July 24, 2009

Congressional Briefing

Tax Evasion and Incorporation Transparency: Show U.S. the Money

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List of Speakers

Raymond Baker is the Director of Global Financial Integrity (GFI) and author of *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free Market System*. GFI promotes national and multilateral policies, safeguards, and agreements aimed at curtailing the cross-border flow of illegal money, thereby enhancing global development and security. Primary areas of activity include cross border taxation issues, international money laundering, international corporate transparency, country by country reporting, and trade mispricing. For more information on any of these or related topics, please contact any of the GFI staff on 202-293-0740, or Heather Lowe at hlowe@gfip.org or Monique Danziger at mdanziger@gfip.org or consult their websites at www.gfip.org and www.financialtaskforce.org.

Jack Blum is the Chairman, and **Sarah Lewis** is the Executive Director, of Tax Justice Network USA. Tax Justice Network USA works to map, analyze and explain the role of taxation and the harmful impacts of tax evasion, tax avoidance and tax havens in order to encourage reform at the global and national levels. Primary areas of activity include transparency in international finance, bank secrecy, tax distortion, evasion and avoidance. For more information on these or related topics, please contact Sarah Lewis at sarah.lewis@taxjusticenetworkusa.org or consult their website at www.taxjusticenetworkusa.org.

Bob McIntyre is the Director of Citizens for Tax Justice (CTJ). CTJ is a research and advocacy organization focusing on federal, state and local tax policies and their impact upon our nation. CTJ promotes fair taxes for middle and low-income families, requiring the wealthy to pay their fair share, closing corporate tax loopholes, adequately funding important government services, reducing the federal debt, and taxation that minimizes distortion of economic markets. For more information on any of these or related topics, please contact Steve Wamhoff on 202-299-1066 or swamhoff@ctj.org or consult their website at www.ctj.org.

Summary of Remarks by Raymond Baker, Global Financial Integrity

There are three bills before Congress at the present time that collectively can improve transparency and in the process improve tax collection: (1) The Stop Tax Haven Abuse Act; (2) the draft bill from Senator Baucus; and (3) The Incorporation Transparency and Law Enforcement Act. The UBS case is an excellent vehicle to illustrate the application of these bills.

In the current UBS case, UBS has already admitted to committing more than one criminal offense, pleading guilty to the criminal charges and being fined $780 million under a deferred prosecution agreement. UBS came onto U.S. soil and did the following: (1) offered tax evasion services to U.S. persons on thousands of occasions; (2) formed offshore non-U.S. companies for investors; (3) transferred U.S. investors' assets into these non-U.S. companies; (4) made the investors the beneficial owners of these supposedly non-U.S. companies; (5) also opened securities accounts at UBS's U.S. offices without registering with the SEC; and (6) engaged in an aggressive cover-up operation to conceal these activities and advised U.S. persons on participating in these cover-up efforts.

UBS did all this despite the fact that it has an agreement with the U.S. government as a Qualified Intermediary under the QI program. The QI program obligates cooperating banks to: (1) know the beneficial owners of accounts of U.S. persons; (2) report tax information with respect to the beneficial owners or withhold U.S. taxes on accounts that hold U.S. securities or accounts where securities transactions are directed from the U.S; and (3) report information to the U.S. government on income earned on such accounts.

This brings us to the current civil case in Miami, a John Doe summons seeking names on 52,000 accounts believed to be held by Americans at UBS. Negotiations involving Justice, Treasury, State, UBS and the Swiss government are underway in order to avoid court judgment. The Swiss argument that to disgorge the names would be a violation of Swiss law is unpersuasive. When you step onto U.S. soil and repeatedly commit a criminal offense, in my judgment you've lost the right to hide behind your sovereignty.

I hope the U.S. hangs tough and demands and gets the names. If it doesn't get them, then I hope we will reach back to the deferred prosecution agreement, deem this failure to be a material breach of the agreement, and move forward with the criminal case against UBS.

Now what do we have on the legislative table that would have curtailed this tax evasion scheme had laws been in place? The Stop Tax Haven Abuse Act is particularly relevant, much of which I hope gets incorporated into Senator Baucus's bill or other legislation. Included are provisions such as the following: (1) all foreign financial institutions that are QI's must inform the U.S. of accounts held beneficially by U.S. persons; (2) U.S. persons are presumed to be beneficial owners if they transfer money to or receive money or property from such a foreign entity; (3) accounts in tax haven jurisdictions are presumed to have compliance issues in John Doe summonses; (4) possession of legal and accounting opinions on compliance with U.S. law does not afford protection to U.S. beneficial owners; (5) the IRS's time for completing an audit where accounts are in tax havens is extended from three to six years.

The Role of Private Bankers In Tax Havens

UBS and Diamonds in a Toothpaste Tube:
Inside the Culture of Private Banking, and the Mind of the Private Banker

The public disclosure in the UBS case has exposed how the culture of the private banking world operates through devious subterfuge. Why else would Bradley Birkenfeld, ex-UBS Private Banker, take on the risk and illegality of buying diamonds with secret Swiss funds and smuggling them hidden in a toothpaste tube through U.S. Customs?

As a client advisor, I traveled to various countries, claiming purpose-of-visit as "pleasure," not "business," on my visa, passing through customs with an adrenalin-fuelled optimism that a random search would not reveal my suitcase stuffed full of elegant business suits and presentations on the advantages of offshore trusts. The routines of my business generated less-than-routine attention: I was once visited by the supposed representative of the head of state of somewhere far from being renowned as a pillar of democracy and human rights, attempting to persuade me to take a private plane there for questioning on hidden funds. Despite sometimes glaring dangers, I went the extra mile for the clients' wishes to bring in their money.

Advancing in such a culture is not unlike absorbing a sort of brainwashing; the mindset is that the client is god. In effect, I was told*: "We serve our clients and protect our clients; we think as private bankers*." The pressure to bring in the $millions pervades the industry, compelling bankers to take risks others would never dream of, all with the belief that they can manage it and that they are in some way invincible.

UBS Swiss bankers with clients in the "Americas" were each given a target of CHF60million (US$56million) net new money to bring in for the year 2007. Consider that kind of target extended through all the private banking operations of banks and trust companies worldwide. The pressure on client advisors from on-high is immense. As a friend still in that business told me, "you know what it's like, good returns are never enough".

Private banking is like a rock sunk into a bowl of jello: you press on one part, and you see an expansion in another direction. As UBS pulls back from taking on US clients, it is expanding its marketing push in Latin America and other regions, in developing nations in particular. As are other private banking operations. The scrutiny on UBS as a larger global institution can even provide a market advantage for the under-the-radar niche players.

Not only business expansion occurs, but the status quo nature of the business is maintained, even with obstacles placed in the way. The devious workaround is part of the private banking mindset. I experienced, first hand, the offshore financial center attitude to the onset of the Qualified Intermediary Program: sell the US Securities but if the client still wants to hold onto such, then give them mutual funds instead, and of course the biggie, put the client's assets in a sham company.

Sarah Lewis, Executive Director, Tax Justice Network USA, July 22, 2009

The Gateway from Tax Cheating to Money Laundering, Terrorist Financing and other Illicit Capital Flows

The system of secrecy jurisdictions, combined with layering of anonymous trusts and sham companies, provides a very convenient route for channeling illicit funds. Within a "tax haven" there is a general assumption that the client is hiding money in order to evade taxes, which often precludes deeper inquiry into the source and purpose of funds unless a massive red flag is waving hard.

While a blind eye is often turned in order to keep generating this lucrative business, there is also active complicity among bankers in money-laundering. This happens with a mindset that assisting a certain elite, without question, is the norm. There is an intertwining of social, business, and political circles where mutual interests are honored and secrets closely guarded.

In the movie "The International" (a Hollywood thriller starring Clive Owen and based on the true story of BCCI), the head of state of a corrupt and poor nation visits the bank's slick and very visible headquarters in Luxembourg. I observed how the Hollywood portrayal was incorrect - corrupt heads of state do not walk through the foyer of the bank. In fact, many private banking clients will never visit the bank where their account is held. The deals are more likely to be conducted, sometimes via middlemen, through such social events as select dinners and parties, big game hunting, the opera or polo games.

The Momentum for Effective Change

The client of Bradley Birkenfeld whose diamonds were smuggled was placing an immense measure of trust in their banker, the person paid to cultivate a relationship with them. The bonding of mutual interests holds the banking secrecy world intact, and huge cracks have now emerged. The UBS exposure and publicity on the collapse of Madoff and Stanford and various other Ponzi Schemes, whistleblowing by Swiss and Liechtenstein bankers Rudolph Elmer and Heinrich Kieber, and revelations of the former UBS and Chase private banker Hernán E. Arbizu who illegally took $millions from his clients' accounts, have generated this momentum.

There is, concurrently, a sea change in political will. The U.S. has the opportunity to add force to the international momentum for effective solutions. In addition to legislative measures directed specifically at combating tax evasion and avoidance, the issue of transparency is paramount.

Cayman, Bahamas, BVI and other tax havens claim higher standards of transparency than the USA, and cite Delaware, Nevada and Wyoming as being non-compliant with international standards of requiring beneficial ownership information. Enacting S569, the Incorporation Transparency and Law Enforcement Assistance Act, would ensure that the United States meets its commitment to comply with FATF anti-money laundering standards, and would restore a critical measure of credibility in its international stature.

Multinational corporate tax abuses, and proposed solutions
Robert S. McIntyre, Citizens for Tax Justice, July 24, 2009

Right now, big multinational corporations are making a mockery of our corporate income tax by manipulating our international tax rules.

The root cause of this problem is that the U.S. does not tax corporations on the profits they earn abroad, at least not until they bring those profits back to the U.S.

Repeal of "deferral" would vastly simplify the taxation of multinational corporations and curb a wide array of abuses. The consequences of deferral are terrible.

First, in some cases, we are actually paying corporations to move plants and jobs abroad.

Second, we are also paying corporations when they make their business *appear* to take place abroad, even if they don't *actually* move plants and jobs abroad. By using investment and transactions that only exist on paper (meaning no products or people actually leave the U.S.) they shift their profits (on paper) to countries that don't tax them. As a result, a big chunk of profits earned in the U.S. go completely untaxed.

A recent GAO report found that 83 of the 100 largest publicly traded U.S. corporation reported having subsidiaries in these countries that don't tax corporate profits. The giant drug company Abbott Laboratories reported 36 such tax-haven subsidiaries. ExxonMobil has 32. The banking giant Citigroup has 427!

A recent report from the Congressional Research Services found that corporations' shifting profits offshore costs the U.S. Treasury as much as $60 billion a year — lost revenues that have to be made up by average American taxpayers.

Conservatives often complain that the U.S. has a high corporate tax rate compared to other countries, but the *effective* tax rate is far lower because of these practices and other loopholes in our tax system.

As a result, U.S. corporate income taxes plummeted from almost a third of all non-Social-Security federal tax revenues in the 1960s to only a sixth of total taxes during the George W. Bush administration. U.S. corporate income taxes used to be among the highest in the world as a share of the economy. But now they rank near the bottom among all developed countries.

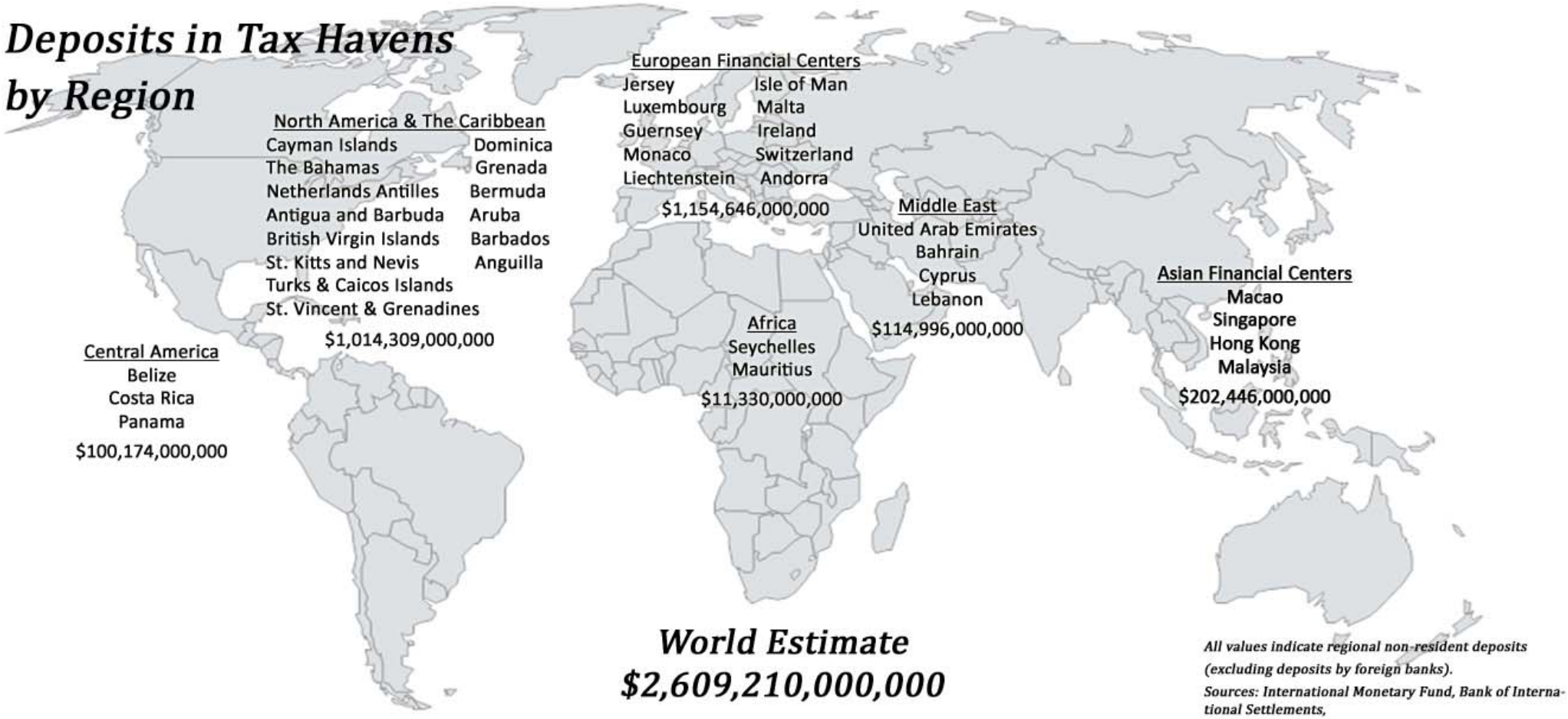
Although President Obama implied during his campaign that he might repeal deferral, he backed away once he took office. But the President does have some useful proposals to protect the U.S. corporate tax base by curbing some of the corporate tax abuses that have helped lead to this sharp decline in corporate tax payments.

He would limit U.S. tax deductions for the costs of earning overseas profits. If corporations get to defer the U.S. taxes on profits they earn abroad, then surely they should also defer taking deductions for expenses related to that offshore income. Our current rules actually provide companies with a negative tax rate on their foreign earnings!

The President also would narrow an egregious loophole that makes it far too easy for companies to artificially shift U.S. profits to tax havens. The President accurately called this "a loophole that lets subsidiaries of some of our largest companies tell the IRS that they're paying taxes abroad, tell foreign governments that they're paying taxes elsewhere — and avoid paying taxes anywhere."

The President's proposals are not particularly harsh. If enacted, they would increase corporate tax receipts by only 5 percent. But they would be a step in the right direction toward leveling the playing field between U.S. and foreign investments and curbing egregious corporate tax sheltering.

Deposits in Tax Havens by Region

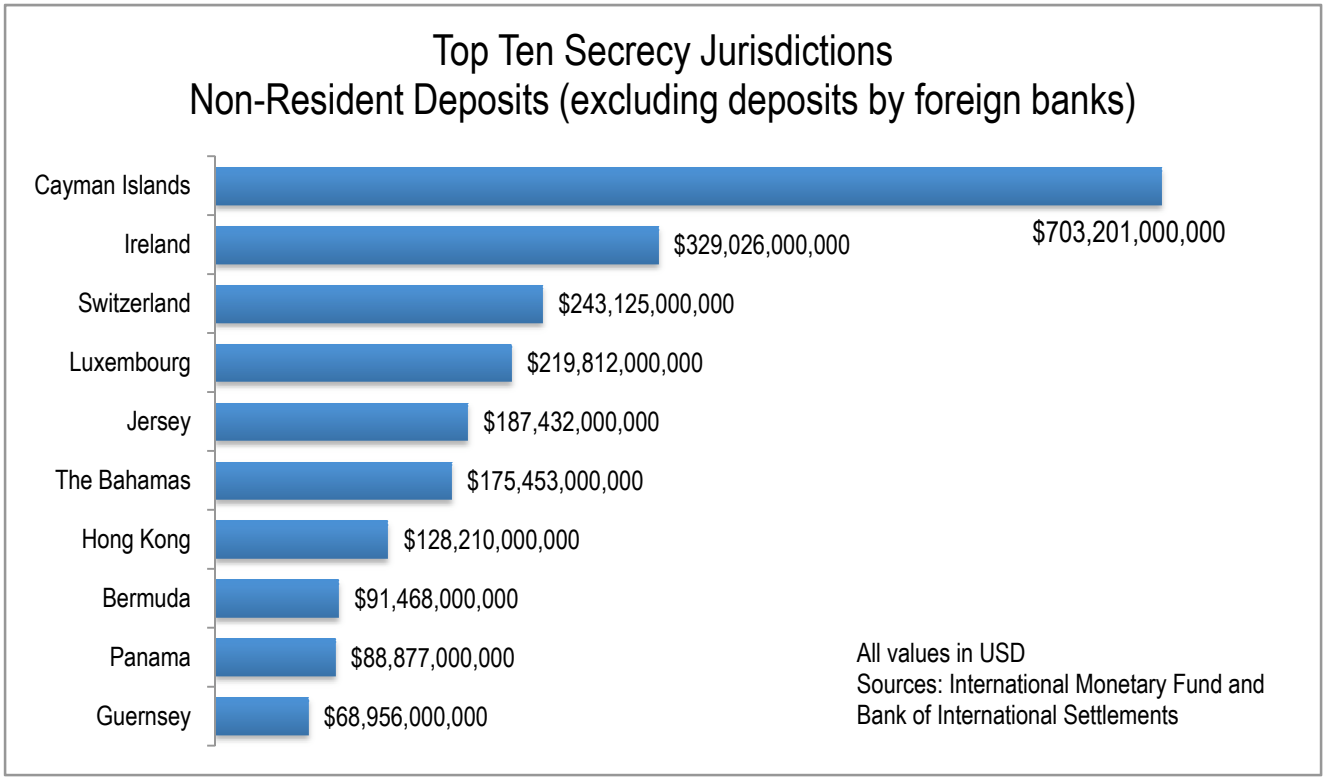


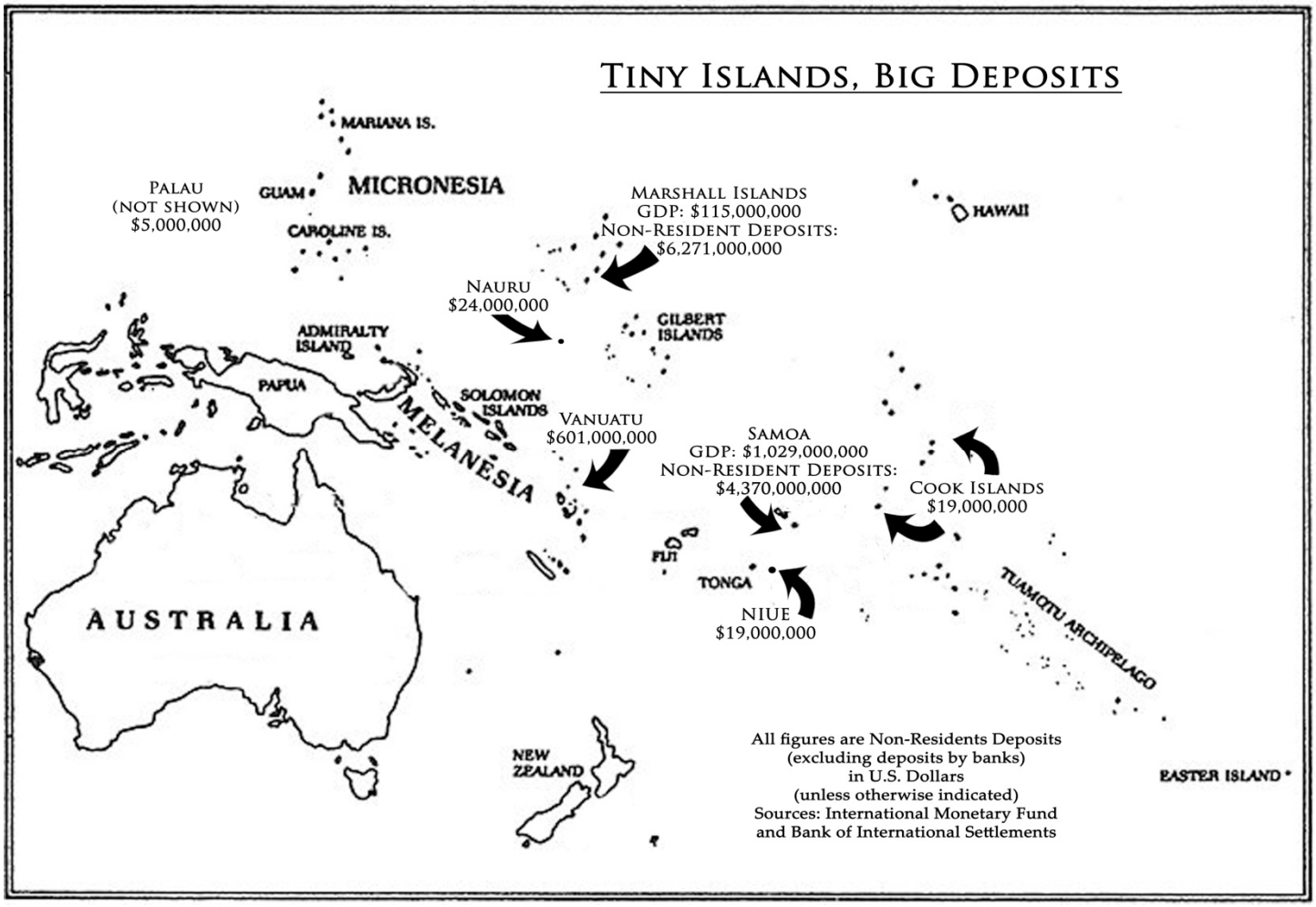
World Estimate
$2,609,210,000,000

All values indicate regional non-resident deposits (excluding deposits by foreign banks).

Sources: International Monetary Fund, Bank of International Settlements,

Deposits in Tax Havens

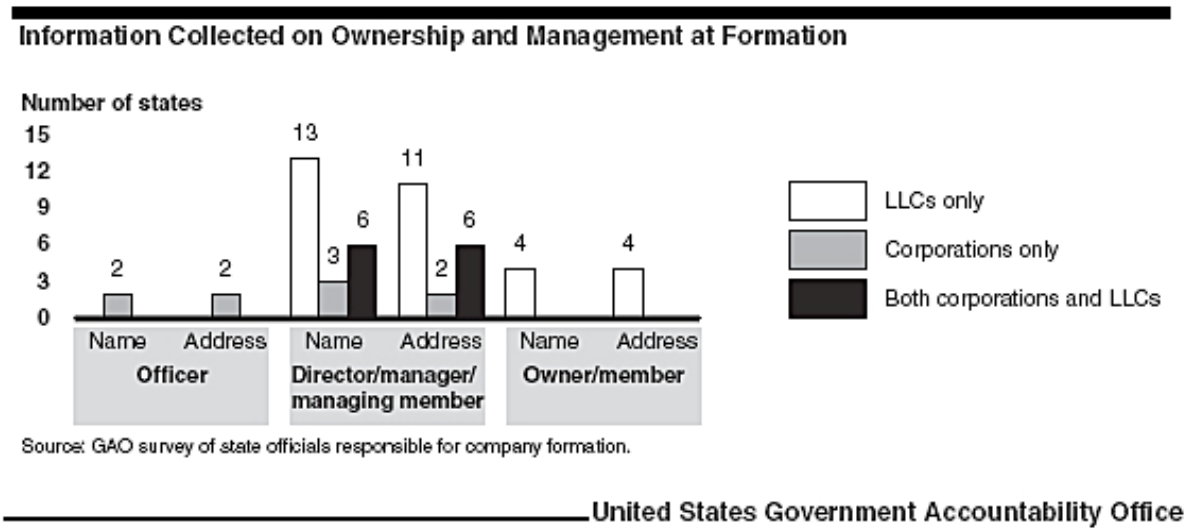




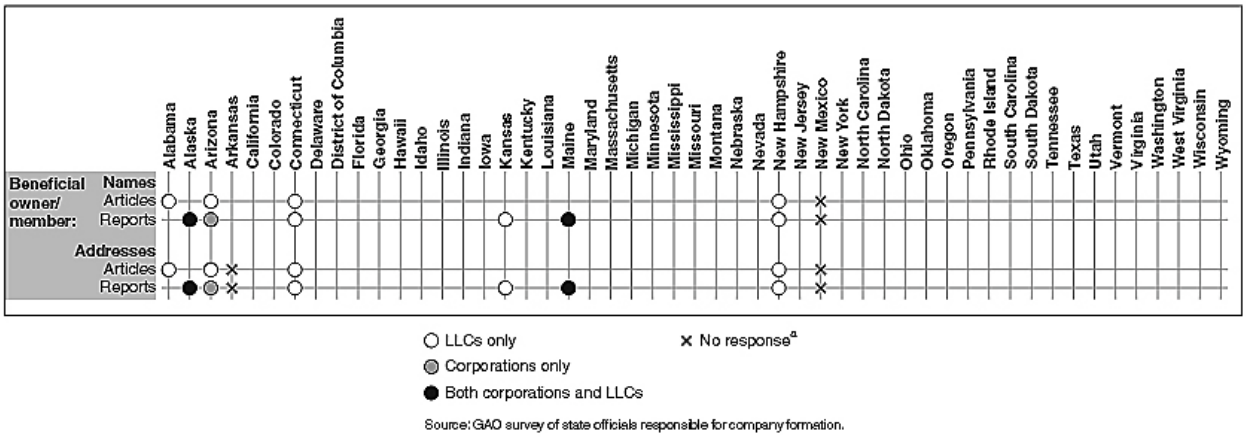
Beneficial Ownership Requirements in U.S. Company Formation

Approximately two million corporations and limited liability companies (LLCs) are formed within the United States (U.S.) each year. Most states do not require beneficial ownership information, even at the first level, at the time of the company's formation or in periodic reports. Law enforcement agencies have voiced concern that investigations within the U.S. and in other countries are hindered due to an inability to determine the beneficial ownership of companies and suspect that individuals have used this financial opacity to facilitate illicit activity involving billions of dollars.

In July 2006, the Financial Action Task Force on Money Laundering, which is the leading international organization combating money laundering, issued a report criticizing the United States for failing to comply with a FATF standard requiring beneficial ownership information to be obtained and urging the United States to correct this deficiency by July 2008. **In response, the United States has repeatedly urged the States to strengthen their incorporation practices by obtaining beneficial ownership information for the corporations and LLCs formed under their laws. The States, however, have not changed their incorporation practices.**



Beneficial Ownership Disclosure Requirements by State



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Addressing Tax Havens and Offshore Tax Evasion

Legislation Pending in the 111th Congress

The following proposals to address to offshore tax havens have been offered.

The Stop Tax Haven Abuse Act (Levin-Doggett Bill)

On March 2, Sen. Carl Levin (D-MI) and four co-sponsors introduced S. 506, the Stop Tax Haven Abuse Act (the "Tax Haven Act") which would enact important new rules to deter offshore transactions designed to avoid U.S. income tax. Rep. Doggett introduced the same measure in the House the next day, with 59 co-sponsors (H.R. 1265).

"Our bill provides powerful tools to end offshore tax haven and tax shelter abuses [which] contribute nearly $100 billion to the…annual tax gap," Levin said. "With the financial crisis facing our country today and the long list of expenses we're incurring to try to end that crisis, it is past time for taxes owing to the people's Treasury to be collected. And it is long past time for Congress to stop tax cheats from shifting their taxes onto the shoulders of honest Americans.

Sen. Levin has introduced similar legislation before. This bill adds three new provisions addressing businesses that incorporate in tax havens, tax withholding on U.S. stock dividends, and expanded reporting for a passive foreign investment corporation (PFIC).

Requiring Economic Substance

Codify the Economic Substance Doctrine (Sec. 401-403 of the bill)
The most important provision of the Tax Haven Act is actually the very last section of the bill. The Tax Haven Act would put the "economic substance doctrine" in the Internal Revenue Code. The doctrine has been developed over the years by courts to disallow losses or deductions that have no economic substance apart from their tax benefits. Unfortunately, different courts have developed different interpretations of the rule and courts do not apply the doctrine uniformly. The bill would put the economic substance doctrine into the tax law, thereby disallowing losses, deductions, or credits arising from "tax avoidance transactions," for example, where the present value of the tax savings far exceeds the present value of the pre-tax profits.

Tax avoidance transactions rely upon the interaction of highly technical provisions of the Internal Revenue Code to produce a tax result not contemplated by Congress. In developing the tax laws, Congress cannot possibly foresee all the ways the rules might be abused. But tax lawyers figure it out for their wealthy clients—at fees upwards of $500 per hour. If the economic substance doctrine is codified, taxpayers would be required to show that a transaction had a substantial non-tax purpose and had real economic consequences apart from the federal tax benefits.

Of all the provisions in the bill, this one is the most important. It would give the IRS an enforcement tool that would cover any tax avoidance scheme, whether or not the other language in the bill specifically prohibited it. The IRS would be able to challenge the next abusive tax shelters that tax professionals are surely already dreaming up.

Deterring the Use of Tax Havens for Tax Evasion

Create the Initial Tax Haven List and Create Rebuttable Evidentiary Presumptions (Sec. 101 of the bill)
Tax havens, which the bill refers to as "offshore secrecy jurisdictions" are foreign jurisdictions with secrecy laws or practices that unreasonably restrict the ability of the U.S. government to get information necessary to enforce its tax and securities laws. An offshore jurisdiction that has an effective information exchange program with U.S. law enforcement would not be a tax haven under the bill. The bill includes an initial list of tax havens as follows:

Anguilla	Isle of Man
Antigua and Barbuda	Jersey
Aruba	Latvia
Bahamas	Liechtenstein
Barbados	Luxembourg
Belize	Malta
Bermuda	Nauru
British Virgin Islands	Netherlands Antilles
Cayman Islands	Panama
Cook Islands	Samoa
Costa Rica	St. Kitts and Nevis
Cyprus	St. Lucia
Dominica	St. Vincent and the Grenadines
Gibraltar	Singapore
Grenada	Switzerland
Guernsey/Sark/Alderney	Turks and Caicos
Hong Kong	Vanuatu

The bill gives the Secretary of the Treasury the power to add (and delete) jurisdictions from the list if they meet (or fail to meet) the definitions in the law.

In the case of transactions, accounts, or entities in "tax havens," as defined in the bill, the Tax Haven Act would create three presumptions in favor of the IRS in a civil (not criminal) tax enforcement proceeding. When one of the opponents in a legal dispute gets the benefit of a presumption, it means that they do not have to prove that element of the case. It is presumed to be a fact and the other side has to disprove it. This is a big advantage to the side with the presumption. It makes winning the case a lot easier. In his statement introducing the act, Sen. Levin stated that the presumptions are intended to eliminate the unfair advantage provided by offshore secrecy laws.

The first presumption is that a U.S. taxpayer who "formed, transferred assets to, was a beneficiary of, or received money or property" from an offshore entity is in control of that entity. For example, this rule would prevent U.S. taxpayers from claiming that the trustee (usually a foreign person or entity) of their offshore trust is not permitted by the trust document to send money back to the U.S. to pay creditors (including the IRS). The second presumption is that funds or other property received from offshore are taxable income, and funds or other property transferred

offshore have not yet been taxed. The taxpayer will have to prove that the funds aren't taxable income, or else pay the tax. The third presumption is that a financial account in a foreign country controlled by a U.S. taxpayer has a large enough balance ($10,000) that it must be reported to the IRS. If the taxpayer does not report it, the U.S. person would be subject to penalties. The bill also provides two evidentiary presumptions to enforce U.S. securities laws.

Taxpayers could provide evidence that the presumptions were not accurate, for example, that funds received from offshore were a gift. But if the taxpayer wants to introduce evidence from a foreign person (like the trustee), an affidavit would not be enough. The foreign person would have to appear in the U.S. proceeding and be subject to cross examination.

Authorize Special Measures Where U.S. Tax Enforcement is Impeded (Sec. 102)
The Tax Haven Act would add to existing Treasury authority to impose special requirements on U.S. financial institutions. Under the Patriot Act, Treasury can impose a range of requirements on U.S. financial institutions dealing with certain entities—from requiring greater information reporting to prohibiting opening accounts. The Patriot Act's provisions are aimed at combating money laundering. The Levin-Doggett bill would extend that authority to allow Treasury to use those tools against foreign jurisdictions or financial institutions that are "impeding U.S. tax enforcement." It would add an additional tool to the Treasury's arsenal: it would allow Treasury to prohibit U.S. financial institutions from accepting credit card transactions involving a designated foreign jurisdiction or financial institution. This provision would greatly inhibit the ability of U.S. residents to access their hidden offshore funds.

Deny Tax Benefits for Foreign Corporations Managed and Controlled in the U.S. (Sec. 103)
This newly-added provision in the Tax Haven Act would treat foreign corporations as U.S. domestic corporations for tax purposes if 1) the corporation is publicly traded or has aggregate gross assets of $50 million or more, AND 2) its management and control occurs primarily in the U.S. The bill would not override the current-law rules for taxing U.S. multinationals with foreign subsidiaries. This provision is similar to the corporate inversion rules adopted in the American Jobs Creation Act of 2005, but adds entities which are incorporated directly in another country.

This provision of the bill is particularly aimed at hedge funds and investment management businesses that are structured as foreign entities, although their key decision-makers live and work in the U.S. As Sen. Levin put it in his statement, "It is unacceptable that such companies utilize U.S. offices, personnel, laws, and markets to make their money, but then stiff Uncle Sam and offload their tax burden onto competitors [we would say all taxpayers] who play by the rules."

Extend Time for Offshore Audits (Sec. 104)
Generally, after you file a tax return, the IRS has three years to complete an audit and assess any additional tax. Because the bank secrecy laws slow down or completely obstruct efforts to obtain information, the bill gives the IRS an additional three years on transactions involving a tax haven. The bill does not change the current-law rule that the IRS has unlimited time to audit in cases involving actual fraud.
10

Increase Disclosure of Offshore Accounts and Entities (Sec. 105)
The success of offshore tax abuses is dependent on secrecy. The bill would create two new disclosure rules that would put the IRS on notice that the taxpayer is using offshore entities.

The first new disclosure rule would expand income reporting responsibilities of financial institutions. Under current anti-money laundering laws, U.S. financial institutions are supposed to know who really owns an account held by an offshore entity. This information is designed to keep the U.S. financial system from being misused by terrorists, money launderers, and other criminals. Also under current law, a financial institution must file Forms 1099 with the IRS reporting income such as dividends and stock sales earned on an account, *unless the account is owned by a foreign entity not subject to U.S. tax law*. The Tax Haven Act would require that U.S. financial institutions file Forms 1099 with the IRS on an account owned by a foreign entity, if the financial institution has knowledge that a U.S. person is the beneficial owner of the foreign entity. This rule would apply to both financial institutions located in the U.S. and foreign financial institutions located outside the U.S. that are voluntary participants in the Qualified Intermediary Program (where they have agreed to provide the IRS information about certain accounts).

The second new disclosure rule would require U.S. financial institutions to report to the IRS a transaction that directly or indirectly opens a foreign account or establishes a foreign entity, such as a trust or corporation, for a U.S. customer. Under existing law, the U.S. customer is already obligated to report that information to the IRS, but many taxpayers do not, relying on the bank secrecy laws to keep their accounts hidden. The third-party obligation to report will make it much more likely that the IRS will have notice of those transactions and be able to investigate them.

Close Foreign Trust Loopholes (Sec. 106)
Many U.S. taxpayers exercise control over a (purportedly independent) foreign trust by using a trust “protector” or “enforcer” to pass instructions to the (purportedly independent) foreign trustee. The bill would provide that, for tax purposes, the person who set up the trust (the grantor) would be deemed to hold any powers held by a trust protector.

Under previous changes to the tax law, foreign trusts are often disregarded and the trust income is taxed to the grantor when it is earned, rather than being allowed to accumulate tax-free. But the current law provision only applies when the foreign trust has a *named* U.S. beneficiary. U.S. taxpayers are avoiding the grantor trust provisions by making sure there is not a *named* U.S. beneficiary, although the trustee has the power to loan trust assets (like jewelry, artwork, or real estate) to

U.S. beneficiaries, or the trustee has been informed (outside of the trust document) that the trust's assets will go to U.S. beneficiaries after the grantor's death. The bill would close this loophole by providing that: 1) any U.S. person actually benefiting from a foreign trust is treated as a trust beneficiary, even if they are not named in the trust document; 2) future or contingent U.S. beneficiaries are treated the same as current beneficiaries; and 3) loans by the foreign trust of *any* trust property are treated as trust distributions for tax purposes.

Deny Legal Opinion Protection from Penalties (Sec. 107)
The Internal Revenue Code provides for a stiff penalty (called the accuracy-related penalty) when a taxpayer engages in a tax-avoidance transaction and the IRS determines that the transaction was not correctly reported on the taxpayer's return. An exception to the penalty applies when the taxpayer has sought legal advice and received an opinion that the transaction is "more likely than not" (at least a 50 percent chance) to survive a challenge by the IRS. Many taxpayers believe, usually correctly, that a legal opinion is all they need to avoid the underpayment penalty.

The Tax Haven Act would require taxpayers to have some other basis, besides the legal opinion, to avoid the penalty on offshore transactions. This provision is designed to "force taxpayers to think twice about entering into an offshore scheme." The Treasury Secretary has the authority to exempt two types of legal opinions from this rule: 1) if the confidence level is substantially higher (70 – 75 percent) than "more likely than not"; and 2) where there is a class of transactions that do not present a potential for abuse.

Close the Dividend Loophole (Sec. 108)
Most income earned by foreigners in the U.S. is not subject to U.S. tax. One exception is dividends on U.S. stocks. Dividends are taxable income and subject to withholding. Two common schemes are used, primarily by offshore hedge funds, to get around this rule. These transactions have no economic purpose other than to avoid U.S. tax, and the bill would close these loopholes.

One technique is to use "equity swaps." A financial institution promises to pay to an offshore hedge fund, for example, an amount equal to: 1) any appreciation in the price of the stock, and 2) any dividends paid on the stock during the swap period. The hedge fund is liable to the financial institution for any decline in the price of the stock during that period. The hedge fund clearly still bears the risks and rewards of ownership of the stock. But this technique allows it to avoid taxes because payments made to a non-U.S. person under an equity swap are treated as foreign-sourced and therefore not subject to U.S. tax withholding. The financial institution has no risk, because it holds the physical shares of stock during the swap period, is paid for any price depreciation, and then "sells" the stock back to the hedge fund. The financial institution earns a fee for handling the transaction, which includes a portion of the tax savings realized by the hedge fund.

The second technique is similar, but involves a "loan" of stock with an upcoming dividend to an offshore corporation controlled by a financial institution. The offshore corporation is obligated by the loan agreement to forward any dividends back to the client. The parties to this transaction claim that these "substitute dividends" are tax-free by relying on a 1997 IRS Ruling which was intended to prevent double withholding when dividends are forwarded from one foreign entity to another. The

IRS testified before a congressional committee that the ruling was never intended to be interpreted the way the parties claim.

The Levin-Doggett bill would treat all payments of dividend-based amounts consistently, making them subject to U.S. tax withholding. The bill would authorize the Treasury Secretary to issue regulations that would also capture dividend equivalent payments when they are netted with other payments under a swap contract or other financial instruments or when they are netted with fees. The Treasury could also issue regulations to reduce possible over-withholding, but only where the taxpayer can establish that U.S. tax was previously withheld. The bill also makes it clear that it does not intend to limit the authority of the IRS to collect taxes on dividend equivalent payments under prior law.

Expand PFIC Reporting Requirements (Sec. 109)
U.S. persons who are direct or indirect shareholders of Passive Foreign Investment Companies (PFICs) are required to report certain information about the PFIC to the IRS. Taxpayers have been able to avoid reporting by using an offshore service provider to hold title to the PFIC stock although the U.S. person has control. The bill would expand the reporting requirement so that a return must be filed by any U.S. person who formed a PFIC, sent assets to it, received assets from it, was a beneficial owner of it, or had beneficial interests in it. It would prevent taxpayers from arguing that no reporting was required because they did not hold a formal ownership interest in the PFIC.

Other Measures to Combat Tax Haven and Tax Shelter Abuses

Increase Penalty for Failure to Make Required Securities Disclosures (Sec. 201)
Companies who are subject to Securities and Exchange Commission (SEC) rules are required to report offshore ownership and offshore transactions in their stock. Tax dodgers have avoided this reporting, claiming that the offshore entities are independent, even though they are effectively controlled by a U.S. company or a majority stockholder. The bill would establish a new penalty of up to $1 million for persons who violate U.S. securities laws by knowingly failing to disclose offshore transactions and stock holdings.

Include Hedge Funds and Company Formation Agents in Money-Laundering Programs (Sec. 202 and 203)
Hedge funds and private equity funds are the only type of financial institutions that are not required by the Bank Secrecy Act to have anti-money laundering programs such as Know Your Customer, due diligence procedures, and requirements to file suspicious activity reports. The Treasury Department proposed, but never finalized, anti-money laundering regulations for these unregistered investment companies, but withdrew them without explanation during the Bush administration. The bill would require Treasury to issue final regulations within 180 days of the bill's enactment.

Company formation agents are also not covered by the anti-money laundering rules. Many taxpayers are aided in their tax avoidance schemes by agents who form companies for them: U.S. company formation agents setting up offshore entities for U.S. clients and forming U.S. shell companies for foreign clients. The Tax Haven Act would direct Treasury to develop anti-money laundering regulations for company formation agents as well.

Facilitate IRS John Doe Summons (Sec. 204)
The IRS uses a John Doe summons to request information from a third party in cases where the taxpayer's identity is unknown. For example, the IRS might issue a John Doe summons to a bank to get information about an account owned by a foreign entity, although the IRS doesn't know who the foreign entity or its U.S. owner is. When the taxpayer is known, the taxpayer gets a notice of a third-party summons and has 20 days to ask a court to quash the summons. When the IRS doesn't know the name of the taxpayer and where to send the notice, the law provides a procedure for the IRS to get advance permission to serve the summons on the third party. To get the court's permission, the IRS must show that: 1) the summons relates to a particular person or class of persons, 2) there is a reasonable basis for concluding that there is a tax compliance issue involved, and 3) the information is not readily available from other sources. The IRS has successfully used the John Doe summons process to identify offshore hidden funds and collect unpaid taxes. The process, however, is expensive and time consuming. The bill would provide that the court may presume that the case raises tax compliance issues when there is an account or a transaction in a tax haven, relieving the IRS of proving that element in case after case.

In cases where an offshore bank has an account with a U.S. financial institution, the bill would allow the IRS to issue a summons for the U.S. bank accounts records without court approval.

The bill would also streamline the process in large "project" investigations. Where the IRS is planning to issue multiple summonses to definable classes of third parties (such as banks or credit card companies) to get information related to specific taxpayers, the bill would provide a process to have one court approve multiple summonses and retain ongoing oversight of the case. The IRS would be relieved of the burden of proving the same facts before multiple judges in many different jurisdictions.

Authorize IRS to Investigate FBARs and Suspicious Activity Reports (Sec. 205)
Current law requires a taxpayer controlling a foreign financial account over $10,000 to check a box on his or her income tax return (for individuals on Form 1040 Schedule B – Interest and Dividends) and to file a Foreign Bank Account Report (FBAR) with the IRS. Here's the glitch: the IRS authority under Title 26 of the U.S. Code allows the IRS to use tax information only for the administration of the Internal Revenue Code or "related statutes." The FBAR requirement is under Title 31. Although the Treasury Department's Financial Crimes Enforcement Network (FinCEN) has delegated its power to investigate FBAR violations to the IRS, it's not clear that the IRS has the authority under the law. The bill would change the statute to make it clear that the relevant sections of Title 31 are to be considered internal revenue laws.

The penalty for FBAR violations is determined in part by the balance of the foreign bank account at the time of the "violation," which is the date the report is due. The report for the previous calendar year is due on June 30, so the penalty is reduced if taxpayers withdraw funds after December 31 but before filing the report. The bill would change the statute to impose the penalty on the highest balance in the account during the reporting period (the calendar year).

Financial institutions are required to report suspicious transactions to FinCEN. FinCEN is required to share the information with law enforcement, but not to IRS agents investigating civil tax enforcement cases. IRS civil (as opposed to criminal) agents are issuing an IRS summons to the financial institutions (at substantial time and expense) to get access to the report which Treasury already has. The bill would clarify that "law enforcement" includes civil tax enforcement, giving IRS civil agents access to the information.

Combating Tax Shelter Promoters

Strengthen Tax Shelter Penalties (Sec. 301 and 302)

The IRS can assess penalties for promoting an abusive tax shelter for up to 50 percent of the fees earned by the promoter. Many tax shelters sell for hundreds of thousands, if not millions, of dollars. The bill would raise the penalty to an amount up to 150 percent of the promoters' gross income from the prohibited activity. A similar provision that imposes penalties on persons who aid or abet an understatement of tax, such as accounting, law and investment firms and banks, would raise the penalty from $1,000 (or $10,000 in the case of a corporation) to up to 150 percent of the aider and abettor's gross income from the prohibited activity. Sen. Levin's statement related the case of an international accounting firm's cost-benefit analysis, deciding to participate in an abusive tax shelter because the average deal would bring them $360,000 in fees and the maximum penalty would be only $31,000.

Prohibit Tax Shelter Patents (Sec. 303)

Since 1998, when a federal appeals court ruled that business methods can be patented, various tax professionals have filed applications for a patent of particular tax strategies. Patents are generally thought to promote innovation by giving the patent holder a temporary monopoly. But as Sen. Levin points out, there's ample incentive for innovation in the form of tax savings: "The last thing we need is a further incentive for aggressive tax shelters." In addition, there are policy concerns that a patent would be used by promoters to claim official endorsement of the strategy or to charge a fee for other taxpayers to use the same strategy, when any taxpayer should be able to use the tax law to minimize their taxes. The bill would prohibit the issuing of tax patents.

Prohibit Fees Contingent on Obtaining Tax Benefits (Sec. 304)

The American Institute of Certified Public Accountants, the Securities and Exchange Commission, and the Public Company Accounting Oversight Board have all issued rules that allow contingent fees only in limited circumstances. In many states, accounting firms are prohibited from charging contingent fees on tax work, to reduce the incentive to devise abusive tax shelters. But the content and enforcement of these rules vary widely. And tax professionals are getting around them by making sure that most of the services are performed in a jurisdiction that does not prohibit contingency fees, even if the client is in a jurisdiction that does. The Tax Haven Act would establish a single national rule that would prohibit tax practitioners from charging fees based directly or indirectly on tax savings.

Deter Financial Institution Participation in Abusive Tax Shelter Activities (Sec. 305)

Many abusive tax shelters depend on some sort of financial transaction, for example, using financing or trading securities. The tax code prohibits financial institutions from aiding or abetting tax evasion, but the agencies that oversee the financial institutions, such as the SEC or the Federal Reserve Bank, are not experts in tax law. The bill would require the bank and securities regulators to develop examination techniques with the IRS to detect these abuses. The new examinations would become part of the routine regulatory exams, and potential violations would be reported to the IRS.

End Communication Barriers between Enforcement Agencies (Sec. 306)
The tax code has stringent rules to keep the IRS from disclosing our tax information. Unfortunately, these rules also prohibit the IRS from informing bank regulators, the SEC, or the PCAOB when a tax examination discloses violations of banking, securities, or accounting laws. The bill would authorize the Treasury Secretary, which oversees the IRS, to disclose tax return information related to abusive tax shelters to those agencies, with appropriate privacy safeguards. The information would only be used for law enforcement purposes, such as detecting securities violations or accounting fraud.

Increase Disclosure of Tax Shelter Information to Congress (Sec. 307)
Although they have been subpoenaed by Congress, accounting and law firms have refused to comply with requests for information, such as documents related to the sale of abusive tax shelters. The tax professionals rely on a section of the Internal Revenue code which prohibits tax preparers from disclosing tax information to third parties. There are regulations that state this provision was never intended to create a privilege or override a Congressional subpoena, but tax professionals continue to obstruct the investigations. The Tax Haven Act would codify the regulations and put the necessary language directly into the law.

The bill would also require the IRS to grant Congress access to information about a Treasury decision to deny or revoke an organization's tax exempt status.

Regulate Tax Shelter Opinion Letters (Sec. 308)
The bill would provide express statutory authority for the Treasury Department to issue regulations that establish standards for tax professionals who provide opinion letters on the tax treatment of potential tax shelter transactions. The standards would address issues such as independence, conflicts of interest, appropriate fees, and collaboration among various practitioners.

The Baucus Bill

On March 10, the Senate Finance Committee began circulating draft legislation proposed by Chairman Max Baucus (D-MT) designed to improve compliance with tax laws that require the reporting of offshore transactions in both information returns and income tax returns.

While the bill would give the IRS some improved tools to enforce the offshore provisions, and close one offshore trust loophole, it is a far cry from the comprehensive legislation proposed by Sen. Levin and Rep. Doggett. It primarily adds additional reporting requirements and increases the penalties for noncompliance, but it does not address some of the fundamental problems that cost the U.S. Treasury an estimated $100 billion annually in tax revenue.

Require Offshore Account Reporting
Early each year, brokers are required to report their customers' securities transactions for the prior calendar year to the IRS on a Form 1099-B. The Baucus bill would require similar reporting by financial institutions of transfers of funds to offshore accounts. By January 31, the financial institutions would have to provide a statement to the customer and then to the IRS by whatever date the regulations provide (most 1099 forms are due March 1). The statement must include: 1) the name, address, and taxpayer identification number of the domestic financial institution and the United States person, 2) the name and address of the offshore financial institution, the type of account, the account number, the name on the account, and the amount transferred, and 3) any other information the Secretary may require by forms or regulations. Transfers on behalf of publicly-traded companies are not subject to reporting.

This information reporting will give the IRS much-needed information to investigate offshore tax evasion. Perhaps more importantly, it will deter much of the activity if taxpayers know that the transfer information will be reported. The penalty is $50 for each failure to file an information report, with a maximum penalty for any year of $100,000.

Lengthen Statue of Limitations Period for IRS Examinations
Generally, the IRS has three years to examine a tax return once it has been filed. For tax returns that disclosed, or should have disclosed, offshore transactions that should have been reported because of the above provision (and other provisions already in the law), the statute of limitations would be extended. The IRS would have an additional six (instead of 3) years after the IRS has received the return to examine it.

Include Foreign Bank Account Reporting with Tax Return
The Baucus bill would require a taxpayer to file a Foreign Bank Account Report (FBAR) with the taxpayer's income tax return, rather than at a different time. Because the FBAR would be part of the tax return, the IRS would have the authority to examine it under its tax administration powers. Under current law, it is unclear whether the IRS has that authority (see the discussion in the Levin-Doggett Bill section of this report).

Create Tax Preparer Due Diligence Requirements
Under this provision, preparers of tax returns would be required to comply with due diligence requirements to be issued by Treasury regulation. The due diligence would be designed to detect any offshore accounts or transactions that are required to be reported on income tax returns or information returns. We presume that the due diligence requirements would be a series of questions that the preparers must ask the taxpayers, similar to the requirements for the Earned Income Tax Credit (EITC). Preparers would be subject to penalties for failure to comply.

Modify Penalty for Failure to Report Offshore Trust Transactions
Current law provides a penalty for failure to report the creation of a foreign trust, transfers to a foreign trust, and the death of a citizen or resident of the U.S. who was treated as an owner or beneficiary of a foreign trust. The penalty is 35 percent of the amount that should have been reported. Often the IRS is unable to compute the penalty because the transaction amount is unknown. The Baucus bill modifies the Internal Revenue Code to provide a minimum penalty of $10,000.

Tax Foreign Trust Transfers of Real Estate, Jewelry, and Artwork
Under current law, a loan of cash or marketable securities to a grantor or beneficiary (or a person related to a grantor or beneficiary) of a foreign trust is treated as a distribution to that person (which would generally be taxable income). This provision would add real estate, jewelry, and artwork to those rules. Grantors and beneficiaries have used offshore trusts to fund their lifestyles, having the trusts "loan" them houses, artwork, and jewelry. Because the transactions were structured as loans, rather than distributions, the grantors and beneficiaries were able to escape taxation on transactions that clearly increased their personal wealth. This provision would close that loophole.

Double Fines and Penalties for Failure to Report Offshore Transactions
Current law provides for assessment of fines, penalties, and interest for failure to file required information returns. There are also interest and penalty provisions for any underpayments of tax. The Baucus bill would double the amount of those "additions to tax" when the failure to file or the underpayment of tax was related to an offshore transaction.

Modify Foreign Entities Treated as U.S. Employers for Withholding Purposes
The Heroes Earnings Assistance and Relief Tax Act of 2008 added provisions requiring certain foreign entities to be treated as U.S. employers for purposes of withholding payroll taxes. The 2008 Act required withholding for "employees" (generally U.S. citizens and residents working offshore or anyone working in the U.S.) of foreign entities if the foreign entity was a subsidiary of a U.S. company and the foreign entity was performing services under a contract with the U.S. government.

The bill would modify the definition of "employee" covered under this rule to include only employees that work a minimum of 100 hours per month for the employer. This would exempt employees that work only a few hours from the withholding requirements.

The President's Budget Proposal Tax Haven Provisions

President Obama's budget includes several tax proposals aimed to "Combat Under-Reporting of Income Through Use of Accounts and Entities in Offshore Jurisdictions." These provisions are estimated to raise just under $9 billion in revenue over the next 10 years. Descriptions of the proposals can be found in the Treasury Department's "Greenbook" at http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf.

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Tax Haven Legislation

Comparison of Current Proposals

Proposal	Levin-Doggett Bill	Baucus Draft	President's Budget
Codify Economic Substance Rule	√		√
Extend the Statute of Limitations	√	√	√
Expand John Doe Summons	√		
Create Evidentiary Presumptions	√		√[1]
IRS Authority to Investigate FBARs	√	√	√
Close Foreign Trust Loophole	√	√	
Close Dividend Loopholes	√		√
"Manage & Control" Foreign Corporations	√		
Disclosure of Stock Holdings	√		
Report Offshore Transfers		√	√
Report New Account or Entity	√		√

[1] Only for the amount deemed to be in an offshore account.

Proposal	Levin-Doggett Bill	Baucus Draft	President's Budget
Report Income of Foreign Accounts with U.S. Beneficial Owners	√		√
QI Filing 1099 for U.S. Customers			√
Double Penalties for Failure to Report		√	√
Expand PFIC Reporting Requirements	√		
Allow Treasury to Restrict Dealings	√		
Hedge Fund Anti-Money Laundering	√		
Increase Penalties on Tax Shelter Promoters	√		
Increase Penalties on Aiders and Abettors	√		
Prohibit Contingent Fees	√		
Prohibit Tax Shelter Patents	√		
Enhance Cooperation Between Agencies	√		
Tax Preparer Due Diligence Requirements	√		
Disclosure to Congress	√		
Regulate Tax Shelter Opinion Letters	√		
Deny Legal Opinion Protection from Penalties	√		
Modify Penalty for Failure to Report		√	√
Change "Employee" for Withholding		√	
Withholding on FDAP from Non-QIs			√
Withholding on Gross Proceeds paid to Non-QIs			√

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Myths and Facts about Offshore Tax Abuses

On May 4, President Obama proposed several measures to address overseas tax avoidance and tax evasion. The proposals are steps in the right direction but could be far stronger. (See CTJ's description of the measures for more technical details.[1])

While the President's proposals are relatively modest, the corporate community claims that these measures are unfair and would limit economic growth in America.

The corporate lobbyists and spokespersons are wrong. Here are some of the frequently repeated myths, and the actual facts, about offshore tax abuses and what the President and many lawmakers want to do about them.

Myth: The practices that the Obama administration is trying to stop are not illegal, so the U.S. government should not interfere with them.

Fact: The practices that concern the Obama administration and others include both legal and illegal practices, and they *all* damage our ability to raise revenue in a fair manner to pay for public services and investments we need. There are three types of practices at issue:

First, there are tax abuses by American individuals that involve hiding income from the IRS. These tax abuses are always illegal, meaning they constitute tax *evasion*.

Second, there are tax abuses by American corporations that involve manipulating tax laws to reduce or eliminate their U.S. taxes in ways that Congress never intended. These tax abuses may be legal, meaning they constitute tax *avoidance*, but many of these practices *ought to be illegal*.

Third, there are features of our tax system that might encourage corporations to base their operations offshore rather than here in the U.S. These provisions should be reexamined by Congress.

[1] Citizens for Tax Justice, "Obama's Proposals to Address Offshore Tax Abuses Are a Good Start, but More Is Needed," May 8, 2009. http://www.ctj.org/pdf/offshoretax20090508.pdf

Myth: The first category of abuses listed above (involving individuals hiding income from the IRS) is no different than the sorts of steps everyone takes to pay as little tax as they can get away with.

Fact: Many people take legal means to lower their taxes through strategies that use various deductions and credits. But most Americans have no opportunities to actually *hide their income* from the IRS, which is very different (and very illegal).

For most of us who receive a wage or salary, our employers report our income to the IRS on W-2 forms. So if we try to hide our earnings from the IRS, there's a good chance we'll get caught.

A teen-ager mowing lawns for the summer might decide to not report the income to the IRS, and they might get away with that. But for the most part, the options for tax evasion are pretty limited for most Americans.

But it's a whole different story for wealthy people and corporations with access to complicated tax-planning schemes involving foreign countries. They can rely on accountants and lawyers to structure complex transactions that shift their income and income-generating assets into a country that has low or no business taxes and that has bank secrecy rules that prevent its financial institutions from telling the U.S. government which American citizens are among their clients and what they're up to.

In other words, wealthy American individuals and corporations wishing to hide their income from the IRS can turn to "tax havens." There is no official definition of a tax haven, but they generally have strict bank secrecy laws and low or non-existent taxes.

It's important to remember that these efforts to shift income and income-generating assets into tax havens do not represent real investments in those countries. These are transactions or investments on paper only.

Myth: The second category of abuses listed above (involving American corporations manipulating, but not necessarily violating, U.S. tax laws) are all steps that companies have to take in order to avoid double-taxation of their foreign income.

Fact: The foreign tax credit already protects against double-taxation. If an American individual or corporation has income that is taxed by a foreign government, the individual or corporation gets a credit against their U.S. tax. No one is proposing to repeal the foreign tax credit.

The U.S. taxes all of the income of its citizens, residents and corporations, no matter where it is earned. But individuals and corporations can take a credit against their U.S. taxes for foreign taxes that they pay, to avoid double-taxation.

Corporations get an additional benefit, which is that they get to "defer" U.S. taxes on the income they earn abroad until they bring that income back to the United States (until they "repatriate" that income).

The President proposes to limit "deferral" for corporations because it has been abused a great deal to reduce taxes in ways that Congress never intended to allow. But even if the President and Congress repealed deferral entirely (which would probably be a better policy), American individuals and American corporations would still be able to use the foreign tax credit, so there would be no fear of double-taxation.

It is true that one of the President's proposals would make changes to the foreign tax credit, but these changes would only ensure that the credit does its job of preventing double-taxation. Currently, American multinational corporations can use the credit against their U.S. taxes for taxes they paid to a foreign government on income that is not even taxable in the U.S. (for example, life insurance proceeds). This is clearly not the purpose of the credit. Addressing this problem would not prevent corporations from using the credit to avoid actual double-taxation.

Myth: Proposals to crack down on offshore tax abuses by corporations will make the U.S. businesses less competitive as they try to compete abroad.

Fact: Most of the corporate practices the administration wants to crack down on probably don't even involve companies that are truly competing abroad. Rather, they involve companies operating within the United States but using sham transactions to make their income appear to be earned abroad, so that the U.S. taxes on that income can be "deferred" (meaning "not paid.")

Even in cases where U.S. multinational companies are carrying out real business in a foreign country, their competition with other companies in that country is generally based on the price they charge for their products. Corporate income taxes don't affect the price a foreign subsidiary can charge so much as they affect the dividends the U.S. owners receive.

Myth: Even if everything explained above is true (that these practices mostly involve U.S. companies scheming to reduce their U.S. taxes on their U.S. profits) it's still a bad idea to crack down on these practices because corporations will simply leave the United States and take jobs with them.

Fact: The U.S. tax system is probably not a significant factor in a company's decision to relocate jobs. To the extent that the U.S. tax system is a factor, the current rules encourage investors to move jobs offshore more than the rules that would exist if the President's reforms were enacted.

Companies locate manufacturing plants where labor and inputs are available, and where regulations are favorable to corporate interests. Certain types of manufacturing need to be

near natural resource inputs or near the end market. For example, auto manufacturers are in the U.S. because that's where the cars are sold. It's too expensive to ship them from somewhere else. If a company sells services, the decision is influenced by the market it serves and by where the employees want to live.

To the extent that taxes do influence decisions about where to locate operations and jobs, the current tax rules are more likely to encourage investors to move jobs offshore than the rules that would be in place if the President's reforms are enacted. The fact that a U.S. corporation can defer taxes on income earned by its foreign subsidiaries might make it slightly more likely that it will base more of its operations abroad than here in the U.S. Obama's proposal to limit deferral would make it *less* likely that companies will base operations and jobs offshore.

Myth: U.S. Corporations need to lower their tax liability any way they can because America's corporate tax rate is so high compared to other countries.

Fact: U.S. corporations do not generally have high taxes compared to those of other countries because there are so many loopholes in the U.S. corporate tax.

The most effective way to compare the tax level of corporations across nations is to compare each nation's corporate tax revenue as a percentage of its economic output (its gross domestic product, or GDP). Compared to other industrial countries, the U.S. ranks below average by this measure.[2]

[2] Citizens for Tax Justice, "United States Remains One of the Least Taxed Industrial Countries," April 2007. http://www.ctj.org/pdf/oecd07.pdf