payment until sometime in the future), the payer’s deduction is not reduced by the antiarbitrage provisions. If the payee is partially subject to tax on the payment, the payer’s deduction may not be denied in its entirety but would be reduced to reflect the reduced tax amount that is not taxable to the recipient. When a notice under the receipt rules is issued, it will announce the HMRC position that the receipt, which would have not been otherwise taxable in the U.K., would be deemed taxable. The provisions apply to U.K. residents or entities subject to tax in the U.K. by reason of a permanent establishment.

### (c) U.K. proposal for exemption system coupled with CFC rules similar to the U.S. rules. In

contain two proposed changes to the 2005 arbitrage provisions. The consultation paper is available as *Doc 2007-27464, 2007 WTD 244-16*.

As a matter of comparative politics, it is worth quoting the introductory text of the finance bills that are enacted in Parliament:

We, Your Majesty’s most dutiful and loyal subjects, the Commons of the United Kingdom in Parliament assembled, toward raising the necessary supplies to defray Your Majesty’s public expenses, and making an addition to the public revenue, have freely and voluntarily resolved to give and to grant unto Your Majesty the several duties hereinafter mentioned; and do therefore most humbly beseech Your Majesty that it may be enacted, and be it enacted by the Queen’s most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows. . . .

<sup>75</sup>A hybrid entity is defined broadly to include any entity treated as a person in one jurisdiction if its profits are taxable to another person or persons under that jurisdiction or any other jurisdiction. Transactions involving certain hybrid instruments are treated as qualifying schemes irrespective of the relationship between the contracting parties, and others are so treated only if effected between related parties.

June 2007 HMRC released a discussion document (the consultation document) covering options for reform of the taxation of foreign profits of U.K. corporations. Significantly, the consultation document seeks views on moving the U.K. system from a credit system to an exemption system for foreign dividends paid to large- and medium-size U.K. companies on 10-percent-or-greater equity interests.<sup>76</sup> As significant as the reform is, it is outside the scope of this report.<sup>77</sup> What is within the scope of the report, however, is the other change referred to in the consultation document as a set of new rules that would be necessary to protect U.K. revenues. That change is a reform of the U.K.’s controlled foreign company rules.<sup>78</sup>

Although the consultation document states that it is proposing a new exemption regime with alternative CFC rules as a corollary to the new exemption rules, the consultation document is widely viewed as the government’s response to *Cadbury Schweppes*.<sup>79</sup> In that case, the European Court of Justice restricted the U.K.’s ability to tax profits of European subsidiaries under its CFC rules unless there are wholly artificial arrangements intended to escape national tax normally payable.<sup>80</sup> According to the consultation document, the import of *Cadbury Schweppes* is that CFC rules can operate to tax foreign subsidiary profits that have been artificially divorced from the activity that creates them, but CFC rules should not tax foreign subsidiary profits

<sup>76</sup>In the consultation document, HMRC also solicits comments on exempting dividends on portfolio holdings.

<sup>77</sup>It is interesting to note, however, that the policy rationale for the approach taken in the consultation document is similar to at least one option that was floated in a recent ABA task force report on options for fundamental reform in the United States — that is, to allow more favorable taxation of foreign income than under current rules, in recognition of both the complexity of the current rules and the small amount of revenue they generate, in part as a result of planning options available. See “Report of Task Force on International Tax Reform,” 59 *Tax Lawyer* 649 (Spring 2006); consultation document at 10 (“Since the credit method does not deliver [capital export neutrality] for multinational business, it is reasonable to consider whether an exemption regime is a more appropriate way of delivering [double tax relief] for it”).

<sup>78</sup>Other related restrictions were also included, such as a restriction on interest deductions in light of the new rules that would exempt some foreign income.

<sup>79</sup>ECJ Case, *Doc 2004-14844, 2004 WTD 141-7 (C-196/04)*. The 2007 Finance Bill included amendments to the CFC regime as an initial response to *Cadbury Schweppes*. Those amendments added another mechanism to avoid the CFC rules when a foreign company establishes that it is conducting genuine business activities.

<sup>80</sup>Like the U.S. rules, the CFC rules created taxable U.K. income in the case of foreign subsidiary income, but did not create U.K. losses in the case of foreign subsidiary losses. After *Marks & Spencer PLC v. Halsey* (ECJ Case C-446/03), losses of European subsidiaries can be relieved in the U.K. in some circumstances.

from a genuine commercial activity. Thus, the consultation document proposes to reform the U.K. CFC rules to draw this distinction more clearly. In so doing, the U.K. rules will in material ways become markedly more similar to the current U.S. rules than they were before,<sup>81</sup> and in some ways would be even more restrictive.<sup>82</sup>

The proposed controlled company rules (so called because they would apply to all income, whether arising in U.K. or foreign subsidiaries) will, if enacted,<sup>83</sup> replace the existing entity-based “all or nothing” approach with a more targeted, income-based approach similar to the U.S. regime. The former approach was said in the consultation document to both undertax and overtax and to add significant complexity and uncertainty about the rules. The proposed rules are said to address those concerns and to be important in light of new risks for diversion of profits that would be opened up by an exemption system.

**ii. Germany.** Four German developments are of primary interest here. First, the German government proposed legislation for 2008 to strengthen its statutory antiabuse rule.<sup>84</sup> Second, Germany tightened its anti-treaty-shopping legislation last year.<sup>85</sup> Third, the German government has floated a discussion draft that contemplates future legislation to require the reporting and disclosure of tax arbitrage transactions.<sup>86</sup> And fourth, the German tax authorities are drafting regulations to implement recent “transfer of functions” legislation,<sup>87</sup> which, if adopted, could constitute an international high-water mark regarding action against the perceived abuse associated with migration of income-generating value from high-tax to low-tax jurisdictions.<sup>88</sup>

<sup>81</sup>It is understood that HMRC coordinated closely with the IRS in drafting the consultation document.

<sup>82</sup>For example, it appears that the new rules would omit an “active royalties” exception, a strong “same-country” exception, and a full look-through for intragroup interest payments to intragroup treasury companies. For a letter to the chancellor objecting to those omissions, see letter from William Reinsch, president, National Foreign Trade Council, to Alastair Darling, Chancellor of the Exchequer, Aug. 24, 2007.

<sup>83</sup>The earliest date those rules are likely to come into effect is Apr. 2009.

<sup>84</sup>Section 42 Fiscal Code (*Abgabenordnung*).

<sup>85</sup>Revised section 50(d)3 Income Tax Act (*Einkommensteuergesetz*).

<sup>86</sup>Introduction of new section 138a Fiscal Code.

<sup>87</sup>New section 1(3) Foreign Tax Act (*Aussensteuergesetz*).

<sup>88</sup>Other relevant legislative developments not discussed at length herein include a 2007 Income Tax Act measure that would deny income tax exemptions under a treaty when the income would be exempt or subject to little tax by the treaty partner, and a 2008 Business Reform Act measure amending the

(Footnote continued in next column.)

**(a) Codification of enhanced antiabuse rule.**

Apparently, Germany’s statutory antiabuse rule has been a weak tool for the government, requiring the revenue authorities to prove the absence of any business purpose before it applies. And because there is no statutory definition of the key concept “abuse of law,” the somewhat vague case law defining abuse has required the interpretation and application of decades of intermittently and inconsistently decided cases. The revised statutory provision<sup>89</sup> enacted as part of the 2008 tax bill replaced the notion of abuse of law with the term “inappropriate legal arrangement” that results in a tax benefit to the taxpayer or a third party not provided under the law. The newly codified revision requires a significant business purpose and shifts to the taxpayer the burden of producing evidence of a significant business purpose.

The definition of inappropriate legal arrangement appears broad, although arguably less so than the proposed amendment of the antiabuse rule.<sup>90</sup> The new standard appears to include transactions that are not customarily executed to achieve particular ends in the absence of tax benefits. The taxpayer may, however, defeat the presumption of tax avoidance and, therefore, application of the new statute by showing a significant business purpose. As such, the standard in the new, more rigorous version of the rule would appear to be similar to the disjunctive version of the economic substance test as applied in the United States<sup>91</sup> — that is, the taxpayer can prevail by showing a subjective business purpose even if there is no objective economic profit potential in the transaction.<sup>92</sup>

**(b) Anti-treaty-shopping rules.** Before its amendment in 2007, the German statutory anti-treaty-shopping rule denied the benefit of reduced withholding under a bilateral treaty or a unilateral measure (for example, implementing the EU parent-subsidiary directive) if:

- there would be no benefit if payment were made directly to shareholders of the interposed foreign subsidiary;

German thin capitalization rules so they apply to interest paid to both related and unrelated parties.

<sup>89</sup>Section 42(1) Fiscal Code.

<sup>90</sup>For a discussion of the proposed version, see Eckhardt, “Germany May Broaden Tax Avoidance Legislation,” *Tax Notes Int’l*, Aug. 20, 2007, p. 709, *Doc 2007-18566*, 2007 *WTD* 155-1; Rose-Anne Claremont, “Germany: Government Proposes New Test, Shifts Burden of Proof on Abusive Transactions,” *BNA Daily Tax Report* at I-1 (Aug. 15, 2007).

<sup>91</sup>See *supra* note 51.

<sup>92</sup>In one significant respect, the German rule appears to be harsher than the rule in a U.S. disjunctive circuit. It does not appear to allow the taxpayer to prevail if it can show economic profit potential but no subjective business purpose. Under the German rule, the fisc will prevail if the tax arrangement primarily served the purpose of tax avoidance.

- there are no business reasons for the structure (a business purpose requirement); and
- the interposed foreign subsidiary does not conduct an active business (have business substance).

The result under the anti-treaty-shopping provision is to look through the interposed foreign subsidiary. Thus, the provision does not necessarily deny all benefits of a reduced withholding rate. Moreover, German courts have diluted the strength of the provision.

For example, in one case, non-German residents formed a Bermuda company, which owned all of the interests in two Dutch companies (BV1 and BV2), which each owned all of the stock of a German company and other Dutch, non-Dutch EU, and non-EU companies.<sup>93</sup> The BVs claimed dividend withholding tax benefits under the Dutch treaty, even though the arrangement was clearly motivated by tax concerns and the BVs had no personnel or telephone lines (but shared the infrastructure of other active sister companies in the Netherlands). The German tax authorities challenged the treaty benefits. The court held for the taxpayer, apparently relying on its findings that there were other affiliates in the Netherlands conducting active businesses<sup>94</sup> and that the arrangement was part of a long-term, strategic structure.<sup>95</sup>

The 2007 anti-treaty-shopping changes are perceived as a response to this case. Under the new rule, benefits may be denied when the shareholder of the interposed foreign subsidiary would not otherwise receive benefits if it received the payment directly and if either:

- there is no business purpose;
- the interposed foreign subsidiary does not earn more than 10 percent of its income from its own business activities; or
- the foreign subsidiary does not have adequate business substance to conduct business activities.<sup>96</sup>

<sup>93</sup>See *Bundesfinanzhof* judgment of May 31, 2005, I R 74, 88/04, *Federal Tax Gazette* 2006 part II, p. 118 (*Hilversum II*).

<sup>94</sup>This presumably allowed the court to discount a treaty shopping intent, since the structure could have used active companies to own the German company.

<sup>95</sup>This ruling involved a structure related to another structure that the courts had previously ruled against. In the predecessor case, there were also other sister BVs, but the court held in favor of the tax authorities, finding that the structure had no business purpose and that BV conducted no business activities by merely holding the shares of one subsidiary GmbH in Germany. See *Bundesfinanzhof* judgment of Mar. 20, 2002, I R 38/00, *Federal Tax Gazette* 2002 part II, p. 819 (*Hilversum I*).

<sup>96</sup>The new rules appear to address the *Hilversum II* decision by clarifying that mere administrative activities and activities performed by related parties in the same jurisdiction will be ignored for testing business substance, and that business purpose will be tested only at the level of the interposed foreign subsidiary.

**(c) Arbitrage transactions.** Germany has floated a draft of what may become proposed legislation prescribing a disclosure and registration regime that would apply to arbitrage transactions.<sup>97</sup> (In what is perhaps a sign of the perceived significance of the measure, the measure was not actually proposed as legislation.) The rules would require disclosure and registration regarding tax arbitrage arrangements (TAAs), arrangements intended to derive benefits from differential tax treatment of assets, entities, and income in different tax jurisdictions.

TAAs that require disclosure and registration would include structures under which:

- an asset can be taken into account — and therefore depreciated — in more than one jurisdiction;
- a legal entity is characterized as tax transparent in one jurisdiction and as tax opaque in the other (such as through check-the-box elections);
- provisions of a tax treaty are not interpreted and applied in the same manner in the jurisdictions involved;
- payments are not characterized in the same manner in the jurisdictions involved;
- the same deductions are taken into account in more than one jurisdiction; and that
  - result in the avoidance of income tax (including withholding tax);<sup>98</sup>
  - cause the relevant tax claims to arise in later tax years; or
  - result in claims for the refund or credit of taxes.

The duty to disclose the TAA would be on anyone who offers or recommends the arrangement in the context of a business relationship by presenting or describing the concomitant tax benefits (a promoter). Promoters would, in particular, include members of the legal profession and tax consultants.<sup>99</sup>

The disclosure requirement would be triggered when an offer or a recommendation is made to a taxpayer to enter into the TAA. Disclosure involves a complete description of the TAA and its purpose as well as a quantification of the expected tax benefits and the number of subscribing taxpayers. The disclosure must be filed electronically with the Federal Central Office of Taxation (FCOT). The FCOT will register the TAA

<sup>97</sup>The 2008 Tax Bill recently passed by the German Bundesrat did not include this disclosure and reporting regime concerning cross-border arbitrage transactions.

<sup>98</sup>The rules do not specify whether the avoidance must be of German income tax, but that is being inferred by practitioners.

<sup>99</sup>“Small” promoters would be excused from the disclosure requirement. Those would be promoters whose gross income from the marketing offer would remain below certain thresholds.

and issue a registration number to the promoter. The promoter is required to provide the registration number to those taxpayers who participate in the TAA. The taxpayer, in turn, is required to disclose the registration number when he files a tax return and seeks to claim tax benefits from the TAA.

Failure to disclose the TAA or to disclose the registration number in a tax return is a misdemeanor and triggers monetary penalties of up to €5 million. These rules are intended to give the tax administration an opportunity to learn of new tax arbitrage schemes even if they are not illegal and to consider preventive legislative or administrative measures. The legislative history and technical explanation of the new draft legislation makes specific reference to the progress made by foreign tax administrations in combating tax arbitrage with the help of similar disclosure and filing requirements.<sup>100</sup>

The new rules would have been applicable to promotions of TAAs occurring on or after the effective date of the proposed legislation. In other words, existing arrangements would not be caught by the new rules. It is unclear whether the new rules will actually be adopted by the legislature, although informed observers expect that they will, perhaps in modified form.<sup>101</sup>

**(d) German transfer of functions rules.** In the Corporate Tax Reform Act 2008, Germany introduced legislation to provide arm's-length standards for the taxation of functional transfers between related parties. The Ministry of Finance is drafting statutory regulations on the subject and would like to treat the doubling of functions the same way as a transfer of functions, as it views the doubling of functions as the beginning of a gradual migration of functions. The ministry's concern is that once a business has established additional capacity for production in the other country, it is a small step toward scaling back domestic activities so that the transfer of business to the other country isn't quite as obvious.

Critics have pointed out that neither the new legal provisions, the legislative history, nor the technical explanations mention doubling of functions as a matter that is intended to be covered by the legislation.<sup>102</sup> Moreover, they argue that it is likely impossible to draw an accurate line between a legitimate business

expansion and a slow intentional migration of functions abroad. Finally, they note that there is no international consensus on how to deal with transfers of functions, let alone doubling of functions.<sup>103</sup> The United States taxes intangibles when they leave the country and claims the right to adjust the price charged on departure if it turns out later it was too low, based on commensurate with income standards. The critics argue that Germany would be breaking new ground by providing that on such a transfer of functions, the outsourcing enterprise has to charge the foreign related beneficiary a price reflecting the profit potential that left Germany.<sup>104</sup> If other countries do not follow suit, they would not allow a corresponding adjustment, and the German-initiated adjustment could result in unrelieved double taxation. This, they argue, will hurt the German economy just as Germany is trying to make its business sector more competitive.

Conceptually the legislation appears to envision a "natural" level of business activity, and hence taxable income, in Germany based on historical practice and the large size of the German economy. As such, the legislation may be more consistent with a formulary view of the division of income among countries than the arm's-length approach as currently understood. Those affected have observed that the at least arguably ill-defined boundaries of the concept, and absence of detailed rules for its implementation, are likely to lead to significant taxpayer uncertainty for the foreseeable future.

### iii. Other countries<sup>105</sup>

**(a) Canada.** Canada's general antiavoidance rule restricts tax benefits that arise in transactions executed primarily for nontax purposes, provided the tax benefit is inconsistent with statutory or treaty provisions. The GAAR was amended in 2005 to clarify that it applies to treaty provisions. Despite that amendment,

<sup>103</sup>The OECD is starting to explore this in a working group whose work is not expected to be completed until late 2008.

<sup>104</sup>In support of its argument, the NFTC cites *Hospital Corporation of America*, 81 T.C. 520 (1983) (*HCA*), for the proposition that U.S. law specifically confirms that a particular business opportunity may be transferred to an affiliate without compensation. Although it may be possible to read *HCA* to support that proposition, it appears dangerous to rely heavily on a case in which the result was an allocation of 75 percent of the income from the foreign subsidiary to the U.S. parent, and the decision is highly fact-based, rejecting the government's assertion of a 100 percent allocation to the U.S. parent only after finding specific facts putting the case under consideration outside the scope of the prior precedents on point.

<sup>105</sup>Selected other countries are discussed here. Additional countries have recently evolved their antiabuse rules or policies in relevant respects, including Australia, Denmark, Italy, China, and others.

<sup>100</sup>Such as those of the U.K., the United States, and Canada, whose representatives are quoted as having reported that those measures are effective and efficient tools in combating the development of tax arrangements.

<sup>101</sup>See note 97 *supra*.

<sup>102</sup>See, e.g., letter from National Foreign Trade Council Inc. dated Aug. 16, 2007, available at <http://www.nftc.org/default/tax/NFTC%20Comments%20on%20Transfer%20of%20Functions%20Regulations%2017.pdf>.

the Canadian judiciary in *MIL*<sup>106</sup> recently declined to apply the GAAR to a set of facts that seemed ripe for its application.

The taxpayer in *MIL* became a resident of Luxembourg to avoid Canadian capital gains tax on the ultimate disposition of its subsidiary stock. In concluding that the tax benefits claimed in the transaction were not inconsistent with the Canada-Luxembourg tax treaty, the Canadian Tax Court refused to read an implicit treaty shopping rule into the treaty and stated that treaty shopping is not a per se abuse under the GAAR. In the view of the Tax Court, the transaction resulted in a tax exemption, which was exactly what was prescribed by the treaty. The Canadian Federal Court of Appeals affirmed the Tax Court decision on June 23, 2007.

This development may suggest that the GAAR is a toothless tiger. It has, however, been observed recently that in both GAAR cases and non-GAAR antiavoidance cases, the pendulum may be swinging back in favor of the Canadian government.<sup>107</sup>

#### (b) France

**(i) Withdrawn arbitration reporting rules.** In 2005 France proposed arbitration reporting rules similar to those recently proposed in Germany. The discussion draft in which the rules were raised was withdrawn, however, and consultations led to a new draft in 2006, also later withdrawn. The French tax authorities are still considering this issue, particularly in the framework of the Seoul Declaration.

**(ii) *Zimmer*.** A recent French court decision has raised concerns about whether a commissionaire will be found to constitute a permanent establishment of its foreign parent. On February 2, 2007, the Paris Administrative Court of Appeal ruled that the activities of *Zimmer SAS*, a French commissionaire of a U.K. principal, created a PE under the France-U.K. tax treaty. The facts in *Zimmer* appear to be consistent with typical commissionaire structures under which the commissionaire: (1) accepts orders, (2) negotiates payment terms, and (3) executes sales contracts on behalf of the principal but in its own capacity, all without the prior approval of the principal. In *Zimmer*, as in many commissionaire arrangements, the commissionaire acted exclusively for the foreign (U.K.) principal. Although this was not a favorable fact, the French court might have reached a different result with a literal reading of the relevant language of the France-U.K. tax treaty, which states that a dependent agent “habitually

exercises in France the authority to conclude contracts *in the name of the principal*” [emphasis added]. Rather, the French court concluded that *Zimmer SAS*, which contractually bound its principal on terms it negotiated, constituted a dependent agent even though, as a technical matter, *Zimmer SAS* concluded contracts in its own name. The commentary to article 5 of the OECD model convention provided support for the court’s reasoning. That commentary states that the relevant inquiry is whether the French company can conclude contracts binding on the principal “even if those contracts are not actually in the name of the [principal].”<sup>108</sup>

*Zimmer* has been appealed to the French Administrative Supreme Court. As such, it may be reversed. Moreover, as with most PE issues, more will turn on how much income is attributable to the PE than whether a PE in fact exists. Also, *Zimmer* seems to leave open the prospect of a structure in which the principal cannot be bound without its consent. And finally, of course, different standards in different countries are likely to yield different results.

**b. Bilateral (tax treaty) rules.** A full discussion of treaty antiabuse rules is beyond the scope of this report, but it may be useful to note briefly several things. First, although the United States has continued its campaign to include detailed and complex limitation of benefits rules in its treaties, it does not appear that other countries are following suit in their treaties with countries other than the United States, and it is possible, as discussed above, that legislation will make all of those efforts superfluous.

Similarly, although the United States led a project in the OECD regarding the treatment of fiscally transparent entities,<sup>109</sup> the antiabuse rule in the U.S. model treaty and most of our treaties in force relating to that subject has not found its way into the OECD model treaty or other bilateral treaties in force. This is perhaps less surprising than in the case of LOB provisions, as few other countries have issues of this sort to the extent that we do, largely as a result of our check-the-box rules.

Finally, it is worth remembering that the “main purpose” antiabuse concept used by the U.K. in its treaties and in its domestic rules discussed above has been offered to, and rejected by, the U.S. Senate in connection with the approval of proposed treaties with Slovenia and Italy.<sup>110</sup> The Italian treaty containing that concept

<sup>106</sup>*MIL (Investments) S.A. v. Her Majesty the Queen*, 2007 FCA 236, affirming 2006 DTC 2784.

<sup>107</sup>See presentation on Canadian developments by Thomas B. Aiken of McCarthy Tétrault at Foreign Lawyers Forum panel on comparative antiavoidance developments, ABA Tax Section Mid-year Meeting, Lake Las Vegas, Nevada, Jan. 18, 2008.

<sup>108</sup>OECD model commentary article 5, para. 32.1.

<sup>109</sup>The OECD project published a report titled “Application of the OECD Model Tax Convention to Partnerships,” available at <http://www.oecdbookshop.org/oecd/display.asp?sf1=identifiers&lang=EN&st1=231999521p1>.

<sup>110</sup>The U.S. Senate approved the tax treaties with Italy and Slovenia on Nov. 5, 1999, but attached reservations that would

(Footnote continued on next page.)

was approved subject to a reservation thereon by the Senate, and it still has not been approved by Italy as a result of that reservation.

### c. Multilateral

#### i. OECD intermediaries project

(a) **In general.** On September 14 and 15, 2006, the heads and deputy heads of the revenue authorities from 35 countries met in Seoul, under the auspices of the OECD's Forum on Tax Administration (the FTA),<sup>111</sup> to share concerns, experiences, and ideas regarding international noncompliance with domestic tax laws. A result of their deliberations was a final declaration summarizing their discussions that has come to be known as the Seoul Declaration. One section of the declaration that prompted considerable interest among the tax bar read as follows:

Our discussions revealed continued concerns about corporate governance and the role of tax advisors and financial and other institutions in relation to non-compliance and the promotion of unacceptable tax minimization arrangements.<sup>112</sup>

Moreover, the declaration stated that the FTA would:

intensify existing work or initiate new work under the auspices of the OECD [to examine, *inter alia*,] the role of tax intermediaries (e.g. law and accounting firms, other tax advisors and financial institutions) in relation to non-compliance and the promotion of unacceptable tax minimization arrangements with a view to completing a study by the end of 2007.

In late July 2007 the OECD posted on its Web site several working papers discussing the role of intermediaries in the context of tax compliance and tax enforcement. The working papers were finalized in a report presented as a topic for discussion at the FTA meeting January 10-11, 2008.<sup>113</sup> The final report, like the earlier working papers, is revolutionary in concept,

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strike the "main purpose" standard from both treaties. The main purpose language is included in the Italy-U.S. tax treaty at articles 10(10) (Dividends), 11(9) (Interest), 12(8) (Royalties), and 22(3) (Other Income). The main purpose language is included in the Slovenia-U.S. tax treaty at articles 10(10) (Dividends), 11(10) (Interest), 12(7) (Royalties), and 22(3) (Other Income).

<sup>111</sup>The FTA was formed by the OECD in 2002 to foster dialogue between tax administrators and to identify and share efficient tax administration practices. The members of the FTA include tax administrators of OECD member and nonmember countries. The FTA meets periodically to discuss international tax concerns relevant to its members.

<sup>112</sup>An English version of the Seoul Declaration is available at <http://www.oecd.org/dataoecd/38/29/37415572.pdf>.

<sup>113</sup>The report can be accessed via the following link: [http://www.oecd.org/document/39/0,3343,en\\_2649\\_37427\\_39886055\\_1\\_1\\_1\\_37427,00.html](http://www.oecd.org/document/39/0,3343,en_2649_37427_39886055_1_1_1_37427,00.html).

audacious in scope, and surprisingly detailed in presentation, yet has received relatively little attention.<sup>114</sup>

Perhaps the first remarkable thing to note about the final report on intermediaries is that it devotes comparatively little attention to intermediaries. Rather, the drafters appear to have taken to heart the concerns of tax lawyers<sup>115</sup> that they are ethically bound to represent their clients zealously, so that the OECD work should take into account that the obligations and responsibilities of taxpayers and their lawyers must be aligned.<sup>116</sup> As a result, the final report focuses primarily on the relationship between revenue authorities and the taxpayers themselves. The focus reflects the report's assumption that the best approach is to decrease the demand for aggressive tax planning rather than to control the supply side.

More substantively, the final report proposes two complementary and revolutionary changes to the relationship between taxpayers and revenue authorities. First, the final report proposes a regime under which taxpayers (and tax advisers) are risk-assessed by the revenue authorities and classified along a spectrum ranging from high risk to low risk. The assessment then determines how particular taxpayers (and advisers) are dealt with by revenue authorities. Second, the final report proposes an enhanced relationship among the three parties, the essential terms of which are that taxpayers become more transparent with revenue authorities and revenue authorities give taxpayers five things that they most want from revenue authorities that they may not be getting today. The details of these regimes are discussed below.

(b) **Risk management.** Chapter 5 of the final report addresses risk management.<sup>117</sup> The intended taxpayer benefits of the risk assessment process are those

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<sup>114</sup>This is perhaps not surprising to those who believe OECD projects receive significant attention only when they present an imminent probability of significant fiscal impact to a sufficiently large number of influential business taxpayers. Under that standard, the only element missing from the OECD intermediaries project may be imminence.

<sup>115</sup>In Feb. 2007 tax officials involved in production of the working papers consulted a group of seven U.S. tax lawyers regarding the project. The author was a member of that group.

<sup>116</sup>Any other approach, the lawyers observed, would put them at risk of committing transgressions punishable under professional ethics rules.

<sup>117</sup>Chapter 3 of the report discusses the "tripartite" tax environment shaped by taxpayers, tax intermediaries, and revenue authorities. Chapter 4 describes country responses to intermediaries that engage in aggressive tax planning. Chapter 6 highlights the need for revenue authorities to obtain information from taxpayers to combat aggressive tax planning. Chapters 7 and 8 address the enhanced relationship mentioned above and described below. The banking industry, which is recognized to be both a taxpayer and a tax intermediary, is discussed in Chapter 9.

that come along with being designated a low-risk entity,<sup>118</sup> including lower compliance costs and avoiding the more intense scrutiny that comes with being in the minority of high-risk taxpayers, as well as the benefits of the “enhanced relationship” discussed below. The benefits of the process for the revenue authorities are better resource allocation and better information regarding tax planning that will come to their attention through the better use of their resources<sup>119</sup> and through the actions of taxpayers seeking to be designated as low risk.<sup>120</sup>

A taxpayer’s risk profile would be assessed over a period of years and could change from year to year. In general, a low-risk taxpayer would be one that:

- ensures that its tax systems, people, and processes are “robust”;
- is transparent and cooperative with the revenue authorities; and
- draws revenue authorities’ attention to those issues regarding which there may infrequently be a disagreement over the interpretation of the law.

The taxpayer would be assessed on a risk profile, allowing it to be compared with other similarly situated taxpayers. A risk profile used for comparison with other taxpayers might consider factors such as:

- effective tax rate;
- size, structure, and complexity of the business and its financing;
- tax governance (existence of a tax strategy, accountability for tax decisions);
- propensity to interpret the law in ways that differ from the revenue authorities’ interpretation;
- appetite for tax planning and risk;

- strength of underlying processes and systems (integrity of accounting data);
- complexity of legal arrangements;
- openness and transparency; and
- history of cooperation with revenue authorities.

Notably, the final report did not develop the suggestion made in the draft working papers that national revenue authorities “could make use of national and international risk profiles of tax advisers (as firms or individuals).” The working papers issued in July 2007 noted that because there is often an informal view among examiners regarding tax advisers, “the question may not be whether this approach should be adopted but whether it should be adopted in a more structured way” than it now is. The earlier working papers foreshadowed potential problems inherent in applying such a system, including the strength of the data obtained, the reliance on subjective judgments, the power afforded revenue bodies in this regard, and the commercial interests of tax practitioners affected. Perhaps on the basis of these concerns, the final report did not make a recommendation regarding profiling tax advisers, simply stating that individual countries may “decide how to take this forward.”

**(c) Enhanced relationship.** Chapter 8 addresses the “enhanced relationship” pot of gold at the end of the risk assessment and risk management rainbow. The final report suggests that the authors have been influenced by recent movements away from the “basic” taxpayer-revenue authority relationship in the Netherlands, Ireland, and the United States.<sup>121</sup> The report offers the CAP (compliance assurance process) program as the prime U.S. example of this movement, illustrating the benefits of current real-time disclosure by taxpayers in exchange for prompt issue resolution.<sup>122</sup>

The enhanced relationship is defined by greater fulfillment of what revenue authorities want on the one hand and what taxpayers want on the other. What revenue authorities want is simply stated: greater transparency and disclosure. The concept is further explained as a “self-risk assessment,” but also seems to include

<sup>118</sup>The report focuses primarily on large corporate taxpayers. The report notes, however, that high-net worth individuals are the second principal market for aggressive tax planning, and that further study is warranted to determine what approaches are effective in addressing individual tax abuse.

<sup>119</sup>The report discusses many sources of information and comments favorably on the advent of FASB Interpretation No. 48 in the United States as one of them. The report also mentions the ability of revenue authorities to gain access to tax accrual workpapers. *But see* *Textron v. United States*, *supra* note 6. The report also implicitly endorses the recent expansion of JITSIC from four members (the United States, the U.K., Canada, and Australia) to five (adding Japan), and from one office (in Washington) to two (adding one in London).

<sup>120</sup>The process is designed to allow the Revenue’s resources to be devoted to addressing (for example, through proposed legislation) tax planning involving a tax position that is tenable but has unintended and unexpected tax revenue consequences, and to discovering and addressing tax filing positions that are taken without open disclosure that uncertainty remains whether the position accords with the law.

<sup>121</sup>The working paper perhaps unintentionally reveals a bias in perception by stating that these programs provide “incentives to full compliance.”

<sup>122</sup>The Dutch program involves a nonbinding but written agreement between the revenue authorities and participating taxpayers under which the taxpayers undertake to “actively notify the Tax Administration of any issues with a possible and significant tax risk.” The basic expectation in the Irish program is that participating taxpayers will be open with the revenue authorities about their tax planning strategies and, in return, the revenue authorities will undertake to respond as quickly as possible to requests for interpretation assistance from businesses and their tax advisers.

the notion of expanded clearances and rulings as taxpayers bring more transactions to the attention of the revenue authorities.

What taxpayers are said to want is more complex. The study team's consultations informed the team that what revenue bodies need to demonstrate to give taxpayers<sup>123</sup> the incentive to engage in the enhanced relationship are:

- commercial awareness;
- an impartial approach;
- proportionality;
- openness and transparency; and
- responsiveness.

Each of these five perceived taxpayer requirements is discussed at some length in the final report. And the discussion of each contains tantalizing, albeit sometimes aspirational, ideas. For example, the discussion of an impartial approach states that revenue officials must act in the best interest of the "entirety of the system" and recognizes that tax advisers may have ethical obligations that diverge from that goal.<sup>124</sup>

As another example, the discussion of commercial awareness suggests that revenue authority employees should be better attuned to the fact that the profit motive is the basic animating feature of the corporate taxpayer. The discussion of proportionality states that revenue authorities should ask only appropriately focused questions, have an appreciation of materiality in the context of a tax audit, and close audits once the significant issues have been satisfactorily explored. The discussion of "responsiveness" acknowledges that, if revenue agents were overruled by management, it could destroy the certainty required by taxpayers. And the discussion of "openness and transparency" states that taxpayers should legitimately expect their voice to be heard on changes in tax policy and tax administration, with open engagement early enough to influence final decisions.<sup>125</sup>

<sup>123</sup>The final report discusses the role of tax intermediaries in the enhanced relationship, and the possibility of a specific enhanced relationship for tax intermediaries, although the discussion of the relationship is less developed than that described for taxpayers. The report suggests that, as part of an enhanced relationship, it would be beneficial for tax advisers "to develop and maintain a level of 'policy awareness,'" which is defined as the "ability to predict which transactions and issues the revenue body will want disclosed."

<sup>124</sup>That discussion also comes close to acknowledging that in the real world, revenue bodies often may seek to collect more than the "right" amount of tax. The discussions of the five elements in the final report, however, are significantly less forward-leaning than the discussions on which they were based in the working papers.

<sup>125</sup>One is reminded of a rulemaking in early 1998 regarding the use of hybrid entities under subpart F.

It is clear that all of these elements are extremely attractive. What is unclear is whether the benefits outweigh the costs of, effectively, laying down arms and opening the reactors to inspection and, even if the benefits do outweigh the costs, whether the trust exists to proceed. Both topics are dealt with in the final report, and, needless to say, the prospects are presented as positive.<sup>126</sup> Also, the daunting task of implementation is broached, although too briefly in light of its significance.<sup>127</sup>

## ii. Other OECD initiatives

**(a) Business restructurings project.** The OECD Committee on Fiscal Affairs has for several years operated a working group on business restructurings that is addressing both government and taxpayer concerns related to those tax examinations held in various countries in recent years that have either sought to find taxable transfers of intangibles in connection with business restructurings or that have sought to find "deemed PEs" left behind in the transferring countries.<sup>128</sup> The working group has held numerous discussions with business groups, both through an ongoing advisory group and through discussions at OECD-affiliated tax conferences. To date, the project has not resulted in any policy recommendations, although it appears to have been an effective forum for thoughtful debate of the various policy interests involved in this area. As noted above, policy recommendations are expected at the end of 2008.

**(b) Tax competition project.** The OECD's tax competition project started as an examination into the practices of tax havens and OECD member countries that were designed to attract, or that had the effect of attracting, specific mobile capital from other jurisdictions.<sup>129</sup> It evolved to focus on secrecy and information

<sup>126</sup>The final report did clarify that revenue bodies should strive to offer the enhanced relationship to all taxpayers, rather than only to those that engage in disclosure and transparency, although the report finds that it may be easier to offer the enhanced relationship to compliant taxpayers. In any case, the final report concludes that taxpayers nevertheless have significant incentives to participate in the enhanced relationship — the early disclosure and resolution of tax issues.

<sup>127</sup>Other important topics, including the expanded use of alternative dispute resolution, are also discussed.

<sup>128</sup>Information about the project can be found at the following page on the OECD's Web site: [http://www.oecd.org/document/0/0,3343,en\\_2649\\_37427\\_38791616\\_1\\_1\\_1\\_37427,00.html](http://www.oecd.org/document/0/0,3343,en_2649_37427_38791616_1_1_1_37427,00.html).

<sup>129</sup>In 1996 OECD ministers initiated a project to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998." G-7 leaders announced their support of the OECD project at their 1996 meeting in Lyon, stating that "tax schemes aimed at attracting financial and other geographically mobile activities can

(Footnote continued on next page.)

exchange, and as such, was evaluated in a recent book on the subject as a “qualified failure.”<sup>130</sup>

For our purposes, only a few observations seem relevant and appropriate. First, it must be acknowledged that at least some of the elements of the project (for example, the “no substantial activities” criterion for listing) took their shape as a result of compromises that made them and, therefore, the project as a whole to some extent, challenging to defend. Second, the challenges faced in the effort yielded significant lessons learned, some of which have been articulated by apparently objective observers and which might be used in shaping further efforts along these lines.<sup>131</sup> And third, the scope of the project was narrowed, but the continuation of the project with a focus on information exchange suggests that multilateral action, at least on problems of the sort identified by Levin in his proposed legislation, is a realistic possibility.

### iii. European Commission communication.<sup>132</sup>

The European Commission recently issued a communication that emphasizes the need for greater cooperation between states in adopting antiabuse legislation.<sup>133</sup> On December 10, 2007, the commission issued a communication asking member states to review antiabuse legislation in light of recent judicial developments of the ECJ. The goal of the member state review is to adopt antiabuse measures that are consistent with ECJ precedent, but that do not too broadly interpret precedent at the expense of raising revenue and protecting the domestic tax base. As a core component of the review, the ECJ advocated a coordinated approach with the communication aimed at generating debate and future coordination between and among the member states with the commission acting as a facilitator.

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create harmful tax competition between States, carrying risks of distorting trade and investment, and could lead to the erosion of national tax bases.”

<sup>130</sup>J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation* (Cornell University Press, 2006), reviewed in Sullivan, “Economic Analysis: Lessons From the Last War on Tax Havens,” *Tax Notes*, July 30, 2007, p. 327, *Doc 2007-17436*, 2007 TNT 147-5.

<sup>131</sup>*Id.* These include the need, if the project is to succeed, for both enhanced incentives and enhanced political will for meaningful sanctions. *Id.*

<sup>132</sup>For a broader analysis of EU antiavoidance developments, see the presentation based on her forthcoming doctoral dissertation by Alice Niemann of the Max Planck Institute at the Foreign Lawyers Forum panel on comparative antiavoidance developments, ABA Tax Section Midyear Meeting, Lake Las Vegas, Nevada, Jan. 18, 2008.

<sup>133</sup>The communication is available at *Doc 2007-27004*, 2007 WTD 240-2.

**iv. Papal encyclical.** At the risk of putting one religious reference too many in this report,<sup>134</sup> I couldn’t resist adding that on August 15, 2007, the tax press reported that Pope Benedict XVI was set to condemn tax evasion and the use of offshore tax havens as immoral and unjust practices.<sup>135</sup> The papal denunciation was expected to take the form of an encyclical to be released in a matter of days that would discuss taxation within the context of a broader discussion of social justice and the economic challenges of globalization.<sup>136</sup> The move was said to represent a rare instance of one of the world’s major religious figures taking a firm stance on the secular matter of taxation.<sup>137</sup>

## B. Analysis

As stated at the outset, the purpose of this report, in true scholarly tradition, was to describe a series of micro-level developments that appeared related and to determine if in fact there were relationships and trends to be discerned. To assist in that effort, it may be worthwhile to briefly summarize the developments.

### 1. Summary of Developments

**a. Transaction disclosure and transparency.** It seems clear that there is a trend, at least among some major developed countries, toward greater disclosure. Transaction reporting rules targeting a broad swath of transactions perceived as potentially aggressive have been adopted in the United States and the U.K. Disclosure rules focused on arbitrage transactions are under public consideration in Germany and are reportedly under consideration by the revenue authorities in France, after the withdrawal of a previously proposed version.

The trend toward transparency is also prominent in the final report produced in connection with the OECD’s intermediaries project, and in the work of JITSIC, although that is transparency of a different sort. And the focus on information exchange as the primary or exclusive aim of the OECD’s tax competition project suggests that at least this aspect of that work has consensus support.

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<sup>134</sup>For an interesting perspective on the role of religion in politics today, see Mark Lilla, “The Great Separation,” *The New York Times*, section 6, p. 28 (Aug. 19, 2007).

<sup>135</sup>See Kristen A. Parillo, “Pope to Denounce Tax Havens,” *Tax Notes Int’l*, Aug. 20, 2007, p. 732, *Doc 2007-18877*, 2007 WTD 158-1.

<sup>136</sup>Encyclicals are authoritative statements of Catholic Church policy authored by the pontiff and issued intermittently by the church.

<sup>137</sup>The Catholic Church in India had voiced its support of domestic measures combating tax havens and tax abuses, perhaps in anticipation of the papal encyclical on the issue. See *Tax Notes Today* (Aug. 21, 2007). In an apparently unrelated, but ironically coincidental development, the EU has initiated an investigation to determine whether tax breaks afforded to the Vatican violate EU standards. See *BNA Daily Tax Report* at I-1 (Aug. 29, 2007).

**b. Arbitrage.** As stated above, a close look at U.S. developments indicates that although arbitrage has become a greater focus over the years, it is still treated in the United States as a practice that does not as a general proposition violate any laws, rules, or policies, and violates specific rules only in those rare cases in which the type of arbitrage that raises concerns is specifically articulated in legislation of a rulemaking. The review of U.S. developments above suggests that, at most, arbitrage can be viewed as a transactional feature that might suggest further inquiry into the transaction is warranted.<sup>138</sup> And although one might be able to draw a distinction between arbitrage that occurs naturally and arbitrage that is the result of deliberate planning, that distinction has not emerged as a specifically articulated basis for distinguishing among arbitrage transactions in the United States.

In one sense, the U.K. has gone further than the United States, enacting legislation allowing HMRC to disallow the benefits of a transaction on the basis that it involves arbitrage (as long as it meets other criteria, including a subjective intent test). In another sense, however, the legislation is narrow, as it is not self-executing and requires specific action against the taxpayer on the part of HMRC before the benefits are disallowed.

Germany has also proposed to go further than the United States, although its rules are only in the discussion stage, and they do not go as far as to address the merits of the tax positions taken in arbitrage transactions. That is, although the rules would not prescribe substantive tax results, they would require disclosure and registration of tax arbitrage arrangements. The United States formerly had included arbitrage as a filter in regulations requiring transaction disclosure, but that filter was withdrawn.

France considered rules similar to Germany's proposed arbitrage rules, but withdrew them. Although they are reportedly still under consideration, they have not reappeared for some years.

**c. Adviser/return preparer focus.** One trend that appears to have emerged recently is the focus on advisers. In the United States, this has taken the form of rules that complement the taxpayer reporting and disclosure rules. Similar rules apply to advisers in the U.K. regarding "hallmark" transactions and are under discussion in Germany regarding arbitrage transactions. The focus on advisers also is evident in the recent amendments to the return preparer rules, which divorce the taxpayer standards for undisclosed return positions from the return preparer standards.

<sup>138</sup>This was the sense in which arbitrage was used in Notice 98-5, in which an arbitrage transaction violated the rules only if it failed an objective economic benefit test.

Ironically, the recent development regarding adviser focus that could be the furthest-reaching, the OECD intermediaries project, recognizes the importance of symmetry in the standards between advisers and taxpayers so much so that the final report focuses to a much greater extent on taxpayers themselves than advisers, despite the Seoul declaration mandate under which the work is being done and the informal name by which the project has become known.

**d. Statutory antiabuse rules.** As the United States debates the enactment of a general statutory antiabuse rule, it is worth observing developments in other countries. It is widely believed that Canada's antiavoidance rule is a weak tool in the hands of the Canada Revenue Agency. The recent *MIL* case, affirmed on appeal, suggests that even a specific legislative clarification that the statute can apply to a certain type of transaction is no assurance that the statute will be applied by the courts in a robust manner. The German experience with its statutory anti-treaty-shopping rule as applied in *Hilversum II* is similar, although the application of the rule in *Hilversum I*, the amendments to the rule introduced after *Hilversum II*, and the recent amendments to the German general antiavoidance rule might be cited as support for the proposition that an imperfect statute can be improved, and the perfect should not be the enemy of the good.

It should also be noted that the U.K. considered adoption of a statutory antiavoidance rule in a consultation document released in the late 1990s, but ultimately concluded that no such rule should be adopted.<sup>139</sup> Yet the U.K.'s recent experience in the *As-tall* case<sup>140</sup> suggests that even in the U.K., common-law antiabuse rules may be vibrant enough for that system.<sup>141</sup>

**e. Case law.** Recent trends suggest that a purposive interpretation of the tax law is resurgent. In the United States, the government has won many of its recent economic substance cases, although perhaps the most significant of these was likely at least in part an appellate reaction to a radical lower court opinion. In the U.K., the *Ramsay* principle was recently applied to defeat a structured transaction, and, even in France, where the civil law system would seem to require a more literal interpretation of the law, the government won a recent case even though a literal reading of the relevant treaty might easily have led to a different result. Only in Canada and Germany, which, ironically, have the

<sup>139</sup>For an overview of the proposed U.K. general antiabuse rule, see a consultative document issued on the subject, available at [http://www.hmrc.gov.uk/consult/consult\\_1.pdf](http://www.hmrc.gov.uk/consult/consult_1.pdf).

<sup>140</sup>See *supra* note 66.

<sup>141</sup>Of course, in the U.K. parliamentary system, perceived abuses can be addressed by legislation that, on proposal, is almost assured of enactment.

strongest statutory antiabuse rules, has the recent case law been less favorable to the government. And even in Canada, it appears that the pendulum may be swinging in favor of the government.

**f. Tax minimization through the use of low-tax jurisdictions.** Although tax havens are always a focus of tax administrations, a number of developments suggest an increased focus on tax minimization through the use of low-tax jurisdictions. In the United States, the Doggett bill, the Levin bill, and the Neal bill all suggest serious legislative interest in, and the material possibility of, action targeting the use of low-tax jurisdictions. In the U.K., a tightening of the controlled foreign corporation rules, even though in the context of a more general relaxation of the rules for the taxation of foreign income, suggests a heightened focus on the use of low-tax jurisdictions. And the CFC planning techniques that have come under scrutiny in the *Zimmer* case in France, the duplication-of-functions proposals in Germany, and the OECD's harmful tax competition and business restructuring projects all have their roots in the exploitation of low-tax jurisdictions. It remains to be seen whether the pressure placed on these techniques by those and similar developments will force a change in the standard tax planning employed around the world today, or instead will force a change in the tax systems they are exploiting.

**g. Enforcement.** That tax administration and enforcement is becoming more global cannot be denied. So far, the changes have been evolutionary, not revolutionary, but that could change if the proposals in the OECD's intermediaries project are adopted, or cross-border enforcement changes qualitatively in light of expansive interpretations of *Pasquantino*. In any event, what seems likely is that the interconnectedness of revenue authorities will only increase, suggesting that taxpayers will need increasingly astute advisers who can guide them not only through the substantive judgments to be made under their systems, but also through the procedural thicket of an increasingly interconnected tax enforcement environment.

#### 2. Coherence or Babel?

So what trends are there? There appears to be a trend toward greater transparency and global administrative enforcement. Some developments suggest a greater focus on advisers and intermediaries, although

it is hard to call that a trend with the largest project on the subject, the OECD's intermediaries project, actually turning away from an adviser focus. Similarly, the advance of statutory antiabuse rules probably cannot yet be termed a trend, because some large countries have considered it and to date rejected it (and the countries that have adopted it may not have found it a net plus). And although a purposive approach in the case law may be gaining ground in the U.K. and France, the U.K. has witnessed a temporary resurgence of purposive interpretation before, and France's civil law system seems to provide a natural cap on the extent to which purposive interpretation of the law will be allowed.

Regarding arbitration, it seems that there is a trend toward greater attention to the phenomenon, as the balance shifts from arbitration being mostly coincidental to arbitration being increasingly planned. And it also seems that some countries have taken steps to address transactions or classes of transactions featuring arbitration. What seems clear, however, is that there is no agreement that arbitration per se is objectionable (at least the position of United States tax officials is that it is not), there is no multilateral agreement on how to address those transactions featuring arbitration that might be objectionable, and there is certainly no agreement that there exists a coherent international tax common law restricting arbitration.

### III. Conclusion

Although the building blocks of an international tax antiabuse standard may now be perceived in the rules and policies of various countries, and although such a standard may in the future develop, it seems fair to conclude that it does not today exist. Whether it is desirable may be principally a function of what that standard is, and whether one is advocating for taxpayers or the government. It also may be informed by one's interpretation of the Tower of Babel passage opening this report. Whatever the analytical framework, the question of desirability may be overtaken by events if, as may well happen, such a standard in fact emerges. The issue may be explored profitably in future work by taxpayers, governments, and multilateral organizations such as the OECD. ◆