4-1-1982

Foreign Illegality: No Absolute Bar to Enforcement of Internal Revenue Service Summons

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RECENT CASES

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United States v. Vetco Inc., 644 F.2d 1324 (9th Cir. 1981); *cert. denied.* 102 S. Ct. 677 (1982).

In October 1977, the Internal Revenue Service, (I.R.S.), issued a summons to Vetco Inc., a United States corporation, to obtain business records of its wholly-owned Swiss subsidiary.[1] Vetco claimed that compliance with the summons would require violating the Swiss law, which prohibits the disclosure of business information to foreign officials,[2] and refused to supply the documents requested. The I.R.S. moved to enforce the summons. The district court, after a briefing on Swiss law, granted enforcement of the summons and later imposed sanctions upon Vetco's failure to comply with the order. Affirming both the enforcement of the summons and the sanctions, the United States Court of Appeals for the Ninth Circuit held: (1) the Swiss-U.S. Tax Treaty[3] is not the exclusive means of obtaining records of Swiss subsidiaries of American corporations; (2) the possibility of criminal liability does not excuse the failure of a taxpayer subject to U.S. taxation to produce documents located in Switzerland; and (3) courts must employ a balancing test to determine whether the foreign "illegality excuse" will prevent enforcement of a U.S. summons.[4]

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1. The summons was also issued to Vetco's accountants, Deloitte, Haskins & Sells, and its lawyers, Kindel & Anderson. Pursuant to I.R.C. § 7609(b)(2), Vetco ordered both parties not to comply with the summons.

2. Article 273 of the Swiss Penal Code provides:

> "Whoever makes available a manufacturing or business secret to a foreign governmental agency or a foreign organization or private enterprise or to an agent of any of them; shall be subject to imprisonment and in grave cases to imprisonment in a penitentiary.
>
> The imprisonment may be combined with a fine." StGB Art. 273.

3. Convention on Double Taxation of Income, September 27, 1951, United States-Switzerland, 2 U.S.T. 1751, 1760-61, T.I.A.S. No. 2316.

4. United States v. Vetco Inc., 644 F.2d 1324 (9th Cir. 1981), *cert. denied*, 102 S. Ct. 671 (1982).

The Criminal Division of the I.R.S. investigated Vetco for failure to report the income derived from its wholly-owned subsidiary. Subpart F of the Internal Revenue Code requires a domestic corporation to report the income of any foreign subsidiaries. I.R.C. § 964(c) provides that an American corporation must keep sufficient information in the U.S. concerning their subsidiaries to determine whether Subpart F tax is due. Nonetheless, Vetco, like many other domestic corporations maintained relevant documents abroad with the expectation that foreign laws prohibiting the disclosure of business records would shield the subsidiary from the reach of an I.R.S. investigation. Although the Swiss-U.S. Tax Treaty has provisions for exchanging information, the Swiss reserve the right not to transmit business information protected under the confidentiality statutes.[5] Moreover, many U.S. courts, most notably in the second circuit, have held that the doctrine of international comity prevents a domestic court from imposing discovery orders which would compel the recipient to violate another country's laws.[6] As a result, foreign laws prohibiting the disclosure of business information have hindered the government's investigative attempts under Subpart F.[7]

Vetco first challenged the ability of the I.R.S. to employ its summons power to obtain business-related documents in Switzerland. Vetco maintained that the Swiss-U.S. Tax Treaty was the sole means to obtain such information. The court, after discussing the relevant portions of the treaty, responded that the treaty was but one of the many ways the government could choose to obtain such information from corporations subject to U.S. taxation. In fact, the I.R.S. Audit Manual endorses the use of the summons to obtain information. A treaty will only serve as the exclusive means when it so expressly provides. Since the treaty did not bar the use of the summons, and did not state that its methods would be ex-

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5. 644 F.2d at 1333.

6. In *In re Chase Manhattan Bank*, 297 F.2d 611 (2d Cir. 1962), the court upheld a district court's modification of subpoena upon showing that compliance with the summons would violate Panamanian law. Quoting *Ings v. Ferguson*, 282 F.2d 149, 152 (2d Cir. 1960). The court stated: "Upon the fundamental principle of international comity, our courts dedicated to the enforcement of our laws should not take such action as may cause a violation of the laws of a friendly neighbor or, at the least, an unnecessary circumvention of its procedures." *Id.* at 613. For an analysis of international comity regarding foreign discovery orders *see*, Note, *Ordering Production of Documents Abroad in Violation of Foreign Law*, 31 U. CHI. L. REV. 791 (1964).

7. *See* Spall, *International Tax Evasion and Tax Fraud: Typical Schemes and Legal Issue Raised by Their Detection and Prosecution*, 13 LAW. AM. 325 (1982).

clusive, the court concluded that there was no violation of I.R.S. regulations.[8]

Secondly, Vetco argued that possible criminal prosecution in Switzerland excused its compliance with the summons. The "illegality excuse" for failure to produce documents located in a country whose laws prohibit compliance with a discovery order is rooted in *Société International Pour Participations Industrielles v. Rogers.*[9] There, a Swiss company sued to recover property seized by the United States under the Trading with the Enemy Act. The court ordered production of various documents which Swiss law prohibited the litigant from disclosing. As a result, the Swiss government confiscated the information. Upon Société's failure to comply with the discovery order, the district court imposed sanctions and dismissed the action. On appeal, the Supreme Court reversed. The Court held that the fear of criminal prosecution abroad constituted a "weighty excuse for non-production,"[10] and reinstated the action.

Vetco argued that the holding in *Société* prevented both the enforcement of the summons and the imposition of sanctions. The court, however, rejected any analogy between *Société* and the case at hand. The court found that the foreign illegality defense was restricted to instances where the litigant, as in *Société*, made a good faith effort to comply with the request. The taxpayer in *Vetco* made no comparable display of good faith. In fact, the court noted that the taxpayer was deliberately delaying production.[11] Moreover, unlike the situation in *Société*, where the Swiss government actually confiscated the documents, Vetco failed to affirmatively demonstrate that production of the documents would actually lead to criminal prosecution.

The court further distinguished *Société* on the basis that the discovery order was civil in nature, while in *Vetco*, the summons was of a criminal nature. The court stated that a criminal summons served a more pressing national interest and should be more widely recognized in the international community.[12] At first blush, it appears that the distinction between criminal and civil should not be dispositive. However, the court sought to distinguish the

8. 644 F.2d at 1329.
9. 357 U.S. 197 (1958).
10. *Id.* at 211.
11. *Id.* at 1370, n.6.
12. *Id.* at 1330.

I.R.S. summons from the broad discovery orders issued in antitrust litigation, a field where foreign illegality continues to pose a significant impediment to obtaining documents located abroad.[13]

The court also rejected the notion that international comity prevents a domestic court from ordering production of documents abroad which would require the recipient to violate the foreign country's laws. Instead, the court adopted a balancing approach, as set forth in the Restatement (Second) of Foreign Relations Law of the United States. Section 40 provides:

> Where two states have jurisdiction to prescribe and enforce rules of law and the rules they may prescribe require inconsistent conduct upon the part of a person, each state is required by international law to consider, in good faith, moderating the exercise of its enforcement jurisdiction, in the light of such factors as
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> (a) vital national interests of each of the states,
>
> (b) the extent and the nature of the hardship that inconsistent enforcement actions would impose upon the person,
>
> (c) the extent to which the required conduct is to take place in the territory of the other state,
>
> (d) the nationality of the person, and
>
> (e) the extent to which enforcement by action of either state can reasonably be expected to achieve compliance with the rule prescribed by that state.[14]

The first factor considered was the vital national interest of both countries involved. The United States has a strong interest in collecting taxes and in effectuating tax fraud investigations. The Swiss, on the other hand, have a national interest in preserving the confidentiality of business transactions. This interest, the court held, is diminished where the party involved is a subsidiary of an American corporation and the party seeking the information is required to keep the information confidential.[15] The court refused to find that Swiss confidentiality laws protected foreign subsidiaries of domestic corporations in the absence of an interest justified by Swiss public policy.

Next, the court examined the possibility of actual criminal prosecution in Switzerland. The court found no person had ever

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13. *See* Note, *Foreign Nondisclosure Laws and Domestic Discovery Orders in Antitrust Litigation*, 88 YALE L.J. 612 1979).

14. 644 F.2d at 1331, quoting Section 40, RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES (1965).

15. *Id.*

been prosecuted for complying with a court order to produce documents to the I.R.S. A Swiss Federal Attorney submitted an affidavit stating that compliance with an I.R.S. summons may be a defense to Article 273 of the Swiss Penal Code.[16] The court warns that before a taxpayer uses the foreign illegality defense to prevent enforcement of a summons, the fear of prosecution must be imminent. This will prevent taxpayers from utilizing the "illegality excuse" unless they can prove that there has been similar prosecution in the past and that enforcement is substantially certain. Another important factor on the balancing of hardships was the extent to which the taxpayer brought the dispute upon himself. Vetco was required to keep sufficient records of its subsidiary in the United States pursuant to I.R.C. § 964(c), but failed to do so. The court noted that it was the taxpayer's own fault for failing to keep the necessary documents in the U.S., and the entire event could have been avoided.[17] In short, a taxpayer who deliberately creates legal impediments to prevent discovery efforts in U.S. litigation will find no success in asserting the foreign illegality defense.

Finally, the court examined alternative means of compliance. The court found no substantial equivalent to the production of the documents in the U.S. The Swiss Federal Attorney stated that it would not respond to a letter rogatory.[18] In the past, the Swiss-U.S. Tax Treaty and the Swiss government had provided no assistance in tax fraud cases.[19] The examination of documents in Switzerland is prohibited by Article 271 of the Swiss Penal Code.

After balancing the interests involved, and examining the alternative means of compliance, the court affirmed both the enforcement of the summons and the issuance of sanctions. The message in *Vetco* is clear: Foreign laws preventing disclosure of documents in their jurisdiction will not enable a person subject to United States taxation to conceal essential information from a tax fraud investigation.

The significance in *Vetco* lies in the court's rejection of the Swiss-U.S. Tax Treaty as the exclusive means of obtaining documents in Switzerland. The I.R.S. is no longer forced to bear the

16. *Id.* at 1332.
17. *Id.*
18. *Id.* at 1333.
19. *Id.* (citing X & Y Bank v. The Swiss Federal Tax Administration, 76-1 U.S.T.C. ¶ 9452 at 84,213 (Swiss Fed. Sup. Ct. May 16, 1975)).

administrative burdens of the tax treaty since it can now safely assert its summons power to obtain necessary information. More importantly, by limiting *Société* to civil cases where the litigant made a good faith effort to comply with the discovery request, the court leaves no vitality to the foreign illegality excuse in tax fraud investigations. The holding prevents almost all taxpayers from using foreign illegality to shield essential information from the I.R.S. Only when the taxpayer can affirmatively demonstrate that criminal sanctions are substantially certain and only after making a good faith effort to comply with the discovery request can a taxpayer successfully utilize the foreign illegality defense. By balancing competing interests, the I.R.S. is certain to prevail over any sham attempts to conceal information from the government. Perhaps this is the I.R.S.'s best attack to discover the millions of dollars abroad which escape the reach of U.S. taxation due to foreign confidentiality statutes. As in *Vetco,* the I.R.S. can summons the information from the taxpayer subject to U.S. taxation, who can no longer successfully assert that foreign illegality prevents the enforcement of the summons. The significance of *Vetco* is its hardline approach to a long-standing problem plaguing United States tax officials.

Yet, *Vetco* has implications far more wide reaching than tax fraud investigations.[20] The balancing test employed can be utilized to pierce the shield of almost any foreign confidentiality statute where vital national interests demand complete discovery.

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20. Following *Vetco,* the court in *S.E.C. v. Banca Della Svizzera Italiana,* 92 F.R.D. 111 (S.D.N.Y. 1981) held that a Swiss corporation which transacted purchases on the American securities exchanges could not make deliberate use of Swiss nondisclosure laws to evade the American securities laws. The court ordered the Swiss corporation to answer interrogatories concerning its undisclosed principals, finding that the vital national interest in preserving the integrity of the securities market justified the imposition of the discovery order in contravention of Swiss nondisclosure laws.