The Efficacy of Extra-territorial Jurisdiction and US and EU Tax Regulation

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States are increasingly resorting to extra-territorial measures to regulate many areas of the economy and society. Extraterritorial and unilateral US regulation imposes substantial compliance risk for individuals and firms doing business – either directly or indirectly – with the United States. The extraterritorial reach of US tax law creates significant challenges both for US persons and non-US persons in their international activities and operations. Many states have adopted blocking laws against extraterritorial US laws, but they have had little success in curbing the scope and application of extraterritorial US financial laws to cross-border financial transactions, mainly because of the inter-connectedness of the global financial system and the reserve currency status of the US dollar. US unilateralism and extraterritoriality, especially with respect to tax assessment and enforcement, has attracted much controversy and criticism. European Union law offers an alternative model of cross-border surveillance and indirect enforcement of EU state income tax laws with respect to the interest income earned on bank accounts by non-residents who reside in other EU countries. Although EU directives have limited application in this area, they demonstrate how a mutual legal assistance regime can be devised for states acting together to conduct cross-border surveillance of income tax liability and to collect tax with the assistance of foreign tax authorities. The EU tax surveillance regime on interest income contains adequate flexibility for EU states with strong bank secrecy laws to choose between reporting the tax liabilities of non-resident account holders or to collect the tax on behalf of the state of the non-resident account holder. The EU approach respects national sovereignty while achieving the overall tax assessment and collection objectives. The divergent approaches between the EU and US demand a global solution. Despite the political obstacles, more global coherence and coordination could be achieved in this area without sacrificing the national objectives of combating tax avoidance and evasion, and tax fraud.

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Overview

Economic globalization and advances in technology have necessitated more expansive notions of jurisdiction that allow states to regulate activities beyond their geographic borders that affect their economies and societies. Although most states accept that enforcement jurisdiction is territorially based (unless there are inter-state agreements to the contrary), many states are increasingly adopting statutes and regulations based on extra-territorial prescriptive jurisdiction that seek to regulate conduct abroad. In the area of tax compliance and enforcement, many states have found it necessary to collect information from foreign authorities in order to monitor their residents' compliance with domestic tax law. For example, some states, such as the United States, follow a unilateral approach by issuing subpoenas against foreign banks or other entities and individuals to report the income they or their US customers earn abroad in order to assess universal tax liability.[1] Many states and their nationals, however, have difficulty complying with such extraterritorial US orders because of domestic law restrictions and the international legal principle known as the "revenue rule", which prohib-

[1] This type of extraterritorial jurisdiction has attracted fierce criticism on the grounds that the international law of jurisdiction is mainly territorial in character and that only in the most exceptional circumstances when fundamental norms of international law have been violated can states be justified in imposing extraterritorial jurisdiction. See discussion below.

its a state from assisting the enforcement of another state's revenue laws, unless there is a specific statute or treaty to the contrary.

States have overcome some of these legal challenges by negotiating mutual legal assistance treaties that permit enhanced cooperation and coordination in the exchange of information and evidence between states in enforcing their tax laws and other public law regulations. Within the European Union (EU),[2] a more comprehensive legal framework has emerged that requires member states to collect information on domestic bank account holders who are resident in other EU states and, in certain circumstances, to withhold income tax on interest earned and transfer it to the tax authorities of the EU state where the account holders reside. This chapter suggests that the EU Directives which implement this cross-border surveillance and information exchange regime provide a more coherent framework than the unilateral approach of US authorities in issuing subpoenas demanding the disclosure of information that is collected and maintained in foreign countries in possible violation of the laws of those countries and international law.

Part I analyses the concept of jurisdiction in international law and how it has been interpreted by various courts and applied by regulatory authorities in certain areas of commerce and financial transactions and the implications for extraterritorial tax assessment and enforcement. Part II examines extraterritorial jurisdiction as it relates to US tax law, the revenue rule, and the extraterritorial aspects of the US Patriot Act. The Patriot Act expands the application of US anti-money laundering law to include all criminal predicate offences under federal law, including tax evasion. This has important implications for the extraterritorial enforcement of US tax law.

Part III examines the EU regime governing the exchange of information and surveillance on savings account income earned by EU residents in bank accounts located in other EU states. This transnational tax surveillance regime represents an alternative model to that of the US unilateral approach of imposing disclosure requirements and enforcements actions on an extraterritorial basis and the need for a more coherent transnational tax regime.

I. The Concept of Jurisdiction and Extraterritoriality

Most nations generally recognise four bases of jurisdiction to prescribe public law: (1) Territorial, (2) Nationality, (3) Protective and (4) Universal.[3] The exercise of prescriptive jurisdiction over persons, territory, property and acts or events has varied across states depending on a country's historic and geographic development.[4] States interpret their jurisdictional authority differently, especially with respect to extraterritorial conduct. This poses a challenge for national policymakers in devising effective and efficient tax compliance regimes and enforcement policies. A state's regulation of extraterritorial conduct should be based on realistic policy objectives which should respect international norms and the legitimate interests of other states.

1. Territorial Principle

A fundamental axiom of international law is that the state is deemed to exercise exclusive jurisdiction over its territory.[5] Indeed, this derives from the mid-seventeenth century Westphalian concept of territory as the primary basis for legal authority and politi-

[2] Throughout this paper, I will refer to the European Union in a broad sense to include all the member states of the European Economic Area (EEA).

[3] *L. Henkin,* International Law (1995, 232). A state's authority to prescribe jurisdiction, adjudicate cases and enforce its judgments derives primarily from its sovereignty; however, jurisdiction is not co-extensive with state sovereignty (*Jennings* and *Watts,* 1992, 457). *The Lotus* case PCIJ, Ser. A, No. 10, p. 19. *Oppenheim* interpreted sovereignty as comprising the *external* and *internal* independence of a state with respect to its liberty of action outside its borders as well as its liberty of action inside its borders, and involves territorial authority over all persons and things within its territory (*Jennings* and *Watts,* 1992, 382).

[4] *J.G. Starke,* International Law (London: Butterworths) (1984) 496–97.

[5] *M. Shaw,* International Law (1999) 62. The ancient Greeks also recognised the primacy of geographic territory as an essential element in the sovereign jurisdiction of a particular society (*Gottmann,* 1973, 27). In contrast, Roman law placed more emphasis on ties of personal allegiance and religion, rather than on territory. The Roman attitude was predicated upon the creation and defence of a large empire, with relatively fluid borders, across which Roman citizens and persons would move and would have their conduct subject only to Roman law.

cal power.[6] Most modern academic treatments of the principle of jurisdiction in international law are derivative of *Kelsen*'s classic analysis of jurisdiction in *A General Theory of State and Law*.[7] Although he accepted the traditional view that a state's ability to exercise its coercive power over individuals and firms was confined to its territorial boundaries, *Kelsen* recognised that it was "not impossible" for a state to prescribe general or individual norms of its legal order to persons or things outside its territory, but it would be "illegal" under international law for the state asserting jurisdiction to attempt to enforce or execute its norms by a coercive act within the territory of another state without that state's consent.[8] For states to coexist without conflict, it was necessary for international law to delimit the territorial spheres of validity of the various national legal orders.[9] International law's territorial limitation on the unilateral enforcement by one state of its laws in another state applied only to its coercive acts in another state and the procedures which led to them. He observed, however, that, despite the prohibition against a state enforcing its norms in the territory of another state, it could regulate the behaviour of individuals in another state's territory. In other words, states could condition the application of sanctions against a person within their territory for behaviour or omissions that occurred in another state's territory.[10]

Similarly, regarding extraterritorial criminal jurisdiction, *Jennings* and *Watt*[11] took the view that states could impose jurisdiction over the acts of foreigners committed in foreign states if these acts were performed in preparation of or participation in common crimes committed or attempted to be committed in the country asserting jurisdiction. Under these circumstances, extraterritorial criminal jurisdiction could be imposed on foreign persons for committing acts abroad that injure nationals of the state asserting jurisdiction or which threaten the safety and security of the state.

During the nineteenth century, the territorial principle was the primary source of jurisdiction under the English Common Law; it was also accepted in US courts and in other common law jurisdictions as the primary, if not exclusive, basis of jurisdiction until well into the twentieth century. The principle was expressed by Lord *Macmillan:*

> "It is an essential attribute of the sovereignty of this realm, as of all sovereign independent States, that it should possess jurisdiction over all persons and things within its territorial limits and in all causes civil and criminal arising within these limits."[12]

According to English law, the mere physical presence of any person or thing within the territory is sufficient to attract jurisdiction without the necessity for either domicile or residence.[13] Parliamentary statutes are presumed to apply exclusively to persons, property and events in the territory over which it has territorial jurisdiction, unless a contrary intention appears, and statutes are construed with reference to this presumed intention.[14] US courts use a similar rule of construction. Moreover, Australian law also provides for such a presumption as stated in section

6 *De Visscher* observed that "[h]istorically the territorial home of the State is the foundation of the political and legal order born in the sixteenth century and definitively consecrated in Europe by the Treaties of Westphalia." (1957, 195–96). See also discussion in *Starke* (193–194). The territorial primacy of state jurisdiction was recognised by former World Court Judge *Huber* (sole arbitrator) in the *Island of Palmas* case (1928) who observed that "the first and foremost restriction imposed by international law upon a State is that – failing the existence of a permissive rule to the contrary – it may not exercise its power in any form in the territory of another State." Award of the Permanent Court of Arbitration in the *Palmas Island* Case, Netherlands-United States, p. 16.

7 *H. Kelsen,* The General Theory of State and Law (1949) 208–212.

8 *Ibid.,* 208.

9 He defined a state's territorial sphere of validity to be "the space within which the acts of the State and especially its coercive acts are allowed to be carried out" (*ibid.,* 209).

10 He observed that a state "could attach sanctions to delicts committed within the territory of another State." See *Kelsen* (1949, 209).

11 *R. Jennings* and *A. Watt* (1992) International Law 468.

12 *The Cristina* [1938] AC 485, 96–97 (per Lord *Macmillan*).

13 See *Dicey* and *Morris,* 1993, r. 24, 303–310. See also *South India Shipping Corp. Ltd. v. Export-Import Bank of Korea* [1983] WLR 585, [1985] 2 All ER 219 (CA). Indeed, under the so-called "transient jurisdiction" an English court may impose jurisdiction on a person who is served with a writ during a mere fleeting presence in British territory. *Colt Industries Inc. v. Sarlie* [1966] 1 WLR 440 (in civil matters, English courts will assume jurisdiction over non-resident alien defendants if a writ is served on them while visiting the UK temporarily, even though the cause of action arose abroad).

14 See *Holmes v. Bangladesh Biman Corporation* [1989] 1 AC 1112, 1126, 1132–1133, 1135–1138; See also *Jennings* and *Watts* (1992, 82).

21(b) of the Acts Interpretation Act of 1901, which provides that "In any Act, unless a contrary intention appears [...] references to such localities' jurisdictions and other matters and things shall be construed as references to such localities' jurisdictions and matters and things in and of the Commonwealth."[15] Similarly, under most common law jurisdictions, the territorial scope of legislation that creates a criminal offence employs the presumption against extra-territorial application, for the law is treated as applying only to acts and omissions taking place in the territory of the legislature.[16]

In the late twentieth century, however, the growth of multinational enterprises, the liberalisation of international markets, and the rise of electronic commerce have significantly reduced the relevance of territory as a basis for jurisdiction. Similarly, systemic changes in the structure of the world economy have circumscribed the power and influence of states within their own territories. Indeed, advances in technology and military weapons have diminished the importance of geographical boundaries in protecting the inhabitants of a territory. Many scholars have postulated that these developments have not only resulted in a diminution in the power of the nation state but also in a decline of the Westphalian system of international law based fundamentally on sovereign territorial states.[17]

2. Objective Territorial Principle

The United States and some other jurisdictions have adopted the objective territorial principle[18] in their state practice as applied to offences or acts commenced in another state, but which (a) are consummated or completed within their territory, or (b) producing gravely harmful consequences to the social or economic order inside their territory.[19]

An important application of the objective principle was by the Permanent Court of International Justice (PCIJ) in 1927 in the *Lotus* case.[20] The *Lotus* case represents a practical explanation of how the concept of territorial sovereignty may justify a nation in applying its laws to both nationals and non-nationals beyond its borders.[21] In *Lotus,* the French officer of the deck on board the *Lotus,* a French ship on the high seas, was responsible for its collision with the Turkish ship *Bozkort*, sinking it and killing several members of its crew. After the *Lotus* entered the harbour at Istanbul, the two French officers explained the events and they were then arrested by Turkish authorities on manslaughter charges under Turkish criminal negligence law. The French government objected on the grounds that the French officers' acts were confined to the French ship on the high seas, and that therefore Turkish law could not apply to determine their guilt. France and Turkey agreed to submit the case to the PCIJ.

The Court ruled that Turkey had not violated principles of international law by exercising criminal jurisdiction and thereby Turkish law could govern, even though the French officers on board the French ship were acting in French territory at the time of the

[15] See *Wanganui-Rangitikei Electric Power Board v. AMP Society* (1934) 50 CLR 581.

[16] *Goodwin v. Jorgensen* [1973] 128 CLR 374, 383; *MacLeod v. Attorney General of NSW* [1891] AC 455, 458; *Cox v. Army Council* [1963] AC 48, 67. The exercise of territorial jurisdiction has also traditionally included the territorial sea or maritime coastal belt, a ship bearing the flag of the state seeking jurisdiction, and ports.

[17] *De Visscher* (1968, 405). Indeed, *Dembinski* (1975, 145) writes that the movement toward statehood and national sovereignty based upon exclusive territorial jurisdiction seems to have reached its apogee and that new technological factors have minimised the importance of the territorial principle of jurisdiction.

[18] Professor *Hyde* defined the objective territorial principle as follows:
"The setting in motion outside of a State of a force which produces as a direct consequence an injurious effect therein justifies the territorial sovereign in prosecuting the actor when he enters its domain."
Hyde, Public International Law, vol. ii (2nd ed.)(1945) 201–17.

[19] See *United States v. Aluminum Co. of America* (Alcoa), 148 F.2d 416, 419 (2d. Cir. 1945). (Second Circuit ruling that Congress had power to prescribe law and impose sanctions against foreign defendants for engaging in anti-competitive conduct outside US if such conduct was intended to have, and did have, a direct and substantial effect within US territory).

[20] The *Lotus* case *(France v. Turkey),* PCIJ, Series A, No. 10 (1927).

[21] *Ibid.,* 23.

incident.[22] A majority of the court took the view that the objective territorial principle was applicable and in applying it the Court treated the Turkish vessel as Turkish territory in order to consider the collision as having affected Turkish territory.[23] Although some scholars view the Court's judgment as "unhelpful" and "characterized by vagueness and generality" in its approach to principles of international jurisdiction,[24] the Court does clearly endorse the principle of extra-territorial criminal jurisdiction in certain situations by stating:

> "Though it is true that in all systems of law the territorial character of criminal law is fundamental, it is equally true that all, or nearly all these systems extend their jurisdiction to offences committed outside the territory of the State which adopts them and they do so in ways which vary from State to State. The territoriality of criminal law, therefore, is not an absolute principle of international law and by no means coincides with territorial sovereignty."[25]

In addition, regarding the question of general jurisdiction under international law, the court adopted the proposition that the independence of sovereign states implied that, as a rule, territorial sovereigns were free to do what they wished, as long as such action did not violate a prohibitory rule of customary international law. With respect to the assertion of jurisdiction, the Court wrote:

> "Far from laying down a general prohibition to the effect that States may not extend the application of their law and the jurisdiction of their courts to persons, property and acts outside their territory, it leaves them in this respect a wide measure of discretion which is only limited in certain cases by prohibitive rules. As regards other cases, every state remains free to adopt the principles which it regards as best and most suitable."[26]

Moreover, the court created a presumption that the state opposing the application of extraterritorial jurisdiction (France) had the burden of proving that such jurisdiction violated international law, and that France had failed to carry that burden.[27]

The *Lotus* decision was a direct challenge to the more restrictive interpretation of territorial jurisdiction that had been adopted by many states, including the United Kingdom.[28] The dissenting judges held firmly to the view that a state's jurisdiction may not exceed its territorial boundaries.[29] Although the PCIJ's ruling has no binding effect on states other than those which were parties to the dispute before the court, it has had a broader impact on international law and state practice because it is premised on the notion that a consensual international legal system cannot contain a rule prohibiting a sovereign state from prescribing rules against activities outside its borders that have harmful effects within the state's territory.[30] Any other conclusion would legally place each sovereign and, more important, the people whom that sovereign protects, at the mercy of the internal acts and politics of every other state. In contrast, a nation state may consent to such external compulsion by entering a treaty or agreement which would commit its people and territory to such an international obligation. Without such an agreement, however, there is insufficient evidence of state practice to demonstrate that a state cannot take extraterritorial meas-

22 A divided Court found for the Turks. Because the votes were equally divided, the decisive vote of the Court's President, Judge *Huber,* was in favour of Turkey, resulting in a judgment against France. See 2 World Ct. Rep. p. 32 *(Huber, J.),* 2 World Ct. Rep. p. 45. Judges *Moore, de Bustamante, Oda, Anzilotti* and *Pessoa* also agreed with the Turkish position. Ibid., p. 4, 32, 2 World Ct. Rep. p. 23, 46. In contrast, Judges *Loder, Weiss,* Lord *Finlay, Nyholm,* and *Altamira* voted against the right of Turkey to exercise jurisdiction over the French officers. *Ibid.,* 2 World Ct. Rep. pp. 23, 46.

23 PCIJ, Series A, No. 10 (1927) p. 23.

24 See *I. Brownlie,* Principles of Public International Law (1990) 302–303.

25 See PCIJ, Series A, No. 10 (1927) p. 30 (Judgment of September 7); see also 2 World Ct. Rep. 23, 44.

26 *Ibid.,* 22.

27 *Ibid.,* 28.

28 Indeed, the British judge on the PCIJ during the *Lotus* case, Lord *Finlay,* voted against the Turkish assertion of both specific and general jurisdiction over the acts of the French officers on board the French ship. Many British scholars have criticised the *Lotus* case as a derogation from generally accepted principles of territorial jurisdiction. See *J. Brierly,* 58 Hague Recueil (1936, IV) 146–47, 183–84; *G. Fitzmaurice,* 92 Hague Recueil (1957, II) 56–57; *H. Lauterpacht,* International Law: Collected Papers, i (1970) 488–90.

29 See Dissenting opinion, *J.B. Moore,* quoted in D.J. Harris, Cases and Materials in International Law (4th ed.) (1991) 262–63.

30 This is particularly true of extraterritorial income tax regulation. In today's globalised economy, there are few barriers for some individuals and firms in shifting their earnings and assets to jurisdictions beyond the direct reach of their home tax authorities. Although mutual assistance treaties are designed to enhance cross-border supervision and enforcement, they are often limited in their effect because of procedural obstacles and delays. States may therefore resort to unilateral and extraterritorial regulatory instruments to achieve their tax policy objectives.

ures to protect against such external interference. The *Lotus* case therefore correctly refused to infer such a mandatory prohibition from the principle of territorial sovereignty.

The absence of such a general prohibition does not of course mean that nation states are free to interfere with each other's internal affairs whenever harmful local effects might justify such interference. Rather, this recognition of the legal possibility of concurrent jurisdiction of two or more states over the same acts and the persons committing such acts necessarily suggests that community members are required to accommodate their conflicting interests in good faith on a case by case basis when each has legitimate authority to prescribe.[31] This proposition derives from the exigencies of the modern international system where states confront transnational problems that affect their essential core functions. Accordingly, the four basic jurisdictional principles of customary international law – territorial, nationality, protective and universal principles – must reflect the realities of state practice and the relative capabilities of states to regulate and control persons and affairs beyond their territorial boundaries where they possess the economic and political means to do so.[32]

A strict adherence either to a narrow concept of territoriality or a more expansive concept of the effects doctrine or nationality principle may not provide practitioners and judges with a reliable starting point for determining generally accepted international standards for resolving disputes over concurrent claims of jurisdiction by two or more states. The tendency of modern jurists to apply the principle of extra-territorial jurisdiction espoused by the PCIJ in the *Lotus* case has been widely criticised because the case concerned a very specific issue, namely, the exercise of criminal jurisdiction over cases concerning collisions of ships at sea. The main criticism of the *Lotus* doctrine is that traditional concepts for determining domestic jurisdiction – *i.e.* territoriality and nationality – depend for their validity on the supremacy of the traditional doctrine of sovereignty of states in the international legal system. Although the role of the notion of sovereignty remains an important principle of international law, it has undergone major changes in recent years as territorial boundaries have been made less relevant due to the dramatic changes in technology and international commerce which are sweeping the global economy. As a result, notions of domestic jurisdiction, so closely intertwined with the concept of sovereignty, are changing as well and have led to the emergence of what some scholars have called "transnational solidarities".[33] By the latter expression, one must refer to a set of values and interests, common to each and every state, which are perceived as shared concerns by the international community as a whole. The interpretation and enforcement of such values and interests, however, will almost always depend on the national interests of the regulating state, and may often result in states using extraterritorial measures to promote such interests.

In addition, US courts have recognised that the objective territorial principle includes an "effects doctrine" which allows Congress to enact laws regulating activity outside US territory if it is reasonably foreseeable that such activity would produce substantial effects within US territory.[34] Indeed, the territorial impact of the extraterritorial activity is the crucial link that justifies extraterritorial jurisdiction. The US Supreme Court adopted a narrower rule for determining whether the effects doctrine supports the extraterritorial application of US antitrust laws. In *California v. Hartford Fire Insurance*, the Court held that Congress could create extraterritorial subject matter jurisdiction over the acts of non-US defendants in foreign jurisdictions if it were reasonably foreseeable that such acts would have a direct and substantial effect on US commerce and if the imposition of extraterritorial jurisdiction did not create a "true conflict" with the laws of the foreign jurisdiction where the acts occurred.

3. Nationality Principle

Generally, the nationality principle of international law provides that a state may exercise jurisdiction over the activities or conduct of its nation-

[31] US Restatement of the Law of Foreign Relation (American Law Institute) s. 403(3).

[32] A fifth principle, not generally accepted in state practice as part of international law, is the passive personality principle. See discussion in *I. Brownlie,* Principles of Public International Law (1999) (OUP, 5th ed.) 303–04.

[33] See Note Constructing the State Extraterritorially: Jurisdictional Discourse, the National Interest, and Transnational Norms, (1990) Harv. L. Rev.

[34] *Alcoa,* 148 F. 2d at 418–19.

als, wherever they are located, and an individual's nationality is generally determined by citizenship.[35] Generally, a corporation's nationality is determined either by its country of incorporation or its principal place of business.[36] Accordingly, the nationality of a parent corporation's foreign subsidiaries and affiliates is that of the foreign state of incorporation or their principal place of business. Generally, the laws of the state of the parent corporation did not regulate the activities of foreign subsidiaries and affiliates that did not operate in the jurisdiction of the regulating state. In the context of economic sanctions, however, this began to change during the First World War and in the late 1930s as the United States, United Kingdom, and other belligerent countries utilised extra-territorial trade controls to target third country (neutral) trade with enemy states. In particular, the US and UK imposed sanctions on home-state companies whose foreign subsidiaries and branches were trading with enemy states.[37] Similarly, as a general matter, US tax law has applied jurisdiction to the income of foreign corporations operating outside the United States if those foreign corporations are controlled by a US person (*i.e.* individual or corporate entity). Essentially, this type of extraterritorial jurisdiction attributes the nationality of a parent company to its controlled foreign subsidiaries and affiliates. By contrast, the United Kingdom has held firmly to the traditional view that the nationality of a corporation is determined by its place of incorporation or principal place of business, and may not be determined by the nationality of its controlling shareholders.[38]

4. Active and Passive Nationality Principle

In the twentieth and twenty first centuries, however, the international economy has undergone significant growth and integration and the international trading activities of multinational companies have become a common occurrence. States have therefore found it necessary to restrict the activities of their nationals in a manner which protects the state's national interest. As a result, many states, such as the United States and the United Kingdom, have relied on the nationality principle to require that its nationals adhere to its home country laws wherever they reside in the world, unless there is a direct conflict with the laws of the nation in which they reside.[39] This type of jurisdiction based on nationality falls into two categories: *Active Nationality Principle* and *Passive Nationality Principle*. As stated above, the active nationality principle allows a state to assume jurisdiction over all of its nationals, wherever they may be located. The active nationality principle is generally conceded by international law to all states seeking to apply it.[40]

The Passive Nationality (or Personality) Principle authorises a state to assume jurisdiction over an alien for acts committed abroad if such acts caused injury or damages to one of the state's nationals.[41] International law recognises the passive nationality principle subject to certain qualifications. For instance, a state which does not recognise the passive nationality principle in its state practice has no obligation to acquiesce in proceedings on this basis brought against one of its nationals by another state. States utilising this principle argue that if a delict is committed in a foreign state and its courts are unable or refuse to punish the persons causing the injury, the state of which the victim is a national is entitled to institute proceedings if the defendant comes within the territorial jurisdiction. This principle basically recognises a state's right to protect its citizens when they are abroad and to vindicate their rights, if necessary, if the foreign state denies them justice. Many states and jurists have criticised this principle because it is difficult to attribute

35 *Nottebohm* Case *(Liechtenstein v. Guatemala),* ICJ Reports, 1955, p. 4.

36 Case concerning *Barcelona Traction, Light and Power Co.,* ICJ Reports, 1970, p. 3.

37 See *M. Domke* (1943) Trading with the Enemy in World War II, chap. 2 (New York: Central Book Co.).

38 The UK corporate income tax provisions however require in some circumstances that certain income of a UK-controlled foreign subsidiary be attributed for corporate income tax purposes to the UK parent company or UK-controlling shareholder. *D. Sandler* (1998) Tax Treaties and Controlled Foreign Company Legislation (London: Kluwer Law) p. 263.

39 United Kingdom legislation has conferred jurisdiction extraterritorially over nationals, *inter alia,* in respect of treason, murder, bigamy, and breaches of Official Secrets Act. See *Brownlie* (1990, 300).

40 A correlative principle is contained in the international law of extradition that no state is bound to extradite from its territory a national guilty of an offence committed in another country.

41 *R. Jennings (*1967) 154; *F. A. Mann* (1964) 40–41. *Moore* (1906, ii, 228–42) cites the *Cutting* case where Mexican court exercised jurisdiction in respect of the publication in Texas of a defamatory letter by an American newspaper.

an injury to the interests of a state merely because "one of its nationals has been the victim of an offence in a foreign country" (*Brownlie,* 1990, 301–302). The criminal codes of Mexico, Brazil and Italy, and several other countries embody the principles of the passive nationality principle (*Moore,* 1906 ii, 228–242). The common law jurisdictions, however, especially the United Kingdom and the US, have never explicitly recognised the propriety of the principle.[42]

The civil law systems of continental Europe have traditionally relied on an expansive notion of the nationality principle to impose extraterritorial jurisdiction on home state nationals or companies operating in foreign territories. For example, Article 14 of the French Civil Code confers jurisdiction on French courts over contractual obligations with a French national, even though the contract is made abroad with a non-resident foreigner.[43] Indeed, the use of extraterritorial measures to regulate anti-competitive practices based on the nationality principle and the effects doctrine has been adopted by the European Commission and some European Community states. Specifically, Germany has expressly adopted the effects doctrine in its competition law for regulating extraterritorial conduct that has an anti-competitive impact on German markets.[44] Similarly, based on the competition law principles of Article 81 (ex-Article 85) of the Treaty of Rome, the European Commission has expressly adopted the effects doctrine as a tool of regulatory enforcement to impose extraterritorial jurisdiction against anti-competitive practices outside the EU which impact Community markets.[45] Although the European Court of Justice (ECJ) upheld the Commission's use of such extraterritorial measures to enforce EC competition law, it has refused to recognise the effects doctrine as the legal basis for its decisions.[46] Rather, the ECJ has accepted the economic control principle or unity of the enterprise doctrine as the legal basis for imposing extraterritorial jurisdiction on anti-competitive acts outside the EU that impact EC markets.[47] Moreover, the European Court of First Instance has interpreted EU Merger Control Regulation No. 4064/89 as having extraterritorial effect against concentrations formed outside the EU by non-EU undertakings where such concentrations create or strengthen a dominant position within the EU that impedes effective competition under Article 82 (ex-Article 86) of the Treaty of Rome.[48]

5. Corporate Nationality

The definition of "corporate nationality" presents particular difficulties because corporations may have substantive connections with several jurisdictions. The International Court of Justice has recognised that as a matter of customary international law the nationality of a corporation belongs to either the state of incorporation or principal place of business.[49] Although US state practice holds that a corporation normally has the nationality or citizenship of the country where it is incorporated, or where it has its principal place of business, there are statutory exceptions.[50] For instance, the Internal Revenue Code taxes foreign source income of foreign corporations if they are owned or controlled by US citizens, thereby treating those corporations as if they were US nation-

[42] *Lotus* case, PCIJ, Series A, No. 10 (1927) (see Judge *Moore's* [US judge] view objecting to extraterritorial jurisdiction based on the state's policy to protect its nationals abroad).

[43] Article 14, Code Civile (France). Article 14 appears to rely on the passive personality principle.

[44] Indeed, the Federal Republic of Germany has codified the effects doctrine in its competition law. See Gesetz gegen Wettbewerbsbeschränkungen (GWB), § 98(2) ("Act against Restraints on Competition"). The German Supreme Court has defined the parameters of application of that law to conduct outside the territory of the Federal Republic. See *Oil Pipelines* case, Decision of 12 July, 1973, 25 BGHSt 208; and *Organic Pigments* case, Decision of 29 May 1979, 74 BGHZ 322.

[45] Case 89/85, *Ahlstrom Asakeytio et autres v. Commission* des *Communautés Européennes* [1988] E.C.R. 5193, 4 C.M.L.R. 901 [hereinafter *In re Wood Pulp Cartel] In re Wood Pulp Cartel* involved a violation of Article 85 where the European Commission found that several entirely foreign companies, including US, conspired to fix prices in violation of Article 85, and relying exclusively on 'effects' provision of Article 85; EC Commission relied on the effects doctrine to impose jurisdiction and penalties on the foreign companies.

[46] *In re Pulp Wood cases* [1988] E.C.R. 5196–98. The ECJ appeared to rely on the unity of the enterprise doctrine that it adopted in *Europemballage Corp. v. E.C. Comm'n* [1973] E.C.R. 215.

[47] *I.C. Industries Ltd. v. EEC Commission* [1972] E.C.R. 619 (applying the unity of the enterprise theory).

[48] *Gencor Ltd. v. Commission of the European Communities,* Case T-102/96, Judgment – Court of First Instance (5th Chamber) (25 March 1999) paras. 90–103.

[49] See *Barcelona Traction,* ICJ Reports, 1970, p. 3.

[50] See *Fletcher Corporations* (1974) ss. 25–26.

als for taxation purposes.[51] US tax law utilises the nationality principle to impose extraterritorial jurisdiction over US-controlled foreign corporations and business entities, unless the tax code applies specific statutory provisions to the contrary.[52] The nationality principle provides the basis for the US to restrict the business activities of foreign business entities that are subject to US control with the result that foreign branches or wholly-owned affiliates of US parent companies are required to comply with US economic regulation.

The imposition of extraterritorial controls on foreign subsidiaries of domestic parent companies has also raised significant issues of concurrent claims to jurisdiction by competing states. Traditionally, foreign subsidiaries doing business abroad are considered separate legal entities and as such are entitled to be qualified as foreign companies provided that they are incorporated in the foreign state in which they operate or have their registered offices.[53] As a legal matter, therefore, the conduct of a company was regulated by the state of incorporation and the state where the company did business. No significance was attached to other criteria such as ownership or economic and political control.[54] This rather formalistic method for determining which state has the jurisdictional authority to regulate the activities of companies or entities has failed to take account of the complex nature of the modern multinational enterprise where ownership, management, and workforces have become increasingly global. As such, this approach is not particularly well suited to evaluate which states have a legitimate enough link with a particular company to justify the imposition of regulatory jurisdiction.[55]

As a result, the EC and US economic regulatory regimes have responded to these formalistic constraints on national economic regulation by adopting sophisticated techniques using various legal criteria to evaluate corporate affiliation and agency relationships for jurisdictional purposes. Such criteria are responses to the increasing complexity of the global marketplace in which the nature of international business transactions has been fundamentally changed, in part, by advances in technology. Indeed, the International Court of Justice in *Barcelona Traction* recognised the possibility that other legal criteria, derived from the world's leading legal systems might gain general consensus so that "sometimes links to one State have to be weighed against those of another". Such newly-emerging techniques and criteria might be applied as generally recognised principles of law for determining extraterritorial jurisdiction in an increasingly complex global marketplace.[56] Yet, at this stage of development, there is still resistance in state practice to these emerging standards of extraterritorial jurisdiction for regulating multinational enterprises.[57]

US state practice, however, seeks to regulate events and affairs that occur solely outside US territory through its regulatory control over multinational enterprises and financial firms that are involved in US-connected commerce. In criminal law, US tax law imposes liability on third party foreign entities (*i.e.* individuals or corporations) who conspire to circumvent US tax law or take acts which facilitate tax evasion.[58] In such conspiracy cases, third country states have been more willing to accept the application of extra-territorial measures when it can be adequately proved that their nationals had wilfully intended to violate US controls.[59] In these cases, the *locus delicti* is not considered a decisive factor, and whether the conspiracy has occurred, in whole or part, in the regu-

[51] See Internal Revenue Code, 26 U.S.C. § 903.

[52] Similarly, US sanctions regulations pierce the veil of corporate nationality by imposing US jurisdiction on companies incorporated under the laws of foreign states if the companies are subject to the control of a US person. The Office of Foreign Assets Control and the Bureau of Export Administration take the view that these laws apply to non-US corporations that are owned or controlled by US persons. 31 CFR § 515.329 (a)–(d) (2006).

[53] See case concerning the *Barcelona Traction, Light and Power Co. Ltd. (Belgium v. Spain)* Second Phase, ICJ Reports, 1970, p. 3, 48.

[54] *Ibid.*, p. 48. The ICJ ruled in *Barcelona Traction* that the only admissible legal basis for attributing nationality to a corporation for purposes of diplomatic protection was the company's state of incorporation or place of operation. *Ibid.*

[55] See *Blumberg* (1993, 43–48) discussing changing legal structures of multinational enterprises, *cf. Caves* (1982, 26).

[56] *Barcelona Traction,* ICJ Reports p. 42.

[57] See *Brownlie* (1990, 314).

[58] See 18 U.S.C. sec. 2 (1998).

[59] See *Brownlie* (1990, 314) citing "Statement of Principles According To Which, In the View of The United Kingdom Government, Jurisdiction May Be Exercised Over Foreign Corporations In Anti-Trust Matters", Aide Memoire (20 October 1969).

lating state's territory does not appear to be a crucial issue (*Bianchi,* 1992, 366–374). Moreover, in such cases, US law places the burden of proof on the US government to demonstrate that such a conspiracy to circumvent US controls has occurred.[60]

6. Blocking Laws

Although most activity which occurs outside of US territory is not subject to the extra-territorial jurisdiction of US laws, the broad reach of US law in the area of antitrust, financial regulation, economic sanctions, and tax assessment has become a matter of concern to many countries. Many countries have adopted blocking statutes that prohibit individuals or companies from complying with the extra-territorial orders or controls of foreign states. Blocking laws have mainly been directed against the extra-territorial application of US laws, but have also been used by Arab states in their boycott of all foreign persons who trade or invest in Israel anywhere in the world. Blocking laws generally take three forms. First, an automatic blanket prohibition to comply with foreign orders unless the request passes through approved government channels.[61] Second, discretionary authority to designate government agencies or ministers to prohibit compliance with certain foreign orders (UK, Canada and Australia).[62] Third, either automatic prohibition against compliance or administrative discretion to prohibit such disclosures (Swiss bank secrecy).[63] Under US law, there is generally no foreign sovereign compulsion defence for complying with foreign blocking orders against extraterritorial US regulations.[64]

In addition, a number of countries, including the member states of the European Union, Canada, Mexico and Japan, have protested diplomatically, as excessive intrusions into their spheres of influence, broad assertions of authority by US courts.[65] US courts have recognised this concern and have, at times, responded to it by balancing the use of the effects doctrine with both the requirements of foreign law and the rules of the conflict of laws.[66] In any event, it is evident that at some threshold point the interests of the United States may become too weak and the foreign harmony incentive for restraint too strong to justify an extra-territorial assertion of jurisdiction. International law provides no specific answer, however, for determining what that threshold should be. This is why it is difficult to determine the permissible scope under international law for creating prescriptive jurisdiction for assessing and imposing extraterritorial tax liability.

Although modern state practice has evolved to permit certain extraterritorial approaches to jurisdiction, there remains considerable support for a strict adherence to traditional principles of territorial jurisdiction. Indeed, this is true in the area of extraterritorial tax regulation where state practice has coalesced around two approaches: (1) the traditional territorial approach that restricts the imposition of liability to those persons and entities who operate or are registered in the sanctioning state; and (2) an extraterritorial approach to jurisdiction that relies on the effects doctrine and a broad application of the nationality principle. The strongest advocates of the territorial approach are the United Kingdom,[67] Japan and Australia, while extraterritorial approaches using either the effects doctrine or the nationality principle as a

[60] This burden would also apply to US tax agency determinations of extraterritorial conspiracies to violate US tax law.

[61] (France) Law No. 80-538 Journal Officiel 1799 (1980).

[62] See UK Protection of Trading Interests Act 1980; Foreign Extra-territorial Measures Act 1992 (amended 1996) (Canada); and European Union Regulation 2271/96 (blocking the extraterritorial application of designated foreign laws). See discussion in *K. Alexander* (2009) Economic Sanctions: Law and Public Policy (London: Macmillan) chap. 8.

[63] See *Minpeco SA v. Conti Commodity Inc.,* 116 FRD (SDNY 1987) (citing Swiss bank secrecy laws).

[64] See *United States v. Brodie et al.,* 174 F. Supp 2d 294 (2001). *(No foreign sovereign compulsion for defendants because of UK & Canadian blocking statutes).*

[65] *G. Born* and *Westin,* International Litigation (Chapel Hill; Carolina Press) (1992) 360–366.

[66] See *Timberlane Lumber Co.v. Bank of America,* 549 F.2d 597, 599 (9th Cir. 1976).

[67] It is important to note, however, that British criminal law has become more expansive in imposing extraterritorial jurisdiction in recent years. Section 102(1) of the Criminal Justice Act 1988 states:
"'Criminal conduct' means conduct which constitutes an offence to which this part of this Act applies or would constitute such an offence if it had occurred in England and Wales or Scotland."
Section 93A of the Criminal Justice Act 1993 recodifies this provision and applies it in the case of money laundering.

jurisdictional basis have been embraced by Canada,[68] France, Germany and the US.[69]

II. Extraterritorial US Tax Law, the Revenue Rule and Money Laundering

Increased linkages in the world economy have made it necessary for states to cooperate and coordinate their economic regulatory activities on a cross-border basis and in certain circumstances to assist one another in ensuring compliance with their tax laws. Indeed, the Organization for Economic Cooperation and Development (OECD) has adopted a model tax treaty to facilitate bilateral efforts between OECD countries in providing information to state tax authorities for more effective enforcement of their tax laws and in particular to combat tax evasion and fraud. As discussed below, the European Union has adopted directives which authorise the exchange of information between EU state tax authorities on the amount of interest earned as income in bank saving accounts, and in certain circumstances the EU state host authority is required to withhold income tax from the interest income earned on the accounts of residents of other EU states and to transfer the withheld tax to the home EU state of the accountholder. This extensive network of cross-border tax cooperation is a recent phenomenon in multilateral and bilateral efforts to prevent tax evasion and fraud. As mentioned above, the US has followed two-track approach: (1) pursuing multilateral and bilateral efforts to enhance cross-border tax surveillance, and (2) a unilateral and extraterritorial approach that has created political tensions with many countries and serious legal issues under international and domestic law. In considering US extraterritorial efforts, it should be recalled that the general principle of international law – known as the revenue rule – prohibited a state from enforcing or recognising the tax or revenue laws of another country.[70] For instance, *Holman v. Johnson*[71] involved a contract action in an English court for a debt incurred for the sale of tea in Calais, France that was intended to be smuggled into England without paying excise duty. In rejecting the contract action on illegality grounds, Lord *Mansfield* observed in *obiter dicta:*

> "For no country ever takes notice of the revenue laws of another."

This became known as the revenue rule in common law jurisprudence and was recognised throughout all common law jurisdictions and some civil law countries.[72]

Indeed, the US courts recognised the revenue rule in a number of cases. In *HM British Columbia v. Gilbertson*, the US federal circuit court upheld a Washington state court's ruling that the revenue rule prevents US courts from enforcing a judgment rendered for taxes by the courts of a foreign government.[73] Significantly, Judge *Learned Hand* in 1929 in upholding the revenue rule stated its purpose:

> "Even in the case of ordinary municipal [tax] liabilities, a court will not recognize those [liabilities] arising in a foreign state, if they run counter to the 'settled public policy' of its own. Thus a scrutiny of the liability is necessarily always in reserve, and the possibility that it will be found not to accord with the policy of the domestic state. This is not a troublesome or delicate inquiry when the question arises between private persons, but it takes on quite another face when it concerns the relations between the foreign state and its own citizens or even those who may be temporarily within its borders. To pass upon the provisions for the public order of another state is beyond the powers of a court; it involves the relations between the states themselves, with which courts are incompetent to deal, and which are entrusted to other authorities. It may commit the domestic state to a position which would seriously embarrass its neighbor. Revenue laws fall within the same reasoning; they affect a state in matters as vital to its existence as its criminal laws. No court ought to undertake an inquiry which it cannot prosecute without determining whether those laws are consonant with its own notions of what is proper."[74]

[68] Indeed, the Canadian Constitution imposes no territorial limits on federal legislative jurisdiction. This derives from section 3 of the Statute of Westminster that grants Dominion Parliaments the power to adopt legislation with extraterritorial effect. See Statute of Westminster, 1931, 22 Geo. 5, ch. 4, § 3 (stating "[I]t is hereby declared and enacted that the Parliament 123 of a Dominion has full power to make laws having extraterritorial operation).

[69] See *K. Meessen,* Exports Controls (Martinus Nijhof, Dordrecht) (1992) 8–10.

[70] See *A. Lowenfeld,* International Litigation and Arbitration (2nd ed. 2002) (St. Paul: West) 1–9. The revenue rule has also been applied expansively to include other public regulatory laws that involve civil penalties and administrative fines. *Ibid.*

[71] *Holman v. Johnson* (1775) 98 Eng. Rep. 1120.

[72] The Canadian courts of British Columbia recognised the revenue rule in *US v. Hardin,* 1963 Canada Law Reports 366 (S.Ct. Canada, 1963).

[73] 597 F.2d 1161.

[74] *Moore v. Mitchell,* 30 F.2d 600, 604 (2d Cir. 1929).

It is interesting to consider how the revenue rule has affected the development of tax policies of some countries, especially with respect to the extraterritorial application of tax reporting and assessment obligations. The revenue rule's main requirement – that a state shall not enforce or recognise the revenue laws of another jurisdiction – has been analysed from a number of perspectives and has been applied to a wide range of public law regulatory actions.[75] The revenue rule has been cited in a wide variety of cases, all the way from the decision of the English House of Lords[76] not to enforce an Indian bankruptcy liquidator's judgment in India against an English company for unpaid Indian income tax to the New York Court of Appeals decision to refuse to enforce a foreign exchange contract for Brasilian currency involving a Brasilian bank on the grounds that the contract was in breach of Brasil's exchange rate controls.[77] The revenue rule's strict prohibition on enforcing a foreign state's public law of revenue regulation, as a general matter of international law, may have contributed to some states adopting more unilateral assessment and enforcement actions, especially with respect to the assessment of tax liability for income earned abroad. The difficulties created by the revenue rule can also explain why so many countries have entered into bilateral mutual assistance treaties that allow states to coordinate their tax policies for individuals and companies with transnational business interests.

The US government has followed a two-track approach over the years involving the use of, on the one hand, unilateral and extraterritorial tax assessment methods and enforcement measures, and, on the other, a multilateral and bilateral policy involving agreements and treaties with countries to support cross-border assessment and enforcement. Indeed, since the US income tax code was enacted in 1913, US courts have interpreted the prescriptive scope of jurisdiction broadly for the assessment of a US person's income tax liability. In *Cook v. Tait,*[78] the Supreme Court held that neither the US constitution nor international law is violated by US taxation of the worldwide income of citizens who reside and are permanently domiciled in a foreign country and who receive their income from property located there.[79] This is supported by section 61 of the US tax code which provides in relevant part, with some exceptions, that US citizens, resident aliens and domestic corporations are taxed on their worldwide income. Foreign income is taxable unless expressly excluded from gross income. Although the foreign income of non-resident aliens and foreign corporations are usually excluded from US income taxation, there is no similar exclusion for the foreign income of US citizens, resident aliens as well as US companies and entities.

The case of extraterritorial taxation of a resident's or non-resident's income poses particular challenges for home and host country tax authorities. On the one hand, certain techniques of regulatory control that are extraterritorial are accepted to the extent that they regulate or penalise a course of conduct that presents an effective and significant connection with the forum state.[80] Naturally, however, there are factual scenarios that consist of activity or conduct that present a less direct connection or link with the state asserting jurisdiction. For instance, the principle of nationality in US tax law demonstrates how non-resident citizens can be subjected to the jurisdiction of their national state; however, when the state of residence imposes commands which conflict with the state of nationality (for instance double taxation), the state of residence may likely prevail.[81] The justification for the state of residency having priority is that ordinarily it will have actual control over the persons residing within its territory, in which case there will be a presumption that enforcement action is more likely to be taken by the state of residence. The state of residence can ensure compliance with its commands by coercive means and thereby pose greater detriment to the resident alien. Therefore, a strong argument exists that the national state's power to exercise jurisdiction over

[75] See *A. Lowenfeld* (2002, 3rd ed.) International Litigation, 11–49.

[76] *Government of India v. Taylor* [HL] [1955] A.C. 491.

[77] *Banco Frances E Brasileiro S.A. v. John Doe* (1975) 36 N.Y. 2d 592, *cert. denied,* 423 U.S. 867.

[78] 265 US 47, 56 (1924).

[79] See also *Skiriotes v. Florida,* 313 US 69 (1941) – upheld a Florida statute governing conduct of US citizens in the Gulf of Mexico beyond territory of Florida "the United States is not debarred by international law from governing the conduct of its citizens upon the high seas or in even in foreign countries."

[80] *K. Meessen* (1992) Export Controls (1992) (Martinus/ Nijhof) 8.

[81] See *F. A. Mann,* Studies in International Law (1984) (OUP) 30.

its non-resident citizens has to yield to the concurrent power of their state of residence.

1. The Patriot Act[82] and extraterritorial Tax Offences

In considering the scope and effect of US tax law, it should be borne in mind that individuals and business entities are subject to potential civil and criminal liability for failing to report and pay tax on income earned worldwide. Moreover, under the money laundering legislation of most developed countries, tax fraud and tax evasion are both predicate criminal offences for the money laundering offence. Under US law, this is significant, as US money laundering law has extraterritorial effect and it includes the predicate offences of tax fraud and tax evasion, wherever this occurs.

This section will discuss the nature of criminal tax law enforcement and show how it has been internationalised under the Patriot Act of 2001. The Patriot Act expands the application of US anti-money laundering law to include all criminal predicate offences under federal law, including tax evasion.[83] This has important implications for the extraterritorial enforcement of US tax law.

Section 311[84] provides the Treasury Secretary with discretionary authority to impose one or more of five new "special measures against foreign jurisdictions", foreign financial institutions, transactions involving such jurisdictions or institutions, or one or more types of accounts (including foreign accounts), that the Secretary determines to pose a "primary money laundering concern" to the United States. The special measures include: (1) requiring additional recordkeeping or reporting for particular transactions; (2) requiring identification of the foreign beneficial owners of accounts at US financial institutions; (3) requiring foreign banks to identify any of its customers who use (*i.e.* transfer of funds) an inter-bank payable through account opened by that foreign bank at a US bank; (4) requiring foreign banks to identify any of its customers who use an interbank correspondent account opened by that foreign bank at a US bank; and (5) after consultation with the Federal Reserve Board, the Secretary of State and Attorney General, to restrict or prohibit the opening or maintaining of certain interbank correspondent or payable-through accounts. The Treasury Department has already issued some regulations regarding recordkeeping and the level of disclosure, and will issue further regulations in the coming months.

Although foreign banks will not have to disclose such information directly to US authorities, US financial institutions will be required to collect this information from foreign banks and if necessary to report this information to US regulatory authorities. The objective of these measures is to establish enhanced due diligence and recordkeeping requirements for foreign banks that hold private banking accounts with US financial institutions. The effect of the legislation will be to require foreign persons (business entities and individuals) who are the owners or beneficial owners of private banking accounts with a foreign bank that also maintains certain accounts with a US bank to disclose the nature of its wealth or commercial affairs with its foreign banker. The US bank will then collect this material and make it available for inspection by US authorities. These requirements will apply only to foreign banks operating under a licence from either an offshore jurisdiction that has not complied with recognised international standards or any other jurisdiction designated by the Financial Action Task Force as having failed to comply with its minimum international standards.

If a foreign bank decides that it wants to opt out of these US regulatory controls, it must terminate all its correspondent, interbank and other accounts with US financial institutions. However, this will be a difficult option for many foreign banks that derive a significant amount of their business from transfers and transactions involving the US interbank payment system. Indeed, the international reach of the US banking system is demonstrated in part by the need of most non-US financial institutions to have access to US currency via a US bank in order to participate in the foreign exchange market. This type of link to the US euro-dollar market will attract extraterritorial jurisdiction for a foreign bank under the Patriot Act. It remains to be seen whether the benefits for a foreign bank of maintaining interbank payment links with

[82] The International Money Laundering Abatement and Anti-terrorist Financing Act of 2001.

[83] Title III of the Patriot Act is entitled the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001.

[84] This adds a new section 5318A to the US Bank Secrecy Act of 1970.

US financial institutions exceed the costs (including lost business) of complying with the new legislation.

2. Correspondent Accounts

The legislation recognises that transactions involving offshore jurisdictions make it difficult for US authorities to follow the money earned by organised crime groups and global terrorist organisations. One way in which money is laundered is through correspondent banking and payment facilities, which are often manipulated by foreign banks to permit the laundering of funds by hiding the true identities of the parties involved in the transactions. To this end, section 312 creates special disclosure requirements for foreign banks that maintain correspondent accounts[85] and other private banking accounts at US financial institutions by adding a new subsection (i) to the Bank Secrecy Act[86] which requires US financial institutions to establish "appropriate", and, if necessary, enhanced due diligence procedures to detect and report instances of money laundering. New and enhanced due diligence standards are required for US financial institutions that enter into correspondent banking relationships with foreign banks that operate under *either* an offshore banking licence,[87] or a banking licence issued by states that have been (1) designated as non-cooperative with international anti-money laundering standards issued by an international body (*i.e.* FATF) with the concurrence of the US representative to that body, or (2) subject to special measures set forth under section 311 (see above). Similarly, section 312 also creates new minimum due diligence standards for maintenance of private banking accounts by US financial institutions.[88]

Section 313(a) prohibits certain covered financial institutions[89] from establishing, maintaining, administering or managing correspondent accounts with "shell banks", which are defined as a foreign bank that has no physical presence in any jurisdiction.[90] This provision also requires covered financial institutions to take "reasonable steps" to ensure that correspondent accounts provided to foreign banks are not being used indirectly to provide financial services to foreign shell banks. In addition, section 319(b) requires that covered financial institutions which provide correspondent accounts to a foreign bank to maintain records of the owners of the foreign bank and the designated agent in the United States to accept service of legal process.

An exception exists, however, to permit a covered financial institution to maintain correspondent accounts with foreign shell banks that are affiliated with a depository institution, credit union or foreign bank that maintains a physical presence in the US or in another jurisdiction, and the shell bank must be subject to supervision by the banking authority that regulates the affiliated entity. The broad definition of "covered financial institution" means that non-bank institutions, such as brokers and dealers in securities that operate in the United States, will be prohibited from establishing, maintaining, administering or managing an account for a foreign shell bank that is not a regulated affiliate.[91] To qualify as a regulated affiliate, the affiliated depository institution must demonstrate that it is regulated by a financial authority whose standards comply with generally accepted international norms as set forth by international bodies (*i.e.* Financial Action Task Force).

The legislation contains provisions to promote mutual assistance and cooperation with foreign

[85] Section 311 defines "correspondent account" with respect to banking institutions as an account "established to receive deposits from, make payments on behalf of a foreign financial institution, or handle other financial transactions related to such institution". This amends 31 U.S.C. §5318A (e)(1)(B).

[86] See 31 U.S.C. §5318 (i) (as amended).

[87] An offshore banking licence is defined as a licence to conduct banking business, where a condition of the licence is that the bank may not offer banking services to citizens of, or in the local currency of, the jurisdiction issuing the licence. See Supervisory Letter SR 01–29, Board of Governors of the Federal Reserve System (26 November 2001).

[88] These new standards became effective on 1 August 2002.

[89] 31 U.S.C. §5318(j) defines "covered financial institution" as (1) any insured bank as defined in s. 3(h) of the Federal Deposit Insurance Act (12 U.S.C. §1813[h]); (2) a commercial bank or trust company; (3) private banker; (4) an agency or branch of a foreign bank; (5) a credit union; (6) a broker or dealer registered with the Securities and Exchange Commission under the Securities and Exchange Act of 1934 (15 U.S.C.) § 78a *et seq.*

[90] Sec. 313(a) codified at 31 U.S.C. §5318(j) (effective date 25 December 2001). A physical presence is a place of business that is maintained by a foreign bank and is located at a fixed address, other than solely an electronic address, in a country in which the foreign bank is authorised to conduct banking activities. *Ibid.*

[91] Sec. 313(a) codified and amended at 31 U.S.C. §5318 (j).

authorities by requiring the Secretary of Treasury to issue regulations to foster cooperation amongst financial institutions, regulators and law enforcement agencies by permitting the sharing of information between regulators and law enforcement authorities regarding the activities of persons suspected, based on credible evidence, of engaging in money laundering activity or terrorist acts. This section also allows banks to share information with other banks, without violating confidentiality laws, regarding suspicious accounts or transactions involving possible terrorist finance or money laundering activity.[92]

Significantly, for tax offences, section 315 makes most other existing federal crimes serve as predicate offences for the crime of money laundering, including certain export control violations,[93] firearms violations, and certain computer fraud offences. US courts are granted "long-arm jurisdiction" over foreign persons who commit money laundering offences under US law.[94] This extraterritorial jurisdiction also applies to foreign banks opening US bank accounts, and to foreign persons who convert assets ordered confiscated by a US court. A federal court will have the authority to issue *ex parte* pre-trial restraining orders or to take other necessary action to preserve property in the United States to satisfy a possible future judgment. A federal court may appoint a receiver to collect and take custody of a defendant's assets to satisfy a criminal or civil money laundering or forfeiture judgment.

3. Interbank Accounts

US regulators are now given broader powers to collect information from US financial institutions by requiring them to produce requested information within 120 hours within receipt of a request.[95] Foreign banks that maintain correspondent accounts with US banks are required to appoint agents within the United States territory for service of process. The Attorney General and the Secretary of the Treasury can issue summons or subpoena records or documents, wherever located, relating to such correspondent accounts. US financial institutions will be required to sever their relationships with the foreign bank if it *either* fails to comply with the summons or subpoena *or* fails to contest the action in the relevant US court within 120 hours of it being served.[96]

Requiring the identification of the "foreign beneficial owners" of accounts with US financial institutions may create a disclosure obligation for many companies and trusts who are organised in foreign jurisdictions that might conflict with secrecy requirements under local law. Moreover, some jurisdictions make it a criminal offence to disclose information that identifies beneficial owners of shares in certain companies or the beneficiaries under certain trust arrangements. Section 319 takes account of this by vesting authority in the Attorney General to suspend or terminate a forfeiture under this section if the Attorney General determines that a direct conflict of laws exists between the laws of the jurisdiction in which the foreign bank is located and the laws of the United States with respect to liabilities arising from the restraint, seizure, or arrest of such funds, and that such suspension or termination "would be in the interest of justice and would not harm the national interests of the United States."[97]

The Patriot Act represents a broad extension of US extraterritorial jurisdiction to the maintenance of US dollar accounts held and maintained by foreign banks or other financial intermediaries. The information reported by foreign banks to their US correspondent banks can be used for any federal regulatory or criminal investigation and can be shared between state regulatory and tax authorities. Although the Patriot Act has not yet been invoked in a tax enforcement action, it is not clear to what extent US authorities are invoking its provisions as part of tax investigations. The Patriot Act provides a model of unilateral enforcement that utilises the importance of the US dollar as an international reserve currency to assist US authorities in imposing US legal requirements on foreign banks, intermediaries and their cus-

[92] The section also requires the Treasury Secretary to publish a semi-annual report with a detailed analysis of patterns of suspicious activity and other investigative insights gathered from investigations and bank reporting.

[93] These violations fall under both Arms Export Control Act's Munitions List (22 U.S.C. § 2778), and the Export Administration Act's Regulations (15 CFR parts 730–744) regarding export controls of goods and services that may be re-exported or re-sold from a third country to a targeted country or terrorist group or criminal organisation.

[94] Sec. 317.

[95] Sec. 319 (b)(1)(B)(2).

[96] Sec. 319 (b)(3)(A).

[97] Sec. 319 (a)(1)(B).

tomers. Its extraterritorial scope may lead to future US tax enforcement actions against the owners of foreign bank accounts denominated in US dollars. Although the Act contains provisions that encourage US authorities to coordinate cross-border investigations and enforcement, it is not clear how effectively US authorities have used these provisions with foreign authorities.

III. EU Tax Law Enforcement

Under the Maastricht Treaty of 1992, the European Community's competence to regulate criminal and tax matters was not generally accepted as a conferred power on the Community in the EC pillar. As the EC, however, has extended its regulation to many areas of economic and financial activity, it has prescribed criminal sanctions and related proscribed conduct in a number of areas. In 2005 the European Court of Justice upheld EC competence to prescribe that EU states should enforce EC law by means of the criminal law.[98] Moreover, the Treaty of Lisbon abandons the EU pillar structure and integrates criminal law and cooperation in criminal matters into the Community framework.

The European Union will now unquestionably have competence to regulate all criminal law and mutual cooperation to enforce criminal law.[99] In the area of tax administration, European Union Directive 77/799 was the first European Community legislation to establish a mutual assistance framework for the exchange of information between EC states with respect to tax matters. It was an important milestone because it created procedures by which EC state authorities could exchange tax information with one another. The Directive was adopted with the stated objective of preventing harmful competition between EC states, some of whom were using bank secrecy statutes and strict regulations prohibiting the reporting of income as a form of unfair competition. Moreover, in some EC states, the effect of bank secrecy laws was to facilitate tax avoidance and evasion and in some cases tax fraud. To combat this, Directive 77/799 established the first mutual administrative assistance regime between EC states in tax matters. Tax policy was for the first time treated as a subject in its own right in order to prevent harmful competition, tax avoidance and evasion.

Although Directive 77/799 enhanced cross-border coordination between EC states in investigating specific cases of tax evasion and fraud, it did not override the general bank secrecy law prohibitions on the reporting of income in accounts held with banks operating in EC states for non-residents who resided in other EC states.

In response, the European Commission proposed a Savings Tax Directive in 2001 which was approved by the Council of Ministers and Parliament in 2004. The Savings Tax Directive 2004 requires the exchange of information for taxation of savings income in the form of interest payments. It imposes obligations for "paying agents" (*i.e.* banks) in the EU to report to the tax authorities of the countries where the banks have their place of establishment income in the form of interest payments distributed to "beneficial owners" (*i.e.* account holders) resident in other EU member states.[100] The state authority of the reporting bank can then communicate the information about the payments automatically to its counterpart authority in the EU member state where the account holder resides.[101] In short, even if the account holder does not report its income, the tax authority of the country where the taxpayer resides will obtain this information through automatic communication by the foreign tax authority and the foreign bank can then tax the payments by imposing a withholding tax on the customer's account. The Savings Tax Directive also enhances the ability of states to make additional requests for information from the tax authorities of states where the requesting state's resident is believed to hold bank accounts and to be earning interest income that has not been reported for income tax purposes.[102]

[98] Case C-176/03, *Commission v. Council* [2005] ECR-I-7879; case C-440/05.

[99] Some observers have observed that the EU institutional structure has moved away from a *state-state* inter-state governance framework as set forth in the Treaties of Rome and Maastricht to a more supranational pooling of sovereignty among EU states that embraces a *state-state-citizen-EU* dimension. Indeed, article 2 of the Treaty on European Union (as amended by the Lisbon Treaty) states that the EU is an *"area of freedom, security, and justice without internal frontiers"*.

[100] Savings Tax Directive, article 8.

[101] Article 9.

[102] See Directive 77/799, and article 9 (3) Savings Directive.

The EU savings tax directives demonstrate how a mutual legal assistance regime can be devised that allows states acting together to conduct cross-border surveillance of the interest earned on bank accounts held by non-resident individuals and business entities. This EU surveillance regime contains adequate flexibility for EU states with strong bank secrecy laws to opt out of the reporting requirements and instead to withhold tax on interest income from non-residents' bank accounts and transfer the tax to the home country of the non-resident account holder. This more flexible regime respects national sovereignty while achieving the overall objective of promoting greater surveillance of cross-border tax assessment.

IV. Conclusion

Economic globalisation has necessitated that states adopt extraterritorial regulations to promote their economic and political interests. Extraterritorial US tax law remains a serious compliance challenge for US individuals and firms in their global operations and for non-US companies and non-US nationals who do business with US persons. Blocking laws are generally ineffective in curbing extraterritorial jurisdiction, particularly with respect to cross-border financial transactions because of the inter-connectedness of the global financial system and the reserve currency status of the US dollar. The US unilateral and extraterritorial approach to tax assessment and enforcement has attracted much controversy and criticism. European Union law offers an alternative model of cross-border surveillance and enforcement of EU state income tax laws with respect to the earning of interest on bank accounts by foreign residents of other EU states. The divergent approaches between the EU and US demand a global solution. The OECD could undertake further efforts to address the extraterritorial nature of US tax law so that there is more coordination with foreign authorities. Despite the political obstacles, more global coherence and coordination could be achieved in this area without sacrificing the national objectives of combating tax avoidance, evasion, and fraud.