on the issue. Solomon said he expected Treasury would continue the discussion of territoriality and get into details such as what kind of income would be exempt and what would be considered foreign income.

Michael J. Boskin of Stanford University suggested implementing a credit-method VAT of 10 percent to 14 percent, conforming book and tax income to address corporate tax shelter problems, imposing a 15 percent corporate rate, and broadening the base, although he said Treasury's examples of provisions to eliminate were ''not possible or realistic.''

Speaking to reporters after the conference, Solomon and Robert Carroll, Treasury assistant secretary for tax analysis, said there is no deadline for Treasury's study of competitiveness.

''We have to sit down and really try to put together some of the thoughts from today. That's really what our next step is. And then we have to figure out what we may do,'' Solomon said.

House Ways and Means Committee Chair Charles B. Rangel, D-N.Y., encouraged the administration to join him at the table to reform the tax code.

> ***'Secretary Paulson knows that if he wants to move forward on tax reform, my door is open — in fact, he doesn't even have to knock,' said Rangel.***

''What has been missing from the debate thus far are tax reform proposals endorsed by this administration and a willingness to work across party lines to enact that reform,'' Rangel said. ''Secretary Paulson knows that if he wants to move forward on tax reform, my door is open — in fact, he doesn't even have to knock.'' (For a press release from Rangel, see *Doc 2007-17491* or *2007 TNT 145-36*.) ■

ECONOMIC ANALYSIS

Lessons From the Last War on Tax Havens

By Martin A. Sullivan — martysullivan@comcast.net

In a war waged primarily from 1998 through 2002, 35 tax havens — including some of the world's smallest countries — beat back an attack on their offshore business led by the OECD, the protector of the collective economic interest of 30 of the world's biggest countries. How did these pea-pod economies overcome the superpowers? In a nutshell: They kept the battle at a rhetorical level and then, with the support of like-minded third parties, developed verbal counterattacks to the OECD's opening assaults.

This is all described in a balanced and thoroughly researched study entitled *Havens in a Storm: The Struggle for Global Tax Regulation* (Cornell University Press, 2006, 211 pages). The author, J.C. Sharman, is an Australian political scientist with little prior knowledge of taxation, but he may have written one of the best books out there for tax experts trying to make sense of big countries' policies toward tax havens.

Play by Play

The story begins in May 1996 when the heads of state of G-7 nations meeting in Lyon, France, asked the OECD to develop measures to ''counter the distorting effects of harmful tax competition.'' The OECD talked it over for two years and in 1998 released ''Harmful Tax Competition: An Emerging Global Issue.'' All OECD member nations, except tax havens Luxembourg and Switzerland, approved the report.

The landmark 1998 report listed characteristics of tax havens: low or zero tax rates, lack of tax information exchange with other countries (even if there is exchange for fraud and money laundering), a high degree of bank secrecy, and lack of real economic activity associated with the income generated. The OECD established a Forum on Harmful Tax Practices to compile a ''blacklist'' of tax havens. Blacklisted countries faced veiled threats of multilateral actions in the form of sanctions euphemized as ''defensive measures.''

The Forum on Harmful Tax Practices scrutinized 47 jurisdictions. Six were deemed not to meet the tax haven criteria. Six others — Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, and San Marino — made ''advance commitments'' to undertake specified reforms to avoid inclusion on the list. That left 35 jurisdictions on the OECD blacklist published in its June 2000 report, ''Towards Global

The OECD June 2000 Tax Haven Blacklist

1. Andorra	13. Grenada*	25. Niue*
2. Anguilla*	14. Guernsey*	26. Panama*
3. Antigua and Barbuda*	15. Isle of Man*	27. Samoa*
4. Aruba*	16. Jersey*	28. Seychelles*
5. Bahamas*	**17. Liberia**	29. St. Lucia*
6. Bahrain*	**18. Liechtenstein**	30. St. Kitts & Nevis*
7. Barbados**	19. Maldives**	31. St. Vincent and the Grenadines*
8. Belize*	**20. Marshall Islands**	32. Tonga**
9. British Virgin Islands*	**21. Monaco**	33. Turks & Caicos*
10. Cook Islands*	22. Montserrat*	34. U.S. Virgin Islands*
11. Dominica*	23. Nauru*	35. Vanuatu*
12. Gibraltar*	24. Netherlands Antilles*	

*Jurisdictions subsequently committed to ''improving transparency and establishing effective exchange of information in tax matters.''
**Jurisdictions the OECD subsequently determined should not be included on the list of tax havens.
Note: The countries in **bold** remain on the OECD blacklist. On its Web page providing access to the June 2000 report, the OECD warns: ''More than five years have passed since the publication of the OECD list contained in the 2000 Report and positive changes have occurred in individual countries' transparency and exchange of information laws and practices since that time. The list has not been updated to reflect such changes. If a country chooses to use a list of countries derived from the OECD list, it should do so based on the relevant current facts. Thus, progress made in the implementation of the principles of transparency and effective exchange of information in tax matters should be taken into account by such countries and their legislatures.''

Tax Cooperation.'' Again, Luxembourg and Switzerland abstained from endorsing the report. And again, but this time with the blacklisted countries identified, the OECD suggested that the uncooperative jurisdictions that did not adequately commit by July 31, 2001, to eliminate harmful practices could be subject to coordinated defensive measures, including:

- comprehensive information reporting for transactions involving listed tax havens;
- denial of foreign tax credits to distributions from listed tax havens;
- disallowance of deductions, exemptions, or credits related to transactions with listed tax havens;
- withholding taxes on payments to residents of listed tax havens;
- enhanced audit and enforcement activities regarding listed tax havens;
- not entering into any new comprehensive income tax conventions with listed tax havens and possible termination of existing conventions; and
- charges or levies on specific transactions involving listed tax havens.

Previously restrained in their opposition to the OECD, tax havens responded energetically to the publication of the blacklist. At the Caribbean Community summit of July 2000, and at a meeting of commonwealth finance ministers (25 of the listed jurisdictions were former or current British colonies) in September 2000, tax havens began to coordinate their defense to the OECD's attack. Measures included promises to not sign up for the initiative, publicly challenging the OECD, and bilateral lobbying to more sympathetic OECD states. The tax havens aired their grievances directly at a January 2001 meeting between targeted jurisdictions and the OECD. And in March 2001 they formed the International Tax and Investment Organization (ITIO, later known as the International Trade and Investment Organization) to further their anti-OECD efforts.

Previously restrained in their opposition to the OECD, tax havens responded energetically to the publication of the blacklist.

But the big turning point was the change in the U.S. support for the OECD initiative. Previously, under the guidance of Treasury Secretary Lawrence Summers, the Clinton administration had led the crackdown on tax havens. In its last budget, released in February 2000, the administration proposed U.S. legislation that would have required reporting of payments to havens and the denial of foreign tax credits associated with tax haven income. (These two proposals were similar to the first two OECD ''defensive measures'' listed above.)

The Bush administration did not immediately oppose the OECD initiative. On the contrary, on February 22, 2001, Treasury Secretary Paul O'Neill signed on to the G-7 finance ministers' communiqué in Palermo, Italy, reaffirming American support for the OECD tax haven initiative. And at a February 17 press conference after the G-7 meeting, O'Neill stated: ''While I indicated to my colleagues that certain aspects of these efforts are under review by the new Administration, I support the priority placed on transparency and cooperation to facilitate effective tax information exchange."

And in an undated letter from early 2001, Treasury Assistant Secretary Mark Weinberger wrote Sen. Don Nickles:

> Countries generally should not engage in practices that make it easier for other countries' laws to be broken or frustrated. With respect to our tax laws, those practices might include bank secrecy rules or an unwillingness to exchange tax information with us that would permit taxpayers more readily to evade our laws. In this respect, we are mindful of the views expressed by the Senate Foreign Relations Committee in late 1999 regarding its opposition to any softening of the United States' commitment in the context of tax treaties to full tax information exchange, including information otherwise protected by bank secrecy rules.
>
> The United States has historically sought to persuade other countries to modify practices that obstruct the enforcement of the tax laws enacted by Congress. Although the United States has enjoyed considerable success in that regard independent of the efforts of other countries, there may be some value in coordinating our efforts with those of countries with similar concerns through multilateral forums like the OECD.

(*Doc 2001-9693, 2001 TNT 66-37*)

But the Bush administration's support would be short-lived. A highly effective lobbying campaign was mounted by the newly formed Center for Freedom and Prosperity (CFP). The president of CFP was former Republican congressional staffer Andrew Quinlan, who worked closely with Heritage Foundation economist Daniel Mitchell. (For an interview with Mitchell, see p. 352.)

As a result of Quinlan and Mitchell's lobbying, letters flooded into Treasury from the usual antitax conservatives in Congress. But they also got the support from the Congressional Black Caucus, whose members said in a letter to O'Neill that the OECD initiative "threatens to undermine the fragile economies of some of our closest neighbors and allies." According to Sharman, the ideologically motivated CFP played a pivotal role in reversing the Bush administration's initial stance. The CFP achieved a "stunning victory" (in its own words) when O'Neill released a statement on May 10, 2001, announcing that Treasury would not support the OECD's initiative to stamp out "harmful tax competition." (For the statement, see *Doc 2001-16886* or *2001 TNT 117-55*.)

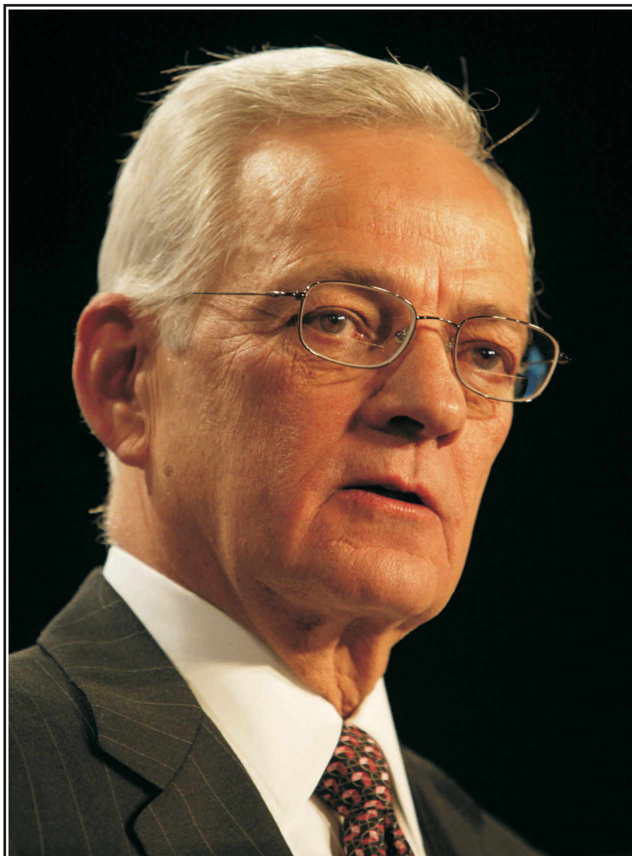


Photo courtesy of Brooks Kraft/CORBIS

Former Treasury Secretary Paul O'Neill's May 10, 2001, announcement turned the tide against the OECD.

After O'Neill's announcement, the OECD efforts to curb "harmful tax competition" slowly dissolved into a series of toothless pronouncements, a mixture of cheerleading and scorekeeping that continues to this day. Beginning in 2001 the OECD started to abandon its confrontational approach. Tax havens were now "participating partners." The original July 31, 2001, deadline to avoid defensive measures came and went without a murmur, and the OECD later publicly admitted that it had no intention to pursue them in the future.

The OECD also downsized its goals. Its entire focus became information exchange on request with tax havens on civil tax matters. Even this was undermined by something called the "Isle of Man clause." Under this proviso, agreed to by many of the havens, no reforms were required until every listed state and every OECD member state — including Luxembourg and Switzerland — committed to do the same. In 2003 this condition was extended to include third-party competitors such as Hong Kong and Singapore. Therefore, in Sharman's words, tax havens "were in effect not committed to anything." He continued:

> As a result, the OECD abandoned the goal of establishing a universal standard and uniform timetable for exchange of civil tax information, freeing ''participating partners'' from commitments they had made earlier. Thus the OECD had to give up its ambition to regulate international tax competition. Furthermore, it had abandoned the exclusionary ''name and shame'' approach and had been forced back on its traditional methods of seeking to raise regulatory standards by dialogue, persuasion, and peer pressure.

Did the OECD Really Lose?

Should readers accept Sharman's working assumption that ''by 2002 the small state tax havens had prevailed, and the campaign to regulate international tax competition had failed,'' resulting in ''a qualified tax haven victory and a qualified OECD defeat''? After all, the OECD is still hard at work on its harmful tax practices project. It has meetings, publishes reports, and issues press releases. Overall, it presents an image of continuing and ''considerable progress.''

The OECD's upbeat assessments, although not as strident, remind us of the Treasury Department when it reported on May 3, 2007, to the Senate Finance Committee:

> 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.
>
> We have made great strides in raising international standards.
>
> 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.
>
> We have more to do in this area. Nonetheless, we have made great strides in recent years.

(*Doc 2007-10957, 2007 TNT 87-34*)

It is true that the OECD and Treasury efforts have effected reform on many of the shadier practices in tax havens. As Joann M. Weiner comments: ''Advances in improving transparency and increasing exchange of information have helped curb the worst abuses of the international tax system and, in effect, have transformed many offshore financial centers from rogue states into well-regulated financial centers.'' As she further notes: ''More tax havens are sharing banking information and improving the transparency of their tax systems than at any other time in history.'' (''How the OECD and the U.S. Learned to Get Along With the Tax Havens,'' *Tax Notes Int'l*, Apr. 16, 2007, p. 229, *Doc 2007-8228, 2007 WTD 74-9*.)

While the OECD may deserve an ''A'' for effort, and while we may judge the outcome of its project as the best that could be done with the resources and political support at its disposal, we need not accept it as adequate. As Weiner also points out: ''Although a decade has passed since the OECD released its report proposing a number of recommendations on how to curb harmful tax practices and tax havens, *tax havens are flourishing as much as they ever have*'' (emphasis added).

In a 2007 interview, Weiner asked Jeffrey Owens, director of the OECD Centre for Tax Policy and Administration, the brilliantly simple question: How can we accept the OECD project as a success when the Cayman Islands has never made it onto the OECD's official blacklist? (''TNI Interview: Jeffrey Owens,'' *Tax Notes Int'l*, May 28, 2007, p. 913, *Doc 2007-12075, 2007 WTD 105-9*.) Owens's answer did not really address the question, so let's try to do it here.

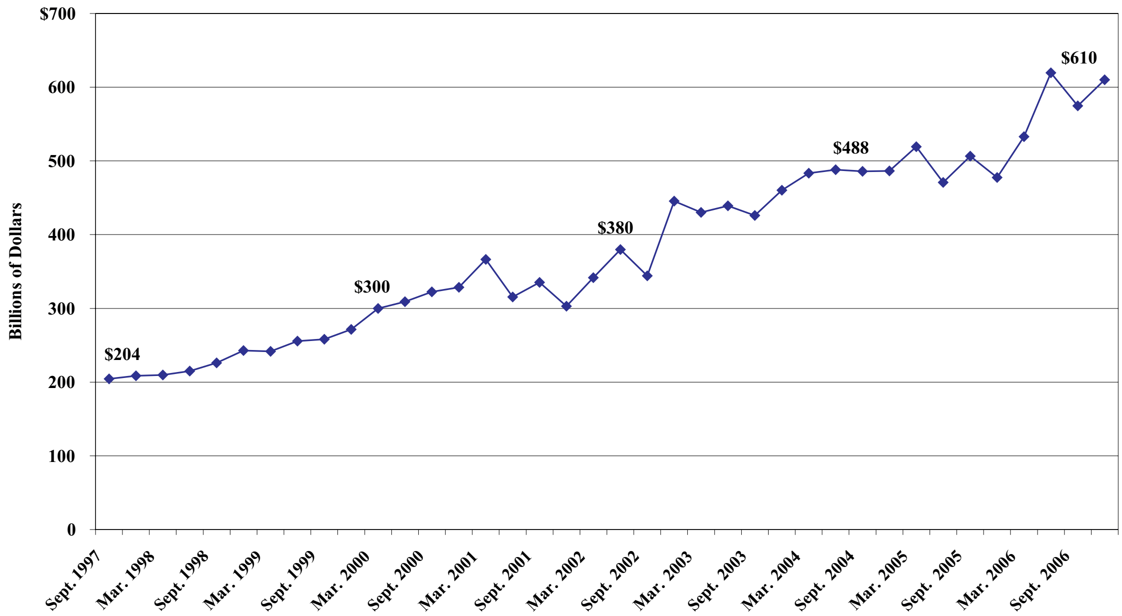
> ***The 'great strides' and 'considerable progress' Treasury and the OECD talk about have not even come close to solving the problem of offshore tax evasion.***

To put it bluntly, the ''great strides'' and ''considerable progress'' Treasury and the OECD talk about have not even come close to solving the problem of offshore tax evasion. An indication of this is that the U.S. compliance rate for the reporting of offshore accounts by country remains abysmally low even though the dollar volume of bank accounts in the Cayman Islands has tripled since the inception of the OECD project. (See ''Offshore Account Reports Rising, but Compliance Remains Low,'' *Tax Notes*, June 18, 2007, p. 1099, *Doc 2007-14435*, or *2007 TNT 118-7*, and the accompanying graph.)

Why has the OECD's effort fallen short? The Bush administration's May 2001 pronouncement seems like a logical place to start looking for an answer. But if you scratch below the surface, it's not obvious what damage it did. Here's what O'Neill wrote to his fellow G-7 finance ministers in June 2001 to explain his position:

> Where a taxpayer is suspected of evading the U.S. tax laws through the use of offshore entities or secret bank accounts, we sometimes need information from another country to address that situation. . . . In this regard, the

Bank Deposits in Cayman Islands Banks Not Owned by Other Banks, 1998-2006



Source: Bank for International Settlements, *BIS Quarterly Review*, June 2007, Table 2B, "External Positions of Banks in All Currencies Vis-à-Vis the Non-Bank Sector."

development of a framework for reaching information exchange agreements with countries that have shown little interest in cooperating in this regard in the past will be valuable. The proposals by the OECD to promote adequate record keeping and legal mechanisms for effective information exchange when necessary in specific cases contribute to the development of such a framework.

Other aspects of the OECD initiative, however, go beyond what is necessary to enforce our respective tax laws. The OECD initiative implicates low-tax regimes that may be designed to encourage foreign investment but that have nothing to do with evasion of any other country's tax law. Countries must be free to adopt tax policies that encourage investment and promote economic growth. We should not interfere in any other country's decision about how to structure its own tax system when that system does not serve as an obstacle to enforcing our own tax laws.

I have concluded that the United States should attempt to refocus the OECD project on its core element: the need for countries to be able to obtain specific information from other countries upon request in order to prevent noncompliance with their tax laws.

(*Doc 2001-16886, 2001 TNT 117-55*)

Those are hardly the words of somebody who doesn't care about offshore evasion, and they are a far cry from the verbal tirade of the CFP. In many ways, Treasury's statement did help the OECD. The effort lacked focus, and some of its goals were scattered. Effective information exchange *is* the key to fighting bank secrecy.

Or you could take a more cynical view:

> [O'Neill's explanation] makes it seem as if the OECD initiative had strayed away from the initial intention of the 1998 report and that the United States had succeeded in bringing it back on track. In reality, it appears rather that the United States succeeded in hijacking the initiative to focus it on its own preoccupation with obtaining information to combat money laundering and terrorism — and tax evasion by individuals — and away from the original intention to eliminate or neutralize those tax regimes that provide special privileges for geographically mobile services.

(Alex Easson, "Harmful Tax Competition: An Evaluation of the OECD Initiative," *Tax Notes Int'l*, June 7, 2004, p. 1037, *Doc 2004-11769, 2004 WTD 111-18*.)

Beyond the adjustment to overall objectives, there were three policy changes after the O'Neill

Photo courtesy of OECD/Paris

Jeffrey Owens: The OECD's point man in the fight against "harmful tax competition."

intervention. First, the deadline for havens to make a commitment was moved back a few months. Second, the ''no substantial activity'' criterion — the identification of tax havens as promoters of shell companies — was dropped from the definition of a tax haven. In practice, these were no big deal.

The third policy change, however, had bite. The Isle of Man clause allowed countries to be dropped from the blacklist if they made commitments, with the added condition that the commitment need not come into force until all other tax havens — including OECD members Luxembourg and Switzerland — agreed to the same conditions. Thus, by promising very little, countries were able to (1) get off the blacklist and (2) remove the threat of any additional sanctions.

As a result, progress toward eliminating bank secrecy has been slow. Commitment by the tax havens to the OECD principles of transparency and information exchange signals only the first step of a process. Before deterrence of evasion can begin, a haven must negotiate bilateral tax information exchange agreements, enact legislation, and — usually after a multiyear transition period — set up and maintain the bureaucratic machinery to enforce the agreements.

There are 30 OECD member countries and 33 ''participating partners'' that have made commitments to transparency and effective exchange of information. Multiplying these two numbers yields 990. That's the number of bilateral tax information exchange agreements that should ideally exist as a result of the OECD initiative. Unfortunately, only about 15 of these bilateral TIEAs now exist, and another 40 are in the pipeline. Obviously, many more years of international travel and negotiations will have to take place before participating partners and OECD members even get close to filling out the program.

But to really grasp the inadequacy of the current and proposed tax information exchange, imagine a world where all necessary TIEAs, enabling legislation, and personnel and procedures recommended by the OECD are in place. Tax information exchange would be widespread, but it would be available only on request. Exchange of information on request is a cumbersome process. It occurs only when one government formally asks another for particular information about a specific taxpayer.

The U.S. needs automatic information exchange to start to bring compliance on income from foreign deposits in line with domestic compliance.

What does a developed country — let's call it ''the U.S.''— need from a tax haven, which we'll call ''Cayman''? If there are 50 or 100 or 300,000 accounts in Cayman owned by U.S. citizens, the U.S. needs automatic information exchange to start to bring compliance on income from foreign deposits in line with domestic compliance. Information that is exchanged automatically typically consists of details of income like interest accruing on accounts of large classes of depositors. It can be collected routinely to form data sets that can be cross-checked with other data.

Information exchange on request — the current OECD standard — yields, we guess, a few dozen evaders each year who are already in hot water anyway. The Bahamas-U.S. TIEA provides that requests for tax information must be in writing and contain specified details that include the name of the person, the type of information requested, the period for which the information is requested, the likely location of the information, the applicable U.S. federal tax law, whether the matter is criminal or civil in nature, and the reasons for believing that the requested information is ''foreseeably relevant or material'' to U.S tax administration.

To make use of a TIEA with this limitation, the U.S. government must go through a cumbersome process — and know the name of the suspected tax evader! So, on-request information exchange only corroborates and embellishes existing evidence. It does not help the IRS discover and find tax evaders.

On-request information exchange may help keep the really bad guys out of tax havens. And, as noted by acting Treasury International Tax Counsel John Harrington and Senate Finance Committee ranking minority member Chuck Grassley, R-Iowa, at the

May 3 Finance Committee hearing, TIEAs have a strong deterrent effect. (For Harrington's statement, see *Doc 2007-10957* or *2007 TNT 87-34*; for Grassley's, see *Doc 2007-10974* or *2007 TNT 87-22.)*

As the financial communities of tax havens are well aware, the absence of 'fishing expeditions' provides great comfort to the garden-variety offshore evader who knows it will be easy to get lost in the crowd.

But as the financial communities of tax havens are well aware, the absence of ''fishing expeditions'' — as the offshore community disparagingly calls automatic exchanges — provides great comfort to the garden-variety offshore evader who knows it will be easy to get lost in the crowd. And over time, any deterrent effect is bound to diminish as the word gets out that the odds of getting into trouble solely because of the existence of a TIEA are fairly slim.

Is there any evidence to support the conclusion that on-request information reporting will not make significant inroads on tax evasion? Consider IRS statistics on compliance (*Tax Notes*, May 21, 2007, p. 711, *Doc 2007-11600, 2007 TNT 93-8*). When there is comprehensive information reporting (as in the case of U.S. dividends and interest), the compliance rate is 96 percent. That is analogous to automatic information exchange. When there is little or no information reporting, the compliance rate drops to 46 percent. That is analogous to reporting on request. Given that offshore investors are likely to be more prone to evasion than on-shore investors, and given that on-shore information reporting is likely to be more comprehensive than on-request international exchange, the offshore compliance rate when information exchange is on request can be expected to be lower than 46 percent.

And automatic information exchange is not something you hear a lot about in policy discussions. The distinction between on-request and automatic information exchange is often blurred. But the idea of automatic information exchange is hardly peculiar. Provision for automatic information exchange is a standard component of U.S. tax treaties.

In his May 3 testimony before the Finance Committee, University of Michigan law professor Rueven Avi-Yonah endorsed the renegotiation of existing U.S. TIEAs to include provisions for automatic information exchange (*Doc 2007-10989, 2007 TNT 87-36*). Similarly, David Spencer, New York tax attorney and adviser to the Tax Justice Network, likes the idea of automatic information exchange (*Accountancy Business and the Public Interest*, vol. 4, no. 2, Jan. 2006):

> The solution to the problem of capital flight and tax evasion in the international context is the automatic exchange of tax information between governments. If governments automatically exchange information about cross border income payments, without the impediment of bank secrecy and confidentiality, it would be difficult for the recipient of the income to evade tax in his/her/its country of residence.

Perhaps the best evidence of the merit of automatic information exchange is that it is the centerpiece of the EU savings directive. The provisions of the directive, adopted in June 2003 and in effect since July 2005, apply to all members of the EU as well as U.K. crown dependencies (the Channel Islands and the Isle of Man) and U.K. overseas territories (including the Cayman Islands), dependent territories of the Netherlands, and some other ''third countries'' (including and Liechtenstein and Switzerland) that are not EU members. Of those jurisdictions, most have opted for automatic tax information exchange, as encouraged by the EU. Austria, Belgium, Luxembourg, Switzerland, Liechtenstein, the Isle of Man, and the Channel Islands have opted for imposing a withholding tax on foreign investors in lieu of automatic information exchange.

Automatic information exchange is the centerpiece of the EU savings directive.

As Spencer points out: ''The EU Directive on the Taxation of Savings, if successfully implemented, could serve as a model for the automatic exchange of information between other countries.'' If the U.S. is serious about reducing offshore tax evasion, it should consider — as several other non-EU countries have — participating in the automatic exchange provisions under the EU directive.

Postgame Analysis

To a political scientist like Sharman, the defeat of large nations by the small provides a fascinating case study in international relations. The only drawback of his book is his repeated use of obtuse academic jargon like ''constructivism'' and ''speech acts.'' But readers are more than compensated for these annoyances by Sharman's fresh perspective. He considers a wide range of issues ignored in the usual dialogues on tax policy.

It is entertaining to consider, for example, why the larger nations did not use their militaries to enforce their will on smaller nations. After all, the U.S. did invade two of the blacklisted nations in recent times — Grenada in 1983 and Panama in 1989. And there is no doubt military action would have been effective and efficient. But it would be outside the normative standards of legitimate conduct by large countries toward small countries. ''Gunboat diplomacy'' and all its connotations of imperialism, Sharman notes, are too costly, not in material terms, but in their impact on international reputation.

Moving on, Sharman then considers sanctions. Economic coercion — like that imposed at various times on Cuba, Iraq, and South Africa — is a far less drastic option than military action. It can take a variety of forms, including freezing overseas assets of a tax haven's residents, blocking multilateral loans to a haven, discontinuing its foreign aid, imposing antidumping measures on its exports, issuing tourist advisories against travel to havens, or imposing visa restrictions on travel. (Another possibility, favored by *Tax Notes* contributing editor Lee A. Sheppard, is blocking wire transfers to tax havens.) All those measures could inflict a great deal of damage and be effective in helping to elicit the desired response from tax havens.

> ***Because tax havens place huge importance on preserving their reputations, the OECD's development of a blacklist was a powerful economic weapon.***

Potential economic weapons go far beyond the OECD's tamer, tax-oriented defensive measures, but even still, in Sharman's words, ''there has been a strange reluctance to use these measures.'' In the end and in the face of mounting political pressure, the OECD's threatened deployment of defensive measures turned out to be a ''bluff.'' For the OECD in particular — after all, it is an organization devoted to economic cooperation and development — inflicting economic pain was not an action consistent with its charter.

Despite the absence of military and economic coercion, however, Sharman highlights the fact that the OECD's development of a blacklist was in and of itself a powerful economic weapon. To appreciate its potential to harm, you must understand the huge importance tax havens place on preserving their international reputations. Sharman provides a detailed examination of the central role reputation played in the war against tax havens:

> The success or failure of a tax haven is more dependent on reputation than any other single factor. . . . [R]eputation is the main point of competition among a relatively large number of tax havens that are engaged in fierce competition with each other within and across regions. Jurisdictions with more established financial centers assiduously cultivate their image as secure, stable, and well-run investment destinations. As a consequence, they are able to attract a greater volume of more lucrative business. . . . [I]t is commonsensical that no amount of secrecy and protection from tax authorities will attract investors to jurisdictions in which deposits are thought to vanish into thin air.

To further illustrate his point, Sharman quotes official sources. From the British Virgin Islands: ''Reputation is our most important single asset. We are very proud and protective of it, and fully committed to maintaining and enhancing it.'' From the Cayman Islands: ''Reputation is our most important asset.'' From the Bahamas: ''Our institutions live by their reputations.'' And when asked what qualities his country tries to project, a Bahamian official replied: ''Stability, stability, stability, stability, stability.''

Relaying the view of a Liechtenstein banker, Sharman describes the fragility of reputation:

> The word ''Liechtenstein'' should immediately be associated with the ideas of security, reliability, confidentiality, and professionalism. Given that information gathering is costly, and there are many alternative investment destinations, if instead ''Liechtenstein'' conjures up ideas of crime, money laundering, and suspicious practices it is unlikely investors will look for more information to correct a bad first impression.

Reputation was a ''precious commodity'' that was highly vulnerable to OECD attacks. So even without the use of conventional economic sanctions, the OECD had enormous leverage on tax havens. Although the tax havens ultimately prevailed over the OECD, the inclusion or threat of inclusion on the OECD's blacklist was highly effective. As already noted, six major tax havens capitulated to the OECD's demands to remain off the list. At least one of them, Bermuda, has used its absence from the list as a selling point in its promotional material.

But the OECD itself was vulnerable in a war of words. Its reputation was its strength, but also its weakness. It relied on its identity as a rational, impartial, and expert body to persuade policymakers to adopt change because it could do little to coerce them. As one official put it: ''The OECD doesn't have any aircraft carriers.''

The OECD's reputation — and therefore its overall effectiveness — was damaged when it became ''rhetorically entrapped'' by tax havens and their allies. The haven coalition argued that small-nation sovereignty was being compromised by an organization of which they were not members. They were being bullied by a ''rich countries' club.'' They stressed that they were often excluded from deliberations and that when they were included, they were not treated as equals. They emphasized their lack of alternative means of economic development — and, in some cases, that the development of banking centers had been urged by the rich nations in the first place. Perhaps the most effective counterargument offered by havens was their highlighting of the inconsistency of the OECD efforts, which excluded OECD members Luxembourg and Switzerland from any proposed sanctions.

Next Time

Tax havens provide investors the opportunity to illegally hide their income and assets from tax collectors. The result is billions of dollars of lost revenue every year and gross unfairness to the chumps who are too busy, too scared, too uninformed, or too principled not to play the evasion game. There's a lot governments can do on the ''demand side'' to reduce offshore evasion — including lowering tax rates and increasing penalties and reporting requirements. This article is about the other side — the ''supply side''— of tax offshore evasion: the availability and accessibility of tax havens.

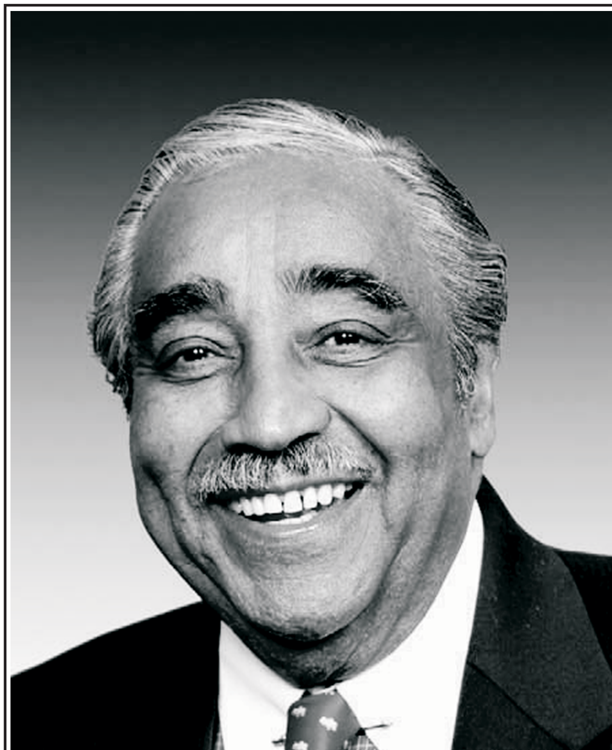
Government officials who make future efforts to curtail the supply of tax havens can learn a lot from the failed OECD effort. Those lessons include:

A clear statement of objectives. Tax evasion made possible by bank secrecy is the heart of the problem with tax havens. As Sheppard pointed out in 2001:

> The phrase ''tax competition'' is something of a misnomer for the 1998 report. The report explicitly states that it does not address the prototypical situation of tax competition, when one country just has a lower tax rate than the other. Nor does the report advocate a minimum level of tax.

(''It's the Bank Secrecy, Stupid,'' *Tax Notes*, Apr. 16, 2001, p. 385, *Doc 2001-10900, 2001 TNT 73-5*.)

By employing anti-tax-competition terminology, the OECD needlessly became a sitting duck for crippling verbal attacks by right-wingers. Sheppard asks rhetorically: ''Would the legislators quibble as much with a report entitled 'Destructive Bank Secrecy'?'' The answer, of course, is absolutely not.



File photo

House Ways and Means Committee Chair Charles B. Rangel cosigned a letter in 2001 strongly supporting tax havens.

Policymakers mounting a challenge to offshore tax evasion have to distance themselves from the distinct issue of tax competition.

Anticipate objections from the political right. The CFP is itching for another fight. Its main argument about the benefits of tax competition (in restraining the size of government) should be irrelevant. A clearly specified antihaven effort would have nothing to do with stopping legal tax avoidance. Only tax competition fostered by illegal evasion would be stifled. And the CFP does not condone illegal tax evasion.

Anticipate objections from the political left. The Congressional Black Caucus is concerned about the economic damage that would be done to Caribbean nations and other developing countries if fees from financial and legal services in tax havens were no longer available. Concerns about causing unemployment in poor nations should not be dismissed. And if, based on your knowledge of U.S. politics and foreign aid, you think humanitarian concerns will not be a large political factor, consider that the current chair of the House Ways and Means Committee, Charles B. Rangel, D-N.Y., is a member of the caucus. In a May 11, 2001, press release, Rangel praised O'Neill's reformulation of U.S. policy toward havens, saying, ''The OECD effort would have unfairly harmed our Caribbean friends without making certain that these countries have sufficient sources of income'' (*Doc 2001-13706, 2001 TNT 94-46*).

Propose realistic sanctions. Without the threat of substantive sanctions that tax havens can realistically expect developed nations to enforce, most havens will not be persuaded to adopt reforms contrary to their economic interests. Given the fragility and importance of reputation to tax havens, blacklisting should be one of those sanctions. But, as evidenced by the history of the failed OECD effort, blacklisting may not be enough for havens to adopt reforms that would significantly reduce their attractiveness to tax evaders. Furthermore, economic sanctions may have to be expanded beyond the defensive measures outlined by the OECD — that is, to nontax economic sanctions. Avi-Yonah made this observation in his May 3 testimony to the Finance Committee:

> If the political will existed, the tax haven problem could easily be resolved by the rich countries through their own action. . . . 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.

Propose generous benefits. We know by deductive economic reasoning that the fee and service income tax havens earn is significantly less than the revenue lost by governments through tax evasion. Governments that gain revenue from tax haven reforms should be able to provide aid to havens commensurate with the income lost by tax havens and still come out ahead. Proper calibration of aid efforts would be greatly assisted if havens simply told benefiting governments their expected losses and requested aid packages to compensate for those losses. Bruce Zagaris, an expert on Caribbean tax issues, points out that the U.S. has cut back assistance to Caribbean nations at the same time that it is seeking increased information exchange. He recommends that the U.S. adopt a policy of linking new tax and investment incentives to tax information exchange. (''TIEAs and the Case for Caribbean Tax and Investment Incentives,'' *Tax Notes Int'l*, Mar. 4, 2002, p. 983, *Doc 2002-5072, 2002 WTD 42-15*.)

Avi-Yonah told the Finance Committee:

> The U.S. should adopt a carrot and stick approach to tax havens in order to provide incentives to cooperate with information exchange. In particular, the U.S. 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.

At that same hearing, Owens also made thoughtful comments on providing aid to tax havens adopting reforms:

> Some of the smaller offshore jurisdictions will require assistance in replacing their ''concealment center'' activities by other real economic activities which can ensure the long term viability of these economies. This will require a ''whole of government'' approach from OECD countries that takes into account a number of different dimensions. Since the immediate beneficiaries of the implementation of the new tax standards will be the treasuries of OECD countries whereas the providers of assistance will be the state or foreign affairs departments of OECD countries, these policies must be coordinated both between OECD countries and between international organizations, particularly the IMF, World Bank and OECD. In addition, it is also important for OECD governments to consider the importance of establishing effective exchange of information mechanisms when expanding trade relations with offshore jurisdictions (e.g. through free trade agreements or other similar agreements) so that the further removal of trade barriers does not also result in expanded opportunities for offshore evasion.

(*Doc 2007-10986, 2007 TNT 87-35*)

Coordinate antievasion efforts with related efforts to reduce drug trafficking, money laundering, and terrorist financing. Many citizens who abhor other serious crimes have a lax attitude about tax evasion. This perspective is often shared by government and bank officials of both onshore and offshore jurisdictions. For example, bankers may abstain from lodging suspicious transactions reports when the crime in question is only tax evasion. Perhaps little can be done to change attitudes of the general public, but efforts against tax evasion would be bolstered by dismantling distinctions between ''fiscal'' and ''serious'' crime in the financial and law enforcement communities. Both types of criminals conduct clandestine activities in tax havens. Both can be swept up in the same net.

Consistency and a level playing field. Information sharing (and appropriate sanctions) should be widely and uniformly applied. In a war of words in which logic ultimately prevails and hypocrisy is exposed, there cannot be exceptions to antihaven efforts for European allies like Switzerland and Luxembourg. Moreover, the great financial centers of New York and London must provide legitimate foreign governments the same type of financial information the U.S. and U.K governments seek from tax havens.

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There is only so much a limited body like the OECD can do to oppose tax havens. Without the strong backing of member governments, it can only trim the excesses of jurisdictions susceptible to attacks on their reputations. If member countries want significant reductions in offshore tax evasion, they have to expend political capital in the international arena. Some say it is not proper for large countries to bully small countries just so the large countries can enforce their tax laws. That is not the view of the U.S. government as expressed by O'Neill in 2001. And certainly in other important areas of public policy — for example, narcotics and intellectual property — the U.S. aggressively encourages sovereign foreign governments to change their laws and enforcement efforts to be consistent with U.S. policy. In any such effort, the resources and diplomatic skills of the State Department will be indispensable.

Some may say that this is too tall an order and that exerting pressure on sovereign governments to collect tax revenue is not worth it. Perhaps. Perhaps we have to live with offshore tax evasion to further other foreign policy goals. That judgment is beyond the scope of pure tax policy. But it is up to tax experts to inform policymakers of the possibilities. ■

NEWS ANALYSIS

Current Taxation of Deferred Compensation

By Lee A. Sheppard — lees@tax.org

Around here, we don't care whether Harry Potter lives or dies. We don't know the ending, but we would want to point out that the kid who plays Harry in the movies is not getting any better looking.

Our recommended summer reading, for readers who like a dose of reality with their fairy tales, is *Richistan*, by *Wall Street Journal* correspondent Robert Frank. Frank has the somewhat bizarre title of "wealth reporter" at that paper, whose readers eat up his tales of the lifestyles of the rich and not famous. Frank's thesis, borne out in the title, is that members of America's new class of superrich have formed their own separate, parallel country. Trouble is that they control everything from politics to consumption patterns in the country that the rest of us live in.

Frank is no Marxist, even though one might think that hanging around yacht shows and butler schools would push a reporter's politics to the left in a hurry. He reports in a dispassionate style and even finds some redeeming qualities among his subjects.

Frank matter-of-factly details the ways the new rich differ from the old rich. One of the chief demarcations is their boats. The old rich sailed — a difficult and uncomfortable pastime that has been aptly described as standing fully clothed in a cold shower while tearing up hundred-dollar bills. The ultimate in boats for them is an antique teak sailboat with wood that has to be varnished and brass fittings that have to be polished.

> ***There never should have been such a thing as a nonqualified plan. A qualified plan should have been the exclusive means of deferral of compensation.***

The new rich don't sail. They have tacky power yachts so large that they could pass for Carnival cruise ships and cost about as much to maintain. A tank of fuel for one of these monsters costs more than the average household income. There are so many of these megayachts, Frank reports, that some resort areas have to regulate yacht traffic jams. Some pleasure boats are so big they have to dock at commercial ports next to oil tankers and sky cranes — obviating the point of showing off next to other yachts.