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AMERICA THE TAX HAVEN

By James S. Henry January 29, 1989

WE USUALLY think of tax havens as exotic, far-away places filled with shady characters whose business is taking in "laundry" and keeping secrets -- sultry tropical resorts like the Antilles, the Bahamas and Panama or chilly alpine retreats like Switzerland and Liechtenstein. It may come as a surprise, therefore, to learn that, at least so far as wealthy foreign investors are concerned, one of the world's largest tax havens is right here, on shore. As our country's economic position has shifted from international creditor to international debtor in the 1980s, failure to update our tax laws to reflect the new reality -- combined with the U.S. Treasury's growing need to attract foreign capital to finance its huge budget deficit -- have put the United States in the unattractive position of enticing foreign investors to escape taxation either at home or in this country. We did not come to embrace this dubious role all at once. Actually, the United States has long been a technical tax haven. Clever foreign investors have for many years been able to legally avoid paying almost all U.S. income and estate taxes on most forms of investment income generated here {see box}. And if they chose not to tell their home countries about the income, it was unlikely to be taxed anywhere. Even if the United States has a tax treaty with the home country that provides for information exchanges with foreign tax authorities, enforcement is not simple, because U.S. authorities may lack information on the income received by nonresident aliens here. Currently the United States has tax treaties with most industrial countries but with relatively few developing ones -- and none in Latin America. Until the mid-1970s, however, few foreign investors paid attention to the opportunities for tax avoidance offered by this country. Until then, the United States was still basically a net exporter of capital, and the main users of havens like Panama and the Antilles were . . . fellow Americans! These haven-seekers were primarily U.S. multinationals and individuals who sought to avoid taxes and regulations by setting up shell companies and foreign trusts offshore. Indeed, for more than 50 years our IRS has waged a more or less aggressive campaign against the abuse of such offshore havens by our fellow taxpayers. Beginning in the mid-1970s, however, there was a dramatic rise in the use of the United States itself as a haven. The offshore havens increasingly became "insulators" for investments or loans that were ultimately headed to our own shores. Such changes occurred in response to three strong waves of foreign investment that made the United States a net capital importer for the first time since before World War I. The first wave brought Arab investors, flush with petro-dollars after the 1973 oil crisis. In the late 1970s they were succeeded by Latins, who preferred to invest their flight (and cocaine?) capital in condos on Miami's Brickell Avenue, Texas' Padres Island and Colorado's Vail, rather than in their own insecure countries. The latest wave, which we're still riding, arrived in the mid-1980s from our more prosperous First World competitors, notably Japan and Germany, attracted by the dollar's sharp decline. Much of this incoming capital was direct investment, where foreigners bought U.S. businesses in order to operate them. This type of investment is usually taxed at ordinary corporate rates. But more than half of the capital inflow has been investments in financial assets or real estate by wealthy individuals, who benefit greatly from our favorable tax laws. These developments have not escaped the attention of the U.S. legal and accounting professions. A nationwide network of so-called "inbound" specialists has grown up to cater to the legal and accounting needs of foreign investors. The Committee on U.S. Activities of Foreign Taxpayers has become one of the largest and most active in the American Bar Association's Section on Taxation, and every major accounting firm now has its own cadre of inbound experts. For example, Peat, Marwick, Mitchell has 25 partners who are specialists in international taxation, and it publishes its own newsletter for foreign investors -- "Project U.S.A." Arthur Anderson recently hired two leading experts on tax havens away from the U.S. Treasury and set them to work serving private clients. What are the ethics of helping foreigners park their funds here tax-free -- presumably, in many cases, earning income that is not reported at home? According to the vice chairman of the ABA's committee, the matter is quite simple: "American lawyers have no obligation to enforce the laws of another country. The U.S. has no tax treaties with any Latin country . . . . Besides, there are competing interests. On the one hand, we want to encourage the flow of capital to the United States partly to finance our own deficits. On the other hand, there's the question of equity for countries like Mexico . . . . But I really don't see what's wrong with giving your assets a juridical home." Anyone who has ever interviewed a Panamanian or Swiss lawyer about the propriety of helping Americans "give their assets a juridical home" will find such logic strikingly familiar. Our conversion into the premier haven for the world's tax avoiders is, in large part, the result of the failure to keep our tax code up-to-date in terms of economic realities. The law is still rooted in the good old days when the United States was a capital exporter and the rest of the world was playing catch-up. In the tax lawyer's jargon, we were then a "resident" country. In contrast, most other countries were "source" countries -- that is, they were net importers of equity, loans and technology, and therefore net payers of interest, dividends and royalties to foreign creditors like us. In the 1950s and 1960s we still had the world's largest international banks, which made a lot of foreign loans. So we naturally favored tax laws that left interest payments to foreign bankers alone. We had the world's largest film industry, which charged royalties for its works everywhere. We had the world's largest pharmaceutical industry, which licensed its technology widely in exchange for royalties. RCA was still the world's leading developer of commercial television technology, and it collected royalties on every TV set and VCR manufactured by the Japanese. And so on. So it was natural that we wanted all these foreign payments left untouched by the taxing authorities in the "source" countries where they originated. But, since we were, in the good old days, a relatively high-tax country, with a progressive income tax, we were also opposed to foreign tax systems that enticed our own investors offshore. Thus we deplored "foreign tax havens," which we conveniently defined as countries that taxed their own residents too little, giving people and companies an incentive to locate there. During the 1960s, senior

Treasury officials actually went on a kind of moral crusade in favor of low "source" taxation and strong "resident" taxation, and President Kennedy reportedly threatened the Swiss with economic sanctions if they did not cooperate more fully with the IRS. To be consistent, we enacted tax policies at home similar to the ones we advocated abroad. After all, the United States could hardly expect other countries to exempt foreign interest from taxation if we did not do so, too. Such principles did not really cost very much at that time -- there was little foreign investment here to tax, compared to all our own foreign investments and loans. And of course our banks loved this policy -- it helped them make loans and sell flight deposits, all at once. Not surprisingly, many other countries did not share our vision of tax justice. Many developing countries levied stiff taxes on the profits of multinationals, and quite a few added withholding taxes on the royalties and interest paid to foreigners -- usually modest ones that generated revenue without driving the foreign banks away. The conditions for our "superior tax morality" began to erode in the late 1960s, when the United States first began to run up huge balance-of-payments deficits. By the mid-1980s we had exchanged a "resident" economy for a "source" economy. Furthermore, our own domestic tax system had become much less progressive and more dependent on Social Security, excise, sales and property taxes, which offshore havens can't defeat. So the incentive for our own citizens to exploit foreign tax havens also declined. (This is not to suggest that the United States is no longer opposed to offshore havens. Drug traffic, for example, has given policymakers a new reason to campaign against them.) And finally, of course, there were those large budget deficits to be financed at a time when net private savings in this country were headed toward a post-war low. Small wonder that, in 1984, Congress repealed the 30-percent withholding tax on interest earned on foreign-held government and corporate securities or that, in 1985, the Treasury issued special registered securities tailor-made for foreign investors desiring anonymity. Meanwhile, many of our friends and neighbors have become primarily "resident" countries, exporting more capital than they take in. These include not only the Japanese and the Germans, but also many so-called Latin "debtors," whose own elites often own far more flight capital abroad than the value of their countries' debts. International tax law still lags far behind these fundamental changes. The United States still taxes wealthy foreigners on the basis of residency, while many of their home countries, especially in the Third World, still tax them on the basis of the income's source -- with zero taxes for foreign-source income. As a result, much of this U.S. portfolio investment income simply falls through the cracks, and is taxed by nobody. So there has come to be a large class of wealthy "citizens of the world," residents-of-nowhere, who wander the globe from Gstaad to Rome to London to New York to Tokyo and back again, enjoying what must be one of life's greatest pleasures: the total avoidance of personal income taxes. In tax policy, perhaps it is time for the United States to start behaving more like the debtor that is really is. James Henry, a New York lawyer and economist, is writing a book on Third World capital flight to be published by Alfred A. Knopf.