

7-11-2013

## Instantaneous Exchange of Information: Technology addressing laws that facilitate tax evasion in other jurisdictions

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### Recommended Citation

Mercuri, Enrico (2013) "Instantaneous Exchange of Information: Technology addressing laws that facilitate tax evasion in other jurisdictions," *Revenue Law Journal*: Vol. 23 : Iss. 1 , Article 4.  
Available at: <http://epublications.bond.edu.au/rlj/vol23/iss1/4>

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# Instantaneous Exchange of Information: Technology addressing laws that facilitate tax evasion in other jurisdictions

## **Abstract**

This article follows another published in July 2013 which proposed an international tax database as a means to counter tax evasion. The purpose of proposing an international database is to recommend a suitable strategy for global information sharing. Such a mechanism will enable revenue authorities to access a bank of relevant evidence to assist in compliance evaluation. An example of this is transfer pricing: by accessing stored information from audits internationally, revenue authorities may be able to determine whether transactions occurring between Multinational Enterprises (MNE) group members are arm's length or otherwise. In a broader compliance sense it would allow access to taxpayer information linked to various forms of profit shifting. The difference between the proposed database and other forms of exchange of information is that taxpayer information is routinely uploaded into an international repository. It is kept stored and available to group members at the onset of their risk reviews or audits so auditors are better able to quantify risk prior to initiating compliance action

## **Keywords**

International tax database, global information sharing, tax evasion

# INSTANTANEOUS EXCHANGE OF INFORMATION – TECHNOLOGY ADDRESSING LAWS THAT FACILITATE TAX EVASION IN OTHER JURISDICTIONS<sup>1</sup>

ENRICO MERCURI\*

This article follows another published in July 2013 which proposed an international tax database as a means to counter tax evasion.<sup>2</sup> The purpose of proposing an international database is to recommend a suitable strategy for global information sharing. Such a mechanism will enable revenue authorities to access a bank of relevant evidence to assist in compliance evaluation. An example of this is transfer pricing: by accessing stored information from audits internationally, revenue authorities may be able to determine whether transactions occurring between Multinational Enterprises (MNE) group members are arm's length<sup>3</sup> or otherwise. In a broader compliance sense it would allow access to taxpayer information linked to various forms of profit shifting.<sup>4</sup> The difference between the proposed database and other forms of exchange of information is that taxpayer information is routinely uploaded into an international repository. It is kept stored and available to group members at the onset of their risk reviews or audits so auditors are better able to quantify risk prior to initiating compliance action.

## 1. THE PROPOSED INTERNATIONAL TAX DATABASE

### 1.1 Introduction

The introduction of a central international repository is a radical idea in government revenue collection which has been primarily geographically focused. OECD members have historically focused on their own jurisdictions and requested information<sup>5</sup> from each other when needed for prescribed domestic compliance action. They have also transferred information between them

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<sup>1</sup> Although external affairs are mostly concerned with our relationships with other nation States, they are not exclusively so concerned. There may be circumstances where Australia's relationship with persons or groups who are not nation States, is part of external affairs. The existence of powerful transnational corporations, international trade unions and other groups who can affect Australia, means that Australia's external affairs, as a matter of practicality, are not confined to relations with other nation States. Murphy J. *Commonwealth v Tasmania* [1983] HCA 21; (1983) 158 CLR 1 (1 July 1983) at 506.

<sup>2</sup> Mercuri, Enrico (2012) "Arguments for an international tax base," *Revenue Law Journal*: Vol. 22: Iss. 1, Article 9. Available at: <http://epublications.bond.edu.au/rlj/vol22/iss1/9>

<sup>3</sup> Australian Taxation Office, (1997). Taxation Ruling TR 97/20 Income tax: arm's length transfer pricing methodologies for international dealings.

<sup>4</sup> OECD (2013). *Addressing Base Erosion and Profit Shifting*, OECD Publishing.

<sup>5</sup> OECD (2006). *CFA Approves New Manual on Information Exchange*. See Module 1: Exchange of Information on Request. <http://www.oecd.org/tax/exchange-of-tax-information/cfaapprovesnewmanualoninformationexchange.htm> Accessed 6 March 2014.

spontaneously,<sup>6</sup> automatically,<sup>7</sup> on an industry-wide basis,<sup>8</sup> simultaneously<sup>9</sup> or via tax examinations abroad.<sup>10</sup> Concurrent to the usual security and technological risks associated with such transfers there has been the countervailing need for each OECD member to protect its own commercial and revenue interests. Moreover, the need to address the activities of the multinational enterprise (MNE) on a global basis impinges now more than ever on this view.<sup>11</sup> Consequently, an international tax database is able to both accelerate exchange of information and contribute to the evaluation of MNE tax compliance. However, such a database also brings a need to address the various potential risks it may create. Such risks include the complexity of implementation of a global database and whether the concept complies with the current scope of treaty arrangements; political acceptance across diverse political environments and culturally disparate jurisdictions; threats to privacy of taxpayers; challenges from vested interest groups; quality of the data uploaded onto the database; and ownership, location and management of the database. Such risks require a mitigation strategy as part of the planning process.

## 1.2 What does the database look like?

Structurally, the proposed database is an information repository commonly owned by jurisdictional members. It has the following components:

- A *data warehouse* containing tables each having a relationship to the other. This is otherwise known as a ‘relational database’; and
- A *front end* component which allows operational staff to interrogate the data warehouse.

These two major components can be described as follows. The data warehouse component holds the data provided by members as a result of their risk and intelligence and audit work. This warehouse can be interrogated by programmers who write codes to extract data with a high degree of specificity.

The ‘front end’ component contains data in predetermined bundles. The information is basic and is generally not used for complex analytics. Bundling can be based on themes readily available to compliance officers who may not require complex analytics. It is this component which would be accessed by compliance officers performing risk reviews or audits.

Examples of data warehouse information are:

- Identification of entities by a Taxpayer Identification Number (TIN). Entities including trusts and hybrid trusts can be linked to each other using a subordinate identifying number;

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<sup>6</sup> Ibid. Module 2: Spontaneous Information Exchange.

<sup>7</sup> Ibid. Module 3: Automatic (or Routine) Exchange of Information.

<sup>8</sup> Ibid. Module 4: Industry-wide Exchange of Information.

<sup>9</sup> Ibid. Module 5: Simultaneous Tax Examinations.

<sup>10</sup> Ibid. Module 6: Tax Examinations Abroad.

<sup>11</sup> OECD (2012). Automatic Exchange of Information. What it is, how it works, benefits, what remains to be done. Organisation for Economic Cooperation and Development (OECD).

[http://www.oecd.org/ctp/exchange-of-tax-information/AEOI\\_FINAL\\_with%20cover\\_WEB.pdf](http://www.oecd.org/ctp/exchange-of-tax-information/AEOI_FINAL_with%20cover_WEB.pdf)

Accessed 22 January 2014.

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- Information derived from audits such as correspondence, meeting minutes, agreements and governance documentation;
- Correspondence between the taxpayer and revenue authorities. This will include responses to questionnaires;
- Accounting reports;
- Tax returns including supporting schedules such as International Dealings Schedules; and
- Data analyses conducted by other agencies including statistical methodologies used and codes used to extract the data.

Examples of ‘front end’ information are:

- Identification of MNE group members and related entities. Quoting the TIN or other identifier will lead to immediate provision of the entire known group of related entities;
- Income tax returns and accompanying schedules over successive years in various jurisdictions; these can be linked by the database to related entity returns and schedules; and
- Audit information gained by revenue authorities. These can be linked by the database when citing the relevant TIN or other identifier.

Access to either of the database elements would depend on the role of the officer seeking access. It is expected that officers involved in risk and intelligence work will require access to data in its raw form. This will enable comparison of cohorts of data in aggregate. It will enable analytics work to extract trends across the whole of the data in the warehouse.

In contrast, officers who are conducting a risk review or audit can access the front end for information related to their particular compliance product.<sup>12</sup> This role rarely requires manipulation of data. It tends to involve analysis of accounting documents, tax lodgement documents and legal documentation on a case by case basis.

The two approaches function in concert. Namely, risk and intelligence officers apply analytics to raw data to detect trends in tax evasion. This in turn can lead to identification of corporations which require individual risk work. At this point compliance officers are able to examine the characteristics that led to the corporation being identified by the risk and intelligence officers. In addition, they can build on this by examining information specific to the corporation and related parties. This may lead to identification of transactions relevant to a risk hypothesis. From there, compliance officers can use risk products to question the taxpayer to clarify the risk.

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<sup>12</sup> See ATO Large Business Active Compliance Manual and the related Large Business and tax compliance publication (LBTC). <http://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Large-business-active-compliance-manual---income-tax/>. Accessed 25 January 2014.

The benefit of this approach is that it becomes possible to gain a deeper understanding of a taxpayer's tax compliance. Analytics work may be limited in identifying risks to revenue. This is because the number of risks identified will depend on the integrity of the statistical methodology used. When extracting trends from large amounts of data it may not be possible for the methodology to pin point transactions which breach tax legislation. This is a qualitative evaluation conducted by the compliance officer. The compliance officer can focus on taxpayer governance processes, accounting records and agreements to verify risks. These risks can also include further risks the compliance officer detects during the course of enquiries. The officer can then confirm or refute the existence of any risk hypothesis.

### 1.3 European Union (EU) databases

Other databases can be useful as models of how information in different jurisdictions is combined for compliance purposes. The EU electronic databases fall under the jurisdiction of the European Union and are roughly divided between Customs and Taxation information. They contain data relevant to managing customs and tax activities for a total of 28 countries.<sup>13</sup> The European Commission empowered by the European Constitution develops and operates the databases.<sup>14</sup> The legal mechanism for participation by member countries is through relevant treaties.<sup>15</sup> Access to the databases is permitted to taxpayers to assist in informing and educating them.

Such a constitutional structure is of course not possible when one considers the scale of the proposed international taxation database. As there is no governing Union or parliament, membership and exchange of information will be based on existing treaties between database members. This, in turn, will be circumscribed by the scope of the treaties. Subject to possible modification of treaties, members will be able to upload data relevant to their jurisdiction. They will also be able to access information already loaded onto the database by other members.

The key distinction between the EU system and the proposed database is that the latter is primarily designed to accommodate the compliance activities of revenue authorities. The purpose is to address tax evasion. A limited amount of access is also possible for taxpayers to inform and educate them on taxation issues. Another distinguishing feature of the proposed database is the degree of sensitivity of published information. Much of it will have been gained through the intrusive powers which underpin audits. It can therefore have content based on highly sensitive commercial and intellectual property. Consequently, the laws governing publication on the database and the safeguards protecting stored information will need to be more stringent. This is particularly the case given the jurisdictional members will be global rather than European. It is proposed to eventually open membership along the lines of United Nations membership which

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<sup>13</sup> European Union, (2013). "How the EU works." Retrieved 1 January 2014, from [http://europa.eu/about-eu/index\\_en.htm](http://europa.eu/about-eu/index_en.htm)

<sup>14</sup> European Union, (2013). "Taxation and Customs Union - Electronic Databases." Retrieved 1 January 2014, from [http://ec.europa.eu/taxation\\_customs/common/databases/](http://ec.europa.eu/taxation_customs/common/databases/)

<sup>15</sup> European Union, (2013). "EU Treaties." Retrieved 1 January 2014, from [http://europa.eu/about-eu/basic-information/decision-making/treaties/index\\_en.htm](http://europa.eu/about-eu/basic-information/decision-making/treaties/index_en.htm)

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currently sits at 193 members.<sup>16</sup> Therefore, any information leakage on this scale can have far reaching consequences.

### 1.4 The EU databases in detail

The EU manages a range of databases<sup>17</sup> that provide Customs and Taxation information. They seek to facilitate information access and compliance work by member jurisdictions and are listed on the EU website as follows:<sup>18</sup>

#### **Customs**

##### *Authorised Economic Operators (AEO)*

This database contains the list of the "authorised economic operators" who agreed on disclosing their name, as well as those of the AEO Competent Customs Authorities. AEOs depending on the type of certificate can benefit from customs simplifications and facilitations of customs controls relating to security and safety.

##### *Customs Officer*

The database provides the details of Customs offices in EU countries and countries of Common transit procedure.

##### *European Binding Tariff Information (EBTI)*

EBTI provides traders with EU-wide legal certainty about the tariff classification of the goods that they intend to import or export. The database contains all EBTI that has been issued on request by customs of EU Member States and that is still valid today

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##### *European Customs Inventory of Chemical Substances (ECICS)*

This customs database allows users to identify chemicals, classify them correctly in the Combined Nomenclature and name them in all EU languages for regulation purposes

##### *EORI*

Economic Operators Identification and Registration number

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<sup>16</sup> United Nations, (2014). "Member States of the United Nations." Retrieved 3 January 2014, from <http://www.un.org/en/members/>

<sup>17</sup> European Union, (2013). "Taxation and Customs Union - Electronic Databases." From [http://ec.europa.eu/taxation\\_customs/common/databases/](http://ec.europa.eu/taxation_customs/common/databases/)

<sup>18</sup> Ibid.

## *EPORT*

EXPORT (ECS) is an application that allows tracking the goods in export. The tracking is done via the Movement Reference Number (MRN).

## *QUOTA (Tariff quotas and ceilings)*

This database allows tracking the overall EU usage of "First come first served" import quotas for certain third countries. It displays the balances of each tariff quota applicable in the present year and in the past year. It also indicates the date when a particular tariff quota is exhausted

## *SURVEILLANCE (Autonomous Tariff Suspensions)*

The database displays the volumes of specific products under 'surveillance' or monitoring imported into the EU customs territory in the present and in the past year. It is updated at the end of each working day

## *TARIC (Integrated Community Tariff)*

A multilingual database covering all measures relating to tariff, commercial and agricultural legislation. It gives economic operators a clear view of what they need to do when importing or exporting goods. It helps answer questions such as "Where do I classify my goods?" or "What is the legislation applicable to import?"

## *TRANSIT*

TRANSIT is an application that allows tracking the goods in transit. The tracking is done via the MRN.

## **Taxation**

### *SEED (System for the Exchange of Excise Data)*

The SEED ON EUROPA database allows businesses to check the validity of an excise number.

### *"Taxes in Europe - Tax reforms" databases (TEDB/TAXREF)*

The "Taxes in Europe – Tax reforms" databases provide information on the main taxes in force in the EU Member States as well as on the reforms in Personal income tax, Corporate income taxes, VAT, EU harmonised excise duties and Social security contributions.

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### *TIC ON EUROPA (Taxation Information and Communication)*

TIC provides Member State information on invoicing rules, VAT refunds and the standard VAT rate.

### *TIN ON EUROPA (Tax Identification Numbers)*

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TINs (Tax Identification Numbers) are used by EU countries to identify taxpayers.

*VIES (VAT Information Exchange System)*

The database is a toll for checking the validity of a VAT number issued by an EU Member State.

These databases cover a raft of information relevant to customs duties and various forms of taxation. As is clear from the explanations in the table, these include an identification system of commercial operators, an online system to improve efficiency in customs clearance, locations of relevant customs offices, EU wide tariff classification information, an identification system for chemicals, and tracking of goods during transit using an MRN.

In terms of tax databases, the table describes access to Excise numbers, Taxpayer Identification Numbers (TINs), Value Added Tax (VAT) number and information about taxes in Europe and on VAT.

### 1.5 The link between the EU databases and the international tax database

While the overlap between customs information and the proposed international tax database is beyond the scope of this thesis, it is helpful to note that a link exists. In particular, a future development could be the validation of tax claims by comparing tax lodgments with global customs data on actual shipments of tangible goods.

It is useful to note the strength of these EU databases in terms of education of taxpayers and their identification through unique identifiers. This approach can be applied in the international tax database. An educational component would inform and assist taxpayers in deterring non-compliance or tax evasion within their own jurisdiction. It could also have content that would assist in evaluating legal responsibility in other jurisdictions. Moreover, such information could assist tax managers within MNEs to clarify their tax position. It is expected managers will also consult advisors when taking an aggressive tax position.

### 1.6 The difference between Instantaneous Exchange of Information and current models of Automatic Exchange of Information

The strength of the proposed international tax database is that it can provide information gained from audit related activity. Donor members could as an example upload an audit file onto the database for viewing by other members. These other members can then examine their own files to determine the integrity of the information they hold. Such evaluation could be termed instantaneous exchange of information (IEOI). This is because the exchange of information may occur independently of any current compliance activity conducted by members. There may be no activity underway. It occurs independently of any request for information or may be concurrent to that request. Correspondingly, the database can be termed an IEOI database.

A unique identifier would assist MNEs in declaring the position of their group members when lodging returns. It would also assist revenue authorities during audit activity by linking related parties.

The value of the exchange is highest when downloaded by members who do not have a sophisticated information base or compliance programme in place. These may include revenue

authorities from developing countries who could gain significant insights into the activities of MNEs whose group members reside in their jurisdiction. By reviewing the MNE's international activities in this way, information such as agreements between group members could shed light on tax obligations to both developing and developed countries. This approach would balance the interests of certain MNEs as against those of such countries.

An additional benefit of the international taxation IEOI database is that it can be used to assess taxation responsibilities beyond those related to tangible products. By including overall information held in audit files, members will be able to access audit information related for example to service income or expenditure between group members, royalties, the activities of permanent establishments, etc. Such information will assist less sophisticated revenue authorities in evaluating the activities of MNEs using the perspective of sophisticated audit scrutiny.

A key difference between the proposed IEOI database and the European databases is that the latter are not used as an exchange of information mechanism. Exchange of information is generally still a process that is sequential and triggered by a requisite treaty based process. Therefore, it is not possible to rely on the EU databases as a model for this function.

Exchange of information to date has been based on the existing OECD model. It is at best formulated in what is termed 'automatic exchange of information.' The proposed IEOI database further facilitates exchange of information. It is instantaneous because the information is already held in the IEOI database and is accessed upon demand by IEOI database members. There is no request process unless it occurs in addition to accessing the database. For this reason the proposed IEOI database is an adjunct to existing information systems. It does not replace them outright but supports the current flow of information between jurisdictions.

Automatic exchange of information is termed 'automatic' because it:<sup>19</sup>

is understood to involve the systematic and periodic transmission of "bulk" taxpayer information by the source country to the residence country concerning various categories of income (e.g. dividends, interest, royalties, salaries, pensions, etc.).

Automatic exchange of information also has the following characteristics:<sup>20</sup>

The information which is exchanged automatically is normally collected in the source country on a routine basis, generally through reporting of the payments by the payer (financial institution, employer, etc). Automatic exchange can also be used to transmit other types of useful information such as changes of residence, the purchase or disposition of immovable property, value added tax refunds, etc. As a result, the tax authority of a taxpayer's country of residence can check its tax records to verify that taxpayers have accurately reported their foreign source income. In addition, information concerning the acquisition of significant assets may be used to evaluate the net worth of an individual, to see if the reported income reasonably supports the transaction.

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<sup>19</sup> OECD (2012). Automatic Exchange of Information. What it is, how it works, benefits, what remains to be done. [http://www.oecd.org/ctp/exchange-of-tax-information/AEOL\\_FINAL\\_with%20cover\\_WEB.pdf](http://www.oecd.org/ctp/exchange-of-tax-information/AEOL_FINAL_with%20cover_WEB.pdf) Accessed 22 January 2014.

<sup>20</sup> Ibid.

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The information is therefore regarded as automatic because it is in bulk, is organised and occurs at defined points in time. It is not automatic because it instantaneously follows a request for information from another jurisdiction. It is also not case specific but relies on the assumption that the provision of general information may lead another jurisdiction to identify inaccurate reporting by its residents.

The proposed IEOI database contains information that is pre-loaded and case specific. It embraces automation and the bulk format through data uploads from members. However, the upload is derived from audit cases and equally importantly identifies related entities subject to the audit.

The information transfer is better termed ‘instantaneous’ because the uploaded information is stored in advance of an information request. Its character has instantaneity because any available information is already accessible to the enquiring member at the time the officer accesses the IEOI database. Any information that is not already loaded can be accessed through conventional request for information processes.

This begs the question of ‘where to from here?’ It is arguable that over time the amount of stored information will increase significantly. This will lead to specialist teams within revenue authorities working on the proposed IEOI database. Over time these teams will work co-operatively with their counterparts in other jurisdictions. Such collaboration will contribute further to international cooperation. This can benefit participants in the following ways:

- Greater identification of tax avoidance patterns through analytics work
- Faster exchange of information
- Availability of information when it is needed most: at the point of a risk review or audit
- Confirmation of which MNEs have a culture of better tax compliance
- More efficient entry into Advance Compliance Agreements with entities that are able to meet the compliance thresholds
- More efficient use of revenue authority resources through focussing on entities that put revenue most at risk
- A better formation of risk hypotheses through better information
- A greater evidence base for litigation cases
- Better education of professionals through the education component of the IEOI database
- A gradual shift in the compliance culture in corporations
- An improvement in revenues of third world member countries through greater education

## 1.7 Kind of information to be uploaded

At the early stages of implementation, the kind of information uploaded to the IEOI database will need to be restrictive and the content decided on by negotiation between early IEOI database members. It is recommended an incremental approach be taken at the onset. An option may be to start with an industry-based project similar to those described in the OECD Manual on Information Exchange.<sup>21</sup> Such a project could for example examine the pricing strategies of manufacturers whose products are distributed internationally. Alternatively, the pricing of commodities in the extractive industries could be a project whereby members upload pricing information they have from their own risk reviews and audits. This information could include copies of international agreements between related and unrelated parties. Members could make their review as specific or broad as staffing will allow. Risk and Intelligence staff from each IEOI database member could then examine uploaded information to determine whether there are any concerns from a private international law perspective.

Another approach could be to start with a specific tax product. A relevant one could be transfer pricing which would mirror the suggested method in the recently published OECD draft on Transfer Pricing documentation and country by country reporting.<sup>22</sup> This provides that an MNE submit a master file of its group with relevant information in five categories<sup>23</sup>

- a) Group organizational structure;
- b) Description of MNE's business or businesses;
- c) The MNE's intangibles;
- d) The MNE's intercompany financial activities; and
- e) The MNE's financial and tax positions

In addition the MNE would need to keep local files<sup>24</sup> to demonstrate among other things transactions between group affiliates in different countries. The information would also include financial information on the transactions, a transfer pricing comparability analysis and information on the selection and application on the most appropriate transfer pricing method for the year in question.

In this approach the IEOI database could store the master file. The OECD discussion draft envisages the master file being made available to each affiliate in its own country.<sup>25</sup> In this way, it can be accessed by the revenue authorities in the respective country. Another approach would be to upload the master file onto the IEOI database and make it available to revenue authorities

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<sup>21</sup> OECD (2006). CFA Approves New Manual on Information Exchange. See Module 1: Exchange of Information on Request. Module 4: Industry-wide Exchange of Information. <http://www.oecd.org/tax/exchange-of-tax-information/cfaapprovesnewmanualoninformationexchange.htm> Accessed 6 March 2014.

<sup>22</sup> OECD (2014). Discussion Draft on Transfer Pricing Documentation and CbC Reporting. Published 30 January 2014. <http://www.oecd.org/ctp/transfer-pricing/discussion-draft-transfer-pricing-documentation.pdf> Accessed 11 March 2014.

<sup>23</sup> Ibid at paragraphs 18 to 22.

<sup>24</sup> Ibid at paragraphs 23 and 24.

<sup>25</sup> Ibid at paragraph 45.

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when required. A condition of access could be to demonstrate the foreseeable relevance of the request for the master file to the IEOI database administrator. Alternatively, as suggested by the OECD, revenue authorities could request the file from each other under current treaty arrangements.<sup>26</sup>

Early stage projects should be reviewed to determine how successful they have been in improving the quality of reviews and audits. This can lead to further suggestions as to how to improve information sharing. Members will also become accustomed to working with each other in a collaborative manner. This can then lead to a culture of international knowledge and compliance which can be used to assist taxpayers in their international tax planning. This approach can lead to taxpayers being better informed and potentially making fewer errors in tax planning.

### 1.8 Stages of access including limited access

It is self evident that not all IEOI database members will have the same resources or sophistication in their tax administration. For this reason it follows that some will not be able to contribute information to the IEOI database to the degree of better funded and more sophisticated administrations. This dichotomy needs to be viewed with broader consideration as there may be benefits derived from developing countries that are not obvious. It also needs to be viewed with a longer term perspective.

Certain developing countries attract commercial interest from MNEs due to their particular economic resources. This may come from a specific economic advantage: lower labour rates for manufacturing or perhaps it is resource rich. Such advantages can be of interest to MNEs as part of their global supply strategies. Therefore, agreements such countries enter into may be useful to other IEOI database members in understanding how a MNE runs its businesses.<sup>27</sup> These can be uploaded onto the IEOI database for the scrutiny of other members. Such agreements can also shed light on how the MNE conducts its financial allocation (e.g. intragroup markups or allocation of expenditure items which allocate costs between group members). This kind of information – both quantitative and qualitative – assists more sophisticated revenue agencies in understanding the group culture of an MNE and what degree of risk it may pose to their revenue.

Again an incremental approach may be useful where access for developing countries would be primarily to the educational materials stored on the IEOI database. For example, much of the information from an audit case can be sanitized, removing detail that can identify the taxpayer and perhaps the jurisdiction. The ATO already has an analogous approach to assist taxpayers and their advisors to understand their obligations through its Register of Private Binding Rulings.<sup>28</sup> The published result is a document based on the facts of a real case to which the law has been

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<sup>26</sup> Ibid.

<sup>27</sup> The importance of understanding the taxpayer's business is emphasized in the ATO publication *Large Business and Tax Compliance*. Australian Taxation Office at page 29.  
[http://www.ato.gov.au/uploadedFiles/Content/LB\\_I/downloads/BUSINESS16985LargebusinessandtaxCompliance.pdf](http://www.ato.gov.au/uploadedFiles/Content/LB_I/downloads/BUSINESS16985LargebusinessandtaxCompliance.pdf) Accessed 15 March 2014.

<sup>28</sup> See Register of Private Binding Rulings published on [www.ato.gov.au](http://www.ato.gov.au). See <http://www.ato.gov.au/General/Rulings-and-ATO-view/In-detail/Private-rulings/Register-of-private-binding-rulings/> Accessed 23 March 2014.

applied but which still preserves the privacy and secrecy obligations towards the taxpayers. The next step from within the educational phase could be the granting of observer status in a project whose information is foreseeably relevant to the developing country's compliance activity. This could lead to developed countries mentoring the observer thereby extending the educational role to live cases.

Regarding developing country direct access to IEOI database technology, the exchange of information could continue using existing OECD recommended methods of current standard transfer formats. These are:<sup>29</sup>

- the 1997 Standard Magnetic Format (SMF) which was recommended by the OECD Council C(97)30/FINAL, and
- the Standard Transmission Format (STF 2.1) recommended for use as of 1 January 2012 and based on XML.

However, it is likely that there would be an increase in volume of information transferred from the IEOI database. To overcome this, a possible option is to have a server access pilot project involving a developing country which has existing computer systems. Using internet access supported by user IDs and passwords will allow the revenue agency initial access to the IEOI server. This could be combined with secondment of staff from a developed country to assist with the increased flow of information. Experienced technical staff could assist with implementation of server access and use of the information from within the relevant agency.

### 1.9 Management and operation of the IEOI database

The management and day to day operation of the IEOI database could start with a developed country committing a team to a pilot project. Such a small scale project could be conducted using existing technology. This would mean segmenting a part of an existing developed country computer system and initiating the project with one other jurisdiction. In this way, a prototype version of the IEOI database could be constructed leading to a multi-jurisdictional application. This approach could enable proof of concept and relevant calculation of costs. It would also allow testing of security systems to ensure current standards are maintained during multi-jurisdictional transfers.

Once the pilot is complete and evaluated it would be possible to engage other jurisdictions to participate in a multilateral project. This second stage would no doubt face greater complexity and require quality assurance over a significant period of time. This would need to take place prior to contemplation of a global arrangement.

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<sup>29</sup> OECD Exchange of Information Common Technical Solutions. <http://www.oecd.org/ctp/exchange-of-tax-information/commontechnicalsolutions.htm> Accessed 22 March 2014.

# INSTANTANEOUS EXCHANGE OF INFORMATION – TECHNOLOGY ADDRESSING LAWS THAT FACILITATE TAX EVASION IN OTHER JURISDICTIONS

## 2 CHALLENGES TO IMPLEMENTATION OF THE IEOI DATABASE

### 2.1 General

Implementation of the IEOI database has risks in different areas that need to be evaluated and mitigated. The first risk is in reaching the implementation stage. This will require acceptance of the concept of a multi-jurisdictional IEOI database. Secondly, there will need to be coordination of the members. It is unlikely a single jurisdiction would be prepared or capable of coordinating the multi-jurisdictional arrangement required. The OECD is the likely candidate for such a role. The OECD can design and publish strategies through coordination with the G20 as it has done in the past<sup>30</sup>. Implementation could occur with the OECD using its existing model conventions or as is more likely, the design of a new convention which can accommodate a greater scope of information sharing. The G20 has the key role in creating sufficient momentum at the political level to achieve implementation. Accordingly, there will be a need to persuade potential IEOI database members of the long term benefits of such a venture. In particular, developed countries may be less inclined to provide data when it may primarily assist developing countries. They will probably not obtain an immediate return for their contribution. Developing countries stand to gain a good deal from this generosity of developed countries. In addition, certain countries may have concerns about the information they provide being accessed by countries whose political character is unfavourable. Addressing this requires persuading potential participants of the long term benefit to them and others of such access to information. In short, there will need to be argument supporting the altruism of such an endeavor.

Revenue administrations have highly complex security systems and processes to protect the data they hold on taxpayers. These levels of security would need to be replicated with the IEOI database in order to ensure protection of information. The difficulty facing revenue administrations is the need to balance their sovereign interests and revenue needs against those of other sovereigns. The requirement to provide information lies in domestic legislation which provides for the application of international agreements in domestic law.<sup>31</sup> This tension between national interest and international obligation may result in a resistance to loading information onto the IEOI database.

### 2.2 Current solutions

It should be said at the onset that many of the risks associated with an IEOI database are also present in existing exchange of information mechanisms. Therefore issues such as unauthorised access to servers, unauthorised staff access and leakage of information are commonplace challenges for IT security. They are a current consideration for each revenue agency system around the world and are a focus of OECD recommendations as discussed below. They also exist in relation to any server including those of other institutions and those in the private sector. The particular question facing an IEOI database is that it becomes a single repository for multiple

<sup>30</sup> Standard for Automatic Exchange of Financial Account Information. Common Reporting Standard OECD 2013. This is the most recent example of the endorsement by the G20 Ministers and Central Bank Governors of the Common Reporting Standard model. <http://www.oecd.org/ctp/exchange-of-tax-information/automatic-exchange-of-financial-account-information.htm> Accessed 8 March 2014.

<sup>31</sup> In Australia's case see the International Agreements Act 1953 (Cth)

jurisdictions. Therefore, security levels must reflect this in staff monitoring, encryption of data and security systems.

Relevantly, the OECD has published a guide on security of information transferred by exchange of information.<sup>32</sup> The publication offers guidance on the legal framework necessary to protect confidentiality and is directed at the 110 jurisdictions who participate on an equal footing in the OECD Global Forum.<sup>33</sup> This includes the confidentiality provisions in tax treaties, Tax Information Exchange Agreements (TIEAs) and multilateral instruments on mutual administrative assistance.<sup>34</sup> The guide also discusses the need for confidentiality provisions in domestic legislation.<sup>35</sup>

In addition to legislative provisions, the guide addresses the need for domestic policies and administrative practices to implement treaty and domestic law obligations.<sup>36</sup> This requirement must be reviewed and endorsed at the top level of a tax administration. Further protection of confidentiality is recommended in the form of employee background checks, employment contracts and training. In addition, the guide discusses storage and internal transfer standards for information received through exchange of information.<sup>37</sup> Other aspects recommended by the guide are departure policies for terminating access when no longer needed or the employee leaves the agency; information disposal policies; and policies related to unauthorised disclosure.

Of particular relevance is the need for appropriate practices in dealing with information received by exchange of information. This includes classification, storage, access and transmission to other areas of the administration. It would be a necessity for prospective IEOI database members to comply with these guidelines. The recommendations at the end of the guideline specifically address a jurisdiction's legal framework and administrative policies and practices to protect confidentiality.

It may be necessary, however, to strengthen the above guidelines to accommodate the demands of a single international server. Such improvements will require future detailed research and appropriate modeling to evaluate relevant risks. With an appropriate framework in place, competent authorities at revenue administrations could access the server and download information required for their specific compliance action. This could relate to the jurisdiction's

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<sup>32</sup> OECD (2012) Keeping it Safe. Joint OECD/Global Forum Guide on the Protection of Confidentiality of Information Exchanged for Tax Purposes.

<sup>33</sup> Ibid. See page 2.

<sup>34</sup> Ibid. See Article 26 of the OECD Model Tax Convention discussed at page 12, Article 8 of the Model Agreement on Exchange of Information on Tax Matters ("TIEA") discussed at page 13, and Article 22 of The Multilateral Convention on Mutual Administrative Assistance in Tax Matters discussed at page 14.

<sup>35</sup> Ibid. See page 15. An example of such a provision in Australian law is at section 355-205 Tax Administration Act 1953.

<sup>36</sup> The policy must include background checks/security screening of employees; employment contracts; training; access to premises; access to electronic and physical records; departure policies; information disposal policies; and managing unauthorised disclosures.

<sup>37</sup> The guide refers to servers that are secure and firewalled. Also, employees are to have individual user id's and passwords and individual access to files must be recorded. To support this the guide refers to many jurisdictions already having internal systems and audit systems to protect confidentiality.

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own review or audit of a taxpayer or it could be part of a coordinated effort by multiple jurisdictions.

### 2.3 Cultural shift

To date much of the exchange of information between treaty partners has been on a request for information basis. However, recent developments in automatic exchange of information<sup>38</sup> have raised questions<sup>39</sup> as to whether the current culture of exchange of information can accommodate non-request based transfers. In particular, it is important to recognise the challenge of cultural change in transferring from one system to another. The shift from a passive role of responding to information requests is essentially different to the active one of automatically sending information. This is because through the treaty obligations it effectively imposes information transfer on a jurisdiction without the catalyst of an information request. Automatic exchange of information establishes an obligation to transfer information at the onset and it is up to the jurisdictional partners to follow the rules from then on. This information must be provided irrespective of whether the jurisdiction sending the information has collected it for its own purposes or has a history of having done so with a particular taxpayer or receiving jurisdiction.

IEOI will require corresponding cultural acceptance, as the information transfer will also not be prompted by a request from a single jurisdiction. Rather, and analogously to its automatic counterpart, it will have its genesis in a treaty agreement and follow the framework of a bulk transfer with an agreed format. In addition, it will add a further degree of automation by having the information uploaded to a single global server rather than being transferred directly to a requesting jurisdiction. This characteristic will require its own particular cultural shift which will take time to permeate jurisdictional mindsets.

### 2.4 Privacy and Security issues

As stated, privacy and security safeguards already exist in the legal framework of many jurisdictions and in their treaty arrangements with other jurisdictions. It is still worthwhile emphasising the risks in the areas of confidentiality of information. Particularly, protecting the privacy of taxpayers is key to the proposed IEOI database. Breaches of privacy will undermine confidence in the IEOI database. The expectation is that it should address evasion while protecting taxpayer rights. Information sourced or leaked from the IEOI database could provide unintended benefits to taxpayers' competitors. Such illegally sourced information could in turn be sold to interested parties.<sup>40</sup>

<sup>38</sup> Standard for Automatic Exchange of Financial Account Information. Common Reporting Standard OECD 2013. This is the most recent example of the endorsement by the G20 Ministers and Central Bank Governors of the Common Reporting Standard model.  
<http://www.oecd.org/ctp/exchange-of-tax-information/automatic-exchange-of-financial-account-information.htm> Accessed 8 March 2014.

<sup>39</sup> Harrington J John. Automatic Information Exchange: Did the Dog Just Catch the Bus? Tax Analysts 2014. 7 April 2014.

<sup>40</sup> See risk commentary by Chris Lintott, Partner at Penningtons LLP.  
<http://www.penningtons.co.uk/Global/PA%20News/should-tax-authorities-across-the-globe-automatically-exchange-information.aspx?th=PI> Accessed 10 January 2014.

Examples are information on taxpayers' pricing of goods and services or tax information related to sensitive intellectual property owned by the company. In the case of corporations involved in research and development (R&D), the intellectual property value could be extremely high and leakage of this type of information could cause serious international commercial losses. The same concerns apply to R&D information provided by Defence contractors. In this case, a leakage of information could have military implications for clients who eventually purchase equipment evolved from such R&D.

Taxpayers whose interests have been breached via the proposed IEOI database have similar redress to those whose interests are affected under any existing transfer of information. From the perspective of civil action, the court systems are available to remedy breaches and award damages accordingly. From an administrative perspective, revenue administrations are empowered to address security breaches whether by their own staff or unauthorised access from an external source. From a criminal law perspective, there are remedies available via a jurisdiction's own domestic provisions.

## 2.5 Legal framework: scope of current treaties

There is a legal risk associated with donating and accessing data from the proposed IEOI database. This risk relates to a jurisdiction exceeding the scope of powers granted to it through the relevant international treaty. In addition, the treaty itself may be deficient in that it contradicts the scope of OECD modelling which requires information requested or provided to have 'foreseeable relevance' to a compliance activity being undertaken by the requesting (here 'accessing') jurisdiction. Unless foreseeable relevance ceases to be the qualitative measure for determining the scope of the information provided, the information accessed will need to either comply with the principle or it will need to be an exception.

## 2.6 Challenges to intervention by the State

It is important to consider the response of taxpayers who will oppose such a proposed measure. These proponents tend to reject State intervention in revenue matters. Often citing writers such as Adam Smith<sup>41</sup> such commentators advocate limiting government involvement in favour of a system of natural integrity based on mutual self interest in a free market condition. Therefore, increasing government scrutiny through the proposed IEOI database contradicts this position. Addressing the related political dimension is beyond the scope of this discussion but it is worthwhile noting the existence of such views.

## 2.7 Location and Management

An aspect requiring consideration is the location and management of the server. Physical access to the IEOI database is a risk as it places control of the data in the hands of a particular jurisdiction. This can be mitigated by choosing a site which best supports political neutrality. Other matters for consideration are: the financial capacity of a country to fund a prototype IEOI database; its degree of prominence in bodies such as the OECD, the IMF and the G20; the

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<sup>41</sup> Smith, A. (2008). *Wealth of Nations*, Oxford University Press.

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support it is likely to attract from potential members; and its legal and administrative sophistication. Management of the IEOI database could also be conducted or supported by a representative multinational body whose members are chosen by their respective jurisdictions.

### 2.8 Quality of the data

Another risk to the proposal is the possibility of data being uploaded in a perfunctory manner so as to merely fulfill membership requirements. However, the data is inaccurate or of little potential relevance to other members. Such a risk can only be evaluated over time through quality control mechanisms. To mitigate such a risk it will be necessary to have appropriate governance which ensures qualitative standards are maintained by members.

### 2.9 Cost

A detailed cost analysis will be necessary to ensure viability of the proposed IEOI database. For this reason a prototype version is recommended. It will enable both costs and savings to be measured ahead of any full scale launch of the proposal. Funding for such an experimental model would be modest and likely possible at the University research level. In addition to measuring costs, a research based prototype could receive input from both the government and private sectors. Moreover, such research would enable extrapolation of costs for a full scale version. This extrapolation could include costs linked to database storage capacity and the efficient contemporaneous information transfer to multiple jurisdictions. Funding for the full scale version could then be properly planned by a single jurisdiction or between founding partner jurisdictions who could share costs as well as benefits of the IEOI database.

## 3 CONCLUSION

The proposal of an IEOI database recommends using current technology to help address the impact of laws that stimulate tax evasion outside their jurisdiction. The proposal acts as an adjunct to existing information exchange mechanisms and provides immediate access to stored information. The success of the proposed mechanism is predicated on sufficient volume and quality of stored information. It is expected that the sharing of this information by member jurisdictions will present some implementation problems at the early stages. However, given the benefits of membership access there will be an incentive for jurisdictions to join. This incentive operates in a positive sense in terms of information availability and also in a negative sense that exclusion from the IEOI database will be a disadvantage to revenue collection for non participants.

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