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AVI-YONAH TESTIMONY FOR HEARING ON OFFSHORE TAX EVASION
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My name is Reuven S. Avi-Yonah. I am the Irwin I. Cohn Professor of Law and Director of the International Tax Master of Law Program at the University of Michigan Law School. I hold a JD (magna cum laude) from Harvard Law School and a PhD in History from Harvard University. I have 18 years of full and part time experience in the tax area, and have been associated with or consultant to leading law firms like Wachtell, Lipton, Rosen & Katz and Cadwalader, Wickersham & Taft. I have also served as consultant to the US Treasury Office of Tax Policy and as member of the executive committee of the NY State Bar Tax Section. I am currently Chair-Elect of the ABA Tax Section Committee on VAT, a member of the Steering Group of the OECD International Network for Tax Research, and a Nonresident Fellow of the Oxford University Center on Business Taxation. I have published eleven books and over 70 articles on various aspects of US domestic and international taxation, and have thirteen years of teaching experience in the tax area (including basic tax, corporate tax, international tax and tax treaties) at Harvard, Michigan, NYU and Penn Law Schools.

I would like to thank Senators Baucus and Grassley and the Committee staff for inviting me to testify today on the international tax gap. Some of the following testimony is based on an article I co-authored with Joe Guttentag, but I remain solely responsible for what follows.[1]

1. The Extent to Which U.S. Persons move assets offshore to avoid U.S. Taxation.

In July of 1999, the Justice Department entered into a plea bargain with one John M. Mathewson of San Antonio, Texas. Mr. Mathewson was accused of money laundering through the Guardian Bank and Trust Co. Ltd., a Cayman Islands bank. Mr. Mathewson was Chairman and controlling shareholder of Guardian, and in that capacity had access to information on its depositors. In return for a reduced sentence, Mr. Mathewson turned over the names of the persons who had accounts at Guardian. The result was an eye-opener: The majority of the accounts were beneficially owned by US citizens, and the reason they used a Caymans bank had nothing to do with laundering funds earned in criminal activities. Instead, the accounts were in the Caymans for the purpose of evading federal income taxes on income earned legally, relying on the Caymans' lack of an income tax and promise of bank secrecy. The IRS ultimately settled 1,165 cases with the

[1] See Joseph Guttentag and Reuven Avi-Yonah, Closing the International Tax Gap, in Max B. Sawicky (ed.), Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration (EPI, 2005), 99.

individual taxpayers for a total collection of $3.2 billion- an average of $1.7 million per taxpayer.[2]

Guardian's US clients relied on four simple realities: First, in today's world, anyone can open a bank account in the Caymans for a minimal fee over the internet, without leaving the comfort of their home. Second, the account can be opened in the name of a Caymans corporation, which can likewise be set up long-distance for minimal transaction costs (as evident from any perusal of the back pages of the Economist magazine, where law firms advertising such services abound). Third, money can be transferred into the account electronically from the US or from abroad, and in most cases there would not be any reporting of such transactions to tax authorities. Finally, the funds in the Caymans account can then be used for investments in the US and in other high tax jurisdictions, and there would generally be no withholding taxes on the resulting investment income, no Caymans taxes, and no information on the true identity of the holder available to the IRS or any other tax authority. Significantly, other than the use of the Caymans, both the underlying funds that were deposited in the Guardian accounts, and the investment income, were generally purely domestic transactions, and the tax evaded was US income tax on US source income beneficially owned by US residents.

Another, more recent example of transactions designed to shield income from tax by using offshore entities is the Sam Wyly case, as set out in a recent report by the U.S. Senate Permanent Subcommittee on Investigations.[3] The essence of the transactions was as follows: The Wylys had nonqualified stock options on the stock of various publicly traded US corporations, which they received as part of their compensation package as officers and directors of those corporations. The relevant transactions involved five steps. In step one, the Wylys contributed the options to an Isle of Man (IOM) trust treated for US federal tax purposes as a grantor trust. In step two, the IOM grantor trust sold the options to an IOM corporation controlled by an IOM non-grantor trust in exchange for a private annuity contract. In step three, the IOM grantor trust liquidated and distributed the private annuity contract to the Wylys. In step four, the options were exercised by the IOM corporations, resulting in significant gains. In the final step, the IOM corporations used the funds realized by exercising the options, as well as other funds contributed by the Wylys (through the IOM non-grantor trusts), in ways the directly benefited the Wylys, such as purchases of US real property, jewelry, art collectibles, and loans to the Wylys through a Cayman Islands corporation.

The Wylys claimed that the tax results of this series of transactions are as follows: Neither the contribution of the options to the IOM grantor trust, nor the exchange of the options for private annuity contracts, triggers the realization of gain on the options (which but for the transaction would be taxable to the Wylys as compensation income under IRC sec. 83). The gain is triggered only when the options are exercised in the hands of the

[2] Boyd Massey, Convicted Bank Chairman is Key to Dozens of New Tax Haven Cases, 1999 TNT 171-2; Cynthia Blum, Sharing Bank Deposit Information with Other Countries: Should Tax Compliance or Privacy Claims Prevail, 6 Fl. Tax Rev. 579 (2005).

[3] Permanent Subcommittee on Investigations, Tax Haven Abuses: The Enablers, the Tools and Secrecy (2006).

IOM corporation, and since at that point it is capital gain of a foreign entity, no US tax is due. The Wylys have to pay tax only when they receive payments on the private annuity contract, resulting in significant deferral. The purchase of various US assets and loans to the Wylys from the IOM corporations have no US tax consequences because the corporations (and the IOM non-grantor trusts that control them) are unrelated to the Wylys.

The Wylys received opinions that the transactions were more likely than not to withstand scrutiny, and the transactions are currently under review by the IRS. If upheld, these transactions raise troubling issues regarding the ability of wealthy individuals to shield income from current tax, while using the income to benefit themselves and their families.

The ability to use the Caymans, the Isle of Man, and other offshore tax havens to evade income taxes is a relatively recent phenomenon. Since about 1980 there has been a dramatic lowering of both legal and technological barriers to the movement of capital, goods and services, as countries have relaxed their tariffs and capital controls, much of the world economy has shifted from goods to services, and electronic means of delivering services and transferring funds have developed. At the same time, the tools used by tax administrations to combat tax evasion have not changed significantly: Most tax administrations are limited to enforcing taxes within their jurisdiction, and for international transactions, can only rely on outdated mechanisms like exchange of information under tax treaties with other high-tax countries, which are unavailing for income earned through tax haven corporations. Simply put, we have the technology which enables people to conduct their affairs without regard to national borders and without transparency, while restricting tax collectors to geographic borders, meaningless in today's world.

The US legitimately boasts one on the world's higher compliance rates for tax collections. However, most of the taxes collected by the IRS are from income that is subject either to withholding at source (e.g., wages) or to automatic information reporting to the IRS by financial institutions (e.g., interest or dividends from US payors). The IRS has recently estimated that in 2001 there was a total "tax gap" (i.e., a difference between the taxes it collected and the taxes it should have collected under existing law) of between $312 and $345 billion, or about 16% of total taxes owed.[4] A large portion of this gap results from income that is subject to neither withholding nor information reporting, such as most income of small businesses and income earned from foreign payors. For these types of income, the compliance rate falls from over 90% to under 50%.[5]

No one, including the IRS, has a good estimate of the size of the international tax gap. This is not surprising given that the activities involved are illegal, but one can make an educated guess based on a few publicly available numbers. In 2003, the Boston Consulting Group estimated that the total holdings of cash deposits and listed securities

[4] Internal Revenue Service, The Tax Gap, www.irs.gov/pub/irs-utl/tax_gap_facts-figures (2005).
[5] Testimony of Treasury Assistant Secretary for Tax Policy Eric Solomon before Senate Finance Committee on Ways to Reduce the Tax Gap (April 18, 2007); Henry J. Aaron and Joel Slemrod (eds.), The Crisis in Tax Administration. Washington, DC: The Brookings Institution (2004).

by high net worth individuals in the world were $38 trillion, and that of these, $16.2 trillion were held by residents of North America. Out of these $16.2 trillion, "less than" 10 percent was held offshore (as compared with, for example, 20-30% offshore for Europe and 50-70% offshore for Latin America and the Middle East).[6]

If one translates this estimate into approximately $1.5 trillion held offshore by US residents, and if one assumes that the amount held offshore earns 10% annually, the international component of the tax gap would be the tax on $150 billion a year, or about $50 billion. This figure is in the mid range of estimates of the international tax gap in 2002 by former IRS Commissioner Charles O. Rossotti ($40 billion) and by IRS consultant Jack Blum ($70 billion).[7] As an order of magnitude, an estimate of $50 billion for the total international tax gap (for each tax year) appears congruent with the $3.2 billion actual recovery by the IRS from a single Cayman bank (for multiple tax years).

2. The Potential for Offshore Entities to Serve as a Vehicle for Circumventing U.S. Tax Laws.

U.S. Tax Law currently includes several provisions designed to prevent U.S. residents from using offshore entities to circumvent U.S. tax law. In particular, the anti-deferral rules (primarily Subpart F, IRC secs. 951-964, and the PFIC rules, IRC secs. 1291-1298) provide for current taxation of US shareholders on certain types of income (primarily passive income) earned through foreign corporations. However, it is unclear to what extent the IRS is successful in enforcing these rules. In particular, the PFIC rules apply to any US share ownership in a foreign corporation that earns primarily passive income. Since the US shareholder does not have to control the foreign corporation, it is difficult for the IRS to adequately monitor how many US citizens or residents own shares in a PFIC, especially in situations in which treaty information exchange is not available (e.g., when the PFIC is located in a tax haven and bank secrecy provisions apply).

For foreign trusts, U.S. tax law provides for current taxation (as "grantor trusts") of trusts with current U.S. beneficiaries (IRC sec. 679). However, as shown by the Wyly case, it may be possible to structure foreign trusts in a way that avoids this rule. If a foreign trust is regarded as unrelated to a U.S. settlor, it may in turn own shares in foreign corporations without triggering Subpart F or the PFIC rules (since the U.S. settlors do not own shares in the corporations directly or by attribution).

3. The Intersection between U.S. Tax Law and Offshore Trust Law

As the Wyly case indicates, foreign trust law in many tax haven jurisdictions (e.g., the Isle of Man) allows the appointment of trust "protectors" which have significant control over decisions of the trustees. This enables U.S. residents to set up foreign trusts that have no current U.S. beneficiaries (the current beneficiaries are foreign charities) and

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[6] Boston Consulting Group, Global Wealth Report, www.bcg.com/publications/PUBID=899 (2004). For consistent figures see also Merrill Lynch, World Wealth Report, www.ml.com/media/18252.pdf (2004).

[7] Martin A. Sullivan, US Citizens Hide Hundreds of Billions in Cayman Accounts, 103 Tax Notes 956 (2004).

thus avoid the application of IRC sec. 679. The U.S. residents then appoint friends or employees as protectors of the trust. The desired tax result is that the trusts are considered unrelated to the U.S. settlors and therefore may use their funds (directly or through controlled corporations in tax havens) in ways that benefit the U.S. settlors (such as loans, purchases of real property, etc.), without triggering any U.S. tax consequences. The settlors are in practice assured (because of their close relationship with the protectors) that the trusts will make no current distributions and that upon their death the assets will be distributed to contingent U.S. beneficiaries (typically their children).

4. The Effect of Foreign Jurisdiction Secrecy Rules on the Efficacy of Tax Law.

Foreign tax haven jurisdictions typically have strict bank secrecy laws that prohibit release of depositor information. The US currently has bilateral information exchange agreements with several tax haven jurisdictions. However, most of the existing agreements are restricted only to criminal matters. Criminal matters are a very small part of overall tax collections, and pose very difficult evidentiary issues in the international context. Moreover, the agreements sometimes require the subject matter to be criminal in both the US and the tax haven, which would never be the case for pure tax evasion. In addition, they typically require the US to make a specific request relating to particular individuals, and they also typically do not override bank secrecy provisions in tax haven laws. These limitations mean that existing tax information exchange agreements, while helpful and important in some cases, are of limited value in closing the overall international tax gap.

For example, as the Wyly case shows, a U.S. resident may transfer funds to a foreign nongrantor trust with an unrelated trustee and a formally unrelated protector. The trust is located in the Isle of Man, which is covered by the U.S./U.K. tax treaty and thus subject to broad exchange of information. However, loans to the U.S. settlor from the trust can be made via a Cayman Islands conduit. As a result, the interest paid back to the conduit is not covered by effective information exchange and the U.S. payor has no way of knowing who it the ultimate beneficial owner of the funds. Thus, the IRS is unlikely to find out about this arrangement, which it could challenge (if it knew about it) as a disguised distribution from the trust (which would also render the trust a grantor trusts whose income is taxable to the U.S. settlor/beneficiary under IRC sec. 679).

5. The Adequacy of Reporting and Withholding Rules.

Under current U.S. rules, withholding is required (under IRC secs. 1441-1442) if the U.S. payor knows (or has reason to know) that the payment is subject to withholding. Similar rules apply to information reporting. However, if a U.S. payor receives a Form W-8BEN from a payee certifying that it is a foreign corporation, it may not withhold or submit Form 1099 (information report) to the IRS, even if it knows that the foreign corporation is de facto controlled by a U.S. person.

6. Recommendations to Address Offshore Tax Abuses.

a. Increased IRS enforcement.

It is well known that the IRS has in recent years faced an increased workload with diminished resources. From 1992 to 2001, IRS "full time equivalent" staff decreased by about 20,000 positions. This trend has been reversed more recently, but as former Commissioner Rossotti has written, the increase is not enough to keep up with the increase in complexity of the tax system and the size of the economy.[8] Congress has repeatedly in recent years increased the complexity of our tax law without adding funding to the IRS. Bipartisan groups like the Committee for Economic Development have recently called for more resources and political support to be given to the IRS.[9]

I believe the IRS should dedicate more resources to attempting to close the international tax gap. In particular, the IRS should give more priority, and be given more resources, to audit compliance with existing laws requiring US taxpayers to report ownership of foreign bank accounts and stock in foreign corporations. Moreover, the IRS should focus on auditing businesses relying on e-commerce in overseas transactions, which are particularly susceptible to abuse. If the Mathewson case is any indication, such increased attention may generate many dollars in tax revenue for every dollar spent on enforcement.[10]

b. Bilateral information exchange.

The Organization for Economic Cooperation and Development (OECD) has recently modified Article 26 (Exchange of Information) in its model income tax treaty, and has adopted a model Tax Information Exchange Agreement (TIEA), both of which are intended address the problems with current exchange of information agreements discussed above. Under the new Article 26 and model TIEA, exchange of information is automatic (rather than just by request), relates to civil as well as criminal tax liabilities, does not require "dual criminality" or suspicion of a crime other than tax evasion, and overrides bank secrecy provisions in domestic laws. I believe the US should renegotiate its existing tax treaties and exchange of information agreements to incorporate all the changes made by the OECD in its model treaty and TIEA.[11]

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[8] Charles O. Rossotti, Letter to Senators Charles Grassley and Max Baucus (March 22, 2004).

[9] Committee for Economic Development, A New Tax Framework: A Blueprint for Averting a Fiscal Crisis (2005).

[10] For example, transfers by US banks to foreign banks, such as occurred in the Mathewson case, generate bank records which can be audited by the IRS. Similar records may not exist for transfers from foreign banks or non-bank networks (e.g., the *hawala* trust-based network). These types of transfers are also used by terrorists and it would be advisable to use the well developed expertise of the IRS to combat both tax evasion and terrorist financing activities. Similarly, more use can be made of credit card records and other data mining techniques to establish which US taxpayers have foreign accounts that they have not disclosed (as required by current law) on their tax return.

[11] The U.S, has negotiated a large number of TIEAs, including TIEAs with tax havens such as the Netherlands Antilles, the British Virgin Islands and the Cayman Islands, but they fall short of the OECD model TIEA.

I will discuss below the steps I believe are needed to induce tax haven jurisdictions to negotiate such agreements with the US. For other jurisdictions that are not tax havens, the inducement is the information they can obtain from the US on their own residents. To ensure such information is available, the Treasury should finalize regulations proposed by the Clinton administration that require US banks and financial institutions to collect information on interest payments made to overseas jurisdictions when the interest itself is exempt from withholding under the portfolio interest exemption.[12] The Treasury has recently proposed to limit such regulations to 16 designated countries, but as Blum writes, there is no legitimate privacy or other reason to impose such limitations. The banks should collect all the information, and the Treasury should use its existing authority not to exchange it in situations in which it might be misused by non-democratic foreign governments (e.g., when freedom fighters use US bank accounts).

c. Cooperation with OECD.

Current Treasury policy is to focus on bilateral agreements to obtain needed information exchange cooperation. However, the OECD has been at the forefront of persuading tax haven jurisdictions to cooperate with information exchange, and is an organization that the US had traditionally played a leading role in and whose work benefits both governments and the private sector. The US should cooperate with the OECD and other appropriate international and regional organizations in their efforts to improve information exchange and in particular to persuade the tax havens of the world to enter into bilateral information exchange agreements based on the OECD model. The OECD has made significant progress since it began focusing on this issue in 1998, but more needs to be done, both on persuading laggard jurisdictions to cooperate and on increasing the level of information exchange available from cooperating jurisdictions.

d. Incentives to tax havens.

The US should adopt a carrot and stick approach to tax havens in order to provide incentives to cooperate with information exchange. In particular, the US and other donor countries, multilateral and regional organizations should increase aid of a type which would enable those countries to shift their economies from reliance on the offshore sector to other sources of income.

It should be noted that the common perception that the benefits of being a tax haven flow primarily to residents of the tax haven is misguided. The financial benefits of tax haven operations, while funding a minimal level of government services, often flow primarily to professionals providing banking and legal services, many of whom (like Mr. Mathewson) live in rich countries, rather than to the often needy residents of the tax havens. Thus, with some transitional support, it is likely that most of the tax havens would see the welfare of their own residents improve as they wean themselves from dependence on the offshore sector.

e. Sanctions on non-cooperating tax havens.

[12] Blum, supra.

In the case of non-cooperating tax havens, I support the US Treasury using its existing authority to prospectively deny the benefits of the portfolio interest exemption to countries that do not provide adequate exchange of information.[13] This step is necessary, in my opinion, to prevent non-cooperating tax havens from aiding US residents to evade US income tax.

A principal problem of dealing with tax havens is that if even a few of them do not cooperate with information exchange, tax evaders are likely to shift their funds there from cooperating jurisdictions, thereby rewarding the non-cooperating ones and deterring others from cooperation. Thus, some jurisdictions have advertised their refusal to cooperate with the OECD efforts.

However, if the political will existed, the tax haven problem could easily be resolved by the rich countries through their own action. The key observation here is that funds cannot remain in tax havens and be productive; they must be reinvested into the rich and stable economies in the world (which is why some laundered funds that need to remain in the havens earn a negative interest rate). If the rich countries could agree, they could eliminate the tax havens' harmful activities overnight by, for example, refusing to allow deductions for payments to designated non-cooperating tax havens or restricting the ability of financial institutions to provide services with respect to tax haven operations.

The EU and Japan have both committed themselves to tax their residents on foreign source interest income. The EU Savings Directive, in particular, requires all EU members to cooperate in exchange of information or impose a withholding tax on interest paid to EU residents.[14] Both the EU and Japan would like to extend this treatment to income from the US. Thus, this would seem an appropriate moment to cooperate with other OECD member countries by imposing a withholding tax on payments to tax havens that cannot be induced to cooperate in exchange of information, without triggering a flow of capital out of the US.

f. Changes to IRC sec. 679.

Under IRS sec. 679, foreign nongrantor trusts are treated as such, rather than as grantor trusts, because they do not have a current US beneficiary. They may, however, have contingent US beneficiaries, who will become current beneficiaries after the U.S. settlor's death. The IRS should consider amending IRC sec. 679 to treat as grantor trusts all foreign trusts with current or future US beneficiaries, because the relationship between the trust protectors and the settlor makes it highly likely that all trust income that is not currently used to benefit the settlor will in fact be distributed to the contingent beneficiaries, rather than to the current non-US beneficiaries.

[13] See IRC section 871(h)(6).
[14] EU Directive 2003/48/EC on Taxation of Savings (2003).

g. Distributions from Foreign Trusts.

Foreign nongrantor trusts may use their assets in various ways that directly benefit the settlors, even though they are not current beneficiaries. For example, they could (directly or through foreign corporations they control) purchase US real estate, jewelry and art collectibles for the settlors, make US investments as directed by the settlors, and lend the settlors money. These transactions may in fact constitute trust distributions under current law, in which case the trusts become grantor trusts under IRC sec. 679 since they have current US beneficiaries. However, to the extent this is not the case, the law should be changed to prevent such direct benefits from inuring to US settlors without any US tax consequences.

h. Definition of Control under IRS sec. 679.

The IRS should consider treating foreign trusts as grantor trusts when they are in fact controlled by protectors who are close collaborators and employees of the settlors. In assessing whether a foreign trust is related to the settlor, a flexible standard of control (such as that used under IRC sec. 482 to test whether parties are related) should be used, rather than a bright line rule that inevitably has loopholes built into it. Similar rules can be applied for purposes of applying Subpart F and the PFIC rules to foreign corporations.[15]

i. Withholding and Information Reporting.

The IRS should revise its regulations (under IRC secs. 1441-1442) to provide that US payors may not accept W8-BEN as evidence of foreign status, and must issue Form 1099s, when they know (or have reason to know) that payments to foreign corporations in fact inure to the benefit of US persons.

7. Conclusion.

I believe that the international tax gap is a significant component of the overall tax gap and may in fact be larger than some components that have attracted more public and IRS attention, like corporate tax shelters or EITC fraud. I also believe that in order to maintain any kind of tax system, the US public needs to be confident that current law can be enforced and that tax evasion will be caught and prosecuted. Thus, I hope that bipartisan support can be found for taking the steps identified above to close the international tax gap. These steps offer the potential of raising additional revenue without raising taxes, and of leveling the playing field between ordinary Americans who pay their fair share of taxes and others who do not.

[15] For an example of a court applying such a standard for Subpart F purposes see Garlock, Inc. v. Comm'r, 489 F.2d 197 (2nd Cir. 1973).