CUSTODY CONTROL AND OFFSHORE AFFILIATES

by

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Introduction

The expansion in the number and size of foreign operations of Australian taxpayers, Australian operations of foreign taxpayers and the growing awareness in the Australian Taxation Office (ATO) of the extent to which Australian taxpayers living or investing abroad do not lodge returns or understate their income have emphasised the importance of enforcing taxation obligations associated with the international operations of Australian taxpayers. A prerequisite of the ATO's successful tax enforcement efforts, domestically and internationally, is the compilation of pertinent information on taxpayer activities. Therefore, an effective and efficient process of collecting adequate amounts of usable information is crucial to the success of the ATO in its tax enforcement task.[1]

There are two primary powers provided in the *Income Tax Assessment Act* 1936 (Cth) (*ITAA*) which the Federal Commissioner of Taxation (Commissioner) may use to collect information:[2]

1. The Commissioner has a right of access to buildings, places, books, documents and other papers containing relevant information, under the passive or non-coercive s.263 power.

2. The Commissioner has the power to compel persons to provide information, produce documents, and attend and give evidence, under the active or coercive s.264 power.[3]

In 1989 the federal government proposed[4] the addition of offshore information procedures which contain evidentiary exclusionary sanctions for non-compliance. These were modelled on United States (US) and Canadian provisions and enacted as s.264A *ITAA*.[5]

Section 264A empowers the Commissioner, where the Commissioner has reason to believe that information relevant to the assessment of a taxpayer is either-

(a) within the knowledge of a person;

(b) recorded in a document; or

(c) kept by mechanical, electronic or other device outside of Australia -

to issue an offshore information notice to a taxpayer.

A s.264A offshore information notice will require the taxpayer to give the Commmissioner information and/or documents (or to make copies thereof) within the period and manner specified. Failure to comply with the notice will trigger evidentiary exclusionary sanctions. That is, without the Commissioner's consent, information that was the subject of the notice or secondary evidence of that information is not admissible in proceedings disputing the taxpayer's assessment.[6]

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1 The fact that around three quarters of the Commissioner's taxpayer audits and investigations disclose discrepancies from the tax position reported in returns suggests that the Commissioner is not obtaining ideal information (see Commissioner's Annual Report (1990-91) at pp 43-50).

2 As with much analogous Commonwealth and State legislation.

3 This basic dichotomy has also been found in, and the importance of these powers to the Commissioner's administration of the Act is indicated by the existence of, analogous provisions of the New Zealand *Inland Revenue Department Act* 1974 (ss 16 and 17), the UK *Taxes Management Act* 1970 (ss 20C (search warrant power) and 20(1)-(8)) and the USA Internal Revenue Code (ss 7602(a)(1) and (a)(2)-(3)), though the precise ambit of the powers given has varied from time to time.

4 *Taxation of Foreign Source Income - An Information Paper*, April 1989, AGPS, Canberra.

5 *Taxation Laws Amendment (Foreign Income) Act* 1991, No 5 of 1991.

6 Section 264A(10) ITAA.

Although these offshore information procedures have not been exercised in Australia as yet, nor have they been subject to judicial review, there is no doubt that they do further empower the Commissioner in his audit capacity. However, s.264A does not supersede the information gathering power of s.264(1)(b).[7] In fact, the Commissioner may not be content with the results obtainable by the use of s.264A. It is the second limb of s.264(1)(b) *ITAA*, empowering the Commissioner to require any *person to produce all books, documents*[8] *and other papers whatever in his custody or under his control*,[9] that I examine in this paper.

Can an Australian resident company be compelled to produce documents which are held, outside of Australia by its branch or its subsidiary? The primary issues for consideration here are:

1. any territorial limitations on the power of the Commissioner to serve a s.264(1)(b) notice;
2. the meaning of "custody" and "control" in s.264(1)(b);
3. whether offshore affiliates have "custody" and "control" of documents; and
4. the effect of foreign laws on a s.264(1)(b) notice.

Service

Section 264 *ITAA* is expressed in terms which permit notices to be served on "any person". Does this mean that there are no jurisdictional limits to the service of a s.264 notice?

A line of authorities answers this question in the negative. According to James LJ in the English Probate Division decision of *Niboyet v Niboyet*[10]:

> "It is always to be understood and implied that the legislature of a country is not intending to deal with persons or matters over which, according to the comity of nations, the jurisdiction properly belongs to some other sovereign or State."[11]

According to Dixon J in the High Court of Australia in 1932:

> "... the only safe course to pursue is to apply the settled, if artificial, rule of construction for confining the operation of general language in a statute to a subject matter under the effective control of the Legislature."[12]

Two years later, His Honour said:

> "... an enactment describing acts, matters or things in general words, so that, if restrained by no consideration lying outside its expressed meaning, its intended application would be universal, is to be read as confined to what, according to the rules of international law administered or recognized in our Courts, it is within the province of our law to affect or control. The rule is one of construction only ..."[13]

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7 See s.264A(24) ITAA.

8 "Documents" in the remainder of this paper refers to "books, documents and other papers".

9 The legislatures of the Commonwealth and of the States confer on a number of authorities the power to issue notices requiring the production of books and records and to require the giving of evidence before officers of those authorities: see *Trade Practices Act* 1974 s.155 and *Australian Securities Commission Act* 1989 Div 3. Other Acts administered by Australia's Federal Commissioner of Taxation also have similar information and evidence gathering provisions, for example, s.128 of the *Fringe Benefits Tax Assessment Act* 1986 and s.23 of the *Sales Tax Assessment Act (No 1)* 1930. Although these provisions vary from s.264, in their scope and in the form and content of the notices issued, the differences are not major.

10 (1878) 4 PD 1 at 7.

11 See also Brett LJ at 20, *Barcelo v Electrolytic Zinc Co of Australasia Ltd* (1932) 48 CLR 391 at 424 per Dixon J and *Koop v Bebb* (1951) 84 CLR 629 at 646 per McTiernan J.
In *Bloxam v Favre* (1883) 8 PD 101 at 107 per Hannon P adopting 'Maxwell on Statutes':
> "Every statute is to be so interpreted and applied, as far as its language admits, as not to be inconsistent with the comity of nations or with the established rules of international law."

12 *Barcelo v Electrolytic Zinc Co of Australasia Ltd* (1932) 48 CLR 391 at 423.

13 *Wanganui-Rangitikei Electric Power Board v Australasian Mutual Provident Society* (1933-1934) 50 CLR 581 at 601. See also Gavan-Duffy CJ and Starke J at 596 and *Mount Albert Borough Council v Australasian Life Assurance Society* [1938] AC 224, Editorial Note, at 225.

And according to Maxwell on Statutes:

> "... the presumption is that Parliament does not design its statutes to operate on its subjects beyond ... territorial limits ... They are, therefore, to be read, usually, as if words to that effect had been inserted in them."[14]

It is apparent from this line of authority that in the absence of a jurisdictional link with Australia the Federal Commissioner of Taxation cannot require the production of documents from an entity which is outside of this jurisdiction.

This jurisdictional link is found by way of the terms "custody" and "control" in s.264.

"Custody" and "Control"

The recipient of a s.264 notice is required to produce only those documents which are in their "custody" or under their "control".[15] The issues of "custody" and "control" were developed in the classic *Smorgon* case.[16] The Full High Court in *Smorgon* held that a bank had "custody" or "control" of the contents of safe deposit boxes kept on its premises. The bank in this case retained the two keys needed to open the depositor's box; one of the keys being the duplicate of the depositor's key. Even though the bank was contractually bound to the depositor not to use the duplicate key, it had the actual ability to produce the contents of the box and this was sufficient to satisfy the "custody" and "control" requirements of s.264(1)(b). Gibbs ACJ said:

> "... the word 'custody' means such a relation towards the thing as would constitute possession if the person having custody had it on his own account ... The section is not concerned with the legal relationship of the person to whom the notice is given to the documents which he is required to produce: it is concerned with the ability of the person to whom the notice is addressed to produce the documents when required to do so. Therefore, in my opinion, a notice can be given under the section to any person who has physical control of the documents in question, whether he has or has not the legal possession. For example, if an employer gives his books of account to a servant to keep on his behalf, a notice under sec 264 can be given to the servant, who has physical control, although the master has the legal possession. However, 'control' in sec 264(1) is not limited to physical control, and in the example given the notice could be given to the master who has legal control of the documents, as well as to the servant. Indeed I can see no reason why a notice cannot be given to a person who wrongfully has physical control of the documents, or to a person who has parted with possession but retains a right to legal possession ..."[17]

Mason J went further:

> "The content of 'control' is somewhat different from that of 'custody'; however, both are wide enough to include many types of possession which are not commensurate with full ownership.[18] It is difficult to ascribe a precise meaning to 'control' in sec 264 as the content of the word is normally dictated by its context and can vary from sole absolute dominion

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14 This presumption operates "in the absence of [a contrary] intention clearly expressed or to be inferred either from its language, or from the object, subject-matter, or history of the enactment": see *Pugh v Pugh* (1951) 2 All ER 680 at 682 per Pearce J citing 'Maxwell on Statutes' (9th ed) at 148.

> "The general rule is extra territorium jus dicenti impune non paretur ... This does not, indeed, comprise the whole of the legitimate jurisdiction of a State, for it has a right to impose its legislation on its subjects, natural or naturalised, in every part of the world; and on such matters as personal status or capacity it is understood always to do so."

15 As with the obligation upon a person to whom a subpoena is addressed: see *Amey v Long* (1808) 9 East 473 and *Rochford v TPC* (1982) 43 ALR 659.

16 *FCT v ANZ Banking Group Ltd*; *Smorgan v FCT* 79 ATC 4,039.

17 *Ibid* at 4,044; note also at 4,057

> "The primary definition of 'custody' in the Shorter Oxford English Dictionary is 'Safe keeping, protection; charge, care, guardianship'."

18 *Johnston Fear & Kingham v The Commonwealth* (1943) 67 CLR 314 at 324 per Rich J [Mason J's footnote].

> over the object 'controlled' to 'something weaker than "restraint", something equivalent to "regulation"'.[19] Although the use of the composite expression 'in his custody or under his control' does not assist us in determining the precise limits of the meaning of 'control', it does evidence a legislative intention to employ the words in their widest sense."[20]

Prima facie, there are no jurisdictional limitations to the accessing of specified documents if an entity within the Commissioner's jurisdiction has "custody" of those specified documents. The Commissioner may simply serve a s.264(1)(b) notice on that entity requesting such documents. Where the Commissioner is attempting to access documents which are in the "custody" of an offshore affiliate of an Australian company, the Commissioner must establish a jurisdictional link with the offshore documents in order to obtain the access. If an entity within the Commissioner's jurisdiction has "control" of the documents, the Commissioner may serve a s.264(1)(b) notice on that controlling entity requesting the documents:

> "... the question is, has the person to whom the notice is given such custody or control as renders him able to produce the documents?"[21]

Offshore Affiliates

(a) Branches

> "Mr Justice North, on the question of whether a director has a right to see and take copies of documents belonging to his company, held that he had such right ..."[22]

A company director also has the right to see and take copies of documents belonging to the branch of a company as a branch is merely an extension of a company and is not a separate entity. An Australian resident company would *prima facie* have "custody" and "control" of branch documents since the company and the branch are the same legal person. The Commissioner may require the production of documents of the domestic corporation's offshore branch by serving a s.264(1)(b) notice on the Australian resident company. The Australian resident company would only be excused from producing the documents if it was physically unable to do so.[23]

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19 *Bank of New South Wales v The Commonwealth* (1948) 76 CLR 1 at 385 per Dixon J [Mason J's footnote].

20 *Supra* n.17 at 4,051. Further, "There is to my mind no reason to limit the scope of `custody and control' to `exclusive custody and control'." (*Ibid*). Mason J considered that the bank had "control" over the documents to a sufficient degree to come within the scope of that word as it is used in s.264(1)(b) whether or not it also had possession or custody of the documents (*Ibid*).

21 *Ibid* at 4044, per Gibbs ACJ.

22 *Burn v The London and South Wales Coal Company and the Risca Investment Company* (1890) 7 TLR 118 at 118-19.

23 *Supra* n.17 at 4044 per Gibbs ACJ and at 4051 Mason J. Similar reasoning is reflected in US case law, see *In re Ironclad Mfg Co* 201 F Rep 66:

> "The presumption [is] that a corporation is in the possession and control of its own books. It cannot be allowed to rebut that presumption by the mere bald statement of some officer that he does not know where they are; it must clearly show that it does not have, and cannot obtain, possession of them. Any other rule would permit corporations to ignore court orders with practical impunity."
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> "If it be claimed that the books have passed out of the possession of the corporation, there should be the fullest disclosure of the latest date when the books were in its possession and of the circumstances under which they were removed therefrom. If they have passed into the possession of some one who has no right to them, and presumably no one but the corporation has the right to them, there should be full disclosure as to what steps have been taken to recover possession. If some faithless officer has secreted them, the courts are open to the corporation to effect their return. If they have been destroyed and cannot, therefore, be produced, time, place, and circumstances of such destruction should be shown as fully as possible, so that the court may be able to determine whether the corporation was itself innocent, or whether such destruction was an operation in which officers, directors, and stockholders all took part or to which they assented." (at 68-9)

In *First National City Bank of New York v IRS* (1968) 396 F2d 897 the court held that there is a presumption that a corporation is in control of its own books and records. Where an officer or agent of a branch has the authority to send the books to the parent for any corporate purpose, the parent has sufficient control over the books for the summons or subpoena to be enforceable (at 898).

(b) Subsidiaries

Throughout the remainder of this paper, reference is made to extensively persuasive, although non-binding, United States decisions.[24] These decisions are particularly useful as there is a void in domestic judicial interpretation in the area of international taxation administration given that the ATO has, to date, not been particularly active in the international arena.

(c) Non-Controlled Foreign Corporations

A subsidiary of a corporation is a separate legal entity.[25] As such, *prima facie*, no other entity has "control" of a subsidiary. Thus, *prima facie*, the Commissioner may not require production of the documents of a domestic corporation's offshore subsidiary.

An example of a departure from this rule is where an Australian head office has a commercial or agency agreement with an offshore subidiary to ensure full access to documents at all times. In this situation, a s.264(1)(b) notice may be served on the directors of the Australian resident company to produce the relevant documents as they have such control as renders them able to produce them.[26]

Another interesting departure from this rule is found in the US *Toyota* case.[27] In this case, the United States' Internal Revenue Service (IRS) brought an action against an offshore parent company and its wholly owned US subsidiary to enforce summonses issued to each corporation during the course of a US audit of the subsidiary. The offshore parent company moved to dismiss the enforcement action on the ground that jurisdiction over it was not conferred by s 7604(a) of the *Internal Revenue Code* (IRC). Section 7604(a) IRC authorised the IRS to bring a summons enforcement action in the court "for the district in which [the person summoned] resides or is found". The Court found that the wholly owned US subsidiary operated as a distinct corporate entity with its own books, records, bank accounts, tax returns, financial statement and accounting procedures. The Court found, however, that there was a "significant overlap" between the senior management and board of directors of the offshore parent company and its wholly owned US subsidiary. Also, the parent company's managing director served as president of the subsidiary, and the parent company's president and chairperson served as directors of the subsidiary. In addition, the Court found that approximately two dozen employees of the subsidiary were formerly employed by the parent company and, according to the Court, were likely to return to the employment of the parent company. The Court also found that the parent company derived "substantial economic benefits" from sales to and dividends from its subsidiary.

Although the parties agreed that the parent company "resided" in a country other than the US (within the meaning of s.7604(a) *IRC* because it was incorporated and had its principal place of business in a foreign country), the Court held that the foreign parent company could be "found" in the United States.

There is no relevant Australian legislation which uses the jurisdictional description "for the district in which [the person summoned] resides or is found". However, this decision may instil some optimism in Australia's Federal Commissioner of Taxation as it is a significant illustration of the US courts' preparedness to interpret its access powers expansively in order to establish jurisdiction.[28]

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24 It should be noted that the Australian High Court has equated the US Supreme Court to United Kingdom Courts with regard to the respect it will pay to its decisions on points common to each country: see *Waghorn v Waghorn* (1941) 65 CLR 289 at 292, *The Banking Case* (1948) 76 CLR 1 at 306 and 366, *Commonwealth v Huon Transport Pty Ltd* (1945) 70 CLR 293 at 307 and *Melbourne Corporation v The Commonwealth* (1947) 74 CLR 31 at 60.

25 *Salomon v Salomon* [1897] AC 22.

26 *Supra* n.17 at 4044 per Gibbs ACJ.

27 *Toyota Motor Corp v United States*, 83-1 USTC 9302, F Supp 354 (CD Cal).

28 *Ibid* at 357-359. See *Matter of Marc Rich & Co, AG v United States*, 707 F 2d 663 (CA-2 1983), cert denied, 463 US 1215 (1983) (A Swiss parent company of a subsidiary which was engaged in US business was required to produce documents covered by a subpoena which was issued by a grand jury investigating possible tax fraud).

(d) Controlled Foreign Corporations

Given that a controlled foreign corporation is a separate legal entity from its parent company in the same way as a non-controlled foreign corporation,[29] can it therefore also be said that, *prima facie*, no other entity has "control" of a controlled foreign corporation for the purposes of s.264(1)(b)? The answer to this question is "Yes". The relevant section which provides the definition of a "CFC" or "controlled foreign company" is s.340 *ITAA*.[30] This section deems certain companies to be "controlled" by five or fewer Australian entities[31] or by one single Australian entity (an "assumed controller") whose associate-inclusive control interest in the company is not less than 40%.[32] If the Commissioner can show factually that "the person to whom the notice is given [has] such ... control as renders him able to produce the documents"[33] then the Commissioner may request production of the documents of the offshore controlled foreign company pursuant to s.264(1)(b).

Where the overseas subsidiary is wholly owned and/or controlled by an Australian resident company then it can be argued that the domestic company has control of documents held by the subsidiary since it would have the authority to force the subsidiary to produce the documents. This approach has been judicially accepted in the United States.[34] As the s.264(1)(b) notice is similar to the United States' "administrative summons",[35] the use of the administrative summons may be instructive.[36]

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29 *Salomon v Salomon* [1897] AC 22.

30 See s.317 *ITAA* definition of "CFC" or *"controlled foreign company"*.

31 Paragraphs 340 (a) and (c) *ITAA*.

32 Paragraph 340 (b) *ITAA*.

33 *Supra* n.16 at 4044, per Gibbs ACJ.

34 See *Societe Internationale Pour Industries v Rogers* 357 US 197 (1958), *First National City Bank v IRS* 361 US 948 (1960). The US' IRS has had several occasions to issue administrative summonses to domestic corporations for books and records held by foreign branches and subsidiaries: see GP Crinion 'Information Gathering on Tax Evasion in Tax Haven Countries' (1986) 20 *International Lawyer* 1209 at 1215. Six cases in which US tax authorities have issued summonses or subpoenas to US corporations for books and records held by a foreign operation are: *In re National Public Utility Inv Corp* 79 F2d 302 (2d Cir 1935), *First National City Bank of New York v IRS* 271 F2d 616 (2d Cir 1959), cert denied, 361 US 948 (1960), *In re Chase Manhattan Bank* 297 F2d 611 (2d Cir 1962), *United States v First National City Bank* 396 F2d 897 (2d Cir 1968), *United States v Vetco Inc* 691 F2d 1281 (9th Cir 1981), cert denied, 454 US 1098 (1981), and *United States v First National Bank of Chicago*, 699 F2d 341 (7th Cir 1983).

35 R Woellner and L Burns 'International Information Flows - The Tax Implications' (1989) 6 *Australian Tax Forum* 143 at 165.

36 Where the controlled foreign company is not fully owned this presumption cannot, prima facie, be made.
However, where there is an "assumed controller" pursuant to s.340(b) *ITAA* there is an argument that that "assumed controller" will be presumed to have "control" of the offshore subsidiary and, hence, the documents of the offshore subsidiary for the purposes of s.264(1)(b).
The courts have long adopted an approach to the interpretation of legislation that is founded on the expectation that words will be used precisely. The view is taken that where a word is used consistently in legislation it should be given the same meaning consistently.
Hodges J in Craig, *Williamson Pty Ltd v Barrowcliff* [[1915] VLR 450 at 452] said:

> "I think it is a fundamental rule of construction that any document should be construed as far as possible so as to give the same meaning to the same words wherever those words occur in that document, and that that applies especially to an Act of Parliament ...".

[See also *Registrar of Titles (WA) v Franzon* (1976) 50 ALJR 4 at 6 per Mason J. Similar views were expressed in *R v Central Cane Prices Board; Ex parte Colonial Sugar Refining Co Ltd* [1917] St R Qd 1.]
As the word "controller" appears in paragraph 340(b) rather than "control" this term does not fall neatly within the (above enunciated) common law rule that a word used consistently in legislation should be given the same meaning consistently.
However, it is arguable that the use of inflected forms of a word should be given the consistent, although inflected, meaning of the word. If this argument is accepted, an Australian entity described in paragraph (b) of s.340 *ITAA* would have deemed "control" of the controlled foreign company for the purposes of s.264(1)(b) *ITAA* as well as for Part X of the same Act. The Commissioner would thereby have authority to request the production of documents of such a controlled foreign company from that controlling Australian entity.

Foreign Laws

(a) Introduction

In an economy increasingly characterised by international transactions and multinational corporations with divided loyalties and responsibilities, Australian courts will inevitably face problems caused by conflicts between the laws of nations. One particularly troublesome area is the enforcement of s.264(1)(b) notices compelling the production of documents in violation of foreign law.

Australian taxation authorities have had difficulty in obtaining necessary information from tax havens. Tax haven governments generally fail to provide the requested information because:

1. it does not compile that information;
2. its bank and commercial secrecy laws prohibit disclosure of that information; or
3. it does not have any agreement with Australia authorising the release of that information.

As was discussed earlier, there is a general assumption against legislation operating extraterritorially. Therefore it is clear that the Commissioner could not compel a person to produce documents held offshore under s.264(1)(b) where that person is under a legal prohibition or obligation imposed by a law of that overseas country not to produce those documents.

This conclusion is of concern to the Commissioner because it would mean that an Australian resident company could, by transferring documents to an offshore point with a municipal law which prohibits production of documents, avoid the operation of s.264(1)(b). However, such a conclusion is not entirely valid. The issue is: which obligation will be given predominance by Australian courts when the person from whom the information is sought pleads the overseas secrecy obligations as a defence to s.264(1)(b) obligations - the Australian obligation to produce the information or the overseas obligation not to disclose it? In the absence of Australian authority in this area[37] it is useful to turn to US case law which is comparatively developed and is instructive.

(b) *Brownell*

In 1957 in *Societe Internationale Pour Participations Industrielles et Commerciales, SA v Brownell*[38] the United States Court of Appeals said:

> "... the procedural laws of the United States, as well as the substantive laws, may not be relaxed upon its courts because of difficulties a party may have with a different sovereign power ... nothing short of a complete release of the papers by the [foreign] Government ..., leaving this court or its representative in a position to decide what is relevant or what is to be produced, will comply with our laws."[39]

(c) *Rogers*

A year later *Societe Internationale Pour Participations Industrielles et Commerciales, SA v Rogers*[40] established that a domestic parent company has control over the books and records of its subsidiaries and a court may require production of those records even where they are held in a foreign jurisdiction so long as the domestic corporation is subject to the US jurisdiction.[41]

In *Rogers* the plaintiff corporation claimed that the District Court's dismissal of its action for failure to comply with a discovery order was unjustified because compliance would subject it to criminal penalties under foreign law.[42] The United States Supreme Court acknowledged that fear

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37 There are currently no Australian decisions on point.

38 243 F2d 254.

39 *Ibid* at 256.

40 (1958) 357 US 197.

41 In *Rogers* case the Court held that a Swiss holding company controlled certain records held by its Swiss bank on the basis of a showing that the holding company and its bank were substantially identical, *Ibid* at 200 and 204. The obligation to respond to a request for information applies even though the person served may find it necessary to go to some other place within or without their jurisdiction in order to obtain the documents required to be produced: see *Equitable Trust Co v Schwebel* DCEDPa, 40 F Supp 112, *Kempsonv Kempson* 63 N J Eq 783, 52 A 360, 625, 58 LRA 484, 92 Am St Rep 682.

42 *Supra* n.40 at 200.

of criminal prosecution, whether by the United States or a foreign sovereign, constituted a "weighty excuse" for non-production.[43] Nevertheless, the Court rejected the plaintiff's arguments that the relevant foreign law deprived it of control over the documents[44] and thereby with an immunity from production orders.[45] The Court stated:

> "... to hold broadly that the petitioner's failure to produce the [relevant] records because of fear of punishment under the laws of its sovereign precludes a court from finding that petitioner had "control" over them, and thereby from ordering their production, would undermine congressional policies ..., and invite efforts to place ownership of American assets in persons or firms whose sovereign assures secrecy of records."[46]

The "good faith" test, articulated in *Rogers*, was the first standard developed to resolve these conflicts[47] and consists of the following essential characteristics:

1. it is to be applied in determining sanctions for non-compliance rather than in deciding whether the production order should issue;[48]

2. attempts to obtain waivers from the foreign government to overcome its disclosure restrictions are required to avoid sanctions;[49] and

3. deliberately placing documents in countries where non-disclosure laws exist, or any other showing of bad faith, will justify the use of sanctions.[50]

The hardship inflicted upon the person ordered to produce the information and the interests of the foreign state in prohibiting disclosure are not significant under the "good faith" standard.

(d) First National City Bank of New York

The oppressive nature of the "good faith" approach led to the development of the *First National City Bank of New York v IRS*[51] "balancing of interests" test. The newer standard attempts to resolve conflicts between national laws by weighing the competing interests of the parties and countries involved in the dispute. It encourages restraint in the assertion of enforcement jurisdiction when onerous or undesirable consequences are likely to result.[52]

In *First National City Bank of New York* it was held that a national bank, with its branch offshore, was not entitled to defeat a summons of the IRS for production of certain records of its foreign branch on the ground that compliance with a subpoena would involve a violation of foreign law. The foreign law in question banned any general examination of the bookkeeping in the offices of merchants. The bank was held not to be entitled to defeat the summons because the licensing of the national bank was some ground for inference that the foreign prohibitions did not extend to examination by and disclosures to duly authorised officers of the US Government. The

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43 *Ibid* at 211.

44 *Ibid* at 205 (1958). The issue of control has more typically arisen in circumstances in which foreign affiliates of a US corporation physically possess the documents in question. See, eg, *In re Grand Jury Subpoenas Duces Tecum Addressed to Canadian International Paper Company* 72 F Supp 1013 1020-21 (SDNY 1947) (the location of records in Canada does not excuse production where subject of subpoena has effective control over documents). The argument that subsidiaries and branches of US corporations are separate entities and are, thus, exempt from subpoenas served on the head office has not been well received: see, eg, *First National City Bank v IRS*, 271 F 2d 616, 618 (2d Cir 1959) (the bank had control over documents since it could require its branch to send records to the head office for corporate purposes), *In re Equitable Plan Company*, 185 F Supp 57, 59-60 (SDNY 1960) (the independent entity doctrine does not create an exception to the requirement that a branch comply with a subpoena).

45 *Supra* n.40 at 212.

46 *Ibid* at 205.

47 *Supra* n.40.

48 *Ibid* at 208.

49 *Civil Aeronautics Bd v Deutsche Lufthansa Aktiengesellschaft*, 591 F 2d 951, 953 (DC Cir 1979).

50 *Societe Internationale pour Participations Industrielles et Commerciales, SA v Rogers*, 357 US 197 at 208-209 (1958), *General Atomic Co v Exxon Nuclear Co*, 90 FRD 290, 296 (SD Cal 1981), *United Nuclear Corp v General Atomic Co.*, 96 NM 155 at 230-31, 629 P 2d 231 at 306-7 (1980), 451 US 901 (1981).

51 271 F2d 616 (2d Cir 1959), cert denied, 361 US 948 (1960).

52 Section 40 of the *Restatement (Second) of the Foreign Relations Law of the United States* contains the foremost articulation of the "balancing of interests" test.

Court also held that there is a presumption that a corporation is in control of its own books and records. Where an officer or agent of a branch has the authority to send the books to the parent for any corporate purpose, the parent has sufficient control over the books for the summons or subpoena to be enforceable.[53] The Court held:

> "'It is no longer open to doubt that a federal court has the power to require the production of documents located in foreign countries if the court has in personam jurisdiction of the person in possession or control of the material[54]'.[55] ... The difficulty arises, of course, when the country in which the documents are located has its own rules and policies dealing with the production and disclosure of business information - a circumstance not uncommon. This problem is particularly acute where the documents are sought by an arm of a foreign government. The complexities of the world being what they are, it is not surprising to discover nations having diametrically opposed positions with respect to the disclosure of a wide range of information.[56] ... In any event, under the principles of international law, 'A state having jurisdiction to prescribe or enforce a rule of law is not precluded from exercising its jurisdiction solely because such exercise requires a person to engage in conduct subjecting him to liability under the law of another state having jurisdiction with respect to that conduct.'[57] It is not asking too much however, to expect that each nation should make an effort to minimize the potential conflict flowing from their joint concern with the prescribed behavior.[58] Where, as here, the burden of resolution ultimately falls upon the federal courts, the difficulties are manifold because the courts must take care not to impinge upon the prerogatives and responsibilities of the political branches of the government in the extremely sensitive and delicate area of foreign affairs.[59] Mechanical or overbroad rules of thumb are of little value; what is required is a careful balancing of the interests in the facts and circumstances of the particular case.[60] ... In evaluating [the bank's] contention that compliance should be excused because of the alleged conflict between the order of the court below and [foreign] law, we are aided materially by the rationale of the recent Restatement (Second), Foreign Relations Law of the United States, s.40 (1965):[61]
>
> Where two states have jurisdiction to prescribe and enforce rules of law and the rules they may prescribe require inconsistent conduct upon the part of a person, each state is required by international law to consider, in good faith, moderating the exercise of its enforcement jurisdiction, in the light of such factors as
>
> (a) vital national interests of each of the states,
>
> (b) the extent and the nature of the hardship that inconsistent enforcement actions would impose upon the person,
>
> (c) the extent to which the required conduct is to take place in the territory of the other state,
>
> (d) the nationality of the person, and

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53 See *United States v First National City Bank* 396 F 2d 897 at 898 (1968).

54 See, eg, *First National City Bank of New York v IRS* 271 F 2d 616 (2d Cir 1959), cert denied, 361 US 948, 80 S Ct 402, 4 L Ed 2d 381 (1960) (judgment footnote).

55 *Supra* n.53 at 900-1.

56 *Ibid* at 901.

57 *Restatement (Second), Foreign Relations Law of the United States*, s.39(1) (1965) (judgment footnote).

58 *Ibid* s.39(2). Compare Report of Oral Argument, 25 USLW 3141 (Nov 13, 1956) and *Holophane Co v United States*, 352 US 903, 77 S Ct 144, 1 L Ed 2d 114 (1956) (judgment footnote).

59 See, eg, *Chicago & Southern Air Lines v Waterman SS Corp* 333 US 103, 111, 68 S Ct 431, 92 L Ed 568 (1948).

60 *Supra* n.53 at 901.

61 Discussed by Sahagian NH 'Summonses - Production of Documents Located Abroad Upheld Despite Foreign Nondisclosure Laws: *US v Vetco Inc*' (1982) 6 *Suffolk Transnational Law Journal* 419 at 421 and 426-7.

(e) the extent to which enforcement by action of either state can reasonably be expected to achieve compliance with the rule prescribed by that state.[62]

Whatever one may think of requiring disclosure of records of a [foreign] corporation reported in a bank in [a foreign country], surely an American corporation cannot insulate itself from a federal Grand Jury investigation by entering into a contract with an American bank abroad requiring bank secrecy."[63]

As one might expect, the US courts tend to come down in favour of the view that the public policy of protecting the US revenue outweighs the overseas secrecy obligation; though on occasions they have supported the overseas secrecy provisions.[64]

(e) *Vetco*

In *Vetco*[65] the Court applied a "balancing of interests" approach to decide whether possible foreign criminal liability was a valid defense to the enforcement of a summons. The five factors considered by the Court were:

1. the national interests of the United States and the foreign country;
2. the extent of hardship on the taxpayer and the auditors from compliance;
3. the location of compliance, the nationality of the parties and the expectation of compliance in each state with that state's rules;
4. the importance of the documents; and
5. the availability of alternative means of compliance.

The Court found that the US had a strong interest in collecting taxes from and prosecuting tax fraud by its own national operating outside the US through foreign subsidiaries. Acknowledging that the foreign country also had an interest in protecting the secrecy of business records, the Court held that the foreign country's interest was diminished because (a) the subsidiary in the foreign country could have consented to disclosure under the foreign law, and (b) the IRS was required to keep the requested documents confidential under the Internal Revenue Code (IRC).[66]

The second factor did not prevent enforcement because the Court was not convinced that there would be any criminal prosecution as a result of disclosure or that any third parties would object to the production of the documents. A representative of the foreign country's Federal Attorney had submitted an affidavit stating that an order of a US court enforcing a summons might constitute duress and serve as a defence to a criminal charge. Moreover, the Court stated that: (a) the taxpayer could have maintained records in the US[67] to enable a determination of the foreign subsidiary earned US taxable income, (b) it did not maintain those records, and (c) neither the dispute with the IRS nor the foreign legal problem would have arisen if it had maintained the records. Thus, the Court had little sympathy for the taxpayer and the auditors in applying the hardship factor.[68]

The third and fourth factors also did not prevent enforcement since the documents were: (a) located in the foreign country but were to be produced in the US and could be shipped to the taxpayer by its wholly owned subsidiary, and (b) were relevant to the determination of the taxpayer's US taxable income and were not shown to be cumulative of records already produced.[69]

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62 *Supra* n.53 at 902 (2d Cir 1968). See also, generally, Kaplan RL *Federal Taxation of International Transactions - Principles, Planning and Policy* West Publishing Co 1988 at Ch 4.

63 *Supra* n.53 at 905 (2d Cir 1968).

64 *Supra* n.35 at 167-8. See also *Consolidated Rendering Co v Vermont* 207 US 541, 28 S Ct 178, 52 L Ed 327, 12 Ann Cas 658, *Independent Order of Foresters v Scott*, 223 Iowa 105, 272 NW 68, *Copper King of Arizona v Robert* 76 N J Eq 251, 74 A 292, *Holly Mfg Co v Venner*, 86 Hum 42, 33 NYS 287.

65 644 F2d 1331.

66 Section 6103 IRC: 644 F 2d 1331.

67 As required by s.964(c) IRC.

68 *Supra* n.65 1331-2.

69 *Ibid* at 1332.

The Court of Appeals held that the interest of the US government in enforcing revenue laws weighed against the interest of a foreign government in preserving the secrecy of business records.[70] Accordingly, the Court ordered the corporation to comply with the summons.[71]

It will be difficult for taxpayers to prevail under the "balancing test" of the Court of Appeals in the Vetco case since it is likely that the interest of the country collecting the tax and prosecuting tax fraud will almost always be found to outweigh the competing interests of the other country. Certainly taxpayers will have very heavy burdens of proof in enforcement actions of this type. One factor that will be important is whether the taxpayer maintained complete and accurate books and records required by law and willingly provided those books and records to the relevant revenue authority during the course of the audit. Another important factor will be whether the taxpayer made a good faith effort to overcome foreign legal obstacles to production of the requested books and records.

(f) First Chicago

In the 1983 United States Court of Appeals decision, *United States v First National Bank of Chicago*,[72] it was held that compliance with an IRS summons to produce records located at the foreign branch of the First National Bank of Chicago was not required because the persons who could make the records available would be subject to criminal prosecution under foreign law.[73] The Court of Appeals adopted the Restatement "balancing test" as a framework for evaluating this issue[74] and, after enumerating the factors in the test, proceeded to apply each of them to the First Chicago situation. The fact that the disclosure would be initiated in a foreign country and the likelihood that foreign nationals would participate in the release of the information weighed in favor of First Chicago, because exposure of those individuals to criminal liability in their country would be high.[75]

The Court then emphasised the extent and nature of the hardship that compliance would inflict upon the individual employees of First Chicago.[76] Citing a comment from the Restatement, the Court noted that when criminal sanctions rather than civil liability are involved a state should consider more seriously the option of not exercising its enforcement jurisdiction.[77] In *First Chicago* those sanctions included only imprisonment with no possibility of reduction to a fine. According to the Court the rationale for employing such restraint was further strengthened because First Chicago was a neutral party, a mere source of information for the IRS, rather than an adverse party.[78]

With respect to the relative national interests implicated in the conflict, the First Chicago Court recognised the importance of the broad interests of the United States in revenue collection as well as the foreign country's interests in bank secrecy laws.[79] Upon closer inspection, however, the Court found that the US interest in this case was actually a limited one. No investigation of criminal tax evasion was involved because the summons was served only for the purposes of levy and collection.[80] The case appears to be at odds with, yet distinguishable from, recent decisions which have held that foreign law should not deter courts from enforcing orders compelling production of information or imposing sanctions for violations of such orders.

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70 *Ibid* at 1333 (9th Cir). See also *In re Grand Jury Proceedings*, 532 F 2d 404 (5th Cir 1976) (a wide discretion was granted to US tax investigators in obtaining information from financial institutions where tax evasion involved).
71 *Supra* n.65 at 1333 (9th Cir). The Court further imposed contempt sanctions for failure to so comply.
72 699 F 2d 341 (7th Cir 1983).
73 *Ibid* at 342.
74 *Ibid* at 345.
75 *Ibid* at 345-6.
76 *Ibid.*
77 *Ibid.*
78 *Ibid* at 346.
79 *Ibid.*
80 *Ibid.*

(g) *Toyota*

In the 1983 *Toyota case*[81] the Court found that: (a) the foreign pricing information was "fundamental" to the IRS,[82] (b) the requested information was specific, (c) the information could not be obtained by alternative methods because the foreign tax authorities had not complied with the IRS' requests for the information under the relevant international tax treaty, (d) letters rogatory probably would not be recognised by the foreign court summons authority,[83] and (e) the interests of the United States in determining the subsidiary's correct US tax liability outweighed any national interest of the foreign country in preventing disclosures of documents located in the foreign country,[84] particularly since double taxation could be prevented under the competent authority provisions of the relevant international tax treaty.

(h) *Garpeg*

In 1984 the *Garpeg*[85] decision was handed down. In connection with a criminal investigation of Gucci Shops Inc (a US corporation) and Aldo Gucci (Gucci Shops' chairperson and a US resident) the IRS issued a summons to two banks (as third-party recordkeepers)[86] requesting each bank to produce all records at all branches, including each bank's specified foreign branch, pertaining to Garpeg Ltd (a foreign corporation controlled by members of the Gucci family). Garpeg moved to quash the summons on the grounds that the summons: (a) were overbroad in failing to limit the requests to records of transactions with Gucci Shops Inc and Aldo Gucci, and (b) called for the production of records located in a foreign country in contravention of that foreign country's confidentiality laws. The Court held that the IRS' summons was too broad but that: (a) it should be enforced to the extent necessary to require the production by one of the banks of records concerning any financial transactions between Garpeg and Gucci Shops Inc and Gucci, and any financial transactions by Garpeg with third parties authorised by Aldo Gucci as signatory, (b) the IRS could issue a new summons if further investigation indicated that additional relevant information was contained in Garpeg Ltd's records held by that bank, and (c) under the "balancing test", the US' interest in tax collection outweighed the foreign country's interest in bank confidentiality and the possible hardship to the specified bank, which the Court found to be "somewhat speculative".[87]

The Garpeg saga represents another major step forward for the IRS in gaining access to foreign based documentation in aid of US tax audits, since the IRS prevailed against third parties who were not under investigation and who did not have clearly established direct relationships with the taxpayers who were under investigation, as in the case of the parent-subsidiary relationships in the *Vetco* and *Toyota* cases.

(i) Compelled waiver

The tensions between the US and foreign countries with secrecy provisions increased as law enforcers began to use a new device, the compelled waiver,[88] to further their investigations.[89] This device circumvents the policy of confidentiality by coercing the bank's customer to waive secrecy

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81 *Supra* n.27.
82 Section 482 *IRC* audit.
83 569 F Supp at 1162-3.
84 Under the *Vetco* "balancing test".
85 *Garpeg Ltd v US*, 84-1 USTC 9323, 583 F Supp 789 (SDNY).
86 Under s.7609 *IRC*.
87 *Supra* n.85. The Court also concluded that the bank had not established sufficient grounds to warrant granting the extraordinary remedy of an injunction against Garpeg Ltd from continuing the foreign litigation (to restrain the bank from producing the requested documents to the IRS or to any other person or from removing the documents from the foreign jurisdiction) and that it could not compel a foreign corporation such as Garpeg to waive rights conferred on it by foreign law (at 797-9).
88 'Compelled waiver' is the popular term for a consent directive which, when signed, waives an individual's right to secrecy of his bank records.
89 See *US v Doe* 775 F 2d 300.

protections extended by the foreign jurisdiction,[90] and thereby permitting a foreign bank to release financial information concerning the customer's account without fear of liability. Rather than solving this substantive conflict of laws problem, the US and the courts of foreign countries have perpetuated the conflict by applying their respective domestic law analyses in compelled waiver cases US courts have addressed only the issue of whether compelling consent violates a defendant's fifth amendment rights under the United States Constitution.[91] Some foreign countries, on the other hand, have refused to recognise the consent to waive bank secrecy because it was given under compulsion. This intransigence cannot be explained or excused simply by the foreign country's desire to thwart US intrusion. The conflict of national policies reflects fundamental differences about taxation as a policy and tax evasion as a crime.

Section 264A *ITAA*

Irrespective of the United States' success in its use of its access powers in obtaining documentation which is held offshore, Australian legislators recognised that the Federal Commissioner of Taxation may have difficulty in obtaining pertinent information concerning offshore entities if the Commissioner was limited to the ss.263 and 264 powers. Accordingly, in 1989 the Federal Government proposed[92] the introduction of "offshore information procedures". These were modelled on US and Canadian provisions and subsequently enacted as s.264A ITAA.[93]

As we have seen, s.264 will have no application where the party served with the notice does not have control of the relevant documents or control of a third party who has custody of the relevant documents. It is clear that it is difficult to establish control of documents in many situations, particularly where control distancing measures are actively adopted. Further the US courts have shown reluctance to enforce a s 264-type access power[94] where the employee of a third party is exposed to imprisonment.[95] In order to ensure effective administration in such circumstances s.264A was enacted. Section 264A(10) *ITAA* provides that where there is a failure to supply the information or documents requested under the notice, the information, documents nor secondary evidence of those documents is admissable in proceedings - before a court or the Administrative Appeals Tribunal in which the taxpayer disputes the assessment - without the Commissioner's consent. The fact that supply of the information requested would lead to a breach of a foreign secrecy law is not a ground for arguing that the information is inadmissable.[96]

The US, Canadian and New Zealand jurisdictions have enacted similar legislation.[97] Although there has been a reluctance by revenue authorities to use these powers recent decisions in the US[98] and Canada[99] have given affect to them. These decisions confirmed the usefulness of such provisions as a deterrent to taxpayers who manufacture the unavailability of information. Although these powers have not been exercised in Australia as yet, or been subject to judicial review, there is no doubt that they further empower the Commissioner in his audit capacity.

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90 See, eg, *Davis* 767 F 2d at 1033-5 and *Ghidoni* 732 F 2d at 816.
91 US CONST amend V "No person ... shall be compelled in any criminal case to be a witness against himself...".
92 *Taxation of Foreign Source Income - An Information Paper*, April 1989, AGPS, Canberra.
93 *Taxation Laws Amendment (Foreign Income) Act* 1991, No 5 of 1991.
94 Section 7602 *IRC*.
95 See *US v First National Bank of Chicago* 699 F 2d 341 (7th Cir 1983), 83 1 USTC 9159.
96 Section 264A(12) *ITAA*.
97 Sections 982 and 6038A IRC (US), s.231.6 *Income Tax Act* (Canada) and s.21A *Income Tax Act* 1976 (NZ).
98 *Flying Tigers Oil Company Inc v Commissioner* (1989) 92 TC 82. The US provision which has been in the IRC since 1982 was applied by the US Tax Court for the first time in 1989 in *Flying Tigers*. Also see generally Patton 'The IRS Access to Foreign Based Documents: *Flying Tigers Oil Company Inc*' (1989) 18 *Tax Management Journal* 433, Fuller, 'Inbound Section 482 Information/Disclosure' (1990) *Tax Notes International* 69; and Cole 'New IRS Record Keeping and Summons Requirements for Enforcing US Transger Pricing Rules in Foreign Owned Situations' [1990] *Intertax* 83.
99 *John Merko v The Minister of National Revenue* 90 DTC 6643.

Section 264A does not supersede s 264(1)(b).[100] In fact, the Commissioner may not be content with the results obtainable by the use of s.264A. For example, if the *Vetco* case had arisen after s 982 (the US' *IRC* equivalent of s.264A *ITAA*) was enacted, the IRS could have issued a formal document request (FDR) to the taxpayer (but not its auditors or lawyers) for the books and records of the foreign subsidiaries. The effect of the foreign law, which was the principal issue in the *Vetco* case, would have been irrelevant, and the taxpayer could not have introduced the requested documents at trial if it did not comply with the FDR. However, it is doubtful that the IRS would have been satisfied with s.982-type results and the IRS probably would have pursued its summons enforcement action in any event.[101]

The IRS in *Gerling International*[102] did not rely on s 982 "because of the inadequacy, under the circumstances of this case, of the limited sanction provided by that section". Similarly, it is clear that the IRS did not believe that its objectives could be satisfied in the Gucci case by proceeding under s.982 *IRC*. Section 264(1)(b) therefore continues to be a very important access power for the Commissioner in the international enforcement arena. If the Federal Commissioner of Taxation believes that illegality under foreign law is a serious obstacle to production of the requested documents, the Commissioner may resort to s.264A, which negates that defence. However, if Australian courts follow in the steps of US courts concerning IRS access powers, it appears that foreign illegality usually will not be a serious obstacle in an information gathering action.

Conclusion

In light of the US courts expansive interpretation of the enforcement jurisdiction of the IRS and their record in resolving conflicts with foreign law (and given that Australian courts may favour the Commissioner when taxpayers attempt to defeat the ATO's efforts access offshore information), Australian taxpayers operating abroad and foreign taxpayers operating in Australia must be aware that the Commissioner has significant potential to access foreign-based documents in connection with tax audits and tax litigation in Australia. Thus, Australian taxpayers and foreign based taxpayers operating in Australia should plan their international transactions on the assumption that all relevant facts will be on the table in the course of audits by, and litigation with, the Australian Taxation Office concerning those transactions. It may be that the warnings made in respect of the US Internal Revenue Service's powers to obtain offshore information are equally applicable in Australia:

"... taxpayers that ignore Government requests for information or feel that stonewalling is the appropriate technique to be followed, ought to be advised that ... the non-document-producing taxpayer is likely to be the victim of some heavy handed Government enforcement action."[103]

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100 See s.264A(24) *ITAA*.

101 The IRS might also have been able to obtain the documents through pre-trial discovery procedures.

102 *Gerling International Insurance Company v Commissioner*, CCH Dec 42,952, 86 TC No 31 (March 26, 1986).

103 Patton, 'The IRS Access to Foreign Based Documents: *Flying Tigers Oil Company Inc*' (1989) 18 *Tax Management Journal* 433 at 437 cited by M Dirkis 'Foreign Income: Out of Sight - Not Out of Mind' *Taxation in Australia* (Red Edition) 1(1) Aug 1992.