

COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

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May 29, 1979

The Honorable Sam M. Gibbons  
Chairman, Subcommittee on  
Oversight  
Committee on Ways and Means  
House of Representatives

Dear Mr. Chairman:

As you may recall, in his February 5 meeting with you and your staff director, Mr. Dick Fogel of our office discussed the problem we have in trying to obtain access to tax return information exchanged by competent authorities pursuant to the provisions of tax treaties between the United States and foreign countries. At your Subcommittee's April 25 hearings on Tax Havens, Mr. Fogel also raised the issue in response to your question as to whether there would be any impediments to GAO looking at how the Government is dealing with the problem of tax evasion and tax avoidance in tax haven countries.

The problem initially came up in the course of our work in response to a House Ways and Means Committee request that we study Federal and State problems in apportioning corporate income among various jurisdictions for the purpose of computing tax liabilities. The Committee expressed particular interest in the Internal Revenue Service's administration of section 482 of the Internal Revenue Code of 1954, as amended.

As a result of your discussion with Mr. Fogel, it is our understanding that you are willing to work with us to explore ways to obtain Congressional and GAO access to information exchanged by competent authorities so we can carry out our oversight responsibilities to assure that the Government administers our tax laws effectively, efficiently, and economically. To assist you in understanding the issues involved, it was agreed that we would provide you with an analysis of (1) the legal issues, (2) the need for access to such information to accomplish effective oversight, and (3) alternatives for securing access.

After the Subcommittee has had time to study our analysis we would like to meet with you to obtain your views on our analysis, to seek your advice on the desirability of proceeding with one or several of the alternatives we suggest, and to discuss how we can work together on the effort.

LEGAL ISSUES INVOLVED

Income tax treaties to which the United States is a party contain a provision which recognizes that each country may allocate income and deductions between related corporations (such as a parent and its subsidiary) when their dealings have not been at arm's length. These treaties provide for negotiations between the "competent authorities" of the two treaty countries so that agreements on allocations of income and deductions between the corporate entities can be obtained as a means of avoiding double taxation. Thirty-two nations have tax treaties with the United States. All but one 1/ of the treaties contain a secrecy clause which restricts access to exchanged information.

Access to the tax information exchanged under the treaties may be obtained by two means: qualification under the exception provision in the secrecy clause; pursuant to specific statutory authority in the Internal Revenue Code authorizing access to this information.

GAO access to the tax information received by the U.S. competent authority from other competent authorities pursuant to treaty provisions has been denied by IRS officials because they believed that neither the Congress nor GAO has authority to receive or review such information. IRS officials indicated that (1) the Congress and GAO do not meet the exception provision in the secrecy clause and (2) the disclosure provisions of section 6103 of the Code authorizing the Congress and GAO access to returns and return information do not extend to information obtained pursuant to tax treaties.

The secrecy clause contained in nearly all tax treaties is as follows:

"Any information so exchanged shall be treated as secret but may be disclosed to persons (including a court or administrative body) concerned with the assessment, collection, enforcement or prosecution in respect of taxes which are the subject of the present convention."

IRS officials based their decision to deny us access to exchanged information on a review of the documented history of the secrecy clause appearing in the United Kingdom (U.K.)

1/The treaty with Canada does not contain the secrecy clause.

treaty. IRS selected the U.K. treaty because it is one of the oldest tax treaties, requires confidential treatment of exchanged information, and has been a prototype for most of the other tax treaties. IRS' analysis indicated that the exceptions to the secrecy clause were intended to be construed narrowly and that neither GAO nor, by implication, the Congress qualify as "persons \* \* \* concerned with the assessment, collection, enforcement, or prosecution in respect of the taxes which are the subject of the present convention." IRS indicated that the role of both the Congress and GAO is one of oversight, and that to perform this role, we were given access (by section 6103) to returns and return information for purposes of evaluating the effectiveness, efficiency and economy of IRS operations--not for purposes of assessment, collection, enforcement or prosecution.

IRS' interpretation of access allowed by the secrecy clause was also supported by its review of article 26 of the Organization for Economic Cooperation and Development (OECD) Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital. The secrecy clause of article 26 is basically similar to the secrecy clause of the U.K. treaty. Paragraphs 12 and 13 of the OECD commentary for article 26 outline disclosure as being authorized only to three categories of persons: 1) governmental employees and authorities, including courts, concerned with the assessment, collection, enforcement, prosecution, and determination of appeals with respect to the taxes which are the subject of the convention; 2) the taxpayer or his proxy; and 3) witnesses.

IRS' ability to disclose tax information is governed by section 6103 of the Internal Revenue Code. Section 6103(k)(4) authorizes disclosure of returns and return information to the competent authority of treaty nations. However, there is no comparable provision of section 6103 specifically restricting the use which IRS may make of information received from a treaty nation. Thus, as far as section 6103 is concerned, tax treaty information is return information and subject to the provisions of section 6103 governing disclosure of return information. Nonetheless, when dealing with an international treaty, the provisions of the Code as well as the provisions of the treaty must be considered. This dual concern raises the question of whether the treaty or the statute govern in case of a conflict. The Code has partially addressed this question. Section 7852(d), as amended in 1966, provides that no provision of the Code shall apply in any case where its application would be contrary to a provision of a U.S. treaty in effect at that time.

With regard to subsequent treaties, it is necessary to look to general rules of statutory construction. When a treaty and a subsequent act of the Congress conflict, the statutory provision will govern provided there is clear and unequivocal Congressional intent to contravene the treaty and the statutory language will admit no other reasonable construction.

GAO's and the Congress' statutory authority for access to returns and return information is contained in two provisions of section 6103, as amended by the Tax Reform Act of 1976. Section 6103(f), authorizes the House Committee on Ways and Means, the Senate Finance Committee, and the Joint Committee on Taxation to access returns and return information. Section 6103(f) also authorizes access for agents of these Committees. Section 6103(i)(6) authorizes GAO to access returns and return information for the purpose of conducting an audit of IRS, provided such audit is not disapproved by the Joint Committee on Taxation.

However, in amending section 6103 in 1976 to provide for Congressional and GAO access, the Congress did not "clearly and unequivocally" indicate an intention to abrogate treaty secrecy clauses. Thus, the more restrictive disclosure provisions of treaties prevail. Consequently, neither the Congress nor GAO can obtain access to information exchanged by competent authorities pursuant to tax treaties for the purpose of assessing the effectiveness, efficiency, and economy of the Government's tax administration functions.

TAX INFORMATION AVAILABLE IS  
INSUFFICIENT FOR EFFECTIVE OVERSIGHT

When the same income becomes subject to double taxation by the United States and a treaty nation, the taxpayer may obtain relief through competent authority actions. In order to satisfy its goal of eliminating this double taxation, the U.S. competent authority attempts to negotiate a settlement with the foreign nation which will prevent the income from being taxed twice. Corporate officials desiring competent authority relief submit their requests to IRS' Office of International Operations--the organization responsible for competent authority functions. IRS permits corporations to submit these requests at any time during the audit or appeals process.

In addition to negotiating with foreign countries, the U.S. competent authority also takes unilateral actions to

eliminate double taxation for taxpayers. Unilateral action is taken in situations where the foreign nation's statutory period of limitations on tax adjustments expires before negotiations can begin and in situations where the tax adjustments made by IRS international examiners are considered de minimus. In both of these situations, the U.S. competent authority will unilaterally grant the taxpayer relief from double taxation by forgiving the additional U.S. tax that would result from IRS' audit adjustment. Unilateral relief is also granted when competent authority decides that a section 482-type adjustment is not adequately supported.

To identify those competent authority actions to which we are allowed access, IRS has defined treaty information subject to the secrecy clause as including only that information exchanged between U.S. and foreign competent authorities. As such, information IRS receives directly from the taxpayer through IRS' normal audit or appeals process is not considered subject to the secrecy clause even though the information may pertain to the taxpayer's foreign subsidiaries located in treaty countries.

Under this definition, we can review all unilateral actions involving section 482-type adjustments taken by the U.S. competent authority, provided other tax adjustments in the case did not involve information exchanged by competent authorities pursuant to treaty provisions. We can also review competent authority negotiations with Canada because the Canadian treaty does not contain a secrecy clause.

Our review of competent authority actions has been extremely limited due to our access problem. However, it appears that the number of cases involving unilateral actions in relation to the number of cases involving negotiations with foreign nations are such that we should be permitted to review about 40 percent to 50 percent of the total actions taken.

However, those actions which we cannot review represent the reason for the existence of the competent authority function, that is to eliminate double taxation of U.S. taxpayers by negotiating with foreign tax authorities. Thus, we are precluded from reporting on how effectively IRS is performing its competent authority responsibilities and developing data needed by IRS management to take corrective action on problems that may exist.

An indication that problems may exist is competent authority's small workload in comparison with the large

number of section 482-type adjustments that are being made. According to IRS officials, the competent authority workload should be much greater based on the number of section 482-type adjustments recommended by international examiners. These adjustments could result in double taxation of the same income by U.S. and foreign tax authorities. Thus, we would assume that corporations would request U.S. competent authority to negotiate with the foreign government to eliminate double taxation. This does not, however, seem to be happening. Although national statistics are not available, we found that in the Detroit and Cleveland districts, international examiners recommended section 482-type adjustments in 22 of 75 audits of multinational corporations during the 15-month period ending June 30, 1978. Yet IRS statistics show that for the 18-month period ending March 31, 1978, a national total of only 29 cases were closed as a result of negotiations. IRS officials said that studies to identify the reasons for this low workload have never been completed.

We have not yet researched in detail the extent to which limited access to treaty information would adversely affect any work we might do for the Subcommittee on the tax haven problem. But given the testimony of various witnesses at your April hearings on the importance of tax treaties to enable our Government to identify tax evasion schemes in tax haven countries, it appears that we should have access to information obtained pursuant to tax treaties. In addition, given the statements of Mr. Langer and Mr. Cole to the effect that our Government could be more aggressive in negotiating tax treaties to secure proper exchanges of information and in using sanctions to induce countries with Bank Secrecy Laws to cooperate with the United States, we believe it appropriate that the Congress and GAO have access to treaty information to independently assess how well the Executive branch has used, and plans to use the treaty process as a means to combat tax evasion.

#### ALTERNATIVES FOR OBTAINING ACCESS TO TREATY INFORMATION

We believe IRS is correct in its interpretation that the Congress' and GAO's authority to review returns and return information pursuant to the provision of section 6103 of the Code does not extend to information exchanged by competent authorities pursuant to tax treaty secrecy clauses. Therefore, some method for obtaining this tax information must be implemented if the Congress and GAO are to carry out

their oversight responsibilities in this important area. Alternatives to permit a review of treaty information by the Congress and GAO include:

- (1) Having the Internal Revenue Service or Treasury contact those foreign countries GAO selects for review to obtain permission to release the tax information to us where a tax treaty exists between the U.S. and the country.
- (2) Having the Department of the Treasury initiate supplementary protocols with each of the foreign countries to amend the secrecy clause to provide the Congress and GAO access to exchanged tax information.
- (3) Having the Department of the Treasury amend the secrecy clause as each treaty comes up for renewal to permit disclosure of tax information to the Congress and GAO.
- (4) Amending section 7852(d) and section 6103 subsections (f)(1) and (i)(6) to supercede the treaties and provide both the Congress and GAO access to treaty information.

Alternatives 2, 3, and 4 hold the promise of being permanent solutions to the problem of obtaining tax treaty information. As such, we believe it is in the best long-term interest of both the Congress and GAO to pursue one of these three alternatives. Alternative 4 would permit the Congress, rather than the Department of the Treasury, to control the process for correcting the problem, but it would do so to the exclusion of the foreign parties whose interest are involved. Obviously, the Treasury Department would be consulted during the legislative process, particularly since that process could result in a law that creates adverse foreign policy repercussions.

Alternative 2, the renegotiation of 31 tax treaties to amend the secrecy clause, would require substantial effort and considerable time to complete. First, the Congress and GAO would have to persuade Treasury to act. If Treasury agreed, while this alternative would not provide the most timely solution to the problem, it also would not create others of a possibly greater magnitude.

Alternative 3, amending the secrecy clause of the treaties as they come up for renewal, would be a more practical approach for the Treasury Department to pursue. However, once ratified,

treaties tend to remain in effect for considerable periods of time before they are renewed. Therefore, this method could require even more time than alternative 2.

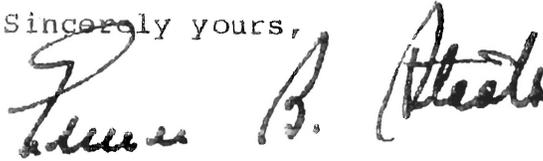
One further problem with alternative 2 or 3 is that the change would involve negotiations with foreign governments. It is not clear whether foreign governments would be willing to agree to expand the number of U.S. agencies that could have access to treaty information without asking for some reciprocal concessions by our Government. The Treasury, IRS, and indeed the Congress, may have problems letting agencies other than competent authorities in other countries have access to U.S. tax information exchanged pursuant to the treaties. Other countries may not have disclosure laws that are as stringent as ours.

Even under alternative 4, the Congress would need to consider whether legislation would generate a move by foreign governments to open up examination of data exchanged pursuant to treaties to more agencies in foreign countries. There is more likelihood of this problem arising under alternative 4. The Congress would need to evaluate and balance the long-term need-to-know against any objections our treaty partners would have with disclosing exchanged tax information to the Congress and GAO and the impact of any objections on IRS' international tax program.

Alternative 1 may be the most practical way to proceed in the short-term. However, no matter which alternative is selected, IRS officials have expressed to us their concern that some foreign countries may object to the release of any tax information. Of particular concern to IRS are the United Kingdom and West Germany. Both have strict internal rules regarding the secrecy of tax information. Accordingly, I believe that it is important to discuss this issue with appropriate Treasury Department officials before we decide on a specific alternative for eliminating the access problem. We need to be very aware of Treasury's concerns and the extent to which such concerns are valid and could result in an adverse effect on Treasury's ability to administer the tax laws.

We look forward to working with you on this issue and appreciate your support of our efforts.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "James B. Atchefs". The signature is written in dark ink and is positioned to the right of the typed name.

Comptroller General  
of the United States