

# Enforcement of Taxes on Foreign Source Income in a New World

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## Abstract

The 21<sup>st</sup> century is characterized by an unprecedented economic and technological globalization. An increasingly free cross border flow of ideas, information, goods, services, and capital has led to the greater integration of economies across the world. These developments have also posed some challenges to national tax systems. A seemingly simple rule found in the tax laws of most countries that “**residents ought to pay taxes on their worldwide income**” now has to prove its feasibility in the face of these new realities. There have been questions: how do the states feasibly administer this tax regime in a world where their tax administrative capacities are highly restricted to their territorial borders, while their residents increasingly trade, invest, and provide services across borders. How do they possibly establish whether their residents earn foreign-source income? What mechanisms do they generally have to administer the law on foreign source income of its residents? The few years of practice have already shown the residence-based tax system is prone to abuse without robust cooperation between states. After all, resolving the question of enforcing tax laws on the foreign source income of resident taxpayers has become one of the main priorities of national and international income tax systems.

This paper attempts to provide some insights into these questions in the light of common tax enforcement practices that countries in the administration of their income tax systems. By doing so, the paper attempts to explain the need for international cooperation in the field of taxes. It also attempts to provide a rationale for the new international framework of automatic exchange of tax information between 97 countries, which will become operative by September 2018.<sup>2</sup> The analysis in the paper is limited to the tax law rules applicable to foreign source income of resident taxpayers who are individuals.

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<sup>2</sup> OECD (2014) *Standard for Automatic Exchange of Financial Account Information in Tax Matters*. France, Paris: OECD. Available at: <<http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-information-in-tax-matters.htm>>. For the list of signatory countries see <https://www.oecd.org/ctp/exchange-of-tax-information/MCAA-Signatories.pdf>

## 1. Introduction

Law plays a significant role in society; one of its most basic role is to ensure a fair, safe, respectful, and adequately progressive society in which every person lives her or his life happily and in harmony with others.<sup>3</sup> In order to promote this collective project, government employees certain mechanisms that allows observance, detection, and sanctioning for the breach of law, all of which are collectively known as law enforcement. The existence of these enforcement mechanisms has been critical to ensure compliance.<sup>4</sup> This very existence of the enforcement is also what distinguishes law from other social norms (e.g. customs, traditions, morality, or other rules of conduct), for without it the law is no more than a moral prescription.<sup>5</sup>

Modern income tax laws have had a significant problem in this regard. There is a clear mismatch between what these laws stipulate and enforceability thereof. The basic premise of income tax laws of most countries is that state's jurisdiction to tax income of its residents does not effectively cease at its territorial borders.<sup>6</sup> Generally, the state taxes the income of its residents from all sources, including those earned inside and outside its borders.<sup>7</sup> For instance, if a resident taxpayer earns employment income by working for a local company, and also holds the shares of a company located abroad or holds deposits with a foreign bank and consequently received dividends and interest income therefrom, the resident taxpayer is generally required to declare all these income to the country of her residence. The income from these domestic and foreign sources is then aggregated as the taxpayer's total income for the year and is taxed accordingly.<sup>8</sup> This tax system is commonly known as "residence-based" or "worldwide-based"

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<sup>3</sup> See J. Locke, *Second Treatise of Government* at 103 (Hackett Publishing 1980). (Locke argues that the person who "exceeds the power given him by the law... may be opposed, as any other man, who by force invades the right of another.)

<sup>4</sup> A.D Wozley, *The Existence of Rules* 1 *Journal Noûs* 1 (1967).

<sup>5</sup> Conrad Johnson, *Moral and Legal Obligation* 72 *Journal of Philosophy* 12 at 315 (1975).

<sup>6</sup> League of Nations Economics and Finance Commission, *Report on Double Taxation* (Geneva League of Nations 1923).

<sup>7</sup> *Ibid.*

<sup>8</sup> An important corollary of this system is the potential double taxation of the resident taxpayer's foreign-source income. If the resident taxpayer has incurred any income tax on the foreign source income in the country where it was earned, the taxpayer is generally provided a foreign tax credit for such taxes thereby mitigating double taxation of the foreign source income. An ultimate result of the foreign tax mechanism is that the resident taxpayer's overall tax burden on foreign and domestic source income would generally be same to the extent that the foreign taxes paid on the income were lower than that of the residence country on the income. Otherwise, the taxpayer's overall tax burden on the foreign source income would be that of the source country. Typically, when levying tax on the foreign-source income of its residents, the residence country allows a foreign tax credit or an itemized deduction for those foreign taxes. Thus, the amount of the foreign tax paid is normally deductible from the amount of tax that is payable on such income to the residence country. As a result, the resident taxpayer is liable to pay the difference in tax rates applicable at the residence and source countries to the residence country to the extent that foreign tax paid is lower than residence country's tax otherwise payable. Provided that tax rates in the source country of the income and the residence country of the taxpayer are comparable, the taxpayer may not owe any tax on the respective

income taxation system (these terms will be used interchangeably throughout the article). Today, an overwhelming majority of countries operate under this system.<sup>9</sup>

However, one of the biggest challenges of the worldwide-based income tax system has been the enforceability of the tax law, especially in relation to foreign source income of resident taxpayers.<sup>10</sup> The income tax is generally assessed on a yearly basis on net accretion to the taxpayer's wealth before consumption during the year but after allowing certain eligible expenses.<sup>11</sup> Thus, the administration of this system depends enormously on determining each resident taxpayer's income status (e.g. the nature and amount of the taxpayer's income) for each taxation year and the support that the government receives from the taxpayer and third parties to collect and process such information. Applying these to the taxation of foreign source income means that a state needs information also from abroad where the taxpayers earn their foreign source income. Does the state have access to such extra-territorial information or tax collection support?

As a fundamental principle of international law, a state cannot carry any administrative

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foreign-source income to her or his residence country, but she or he is still required to declare that income. An overall result of the foreign tax credit system is that the residence country's tax rate in effect applies on all income of the taxpayer regardless of where it is earned - domestically or abroad. See at *OECD Model Tax Convention on Income and on Capital (with commentaries)* art. 23; *United Nations Model Double Taxation Convention between Developed and Developing Countries (with commentaries)* (New York, US 2011); K. Holmes, *International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application* at 1-22 (Amsterdam: IBFD Publications 2007); A. Miller & L. Oats, *Principles of International Taxation* (Haywards Heath: Tottel Publishing 2009).

<sup>9</sup> See *Deloitte, Country Taxation and Investment Guides*: Sections 3 (Business taxation) and 6 (Tax on Individuals)(2014). The Guides provide a summary of tax systems of over 150 countries worldwide. The Guides are available at <https://dits.deloitte.com/#TaxGuides> (Accessed 21 Nov. 2016); See also K. Vogel, *Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments: Part 1*, 8/9 Intertax, at 25 (1988).

<sup>10</sup> R. Gordon, *Can Capital Income Taxes Survive in Open Economies?* at 1159 (Cambridge, Massachusetts: National Bureau of Economic Research 1990), (Gordon notes that income from savings invested outside the country is virtually impossible for a government to monitor. Individuals therefore can evade tax on such savings with very little risk of being caught by tax authorities of their residence country); K. Wagner, *US Taxation of Foreign Income: The Use of Tax Havens in a Changing Tax Environment* 18 Southern Illinois ULJ at 634 (1994), (Wagner points out that noncompliance is an option to most taxpayers with foreign source income because of their tax authorities inability to collect information about foreign financial transactions); P. Baker, *The Transnational Enforcement of Tax Liabilities* British Tax Review, at 313-318 (1993); J. Dubin, *The Causes and Consequences of Income Tax Noncompliance* (New York Springer Science+Business Media, 2012).

<sup>11</sup> Generally, the modern concept of income was shaped in the 1920s and 1930s by the American economists Robert M. Haig and Henry C. Simons. They defined the income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." See R.M. Haig, *The Concept of Income-economic and Legal Aspects* in Robert M. Haig, ed., *The Federal Income Tax* at 1-28 (New York: Columbia University Press 1921); H. Simons, *Personal income taxation: The definition of income as a problem of fiscal policy* at 49 (Chicago University Press, 1938).

act on the territory of another state without the latter's permission.<sup>12</sup> Generally, a state's territorial borders are the beginning and end of its jurisdiction.<sup>13</sup> This means that a state's tax law has no force in another state's territory. In tax law this principle is also known as "revenue rule".<sup>14</sup> This centuries-old but still rigorously applied common law principle holds that a tax claim is generally unenforceable in countries outside that in which the claim has arisen.

These two paradigms, i.e. the states' self-proclaimed jurisdiction to tax residents on their worldwide income and the inherent limitation on their enforcement capacity beyond their national territories, raise some legitimate questions: how does a state feasibly administer its tax jurisdiction over foreign source income of its residents where its enforcement capacity is inherently limited to its territorial borders? How does it possibly establish whether its residents earn foreign-source income? What mechanisms does the state have to administer its income tax system? The author conducts a comprehensive analysis of the common tax enforcement mechanisms available under domestic tax laws to verify if there are clear answers to the raised questions.

## 2. *Administration of taxes on income from domestic sources*

As once one commentator eloquently said, there are two mutually inclusive elements for the effective enforcement of income taxes: tax jurisdiction and tax information.<sup>15</sup> Tax

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<sup>12</sup> See L. Oppenheim, *International Law: A Treatise*, Vol. 2 at 386-458 (London, Longmans, Green and Co 1944), (The territorial authority is an important aspect of public international law. Oppenheim argues that a state may not exercise an act of administration or jurisdiction on foreign territory without permission and that as all persons within the territory of a state fall under its territorial authority, each state normally has jurisdiction – legislative, curial, and executive – over them); See also A. Qureshi, *The Public International Law of Taxation: Text, Cases and Materials* at 308 (London: Graham & Trotman 1ed 1994).

<sup>13</sup> C. Nine, *Global Justice and Territory* (Oxford, U.K.: Oxford University Press 2012); M. Vagias & J. Dugard, *The Territorial Jurisdiction of the International Criminal Court* (2014).

<sup>14</sup> The revenue rule has originated from the Anglo-Saxon jurisprudence. The earliest reported case referencing the rule was decided in 1729 in England in *Attorney General v. Lutwydige*. In this case, Lord Chief Baron Pengelly held that "[b]efore the union this court had no jurisdiction of the revenues in Scotland, and therefore the question is, whether the statute is not exclusive of us, since it is giving a farther jurisdiction to them who had it exclusive of us before." The Revenue Rule was further reinforced in 1775 in *Holman v. Johnson*. In this English case, Lord Mansfield wrote that "... no country ever takes notice of the revenue laws of another". Overall, the doctrine allows a state and its administrative bodies to decline enforcing foreign tax laws and judgments. See UK: TC, 1729, *Attorney Gen. v. Lutwydige*, (1729) 145 Eng. Rep. 674 (Ex. Div.) and UK: TC, 1775, *Holman v. Johnson*, (1775) 98 Eng. Rep. 1120-1121. See also *International Enforcement of Tax Claims*, 50 Columbia Law Review 4 (1950), pp.490-504; B. Mallinak, *The Revenue Rule: a Common Law Doctrine for the Twenty-First Century* 16:79 *Duke Journal of Comparative and International Law* (2006).

<sup>15</sup> T. Greenaway, *Worldwide Taxation, Worldwide Enforcement* 561 *Tax Notes International*, at 759 (2009).

jurisdiction is a legitimate authority to prescribe and collect taxes.<sup>16</sup> Tax information is a type of information that enables tax authorities to carry out this mandate. It is used by tax authorities to determine, assess, collect, and recover taxes. The information normally identifies the taxpayer, verifies its residence, income, and expenses, and establishes links between these elements. Greenaway argues that the tax jurisdiction without having access to such information is useless; while having the tax information without jurisdiction is powerless. Tax enforcement will be real only when both elements are combined.<sup>17</sup>

However, there is a fundamental challenge associated with obtaining tax information. By nature, people disclose their financial information to others only when they perceive it to be in their own interest to do so, or at least where the outcome of the disclosure would be neutral to their interest; otherwise, they tend to hold it back. It also is naïve to believe that people enjoy paying their hard-earned income to the government. In their attempts to understand the roots of tax avoidance and evasion, economics Professors Slemrod and Bakija noted that “it is not any one individual's interest to contribute voluntarily to government's coffers. Each citizen has a very strong incentive to ride free on the contributions of others, since one's own individual contribution is just a drop in the bucket and does not materially affect what one gets from government”.<sup>18</sup> Thus, in the absence of certain enforcement mechanisms, it is not in the taxpayer's immediate self-interest to voluntarily disclose information on their income. This requires the existence of some sort of structural mechanism which ensures reasonable disclosure of taxpayers' periodical income positions to the government.

In a purely domestic context, the governments administer their income tax laws based on information obtained from two primary sources:

- a) Self-assessment reports;
- b) Third-party's tax information reports.

**Self-assessment reports.** Generally, paying taxes is a fundamental constitutional obligation. Persons on whom this obligation mainly falls are statutorily defined as tax residents. The tax obligation of resident taxpayers typically involves three basic requirements:

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<sup>16</sup> R. Martha, *The Jurisdiction to Tax in International Law: Theory and Practice of Legislative Fiscal Jurisdiction* at 54-66 (Boston: Kluwer Law and Taxation Publishers, 1989).

<sup>17</sup> Greenaway, *supra* n. 66 at 759.

<sup>18</sup> See J. Slemrod & J. Bakija, *Taxing Ourselves: a Citizen's Guide to the Debate Over Taxes* at 145 (Cambridge: Mit Press, 2004).

a) **Tax registration.** Generally, an individual or entity aiming to commence an economic activity has to register with a relevant tax authority. For this purpose, the person must undergo a basic identification process by providing the tax authority its name, address, and if necessary, a statement of the nature of purported economic activity or business. Upon registration of this data, the authorities issue the person a specific identification number that is commonly known as a tax identification number (TIN) or, in some countries, social insurance number (SIN). This number is then used to identify the taxpayer for fiscal or other social purposes.

b) **Record keeping.** Registration with fiscal authorities generally obliges the taxpayer to maintain its financial records.<sup>19</sup> The scope of this recordkeeping depends on the type of taxpayer, the nature of economic activity, and the government's access to such information through other sources. For example, if the taxpayer is an employee, the recordkeeping obligation normally rests with the employer, while the recordkeeping obligation with respect to tax-deductible personal expenses remains with the taxpayer, to the extent the taxpayer intends to claim a tax deduction for such expenses.

Corporate taxpayers, on the other hand, generally are subject to strict recordkeeping rules; income tax laws require these taxpayers to keep their tax relevant records in certain forms, and for a specified period of time.<sup>20</sup>

These records typically must allow tax authorities (a) to identify the taxpayer; b) to verify the source, and type of income earned, as well as any deductible expenses, benefits, and allowances. Non-compliance with the recordkeeping obligation may result in the denial of deductions, and potentially civil, administrative, or criminal penalties.

c) **Tax reporting.** Tax residents are also required to make a full and timely self-declaration of their taxable income to fiscal authorities. Such reports are generally submitted annually and are often referred to as "self-assessment reports".<sup>21</sup> Self-assessment is a written declaration by the taxpayer to fiscal authorities of the taxpayer's

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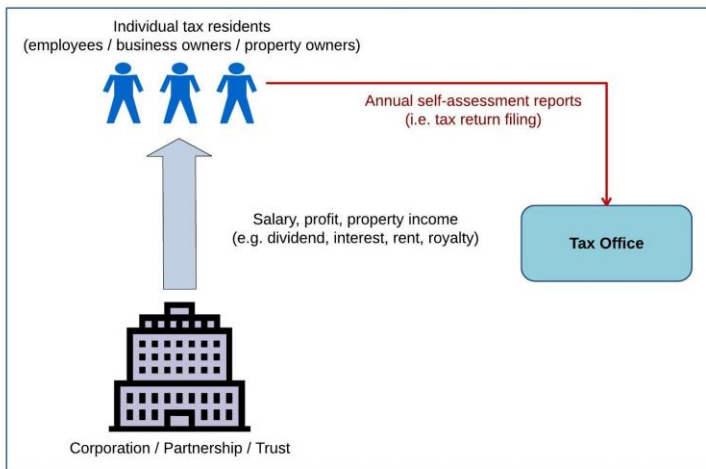
<sup>19</sup> US: Internal Revenue Code, s. 6001; CAN: Income Tax Act, 1985, ss. 230(1); UK: CH14100, s. 140. Available at <<http://www.hmrc.gov.uk/sa/rk-bk1.pdf>>; <<http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Recordkeeping>>; <<http://www.cra-arc.gc.ca/tx/bsnss/tpcs/kprc/menu-eng.html>> (Accessed 24 Nov. 2016).

<sup>20</sup> C. Evans, S. Carlon & D. Massey, *Record Keeping Practices and Tax Compliance of SMEs* 3:2 eJournal of Tax Research (2005).

<sup>21</sup> Self-assessment is timely filing and reporting of required tax information, the correct self-assessment of one's taxes owed, and timely payment of these taxes without much enforcement action. See C. Silvani & K. Baer, *Designing a Tax Administration Reform Strategy: Experiences and Guidelines* at 11 (US, Washington DC: International Monetary Fund, 1997); N. Barr, S. James & A. Prest, *Self Assessment of Income Tax* at 3-8 (London, UK: Heinemann Educational Books, 1977).

income and tax-deductible expenses for a particular period of time. It crystallizes the liability to pay tax, and determines the amount and time at which the tax is due.

Figure 1. Self-assessment / Self-reporting



Self-assessment is typically performed by filing an annual tax return in a form prescribed by a competent tax authority (see Figure 1). Generally, a tax return has three major components: a) a declaration of income; b) a declaration of tax deductible expenses, allowances and eligible tax credits; and finally c) a computation of actual tax paid and/or tax payable for the year by subtracting tax deductions

and allowances from income, and applying tax credits and determining applicable tax rates, and consequently overall tax liability.

The self-assessment report is the most common single source of tax information, and the most common method of tax administration currently available. The system presumes that taxpayers can and should be trusted to compute their own income tax liabilities.

However, this presumption raises important questions: what if the taxpayers fail to make self-assessment or make false self-assessment reports? There is already a long-running theory and a myriad of practical evidence, which establish that taxpayers have no special commitment to honesty when it comes to paying taxes.<sup>22</sup> The taxpayer's decision to declare or not to declare their income is generally determined by the expected outcome of the decision, namely the likelihood of detection of the misreporting or non-reporting.<sup>23</sup> Generally, if the

<sup>22</sup> Tax noncompliance for rents and royalties, for instance, equalled 51%, for non-farm proprietor income, 57%, and for farm income tax noncompliance rate was 72%. Meanwhile, tax compliance rates for income subject to automatic withholding (wages and salaries) and information reporting (interest and dividend income) were estimated to be around 99 and 95%, respectively. See IRS, *Tax Gap Figures in 2001*, at 2, 3. Available at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_figures.pdf](http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf); See also R. Doernberg, *Case Against Withholding* 61 Tex. L. Rev. at 595 (1982) (Doernberg argues that the US tax system is often said to be one of self-assessment, but for some time it has been known that tax compliance is the highest where self-assessment is the least relied upon. The effectiveness of the system is rooted primarily in the government's ability to verify returns filed by taxpayers).

<sup>23</sup> The theory is often referred to as an "economic deterrence model". See M. Allingham & A. Sandmo, *Income Tax Evasion: a Theoretical Analysis* Journal of Public Economics 1 (1972), at 323-338 (1972); J. Roth, J. Scholz & A. Witte, *Taxpayer Compliance* at 82 (Philadelphia University of Pennsylvania Press 1989); H. Kelvin *et al.*, *Unwilling*



likelihood of detection is higher, they more likely it is a taxpayer will declare their income. If this is not the case, they taxpayers are less likely declare their income.<sup>24</sup> Consequently, in such cases, the way to ensure tax compliance would be to make the expected utility of compliance higher than the expected utility of noncompliance. As such, tax compliance behaviour is expected to improve as the detection or visibility of tax non-compliance becomes more probable. Some scholars refer to this phenomenon as the ‘visibility effect’.<sup>25</sup> Professor Kagan argues the visibility of an income-yielding transaction to tax authorities has an enormous impact on tax compliance.<sup>26</sup>

One way to ensure visibility is to pair the self-assessment with some kind of complementary mechanism that allows tax administrations to verify the accuracy and truthfulness of self-assessment reports. This mechanism is called “third-party reporting”.<sup>27</sup> Governments often employ this mechanism, where it is possible, as a parallel source of tax information.

**Third-party tax reporting.** Entities play a central role in the administration of income taxes.<sup>28</sup> As taxpayers, they have to maintain records of their revenues and expenses for

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*or Unable to Cheat? Evidence from a Tax Audit Experiment in Denmark* (2011) 79:3 *Econometrica*, at 689 (2011). (The authors note that one possible explanation for higher rates of tax noncompliance or underreporting of taxable income is the lower probability of detection associated with some types income).

<sup>24</sup> *Ibid*, at 324-325 (The authors argue that if tax liability on a self-reporting form is accurate, then the taxpayer receives some level of utility from the after tax-income. If the taxpayer reports less than the actual taxable income, then the outcome is uncertain because tax authorities may or may not discover the unreported income. If it is not detected, the taxpayer is better off than if he or she reported accurately. But if the unreported income is detected, then he or she is worse off because tax due is collected together with penalties and interests. Therefore, the expected utility of underreporting a given amount of taxable income depends on the probability of detection of the respective income by tax authorities).

<sup>25</sup> R. Kagan, *On the Visibility of Income Tax Law Violations* in J. Roth, J. Scholz & A. Witte, eds., *Taxpayer Compliance* at 77 (Philadelphia: University of Pennsylvania Press 1989); R.K. Merton, *Social Theory and Social Structure* at 320 (US, New York: Simon and Schuster, 1968), (Merton notes that without direct and immediate observability deviant behaviour can cumulate).

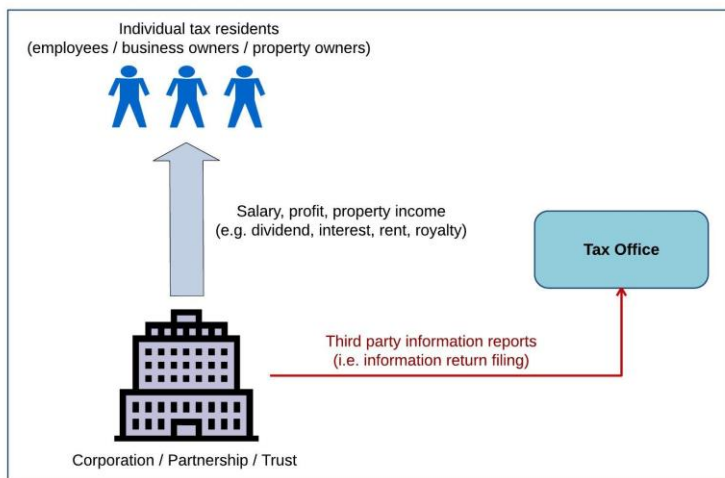
<sup>26</sup> Kagan *supra* n. 69, at 78.

<sup>27</sup> J. Alm, J. Deskins & M. McKee, *Third-Party Income Reporting and Income Tax Compliance* (2006) 06-35 Georgia State University Experimental Economics Center Working Paper; Center for Tax Policy and Administration, *Third Party Reporting Arrangements and Pre-filled Tax Returns: The Danish and Swedish Approaches* (Paris: OECD, 2008); OECD Center for Tax Policy and Administration, *Using Third Party Information Reports to Assist Taxpayers Meet their Return Filing Obligations— Country Experiences With the Use of Pre-populated Personal Tax Returns* (Paris OECD 2006).

<sup>28</sup> Wojciech Kopczuk & Joel Slemrod, "Putting Firms Into Optimal Tax Theory" (2006) 96:2 *American Economic Review*; Henrik Jacobsen Kleven, Claus Thustrup Kreiner & Emmanuel Saez, *Why Can Modern Governments Tax*

accounting and tax purposes. They document payments made to their employees, suppliers, and creditors so that they can claim deductions for these business expenses. This documentation creates a third-party paper trail of information, which is of great interest to tax authorities for verifying the tax liability of other taxpayers. There is a coincidence of interests here between the private parties who seek tax deduction for their expenses, and the government which seeks to levy tax on the income of recipients. And it creates an incentive to cooperate between these parties for effective enforcement of tax laws.

Figure 2. Third party reporting



Thus, government requires the payers of income (e.g. employers) or the facilitators of income payments (e.g. financial institutions) to report to fiscal authorities information on payments made to other taxpayers. Generally, these private parties have two kinds of reporting obligations: automatic reporting (without a specific request from the tax authorities), and specific reporting (in response to a

specific request from tax authorities).

Third party information reporting typically requires filing monthly or annual information returns with local tax authorities reporting (*see* Figure 2).<sup>29</sup> The third party files information returns, often sending a copy to the taxpayer, reporting salary, wage, dividend, or interest income payments made to their employees or customers.<sup>30</sup>

This third-party information reporting mechanism enables tax authorities to verify *the bona fides* of the taxpayer’s annual income reports to the tax administration by systematically matching them with the self-assessment reports presented by taxpayers (*see* Figure 3).

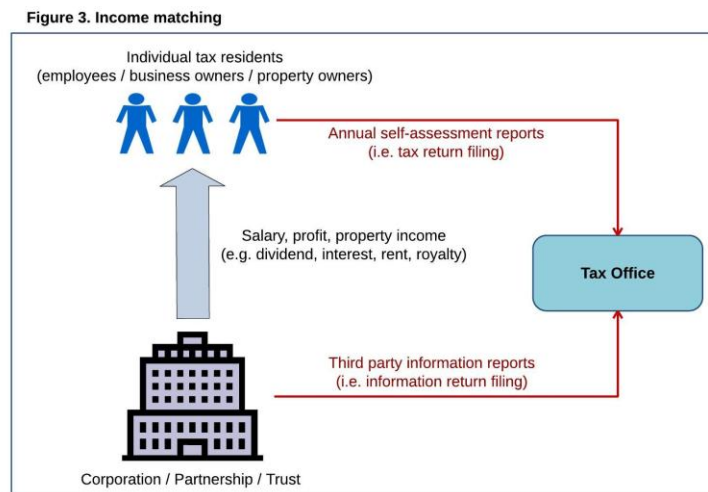
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*so Much? An Agency Model of Firms as Fiscal Intermediaries* (Cambridge, MA: National Bureau of Economic Research, 2009).

<sup>29</sup> In Canada, Ireland, Japan, Norway, and the US, third party information reports are made annually, while in New Zealand and the UK such reports are required to be filed monthly. See OECD Center for Tax Policy and Administration. See *supra* n. 71, at 37-56.

<sup>30</sup> OECD Center for Tax Policy and Administration. *supra* n. 71, at 222-223.

In practice, this verification procedure is known as “income matching”.<sup>31</sup> It is designed to identify potential discrepancies in the reports.<sup>32</sup> If the discrepancies are substantial, tax authorities may ask the reported parties, normally the taxpayer, for an explanation.



However, the third-party tax information reporting mechanism is not always possible, especially when the taxpayer is a self-employed person. In this case, the lack of permanent relationship between the taxpayer and a particular third party makes it difficult to subject the latter to a third-party tax information reporting requirement. Evidence suggests that the taxpayers often take full advantage of this information asymmetry.<sup>33</sup>

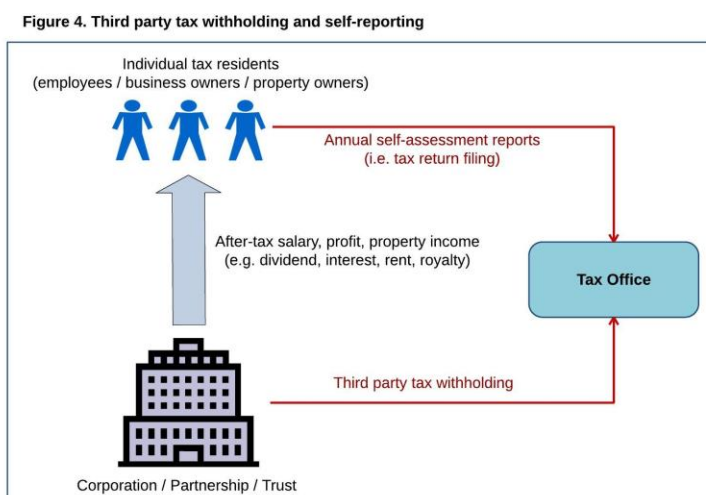
**Third-party tax withholding.** In all advanced economies, most income taxes are collected through third parties. Traditionally, this mechanism is referred to as ‘third-party tax withholding’ or ‘pay-as-you-go’ mechanism. The third party withholding is a mandatory requirement for most payers of income. It requires payers of income to deduct and withhold tax at the source, from the payment they made to the income recipients, and then to transmit the withheld amount to the government. The payer of an income essentially holds back a portion of the income and remits it to the tax authorities, to be applied against the payee's tax liability. Thus, the government collects the tax from the person who pays the income, and not from the person who receives it (*see* Figure 4). The withheld tax is then treated as a pre-payment on account of

<sup>31</sup> J. Alm, J. Deskins & M. McKee, *Third-Party Income Reporting and Income Tax Compliance* (2006) 06-35 Georgia State University Experimental Economics Center Working Paper.

<sup>32</sup> J. Block, *How to Avoid an IRS Audit?* Available at [http://www.wwwebtax.com/audits/audit\\_avoiding.htm](http://www.wwwebtax.com/audits/audit_avoiding.htm) (The article notes that the US tax authorities use a special computerized system to match the tax information reports of taxpayers on their tax return with information gathered from banks and others. For example, if a taxpayer fails to report on its tax return the interest earned on bank savings account, the IRS typically discover it when it matches the bank's interest payment records, called 1099 forms, against the tax return.)

<sup>33</sup> P. Soos, *Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues* 24 UC Davis L. Rev., at 120-122 (1990).

the recipient's final tax liability. This mechanism is often used in parallel or in lieu of third-party information reporting.<sup>34</sup>



A portion of the withheld tax generally may be refunded at the end of a fiscal period when the taxpayer files its tax return, on condition the recipient's annual assessed tax liability is less than the tax actually withheld. Conversely, the taxpayer may be required to make an additional tax payment if it is subsequently determined that the assessed tax liability is more than the tax actually withheld.

Today, virtually every country uses the third-party tax withholding mechanism. In these countries, the withholding mechanism applies mainly to employment income such as salary and wage but not necessarily to investment income (e.g. interest or dividends). The latter is generally subject only to an information reporting requirement unless the recipient is a non-resident taxpayer from whom income tax might otherwise be difficult to collect.

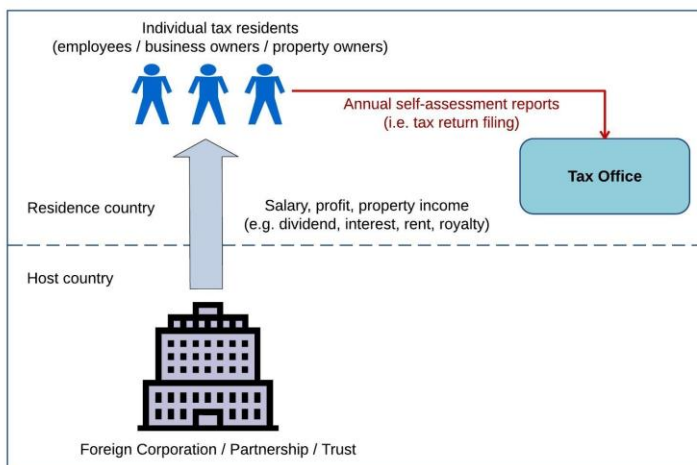
### 3. *Administarion of taxes on income from foreign sources*

**Self-assessment reports.** As discussed above, a residence-based income tax system requires residents to report and to pay tax on their worldwide income. Therefore, engaging in a cross-border economic activity generally entails the same requirements as does engaging in a domestic economic activity. In other words, resident taxpayers generally are required to register with the residence country's relevant tax authority, to comply with recordkeeping obligations, and to make periodical declarations of their foreign-source income to their country of residence (*see* Figure 5).

<sup>34</sup> Withholding tax system was first introduced in Germany to collect income taxes during World War I. By early 1940s, Australia, Canada, and the United Kingdom followed the suit and instituted withholding tax on wage income. The United States introduced it in US: Current Tax Payment Act, 1943. It applied to wage and salary incomes. *Ibid.*, at 125; See also C. Twight, *Evolution of Federal Income Tax Withholding: The Machinery of Institutional Change* 14:3 Cato Journal (1995).

However, the tax implications of foreign-source income are complex. A cross-border activity is prone to some tax issues. One important issue of earning foreign-source income is its vulnerability to international double taxation. Unlike domestic-source income, foreign-source

Figure 5. Self-assessment in cross-border context

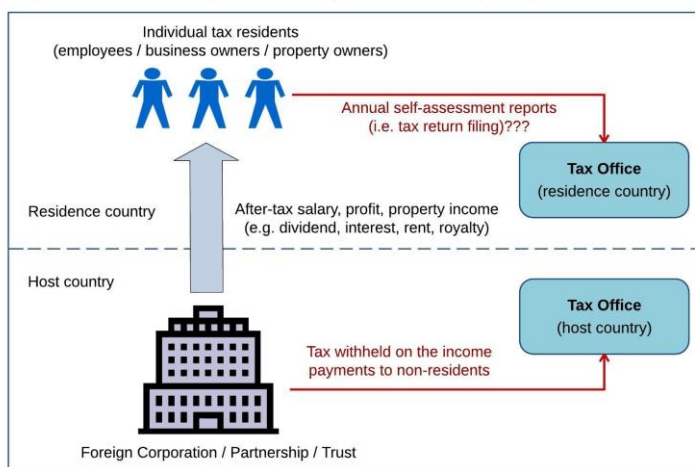


income is normally subject to tax in the host country, in addition to the tax imposed by the domestic country. The payer of the foreign-source income (normally, a foreign entity) must withhold host country taxes upon remittance of the income to the non-resident taxpayer (see Figure 6).

foreign-source income to the residence country? For example, in their reports to the US Congress in connection with the Patriot Act, US tax authorities estimated that 90% of US persons with foreign bank accounts fail to report their interest income from foreign banks to the IRS.<sup>35</sup>

Tax enforcement on foreign-source income raises a fundamental question: what if the resident taxpayer fails to report the foreign-source income to the residence country? For example, in their reports to the US Congress in connection with the Patriot Act, US tax authorities estimated that 90% of US persons with foreign bank accounts fail to report their interest income from foreign banks to the IRS.<sup>35</sup> Another study estimates that yields on 80-90% of foreign-held assets by the wealthy residents of developing countries are never reported to their countries of residence.<sup>36</sup>

Figure 6. Self-assessment, double taxation, and information asymmetry



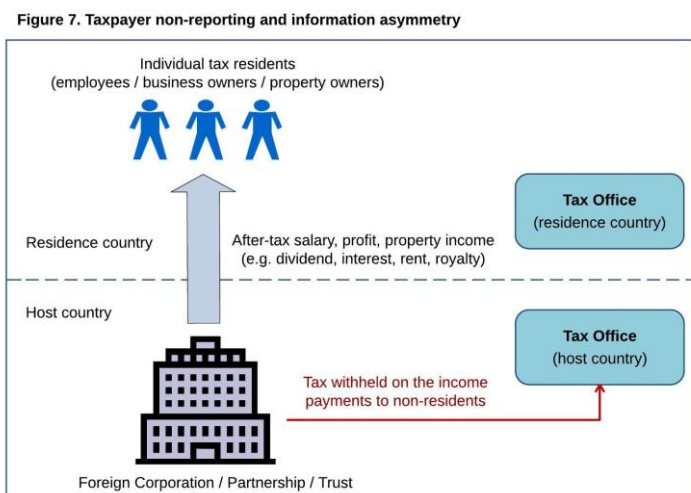
The question is whether the state has *ex ante* structural mechanisms to establish and verify the taxpayer's foreign-source income. More specifically, whether state has *ex ante* access to information on the foreign-source

<sup>35</sup> D. Tillinghast, *Issues of International Tax Enforcement* in H. Aaron & J. Slemrod, eds., *The Crisis in Tax Administration* at 50 (Washington D.C.: Brookings Inst Press, 2004).

<sup>36</sup> M. Mainzer, *The Creeping Futility of the Global Forum's Peer Reviews* at 25 (London: Tax Justice Network 2012).

income.

**Third-party tax reporting and withholding.** Information concerning the foreign-source income of resident taxpayers is normally beyond the reach of the residence country. As a fundamental principle of international law, a state cannot extend its administrative jurisdiction to the territory of another state.<sup>37</sup> This principle implies that a state's domestic tax administrative mechanism, such as third-party tax reporting or third-party tax withholding requirement, have no force of law in another state's territory.



Given these facts, taxpayers face very little risk of visibility of their foreign-source income by the tax authorities of their country of residence. The absence of such systematic tax enforcement mechanisms encourages resident taxpayers to misrepresent their foreign-source income to their residence country, and ultimately to evade the taxation of their respective income by the residence country (*see* Figure 7).

**Tax whistleblower reporting.** Today, some countries have laws and programs that facilitate the flow of a specific information to fiscal authorities. They offer a large monetary reward and guarantee protection from possible retaliation or harm for persons who disclose information of a fellow resident's tax evasion. The 'Tax Relief and Health Care Act' of the

<sup>37</sup> For a discussion of the territorial authority, as an aspect of public international law. See Lasse Oppenheim, *International Law: A Treatise*, Vol. 2 London, Longmans, Green and Co, 1944), at 386-458 (Concluding that a state may not exercise an act of administration or jurisdiction on foreign territory without permission and that as all persons within the territory of a state fall under its territorial authority, each state normally has jurisdiction – legislative, curial, and executive – over them); See also Asif Qureshi, *The Public International Law of Taxation: Text, Cases and Materials*, 1 ed. (London: Graham & Trotman, 1994), at 308 et seq.

United States,<sup>38</sup> ‘Public Interest Disclosure Act’ of the United Kingdom, and the ‘Offshore Tax Informant Program’ of Canada, are some examples of whistle-blower laws and programs.<sup>39,40</sup>

In the summer of 2007, a computer technician at a Lichtenstein bank, LGT, sold CDs to German tax authorities.<sup>41</sup> The CDs contained confidential financial information on thousands of German and non-German residents suspected of holding millions of euros in undeclared accounts with the bank. Germany paid the informant roughly €5 million in remuneration and shared the information with the tax authorities of other countries.<sup>42</sup> This disclosure has broken open one of the massive tax evasion investigations across the globe.<sup>43</sup>

Another similar case is the “UBS case”. In April 2007, Brad Birkenfeld, a former U.S. employee of a Swiss bank, UBS, delivered to the US Internal Revenue Service (IRS) stolen bank data about thousands of U.S. accountholders holding undeclared accounts with UBS in Switzerland.<sup>44</sup> The data resulted in as many as 30,000 U.S. taxpayers confessing to holding undeclared foreign bank accounts. The US Treasury recovered as much as \$5 billion in taxes and penalties.<sup>45</sup>

At the end of 2008, a former employee of the Geneva office of HSBC, Hervé Falciani, offered the French government confidential bank data concerning approximately 130,000 foreign

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<sup>38</sup> On 20 December 2006, the US adopted legislation – US: Tax Relief and Health Care Act, 2006. See also <http://www.irs.gov/uac/Whistleblower-Informant-Award> (Accessed 24 Nov. 2016).

<sup>39</sup> The Public Interest Disclosure Act of the United Kingdom came into force on 2 July 1999. The Act protects workers that disclose information about malpractice at their workplace, or former workplace, provided certain conditions are met. See Pyper *supra* n. 23; See also the Offshore Tax Informant Program in Canada introduced in the 2013 Federal Budget on March 21, 2013. Launched as part of the Canada Revenue Agency's efforts to fight international tax evasion and aggressive tax avoidance, the program allows the CRA to make financial awards to individuals who provide information related to major international tax non-compliance that leads to the collection of taxes owing.

<sup>41</sup> Spiegel Staff, *supra* n. 24; B. Arnold, *Tax Discrimination Against Aliens, Non-residents, and Foreign Activities: Canada, Australia, New Zealand, the United Kingdom, and the United States* (Toronto, Ontario: Canadian Tax Foundation, 1991).

<sup>42</sup> Dougherty & Landler *supra* n. 25.

<sup>43</sup> Esterl, Simpson & Crawford *supra* n. 26.

<sup>44</sup> Hilzenrath *supra* n. 27.

<sup>45</sup> L. Saunders & R. Sidel, *Whistleblower Gets \$104 Million* The Wall Street Journal (11 September 2012). Available at <http://online.wsj.com/article/SB10000872396390444017504577645412614237708.html> (Accessed 24 Nov. 2016).

customers of HSBC. France's finance minister at the time, Christine Lagarde, shared the list with other countries including Germany, Greece, Italy, and the US. This list was often referred to as the “Lagarde list”. On the strength of the information he provided, HSBC was forced to pay a \$1.9 billion settlement with the US. One peculiarity of this case is that Falciani systematically refused rewards for the supplied data.<sup>46</sup>

Recently, in April 2013, the tax authorities of German state of Rhineland-Palatinate announced they had bought a computer disc containing 40,000 records of information on more than 10,000 German residents holding secret accounts in Swiss banks. The authorities claimed they had paid the unidentified informant €4 million in remuneration for the data; but they expect the data to yield tax revenues of about €500 million.<sup>47</sup>

Thus, the tax whistle-blower laws and programs are designed largely to obtain information on the foreign-source income of resident taxpayers. The amounts of a reward to a ‘whistle-blower informant’ is generally a percentage of tax revenue and penalties recovered as a result of the information provided by the whistle-blower. For example, the Canadian tax whistle-blower program rewards the informant up to 15% of the tax revenue collected whenever the information provided leads to the assessment and collection of taxes in excess of C\$100,000. The US whistle-blower law, on the other hand, pays the informant up to 30% of any tax revenue recouped by the IRS as a result of a whistle-blower’s information.<sup>48</sup> For example, in 2012, the Whistle-Blower Office of the U.S. Internal Revenue Agency paid Birkenfeld a landmark \$104 million award for his UBS disclosure.<sup>49</sup>

Indeed, the whistle-blower laws have increased the risk of detection of tax misreporting on foreign-source income, and they helped to decrease the information asymmetries between taxpayers and their respective tax authorities. The promise of lucrative rewards has also created an incentive for people to report abusive taxpayer behavior of fellow taxpayers. However, these laws have also caused some legal and political challenges.

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<sup>46</sup> M. Hesse, *Swiss Bank Leaker: 'Money Is Easy to Hide'* Spiegel International (16 July 2013). Available at <http://www.spiegel.de/international/business/interview-hsbc-swiss-bank-whistleblower-herve-falciani-on-tax-evasion-a-911279.html> (Accessed 24 Nov. 2016).

<sup>47</sup> See Bartsch *supra* n. 28; see also a TV news report on France 24 at <http://www.youtube.com/watch?v=JVSniNw4PyE> (Accessed 24 Nov. 2016).

<sup>48</sup> D. Leblanc, *Whistleblowers in Line for Rewards as Ottawa Cracks Down on Tax Cheats* Globe and Mail (21 March 2013 ). Available at <http://www.theglobeandmail.com/news/politics/budget/whistleblowers-in-line-for-rewards-as-ottawa-cracks-down-on-tax-cheats/article10083229/> (Accessed 24 Nov. 2016).

<sup>49</sup> Saunders & Sidel *supra* n. 109.



**First**, an informant whistle-blower normally obtains such information by breaching foreign banking secrecy, confidentiality laws, or contractual trust obligations. If the whistleblowing act breached the confidentiality or banking secrecy laws, which is often the case, the act may make the evidence vulnerable in court proceedings under the *due process* requirements of law.<sup>50</sup>

**Second**, on a global level, the whistle-blower laws have a great potential to create tensions between countries. Under these laws, one government encourages and rewards the act, whereas another government normally condemns the act by virtue of its confidentiality and privacy laws. No jurisdiction is pleased to have its laws attacked by a foreign government, nor is it pleased its financial institutions have become a target for a foreign whistle-blower. And nor would it be pleased to see the foreign government's support for such actions. Germany–Lichtenstein and US–Switzerland affairs after the whistle-blowing scandal may provide an apparent example for this argument.<sup>51</sup>

Moreover, in light of proliferating tax whistle-blower protection laws and practices, the countries that have already been or have a high potential to become target jurisdictions for whistle-blowers are taking necessary measures against whistle-blower laws. They argue they may decline tax information assistance to their treaty partner if the latter's information request is based on the information obtained from a whistle-blower. For example, soon after the UBS scandal, Switzerland adopted the Ordinance Concerning Administrative Assistance for Tax Convention (Ordonnance relative a l'assistance administrative d'apres le convention contre les impositions "OACDI") on 1 September 2010.<sup>52</sup> Article 5(2)(c) of the OACDI stipulates a tax information request of a treaty partner is refused if the request is grounded on information which was obtained or transmitted by an act punishable under Swiss law. Swiss law makes it a crime to release account holders' names to unauthorized persons. By enacting this legislation, Switzerland

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<sup>50</sup> Narwal Litigation LLP, *Potential Pitfalls of the CRA Offshore Tax Informant Program* (6 Feb. 2014). Available at <http://www.jovennarwal.com/insights/potential-pitfalls-of-the-cra-offshore-tax-informant-program/> (Accessed 24 Nov. 2016).

<sup>51</sup> See E. Pfanner & M. Landler, "Tax Inquiry? Principality Is Offended" *New York Times* (February 20, 2008). Available at [http://www.nytimes.com/2008/02/20/business/worldbusiness/20evasion.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2008/02/20/business/worldbusiness/20evasion.html?pagewanted=all&_r=0) (Accessed 24 Nov. 2016); M. Moore, *Germany Expands Probe of Liechtenstein Tax Evasion* USA Today (February 18, 2008). Available at [http://usatoday30.usatoday.com/money/world/2008-02-18-germany-tax-evasion\\_N.htm](http://usatoday30.usatoday.com/money/world/2008-02-18-germany-tax-evasion_N.htm) (Accessed 24 Nov. 2016). (The articles note that Liechtenstein government authorities argued that they would take legal steps to protect banking clients from German investigators. Prince Nikolaus of Liechtenstein said in an interview that "the country is moving to a more cooperative stance but, of course, it does not like to be bullied").

<sup>52</sup> X. Oberson, *Swiss Report: New Exchange of Information Versus Tax Solutions of Equivalent Effect* at 15 (Turkey: 2014). Available at <http://www.eatlp.org/uploads/public/2014/National%20report%20Switzerland.pdf> (Accessed 24 Nov. 2016).

is sending a message to its tax treaty partners not to use stolen data when making tax information requests to Swiss tax authorities.

All these events question the sustainability of this source of information as a stand-alone enforcement mechanism. As far as tax enforcement is concerned, such laws and programs have only worked for serious, large, and selective tax cases with strong evidence of abuse. Even though the whistle-blower laws play an important role in the arsenal of information gathering tools, it is not a well-suited tool for regular tax enforcement.

**Voluntary disclosure under tax amnesty programs.** In recent years, governments have used tax amnesty programs as another common administrative tool in tax enforcement.<sup>53</sup> Tax amnesty is generally a limited time offer by a government where taxpayers can come forward and voluntarily disclose their previously undeclared tax liabilities in exchange for forgiveness from the general legal consequences of the tax offence. Essentially, it constitutes a special contract between the government and its resident taxpayer whereby the latter agrees to disclose its past failure to declare its tax liabilities or its past underreporting, while the government agrees to waive due criminal and civil charges that would otherwise result from the non-compliance. This agreement allows the non-compliant taxpayers to regularize their past tax liabilities, and to absolve themselves from potential criminal and civil penalties.

Tax amnesty is initiated in cases where a government perceives the tax revenue it actually collects is less than what it reasonably expects. Thus, the amnesty is intended to claw back the uncollected revenue due to taxpayers' past errors or wilful omissions, and to allow taxpayers a smooth transition from tax delinquency to permanent tax compliance in the future.

In practice, tax amnesties can cover all taxpayers or a group of taxpayers. However, they normally target at a segment of economic activities where taxpayers have high rates of non-compliance. Carrying on foreign business and investment activities, and holding offshore financial accounts, are generally considered as such segments of economic activities. Therefore, contemporary tax amnesty programs focus on extracting information on income from such sources.

However, tax amnesty programs have their own problems. Their continuous introduction may negatively effect on the credibility of tax administrations and the integrity of tax systems. First, it implies the government has a problem with its regular tax enforcement mechanisms. Second, the tax amnesty programs have some equity implications as they

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<sup>53</sup> See J.R.F.Lopez-Laborda, *Tax Amnesties and Income Tax Compliance: The Case of Spain* (2003) 24:1 FISC Fiscal Studies (2003); K. Bell, *Cash-strapped States Turn to Tax Amnesties* Bankrate. Available at <http://www.bankrate.com/finance/taxes/cash-strapped-states-turn-to-tax-amnesties-1.aspx> (Accessed 24 Nov. 2016).

essentially forgive a few tax from the general consequence of tax noncompliance. This inherent aspect of amnesty policy may be challenged as an unfair treatment of those taxpayers who always complied with the law but ultimately are treated the same as non-compliant taxpayers. For all these reasons, like the whistle-blower program, tax amnesty programs cannot be fully relied upon as a systematic tax enforcement mechanism.

#### 4. *Establishing a structural enforcement on foreign source income*

As discussed in the preceding sections, apart from resident taxpayers' self-assessment declarations, rare reports from whistle-blowers, and occasional voluntary disclosure and tax amnesty programs, the states have no viable mechanism to enforce their tax laws on the foreign-source income of resident taxpayers.

Freiberg and Cheng once comprehensively discussed the importance of structural enforcement in law which can be useful to discuss in this context.<sup>54</sup> Cheng argues that structural law enforcement is a form of law enforcement which attempts to regulate an undesired behaviour not through *ex post* harsh penalties; but rather, indirectly and *ex ante* through subtly designed arrangements that discourage the undesired behaviour from occurring in the first place.<sup>55</sup> Structural law enforcement focuses on minimizing opportunities available for the undesired behaviour to develop in the first place, rather than on dealing with its consequences.

In his analysis, Cheng describes two types of structural law enforcement but notes that one law can embody both enforcement mechanisms simultaneously.<sup>56</sup> The first type creates a process that makes an undesired behaviour more vulnerable to detection. The focus of the other enforcement mechanism is to prevent the undesirable behaviour from emerging in the first place by making it more difficult or troublesome.

This typology is true for third party reporting and for tax withholding.<sup>57</sup> On the one hand, third party tax reporting makes taxpayer's non-reporting or underreporting vulnerable to detection. It gives the tax authorities a reliable source of information as to a taxpayer's tax liabilities, without having to rely solely on the taxpayer's self-reporting of their income and assets. In so doing, it increases the visibility of the taxpayer's income to tax authorities. Thus, as

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<sup>54</sup> A. Freiberg, *Enforcement Discretion and Taxation Offences*, Enforcement Discretion and Taxation Offences: Proceedings of the Australian Tax Forum 55-91 (1986); E. Cheng, *Structural Laws and Puzzle of Regulating Behaviour* 100:2 Northwestern University LR (2006).

<sup>55</sup> *Ibid*, at 622.

<sup>56</sup> *Ibid*, at 664.

<sup>57</sup> *Ibid*, at 675-676.

the information on taxpayer's income is already available to tax authorities through third parties, it becomes riskier for the taxpayer not to report or misreport it.

Third-party tax withholding performs the latter function. It removes opportunities and incentives for non-reporting or underreporting altogether by applying immediate tax on income at its source before it reaches the taxpayer.<sup>58</sup> The tax withholding fully or partly discharges the person's tax liability upon receipt of the income. As a result, tax is already paid before the income is spent for any other purpose.

However, as soon as resident taxpayers begin to carry out their economic activities across an international borders, the scope of tax enforcement tools available for the state drastically diminishes. The states generally have no access to third-party tax withholding mechanism, nor to third party tax information reporting, which are readily available in a purely domestic context. Thus, the states do not have viable access to tax relevant information about its resident taxpayers. The only common enforcement mechanism the governments have is to impose harsh and steep civil penalties and criminal sanctions for taxpayers who fail to report their taxable income. These sanctions seem ineffective in persuading taxpayers into compliance. Taxpayers know that despite the existence of these sanctions, without systematic verification mechanisms in place, the risk of getting caught for their offshore tax evasion is remote. This reason is, in the author's view, one of the core reasons for the prevalence of offshore tax evasion in the world today. After all, for resident taxpayers, truthful self-reporting on their foreign-source income becomes largely a matter of choice.

Indeed, no foreign third-party readily accepts the inherently costly and regular tax information reporting or tax withholding obligations imposed by foreign tax authorities. There are also insurmountable jurisdictional and practical limitations for implementing such inherently domestic enforcement mechanisms in international context. However, it has become more and more evident that in the context of increasing economic globalization, cross-border economic activities are creating a greater need for tax authorities to obtain extraterritorial information. It is creating a need for better international cooperation in the field of taxation.

## 5. *Emerging global standard of automatic exchange of tax information*

In April 2013, the G20 made a major policy shift in international taxation by endorsing automatic exchange of information as a next global standard for tax information exchanges between states<sup>59</sup>. Within months, the OECD issued a report, which sets out the concrete steps to

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<sup>58</sup> *Ibid*, at 676.

<sup>59</sup> G20 (2013) *the Communiqué of the G20 Finance Ministers and Central Bank Governors in Washington DC on April 19, 2013*. Available at: <<http://www.g20.utoronto.ca/2013/2013-0419-finance.html>>.

be undertaken to realize the new global standard (OECD 2013).<sup>60</sup> In February 2014, the OECD introduced the standard entitled “Standard for automatic exchange of financial account information on tax matters”.<sup>61</sup>

The Standard essentially requires financial institutions to take on the role of tax/information agents with respect to non-resident account-holders and in relation to these account-holders’ countries of residence. The standard requires financial institutions in participating countries to report information on financial accounts held by non-resident individuals and entities to their local tax authorities on a regular basis. The tax authorities then securely transmit this information to these individuals and entities’ countries of residence. Based on the information received, it is then possible for the residence country to verify whether its resident taxpayers have reported their income earned through offshore financial accounts. Overall, the new system attempts to address a long-endured enforcement problem and help the states to better enforce their tax laws on the foreign-source income of their residents.

In 29 October 2014, soon after the OECD had introduced the rules of the standard, the representatives of over 51 jurisdictions came together in Berlin to sign a multilateral agreement, the Multilateral Competent Authority Agreement (MCAA), designed to implement the standard.<sup>62</sup> This agreement marks one of the very few multilateral agreements that exist in the field of taxation. As of the writing of this paper, 97 countries ratified the standard and pledged to work together towards implementation of the standard by September 2018.<sup>63</sup> (Global Forum, MCAA Signatories 2015).

The new system brings with it huge challenges. One of the challenges is to consider

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<sup>60</sup> OECD (2013) *A Step Change in Tax Transparency: Delivering a Standardised, Secure and Cost Effective Model of Bilateral Automatic Exchange for the Multilateral Context*. France, Paris: OECD. Available at: <[http://www.oecd.org/ctp/exchange-of-tax-information/taxtransparency\\_G8report.pdf](http://www.oecd.org/ctp/exchange-of-tax-information/taxtransparency_G8report.pdf)>.

<sup>61</sup> OECD (2014) *Standard for Automatic Exchange of Financial Account Information in Tax Matters*. France, Paris: OECD. Available at: <<http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-information-in-tax-matters.htm>>.

<sup>62</sup> OECD (2014) *Multilateral Competent Authority Agreement*. France, Paris: OECD. Available at <<http://www.oecd.org/tax/exchange-of-tax-information/multilateral-competent-authority-agreement.htm>>. Accessed on: 11 October 2015

<sup>63</sup> Global Forum on Transparency and Exchange of Information for Tax Purposes (2015) *Status of Commitment*. Available at <<https://www.oecd.org/ctp/exchange-of-tax-information/MCAA-Signatories.pdf>>. Accessed on: 28 October 2017.

how to transition from a world without automatic exchange system on a global scale to a world with such a system occurs.

First, there has been an increasing waves of oppositions to the automatic exchange of information system by some secrecy jurisdictions. They reportedly have no interest, or more precisely, an opposing interest to the emerging tax information exchange system. Consequently, the automatic exchange of information system has to confront these oppositions.

Second, the new automatic exchange of information system essentially signals which foreign assets and income earned by resident taxpayers are stashed abroad, likely never to be declared to, or discovered by, the countries of residence. Governments need to find ways to deal with these past tax liabilities in an effective, and less controversial manner, early in the transition to the new regime. Thus, the regularization of past tax liabilities has become a major transitional consideration.

Third, the developed world has been behind the new Standard. Therefore, the architects of the new regime must consider developing country perspectives on the automatic exchange of information if the standard is to be promoted as a global standard. The standard setting bodies need to understand the challenges of involving the developing world in the new regime.

Fourth, when the countries commence automatic exchange of tax information, the volume and scope of information actually exchanged between states will substantially increase compared to the volume under the existing international exchange regimes. Thus, there is an increased possibility of misinterpretation, misuse, or abuse of exchanged information. This possibility raises taxpayer privacy and confidentiality issues.

However, it must be admitted that the new standard was first crucial step to address the common tax enforcement problem described in the paper.

## ***6. Concluding remarks***

Today, most countries claim worldwide tax jurisdiction over their residents by statutorily requiring their residents to pay tax on their domestic and foreign-source income. However, the analyses suggest that the claim has no real force when it comes to foreign-source income. The biggest problem in this paradigm is a government's lack of access to extra-territorial information on the foreign-source income of resident taxpayers. Thus, there is a lack of parallelism in the enforcement of taxes on the parallel incomes. To work properly, a tax system must not only define domestic and foreign source incomes, and not merely stipulate that they are both taxable, it must also have an effective enforcement mechanism.

The results of the analysis suggest that if the states still want to maintain the residence-based income tax system – more precisely, if they still want to see the foreign-source income of

their residents in their future tax base – a substantial reform is necessary. The recent OECD initiative on the automatic exchange of tax information implies that the reform has begun. It suggests that the governments around the world have finally recognized that the solution for the problem lies within international cooperation and they have begun to embrace it.

Overall, it appears that a new era of international cooperation is dawning to the world, and countries are eager to embrace it. Increasing economic globalization requires greater tax administrative cooperation and the emerging automatic exchange of information system is taking the world precisely in this direction.