Testimony of Michael J. McIntyre and Robert S. McIntyre
On Banking Secrecy Practices and Wealthy American Taxpayers
Before the U.S. House Committee on Ways and Means
Subcommittee on Select Revenue Measures
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We thank the subcommittee for the opportunity to present our views on how the United States can reduce international tax evasion by wealthy Americans. One of us, Michael J. McIntyre, is a professor of law at Wayne State University in Detroit. He has written extensively on international tax matters. The other of us, Robert S. McIntyre, is the Director of Citizens for Tax Justice.

The recent revelations of aggressive facilitation of tax evasion by the Swiss banking giant, UBS, has given a public face to the longstanding suspicion that a major segment of the international banking community is fundamentally corrupt. Of course, no knows for sure how many banks have engaged in the types of practices for which UBS has been called to account. The widespread tax fraud by Liechtenstein banks, widely reported in the press, makes clear, nevertheless, that UBS is not just a special case. We believe that the United States and its major trading partners have a major systemic problem of bank fraud that requires major systemic solutions.

We will discuss here three important ways that wealthy Americans evade taxes on their investment income. The first is by transferring assets to offshore tax havens that maintain secrecy to avoid IRS detection. The second is by fraudulently taking advantage of the exemption provided under Internal Revenue Code Section 871(h)(1) for portfolio interest paid to foreign persons. The third is by posing as foreign persons and taking advantage of U.S. income tax treaties, typically treaties with countries that maintain bank secrecy rules. After our discussion of each problem area, we offer solutions that the Congress could pursue to reduce tax evasion in that area.

1. Transfer of Assets to Offshore Tax Havens

A. *Statement of the Problem*

Abusive tax avoidance typically involves complex transactions. In contrast, tax-evasion transactions are unambiguously illegal. Under U.S. tax laws, American citizens and residents are required to report all of their income from whatever source derived, including income earned through deposits in banks located in offshore tax havens. There is no ambiguity or confusion about the applicable law. Yet it is widely suspected that hundreds of thousands of wealthy Americans are moving assets offshore and are failing to report the income earned on those assets. They are not relying on some obscure or ambiguous provision of the law to justify their conduct. They simply are hoping not to get caught.

The Internal Revenue Service has significant powers to ferret out tax evasion that is accomplished by holding assets within the United States. It is understaffed, and its ability to cope even with domestic tax evasion has been compromised over the past decade. Still, the tools for combating domestic evasion are in place and work reasonably well when they are applied. Those tools include withholding at source, information reporting by third parties, and easy assess to records of banks and other financial institutions.

None of these tools is available to catch tax cheats who move their assets to offshore tax havens. These tax havens have strict bank secrecy laws that shelter their financial institutions from any effective reporting requirements. There is no obligation of these banks or other investment agents to withhold taxes due to the United States or to provide the United States with periodical information reports on income paid to American taxpayers. In some cases, the Internal Revenue Service (IRS), through tips or otherwise, may discover that certain American taxpayers appear to be engaging in tax fraud. In some such cases, the IRS may be able to get some limited assistance from the government of an offshore tax haven. In general, nevertheless, the Internal Revenue Service is being asked to locate the proverbial needle in the haystack.

In 1998, the OECD, with support from the United States, sought to pressure offshore tax havens into offering cooperation to OECD member states seeking to combat international tax evasion and abusive avoidance. This initiative had some success. For example, as a result of the initiative, the Cayman Islands negotiated a Tax Information Exchange Agreement (TIEA) in 2001 with the United States, which went into force in 2006. The OECD initiative slowed considerably after 2001, due in part to lack of support from the United States. It has recently been revived, and the revised initiative has already borne fruit. Several tax havens that are infamous for their collusion with tax cheats have signed TIEAs or have promised to do so. Even Switzerland had signaled a willingness to depart from its strict bank secrecy rules in special cases, although it apparently expects the process of agreeing to the terms of any TIEAs to be drawn out over a lengthy period.

The U.S. experience with TIEAs is highly secret. No reports on the use of those agreements are provided to the public. Our general impression, nevertheless, is that the TIEAs have been ineffective in curtailing tax evasion. Some commentators have suggested that they may have a negative value in some cases by giving the appearance of propriety to a government that is fully engaged in the business of attracting and protecting tax cheats. That claim was made, for example, with respect to the executive agreement between the United States and Liechtenstein. The Liechtenstein banks have been in the news of late, due to the discovery that they were facilitating tax evasion by German citizens and, it was soon learned, by citizens of many other countries, including the United States.

TIEAs are not useless. They are a useful first step in encouraging offshore tax havens to cooperate with organized efforts to curtail international tax evasion, and even without further progress can be helpful in a few isolated cases. However, they have not provided a systemic solution to international tax evasion and cannot be expected to do so. As illustrated by the agreement with the Cayman Islands, an exchange of information is limited to cases in which the U.S. tax authorities have already targeted an individual for tax evasion and can "demonstrate the relevance of the information sought" by providing the Cayman tax authorities with the name of the suspected taxpayer, the reason for believing the information requested is within the possession of a person under the jurisdiction of the Cayman government, and so forth. That is, the Cayman government has agreed to be of assistance when the U.S. government has already fingered the tax cheat. It is unwilling to be helpful in identifying U.S. tax cheats in the first instance.

B. *Suggested Solutions*

i. *Provide IRS with the resources and legal protections it needs to detect and prosecute tax evaders*

Virtually all independent observers agree that the IRS does not have the resources needed to fight international tax evasion effectively. It is underfunded in this area by several orders of magnitude. We do not offer advice on what the revised budget should be, since budget recommendations ought to be based on specific proposals for how the requested funding would be used. We simply join those who say that the current level of funding is ridiculously low. One data point suggesting inadequate resources is that the IRS, when it does uncover widespread tax fraud, is led to offer some form of amnesty from fines and criminal prosecution to the offenders who admit their guilt without the need for a trial. Amnesty for tax cheats obviously undercuts the penalties that were devised by Congress to discourage tax evasion. The IRS should be given the resources it needs to make decisions to prosecute tax-evasion cases on the merits.

Congress also needs to make sure that IRS agents working in the field are not subject to personal suit for legitimate actions taken to combat international tax evasion. Stopping tax evasion is a rough and tumble business. Agents often act on tips, and tips sometimes are wrong. Many taxpayers engaged in evasion are belligerent and litigious. There is little doubt that morale at the IRS has been low in recent years, partly due to fears that they would be subject to prosecution and litigation just for doing their job. That fear is due in significant part to a few noxious provisions in the Internal Revenue Service Restructuring and Reform Act of 1998 (H.R. 2676), enacted after the infamous Senate Finance Committee hearings in late 1997. Congress needs to revisit those provisions in an atmosphere less hostile to enforcement of the nation's tax laws.

ii. *Broaden TIEAs to include automatic information exchanges*

What makes U.S. banks a poor choice for the American tax cheat is that banks regularly provide the IRS with information reports about the income earned by their depositors. It is that kind of regular information flows that the United States needs to receive from the financial institutions in the offshore tax havens. Getting agreement from these countries will not be easy. The United States will need to work with the OECD and other groups to fashion a policy that rewards governments that cooperate and imposes penalties on governments that continue to facilitate international tax evasion. The OECD, by extracting TIEAs from some of the world's greatest scofflaw countries, has demonstrated the value of the stick. Practical experience in other areas suggests that the carrot can be even more effective.

iii. *Impose greater reporting requirements on U.S. financial institutions, accounting firms, and law firms*

Many Americans engaging in offshore tax evasion are assisted by U.S. financial institutions, international accounting firms and law firms. These facilitators of evasion should be required to provide the U.S. tax authorities with information reports on transfers to any jurisdiction that is not cooperating with international efforts at curtailing international tax evasion and abusive tax avoidance.

iv. Endorse the United Nations Code of Conduct on Cooperation in Combating International Tax Evasion

At its meeting in October of 2008, the United Nations Expert Committee on International Cooperation on Tax Matters endorsed in principle a code of conduct that would charge participating governments with a moral obligation to take various steps to curtail international tax evasion and abusive tax avoidance. The code, as revised, is expected to be ratified by the committee by June of this year. The code codifies an emerging international standard on transparency and cooperation. One objective of the code is to put moral pressure on rogue governments that refuse to provide information exchange or that actively promote tax evasion by allowing the owners of legal entities to remain anonymous.[1]

2. The Exemption for Portfolio Interest

A. *Statement of the Problem*

The exemption for portfolio interest was added to the Code by the 1984 tax act. Under that exemption, nonresident alien individuals and foreign corporations receiving interest paid on qualifying bonds issued by U.S. persons are not subject to the 30-percent tax under Code section 871(a). The bonds may be in bearer form or in registered form. A qualifying bond must be issued in a fashion that reduces the risk that it will to be held by U.S. persons. The issuer does not need to have actual knowledge, however, of the identity or even the nationality of the holder for the exemption to apply.[2]

Congress enacted the exemption for portfolio interest to expand access of U.S. borrowers to the Eurobond market and other international capital markets. Interest rates on bonds traded in the Eurobond market have tended to be lower than U.S. interest rates. The Treasury Department was particularly keen to gain access to the Eurobond market in order to reduce the cost of financing the large federal deficits that were incurred during the 1980s. The reason for the lower interest rates was quite simple — those lending money in that market were not reporting the income on their investments to their home country. Whether by design or otherwise, the Eurobond market has provided an ideal investment environment for tax evaders.

Congress and the Treasury Department were aware that many of the purchasers of portfolio-interest bonds sold on the Eurobond market would be tax cheats. Indeed, the

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[1] In the interests of full disclosure, it may be noted that one of us (Michael McIntyre) prepared the initial draft of the UN Code of Conduct when he served as interim chair of the Committee's subcommittee on information exchange.

[2] Regulations have been issued that specify the requirements that U.S. issuers must meet in order for interest on their bonds to be deductible. Reg. § 1.163-5(c)(2) (1997). These regulations are effective January 1, 2001. For tax years before 2001, see Temp. Reg. § 35a.9999-5 (1990) (questions and answers) and Reg. § 1.163-5T (1990).

portfolio-interest rules were designed to facilitate tax evasion by investors in portfolio-interest bonds. As noted above, the beneficial owners of the bonds were not required to identify themselves to the bond issuers.

In addition, the beneficial owners of portfolio-interest bonds were allowed to invest in those bonds through so-called “qualified intermediaries.” A qualified intermediary typically was a bank or other financial intermediary that consolidated the investments of various tax cheats and purchased the portfolio-interest bonds on their behalf. The rules were designed to make it difficult for the U.S. government to learn who the tax cheats were. Such ignorance was important because the United States is obligated to provide information about the investment income of residents of countries having a tax treaty with the United States under the treaty’s exchange-of-information article.

Code section 871(h) provides some weak rules intended to prevent American taxpayers from holding portfolio-interest bonds. As the UBS case illustrates, these rules are not effective in preventing Americans from acquiring such bonds. We warned Congress of that danger when the portfolio-interest exemption was first adopted.[3] In brief, the rules designed to make the portfolio-interest bonds attractive to foreign tax cheats by making their invests anonymously make it difficult to prevent Americans from using the cloak of anonymity to become the beneficial owner of portfolio-interest bonds.

In adopting the portfolio-interest rules, the United States actively recruited financial institutions to help foreigners evade the taxes imposed by their government on interest income derived from the United States. This evasion was intended to benefit U.S. borrowers by allowing them to borrow from the tax cheats at a reduced interest rate. The United States also adopted rules intended to prevent these same financial institutions from extending their fraudulent behavior to assist Americans in evading U.S. taxes. The legal rules applicable to these financial institutions were clear. The moral underpinning of those rules was not.

The Treasury Department was given the authority in the 1984 legislation to impose rules that might limit the opportunities for qualified intermediaries to assist Americans in evading U.S. taxes. It waited, however, over a decade to issue regulations governing the withholding obligations of qualified intermediaries. The resulting regulations seemed to assume that the financial institutions that were facilitating foreign tax evasion would act in good faith to prevent evasion by Americans of U.S. taxes. The regulations did not accomplish their goal, as the UBS fraud has illustrated.

The bank secrecy rules of countries such as Switzerland, Belgium, and Luxembourg complicate the problem of determining whether Americans have been investing illegally in portfolio-interest bonds. These countries might provide information to U.S. tax authorities under their tax treaty with the United States if the U.S. tax authorities are able to produce

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[3] *See* “Statement of Robert S. McIntyre and Michael J. McIntyre,” Hearings Before the Subcommittee on Savings, Pensions and Investment Policy And the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance Concerning S. 1557, a Bill to Exempt Foreign Individuals and Corporations from the 30 Percent Withholding Tax on Interest Income,” September 19, 1983.

compelling evidence that one or more identified Americans had engaged in tax fraud. As a practical matter, however, it seems highly unlikely that the U.S. tax authorities have obtained any useful information from treaty partners that have strong bank secrecy rules.

B. *Suggested Solutions*

i. *Eliminate the portfolio-interest exemption*

The world have changed a lot since the portfolio-interest exemption was adopted in 1984. Today, most tax professionals recognize that a country cannot solve its problems of international tax evasion and abusive avoidance without some rather high level of cooperation with its major trading partners. It is unrealistic for the United States to expect other countries to help it police its tax system when it is actively encouraging the residents of those countries to invest "tax free" in the United States. The United States must end is sordid deal with foreign tax cheats by limiting the exemption for portfolio interest to foreign persons who are complying with the laws of their home country.

The easy way, from a technical perspective, for the United States to get out of the tax evasion business would be for Congress to simply repeal the portfolio-interest exemption. That way is also the best way in our view.

ii. *Limit the portfolio-interest exemption to complying taxpayers*

Although the portfolio-interest exemption was designed to attract investment by tax cheats, it also may attract investments from taxpayers who are not subject to tax on foreign income in their country of residence. For example, residents of oil-rich countries, such as Qatar and Saudi Arabia, do not impose an income tax on their residents. Congress may decide to revise the portfolio-interest exemption so that it is unattractive to tax cheats but remains attractive to complying taxpayers.

To make the portfolio-interest exempt unattractive to tax evaders, Congress should take two steps. First, it should require withholding agents, including financial intermediaries, to verify the true residence of taxpayers claiming the exemption. If the withholding agents cannot do so, they would be required to withhold tax at a rate of 10 percent. That money would be held in escrow by the U.S. Treasury Department for a reasonable period and would be paid out to claimants able to substantiate their residence claim.

Second, the Internal Revenue Service should establish procedures for the automatic exchange of information about payments of portfolio interest to residents of countries with which the United States has an tax treaty with an exchange of information article. As noted above, the United States seems to have structured the "qualified intermediary" rules to reduce the likelihood that it would be able to provide treaty partners with information about the tax evasion of their residents. The qualified-intermediary regulations need to be modified substantially, perhaps with a new congressional mandate.

3. Treaty Shopping by American Investors

A. *Statement of the Problem*

The United States has entered into over 60 bilateral income tax treaties, almost all of which significantly reduce the 30 percent withholding rate otherwise imposed by Code section 871 (individuals) and 881 (corporations) on investment income derived from the United States. The typical tax treaty reduces the withholding tax on interest and royalties to zero.

In principal, the reduced treaty rate applies only to persons who are not U.S. persons and who are bonafide residents of the U.S. treaty partner. In practice, the United States has difficulty verifying that those claiming treaty benefits are entitled to those benefits. When the treaty partner has adopted strict bank secrecy rules, it typically offers the United States little help in ascertaining the true residence status of those claiming treaty benefits from the United States. A significant number of these so-called foreign investors are thought to be American citizens.

Treaty shopping is often engaged in by foreign persons who are actually resident in a country that does not have a treaty with the United States. In addition, residents of a country having a tax treaty with the United States may engage in treaty shopping if the treaty entered into with the United States by their country of residence is less favorable than the treaty of some third country. American citizens and residents may engage in treaty shopping by posing as foreign persons entitled to treaty benefits under a tax treaty between the United States and the country in which they are claiming residence. In all of these cases, the U.S. Treasury loses tax revenues to which it is entitled.

The United States has attempted since the late 1970s to curtail treaty shopping by including a "Limitation on Benefits" article (typically Article 22) in its tax treaties. In some cases (e.g., the U.S.-Netherlands treaty), that article is long and complex. How effective the anti-treaty shopping articles have been is unclear. As best we can determine, the Internal Revenue Service has not litigated a single case in which it sought to prevent a taxpayer from obtaining treaty benefits under the "Limitation on Benefits" article.

What is clear is that the United States cannot enforce its anti-treaty shopping rules without obtaining rather detailed information about the status and financial affairs of the persons claiming treaty benefits. Such information is generally difficult to obtain. It may be nearly impossible to obtain when the treaty partner at issue is enforcing strict bank secrecy rules.

The United States has been nearly alone in its efforts to combat treaty shopping, which began in earnest during the Carter administration. Countries have agreed to include a limitation-on-benefits article in their treaties with the United States, but they rarely do so in their treaties with other countries. The OECD has taken some action, primarily at the urging of the United States, to deal with treaty shopping through its Commentary on its Model Tax Convention. The tax guides available worldwide make clear, nevertheless, that treaty shopping is widespread and implicitly condoned by many governments.

Governments seem willing to condone treaty shopping for two reasons. First, they may be indifferent to tax evasion that does not diminish the tax revenues of their country. Second, they may believe that they may obtain some investments in their own country from tax cheats engaging in treaty shopping. They are either unaware or unconcerned that their own residents may be engaging in treaty shopping to earn income tax free in their own country.

B. *Suggested Solutions*

i. Tentative withholding tax on payments to uncooperative states.

We recommend that Congress adopt legislation that would impose a tentative withholding tax of 2 percent on all interest, dividends and royalties paid to persons claiming treaty benefits under a treaty with a country that does not engage in an effective exchange of information. An effective exchange would entail not only the provision of information on specific request but also automatic exchanges of information. To avoid abrogating U.S. treaty obligations in violation of international law, the legislation should make clear that the 2%-withholding tax is refundable in full, with interest, if the taxpayer claiming the treaty benefit proves that it is actually entitled to a zero rate of withholding.

In response to widespread pressures to curtail international tax evasion by banks and other financial institutions, a number of countries, including Switzerland, Luxembourg, and Singapore, very recently have agreed to provide for an exchange of information, notwithstanding their bank secrecy rules.. Switzerland, however, has indicated that it will not break with its bank secrecy regime unless the requesting state provides solid evidence that tax evasion may have occurred by a named individual or entity. Other states may impose similar or additional limitations on their willingness to cooperate with foreign taxing jurisdictions.

A withholding tax, even at a rate as low as two percent, will raise some revenue and, more importantly, will trigger a record-keeping obligation on the persons responsible for withholding. In addition, by watching which taxpayers seek to claim the proffered refund, the U.S. tax authorities will get some clues as to the extent of tax evasion that is occurring.

ii. Eliminate zero rate in new and revised treaties

The United States has been a leader in encouraging countries to agree to impose a zero rate on interest and royalties and even on certain related-person dividends. This policy was thought to increase U.S. tax revenues because the tax forgone in the foreign source countries would reduce the amount of the foreign tax credit that the U.S. would need to give to its residents investing abroad. That policy was never effective in augmenting U.S. tax revenues. Now that the U.S. is a net importer of capital, it clearly is a revenue loser. It is also bad policy. The source country ought to be given a fair share of the income derived from investment within its borders, as the League of Nations acknowledged nearly 90 years ago.

The rules on withholding rates are central to any treaty negotiation, so the United States cannot unilaterally change its treaty rules on withholding rates without violating international law. But it can decline to continue the failed policy of offering zero rates at the negotiating table.

iii. Terminate bad treaties

The United States has a few treaties that are widely viewed as bad treaties that do not serve the interest of the United States. The Treasury Department from time to time has tried to revise these treaties without success. The proper action now is simply to give proper notice of termination. It is possible that such a notice will prompt negotiations that would result in a treaty beneficial to the United States. If so, all to the good. The more likely result, however, is that the United States would have one additional country with which it does not have a tax treaty. That result is clearly better than the status quo.

4. Conclusion

The ability of Americans to tax themselves and fund government programs has declined over the past two decades — and precipitously in the past eight years. To regain the lost power to tax, the government needs to take action to fix its international tax rules and procedures. In particular, it needs to strengthen its system for taxing American citizens and residents on income stashed in tax havens.[4]

Effective action against tax evasion and abusive avoidance schemes requires countries with conflicting economic interests to cooperate in fairly sophisticated ways. In the past, countries have made a show of stopping tax evasion and abusive avoidance only to settle for formal arrangements with little practical effect. Fortunately, the prospects for international tax reform have never been better. This opportunity is the result of several factors, most significantly the major decline in the traditional power of the international financial community and the discrediting of the market as the appropriate mechanism for regulating banks and other financial institutions. Also, the reputation of the big accounting firms has never been worse.

The movement to curtail international tax evasion will not occur without leadership in high places. The Obama administration will need to lead the way in negotiations with its OECD partners and with the many developing countries that are excluded from the OECD.

Congress also has a major role to play in combating international tax evasion. It must repeal beggar-thy-neighbor policies intended to attract investment in the United States by foreign tax cheats. It needs to provide funds and legal protection to the IRS so that the IRS can ferret out the tax cheats and bring them to justice. It needs to encourage the Administration to revise tax-treaty policies that currently facilitate international tax avoidance and evasion. Finally, it needs to take the moral high road by promoting transparency and cooperation in the struggle to contain international tax evasion. One step in that direction would be to endorse the UN's forthcoming code of conduct on that topic.

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[4] *See* Michael J. McIntyre, "A Program for International Tax Reform," 122 Tax Notes 1021 (Feb. 23, 2009).