# Tax and Sovereignty

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**Three years before I was born, the House of Lords heard a case in which the Government of India sought to prove in the voluntary liquidation of a UK registered company which traded in India that tax was due to the Indian Government, including capital gains tax that arose on the sale of the company's business in India**[1].

The main question was whether there was a rule of law which precluded a foreign state from suing in England for taxes due under the law of that state.

The House of Lords was then composed of men who saw things clearly and stated them even more so. Viscount Simonds had this to say about the claim:

> "My Lords, I will admit that I was greatly surprised to hear it suggested that the courts of this country would and should entertain a suit by a foreign state to recover a tax. For at any time since I have had any acquaintance with the law, I should have said as Rowlatt J. said in *The King of the Hellenes v. Brostron*":
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> "It is perfectly elementary that a foreign government cannot come here – nor will the courts of other countries allow our Government to go there – and sue a person found in that jurisdiction for taxes levied and which he is declared to be liable to in the country to which he belongs."

So when I first came across *Government of India v. Taylor* many years ago, I briefly compared my "acquaintance with the law" with that of Lord Simonds and quickly concluded that what was obvious enough for him, and elementary enough for Rowlatt J., was plenty good enough for me. To me, *Government of India v. Taylor* was a judicial rock; something so immutable that it was unquestionable.

Some years ago, I first heard murmurings about countries overcoming this common law principle by entering into bilateral treaties. This idea has found its latest expression in the new OECD Model Article 27 (mutual enforcement of tax debts) which has been adopted by at least France and the US and Australia and New Zealand.

A little later, I agreed to give a paper to the Hong Kong Branch of the Society of Trust and Estate Practitioners (STEP) about Tax Information Exchange Agreements (TIEAs). In thinking about the issue, I felt compelled to read the full decision of the House of Lords in *Government of India v. Taylor.* I realised that not only had I not questioned the decision, but I had never really understood the reasoning behind it and the cases some two hundred years before it.

So I will now try to distill the decision's underlying legal policy and relate its logic to the latest OECD tax mission - its obsession with forcing countries (mostly it seems, who are not its members) to adopt "acceptable standards" of international co-operation in tax matters through exchange of tax information.

Before moving on to the reasoning for the rule, it is worth noting that the rule is expressed even more widely in the decision in *James v. Catherwood*[2] cited with approval in *Government of India v. Taylor:*

> "This point is too plain for argument. It has been settled, or at least considered as settled, ever since the time of Lord Hardwicke, that in a British Court we cannot take notice of the revenue laws of a foreign State."

There was some discussion in this Irish decision as to whether the rule should be restricted to enforcement (direct or indirect) of penalties (as opposed to plain taxes) or whether the rule exists in a federal union of states (like the USA) or in the Commonwealth (at least as between those members who acknowledge the sovereignty of the Queen of England) but no such qualifications to the rule were accepted by either the Irish Court or by the House of Lords.

One explanation of the rule was expressed in *Government of India v. Taylor* to be that:

> "…an enforcement of a claim for taxes is but an extension of the sovereign power which imposed the taxes, and that an assertion of sovereign authority by one State within the territory of another…is (treaty or convention apart) contrary to all concepts of independent sovereignties."

In other words by "taking notice of" and by enforcing the tax laws of a foreign country, the laws of one country become, in essence, the laws of another, with the requested court necessarily having to pass judgment on the provisions of public order of another state. It was further stated in the Irish case of *Peter Buchanan Ltd v. McVery*[3] that:

> "No court ought to undertake an inquiry which it cannot prosecute without determining whether those laws are consonant with its own notions of what is proper."

A further reason why one State (and not just a court of a State) should be very cautious about assisting another State in raising taxes is that it may well be embarrassed by the use to which that other State puts the taxes it helps collect.

Suppose State A has concluded a treaty with State B that obliges State B to assist State A with collecting its taxes. It might help with a tax investigation (say to determine if the taxpayer Mr X has assets secreted in State B) or go further and help collect the tax in question by executing the foreign tax judgment against the asset. Suppose further that State A's assessment to Mr X was via a special law taxing Mr X at a rate 90% of his bonus from a particular company. How will State B feel about helping State A investigate Mr X's assets in its territory? How would it feel about collecting taxes from those assets knowing it is helping satisfy an essentially penal and confiscatory assessment which would be

unconstitutional in its own country? How would State B feel if it knew that State A was at the same time invading its contiguous neighbor – an action implacably opposed by State B?

The answers are obvious – State B would be, or should be, embarrassed to say the least. These questions highlight what can go wrong when States adopt in their jurisdictions, the laws and practices of others in tax matters and in so doing, abandon their own legal precepts in the process by bowing to the laws of another. This example also demonstrates that the deep reluctance the courts have expressed over this is based on reasoning equally applicable to the States themselves so that the fundamental objections expressed in *Government of India v. Taylor* cannot simply be justifiably overcome by bilateral treaties between States.

However, the fact is that for all sorts of reasons, including comity and political expediency, sovereign nations often limit their sovereignty by "giving way" to foreign laws. For example, every comprehensive double tax agreement (DTA) contains provisions concerning tie-breaker or permanent establishment rules and reduced withholding taxes on dividends etc. This inevitably involves surrender or modification of a State's right to tax a person under its domestic law.

Having said this, giving up or reducing a right to tax a foreigner has far less serious implications for territorial sovereignty than the importation of a foreign law and legal system inherently involved in the tax raising and enforcement process.

For this reason alone, territorial sovereignty cannot be said to be absolute. Furthermore, proponents of "international standards" rightly point to the fact that increased international trade and investment and "globalisation" must inevitably lead to international solutions and harmonisation of approaches which, in the absence of an international state, can only be effectively dealt with in ways that inevitably lead to a breakdown in territorial sovereignties.

So how does a sovereign State agree to adopt OECD international standards of tax information exchange with another country and limit the loss of sovereignty to an acceptable level? To answer this question, I will look at Hong Kong, which has recently agreed to adopt current OECD exchange of information standards. This is a particularly useful case study for examining these issues because the OECD require Hong Kong (presumably on behalf of its member states) to amend its domestic law on tax gathering powers as a precondition to entering into comprehensive DTA's with its member states – a loss of sovereignty if ever there was one.

Some background to this issue is necessary.

Hong Kong only taxes trading, salary and rental income sourced in Hong Kong – residence is largely irrelevant to liability. Hong Kong has no taxes on dividends, interest or capital gains and no death taxes or value added tax. This is a narrow tax base and provides only very limited and specific financial information to the local revenue. Currently, the Hong Kong Tax Commissioner only has the power to get information he needs to raise his taxes – not very much information and not very interesting to a high taxing country like France looking to investigate and assess its taxpayers who are subject to every conceivable tax.

What the OECD is saying to Hong Kong is – change your tax laws to extend your information gathering powers or we will not give you the benefits of a DTA such as reduced withholding taxes and the certainty of tie-breaker and permanent establishment rules. They are not yet asking for actual enforcement of tax debts; only significant help with their investigations which are, of course, designed to assist in the assessment and collection of their taxes. How then can Hong Kong agree to this – essentially moving from giving them what information it has under its own laws for its own purposes – which does not directly involve their legal systems impacting on Hong Kong – to becoming an investigating agent for them? This agency inevitably involves Hong Kong's acceptance of their tax raising laws (and implicitly an acceptance of the uses to which they put their taxes) and a significant lessening of limitations in the domestic law on invasion of privacy rights by Hong Kong tax authorities.

It is difficult, but here is what I suggest Hong Kong does, and asks for, as safeguards to its territorial sovereignty[4]:

1. Choose its treaty partners very carefully. Firstly, do not sign treaties with States whose tax and judicial systems offend our basic constitutional protections.
2. Do not agree to wide exchange of information provisions unless our treaty partner has the same ability under its own laws to deliver what we are being asked to deliver. Right now, the USA and several other European countries would fail on requirements regarding beneficial ownership information.
3. Do not sign treaties with States whose tax authorities do not have the practical means of keeping the information confidential or that sell it to the highest bidding kidnapper.
4. Do not sign treaties with States that are not significant trading partners – i.e. they do not have meaningful tax reduction benefits to extend to our taxpayers.
5. Say "no" to automatic exchange of tax information as this would involve the Hong Kong Government losing any control on what information, and about whom, was sent abroad.
6. Insist upon a regular review of treaties to examine the nature and number of information requests with each partner and to examine whether relevant conditions in treaty partner countries have changed since DTA commencement.
7. Require evidence that there is a genuine tax investigation in the requesting jurisdiction relating to a specific taxpayer and that the requesting state has reasonable and demonstrable cause to believe that the taxpayer has dealings in Hong Kong which relate to the specific investigation – to stop fishing expeditions and reinforce the last resort principle.
8. Require, as a pre-condition of a valid request, evidence that the requesting State has exhausted all reasonable investigation powers domestically. This reinforces the last resort principle.
9. Ensure that the requesting State has notified the relevant taxpayer of the request. This gives Hong Kong the comfort that the request is a transparent process and gives the banks, trustees, custodians, or other entities in Hong Kong actually required to hand over information by our competent authority similar comfort and knowledge that the taxpayer/customer in question knows why they are handing over otherwise confidential information.
10. Require treaty provisions to ensure that we are properly reimbursed for costs associated with the assistance rendered.

Some of these safeguards are to be found in the specific text or commentaries to the Model OECD Article 26 and the OECD Model TIEA. But the devil is most certainly in the detail and nothing should be taken for granted in such an important area.

Moral strictures about the evils of tax cheating make it easy to cast aside valid concerns about both the innocents' natural and rightful desire for financial privacy and the importance of territorial sovereignty in a very dynamic world.

But as we all know, hard cases tend to make bad law, so vigilance in these matters is just as, if not more important than ever.

**END NOTES:**

1. *[1955] AC 491*
2. *(1823) 3 Dow Ry. K.B. 190, 191*
3. *Hong Kong is a special administrative region of the People's Republic of China and therefore not a sovereign. However, it has a comprehensive and separate legal and judicial system from China via the Basic Law over which it exercises a high degree of autonomy. It therefore has the same degree of concern over the territorial integrity of its laws vis a vis other States.*
4. *See 3 above.*