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B: Good faith in domestic and international tax law

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Summary and conclusions

The United States is a common law country and a dualist jurisdiction. Treaties approved by the Senate stand on equal footing with federal laws. Good faith is a principle throughout US domestic and international tax law. This report will first discuss and offer examples of how good faith is embedded within the US domestic tax system through stages of the development, implementation, and interpretation of tax laws and regulations. In addition, this report will discuss how good faith is incorporated in international tax law in the execution, implementation and interpretation of tax treaties. In addition, this report will discuss remedies for breach of good faith between contracting states.

The US has a system built on good faith in the enactment, implementation and interpretation of tax laws. Taxpayers with the ability to rely in good faith on established procedures that have certain protections built in. For instance, tax laws are implemented through regulations promulgated by the US Department of the Treasury ("Treasury"). Treasury must follow the Administrative Procedures Act, which provides stakeholders the ability to comment on proposed regulations. Although Congress has the ability to pass retroactive tax legislation, Treasury regulations establish a presumption that regulations do not apply retroactively. In addition, the IRS issues a variety of forms of published guidance available for free online to ensure the public has access to the requirements, and in a form accessible to a lay person. Courts can also review regulations for procedural defects and whether they are consistent with statutes.

A US taxpayer may rely in good faith on the administration of the tax system, including but not limited to the protection of their personal information and the ability to rely on established procedures for filing tax returns, the audit process, and appealing Internal Revenue Service ("IRS") decisions such as determinations of tax or penalties. These procedures allow opportunities for both a taxpayer and the IRS to correct errors they may have made. For instance, taxpayers may amend their tax returns to correct errors they may have made and discovered after filing. Taxpayers are also afforded opportunities to challenge IRS determinations; for instance taxpayers have due process rights in the collection process in which the IRS seeks to obtain a tax it has assessed. Processes such as these accordingly also allow the IRS to fix any of its own errors in assessing tax or penalties.

The US has established procedures to support good faith in international tax law. Treaties are entered into through formal procedures and are subject to multiple layers of review. Although the executive branch enters into treaties, the legislative branch generally has the opportunity to review and revise agreements. More specifically, the Senate Committee on Foreign Relations reviews treaties and can attach to treaties various

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forms of feedback such as amendments, reservations, understandings, declarations, and provisos. Treaties approved by this committee are then put before the entire Senate for a vote, and if at least two-thirds of those Senators present approve, then the treaty is passed. In some instances however, Congress may delegate authority to the executive branch to enter into agreements with other countries without requiring Senate approval. The US can override tax treaties through legislation, and Treasury and the IRS have issued regulation that potentially conflict with or override US tax treaties. In these instances, taxpayers may challenge such regulations through a mutual agreement procedure or in court.

The US has established principles of good faith in treaty interpretation. The principle of good faith has been enshrined in international law, such as the Vienna Convention on the Law of the Treaties (the "Vienna Convention") which establishes certain rules, procedures, and guidelines that include how treaties should be interpreted. The US has not signed the Vienna Convention, but US courts generally follow interpretive rules within the Vienna Convention. In addition, US courts are generally more likely than other countries to look outside of the four corners of a treaty text to determine its meaning and the mutual intent of the parties.

There are remedies, although limited, for jurisdictions and taxpayers affected by treaties that may be ambiguous in application. For instance, a mutual agreement procedure is generally incorporated in US treaties, and is a method of dispute resolution available to taxpayers that believe they are or will be subject to a taxation that is not consistent with a relevant treaty. In addition, a taxpayer may also seek redress in US courts.

Part One: Introduction and defining the principle of good faith

1.1. General overview

The United States is a common law system at the federal level. At the state level, Louisiana is the only civil law state. The other 49 states and the District of Columbia have common law systems.

International law and treaties are incorporated into the federal legal system through the US Constitution.[3] The US is a dualist jurisdiction. The executive branch has the authority to negotiate treaties. The Senate, the upper chamber of the legislative branch, must approve a treaty for it to come into force under US law. Ratification requires the support of two thirds of the Senators present, or 67 of 100 Senators when all are present.[4]

1.2. Good faith under a different name

The concept of "good faith" appears in US tax system in different names. These different names include "diligence", "estoppel", and "good governance."

The concept of good faith, *under a different name*, is embedded within Circular 230, which governs federal tax practice standards before the Internal Revenue Service (the "IRS"). The

[3] US CONST., art. VI, cl. 2; Internal Revenue Code ("Code" or "IRC") § 7852(d)(1).

[4] US CONST., art. II, cl. 2.

rules in Circular 230 are codified as Title 31 of the Code of Federal Regulations, Subtitle A, Part 10 and accordingly have the weight of federal regulations. In addition to providing direct examples of good faith in the tax system, Circular 230 also refers to good faith principles under the term "diligence." Circular 230 provides that a practitioner must exercise due diligence (1) in preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to IRS matters; (2) in determining the correctness of oral or written representations made by the practitioner to the Department of Treasury; and (3) in determining the correctness of oral and written representations made by the practitioner to clients with reference to any matter administered by the IRS.

Good faith also appears in the form of equitable estoppel, a concept which the Supreme Court has long recognized in tax cases.[5] The Supreme Court has previously explained the doctrine by stating that "no one shall be permitted to found any claim upon his own inequity or take advantage of his own wrong."[6] For instance, "[u]nder the doctrine of tax estoppel, a party to litigation may not take a position contrary to a position taken in a tax return."[7] Courts of Appeals have identified different tests for applying the rule.[8] For instance, the Court of Appeals for the Ninth Circuit has held that "(1) the party to be estopped must know the facts; (2) he must intend that his conduct shall be acted on or must so act that the party asserting the estoppel has a right to believe it is so intended; (3) the latter must be ignorant of the true facts; and (4) he must rely on the former's conduct to his injury."[9] Further, in addition to these elements, the Ninth Circuit has so explained that a party seeking equitable estoppel against the Government must show that: "(1) the government engaged in affirmative misconduct going beyond mere negligence; (2) the government's wrongful acts will cause a serious injustice; and (3) the public's interest will not suffer undue damage by imposition of estoppel."[10]

The concept of good faith also appears under the name of "good governance". For example, the IRS introduced the draft document on good governance practices for 501(c)(3) organizations in 2007, which was later published in its final form in 2008 (the "Good Governance Document").[11] As the Good Governance Document notes, the tax law generally does "not mandate particular management structures, operational policies, or administrative practices"; however, the Good Governance Document further states the importance of such good governance and notes that the IRS's interest in good governance is demonstrated through is inquiries about an organization's governance when it applies for tax-exempt status and annually as part of the Form 990 Return of Organization Exempt From Income Tax. Accordingly, the IRS monitors the good governance of a tax-exempt organization from its inception and throughout time.

5 *See R.H. Stearns Co. of Bos., Mass. v. United States*, 291 US 54 (1934).

6 *Id.* at 61-62.

7 *Rizzo v. Nat'l Vacuum Corp.*, 186 A.D.3d 1094, 130 N.Y.S.3d 167 (2020) (quotations omitted).

8 *E.g.*, *Baccei v. United States*, 632 F.3d 1140, 1147 (9th Cir. 2011); *Lignos v. United States*, 439 F.2d 1365, 1368 (2d Cir. 1971).

9 *Baccei v. United States*, 632 F.3d 1140, 1147 (9th Cir. 2011).

10 *Baccei*, 632 F.3d at 1147.

11 "Governance and Related Topics - 501(c)(3) Organizations, IRS, https://www.irs.gov/pub/irs-tege/governance_practices.pdf.

Part Two: Good faith in domestic tax law

2.1. General overview

The concept of good faith is throughout US tax law. For instance, as this section will further explain, the concept of good faith in US tax law is prevalent in each of the three branches of US government, as the law is passed, implemented, and interpreted.

2.2. Good faith in the enactment of law

i. The interpretation of domestic tax legislation

Tax laws are implemented through Treasury regulations[12], and interpreted by the Judicial system. There are three types of Treasury regulations: legislative, interpretive, and procedural and the type of regulation determines the procedures under which those rules are promulgated. Legislative regulations require notice and comment procedures and result when Congress has given the agency the authority to issue rules with the force of law and the agency intended to use that authority. Interpretive rules do not require notice and comment procedures and, as their name suggests, these are interpretive rules and policy statements. Procedural rules similarly do not require notice and comment procedures.

The Judicial Branch generally defers to Treasury regulations when it interprets the law. This doctrine of judicial deference is known as "Chevron Deference" a term coined after a 1984 landmark case, *Chevron USA., Inc. v. Natural Resources Defense Council, Inc*. Under the Chevron Deference doctrine, courts will defer to a federal agency's interpretation of a statute that may be ambiguous or unclear using a two-part test. First, the courts will consider whether Congress has directly spoken on the precise question at issue and ask whether the statute is ambiguous; if Congressional intent is clear, then that meaning controls, and if Congressional intent is ambiguous or the statute does not have relevant language on point, then the court must consider whether the agency's interpretation is a permissible construction of the statute. Second, if Congress "expressly left a gap for the agency to fill in" then such "legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute", and if legislative delegation to an agency on a particular question is implicit as opposed to explicit, then a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.[13] In a watershed case, *Mayo Foundation v. United States*, the US Supreme Court determined that Chevron Deference is the appropriate standard of review for all Treasury regulations.[14]

Chevron Deference has evolved over the years through other case law, and there has been recent uncertainty about the doctrine and its future under recent Supreme Court case law. In 2001, a "Chevron Step Zero" was added to the initial two-part test, to add the new inquiry of whether the agency has rulemaking authority; and if the answer is no, then Chevron would not apply although a court may still give an agency some degree of

[12] Treasury and the IRS also issue subregulatory guidance, such as notices, revenue rulings, revenue procedures, and FAQs, which are not subject to the same level of deference as regulations.

[13] *Chevron, USA., Inc. v. Nat. Res. Def. Council, Inc.*, 467 US 837, 844 (1984).

[14] *Mayo Found. for Med. Educ. & Research v. United States*, 562 US 44 (2011).

deference due to its expertise, and if the answer is yes, then the analysis moves to first step of Chevron Deference.[15] However, there have been three recent Supreme Court cases that made the status of Chevron Deference unclear. For instance, some or all Justices have done the following in recent opinions: (1) not applied Chevron Deference;[16] (2) found that a difficult of interpretation such as a statute's provisions directly conflict was not the kind of ambiguity to trigger Chevron Deference;[17] and (3) given little deference to the agency under the second step of Chevron Deference.[18] Accordingly, although Chevron Deference has not been overturned, there is some uncertainty as to its future as well as the level of deference a court will give to regulations.

ii. The policy approach towards retroactivity or retrospective domestic tax legislation

Congress has the authority to enact retroactive tax legislation. Under the Ex Post Facto Clause of the US Constitution, Congress is prohibited from passing laws which retroactively criminalize behavior.[19] However, taxation is not a criminal punishment, and the Supreme Court has previously explained that "[t]ax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code."[20] The Supreme Court has further held that a "tax statute's retroactive application must be supported by a legitimate legislative purpose furthered by rational means."[21] The Supreme Court has thus expressed its view that a retroactive application of tax laws is sometimes required by "the practicalities of producing national legislation," and has deemed it a "customary congressional practice."[22] Moreover, the Supreme Court has only held that retroactive application of tax laws violated the Due Process clause in a few instances.[23]

Treasury and the IRS may create retroactive rules in certain circumstances. Treasury and the IRS are subject to the Administrative Procedure Act. The Administrative Procedure Act establishes certain procedures the IRS must follow when promulgating legislative regulations. Before Treasury may issue legislative regulations, it must conduct certain "notice and comment" rulemaking procedures, such as giving the public notice that the Treasury intends to issue the regulations and a period during which the public can comment. Treasury is then required to consider those public comments before issuing final legislative regulation.

The procedural implementation of Treasury regulations and other IRS guidance sometimes deviates from other administrative rules implemented under the Administrative

15 *United States v. Mead Corp.*, 533 US 218, 226-27 (2001).

16 *Am. Hosp. Ass'n v. Becerra*, 142 S. Ct. 1896 (2022).

17 *Scialabba v. Cuellar de Osorio*, 573 US 41 (2014).

18 *Michigan v. E.P.A.*, 576 US 743 (2015). *See* Dan Farber, "Everything You Always Wanted to Know About the Chevron Doctrine", Yale Journal on Regulation, 17 October 2017, https://www.yalejreg.com/nc/everything-you-always-wanted-to-know-about-the-chevron-doctrine-by-dan-farber/#:~:text=The%20Chevron%20doctrine%20is%20a,have%20favored%20different%20interpretation%20themselves.

19 US CONST. art. I, § 9, cl. 3.

20 *United States v. Carlton*, 512 US 26, 33 (1994)

21 *Id.*; *see, e.g.*, *Pension Benefit Guaranty Corporation v. R.A. Gray & Co.*, 467 US 717, 729–730 (1984).

22 *Carlton*, 512 US at 30-31, 32; Erika K. Lunder, Robert Meltz, and Kenneth R. Thomas, "Constitutionality of Retroactive Tax Legislation", Congressional Research Service, 25 October 2012.

23 *Nichols v. Coolidge*, 274 US 531 (1927); *Blodgett v. Holden*, 275 US 142 (1928); *Untermyer v. Anderson*, 276 US 440 (1928).

Procedure Act. Section 7805 of the Code establishes that promulgated rules may take effect retroactively, although subject to limitation.[24] Code section 7805(a) provides the general rule that the Secretary may promulgate rules and regulations in connection with the Code. Section 7805(b) of the Code was designed to prevent abuse, and was amended as part of the 1996 Taxpayer Bill of Rights to establish a presumption that regulations do not apply retroactively.[25] In addition, Section 7805(b) of the Code provides that except as otherwise provided in its subsection, no temporary, proposed, or final regulation relating to the internal revenue laws shall apply to any taxable period ending before the earliest of the following dates:

(A) The date on which such regulation is filed with the Federal Register.
(B) In the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register.
(C) The date on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public.

Retroactivity may however apply in certain circumstances such as to prevent abuse, correct procedural defects, and to regulations filed or issued within 18 months of the date of the enactment of the statutory provision to which the regulation relates.[26]

iii. The clarity and certainty of tax legislation

The US has a long standing common law anti-avoidance rule known as the economic substance doctrine ("ESD").[27] A taxpayer who complies with a statute, regulation or other subregulatory guidance must also be able to demonstrate that it entered into the transaction with a non-tax business purpose and/or the transaction changes the economic position of the taxpayer in a meaningful way (absent tax considerations). Prior to 2010, the ESD was a common law doctrine, and courts were split on whether the test is conjunctive.[28] A taxpayer could prevail in certain circuits if it demonstrated either a business purpose or economic substance, while a taxpayer in other circuits would need to satisfy both tests.

In 2010, Congress clarified the inconsistent case law by codifying the ESD with a conjunctive test.[29] As part of codification, Congress added strict liability penalties and limitations on the use of tax opinions to dissuade taxpayers from entering into tax motivated transactions. However, Congress included limitations on the breadth of the ESD so as to ensure businesses could continue to function:

[24] IRC § 7805; *see* Brian Harris and Anna Els, "The Applicability of the Administrative Procedure Act to Federal Tax Legislation", Vol. 91, No. 8, Florida Bar Journal, Sept./Oct. 2017, https://www.floridabar.org/the-florida-bar-journal/the-applicability-of-the-administrative-procedure-act-to-federal-tax-litigation/.

[25] *See* Stuart J. Bassin and Beatrice Larkin, The Limits of Mayo Foundation v. United States: Retroactive Regulations, (19 April 2011), Tax Notes, *available at* https://bassinlawfirm.com/files/2018/01/Limits-of-Mayo-Foundation-v-United-States.pdf (hereinafter "The Limits of Mayo Foundation").

[26] IRC § 7805(b)(2)-(4). It is unclear whether and how the limitations on retroactivity in the Administrative Procedures Act interacts with IRC § 7805(b).

[27] *Gregory v. Helvering*, 293 US 465 (1935). The Supreme Court held that even though the taxpayer complied with the statute, she lacked a non-tax avoidance reason for undertaking the transaction and was denied the tax benefits.

[28] For a discussion of the state of the law pre-codification of the ESD, see Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress (JCS–2–11), March 2011, at 370.

[29] IRC §7701(o).

> The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a US person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.[30]

Despite these limitations, the IRS recently announced that it is considering applying the doctrine to transfer pricing cases.[31]

iv. General anti-avoidance rules

In addition to the common law and codified ESD, courts, Congress, Treasury and the IRS have created several general anti-avoidance rules. This section contains a description of some of the general anti-avoidance rules.

One of the rules is a quasi-good faith doctrine that applies to taxpayers. Generally, a taxpayer is bound by the form of its transaction unless the taxpayer can prove that the transaction was undertaken due to mistake, undue influence, fraud, or duress.[32]

Anti-avoidance rules also include robust reporting and penalty regimes for transactions that Congress, Treasury and the IRS view as tax avoidance or evasion transactions. A taxpayer can be subject to a 20% penalty if the taxpayer is negligent or has a substantial valuation misstatement. The penalty increases to 40% for a gross valuation misstatement. A taxpayer can avoid penalties if it can demonstrate that it satisfies the reasonable cause or good faith exception.[33] For example, a taxpayer can avoid penalties if it can establish that it had substantial authority or a reasonable basis for a disclosed transaction. Alternatively, a taxpayer can avoid penalties if it relied in good faith on a reasoned opinion that it is more likely than not that the transaction would be upheld if challenged by the IRS.

The penalty regime is more stringent for reportable transactions. The goal of the penalty and disclosure regime is to dissuade taxpayers from entering into such transactions. Reportable transactions include listed transaction (37 transactions the IRS believes are abusive),[34] confidential transactions (confidentiality for a fee), transactions of interest, transactions with a contractual guarantee (e.g., partial or complete refund if the IRS denies the benefits of the transaction), and loss transactions (e.g., a corporation with a loss of $10 million in one tax year or $20 million arising over multiple tax years). A taxpayer that

[30] *Id.* at 379 (footnotes omitted).

[31] E. Slowey and I. Gottlieb, *IRS Upping Focus on Economic Substance in Transfer Pricing Audits*, Bloomberg Law News 15 November 2022.

[32] *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967) (en banc); *see also N. Am. Rayon Corp. v. Commissioner*, 12 F.3d 583 (6th Cir. 1993), *Lane Bryant, Inc. v. United States*, 35 F.3d 1570 (Fed. Cir. 1994).

[33] IRC §§ 6662, 6664.

[34] "Recognized Abusive and Listed Transactions", IRS, https://www.irs.gov/businesses/corporations/listed-transactions

entered into a reportable transaction is required to adequately disclose it on IRS Form 8918. If reported, penalties are limited to 20%, and a taxpayer can avoid penalties through a stringent good faith defense. The penalty increases to 30% for an undisclosed transaction, and no defenses are available.[35]

A transaction that fails to satisfy the codified ESD is subject to 40% penalty for an undisclosed transaction and 20% for a disclosed transaction. There are no reasonable cause and good faith exceptions or defenses available.[36]

The penalty and disclosure regime also applies to promoters and material advisors. Promoters are required to maintain lists of taxpayers and disclose the list to the IRS upon request.[37] Further, material advisors are also required to report reportable transactions.[38]

In addition to the ESD and other general anti-abuse doctrines, certain areas of the Code also contain general anti-abuse rules. For example, the partnership rules contain general anti-abuse rules that limit when the IRS will respect a partnership, transactions between partners and the partnership, and transactions under taken by the partnership.[39]

2.3. Good faith in the administration of the tax system

i. Information requests from tax authorities or taxpayers, and the binding or non-binding nature of the information obtained/requested

The US federal tax system provides certain protections for both the taxpayer and the federal government that overall establish good faith in the administration of the tax system. As previously discussed, the IRS follows the Administrative Procedure Act, and in accordance with this law, the IRS must follow the Freedom of Information Act ("FOIA") and the Privacy Act. Both FOIA and the Privacy Act offer taxpayers the right of access to IRS records and documents. With respect to access to records and documents, protections in place for the taxpayer include the Taxpayer Bill of Rights and Section 6103 of the Code. The Taxpayer Bill of Rights establishes certain protections in favor of the right to privacy and confidentiality and the right to confidentiality is codified under Section 6103 of the Code. For the IRS, Circular 230 requires that practitioners before the IRS adhere to duties of good faith with respect to information furnished to the IRS, as well as tax returns and documents, affidavits, and other documents provided to the IRS.

The Taxpayer Bill of Rights provides that a taxpayer has the right to both privacy and confidentiality. For instance, taxpayers "have the right to expect that any IRS inquiry, examination, or enforcement action will comply with the law and be no more intrusive than necessary, and will respect all due process rights, including search and seizure protections, and will provide, where applicable, a collection due process hearing."[40] In addition, the Taxpayer Bill of Rights provides that taxpayers have "the right to expect that any information they provide to the IRS will not be disclosed unless authorized by the taxpayer or by law." Further, taxpayers also "have the right to expect appropriate action will be taken against

35 IRC §§ 6011, 6662A, 6707A.
36 IRC § 6662(b)(6), (i).
37 Treas. Reg. § 301.6708-1.
38 Treas. Reg. § 301.6707-1.
39 Treas. Reg. § 1.701-2.
40 Taxpayer Bill of Rights, IRS, https://www.irs.gov/pub/irs-pdf/p1.pdf.

employees, return preparers, and others who wrongfully use or disclose taxpayer return information."[41] These rights are further protected under other sections of the Code, including those pertaining to confidentiality and disclosure of tax returns and return information.

Section 6103 of the Code protects taxpayer information and provides requirements for confidentiality and disclosure of tax returns and return information. With respect to these confidentiality provisions, a "return" means any tax or information return, declaration of estimated tax, or claim for refund required by, or provided for or permitted under, the provisions of the Code which is filed with the Secretary by, on behalf of, or with respect to any person, and any amendment or supplement thereto, including supporting schedules, attachments, or lists which are supplemental to, or part of, the return so filed.[42] The term "return information" is defined to mean:

(A) a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense,

(B) any part of any written determination or any background file document relating to such written determination (as such terms are defined in section 6110(b)) which is not open to public inspection under section 6110,

(C) any advance pricing agreement entered into by a taxpayer and the Secretary and any background information related to such agreement or any application for an advance pricing agreement, and

(D) any agreement under section 7121, and any similar agreement, and any background information related to such an agreement or request for such an agreement, but such term does not include data in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer.[43]

The term "return information" does not however extend to data in a form which cannot be associated with, or otherwise identify, directly or indirectly a particular taxpayer.

Section 6103 of the Code provides the general rule that tax returns and return information shall be kept confidential, and except as otherwise authorized under the Code, current and former federal, state, and local government officers and employees (and others specifically identified) are prohibited from disclosing any return or return information obtained in any manner in connection with their service as an officer or employee or otherwise or under the provisions of Section 6103.[44] Information under section 6103 of the Code is exempt from disclosure under a FOIA request. However, there are certain exceptions and disclosures may be permitted to certain recipients such as:

[41] *Id*.

[42] IRC § 6103(b)(1).

[43] IRC § 6103(b)(2).

[44] IRC § 6103(a).

- The taxpayer;
- A designee of the Taxpayer, and regulations specify a range of parties that are permissible designees;
- State officials;
- Persons having material interest;
- Committees of Congress, the President and certain appointees;
- Federal officials for purposes of tax administration; and
- Judicial and administrative tax proceedings.[45]

Accordingly, taxpayer information is protected by statute and a taxpayer may rely in good faith that their personal information under Section 6103 will be kept confidential unless an exception applies.

Good faith in the administration of the tax system also provides certain protections for the IRS and the information received by practitioners. The concept of good faith is also embedded within the tax system through Circular 230, which places duties of good faith on practitioners before the IRS (*e.g.*, certified public accountants, lawyers). Circular 230 provides standards for both information to be furnished under Rule 10.20 and standards with respect to tax returns and documents, affidavits, and other papers under Rule 10.34. Under Rule 10.20 for instance, a practitioner must, on a proper and lawful request by a duly authorized officer or employee of the IRS, promptly submit records or information in any matter before the IRS unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged. Further, Rule 10.20 provides that a practitioner may not interfere, or attempt to interfere, with any proper and lawful effort by the IRS, its officers or employees, to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged. In addition, Circular 230 provides restrictions on a practitioner to follow good faith principles by providing that a practitioner may not advise a client to submit a document, affidavit, or other paper to the IRS if any of the following is true: (1) the purpose of which is to delay or impede the administration of Federal tax laws; (2) that is frivolous; or (3) that contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.[46]

ii. The issue and implementation of tax rulings or Advance Pricing Agreements (APAs)

Recent litigation over the termination of two APAs demonstrates that an APA is a contract which requires both parties to enter into and abide by the agreement in good faith.

Taxpayers can achieve certainty through APAs. An APA executed by a taxpayer and the US Competent Authority is a binding commitment, or a contact under US law.[47] As part of the APA process, the taxpayer is required to provide information required under the APA revenue procedure, as well as timely responses to supplemental information and document requests. Additionally, the taxpayer is required to extend the period of limitations.

[45] *See* IRC § 6103.

[46] 31 CFR § 10.34(b).

[47] Rev. Proc. 2015-41, §6.

Once the APA is executed, the taxpayer has an ongoing requirement to file annual reports with the IRS.

Revenue Procedure 2015-41 specifies the reasons for which the IRS can terminate an APA:

> [The IRS] may revoke an APA due to fraud or malfeasance (as those terms are used in section 7121 of the Code), or disregard (as that term is used in sections 6662(b)(1) and (c) of the Code) by the taxpayer in connection with the APA, including, but not limited to, fraud, malfeasance, or disregard involving (i) material facts in the request or subsequent submissions (including an annual report) or (ii) lack of good faith compliance with the APA terms and conditions.
>
> [The IRS] may cancel an APA due to the taxpayer's misrepresentation, mistake with respect to a material fact, failure to state a material fact, failure to file a timely annual report, or lack of good faith compliance with the APA terms and conditions.

In *Eaton Corporation v. Commissioner*, the taxpayer challenged the IRS's termination of Eaton's APAs. Eaton entered into two APAs with the IRS under two prior versions of the APA revenue procedure. During the audit of the first two APA years, Eaton discovered mistakes in its application of the approved methodology. Eaton notified the IRS of its mistakes, and the IRS subsequently issued a notice of deficiency that included a cancellation of the APA due to material deficiencies and mistake as to a material fact.

Eaton successfully argued at the US Tax Court that the IRS abused its discretion in cancelling the APAs because the errors were not material.[48] On appeal, the Sixth Circuit held that an APA is a contract. The party seeking to terminate the contract has the burden of proof to show that it can terminate the contract based on the relevant provisions in the agreement. The appellate court concluded the IRS did not satisfy its burden of proof and Eaton's actions were not material.[49]

The Sixth Circuit's opinion ensures that the significant body of law regarding contracts will apply to APAs, ensuring that neither party can terminate an APA in bad faith or in breach of the contractual terms.

iii. The conduct of tax audits and concluded/negotiated tax audit settlements

The IRS audit process is designed to ensure good faith in the tax system by reviewing returns for compliance while providing taxpayers under audit certain rights. There are several methods by which returns are selected for audit, such as: IRS initiated examinations, claims for refund or credit, related pickup examinations, multi-year examinations, automatics, and change in accounting method. In addition, returns may be selected for audit through a computer analysis known as the Discriminant Information Function ("DIF").

The IRS audit procedure varies where some audits may be conducted by mail, and others require a meeting between a taxpayer and an IRS employee. There are generally four different types of audits: (i) a "correspondence examination" which is handled by mail; (ii) an "office audit" which occurs in an IRS office; (iii) a "field office" audit which includes a

48 *Eaton Corporation v. Commissioner*, TC Memo. 2017-147.

49 *Eaton Corporation*, Nos. 21-1569, 21-2674 (25 August 2022).

revenue agent examining a taxpayer' books and records, which is typically conducted at a taxpayer's home, business office, or a tax professional's office; and (iv) a "calibration audit" or "compliance audit" which is a random, specialized audit.

Taxpayer protections have been established in the audit procedure through statute, regulations, and the Internal Revenue Manual ("IRM"). When conducting a field exam, the IRM requires all IRS examiners "to provide top quality service and to apply the law with integrity and fairness to all."[50] General statutory safeguards apply throughout the audit process.[51] For example, the IRS is required to set a time and place for the examination that is "reasonable under the circumstances."[52] The regulations clarify that this location will generally be where the taxpayer's original books, records, and source documents pertinent to the examination are maintained.[53] However, a taxpayer may file a written request to change the place of the examination.[54] Before an initial interview, the IRS must provide the taxpayer with an explanation of the audit process and the taxpayer's rights under such process.[55] The IRS also maintains on its website a list of records that it might request in an audit.[56] A taxpayer also has right to representation. If a taxpayer states that he or she would like to consult with an attorney or other person permitted to represent the taxpayer before the IRS, then the IRS employee or officer must suspend the interview. In addition, if the IRS would like to contact third parties, it must give "reasonable notice in advance to the taxpayer" that such contacts may be made.

When an examiner concludes the audit and examination of a return, they must explain any proposed adjustments to the taxpayer. In some instances, the IRS proposes that no changes be made and issues a No Change Letter. From here, the tax audit will conclude as an "agreed", "partially agreed", or "unagreed" case and different procedures apply in each circumstance.

When the taxpayer agrees with the proposed adjustments, they generally sign either a Form 4549, "Income Tax Examination Changes" or Form 870, "Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment." Execution of the form will not prohibit the taxpayer from filing a claim for refund in federal district court, but will prevent the taxpayer from challenging any deficiency in Tax Court. In addition, adjustments after an office audit are often agreed to in Form 1092-E "Report of Individual Income Tax Audit Changes", which does not prevent litigation of the deficiency in Tax Court.

In unagreed cases where the taxpayer does not agree with the proposed adjustments, they can request a conference with the Appeals Office. Here, the IRS will issue a "30-day letter" which is a proposed notice of deficiency, notifying the taxpayer of the examiner's findings, requesting the taxpayer agree to the findings and advising the taxpayer of their appeal rights. The taxpayer then has 30 days after the "30-day letter" to request a hearing. Partially agreed cases occur when a taxpayer agrees in part and disagrees in part with the proposed adjustments. Here, the IRS will issue a 30-day letter with respect to the unagreed items and the taxpayer will generally execute a Form 870-AD for the agreed items.

[50] IRM 4.10.1.1.3 (24 August).

[51] Note that this section does not discuss those procedures or a criminal investigation. *See* IRC § 7521(d).

[52] IRC § 7605(a).

[53] Treas. Reg. § 301.7605-1(d)(3)(i).

[54] Treas. Reg. § 301.7605-1(e).

[55] IRC § 7521(b)(1).

[56] IRS Audits, IRS, https://www.irs.gov/businesses/small-businesses-self-employed/irs-audits.

Unagreed cases thus may move forward to the administrative appeals process and Appeals Office conferences. A conference with the Appeals Office is essentially a negotiation, and results in one of the following: (1) a Form 870, (2) a Form 870-AD, (3) a closing agreement, or (4) no settlement, and post-Appeals mediation/arbitration or litigation. A closing agreement is resolved through the requirements set forth in Section 7121 of the Code and the IRS uses two forms to satisfy the statutory requirements of this section: (1) Form 866, which settles conclusively the taxpayer's total tax liability for the years in question, and (2) Form 906, which settles only one or more issues but which can apply to future years for certain issues such as the proper basis of an asset that will affect future tax liability. Closing agreements are "final and conclusive. . . except upon a showing of fraud or malfeasance, or misrepresentation of a material fact".[57]

Accordingly, the IRS has established procedures that govern the entire process from the inception of an audit through to its conclusion. A taxpayer may rely in good faith on these procedures and the IRS's adherence to these processes.

iv. When a taxpayer or the tax authority has made a genuine error and wishes to correct it

The tax administration system offers ways for both a taxpayer to correct a tax error they have made and to correct a tax error that the IRS may have made. Errors are often corrected by taxpayers following IRS procedures to respond to penalties or other notices, and thus sometimes making the IRS aware that it has made an error that it must correct.

A common taxpayer error is overpayment. The IRS has established procedures for when a taxpayer has made an overpayment and would like a refund of the excess paid over the amount owed.

A taxpayer who has made an overpayment must file a claim for refund.[58] Individuals routinely claim a refund of taxes for the current year on their Forms 1040, US Individual Income Tax Return, and for a refund of income taxes overpaid in previous years, on Form 1040X, Amended US Individual income Tax Return. Corporations make claims for a refund of income taxes overpaid on Form 1120X, Amended US Corporation Income Tax Return. Claims for a refund of taxes other than income taxes are made on Form 843, Claim for Refund and Request for Abatement. In general, a claim for refund of overpaid taxes may be made up until the later of either: (i) three years from the date the return was filed, or (ii) two years from the date the tax was actually paid.[59] However, the IRS does allow for circumstances where the statute of limitations has been extended by agreement between the taxpayer and the IRS.[60]

IRS administrative procedures establish opportunities for taxpayers to dispute IRS penalties and amounts due that may be caused by IRS error. For instance, taxpayers have certain due process rights in the collection process in which the IRS seeks to obtain tax it has assessed. Under collection due process ("CDP") procedures the IRS must provide a taxpayer with both a Notice of Filing of the Lien within five business days of the filing of the lien, and Notice of Intent to Levy, at least 30 days before levy.[61] In both instances,

[57] IRC § 7121(b).
[58] IRC §§ 6511(b)(1), 6514.
[59] IRC § 6511(a).
[60] IRC § 6501(c)(1).
[61] IRC §§ 6320(a)(1), 6330(a)(1).

the IRS must inform the taxpayer of their right to request a hearing within 30 days. Lien notices also must include in "simple and nontechnical terms" an explanation of the administrative appeals process and procedures relating to the release of liens.[62]

If a taxpayer requests a hearing in response to a notice of lien or intent to levy, then an Appeals officer who is separate from the collections process will conduct the hearing. A taxpayer at such hearing may make a request to remove the penalty for reasonable cause. If the Appeals officer's decision is adverse to the taxpayer, then the taxpayer may seek judicial review within 30 days of such decision. In addition, if a taxpayer does not timely request a CDP hearing, the taxpayer may obtain an equivalent hearing upon request. Thus, there are certain procedures established for a taxpayer to be informed of their rights, and to dispute tax and penalties assessed. These same procedures allow the IRS to identify and rectify its own errors.

v. Published statutory guidance

Publicly available statutory law and guidance provide procedures and advice upon which taxpayers may rely upon in good faith. For instance, as previously discussed, the IRS is subject to the Administrative Procedure Act, which governs the administrative function of federal agencies. FOIA is one section of the Administrative Procedures Act, and FOIA establishes a "presumption that records in the possession of agencies and departments... are accessible to the people." While FOIA's objective is a "general philosophy of full agency disclosure", as previously discussed, FOIA also maintains an understanding that agencies must protect sensitive information such as certain return information. FOIA led to the IRS making procedures such as the IRM and other guidance discussed below available to the public.

The IRS's published statutory guidance includes tax return instructions and Frequently Asked Questions ("FAQs") [63] to assist both lay taxpayers and tax professionals with completing tax returns. The IRS additionally provides numerous other forms of guidance, such as IRS Publications and which are prepared for both a lay and professional audience, as well as Announcements, Notices, Revenue Procedures, and Revenue Rulings, and written determinations such as Technical Advice Memoranda and Private Letter Rulings ("PLRs"). The IRS also has published online the IRM, which as noted above, is the IRS's official source of instructions for staff.

There are certain limitations to the extent these publications may be relied on. For instance, the IRS takes the position that taxpayers may not rely on unofficial guidance such as tax return instructions, FAQs, and Publications. The IRM also is not binding and does not have the force of law and thus there are limitations to the extent to which a taxpayer may rely on such information. In addition, the IRS cautions that PLRs are only binding for the specific taxpayer to whom the letter is addressed. However, nevertheless, taxpayers generally may rely on published legal advice to assume a tax position in good faith.

As discussed above, the concept of good faith is also incorporated into the tax system with respect to penalties. For example, Section 6664 of the Code provides that there no

[62] IRC §§ 6320(a)(3), 6330(a)(3).

[63] "Frequently Asked Questions and Answers," IRS. https://www.irs.gov/faqs.

penalty will be imposed under Sections 6662 of 6663 of the Code "with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion."[64] Here, good faith refers to an honest belief, without any knowledge of circumstances that would put the taxpayer under a duty to inquire further, and without any intent to defraud. The regulations further provide that the determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.[65] For instance, under certain facts and circumstances, it may be shown that a taxpayer acted with reasonable reliance on the substantive advice of a tax advisor. Another example of the concept of good faith as a defense to penalties is with respect to Section 6700 of the Code, "Promoting Abusive Tax Shelter, etc.". Here, the IRS maintains the authority to waive all or part of the penalty imposed with respect to a gross valuation understatement made under Section 6700 of the Code, if there was a reasonable basis for the valuation and if the valuation was made in good faith.[66] As an additional example, with respect to penalties that may be imposed under Section 6694 of the Code regarding understatement of taxpayer's liability by tax return preparer, there is no penalty when it is shown that there is reasonable cause for the understatement and the preparer acted in good faith.[67]

Part Three: Good faith in international tax law

3.1. General overview

The US is a dualist jurisdiction. The Treasury negotiates and signs tax treaties on behalf of the executive branch. Generally, Treasury begins its negotiations based on the US Model Income Tax Convention (Model Convention), which was last revised in 2016 at the end of the Obama Administration.[68] The Model Convention reflects the current policy positions, including the mechanical limitations on benefits article.

Once the US and the other contracting state reach agreement, the administration, through the State Department, transmits the treaty to the Senate Committee on Foreign Relations ("Foreign Relations").[69] The transmission package includes a letter of transmittal from the executive branch and may include additional materials, such as other agreements, protocols, and a report/technical explanation.

[64] IRC § 6664(c)(1).

[65] Treas. Reg. § 1.6664-4(b)(1).

[66] IRC § 6700(b)(2).

[67] IRC § 6694(a)(3).

[68] *See* "United States Model - Tax Treaty Documents", IRS, https://www.irs.gov/businesses/international-businesses/united-states-model-tax-treaty-documents

[69] The House of Representatives, the lower chamber, does not have a role in approving treaties. Further, the Senate Committee on Finance is the tax writing committee for the Senate, yet it plays an informal role in the tax treaty process by advising Foreign Relations.

Foreign Relations, through the Joint Committee on Taxation[70], prepares its own report on the treaty and holds a hearing to discuss the treaty. Foreign Relations (as well as the Senate during the amendment process) can attach conditions to treaties, including amendments, reservations, understandings, declarations and provisos. An amendment modifies the treaty text and requires the consent of other party to the treaty. A reservation modifies the US' obligations under the treaty but may not change the text of the document. A reservation generally requires approval by the other party. An understanding is an interpretive statement that clarifies or elaborates on a provision in the treaty, but it does not modify the treaty. A declaration is a statement regarding the Senate's position or opinion on a matter. Like an understanding, it does not modify the language of the treaty. Finally, a proviso addresses a matter of US law or procedure and is not included with the ratified treaty that is exchanged with the other party.[71]

In some instances, Congress delegates authority to the executive branch to enter into agreements with other countries without requiring Senate approval. For example, Congress granted the Secretary of the Treasury (the "Secretary") the authority to enter into information exchange agreements with specified countries to obtain information regarding the attendance of US persons at conventions in the Caribbean.[72]

Treasury entered into a series of intergovernmental agreements ("IGAs") with 113 jurisdictions to implement the Foreign Account Tax Compliance Act ("FATCA").[73] Congress did not explicitly grant power to the Treasury to enter into executive agreements with foreign countries, and it is unclear whether Treasury has the authority to enter into FATCA IGAs with countries that do not have an income tax treaty with the US[74]

For those treaties required Senate approval, Foreign Relations eventually votes on the treaty in committee, and if a majority of senators approve the treaty, then it is voted out of committee for consideration by the whole Senate. Generally, the Senate takes up consideration of tranches of tax treaties (*e.g.*, 2 or more) through a unanimous consent motion. Further, debate time can be limited through unanimous consent. However, if one or more members object, then each treaty must be separately debated on the floor which can consume 30 hours of debate time. Senators can amend the treaty on the floor of the Senate. The treaty requires a vote of at least two-thirds of senators present. Most noncontroversial treaties are approved without significant debate through a unanimous consent motion.

Under the Constitution's supremacy clause, the Constitution, US laws, and treaties are the supreme law of the land.[75] A treaty approved by the Senate and ratified by the President has the same effect as federal law.[76] As such, the same good faith principles that

[70] The Joint Committee on Taxation ("JCT") is comprised of both House and Senate members, with an extensive staff of lawyers, accountants, economists and actuaries. The JCT serves as the tax expert and score keeper for Congress. For a discussion of JCT's role for tax treaties, *see* "United States Model - Tax Treaty Documents", IRS, https://www.irs.gov/businesses/international-businesses/united-states-model-tax-treaty-documents

[71] S. Rep. No. 106-71, at 7, 11 (2001).

[72] IRC § 274(h)(6)(C).

[73] *See* "Foreign Account Tax Compliance Act," US Department of the Treasury, https://home.treasury.gov/policy-issues/tax-policy/foreign-account-tax-compliance-act.

[74] For a short discussion of the legality of FATCA IGAs, *see* Nauheim, Cousin, Ewell, Limerick, Lakritz, *and* Lee, 6565 T.M., FATCA — Information Reporting and Withholding Under Chapter 4, § IX.A.

[75] US CONST., art. VI, cl. 2.

[76] *Foster v. Neilson*, 27 US (2 Pet.) 253 (1829).

apply to the application and interpretation of domestic law should apply to the treatment of tax treaties However, it is worth noting that "[t]he last recorded reference of any kind by the Court to the role of good faith in the judicial construction of international treaties was in its 1933 opinion in *Factor v. Laubenheimer*."[77]

3.2. Good faith in treaty interpretation

The principle of good faith has been enshrined in international law, such as the Vienna Convention on the Law of the Treaties (the "Vienna Convention") which establishes certain rules, procedures, and guidelines that include how treaties should be interpreted. Articles 31 and 32 of the Vienna Convention establish basic interpretive principles. Under article 31, a treaty should be "interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".[78] Article 32 further provides that when such an interpretation would leave the meaning ambiguous or lead to a result which is unreasonable, then supplementary materials such as preparatory work may be considered. The US signed the Vienna Convention in 1970, but the US Senate has not given its advice and consent to the treaty. As such, it has yet to be ratified and the US is not required to follow its principles. Nevertheless, the US generally follows the Vienna Convention's principles of treaty interpretation, although US courts are more likely to review supplementary materials.

In US courts, the Vienna Convention is only advisory, but nevertheless, courts generally follow the interpretative rules of articles 31 and 32 of the Vienna Convention. For instance, as a general rule, US courts apply a treaty's ordinary meaning of the language if it is not ambiguous and is consistent with the intent or expectations of its signatories.[79] This approach is consistent with the "ordinary meaning" principle of article 31 of the Vienna Convention. However, when treaty language is ambiguous or obscure or would lead to a result which is "manifestly absurd or unreasonable", then US courts will generally apply the principles of article 32 of the Vienna Convention and consider supplementary means of interpretation.[80]

US courts are generally more likely than other countries to look outside of a treaty's text

[77] Michael P. Van Alstine, "Unknown Death of Good Faith in Treaty Jurisprudence", The Georgetown Law Review, Vol. 93:1885, 1915 (citing and quoting 290 US 276, 293 (1933) (connecting the notion of good faith with the liberal interpretation canon in the observation that "[c]onsiderations which should govern the diplomatic relations between nations, and the good faith of treaties, as well, require that their obligations should be liberally construed so as to effect the apparent intention of the parties to secure equality and reciprocity between them.").

[78] Vienna Convention, art. 31.

[79] *Sumitomo Shoji America, Inc. v. Avagliano*, 457 US 176, 180 & 185, (1982) ("[t]he clear import of treaty language controls unless 'application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories;' " it is axiomatic that a treaty's plain language must control absent "extraordinarily strong contrary evidence.") (citations omitted).

[80] *See* Treaties and Other International Agreements: The Role of the United States Senate, Committee Print for Senate Committee on Foreign Relations, prepared by Congressional Research Services, S. Prt. 164, 106th Cong., Jan. 2001 ("“Relevant factors may include the ordinary meaning of words in context, the title of the agreement and statements of purpose, the circumstances of negotiation, negotiating history, unilateral statements of understanding, subsequent practice, change of circumstances, compatibility with international law and general principles of law, and differences between languages.").

to determine its meaning.[81] US courts often apply canons of interpretation to contracts to determine the mutual intent of the parties.[82] Accordingly, US courts will often look beyond the literal language of a treaty and consider a treaty's "purpose, history and context" as part of its analysis.[83] In addition, US courts will often give deference to the meaning of treaty provisions provided by the government agencies responsible for their negotiation and enforcement, and have also frequently considered materials that arise out of the ratification process of the treaty.[84] Additional sources that US sources consider when interpreting tax treaties are: Treasury Technical Explanations, Senate Foreign Relations Committee Reports, JCT Explanations, Organisation for Economic Co-operation and Development (OECD) Commentaries, and Foreign administrative and judicial determinations.

A mutual agreement procedure ("MAP") is generally incorporated in US treaties, and is a method of dispute resolution available to taxpayers that believe they are or will be subject to a taxation that is not consistent with a relevant treaty.[85] MAP typically arises as a result of a tax adjustment that normally would cause double taxation.[86]

A taxpayer may file a MAP request with the US competent authority, and after reviewing the request, the US competent authority will "normally accept the request for consideration" but may decline to accept the request under certain circumstances.[87] The IRS has issued guidance for when there is a non-US-initiated action, and when there is a US-initiated action. In both instances, the US competent authority will look beyond the four corners of the treaty and will evaluate the request and information provided from various sources. For instance, when there are US-initiated actions, the US competent authority will evaluate the request in light of justifications for the action developed by the IRS Examination Department, views received through simultaneous appeals procedure review, if any, as well as any analyses of the action that the taxpayer or other IRS offices have prepared.[88]

In certain instances, the US may unilaterally grant relief to a taxpayer in response to a MAP request, and when that option is not available, the US competent authority will negotiate with the foreign competent authority. In most instances, the outcome of these negotiations will be a resolution that provides the taxpayer with complete or partial relief from taxation that is not in accordance with the US tax treaty.[89] After the competent

[81] ¶1.05. Construing US Income Tax Treaties Under US Law Checkpoint Source: Andersen: Analysis of United States Income Tax Treaties (WG&L) (hereinafter "Anderson: Analysis of United States Income Tax Treaties") (citing Restatement (Third) Foreign Relations Law of the United States (1987), § 325, cmt. f).

[82] *See El Al Israel Airlines, Ltd. v. Tsui Yuan Tseng*, 525 US 155, 167 (1996); *see also* generally Bloomberg Tax Portfolio 100-3rd: Legal Authorities in US Federal Tax Matters — Research and Interpretation, II. Legislation, B. International Tax Treaties.

[83] *Taisei Fire & Marine Ins. Co., Ltd. v. Comm'r*, 104 TC 535 (1995) (quoting *Crow v. Comm'r*, 85 TC 376, 380 (1985)).

[84] *See, e.g.*, *United States v. Stuart*, 489 US 353, 369 (1989) ; *Great-West Life Assurance Co. v. United States*, 678 F2d 180 (Ct. Cl. 1982); *see generally* Anderson: Analysis of United States Income Tax Treaties.

[85] Rev. Proc. 2015-40, sec. 2.01(2); "Overview of the MAP Process", IRS, https://www.irs.gov/businesses/overview-of-the-map-process (last accessed 25 November 2022); Jason M. Osborn , William McGarrity and May Y. Chow, *United States: The Mutual Agreement Procedure ("MAP"): Advantages And Potential Pitfalls For Resolution Of Double Tax Issues*, Mayor Brown, 5 March 2021.

[86] *See id*.

[87] "Overview of the MAP Process", IRS, https://www.irs.gov/businesses/overview-of-the-map-process (last accessed 25 November 2022).

[88] Rev. Proc. 2015-40, sec. 8.

[89] Rev. Proc. 2015-40, sec. 9.01.

authorities reach tentative competent authority resolution, it is presented to the taxpayer.[90] The taxpayer may then review, ask questions, and ultimately may accept or reject the resolution, and when there are multiple issues in one tentative competent authority resolution, the taxpayer may, subject to the consent of the competent authorities, accept and reject agreements on different issues.[91] If the taxpayer rejects the tentative competent authority resolution, then the taxpayer may pursue other domestic remedies available to it in the US or the treaty country.[92]

If the US and foreign competent authorities are unable to reach a competent authority resolution, then the case may be eligible for resolution through arbitration under the terms of the applicable US tax treaty".[93] Under arbitration procedures, a taxpayer "may submit its analysis and view of the case to the arbitration panel through the US competent authority to the extent permitted under the applicable arbitration treaty."[94] The US competent authority will notify the taxpayer of the arbitration panel's determination and the taxpayer may either accept the determination and its terms will then constitute a competent authority resolution, or reject the determination and pursue any other rights that remain available under domestic law in either the US or the treaty country.[95]

3.3. Potential treaty breaches of good faith

The US can override tax treaties through legislation. Additionally, a later in time treaty or statute controls.[96] However, where Congress has not explicitly overridden a treaty, the treaty and statute should be read harmoniously.[97]

Congress does not need to identify the specific treaty or article of the treaty that is overridden by legislation. For example, the law known as the Tax Cuts and Jobs Act (the "TCJA") included a new provision known as the base erosion and anti-abuse tax (the "BEAT").[98] The BEAT treats any payment from a domestic corporation to a foreign related party that gives rise to a domestic deduction as a base eroding payment. If the domestic corporation has a certain threshold of base erosion payments, then it compares its regular income tax with its BEAT and pays the greater of the two.

The TCJA's legislative history is silent on the interaction between the BEAT and US tax treaties. The BEAT operates to deny deductions for cross border payments of interest and royalties, theoretically in conflict with US tax treaties. To address the interaction with tax treaties and the later in time rule, the Senate Committee on Foreign Relations added a reservation regarding the BEAT to the Chile-US tax treaty:

> Nothing in the Convention shall be construed as preventing the United States from imposing a tax under section 59A, entitled the "Tax on Base Erosion Payments of

[90] *Id.*
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *Id.* at sec. 10.05.
[95] *Id.* at secs. 10.06-07.
[96] *The Cherokee Tobacco*, 78 US 616 (1870).
[97] *Whitney v. Robertson*, 124 US 190 (1888).
[98] IRC § 59A.

Taxpayers with Substantial Gross Receipts," of the Internal Revenue Code (as it may be amended from time to time) on a company that is a resident of the United States or the profits of a company that is a resident of Chile that are attributable to a permanent establishment in the United States.[99]

The Senate has yet to approve the Chile treaty, which the parties signed in 2010.[100]

Treasury and the IRS have issued regulations that potentially conflict with or override US tax treaties. For example, in 2016, Treasury and the IRS were concerned about the wave of inversion transactions. One potential benefit of an inversion is the ability to reduce the US tax base through leverage. Section 385 authorizes Treasury to issue regulations to set forth factors to determine whether an instrument is debt or equity. The proposed and final regulations set forth per se rules that treated certain instruments as equity (either through recharacterization or through a funding rule).[101] These rules may conflict with and attempt to override US treaty obligations.[102] Affected taxpayers could challenge the section 385 regulations through MAP or in court.

In addition to these recent examples, other notable examples include:

- The controlled foreign corporation rules (Revenue Act of 1962) (created CFC rules and imposed tax on CFC's passive income);
- The Foreign Investment in Real Property Tax Act of 1980 (treated sales of US real property as US source income); and
- The branch profits tax (Tax Reform Act of 1986) (imposition of the profits of a US branch/trade or business, designed to replicate the two levels of tax on domestic corporations).[103]

Part Four: Remedies for a breach of good faith between contracting states

4.1. General overview

Remedies for jurisdictions or taxpayers are limited.

First, the competent authorities can use the mutual agreement procedure to resolve disputes in the interpretation of a treaty. The 2016 Model provides that "[t]he competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of this Convention. They

[99] Resolution of Ratification: Senate Consideration of Treaty Document 112-8, https://www.congress.gov/treaty-document/112th-congress/8/resolution-text?overview=closed.

[100] H. David Rosenbloom, *Time for a Tax Treaty Timeout*, 2023 TNI1-6.

[101] Treas. Reg. §§ 1.385-2; 1.385-3.

[102] For a thorough discussion of the treaty interactions, *see* Comment from Nancy McLernon, Organization for International Investment, 11 July 2016, https://www.regulations.gov/comment/IRS-2016-0014-0167.

[103] *See* Andersen: Analysis of United States Income Tax Treaties (WG&L), §1.03[1][a][iii] for a discussion of other notable treaty overrides.

also may consult together for the elimination of double taxation in cases not provided for in this Convention."[104]

Where one contracting party believes the other contracting party has breached its treaty obligations, the contracting party can terminate the treaty. In 2022, the US terminated the Hungary-US tax treaty. A Treasury spokesman said that the treaty was no longer reciprocal because Hungary lowered its corporate income tax rate to nine percent, while the US corporate income tax rate is 21 percent.[105] There is speculation that the termination of the treat was related to Hungary's objection to the EU Pillar Two directive.[106]

A taxpayer can also use the MAP process to address issues where it believes "that the actions of one or both of the Contracting States result or will result for such person in taxation not in accordance with the provisions of this Convention, it may, irrespective of the remedies provided by the domestic law of those Contracting States, and the time limits prescribed in such laws for presenting claims for refund, present its case to the competent authority of one or both of the Contracting States."[107]

A taxpayer may also seek redress in US courts.

104 2016 Model, art. 25(3).

105 Jim Bourg, 'US Treasury to end 1979 treaty with global minimum tax holdout Hungary", 9 July 2022, https://www.reuters.com/world/europe/us-treasury-end-1979-treaty-with-global-minimum-tax-holdout-hungary-2022-07-08/

106 Letter from Mike Crapo, Ranking Member, Senate Finance Committee; James E. Risch, Ranking Member, Senate Foreign Relations Committee; and Kevin Brady, Ranking Member, House of Representatives Ways and Means Committee to The Honorable Janet Yellen, Secretary, US Department of the Treasury and The Honorable Antony Blinken, Secretary, US Department of State(3 November 2022), *available at* https://waysandmeans.house.gov/wp-content/uploads/2022/11/sfrc-sfc-wm_letter_to_state_and_treasury.pdf

107 2016 Model, art. 25(1).

International Fiscal Association