U.S. TREASURY DEPARTMENT
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TESTIMONY OF TREASURY ACTING INTERNATIONAL TAX COUNSEL JOHN HARRINGTON BEFORE THE SENATE FINANCE COMMITTEE ON OFFSHORE TAX EVASION

Washington, D.C.--Mr. Chairman, Ranking Member Grassley, and distinguished Members of the Committee, thank you for the opportunity to participate this morning and discuss the serious problem of offshore tax evasion.

Introduction

From the standpoint of tax administration, offshore tax evasion historically has been a very difficult area to address. Questionable use of low- or no-tax jurisdictions has been an issue for decades. Globalization, however, has made foreign investment and foreign activities common, with overseas markets becoming an increasingly important source of income for U.S. individuals and businesses.

Individuals invest in foreign entities for a variety of reasons. In most instances, these investments represent legitimate business transactions, using foreign entities in ways that are typical for international commerce. At times, however, foreign entities can be used for tax evasion. For example, some individuals invest through a jurisdiction with a reputation for secrecy and opaqueness, hoping to stymie the Internal Revenue Service (IRS) in its administration of the Internal Revenue Code. Others try to hide income from the IRS by setting up elaborate business structures and financial arrangements, some components of which are located offshore.

These varied scenarios make it clear that a one-size-fits-all approach will not work to stop offshore tax abuse while continuing to permit legitimate cross-border transactions, which are vital to the United States' participation in the global economy. This is why the Treasury Department has undertaken a multi-faceted approach to deal with the problem of offshore tax evasion. I would like to describe the actions we have taken and continue to take, especially regarding information exchange, to deal with this difficult but important issue. It is critical to bear in mind that this has been a long-term problem, and we

must continue to take a long-term view in combating offshore tax evasion, while managing expectations about the speed with which progress can be made in addressing it.

The Treasury Department is very concerned about the use of offshore jurisdictions to evade U.S. tax. There plainly have been abuses in this area. We have been aggressively pursuing such abuses, and we intend to continue doing so.

We have sought to target our efforts on the sources of abuse and avoid actions that are so blunt that they hinder the legitimate cross-border trade and investment activities, which are so critical to U.S. business and U.S. jobs. Cross-border transactions are now standard business operations, as globalization has led to increased cross-border investment opportunities. We have to make sure that our tax rules reflect the current economic environment, without hurting the competitiveness of U.S. workers and businesses.

Regulatory and Administrative Actions

As part of our overall effort to improve compliance, the Treasury Department and the IRS have taken a number of important steps on the administrative front and are continuing to work on other avenues to address offshore tax abuses. Although determined tax evaders may flaunt the tax rules, some taxpayers opportunistically seek to take advantage of ambiguous or outdated tax rules. Accordingly, we modify or update U.S. tax rules when we determine that they are being used to perpetrate such abuse. Recent published guidance projects that will improve compliance and that target potential areas of abuse include:

- Foreign Tax Credit: We have taken strong steps to halt misuse of the foreign tax credit. In November 2006, we issued final regulations regarding the proper allocation of partnership expenditures for foreign taxes. In March 2007, we issued proposed regulations that would disallow foreign tax credits tied to participation in certain artificially engineered, highly structured transactions. In August 2006, we issued proposed regulations that would address the inappropriate separation of creditable foreign taxes from foreign source income. We intend to make appropriate modifications and finalize both sets of proposed regulations as soon as possible.

- Transfer Pricing: We have produced, and continue to produce, significant guidance in the area of transfer pricing. In an increasingly globalized economy, cross-border transactions between controlled entities present significant compliance challenges, making guidance in the transfer pricing area an important part of our administrative efforts to address noncompliance. In August 2006, we issued temporary and final regulations addressing the treatment of cross-border services, and followed them up with additional guidance in December 2006. We issued proposed transfer-pricing regulations addressing cost-sharing in August 2005. We intend to finalize both sets of regulations, with appropriate modifications.

- Other Abusive Transactions: We have also shut down arrangements that utilized foreign jurisdictions to perpetuate abuse of the Internal Revenue Code. For example, in October 2006, we published proposed regulations regarding the Federal tax treatment of annuity contracts. These proposed regulations address a type of widely marketed transaction in which taxpayers claimed to be able to defer or avoid gain on the exchange of highly appreciated property for the issuance of annuity contracts. Recent Congressional hearings have highlighted how taxpayers were applying prior law treatment of these contracts to facilitate abusive private annuity arrangements, often involving offshore issuers. The proposed regulations, when adopted as final, will shut down those arrangements.

The IRS has also undertaken several compliance initiatives, including the Offshore Voluntary Compliance Initiative, aimed at taxpayers who used offshore payment cards or other offshore financial arrangements to hide their income, and the Offshore Credit Card Program, designed to identify taxpayers who use offshore bank accounts to hide income and offshore credit cards issued by secrecy jurisdiction banks to repatriate the unreported income. The IRS is continually monitoring this area for opportunities to implement new programs that will stop abusive transactions and improve compliance.

Obtaining Information from Other Jurisdictions

In most cases, however, the problem of offshore tax abuse lies not with our tax rules but with attempts to hide from them. Accordingly, to enforce our tax laws, we have to exchange information with other countries. Information exchange is an area in which the Treasury Department has been working assiduously for several years, and our steady and persistent efforts are bearing fruit.

In today's global economy, countries must be able to obtain and exchange the information needed to enforce their domestic tax laws. A key element of U.S. tax treaties, therefore, is the provision for exchange of information between the tax authorities. Under tax treaties, the competent authority (i.e., the tax authorities designated under the tax treaty) of one country may request from the other competent authority such information as may be relevant for the proper enforcement of the first country's tax laws. The information provided by the other country is subject to the strict domestic confidentiality protections that generally apply to taxpayer information. Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program.

A tax treaty is not feasible or appropriate in all cases, however. In some cases, there simply may not be the type of cross-border tax issues between the United States and the foreign country that are best resolved by treaty. For example, in the case of a country that does not impose significant income taxes, there may be little possibility of the double taxation of income that tax treaties are designed to address. In cases where a full tax treaty is not appropriate or feasible, the Treasury Department seeks to provide for the bilateral exchange of tax information by entering into a tax information exchange agreement ("TIEA") with the other country.

Information Exchange Generally

There are three primary forms of information exchange.

- Exchange of information on request**:** Exchange of information on request occurs when the competent authority of one country asks for particular information regarding specific taxpayers from the competent authority of another country.

- Automatic exchange of information: Information that is exchanged automatically is typically information comprised of many individual cases of the same type. Usually, this type of information exchange consists of details of income arising in the source country (e.g., interest, dividends, royalties, or pensions). This information is obtained on a routine basis (generally through reporting of the payments by the payer) by the sending country and is thus available for transmission to its treaty partners.

- Spontaneous exchange of information: Information is exchanged spontaneously when a country, having obtained information in the course of administering its own tax laws, which it believes will be of interest to one of its treaty partners for tax purposes, passes on the information without the latter having asked for it.

Tax Treaties

Tax treaties typically permit all three types of information exchange. Both the United States Model Income Tax Convention (U.S. Model Tax Convention) and the Organization for Economic Cooperation and Development Model Tax Convention on Income and on Capital (the OECD Model Tax Convention) provide for broad information exchange and do not limit the form or manner in which information exchange can take place. For example, Article 26 of the U.S. Model Tax Convention generally provides that "the competent authorities of the Contracting States [the treaty partners] shall exchange such information as may be relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes of every kind imposed by a Contracting State to the extent that the taxation thereunder is not contrary to the Convention, including information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, such taxes." The Article confirms that each Contracting State must maintain and protect the confidentiality of the tax information it receives from the other State, with disclosure permitted only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, such taxes, or the oversight of such functions.

The Article further provides that each Contracting State "shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own purpose." Thus, a treaty partner may not decline to supply information to the other treaty partner merely because the first treaty partner has no domestic interest in the information. For example, a country may not refuse to provide information on request about the holder of a bank account simply because the country does not tax interest and, therefore, does not collect such information.

Article 26 permits a Contracting State to refuse to share information in certain specified cases, however. A Contracting State may refuse (a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State; (b) to supply information that is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State; or (c) to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. The Article specifically prohibits, however, a treaty partner from refusing to obtain or exchange information because of bank secrecy rules.

The information exchange article in the OECD Model Tax Convention has substantially similar provisions to those described above.

TIEAs

Compared to tax treaties, TIEAs are a more recent phenomenon. In 1983, as part of the Caribbean Basin Initiative, Congress granted the Treasury Department the authority to enter into bilateral or multilateral TIEAs with designated countries in the Caribbean and Central America. This authority was extended in 1986 to allow the Treasury Department to enter into bilateral TIEAs with other countries.

There are several items that are essential to the United States when negotiating a TIEA. First, the TIEA must provide for the exchange of information on request for both criminal and civil tax matters. Many jurisdictions are more willing to exchange information with respect to criminal tax matters, but such a restriction would greatly limit the utility of a TIEA from a U.S. standpoint. Second, the TIEA must provide for the exchange of information even if such information relates to a person who is not a resident or national of the United States or the TIEA partner. We may be more interested in the beneficial owner of an entity formed under the jurisdiction of the TIEA partner than we are in the entity itself. Finally, the TIEA must provide for the disclosure of information regardless of local

"confidentiality" laws that may prohibit such disclosure, including laws relating to bank secrecy or bearer shares. Indeed, such laws may be one of the principal attractions for offshore tax evaders.

Many of our TIEA partners have small tax administrations, and the TIEAs acknowledge this reality. Accordingly, a TIEA often will specify the details that a request for information under the TIEA should contain and also require the IRS to explain why it is making the request. Although each TIEA partner is usually expected to bear the routine costs of fulfilling its obligations under the agreement, TIEAs often require the requesting party to bear "extraordinary costs." This type of feature is often necessary to induce a small jurisdiction to agree to a TIEA.

Information Exchange Is Not Just a Bilateral Issue

The United States is not the only country that has encountered the problem of offshore tax evasion, but it has been a leader in increasing worldwide standards of information exchange to combat such evasion. We have worked with other countries, particularly through the OECD, to raise international standards of information exchange. Although exchange of taxpayer information is effected on a bilateral basis, pursuant to a tax treaty or TIEA, the information exchange practices of third countries matter significantly. Some of the more complicated cases may involve transactions in several jurisdictions, requiring exchange of information with multiple jurisdictions. Thus, the adoption of high standards of international information exchange facilitates our ability to obtain the information we need through our agreements, thereby promoting the sound and effective administration of U.S. tax laws.

We have made great strides in raising international standards. It is now rare for a country to insist that it can only exchange information in which it has a domestic tax interest. In addition, the countries that assert that they cannot provide information because of bank secrecy are becoming fewer and fewer.

Improving the quality of the information available for exchange (e.g., removing bank secrecy and eliminating the requirement of a domestic tax interest) is one of the most important developments in the last few years. In other words, access to relevant information is more important than the method of exchange (e.g., whether automatic or not). In particular, automatic exchange does no good if the underlying information is too limited to be of help.

We also have to make sure that tax information is properly protected. Under U.S. law, we cannot exchange taxpayer information unless we know the other country will protect the confidentiality of that information.

Exchange of non-taxpayer-specific information is also important. Countries often share experiences and schemes that they have encountered. For example, the Treasury Department recently issued proposed foreign tax credit regulations to shut down abusive foreign tax credit "generator" transactions. We learned about these transactions from foreign tax authorities. This kind of communications can be as important as the more traditional exchange of information.

The IRS has been actively involved in the development of several multilateral information exchange programs. The Joint International Tax Shelter Information Centre (JITSIC) was formed by tax authorities in the United States, the United Kingdom, Canada, and Australia. The objectives of JITSIC are to deter promotion of and investment in abusive tax schemes, particularly through information exchange and knowledge sharing. IRS Commissioner Everson has described JITSIC as having sharply improved IRS knowledge and understanding in a number of important international tax areas.

In addition to JITSIC, in January 2006 the IRS and the tax administrations of nine other countries agreed to the establishment of the so-called "Leeds Castle" Group. Under this arrangement, the commissioners of the revenue agencies of China, India, and South Korea agreed to meet regularly with their

counterparts from the United States, the United Kingdom, Japan, Australia, Canada, France and Germany to consider and discuss issues of global and national tax administration in their respective countries. By providing additional opportunities to share information and experience, these organizations are a significant tool in combating offshore evasion.

Taking Stock of Information Exchange

Successes in information exchange do not come overnight. We have the access to information that we have today due to years of patient negotiations and cultivation of information exchange relationships. Moreover, new efforts today may not bear fruit until years from now. For that reason, we are committed to a multi-year approach to expanding our information exchange network. It is important to take a long-term perspective. At times, there have been criticism that we are devoting too much time and resources to expanding our information exchange network; other times we hear that we are not devoting enough. Because this is an area where steady pressure is essential and missteps (or overreaching) can undo years of work, we have to be careful not to disrupt the steady progress we have made.

It is also important to remember that information exchange is inherently voluntary. We cannot force any country to agree to exchange tax information. Sometimes negotiations on this issue are very difficult. The treaty or TIEA partner may be required to repeal or modify domestic law. In addition, signing a tax treaty or a TIEA is only the first step in the process. A healthy information exchange relationship requires us to maintain good relations with our treaty and TIEA partners. Even an ideally drafted agreement is of limited value if the tax authorities do not have a cooperative relationship. For example, if a treaty or TIEA partner believes that the information exchange relationship is not respected or appreciated by the United States, this may have a chilling effect on exchange of information on request or, particularly, on spontaneous exchange of information.

We have more to do in this area. Nonetheless, we have made great strides in recent years. Several new TIEAs have entered into force with jurisdictions that have figured prominently in previously documented accounts of offshore tax evasion. Within the last two years alone, TIEAs have fully entered into force with the Cayman Islands, the British Virgin Islands, the Bahamas, the Netherlands Antilles, Jersey, Guernsey, and the Isle of Man. We also recently signed a TIEA with Brazil, and the newly signed tax treaty with Belgium provides greater information exchange than we have previously been able to achieve with that country.

Moreover, it must be kept in mind that TIEAs and the information exchange article in tax treaties are enforcement tools. Accordingly, there are limits in what we can say publicly about the manner in which we use them and the frequency with which we make requests, without undermining their deterrent effects. The goal is to enforce our laws, and we do not want to convey inadvertently to tax evaders any specific information about how and with whom we exchange information.

However, it is worth noting a few of the public successes that have resulted in part from our information exchange agreements.

- Recently, the U.S District Court in Washington sentenced an individual to nine years in prison for failing to report $365 million in income. This individual, Walter Anderson, had attempted to evade his tax responsibilities by hiding earnings in offshore entities in the British Virgin Islands, Bermuda, the Channel Islands, and Panama. Information that the IRS and Department of Justice gathered through our TIEA with Bermuda helped in the prosecution of this case.

- In 2004, Almon Glenn Braswell was sentenced to 18 months in prison and ordered to pay over $10 million in back taxes, interest and penalties. Mr. Braswell's use of a Bermuda corporation

and bank account as part of his tax evasion scheme was uncovered through requests made under our TIEA with Bermuda.

Conclusion

As both Secretary Paulson and Assistant Secretary Solomon stated in recent testimony before this Committee, the Treasury Department is committed to improving tax compliance without unduly burdening honest taxpayers who currently meet their tax obligations. Tax compliance with respect to offshore transactions is an important aspect of that endeavor. By focusing on information exchange, we seek to reduce offshore tax evasion while achieving these goals.

Thank you again, Mr. Chairman, Ranking Member Grassley, and other Members of the Committee for the opportunity to appear before the Committee today. I would be pleased to answer any questions you may have.

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