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OFFSHORE TAX EVASION: STASHING CASH OVERSEAS

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OFFSHORE TAX EVASION: STASHING CASH OVERSEAS

THURSDAY, MAY 3, 2007

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:07 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Grassley, and Bunning.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

In Ecclesiastes, the preacher urged his listeners to trade overseas, for they would find a good return. He said, "Cast your bread upon the waters, for after many days you will find it again."

World trade has certainly generated a good return: the world's pension, insurance, and mutual fund business now totals at least $46 trillion, the world's stock market capitalization is more than $40 trillion, and the world's credit derivatives market amounts to more than $250 trillion. Foreigners now own about $12 trillion of American stocks, bonds, and other assets, and that includes $2 trillion of Federal Government debt.

Most think international trade is a healthy exchange of goods and services, but, as international trade becomes more complex, it is becoming more and more difficult to track transactions legally subject to taxation.

As a result, offshore tax evasion has become a large and growing element of the tax gap—that share of taxes legally owed that is not paid. For years, the Federal Government has been concerned about U.S. taxpayers hiding behind the veil of foreign corporations, and today the government has the added challenge of keeping up with the $1.5 trillion in the estimated 8,000 hedge funds investing around the globe. The IRS is increasingly outgunned in its effort to enforce tax rules in the international economy.

Consider these offshore tax scams that have recently come to light: two brothers from Texas set up 58 separate trusts as shell corporations, sheltering tens of billions of dollars of assets on which they avoided paying taxes; a car dealer from Illinois was charged with pretending to live in the Virgin Islands just so he could get a break on his taxes; a former U.S. Attorney from North Carolina pleaded guilty to failing to disclose on his taxes that he had an offshore account; a dentist in California was sentenced to 2 years in prison for faking tax deductions and hiding money in an offshore bank account.

These are just the scams that we know about. Common sense dictates they are just the tip of the iceberg. I am pleased that today we can kick off our work in this Congress on international tax evasion. Today we will hear the results of a GAO investigation into a critical part of our offshore tax enforcement program.

GAO focuses on almost $300 billion in funds that it has identified as being transferred out of the United States every year, and GAO considers the tax issues raised by those transfers.

The real amount transferred overseas is much higher, so this is a good start for our oversight agenda. Frankly, one job for the Federal Government is just to nail down the amount being transferred offshore. We need to learn what that total amount is, and after that, we need to learn much more about how much tax is being avoided—that is, both the denominator and the numerator.

Within the $300 billion total, we are told that the IRS has no idea where $19 billion ends up once the funds are transferred overseas. I find this troubling.

Today we will hear the results of two GAO reports. The first deals with qualified intermediaries, which are foreign banks and other exchanges that process funds entering and leaving the United States. In a second report, GAO explains that the IRS takes much longer to finish its examination of an offshore tax evasion case than a domestic case, but the return to the IRS from an offshore case is typically 3 times what is recovered from a domestic case. This is a sure sign that the volume of offshore tax evasion is huge.

GAO gives us some recommendations to consider. GAO recommends that Congress should consider extending the statute of limitations for complicated offshore tax evasion cases. GAO recommends that qualified intermediaries need to do a better job of identifying and tracking the money that they handle. And the GAO recommends that the IRS needs to do a better job of tracking information about foreign financial transactions.

I want to welcome our witnesses from the Treasury Department, the University of Michigan Law School, and the Organization for Economic Co-operation and Development. All three can comment on the GAO findings, and all of our witnesses can help us explore the broader issues on offshore tax evasion.

This hearing can help us to begin thinking about how the international community will eventually structure its tax system, something I care a lot about. We have seen the outsourcing of jobs, but now we are risking the outsourcing of our revenue base.

We have to contend with tax havens, but now even our friends in Europe are busy lowering their corporate taxes. We have also seen cases of American companies moving their intellectual property overseas in order to pay lower tax rates.

Part of the problem is that the Treasury, the IRS, and the American institutions know far less than they should. With international trade increasingly flowing across national boundaries at the speed of light, it is more and more difficult to make sure that we are collecting the taxes that are owed and the honest American taxpayers who work hard and do not have the ability to engage in offshore activity are not left holding the bill.

So today we will examine the effort to combat tax evasion. In days to come, this committee will ask where our tax system should fit in the new global economy. So let us do what we can to ensure that American businesses continue to find profit and trade upon the waters. Let us also make sure that U.S. tax enforcement is not lost at sea, and in not too many days we may once again find the right balance.

Senator Grassley?

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Thank you very much.

For those people who do not follow the work of this committee over a long period of time, and maybe for a couple of our witnesses who do not, let me say, about this issue, that in the 7 years that Senator Baucus has led his party and the 7 years I have led my party as leaders on this committee, there is no issue that we have had more close cooperation and almost unanimity of opinion on than working to close illegal tax loopholes. So, I thank Chairman Baucus for continuing this work with this hearing on offshore tax evasion and the international tax gap.

Like the rest of the tax gap, offshore tax evasion is not a new issue, but it is an issue of growing importance in an increasingly global economy. Senator Baucus gave you the figures on how large it is in the global economy.

In the global economy, investment flows without regard to national borders, but a nation's taxing jurisdiction is a matter of policy and in practical effect is often limited by national borders.

The focus of today's hearing is to examine the problems of U.S. income tax evasion by individual taxpayers who hide their assets and income in foreign bank accounts, or for that matter any foreign entity.

Since 1913, our tax code has subjected U.S. citizens to income tax on their worldwide income. No matter what Internet purveyors of tax evasion say, this principle cannot be avoided by living on a yacht or by putting passive assets or income offshore.

The tax code has rules to prevent this, and reporting requirements to assure that the IRS is aware of the foreign activities of U.S. taxpayers. Taxpayers that willingly violate these rules are guilty of tax fraud.

Our existing reporting requirements regarding foreign activities of U.S. taxpayers are largely a matter of self-reporting. As a result, information exchanged with other jurisdictions is an important tool for our government.

Our income tax treaties contain an article on information exchange designed to help the government obtain quality information to enforce our tax laws. In addition, administrations past and present have entered into over 20 tax information exchange agreements with jurisdictions that are often referred to as "tax havens."

An important part of the value of our information exchange network lies in its deterrent effect. In other words, transparency makes a big difference. Taxpayers who know the IRS can get access to tax information from foreign jurisdictions will obviously think twice before willingly failing to satisfy their self-reporting requirements.

As we will hear today, the OECD encourages effective information exchange, and the United States has been a leader in the international community in this area. Offshore tax evasion is not just a U.S. problem; it is an international problem.

Sensible solutions to the offshore tax evasion problem should aim to improve on our tax information exchange network and not put that network at risk. The problem of offshore evasion is not that our laws permit it; the problem is that there are some taxpayers who are intent on cheating and hiding their income from the Internal Revenue Service.

The IRS has been successful in catching many of these tax cheats, but we are here to say, more can be done. So, I look forward to today's exchange and thank the witnesses for being here.

The CHAIRMAN. Thank you, Senator. I also want to thank you personally for your work in trying to enforce the code, and also your work with me, the two of us working together, on a joint basis.

Senator GRASSLEY. Sure. Absolutely.

The CHAIRMAN. I deeply appreciate that. It means an awful lot to an awful lot of taxpayers in this country, what you are doing.

All right. Now we want to introduce the witnesses. Thank you. The first witness is John Harrington, Acting International Tax Counsel for the Department of the Treasury; then Jeffrey Owens, director of the OECD Center for Tax Policy and Administration, who will discuss OECD's work on offshore tax evasion and effective information exchanges; then Mr. Reuven Avi-Yonah, professor of tax and director of international tax at the University of Michigan; and finally, Mr. Brostek. Michael Brostek is Director of Tax Issues on the Strategic Issues Team at GAO, who will discuss two projects, one on the statute of limitations, the other on the qualified intermediary program.

Thank you all for coming, gentlemen. As you know, we all get about 5 minutes each, but I am sure you have longer statements which will automatically be included in the record.

Mr. Harrington, why don't you proceed?

STATEMENT OF JOHN HARRINGTON, ACTING INTERNATIONAL TAX COUNSEL, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. HARRINGTON. Mr. Chairman, Ranking Member Grassley, and distinguished members of the committee, thank you for the opportunity to participate this morning and discuss the serious problem of offshore tax evasion.

I have a written statement that I would request be made part of the record, and I would like to offer some oral remarks.

My name is John Harrington, and I am Acting International Tax Counsel at the Department of the Treasury. The Treasury Department is very concerned about the use of offshore jurisdictions to evade U.S. tax. We have been aggressively pursuing abuses, and we intend to continue doing so.

At the same time, we have sought to target our efforts on the sources of abuse and ensure that we do not overreact, especially in a way that hinders legitimate cross-border trade and investment activities, which are so critical to U.S. businesses and U.S. jobs.

A one-size-fits-all approach will not work in stopping offshore tax abuse while still permitting legitimate cross-border transactions. This is why the Treasury Department has undertaken a multifaceted approach to deal with the problem of offshore tax evasion.

In my written statement, I describe the actions we have taken and continue to take, especially regarding information exchange, to deal with this difficult but important issue. This has been a long-term problem, and we must continue to take a realistic, long-term view in combatting offshore tax evasion.

While the determined tax evaders may flaunt the tax rules, some taxpayers opportunistically seek to take advantage of ambiguous or outdated tax rules. Accordingly, we modify or update U.S. tax rules when we determine that they are facilitating abuse.

For example, in the last few months we have issued three sets of regulations dealing with misuse of the Foreign Tax Credit. We have issued significant guidance in the area of transfer pricing, dealing with cross-border services and cost sharing. We have also addressed other abuses, such as those involving private annuities.

In most cases, however, the problem of offshore tax abuse lies not with our tax rules, but with attempts to hide from them. Accordingly, to enforce our tax laws, we have to exchange information with other countries.

In today's global economy, countries must be able to obtain and exchange the information needed to enforce their domestic tax laws. Because access to information from other countries is critically important to the full and fair enforcement of U.S. tax laws, information exchange is a priority for the United States in its tax treaty program.

In cases where a full tax treaty is not appropriate or feasible, the Treasury Department seeks to provide for the bilateral exchange of tax information by entering into a Tax Information Exchange Agreement, or TIEA, with the other country.

There are three basic types of information exchange: on request, automatic, and spontaneous. Our tax treaties typically provide for broad information exchange and do not limit the form or manner in which information exchange can take place.

My written testimony describes the information exchange article that we seek in tax-treaty negotiations and the items that are essential to the United States when negotiating a TIEA.

The United States is not the only country that has encountered the problem of offshore tax evasion, but it has been a leader in increasing worldwide standards of information exchange to combat such evasion.

We have worked with other countries, particularly through the OECD, to raise international standards on information exchange. The improvement in the quality of the information available for exchange is one of the most important developments in the last few years.

The adoption of high standards of international information exchange facilitates our ability to obtain the information we need, thereby promoting the sound and effective administration of U.S. tax laws.

Successes in information exchange do not come overnight. We have access to the information that we have today due to years of patient negotiations and cultivation of information exchange relationships. Moreover, new efforts today may not bear fruit until years from now. For that reason, we are committed to a multi-year approach to expanding our information exchange network.

Because this is an area where steady pressure is essential and missteps or overreaching can undo years of work, we have to be careful not to disrupt the steady progress we have made.

It is also important to remember that information exchange is inherently voluntary. We cannot force any country to agree to exchange tax information, and a healthy information exchange relationship requires us to maintain good relations with our treaty and TIEA partners.

We have more to do in this area. Nonetheless, we have made great strides in recent years. Several new TIEAs have entered into force, with jurisdictions that have figured prominently in prior documented accounts of offshore tax evasion.

Within the last 2 years alone, TIEAs have fully entered into force with the Cayman Islands, the British Virgin Islands, the Bahamas, the Netherlands Antilles, Jersey, Guernsey, and the Isle of Man. We also recently signed a TIEA with Brazil, and the recently signed tax treaty with Belgium provides greater information exchange than we previously have been able to achieve with that country.

Although we are limited in what we can say about use of specific TIEAs, I note in my written testimony public examples of high-income individuals whom we were able to catch, in part, through the use of a TIEA.

As both Secretary Paulson and Assistant Secretary Solomon have stated in recent testimony before this committee, the Treasury Department is committed to improving compliance without unduly burdening honest taxpayers who currently meet their tax obligations.

Tax compliance with respect to offshore transactions is an important aspect of that endeavor. By focusing on information exchange, we seek to reduce offshore tax evasion while achieving these goals.

Thank you again for the opportunity to appear before this committee today. I would be pleased to answer any questions that you have.

The CHAIRMAN. Thank you very much, Mr. Harrington.

[The prepared statement of Mr. Harrington appears in the appendix.]

The CHAIRMAN. Mr. Owens?

STATEMENT OF JEFFREY OWENS, DIRECTOR, CENTER FOR TAX POLICY AND ADMINISTRATION, ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PARIS, FRANCE

Mr. OWENS. Chairman Baucus, Senator Grassley, and members of the committee, it is an honor to be here today. I have submitted a written statement for the record.

Clearly, offshore tax evasion is a complex problem which requires a response at a number of levels: at the level of the administration, at the level of legislation, and also at the international level.

Just how big is the problem of offshore tax evasion? The honest answer is, we do not know, in part because of the secrecy that surrounds so many of these jurisdictions that engage in it. But our discussions at the OECD have shown that this is a big problem, and we believe it is growing.

Today there are $5 to $7 trillion of assets held offshore, and the number of tax havens has tripled over the last 3 decades. Of course, much of this activity is legitimate activity, but the experience of tax administrations around the world is that part of this money is there to evade taxes.

Let me give you some examples. Ireland has recently collected $1.2 billion of revenue from Irish residents that use offshore accounts. That is roughly 30 percent of the tax that was paid by self-employed taxpayers in Ireland, a very significant figure.

South Africa estimates that it is losing something like $9 billion to tax havens. Offshore evasion leads tax cheats to off-load their taxes onto honest taxpayers and undermines the fairness and the integrity of our tax system. It distorts competition and it constrains the freedom of governments to design a tax system which reflects their own values.

It was in this context that the OECD member countries launched two initiatives. The first was in 1996 to work on tax havens, and the second was work which led, in 2000, to a new international standard on access to bank information for tax authorities, essentially, the United States' standard.

Given time constraints, I will focus on the tax haven work. The starting point for this initiative was to develop four objective criteria to identify tax havens. First was that a tax haven should have no or nominal taxation, although, let me emphasize, this is never, by itself, sufficient to characterize a country as a tax haven; the second was that a jurisdiction lacks real activities; third, that it lacks transparency; and fourth, and perhaps the most important, it lacks effective exchange of information.

We spent 2 years using these criteria to draw up the OECD 2000 list of tax havens. At that point, the dialogue with these jurisdictions intensified and, by 2002, more than 30 of the havens had endorsed the standards and agreed to implement them, primarily by means of information exchange agreements.

There were, however, five jurisdictions—Andorra, Liberia, Liechtenstein, Monaco, and the Marshall Islands—that refused to engage in this dialogue, and these were placed on the OECD list of uncooperative tax havens.

In 2006, we evaluated how 82 on- and offshore financial centers measured up to these standards. The survey showed, in this book here, that, while significant progress had been made, some countries had a long way to go to meet these standards. Panama, Nauru, and Guatemala had no access to bank information for tax purposes. Cyprus, Hong Kong, and Singapore are severely constrained by their domestic tax interest requirements.

But the survey did show that an increasing number of offshore jurisdictions are engaging constructively in this process, and today we have 21 tax information exchange agreements around the OECD area.

So we are progressing, but I think we need to speed up the process of change, first by encouraging countries to complete the negotiations that are under way—there are roughly about 40 negotiations that are currently being carried out—and also, convincing those jurisdictions that are refusing to negotiate, that it is in their long-term interests to engage in this process.

We also need to convince those jurisdictions that have asked for double taxation treaties that it is hard to justify giving them the full double taxation treaties when they do not have an income tax system. And certainly we must also encourage countries that are not getting engaged in this dialogue, like Singapore and some of the uncooperative tax havens, to do so.

Second, I think governments need to provide tax authorities with the tools and the resources to mount effective campaigns against offshore evasion.

Lastly, the international community should stand ready to help some of the smaller jurisdictions to diversify their economies away from financial activities that are dependent on tax evasion, and also to give political recognition to those jurisdictions—for example, Jersey and Guernsey—that are taking the important, and difficult, steps to meet these standards and to implement them. They deserve that when they have made the changes that have been asked of them.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Owens appears in the appendix.]

The CHAIRMAN. Now, Mr. Avi-Yonah?

STATEMENT OF PROF. REUVEN S. AVI-YONAH, IRWIN I. COHN PROFESSOR OF LAW, UNIVERSITY OF MICHIGAN LAW SCHOOL, ANN ARBOR, MI

Mr. AVI-YONAH. Thank you very much, Chairman Baucus.

The CHAIRMAN. Could you pronounce your name, please, so I make sure I get it right?

Mr. AVI-YONAH. Avi-Yonah.

The CHAIRMAN. Avi-Yonah. Thank you.

Mr. AVI-YONAH. Thank you.

Senator Grassley, members of the committee, it is a real honor and privilege to be here today to talk with you about offshore tax evasion. I also have a report that is included in the record.

Nobody knows for sure how much offshore tax evasion there is, as Mr. Owens just said. What we do know is—this is something that Assistant Secretary Solomon said recently before this committee—that the enforcement ability of the IRS and the compliance rate drop dramatically for payments that are not covered by either withholding or information exchange. That includes both domestic small businesses, for example, and offshore activities.

There are a few cases that have come to light recently, and Chairman Baucus, you have mentioned some of them, and Mr. Harrington had some in his statement. I want to highlight two. One was that, in 1999, the IRS entered into a plea agreement with a single Cayman Islands banker who was caught because of money laundering activities, not because of tax evasion.

But it turned out that most of the money in that particular bank, once the depositor list became public, was held by U.S. citizens who were evading tax, and that single case resulted in over $3 billion of collection by the IRS, 1,165 cases, with an average of $1.7 million each. So, that is significant money.

The other one is a case that came to light last year as a result of the activities of the Permanent Subcommittee on Investigations involving the Wyly brothers that was also mentioned. Part of it may be arguably legal. It involves something that Treasury is doing something about, and they made an exchange of options contract on publicly traded U.S. companies for annuities held through Isle of Man trusts.

But the part that I wanted to emphasize was the fact that, once that exchange had taken place and the options were exercised, arguably in the hands of the unregistered trusts so there was no U.S. tax liability, the money was then mostly funneled back into the United States via the Cayman Islands in order to purchase real estate, and jewelry, and art works, and various other things for the direct benefits of the people who initially gave the money.

Now, you could argue that this may be legal because if you believe that these trusts are really unrelated, then no laws were violated. The trusts were controlled by a protector who was a friend and employee, but not formally related under our attribution rules to the Wylys. They had, as their immediate beneficiary, a European charity, but as a contingent beneficiary the children of the grantors. The IRS obviously is looking into that.

But really the key issue here is that it went down to the Caymans in order to benefit from the secrecy that is provided by the Caymans and not to be covered by the exchange of information under the U.S.-U.K. treaty which extends to the Isle of Man.

So nobody knows for sure how much of this is going on. Joe Guttentag and I published a paper a couple of years ago in which we guesstimated $50 billion of taxes every year as part of the overall tax gap, and that is kind of at the mid-point of estimates that were done by various other people, like former Commissioner Rossotti and others. So as an order of magnitude, that may be about right.

What can be done about it? Well, I think that the suggestions that Mr. Owens just made are excellent. We should certainly continue to pursue information exchange agreements with all of those jurisdictions that are currently non-cooperating.

Some other useful suggestions are contained in the bill that was submitted by Senators Levin, Obama, and Coleman, and I would urge this committee to take a serious look. One of their suggestions, for example, is for a list of tax havens, similar to the OECD list. The advantage of that, of course, is that it provides an incentive for tax levies to be taken off the list.

Finally, I should highlight, I do not know if you are all aware, that current U.S. law already includes a provision that would deny the portfolio interest exemption, that is, the lack of withholding on interest payments to jurisdictions that are not effectively cooperating with the exchange of information. I think that is potentially a pretty big stick to wield to encourage other jurisdictions that are not still cooperative to cooperate in the exchange of information.

Thank you very much.

The CHAIRMAN. Thank you very much. I appreciate that.

[The prepared statement of Mr. Avi-Yonah appears in the appendix.]

The CHAIRMAN. Mr. Brostek?

STATEMENT OF MICHAEL BROSTEK, DIRECTOR, TAX ISSUES, STRATEGIC ISSUES TEAM, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Mr. BROSTEK. Mr. Chairman, members of the committee, thank you for inviting me to discuss our work on the time required to identify and examine offshore tax cases in our review of IRS's qualified intermediary program.

As we have heard, offshore cases are difficult, in part, because IRS does not have jurisdiction overseas. As covered in our report released today, the median time between a return being filed and the completion of an offshore examination was almost 500 days longer than for all non-offshore examinations by IRS.

Although fewer offshore cases resulted in a tax assessment, when they did, those tax assessments were nearly 3 times larger than for non-offshore examinations. However, because offshore examinations need to get through to where people are hiding money, the staff hours involved are higher for offshore examinations and, thus, the return per staff hour is less.

Due to the 3-year civil statute of limitations, IRS sometimes prematurely ends an offshore examination or declines to open an examination when little time remains, even though the declined case may have more assessment potential than cases that actually have more time on the clock.

Congress has created exceptions to the 3-year civil statute of limitations. In some situations, they are similar to the offshore cases, for instance, when a taxpayer fails to report a listed transaction. GAO is suggesting that Congress consider a statute exception for offshore cases in the future.

Congress established the Qualified Intermediary program, the QI program, in 2000 to help ensure that U.S.-source income paid to foreign persons is properly taxed. U.S.-source income includes such things as U.S. and corporate bond debt, stock dividends, and rents.

QIs are foreign financial institutions, like banks, that contract with the IRS to withhold taxes on U.S.-source income they pay to their customers and to report certain information to IRS.

The QI program contains features that lead to the QIs being more likely to properly apply withholding standards than U.S. withholding agents. First, the QIs are located overseas. They are more likely to have direct personal contact with their foreign customers than U.S. withholding agents would. That contact should help them better judge whether the customers are actually qualified for reduced tax rates.

Second, QIs accept enhanced responsibility for ensuring that customers do qualify for lower taxes, such as using documentation identified by IRS to verify the customer's identity.

Finally, and importantly, the QIs agree to have their operations reviewed by external parties and the results reported to IRS so that IRS has some confidence that they are performing well.

Although this program has advantages, weaknesses remain in efforts to ensure that appropriate taxes are paid on U.S.-source income that goes offshore.

First, only 12.5 percent of U.S.-source income is actually handled by QIs. Second, because corporations are taxpayers under U.S. law, U.S. persons may be able to avoid taxes from their U.S.-source income if they set up a foreign corporation. This can make it unclear whether they owe U.S. taxes.

In 2003, nearly 70 percent of U.S.-source income paid overseas went to foreign corporations. You have all looked at the map that was put up here. We may be somewhat more assured that U.S. tax laws are being properly administered in countries with which the U.S. has a tax treaty.

As the large area on our map shows, about 80 percent of U.S.-source income went to persons in treaty countries, countries that we have some confidence are going to apply the law well.

However, small percentages of U.S.-source income, although significant in dollar amount, went to countries that were not even identified by withholding agents. In 2003, U.S. withholding agents and QIs reported $19 billion in transactions, with unknown or unidentified jurisdictions. That represents about two-thirds of the smaller one on the right-hand side of the map.

For that $19 billion, about $505 million was withheld for taxes. We do not know whether a higher withholding rate should have applied, but what we do know is that reduced withholding rates should not be granted unless the withholding agent has properly identified the recipient's residency.

In overseeing withholding agents, IRS does not effectively use available data. For example, withholding agents annually send IRS tax returns and information returns on their withholding activities. Some of these documents are submitted on paper and some are submitted electronically.

IRS has not always transcribed the paper documents into an electronic database. Consequently, it has not been able to verify the accuracy of refund requests at times that withholding agents file. When IRS did not transcribe the paper returns, they were destroyed a year later, in accordance with their paper retention policies. IRS officials cite insufficient funds for this situation.

Finally, external reviews of qualified intermediaries' account opening and handling procedures, while clearly valuable, do not require external auditors to follow up if they come across indications of fraud or abuse during their audits.

This concludes my summary. I would be happy to answer questions.

The CHAIRMAN. Thank you, Mr. Brostek.

[The prepared statement of Mr. Brostek appears in the appendix.]

The CHAIRMAN. For the information of my colleagues, a vote has started. I am going to use my 5 minutes right now, then figure out some way to either adjourn and come right back, or maybe if you want to, Senator, go now, then you can come back. Thank you.

Thank you, gentlemen. I am going to start off by showing you something. You all have seen this. Basically, this is a picture of a three-story building in the Cayman Islands which allegedly has over 12,000 corporations lodged inside, a feat in and of itself. The assumption is that these corporations are shells, whose sole purpose is to evade U.S. taxes.

The first question is, what conceivable reason could there be for those companies to go in there, 12,000, if it is not to minimize taxes? Second, I am going to ask, Mr. Brostek, for you, GAO, to go down there.

Mr. BROSTEK. All right.

The CHAIRMAN. I want you to go to that building. I want you to root around, see what you can find.

Mr. BROSTEK. All right. We will do whatever we can.

The CHAIRMAN. All right. Then come back and tell us what you find, and the degree to which this building is what it is.

Who wants to take a crack at the first question? What are the legitimate reasons for 12,000 corporations having offices in that building? Who wants to give me a possible reason? Mr. Harrington, you are kind of defending the status quo a little bit. You tell us: what legitimate reasons could there be?

Mr. HARRINGTON. I cannot speak to the number of companies.

The CHAIRMAN. Well, it is a large number.

Mr. HARRINGTON. All right. In terms of the question as to why one might set up a foreign corporation, the general answer is that there are some circumstances in which one has to establish a foreign corporation simply to operate in a particular jurisdiction. So, there could be legitimate reasons.

The CHAIRMAN. Now, what might the legitimate business reason be?

Mr. HARRINGTON. In most countries, simply to engage in business one would have to set up a foreign corporation. So one question is——

The CHAIRMAN. Why there? Why not someplace else? Why not in Great Britain? Why not in France? Why not in Singapore? Why there?

Mr. HARRINGTON. Our focus has been trying to go after what we consider the illegitimate uses. There may be a variety of business reasons to set up a corporation.

The CHAIRMAN. Can you give me one? What is a good, legitimate business reason? I am an American individual. I want to incorporate. I am a company. What is the reason why I might want to go to this building? Give me an example of the reason, please.

Mr. HARRINGTON. First of all, in the Cayman Islands, or speaking of any particular jurisdiction, there is an infrastructure that exists in which one may engage in business. It is a significant financial jurisdiction.

I think for us, the question really is not just, do you have a company there, but is the income that is being reported for there, putting aside whether there should be a corporation there, if you are——

The CHAIRMAN. There is no tax. They have no income tax, do they?

Mr. HARRINGTON. No. I mean, from the U.S. standpoint. A lot of these stories, particularly like in this particular case, the issue raised was transfer pricing, whether or not the entities that exist, say, for example, in that building are being used to shift income out of the United States.

The CHAIRMAN. But transfer pricing is a whole different subject. That is a whole different issue. That has nothing to do with my question.

Mr. Brostek, I would just ask you another question. The GAO says, as I understand it, about $19 billion was missing when you examined the roughly $300 billion that has moved overseas. As you know, Joint Tax thinks that figure is much higher, but let us use the figure that you got from the IRS.

Mr. BROSTEK. Yes.

The CHAIRMAN. What $19 billion is missing? Where is it? What do you think? What happened to it?

Mr. BROSTEK. Well, in this case it is not that the money is missing. The withholding agents, whether U.S. withholding agents or qualified intermediaries, have reported to IRS that they paid $19 billion of funds to their customers. What they did not do is identify the jurisdiction that those customers resided in.

Since the jurisdiction is controlling in many cases in terms of whether you deserve a reduced break of withholding for tax purposes, not knowing the jurisdiction seems to be a problem in terms of whether proper decisions were made to reduce the taxes that are withheld.

The CHAIRMAN. Could you just give us a sense of, how much leakage is there, in the sense that you have these qualified intermediaries, these transfer agents, and some agreements with some countries that provide pretty tight withholding, some do not, some aggregate, aggregate pooling, as you said in your report.

Some say we do not have to audit. I mean, there just seems to be a large variation among all the treaties and QI agreements and transfer agent provisions and so forth. Can you give me your sense of how much leakage that allows?

Mr. BROSTEK. Well, I would have to go with the advice of my fellow panelists here. Actually determining how much leakage there is, how much tax evasion is occurring internationally, is an extremely difficult endeavor, in large part because we do not know precisely how much income goes offshore that should have been subjected to tax. So, I am afraid I cannot give you a figure about how much leakage there is.

The CHAIRMAN. Let me ask a general question. The world has changed so much, and is changing so quickly. Money travels at the speed of light anywhere in the world. It is borderless. The world is borderless. To many degrees, nations are irrelevant. It is dated, archaic. There is so much money that goes anywhere, for whatever reasons. Your thoughts on how we catch up, how we deal with all that? It seems to me there has to be much more transparency.

On a related subject, I was quite disturbed to read in the *Wall Street Journal,* page 1, I think it was Monday, of the proliferation of hedge funds and private equity, and the concern about leverage, how much leverage there is in the system today.

Tim Geithner, the head of the Federal Reserve system, had to call hedge funds and other major private equity funds to find out what the collateral is. I mean, it seems kind of strange that the president of the Federal Reserve branch has to call up and find out and ask. There should be some better protection on that subject. But that is just analogous. It is not really directly on point here.

But how do we get more transparency? What is a better way to do it? You mentioned, Mr. Brostek, that there is less evasion where there is more reporting, more withheld, and so forth. But in this new world, this brave new world we are in, what advice do you have as to how we catch up? Mr. Owens, you have thought about this.

Mr. OWENS. I think, in part, the problem you identify is a serious one, because in a sense it is, how do tax authorities, which must remain national tax authorities, confront global taxpayers? That is a difficult issue.

Our answer at the OECD is that the most effective way is by better international cooperation and by promoting high standards, high standards in the area of transparency and high standards in the area of exchange of information.

If we can get these jurisdictions to agree on those standards—and we have up to a point—if we can get them to implement them, then that means that the tax authorities will have access to the information that they need to enforce their own tax systems. I think international cooperation is a key way of resolving this potential conflict.

The CHAIRMAN. Mr. Brostek?

Mr. BROSTEK. We do not actually know to what extent this actually occurs, but from anecdotal evidence a lot of the situations involve individuals in the U.S. who have income that is not reported to IRS. You gave some examples of businessmen, for instance, who had taken their money offshore.

So it is not just a matter of meeting transparency internationally, it is also a matter of getting better transparency over the sources of income of domestic businesses and individuals, because, if their income is not transparent to IRS, then they can, in essence, keep two sets of books, and the money that is not revealed to IRS they can move offshore and make the kind of investments that we are hearing about.

The CHAIRMAN. I am going to follow up on this, but unfortunately there is a vote going on, and I have just a couple of minutes left to get over to the floor. When Senator Conrad gets back, he will resume the hearing. But I am going to have to recess temporarily until the return of Senator Conrad. Thank you.

[Whereupon, at 10:47 a.m., the hearing was recessed, reconvening at 11 a.m.]

Senator BUNNING. We will return the committee to order. Since I am the only one here, I will be the one to ask questions first.

First of all, I would like to ask unanimous consent to put my opening statement in the record. So ordered. [Laughter.]

[The prepared statement of Senator Bunning appears in the appendix.]

Senator BUNNING. Mr. Avi-Yonah, in your testimony you say there is currently $50 billion per year in illegal offshore tax evasion or avoidance. You say this figure is an educated guess. I know you are a very learned man, but this guess is based on some very big assumptions.

It troubles me that you are willing to make this bold estimate, while the IRS, which is in a better position to know, is unwilling to do so. Let us look at how you came up with the number, first. You say that residents of North America, including Canada, have $16.2 trillion in assets and hold 10 percent of these assets offshore. Is that correct?

Mr. AVI-YONAH. Yes.

Senator BUNNING. All right.

Next, you say that the U.S. residents earn 10 percent a year on these assets and they are not paying any U.S. or foreign taxes. You say that they should be paying about 33 percent of these supposed earnings in taxes to the United States, or $50 billion. So you appear to be assuming that just about every American who holds assets outside the United States is breaking the law. Is that correct?

Mr. AVI-YONAH. No, I do not think that is entirely true. This estimate is based on figures that were independently derived by two investment banks, and they relate to the size of holdings in offshore locations.

Senator BUNNING. That you know of.

Mr. AVI-YONAH. That they know of, yes. And I think that what is fair to say is that, while U.S. law clearly requires U.S. taxpayers to disclose offshore bank accounts, for example, and holdings in foreign corporations that earn primarily passive assets and similar types of foreign holdings, the numbers that you get as to how much is actually held and reported to the IRS are significantly lower than $1.5 trillion.

So while it is, I think, fair to say that there are Americans who honestly report offshore holdings and pay tax on them, the fundamental question which I think was reflected in the Chair's question before is, what is the reason to hold passive-type assets offshore if not for tax evasion?

I mean, there may be other reasons, regulatory reasons or other reasons, but I think that the figure that we came up with—yes, it is, as I said, just an educated guess—but it is in the ballpark of other figures that other people have guessed from different sources.

Senator BUNNING. It could be, our tax code is fairly complicated and that may be a reason to put assets offshore.

Mr. AVI-YONAH. Yes. But that clearly does not allow people not to report income to the IRS.

Senator BUNNING. No, no, no. I am not condoning the fact that they do not report their assets. I am just saying that sometimes the tax code is so complicated that it allows people to put assets offshore and requires them to report those assets.

Mr. AVI-YONAH. True. The tax code certainly allows people to put assets offshore. It even allows people to carry luggage full of cash offshore if they want to. They are just supposed to say if they do that. The question is, how many people actually say it?

Senator BUNNING. A follow-up question.

Mr. AVI-YONAH. Yes?

Senator BUNNING. In your written testimony you stated that the IRS faces an increased workload and not enough staff to keep up with it. I would like to share a statistic with you from a column that appeared in the *Wall Street Journal* last month.

The IRS currently has 100,000 agents. That is more than the Environmental Protection Agency, OSHA, and the FDA combined. Would lowering tax rates and a simpler tax code not be a more effective means to achieve tax compliance than what you propose?

Mr. AVI-YONAH. Well, certainly I would be the last person to argue—and I have written a lot about simplification—that we should not simplify the tax code, and certainly if we had a simpler tax code it is conceivable that we could reduce the size of the IRS and the size of enforcement, although I do not think we will ever get to a tax return on a postcard like has been suggested for some extreme cases.

But nevertheless, I think there is no question that part of the problem that the IRS has results from the fact that Congress has, I think, pretty consistently—certainly since 1986—been making the tax code more and more complicated than not, given its adequate resources.

But what this hearing is about, and what my testimony is about, is whether the IRS is able to enforce existing law given the resources that it has. In my judgment, they have serious problems in doing that.

Senator BUNNING. Thank you.

Mr. Owens, is it true that employees at the OECD get tax-free salaries? I have heard a rumor that the OECD even has its own wine cellar. I do not see how an organization that evidently competes for its workers with tax-free salaries can criticize nations that compete for capital with favorable tax policies.

Would you like to comment on this?

Mr. OWENS. Thank you, Senator. Yes. In fact, our salaries are tax-free, but I can assure you that I could certainly increase my salary by a factor of three if I moved to the private sector.

The wine cellar. We do not have a wine cellar at the OECD, but we do have access, in fact, to the excellent French wines that you can buy around the Paris region.

Senator BUNNING. And those are a matter of conjecture whether they are better than California, Napa Valley, and all those that we very much enjoy here in the United States.

Last question. As a person who is accountable to the people in my State every 6 years for shaping tax policy, I have a real problem with an international organization setting standards for our domestic tax policy, whether that is the OECD or the United Nations. Mr. Owens, is the OECD's role as an international tax standard setter anti-democratic?

Mr. OWENS. I certainly hope not, Senator. We see our job, in fact, as trying to help countries design their own tax systems to reflect their own social, economic, and political values. I think what the OECD does is to put a range of options before countries.

Then it is up to them to decide, what are the best policies in their own context. That, I think, is something that we have now done for 50 years. In many cases we have also, in fact, been able to share best practices.

I like to think that one of the roles the OECD has had over the last few years is taking out some of the best practices here in the United States, particularly in the area of exchange of information.

Senator BUNNING. Mr. Chairman, I have exceeded my time, so I would turn it back to you.

The CHAIRMAN. Thank you, Senator.

I am just curious what leverage we have. Mr. Avi-Yonah, you said maybe there is some leverage that we have in some companies by denying the withholding exemption from companies, perhaps, that are not conforming, that is, countries that are tax havens or just do not want to share information and so forth.

It gets a little bit to Mr. Owens's point earlier. I think you said, Mr. Owens, you identified 58 countries as tax havens, and most are committed to addressing the problem of offshore tax evasion. However, there are 5 countries out of the 38 that are unwilling to work with the OECD.

So how do we get countries to report? What leverage do we have? Either of you can respond.

Mr. AVI-YONAH. Well, first, one important point, I think, in the background of all of this relating to a previous question is that the people who avoid taxes this way live in OECD member countries. They live in the U.S., they live in the EU.

Their investments are also going to OECD member countries. You do not leave the money in the Caymans unless you really are a criminal, and then you are paying a negative tax rate for the privilege of leaving your money in the Caymans. The money goes into the Caymans and then it goes out.

The current situation is that we Americans can put our money in the Caymans and invest it, let us say, in Europe, and European tax enforcers, therefore, will not cover that because it only applies to Europeans. Similarly, our tax enforcement efforts generally only apply to Americans and they do not apply to Europeans putting the money into the United States.

That is part of maybe healthy competition to capital, but fundamentally I think the whole tax haven issue could be addressed if we cooperate more with the other rich countries in the world through the OECD, because that is where the money has to go to.

If everybody, for example, agreed that all payments that go to non-cooperating tax havens will be subject to X percent withholding tax, then I think the problem could be resolved tomorrow. That maybe will not happen, realistically, because we have to balance that with our need to attract capital from overseas.

Nevertheless, I think that there are things that we can do in order to increase the pressure. First of all, let me say I have also located, using carrots first rather than sticks—and this is also something that Mr. Owens mentioned—it is quite reasonable to say that some of these countries rely heavily on the offshore sector for their economic development and that we should consider ways of making it easier for them to do other things, like free trade and other things that they produce and other forms of aid. The EU actually puts out proposals like this on the table.

But we should also take into account the stick. The particular stick that I mentioned is the fact that current law permits us to suspend the payment of interest with no withholding, which now applies to anybody in the world no matter where they are or where they live.

Our current concern has to do with Americans setting up corporations in tax havens and then taking benefits from that, which is, of course, illegal, but who is to know in the absence of information?

In those kinds of situations where a country will not tell us who the beneficial owners of these corporations are, I think we should seriously consider not allowing them to benefit from the withholding free flow of interest.

If you look at the numbers in the GAO report, you will see that on maybe $300 billion of flows from 2003, we collect an effective tax rate of maybe 3.5 percent, which is mostly due to legal, legitimate exemptions that we have decided to put into the code. But certainly it suggests how much money is flowing out.

And to the extent that some of this is going to Americans who are hiding behind offshore corporate shells, I think that it is our obligation to honest taxpayers who pay their taxes to do something about it.

The CHAIRMAN. Now, my question is, I do not understand, in this race to the bottom to some degree among various jurisdictions to attract capital, et cetera, is that necessarily inconsistent with more information reporting? I do not think that it is.

Mr. AVI-YONAH. No, I do not think it is either.

The CHAIRMAN. And there are four. I am a little bit perplexed as to why OECD and the United States cannot work with other jurisdictions to have some kind of agreements on transparency. There is a lot of transparency, even though some jurisdictions still want to have lower tax rates in order to attract capital. The two are not inconsistent, are they? Or are they? Mr. Owens, you are at OECD. What do you think?

Mr. OWENS. Well, I think it is very important to distinguish between low-tax jurisdictions and tax havens.

The CHAIRMAN. Right.

Mr. OWENS. In low-tax jurisdictions it is a fact of life. Today we live in a very competitive environment. One way in which countries compete for mobile capital is by lowering their tax rates. That is very different, though, from where a country competes by saying, you come here and we offer you the secrecy that your home tax authorities will not be able to know how much assets you have here and will not be able to know how to tax you.

The CHAIRMAN. Exactly.

Mr. OWENS. How do you deal with this problem? I think part of the way is to get a buy-in from the tax havens to make them feel that they are part of the international framework, to make them feel, in fact, that they are part of the process by which we set the standards.

That is what we have been trying to do over the last 6 years, to say to them, come and join us, come engage in a dialogue. As a result of that dialogue, we actually now have what I think are very high standards of transparency. We also have high standards with respect to the exchange of information.

The means by which we are enforcing those is by bilateral tax information exchange agreements. There, frankly, I think the

United States has led the world. So we need to work harder on that. How do we deal with the five jurisdictions that have said, well, we do not want to have that dialogue with you? I think we just keep coming back to them, saying, do join us, come talk with us.

Three of them actually came down to our Global Forum meeting in Melbourne in 2006. They did not endorse the standards, they did not say they were ready to engage in exchange of information, but at least they were there at the table.

I think one way that the United States can help us is by passing a very strong message to these jurisdictions and to some of the jurisdictions that are saying, well, we are not sure we want to go down this process, we are not sure we want to have exchange of information.

If you can say to them, look, exchange of information is very important for us, it is something we care a lot about because that is the only way that our tax administration is going to be able to administer the U.S. tax system in a fair and effective manner.

The CHAIRMAN. So what would that strong message be?

Mr. OWENS. Sorry?

The CHAIRMAN. What would that strong message be? You said we should send a strong message. What would that be?

Mr. OWENS. I think it is important to say that you would expect, when negotiations begin, that they are completed in a relatively short period of time. I think you can look at the experience of other countries—for example, Canada—which have put in certain carrots and sticks, the carrots being that if you engage in this exchange of information then you would get some of the benefits that would normally be available under a full double taxation treaty. So I think it is important to keep this balance between the carrots that you offer, and the sticks that are there as well.

The CHAIRMAN. But what is the incentive for a country that is a haven, not cooperating, attracts lots of investment right now because of its secrecy provisions, people like it? What is in it for them?

Mr. OWENS. For what I call the more mature offshore jurisdictions, they are interested in engaging in legitimate business, and they know that, if they want to attract legitimate business, that business will not go there unless they have strong reputations.

One of the reasons that we now have over 30 countries that have endorsed these standards is that, by doing so, they are saying to the world, we want to be players in this, we are prepared to play by the same rules, and we are open for legitimate business.

The CHAIRMAN. Thank you.

Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman. And thank you very much for holding this hearing. I think it really is important. It is especially important to the vast majority of taxpayers in this country who are honest, who are paying what they legitimately owe. That burden is getting shifted to them by the growing number of people who are not, and the growing number of companies that are not.

Let me put up a first slide that talks about what the Permanent Subcommittee on Investigations has told us. They have told us that the total loss to the Treasury from offshore tax havens approaches $100 billion a year, including $40 to $70 billion from individuals—Mr. Avi-Yonah, I think that is very much in keeping with your estimate of $50 billion on the individual side—and another $30 billion from corporations engaging in offshore tax evasion. They go on to say, abusive tax shelters add tens of billions of dollars more.

Let us go to the next slide if we could. This is a picture I have shown before of a building in the Cayman Islands, a 5-story building there that is home to 12,748 companies.

This is the most efficient building in the world. It is quite remarkable that all this business activity is occurring out of this little 5-story building down in the Caymans. They are not engaged in business activity out of this building, they are engaged in tax avoidance out of that building.

Let us go to the next slide. We went on the Internet. It is amazing what you can find on the Internet. Tax havens. You punch it in. Offshore tax planning. Punch it in. You get 1,250,000 hits. My favorite is this one: "Live Tax Free and World-Wide on a Luxury Yacht." "Moving Offshore and Living Tax Free Just Got Easier." "Exciting stuff," they say. I will tell you, there are hundreds of these out on the Net. So I think, Mr. Avi-Yonah, your estimate of $50 billion on the individual side, the estimates of the Permanent Committee on Investigations that it is a total of somewhere in the range of $100 billion a year—let me just say, a man, after I made this speech on the floor of the Senate, called me anonymously, described himself as a senior member of a major accounting firm.

He said, Senator, you've just got the tip of the iceberg. He told me, this is much larger than anybody understands. He said, in the last 5 years this has absolutely exploded and that because of a lack of real information reporting, we do not really understand the magnitude of it.

Mr. Avi-Yonah, do you think that could be the case?

Mr. AVI-YONAH. Yes, I do. I mean, I think fundamentally the problem is, as was mentioned before, we do not really know how much of this is going on. There are lots of reasons to suspect that a lot of it is going on. Every time that somebody talks or divulges information, every time the IRS catches somebody based on the existing enforcement efforts, we discover that the problem is larger than what we have thought.

I think that there is every reason to assume, as you say, that this is just the tip of the iceberg, and that every dollar that we invest in additional enforcement efforts will generate many, many more dollars in return, just enforcing existing law and nothing else.

So I think this is fruitful, maybe, or possibly even more fruitful than some of the corporate tax shelter activities which, unfortunately, involve much more complicated transactions and, therefore, are more difficult for the IRS to enforce. Here it is just a question of discovering what is actually going on.

Senator CONRAD. Let me just follow that up because you mentioned more resources. This is a story from the May 3 *New York Times:* "The Internal Revenue Service is curtailing audits of many people who use offshore tax havens, even when agents see signs of tax evasion, because agents fear they can't meet a 3-year deadline for finishing an examination, Congressional investigators have found."

This story goes on to talk about how the Boston Consulting Group has identified that residents of the United States, individuals as well as corporations, are holding $1.5 trillion outside the country. One and a half trillion. That is real money.

I would ask, Mr. Brostek, is it true that you found in your examination that IRS is backing away from audits of people who are engaged in offshore tax havens because they fear they cannot meet the 3-year deadline?

Mr. BROSTEK. Yes. The agents did tell us that. We do not know how often that is the case, but the agents said that there are certainly cases where, with the 3-year statute, if they are not sure that they are going to be able to prove fraud, if they are not sure that they are going to prove a substantial under-statement of income, they may very well close that case out with a smaller assessment than they think they could get, or not even start a case when it is getting close to the 3-year deadline because they do not know they are going to be able to complete it.

Senator CONRAD. My time is about expired, but just a final note on that point. The GAO found the average audit of people with money offshore turned up twice as much in unpaid taxes as audits of people inside the United States.

The average assessment of unpaid taxes tripled, to $17,500 for the limited number of audits that were allowed to run longer than 3 years, and it shot up to nearly $100,000 for the small number allowed to run 5 years. Are those your numbers?

Mr. BROSTEK. Yes, they are.

Senator CONRAD. Thank you.

The CHAIRMAN. Thank you. Thank you, Senator.

Senator Bunning?

Senator BUNNING. Mr. Brostek, I would like to follow up on Senator Conrad's questions. In your statement, you recommended extending the 3-year statute of limitations on tax assessments for taxpayers involved in offshore financial activities. Is that correct?

Mr. BROSTEK. Yes.

Senator BUNNING. I have a few questions about the proposal.

How would you define "offshore financial activities?" Would it apply to ordinary investors in overseas stock markets?

Mr. BROSTEK. Our report did not go to the point of actually defining the specific universe that would be subject to it. We saw that as something that needed to be worked out in consultation with the Department of the Treasury.

Senator BUNNING. It would be defined by the Department of the Treasury what an ordinary financial activity would be?

Mr. BROSTEK. Yes.

Senator BUNNING. All right.

How long would the statute be extended?

Mr. BROSTEK. That is a design issue that Congress would need to make a decision on. There are lots of different options for how this might be done. One might be to simply toll the statute, or stop it from running, during the period of time while IRS is waiting for a taxpayer to respond to an inquiry.

That way, IRS would have the pressure to work the case efficiently while their clock was running and they would not have it counted against them when the taxpayer was failing to respond.

Senator BUNNING. And finally, without a solid estimate of the amount of illegal offshore tax avoidance, how do we know how much money would be saved by the Treasury with this extension?

Mr. BROSTEK. We do not know how much would be saved. I would point out that you could think of this as an equity issue. If you were a taxpayer who has made a relatively innocent mistake on your tax return and you were not trying to hide anything, you have a 3-year period in which IRS can come and audit you. If you are a taxpayer who is setting up elaborate structures to hide what you are doing, you have exactly the same amount of time for IRS to come and get you.

Senator BUNNING. Let me ask you, we had a hearing—I do not know when it was, Mr. Chairman—where we talked about the diminishing returns. The more people you put on trying to find tax cheats, you get to an 85, 86, 87 percentile, and then as you spend money to catch the last 13 percent, there are diminishing returns. You are going to pay more money than you will get back in. Are you agreeing or disagreeing with that?

Mr. BROSTEK. I absolutely agree with that proposition. I do not know that that would immediately apply in the cases that we are talking about. For instance, in a number of the cases for IRS, they uncover a practice that has been going on for a number of years.

If they are able to get that defined and proven for 1 year, there is probably not a whole lot of additional effort that they need to prove the year before, or the year before, but those might be excluded from their purview because of the statute.

Senator BUNNING. Because of the time limit.

Mr. BROSTEK. Correct. So I think that the flexibility of having a longer statute would allow IRS to make better decisions to maximize the return on their work.

Senator BUNNING. Do you think 100,000 people examining tax returns is enough? How does Treasury or the IRS come to a reasonable conclusion on that number?

Mr. BROSTEK. Well, that is certainly something that has to be balanced against an awful lot of considerations, including other demands for Federal funds. I would point out, though, that it is not 100,000 people who are investigating tax returns.

Senator BUNNING. No.

Mr. BROSTEK. A significant portion of IRS personnel are not engaged in the auditing operations.

Senator BUNNING. No, they are not.

Mr. BROSTEK. I believe it is somewhat less than half of the staff who are actually engaged in the examination process.

Senator BUNNING. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

I would like to just focus a little bit on, again, what we do to help encourage countries to become part of the system. The *New York Times* published an article last week on Singapore's efforts to become a tax sanctuary for the wealthy. What can we do, an OECD country or the United States, to bring Singapore in to the system?

Mr. AVI-YONAH. Singapore has a real tax system. It is not a traditional tax haven. In Mr. Owens's distinction, it is a country that has some taxes, even income taxes, on its own citizens—low ones.

I think in that kind of context, there is something to draw them, for example, negotiating a tax treaty. Because if you are a Singapore businessman who actually lives in Singapore, there is much more to be gained from having a tax treaty with the United States than trying to attract people who do not live in Singapore, who have nothing to do with Singapore, to put their money there in order to hide it. Then they will be able to balance the two positions. What is better for them, to help their own people or to try to attract money from overseas?

The CHAIRMAN. Then why do you suppose Singapore has not opted in?

Mr. AVI-YONAH. Well, at the moment they seem to think that they can benefit from the fact—this is what they advertise—that they are not subject to either the EU or the OECD efforts.

The CHAIRMAN. Mr. Owens?

Mr. OWENS. I would agree with that. In fact, we have been having a dialogue with Singapore over the last 2 years. Again, Singapore actually came to the last Global Forum in Melbourne, but they have not endorsed the standards.

It is significant, when you look at Singapore, that they are now the third-largest private banking center in the world, after Luxembourg and Switzerland. So, we do need to engage Singapore in this dialogue.

Part of the problem that you have with Singapore is that it has a combination of bank secrecy—quite strict bank secrecy—and what we call a domestic tax interest, that means that, if a country could not show that there was Singapore tax at stake, Singapore could not respond to a request for——

The CHAIRMAN. Say again. I did not understand that.

Mr. OWENS. If, for example, the United Kingdom asked Singapore, under its tax treaty, to help it investigate a case of tax fraud or tax evasion, Singapore could only respond to that request if there was Singapore tax, itself, at stake. In other words, it would not be enough that just U.K.'s taxes were at stake. That is a very serious limitation.

The CHAIRMAN. So what do we do, again? I am asking the question again. Mr. Harrington, you are raising your hand over there.

Mr. HARRINGTON. Thank you, Mr. Chairman. I think you raised specific issues with respect to Singapore, and obviously Singapore is certainly a country with which we would like to enter into an information-exchange relationship. We have certainly had discussions in that regard. But I think to a certain extent, this circles back to the carrot-and-stick discussion. I think it might be helpful to draw distinctions, say, for example, in the tax-treaty context where a tax treaty is effectively a carrot. I mean, each country derives reciprocal benefits when we enter into a tax treaty with another country. We are dealing with preventing double taxation and reducing withholding rates. I do not think we necessarily would need some sort of carrot for the information exchange that we get through tax treaties. The treaty itself is an inherent carrot.

The issues that are really coming up are with respect to jurisdictions with which we would not enter into a tax treaty, either because there is not significant double taxation or they do not have an income tax system.

That has led to, at least what the U.S. has taken historically, the approach of a tax information exchange agreement, which seems to have caught on in the rest of the world as well. We have been successful in negotiating these, at least recently.

There is an existing carrot, for example, for tax information exchange agreements, so at least with the Caribbean and Central American countries, there is a convention benefit you get to deduct. There is a greater ability to deduct the cost of attending conventions.

The CHAIRMAN. Do we have a treaty with the Cayman Islands?

Mr. HARRINGTON. We have a tax information exchange agreement with the Cayman Islands.

The CHAIRMAN. And can you describe that agreement, please?

Mr. HARRINGTON. It is an agreement that deals with the exchange of tax information. It allows us to get information with respect to both criminal and civil matters. It prevents the Cayman Islands from using bank secrecy or domestic tax interests. It basically allows us to get the information that we need.

The CHAIRMAN. Do we utilize that? My understanding is that, to some degree, IRS is not doing all that they can do.

Mr. HARRINGTON. Yes. And I think, often, this is a little bit of an issue based on the era and time in which people look. For example, the TIEA with the Cayman Islands just entered into full effect within the last 2 years.

It entered into force with criminal matters, I think in the beginning of 2004, and with civil matters, at the beginning of 2006. So on a going-forward basis, and certainly from 2004 and 2006, we have access to information with respect to the Cayman Islands.

The CHAIRMAN. What about other havens offshore?

Mr. HARRINGTON. All right. We have 22 tax information exchange agreements. Just within the last 2 years, the TIEAs have come online with the Cayman Islands, the British Virgin Islands, the Isle of Man, Jersey, Guernsey, and the Netherlands Antilles. We have had one with Aruba. We have an existing one with Bermuda. We have significant numbers of these.

The CHAIRMAN. Are you satisfied with the terms of those exchanges? Should it be tighter? Would you like more information? Should the U.S. have more information pursuant to those exchange agreements?

Mr. HARRINGTON. Well, I think, first of all, the agreements themselves, the text of the agreements, follow our recent model, so they are what we want. Some of these TIEAs have come online recently. We have used, and will continue to use, all of our TIEAs with major offshore financial centers that I described. It is a new relationship. We have been satisfied with the exchanges so far, but they are new, so over time you have to sort of sit back and take another look.

The CHAIRMAN. What is Treasury's estimate on the amount of U.S.-source income that goes overseas?

Mr. HARRINGTON. It goes back to the debate we had about how much offshore——

The CHAIRMAN. No. I am asking Treasury. I am asking Treasury's number.

Mr. HARRINGTON. We do not have a specific number with respect to offshore evasion.

The CHAIRMAN. I am not talking about evasion. I am talking about U.S.-source income that goes offshore.

Mr. HARRINGTON. I do not have that with me.

The CHAIRMAN. GAO says roughly $300 billion in their analysis, and Joint Tax thinks it is $400 billion. Is that correct?

Mr. BROSTEK. The $300 billion is U.S.-source income that withholding agents have reported as from offshore.

The CHAIRMAN. Have reported. So, just that. So Treasury does not have a number?

Mr. HARRINGTON. Senator, I would have to get back to you. It would depend on the definitional issues. Are we talking just about cross-border payments, for example, of interest and dividends, what we call FDAP, the fixed or determinable——

The CHAIRMAN. I am trying to determine whether Treasury has a handle on this or not. That is my question. It sounds like Treasury does not.

Mr. HARRINGTON. There is a tremendous amount of reporting that does take place. I just wanted to give you a more precise number.

The CHAIRMAN. All right. In Mr. Brostek's terms, you have $300 billion of U.S.-source income that is subject to withholding. Is that correct?

Mr. BROSTEK. It was not all subject to withholding. That is the total amount of income that withholding agents had passed through them through their customers.

The CHAIRMAN. Passed through. All right.

Mr. BROSTEK. Not all of that was even properly subject to withholding.

The CHAIRMAN. All right.

Mr. BROSTEK. And that was from 2003, sir.

The CHAIRMAN. All right.

So, Mr. Harrington, does that sound about right based upon your numbers?

Mr. HARRINGTON. I do not have the numbers in front of me. GAO's number sounds reasonable.

The CHAIRMAN. Does Treasury have numbers?

Mr. HARRINGTON. I do not have those numbers with me.

The CHAIRMAN. But does Treasury have numbers, even though you do not have them before you?

Mr. HARRINGTON. I am sure that we do. I just do not have them with me.

The CHAIRMAN. You are sure they do? You do not know that they do?

Mr. HARRINGTON. If I do not have them with me, I simply cannot say that——

The CHAIRMAN. I guess the real question is, obviously, your department has to get a handle on this. That is, how much U.S.-

source income is going overseas, what is the character of it, is income tax properly paid on it, and so forth.

I think Mr. Avi-Yonah estimated it is about $50 billion a year is evaded, or $50 billion worth of tax evasion a year. Does Treasury have a number on that subject? How much?

Mr. HARRINGTON. We consider the international portion to be part of the basic tax gap number.

The CHAIRMAN. So what is the tax gap number attributable to offshore evasion?

Mr. HARRINGTON. I do not think we have a separate breakout.

The CHAIRMAN. Why don't you? Mr. Avi-Yonah has one.

Mr. HARRINGTON. I think the short answer——

The CHAIRMAN. You have more resources, I think, than he. I am not sure about that, but that is my guess.

Mr. HARRINGTON. I think part of the issue, from a focus standpoint——

The CHAIRMAN. And his are estimates. He is saying that is the median. Do you have estimates?

Mr. HARRINGTON. Our focus has been, instead of on particular estimates, on situations where we see evasion, when we see particular abusive transactions, and going after those. This is an area where we are learning, through our tax information exchange agreements, to share information with other countries. We have talked about sorts of bilateral exchanges. There is also a cooperative aspect.

The CHAIRMAN. But how can you know whether you are making any progress if you do not know the amount of the problem?

Mr. HARRINGTON. In terms of how we know we are making progress, for example, we issued some proposed regulations shutting down a particular foreign tax credit generator transaction. We learned about that transaction from some other countries. They had encountered that, and they shared the information with us.

We issued proposed regulations that we believe will effectively eliminate what we think is a substantial amount of revenue loss. So even in situations where there are questions as to what is the proper baseline, the information that we learn, whether it is through a bilateral exchange or through other types of cooperative arrangements, we do use that.

We do not necessarily have to know what the final number is to tell where we are making progress and where we are not. So, I think, even as people struggle to determine what is the proper sort of number, it is still incumbent on us to continue taking——

The CHAIRMAN. I do not know what your background is, but most good business men and women have plans, they have data and benchmarks to try to determine what they are doing. It sounds like you do not have any.

Mr. HARRINGTON. We do. The Treasury has a strategy on reducing the tax gap, as the Secretary and Assistant Secretary Solomon discussed with you. So, this is one component of that.

The CHAIRMAN. All right. But my understanding is that the IRS is saying the offshore tax gap is not included in this so-called $345 billion tax gap that we have been working with. Is that correct? So, really when you are saying the offshore gap, Mr. Avi-Yonah says it is roughly $50 billion, so that is $50 billion on top of the $345 billion we have been talking about. Is that correct?

Mr. HARRINGTON. In terms of particular numbers, I will have to get back to you.

The CHAIRMAN. I am just surprised you do not know more about this subject, Mr. Secretary. I am very surprised, frankly.

I have to conclude this hearing. Now, clearly this is a very frustrating subject, so much we just do not know about. I will give each of the three of you—or the four of you, if you want—an opportunity to tell us what we have to do to get a better handle on this.

You have talked about information sharing and more transparency. I am just trying to get a little more precise sense of where the information sharing should be, how we get more transparency, how we solve this thing. I know you have already given some answers and lots of ideas, but I am giving you an opportunity to say anything more if you want. Anybody? Mr. Brostek?

Mr. BROSTEK. I would go back to a comment I made earlier. For a lot of U.S. persons, it is their income here in the country that they are transferring offshore, and that can be a substantial amount of money.

It is a difficult thing to get information reporting on, when it is cash transactions in a business or between a professional and his or her clients, but it is an area where we need to try to figure out whether there are additional opportunities for getting information reports that routinely tell us the amount of income that someone has received in their business.

It is not our proposal, it is the President's proposal, but one of those proposals is that credit card companies give IRS the annual total receipts that that company received in its business operations during the year.

It could potentially give IRS sort of a bottom line of what the revenue in that business is. You would logically assume that there must have been some cash transactions on top of that. It would help them identify whether a business is under-reporting its income.

There are some concerns that have been expressed from the community about how implementable that procedure is, but that is the kind of thing I think we have to think about in order to make sure we have an idea what the U.S. income is that is going to be transferred offshore.

The CHAIRMAN. All right.

Yes, Mr. Owens?

Mr. OWENS. I would come back to the importance of getting other countries to endorse these transparency and exchange of information standards. If we can have agreement on what the standards are, if we can have a consistent application of them, that goes a long way towards resolving the issues. I always work on the basis that, for tax administration, information is their lifeblood. Deny a tax administration information and it is very hard for them to do their job.

A second thing that you could do is to encourage the Treasury to vigorously pursue its policy of negotiating tax information exchange agreements. I say that because you have much more power to get these countries to the table. Once they have an agreement with you, then other countries can come in behind you, and that helps a lot.

The third thing that would be important is to look at countries that you do not have tax treaties with, countries like Singapore, and perhaps to make this one of your priorities, to have a treaty with Singapore with a full exchange of information. That would be beneficial both for Singapore and the United States.

And the last thing, which we have not really talked about this morning, is the importance of the IRS developing a media strategy. In my paper, I describe the offshore initiatives of Ireland and the United Kingdom, and a large part of their success was the way the politicians went out and said why this was important, and the opportunities that were given to dishonest taxpayers to come into the revenue services and voluntarily disclose before the investigations began. So, media strategy is very important.

The CHAIRMAN. Thank you, Mr. Owens.

Yes?

Mr. AVI-YONAH. Just one suggestion is to have the Treasury establish a list of countries that are and are not cooperating with our exchange of information. It is usually a great incentive for the countries to try to jump from the list that they are not cooperating to the list that they are.

The CHAIRMAN. That is a good idea. I like that idea.

Mr. Harrington?

Mr. HARRINGTON. Thank you, Mr. Chairman. I would go back to Mr. Owens's comment about the need to continue to emphasize the entering into of information exchange agreements. That is something that we have, and will continue, to do.

Also, just in light of our discussion, I think you identified the fact that research is critical. We are learning information through our tax information exchange agreements. We are learning information through cooperation with other countries. As we learn more, we get a better handle on the types of transactions that are occurring, the types of investments that are occurring that lead to greater evasion.

Also, just to emphasize the enforcement opportunities. I know Senator Conrad had a list of things one can find on the Internet. The IRS does have a well-established system to regularly monitor the Internet so they can follow leads and so forth, because the Internet is both a blessing and a curse.

Things like that—the fact that they are so obvious allows people to see the scams and the dubious arguments, but at the same time it makes it above-board and easier to go after the people. So, I'm emphasizing enforcement that we are doing.

The CHAIRMAN. I appreciate that. I just do not get the sense of urgency from Treasury that I think is needed. This is a huge problem. I just urge you, Mr. Harrington, Secretary Paulson, the IRS, to go burn the midnight oil and get a handle on this.

Mr. HARRINGTON. Yes.

The CHAIRMAN. I just do not see and sense the urgency that is needed, in my judgment, anyway, to solve it.

Mr. HARRINGTON. I certainly do not mean to convey to you that we do not think this is important. We do think this is an important issue.

The CHAIRMAN. I did not say important, I said urgent.

Senator Grassley?

Senator GRASSLEY. Thank you very much. As you know, I left in the middle of the second testimony because I had to be down at Judiciary to make quorums, and because I had some legislation to defend.

Mr. Owens, I would like you to clarify the work of the OECD in the area of harmful tax practices and tax cooperation. One of the factors the OECD uses to define a tax haven is "no or nominal taxation." One of the action items you listed in your testimony is to intensify international tax cooperation.

Three questions I want to ask all at once, and I can repeat them if you want me to: does the OECD recognize the sovereign right of countries to set their own tax policies, and that the level of taxes can be a legitimate competitive factor in the global economy?

Two, in the OECD's view, if mobile capital moves from one country's tax jurisdiction to another because of a lower tax rate, is that, by itself, considered harmful?

Lastly, would you please clarify what you mean by the term "tax cooperation?" For example, you are not referring to tax harmonization or some sort of global tax. Is that correct? Go ahead.

Mr. OWENS. Thank you, Senator. I will go to each question separately.

Senator GRASSLEY. Yes.

Mr. OWENS. On the question of, does the OECD recognize the sovereign rights of countries to design their own tax systems, the answer is yes. In fact, one of the basic principles that guides our work in the tax area is that each country has the sovereign right to design its own tax system to reflect its own economy, to reflect its own social values, and to reflect its own political values. That is a principle that underlies all of the work that we do at the OECD in the tax area.

We do not tell our member countries how to design their tax system. You can see that from the diversity of tax systems within the OECD. There are some countries that have very high taxes, there are others that have low taxes. There are some countries that rely very heavily on consumption taxes, there are others that rely on income taxes. Those are choices that they make and we must respect.

Similarly, in the work that we have been doing with the tax havens, we have never told them how they should design their tax systems. Some of these countries, in fact, do not have any income taxes at all. That is a choice that they have made, so we respect it.

Some of them do have income taxes, very low rates. Again, that is a choice that they make. The one thing that we do ask, though, of all countries, both OECD and non-OECD, is that they should be prepared to cooperate to counter abuse.

The second question on mobile capital. We have never characterized a country as harmful just because there is a low rate of tax. We put the emphasis on whether or not a country is transparent and whether or not it meets the exchange of information standards.

In today's competitive world we have to recognize that countries will use their corporate tax rates, their personal income tax rates, to attract capital. That is something that they have the right to do.

Certainly, the OECD does not have any problems with them doing that.

From our organization's perspective, we have consistently promoted the benefits of tax competition, I would like to think not just in the tax area, but right throughout our work.

But we do recognize that to get the full benefits of tax competition, that competition has to be transparent, it has to be non-discriminatory, and countries have to be prepared to cooperate to counter abuse.

The third question you asked was, what do we mean by "cooperation?" Basically, that is where countries agree that they are going to cooperate to counter international abuse. When a taxpayer misuses one country to evade taxes in his home country, then those two countries should be cooperating.

A lot of that cooperation does take place by means of exchange of information. That is a key factor. But it is also the dialogue that takes place at the OECD where countries come and share their experiences. They indicate what policies have been successful, and they also indicate what policies have not been successful. That is an important role that we have.

It is very important to distinguish between tax cooperation and tax harmonization. I do not see that we will ever move towards a world where we have one tax system. Even within the European Union, with 27 countries, they no longer talk about tax harmonization, they talk about tax cooperation. That just reflects the diversity we have within tax systems across the world.

Similarly, the whole idea of moving toward some sort of global tax is not realistic. That certainly is not on the OECD's agenda, and I do not think it ever will be on our agenda.

Thank you.

Senator GRASSLEY. Thank you.

I will go to Mr. Brostek now. There has been a lot of press recently about offshore tax haven jurisdictions luring hedge funds and private equity firms. Given your testimony about how foreign corporations may provide a way for evading U.S. tax, should we be concerned about U.S. taxpayers or tax-exempt organizations investing in offshore hedge funds or private equity funds using structures that allow them to more easily evade U.S. tax?

Mr. BROSTEK. It certainly is the case in many, many tax schemes that what the taxpayer is trying to do is hide the ball so that IRS cannot find out what is going on. So, certainly if anyone is making investments and using a structure that is deliberately intended to hide what is going on, we should be concerned about that. Given the substantial amount of funds that are reported to be invested in hedge funds, you would not need to have much non-compliance to have real money at stake.

Senator GRASSLEY. So there is an issue of linkage of hedge funds to offshore tax evasion issues?

Mr. BROSTEK. Well, we have not shown that in our work, but there is certainly some potential for concern there.

Senator GRASSLEY. All right.

Mr. Harrington, Mr. Owens, Professor, this question I would like to have the three of you consider. We have heard a lot of testimony this morning about the U.S. information exchange network and about the efforts of the international community to promote effective information exchange.

Would each of you please comment on the importance of an effective information exchange network in addressing the international tax gap, and if possible, how tax information exchange fits into the broader international cooperative network designed to detect and enforce financial crimes, be they tax evasion, money laundering, or terrorist financing? Mr. Harrington, then Mr. Owens, then the Professor.

Mr. HARRINGTON. All right. Thank you, Senator Grassley. I would just point out, with respect to information exchange, we do regularly use the information exchange article in our tax treaties and tax information exchange agreements. We fully believe that information exchange is effective, and broadening this network is effective in combatting offshore tax evasion.

Obviously tax evasion is a difficult area to measure, but I would just point out, we are not alone in the belief that increasing the information exchange network helps because I think, as Mr. Owens pointed out in his testimony, many other countries seek to establish this information exchange network with the same belief that this helps in thwarting offshore tax evasion.

Second—this is somewhat anecdotal. The resistance that we sometimes encounter from a potential treaty or TIEA partner about the need for information exchange, and the concern that it has potentially on their financial and other business sectors, is, to us, another good indication that we are really striking something here, given the fact that it raises concerns.

It is perhaps easier to look at it from a negative context. What would the world be like if there were no tax information exchange? If we could not get information from offshore jurisdictions, if we could not get it from other financial centers, we would be operating in the dark.

So in that sense, we believe that it is not just with us, with the United States, in terms of our bilateral relationships, but the fact that other countries entering into additional bilateral relationships creates a web that raises standards worldwide, which we think very much goes to the benefit of the United States and other countries as well.

Senator GRASSLEY. All right.

Mr. Owens?

Mr. OWENS. I could only endorse what Mr. Harrington has said. At the end of the day, you cannot operate a tax system effectively, not in today's global environment, unless you have good access to information.

To get that access, you need to have the agreements in place, whether they take the form of full tax treaties, with exchange of information articles, or whether they take the form of information exchange agreements.

But, for information exchange to work, you need to be sure that the countries you are requesting the information from have access to it, and that is why we must address this issue of bank secrecy. Over the last 10 years, we have worked very hard to improve the effectiveness of exchange of information. We have looked at many of the practical problems that act as barriers to an effective exchange.

We provided a new legal framework in our new article 26. The treaties that the United States has negotiated are based on a model that was developed at the OECD. So exchange of information, you cannot over-emphasize the importance of it, not in today's environment.

Senator GRASSLEY. Professor?

Mr. AVI-YONAH. I would certainly think that the link that you pointed out between information exchange for purposes of committing tax evasion and information exchange for other purposes like money laundering and terrorist activities is a very important one that we should emphasize. These three all go together. It is no accident that sometimes investigation in one area leads to discoveries in another area.

So I think that, from that perspective too, since we are all committed to the other aims, we should link them together and make sure, in particular—the other thing I want to emphasize is that we in the United States should make sure that we have the information available to us to offer to our treaty partners in exchange for the information that they give us.

That was something that was raised before, that there have been some suggestions that we should be doing a better job in having our financial institutions collect information about payments that they make to overseas people, even if they are not U.S. people.

And similarly, in relation to the GAO report, the qualified intermediary system, which is designed to enlist foreign banks and other institutions as partners with the IRS, should collect information that is needed in order for us to be able to exchange information with our treaty partners.

Senator GRASSLEY. All right.

Mr. Owens, the Professor mentioned the list in Senator Levin's bill. Many of those jurisdictions are no longer on the OECD's list of uncooperative tax havens, and the U.S. has entered into tax information exchange agreements with many of them. How would putting these cooperating jurisdictions on the statutory blacklist affect the cooperating nature of the jurisdictions at the international level?

Mr. OWENS. There is, in fact, some overlap between the OECD list and the list that has been prepared by Senator Levin. But I think, while it is very important to note there are some advantages in the listing process, it is also very important to look at some of the risks. You have to recognize that putting a country on any list will have implications that go way beyond the tax area.

Also, if you go down the listing approach, you have to be very clear what criteria you are using to put a country on a list, and even more important, what criteria are you using to get the country off that list.

For the last 5 years, we have put a lot of emphasis on having a constructive dialogue with these jurisdictions, which has resulted in them endorsing the standards, the standards of transparency and exchange of information and a willingness to negotiate exchange agreements. It is counterproductive to put such jurisdictions on any list.

Senator GRASSLEY. Mr. Harrington, the Government Accountability Office's written testimony shows a significant portion of U.S.-source income paid to foreign corporations as interest. Much of this interest would qualify for the portfolio interest exception and be exempted from withholding tax.

The portfolio interest exception enacted in 1984 was meant to remove a barrier for U.S. businesses to tap into foreign bond markets as a source of capital, but Congress recognized this exception might provide some U.S. taxpayers with an avenue of tax evasion, for example, by investing in U.S. debt securities through foreign corporations and then not reporting the net income on their tax returns.

One of the things Congress did to address this concern was to give Treasury the authority to deny the exception to interest paid to persons in jurisdictions that are determined to lack effective information exchange to prevent U.S. income tax evasion. Since 1984, Treasury has not exercised this authority under any administration.

So, Mr. Harrington, is Treasury considering exercising this authority as it looks at ways to close the tax gap, and what issues would Treasury need to address to exercise the authority?

Mr. HARRINGTON. Thank you, Senator Grassley. As you point out, we do have this authority. Other countries know that we have this authority, so it exists as a tool in our arsenal.

The thing I would point out about it, and part of the reason why it has not been used in the past, is the fact that it is a very blunt instrument, and we have not reached the stage with any jurisdiction in which we have found it to be appropriate to use this tool.

It would have repercussions with our broader economic relationship with a jurisdiction to suddenly single them out and impose a withholding tax on the interest payments. We have to ask, who would be hurt, who would be affected? Plainly this potentially affects the interest payments that the U.S. borrowers would pay.

So, its use would raise a lot of significant issues, and we have not reached the point where we have found that we have had to use it. But it is a tool in our arsenal, and one that we have to be prepared to use.

Senator GRASSLEY. Yes. Of course, I can only refer to this administration for 6 years, but it seems to me, in 20 years, there may have been an example of when it could have been used without harming the economy or relationships with another country, et cetera.

It might be one of those things that you would think about using to satisfy Senator Baucus, that you are aggressively concerned about this issue and using every tool you can.

Professor, you note in your testimony that the lack of transparency in foreign tax haven jurisdictions adversely impacts the IRS's ability to detect tax evasion. Of course, I agree with you and the other witnesses here that establishing and maintaining effective information exchange programs, both in treaty partners and non-treaty partners, is very critical to reducing the tax gap.

But this lack of transparency is not limited to shell corporations formed offshore. We have seen news reports about the lack of transparency in the company information processes of many U.S.

States, which allow tax evaders to hide behind domestic shell corporations.

How do you think Congress should consider addressing that problem?

Mr. AVI-YONAH. This issue, I think, is particularly egregious. We are talking about things that are happening in the United States. There are no diplomatic or other issues that pose a barrier.

I think, fundamentally, Congress should seriously consider legislation to make sure that the IRS has full access to data that States actually possess about who sets up corporations in which States.

On a broader level, I mean, it really is a question of policy whether we should be encouraging States who compete with each other in lack of transparency. There are other ways in which States can compete legitimately in terms of setting the tax rates and tax structure, but not so much by advertising that you can set up a shell corporation there and be able to hide your money from the Federal IRS. I find that to be egregious.

Senator GRASSLEY. Mr. Brostek, you noted in your testimony that there is precedent for making an exception to the 3-year statute of limitation rule when IRS is at an informational disadvantage.

In fact, an exception exists in current law that relates to offshore activity of U.S. taxpayers. Under current law, the 3-year statute does not begin to run until taxpayers file required information regarding their investment in foreign entities.

Did the GAO analyze the effectiveness of this or other current law exceptions in the course of its work? Why are these existing exceptions deficient when it comes to taxpayers involved in offshore financial activities?

Mr. BROSTEK. We did not do a focused review of each one of the potential statutory exceptions to the rule. We did look at that somewhat during our work, and it appeared to be fairly narrowly focused. In a significant number of cases for IRS, who is aware of the provisions that allow them to go beyond the statute, they felt they did not have adequate statutory basis to go beyond 3 years.

Senator GRASSLEY. Yes. All right.

Professor, we heard testimony from the person on your left today about the reporting and withholding regime that applies to payment of U.S.-source income to non-U.S. persons.

The existing substantive rules and the reporting and withholding rules attempt to strike a balance between attracting foreign investment in our capital markets and ensuring the right amount of tax is paid on U.S.-source income.

Two of your recommendations may implicate this balance. The first is for the Treasury to finalize regulations proposed by the Clinton administration that require U.S. banks and financial institutions to collect information on interest payments made to overseas jurisdictions when the portfolio interest exception applies.

The second concern concerns third-party reporting by U.S. payors of amounts to certain foreign corporations when the payor knows, or has reason to know, that the foreign corporation is beneficially owned by U.S. individuals. This proposal would be designed to help the IRS detect U.S. taxpayers who disguise themselves as foreign corporations and fail to report income on their tax returns.

Two questions, and I will ask them both: what are your views on how these recommendations would affect the balance that I referred to; and two, if your second proposal went into effect, to what payments would it apply and to what payments would it not apply?

Mr. AVI-YONAH. So, on the first one, I certainly think that we should preserve a balance between attracting investments from overseas and maintaining the integrity of our tax system.

But it does not seem to me that requiring banks and other financial institutions to collect information that would be available, in discussion with the Treasury, to exchange with our treaty partners should negatively affect that balance, simply because, as I said before, the investors have to go to one OECD member country or another. The EU already has regulations that require this kind of information to be available for its own residents.

So to the extent that we do the same thing, the 16 countries' proposal was requested by the EU. This was one of their conditions to have the savings directive come into effect because they wanted to make sure that the money does not flow completely from the EU into the United States.

It seems to me, if we cooperate with them in this regard and we can get them to cooperate with us, this will not change the balance of investment in any meaningful way and would help both countries ensure that their tax laws are enforced in regard to their own residents.

As to the second question as to whether this is a relatively narrow proposal, what we are talking about in this situation is where a U.S. payor or withholding agent knows, or has reason to know, that a payment is actually made to an entity that is, in fact, controlled by a U.S. resident.

So, while this would apply to any kind of payments that are going overseas, this is a relatively narrow class of payments. There is indication in the GAO report, and also in the Subcommittee on Investigations report from last year, that in fact there are situations where U.S. payors rely on the fact that they get a statement that a payment is being made to a foreign corporation at a time when they actually know that that foreign corporation is really a shell for a U.S. resident. I do not think that that is acceptable, and I do not think it will adversely affect the balance that you discussed before.

Senator GRASSLEY. Maybe on that point, I should ask Mr. Harrington if he wants to make any remarks or reaction to what the Professor just said. You do not have to, but I thought if you wanted to, I ought to give you that opportunity.

Mr. HARRINGTON. When your name is invoked, sorry, it is hard not to respond. First, on the bank deposit interest regulations, the proposed regulations, we have issued two sets of proposed regulations. They have generated a substantial amount of comments, and we are still evaluating the comments that we have received.

We work on a lot of issues that would kill a conversation if you tried to raise them at a cocktail party, but these do not fall in that category. These have engendered a substantial amount of controversy, and we are still reflecting on those comments.

As for the foreign trusts, plainly, there are a lot of proposals. We are evaluating them and giving them consideration. But the test for us ultimately in all of these is, does this assist with compliance or not? And in some circumstances, there is a lot of reporting already.

We want to make sure that we do not lead to any additional confusion about who should be paying and who should not, so we are studying these proposals. But again, to us, the ultimate test is, does this assist with compliance or not? So, we are studying them.

Senator GRASSLEY. All right.

Before I ask my last question, I ought to ask, did the Chairman want me to adjourn?

The CHAIRMAN. Yes, please.

Senator GRASSLEY. All right.

Mr. Harrington, much of our reporting regime for foreign activity of U.S. taxpayers is one of self-reporting. For example, U.S. taxpayers are required to report investments in foreign bank accounts, foreign corporations, foreign partnerships, and foreign trusts. As we have seen with other areas of the tax gap, compliance is highest when third-party reporting is involved.

Has Treasury considered whether there are areas of the international tax gap that could be addressed through third-party reporting?

Mr. HARRINGTON. We are looking at potential third-party reporting issues in the international context. I would point out that part of the reason we have so much self-reporting in the international area is because there is not an obvious third party. We do not have jurisdiction over the third party who would do the reporting. That is the difficulty we face.

In the domestic context, we have a whole series of rules where there is reporting. Certainly with a lot of financial payments, at each point along the line there is supposed to be either information reporting or you know it is going to an exempt person. That works as long as it is in a chain.

When you cross borders, you break the chain. We deal with people over whom we do not have jurisdiction. That is the difficulty that we are dealing with. But certainly the things you pointed out, the more information reporting, the greater the compliance, are very important, and this is an area on which we are focusing.

Senator GRASSLEY. All right.

For the Chairman and for the committee, I thank you very much for you participation. I am sorry I could not be with you for the whole two hours.

The hearing is adjourned. Thank you all very much.

[Whereupon, at 12:10 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

AVI-YONAH TESTIMONY FOR HEARING ON OFFSHORE TAX EVASION
US SENATE COMMITTEE ON FINANCE
MAY 3, 2007

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

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

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

In July of 1999, the Justice Department entered into a plea bargain with one John M. Mathewson of San Antonio, Texas. Mr. Mathewson was accused of money laundering through the Guardian Bank and Trust Co. Ltd., a Cayman Islands bank. Mr. Mathewson was Chairman and controlling shareholder of Guardian, and in that capacity had access to information on its depositors. In return for a reduced sentence, Mr. Mathewson turned over the names of the persons who had accounts at Guardian. The result was an eye-opener: The majority of the accounts were beneficially owned by US citizens, and the reason they used a Caymans bank had nothing to do with laundering funds earned in criminal activities. Instead, the accounts were in the Caymans for the purpose of evading federal income taxes on income earned legally, relying on the Caymans' lack of an income tax and promise of bank secrecy. The IRS ultimately settled 1,165 cases with the individual taxpayers for a total collection of $3.2 billion- an average of $1.7 million per taxpayer.[2]

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

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

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

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

The Wylys claimed that the tax results of this series of transactions are as follows: Neither the contribution of the options to the IOM grantor trust, nor the exchange of the options for private annuity contracts, triggers the realization of gain on the options (which but for the transaction would be taxable to the Wylys as compensation income under IRC sec. 83). The gain is triggered only when the options are exercised in the hands of the IOM corporation, and since at that point it is capital gain of a foreign entity, no US tax is due. The Wylys have to pay tax only when they receive payments on the private annuity contract, resulting in significant deferral. The purchase of various US assets and loans to the Wylys from the IOM corporations have no US tax consequences because the Wylys claim the corporations (and the IOM non-grantor trusts that control them) are independent, unrelated entities.

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

The Wylys received opinions that the transactions were more likely than not to withstand scrutiny, and the transactions are currently under review by the IRS. A court could find that the transactions were shams due to the Wylys exercising de facto control over the IOM entities. If, however, the transactions were upheld, they raise troubling issues regarding the ability of wealthy individuals to shield income from current tax, while using the income to benefit themselves and their families.

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

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

No one, including the IRS, has a good estimate of the size of the international tax gap. This is not surprising given that the activities involved are illegal, but one can make an educated guess based on a few publicly available numbers. In 2003, the Boston Consulting Group estimated that the total holdings of cash deposits and listed securities by high net worth individuals in the world were $38 trillion, and that of these, $16.2 trillion were held by residents of North America. Out of these $16.2 trillion, "less than"

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

10 percent was held offshore (as compared with, for example, 20-30% offshore for Europe and 50-70% offshore for Latin America and the Middle East).[6]

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

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

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

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

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

As the Wyly case indicates, foreign trust law in many tax haven jurisdictions (e.g., the Isle of Man) allows the appointment of trust "protectors" which have significant control over decisions of the trustees. This enables U.S. residents to set up foreign trusts that have no current U.S. beneficiaries (the current beneficiaries are foreign charities) and thus avoid the application of IRC sec. 679. The U.S. residents then appoint friends or employees as protectors of the trust. The desired tax result is that the trusts are considered

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

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

unrelated to the U.S. settlors and therefore may use their funds (directly or through controlled corporations in tax havens) in ways that benefit the U.S. settlors (such as loans, purchases of real property, etc.), without triggering any U.S. tax consequences. The settlors are in practice assured (because of their close relationship with the protectors) that the trusts will make no current distributions and that upon their death the assets will be distributed to contingent U.S. beneficiaries (typically their children).

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

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

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

5. The Adequacy of Reporting and Withholding Rules.

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

6. Recommendations to Address Offshore Tax Abuses.

a. Increased IRS enforcement.

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

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

b. Bilateral information exchange.

The Organization for Economic Cooperation and Development (OECD) has recently modified Article 26 (Exchange of Information) in its model income tax treaty, and has adopted a model Tax Information Exchange Agreement (TIEA), both of which are intended address the problems with current exchange of information agreements discussed above. Under the new Article 26 and model TIEA, exchange of information relates to civil as well as criminal tax liabilities, does not require "dual criminality" or suspicion of a crime other than tax evasion, and overrides bank secrecy provisions in domestic laws. These are the principles that underlie the vast majority of US TIEAs, and where they fall short, the US should renegotiate the TIEAs to incorporate these principles.[11]

I will discuss below the steps I believe are needed to induce tax haven jurisdictions to negotiate such agreements with the US. For other jurisdictions that are not tax havens, the inducement is the information they can obtain from the US on their own residents. To

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

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

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

[11] The U.S. has recently negotiated a large number of TIEAs, including TIEAs with tax havens such as the Netherlands Antilles, the British Virgin Islands and the Cayman Islands, but some of them (e.g., the treaty with Switzerland) fall short of the OECD model tax treaty and TIEA.

ensure such information is available, the Treasury should finalize regulations proposed by the Clinton administration that require US banks and financial institutions to collect information on interest payments made to overseas jurisdictions when the interest itself is exempt from withholding under the portfolio interest exemption.[12] The Treasury has recently proposed to limit such regulations to 16 designated countries, but as Blum writes, there is no legitimate privacy or other reason to impose such limitations. The banks should collect all the information, and the Treasury should use its existing authority not to exchange it in situations in which it might be misused by non-democratic foreign governments (e.g., when freedom fighters use US bank accounts).

c. Cooperation with OECD.

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

d. Incentives to tax havens.

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

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

e. Sanctions on non-cooperating tax havens.

In the case of non-cooperating tax havens, I support the US Treasury using its existing authority to prospectively deny the benefits of the portfolio interest exemption to

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[12] Blum, supra.

countries that do not provide adequate exchange of information.[13] This step is necessary, in my opinion, to prevent non-cooperating tax havens from aiding US residents to evade US income tax.

A principal problem of dealing with tax havens is that if even a few of them do not cooperate with information exchange, tax evaders are likely to shift their funds there from cooperating jurisdictions, thereby rewarding the non-cooperating ones and deterring others from cooperation. Thus, some jurisdictions have advertised their refusal to cooperate with the OECD efforts.[14]

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

The EU and Japan have both committed themselves to tax their residents on foreign source interest income. The EU Savings Directive, in particular, requires all EU members to cooperate in exchange of information or impose a withholding tax on interest paid to EU residents.[15] Both the EU and Japan would like to extend this treatment to income from the US. Thus, this would seem an appropriate moment to cooperate with other OECD member countries by imposing a withholding tax on payments to tax havens that cannot be induced to cooperate in exchange of information, without triggering a flow of capital out of the US.

f. Changes to IRC sec. 679.

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

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[13] See IRC section 871(h)(6).

[14] Singapore, for example, has been boasting that it is not subject to the US or OECD efforts to promote exchange of information. The US should consider offering Singapore and other jurisdictions that levy income taxes a full-fledged tax treaty in exchange for cooperation in exchange of information, because the benefits of such a treaty are likely to outweigh the benefits of the offshore sector.

[15] EU Directive 2003/48/EC on Taxation of Savings (2003).

g. Distributions from Foreign Trusts.

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

h. Definition of Control under IRS sec. 679.

The IRS should consider treating foreign trusts as grantor trusts when they are in fact controlled by protectors who are close collaborators and employees of the settlors. In assessing whether a foreign trust is related to the settlor, a flexible standard of control (such as that used under IRC sec. 482 to test whether parties are related) should be used, rather than a bright line rule that inevitably has loopholes built into it. Similar rules can be applied for purposes of applying Subpart F and the PFIC rules to foreign corporations.[16]

i. Withholding and Information Reporting.

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

7. Conclusion.

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

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[16] For an example of a court applying such a standard for Subpart F purposes see Garlock, Inc. v. Comm'r, 489 F.2d 197 (2[nd] Cir. 1973). This proposal, as well as some other related proposals, has been incorporated into draft legislation (S. 681, the "Stop Tax Haven and Tax Shelter Abuse Act") introduced by Sens. Levin, Coleman and Obama on Feb. 17, 2007.

Committee on Finance
Offshore Tax Evasion: Stashing Cash Overseas
May 3, 2007

Responses to Questions for the Record

Questions for Mr. Avi-Yonah:

1. Please comment on the costs and benefits for the United States of blacklisting countries who are not willing to enter into an exchange of information agreement. (Chairman Baucus)

   The main benefit of having a list is the pressure it puts on countries that are on the list to cooperate in order to get off the list, especially if being on the list has real consequences (such as denial of the portfolio interest exemption, as allowed under current law). The main disadvantage is the diplomatic offense to the countries involved, but this has not prevented the U.S. from using such lists (e.g., state sponsors of terrorism, countries that cooperate in illegal boycotts), with both tax and non-tax consequences (see, e.g., IRC sec. 901(j), denying the foreign tax credit to state sponsors of terrorism and countries with whom we do not have diplomatic relations). Many other countries use such lists, for example, for purposes of applying Controlled Foreign Corporation rules (i.e., income from subsidiaries in the listed countries is not eligible for deferral or exemption).

2. Please explain why a country with no income taxation would desire to enter into a double-taxation treaty with the United States and why this would not be beneficial for the United States. (Chairman Baucus)

   Such countries would like to have a tax treaty with us because it will increase U.S. investment. The main benefit of a tax treaty for developing countries is not the reduction of U.S. tax on their residents (since they have little outbound investment to the U.S., and do not like the outbound investment they have, which represents capital flight). Rather, the main benefit is the stability guaranteed to U.S. investors by having a tax treaty (which prevents the country from adopting future taxes), and the implicit signal that the U.S. supports American investment in that country. However, the U.S. has taken the position since the 1980s that it will not negotiate full fledged tax treaties with countries that do not have an income tax because the main purpose of such treaties is to prevent double taxation. In the absence of source-based taxation, and since deferral is usually available without a treaty, U.S. investors do not need a treaty either to reduce source-based tax or to avoid residual residence-based tax.

3. At the hearing, you appeared to endorse the list of jurisdictions contained in S. 681. You also endorsed U.S. involvement in the OECD's efforts to achieve transparency and effective information exchange with respect to many of these jurisdictions. I asked Mr. Owens what effect a statutory list that included cooperative jurisdictions would have on the existing cooperative nature of these jurisdictions at the international level. He responded that listing such jurisdictions could cause some damage to the international goal of tax cooperation regarding the commitment to transparency and information exchange. Do you agree with this view? (Ranking Member Grassley)

   I do not, from a U.S. perspective. I believe the OECD has let countries get off its list with very limited commitments to real information exchange, because of political pressures both within the OECD (which has several members with very low tax rates and significant limits on exchange of information) and from the tax havens (which carried out an effective publicity campaign against the OECD). As stated above, many countries have more extensive lists than the OECD, and I believe the U.S. would help transparency and information exchange, and possibly even the OECD effort, by adopting such a list. This would put real pressure on the listed countries to cooperate, which in turn could lead to a significant reduction in the international tax gap.

United States Government Accountability Office

GAO

Testimony
Before the Committee on Finance,
U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. EDT
Thursday, May 3, 2007

TAX COMPLIANCE

Challenges in Ensuring Offshore Tax Compliance

Statement of Michael Brostek
Director
Strategic Issues

GAO
Accountability * Integrity * Reliability

GAO-07-823T

GAO Accountability·Integrity·Reliability

Highlights

Highlights of GAO-07-823T, a testimony before the Committee on Finance, U.S. Senate

Why GAO Did This Study

Offshore tax evasion is difficult for the Internal Revenue Service (IRS) to address. IRS examines tax returns to deal with offshore evasion that has occurred. IRS's Qualified Intermediary (QI) program seeks to foster improved tax withholding and reporting.

GAO was asked to testify on two topics. First, GAO was asked to provide information on (1) the length of, and assessments from, IRS's examination of tax returns with offshore activity and (2) the impact of the 3-year statute of limitations on offshore cases. Second, for the QI program, GAO was asked to address (1) program features intended to improve withholding and reporting, and (2) whether weaknesses exist in the U.S. withholding system for U.S. source income and QI external reviews and IRS's use of program data. GAO relied on prior work for the first topic. For the QI program, GAO used the latest data that were available and corroborated by IRS.

What GAO Recommends

A report GAO released today suggests that Congress make an exception to the 3-year civil statute of limitations period for taxpayers involved in offshore financial activity. GAO will consider recommendations for the QI program in a forthcoming report.

www.gao.gov/cgi-bin/getrpt?GAO-07-823T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek on (202) 512-9110 or brostekm@gao.gov.

May 3, 2007

TAX COMPLIANCE

Challenges in Ensuring Offshore Tax Compliance

What GAO Found

Examinations involving offshore tax evasion take much more time to develop and complete than other examinations—a median of 500 more days for cases from fiscal years 2002 to 2005, but their resulting median assessment is almost three times larger than for all other examinations. Nevertheless, because they take more staff time, offshore examinations yielded tax assessments per hour of staff time that were about one-half of that for all other examinations. Because of the 3-year statute of limitations, the time needed to complete an offshore examination means that IRS sometimes prematurely ends offshore examinations or decides not to open an examination, despite evidence of likely noncompliance. Congress has granted a statute change or exception when enforcement challenges similar to those found in offshore cases have arisen in the past.

QIs are foreign financial institutions that contract with IRS to withhold and report U.S. source income paid offshore to foreign customers. The QI program provides IRS some assurance that QIs are properly withholding and reporting tax on U.S. source income paid offshore. QIs (1) are more likely to have a direct working relationship with customers who claim reduced tax rates under tax treaties, (2) accept responsibilities for ensuring customers are in fact eligible for treaty benefits, and (3) agree to have independent parties review a sample of accounts and report to IRS.

However, a low percentage of U.S. source income flows through QIs. For tax year 2003, about 12.5 percent of U.S. source income flowed through QIs. About 87.5 percent flowed through U.S. withholding agents, which provide somewhat less assurance of proper withholding and reporting than do QIs. In addition, U.S. persons may be able to evade taxes by masquerading as foreign corporations.

The contractually required independent reviews of QIs' accounts do not require auditors to follow up on indications of illegal acts, as would reviews under U.S. *Government Auditing Standards*. While IRS obtains considerable data from withholding agents, it does not make effective use of the data to ensure proper withholding and reporting has been done.

U.S. Source Income Flowing through QIs and to Foreign Corporations, 2003

Dollars in billions

Total U.S. source income	Amount and percentage flowing through QIs		Amount and percentage flowing to foreign corporations	
	Amount	Percentage	Amount	Percentage
$293.3	$36.6	12.5	$200.5	68.4

Source: GAO analysis of IRS data.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss two topics related to offshore tax evasion: the impact of the 3-year civil statute of limitations on Internal Revenue Service (IRS) offshore enforcement efforts, and the Qualified Intermediary (QI) program. IRS's success in identifying and pursuing all tax evasion is of critical importance. When some taxpayers do not pay their fair share of taxes, honest taxpayers are left with higher tax bills and may find reason to doubt their own willingness to stay compliant. Offshore tax evasion is especially difficult to identify because of the layers of obfuscation that can come with doing business in overseas locations beyond the effective reach of the U.S. government. Doing business outside of the country is, of course, perfectly legal, but hiding income or assets in offshore locations in order to evade taxes is not. Generally, to address offshore tax evasion, IRS examines tax returns with offshore activity to deal with noncompliance once it has occurred. IRS has also initiated the QI program to improve upon the prior system of withholding and reporting of U.S. source income that flows offshore. QIs are foreign financial institutions, such as banks, trusts, and partnerships, that contract with IRS to withhold and report U.S. source income paid offshore to individuals who are not U.S. persons and do not live in the United States (nonresident aliens).

My remarks regarding IRS's offshore compliance activity will focus on (1) IRS's examination of tax returns with offshore activity and how those examinations differ from nonoffshore examinations in their length and in the assessments they ultimately yield and (2) the implications of the 3-year statute of limitations on offshore examinations. Regarding the QI program, I will address (1) features of the QI program intended to improve withholding and reporting, (2) whether weaknesses exist in the U.S. withholding system that complicate identifying beneficial owners[1] of U.S. source income, and (3) whether weaknesses exist in QI external reviews and IRS's use of program data. My statement today is drawn, in part, from our report on offshore tax evasion being publicly released today.[2] The portion of this statement addressing the QI program is based on the

[1] The beneficial owner is the true owner of the income, corporation, partnership, trust or asset, who receives or has the right to receive the proceeds or advantages of ownership. For the rest of this statement, we will use the term "owner."

[2] GAO, *Tax Administration: Additional Time Needed to Complete Offshore Tax Evasion Examinations*, GAO-07-237 (Washington, D.C.: Mar. 30, 2007).

preliminary results of new work. We describe the methodology for our QI program review later in this statement. The offshore report and our QI program review were prepared in accordance with generally accepted government auditing standards.

Let me begin by highlighting two major points about IRS's examination of returns with offshore activity:

- IRS examinations involving offshore tax evasion take longer than other examinations but also yield higher assessments. In conducting offshore examinations, IRS faces inherent difficulty in identifying and obtaining information from foreign sources, often dilatory and uncooperative tactics on the part of taxpayers and their representatives, and technical complexity. Our analysis of IRS examination data from fiscal years 2002 through 2005 showed that offshore cases—measured from when the return was filed to when the examination closed—took a median of about 500 more calendar days overall to close than nonoffshore cases and required nearly four times as many staff hours to examine, on average. These examinations had a median assessment that was nearly three times larger than all nonoffshore examinations but given the greater staff time taken per case, yielded about one half as much in tax assessments per hour of examination time.
- Offshore examinations are subject to the same 3-year statute of limitations on assessments as other types of cases. IRS officials told us that the need to complete an examination and make an assessment no later than 3 years after the return was filed sometimes means that IRS closes an examination before some work is complete and sometimes chooses not to open an examination at all, despite evidence of likely noncompliance. Changes to the statute in the past provide precedent for a longer statute for offshore cases, but any change would likely have both advantages and disadvantages. In a separate report being released today, we suggest that Congress lengthen the statute of limitations for cases involving offshore activity.

I would also like to make three major points about the QI program:

- The QI program contains features that give IRS some assurance that QIs are more likely to properly withhold and report tax on U.S. source income paid offshore than other withholding agents. First, because QIs are in overseas locations, they are more likely to have a direct working relationship with nonresident aliens or other persons who may claim exemptions or treaty benefits. Second, QIs accept enhanced responsibilities for ensuring customers are in fact eligible for treaty benefits and exemptions. Third, and importantly, QIs agree to contract with independent third parties to review the information contained in a sample of accounts, determine whether the appropriate amount of tax was withheld, and submit a report of the information to IRS.

- Although QIs provide enhanced assurance that treaty benefits are properly provided, the vast majority of U.S. source funds do not flow through QIs, and some U.S. taxpayers may inappropriately receive treaty benefits and exemptions as owners of foreign corporations. For tax year 2003, about 88 percent of U.S. source income flowed through U.S. withholding agents, which provide somewhat less assurance of proper withholding and reporting than do QIs.[3] In addition, under current U.S. tax law and regulations, corporations are taxpayers and the owners of their assets and income, regardless of the residency of the underlying corporate owners. By establishing an offshore corporation, a U.S. person(s) may escape identification and required reporting. In 2003, at least 68 percent of U.S. source income was received by foreign corporations. Since the identity of corporate owners is not reported to IRS, U.S. persons may be able to evade taxes.
- QI external reviews give IRS greater assurance that QIs perform their responsibilities properly, but these reviews do not require auditors to follow up on indications of fraud or illegal acts; and IRS does not make effective use of withholding data. Under U.S. *Government Auditing Standards*,[4] auditors performing external reviews like those done for the QIs must follow up on indications of fraud or illegal acts that could affect the matters they are reviewing. Further, data that IRS needs to effectively administer the QI program and ensure that withholding agents perform their duties properly are not readily available and in some instances no longer exist.

Additional Time Needed to Complete Offshore Tax Evasion Examinations

Examinations involving offshore tax evasion take much more time to develop and complete than examinations of other types of returns, but when offshore examinations are completed, the resulting median assessment is almost three times larger than for all other types of examinations. However, because of the 3-year statute, the additional time needed to complete an offshore examination means that IRS sometimes has to prematurely end offshore examinations and sometimes chooses not to open an examination at all, despite evidence of likely noncompliance.

[3] A withholding agent is responsible for withholding tax on payments of U.S. source income and depositing such tax into the U.S. Treasury.

[4] GAO, *Government Auditing Standards, January 2007 Revision*, GAO-07-162G (Washington, D.C.: January 2007).

Some offshore examinations exhibit enforcement problems, such as technical complexity, which are similar to those where Congress has granted a statute change or exception in the past. In a separate report being publicly released today, we suggest that Congress lengthen the statute of limitations for cases involving offshore activity.

IRS generally uses the term "offshore" to mean a country or jurisdiction that offers financial secrecy laws in an effort to attract investment from outside its borders.[5] IRS examinations, both offshore and nonoffshore, are generally of one of three types—correspondence, office, or field. The most complex examinations are done through revenue agent field visits to taxpayer locations, that is, field examinations. Most offshore examinations from 2002 through 2005 were of this type. Generally, unless a taxpayer's tax return involves fraud or a substantial understatement of income, or unless the taxpayer agrees to an extension, the statute of limitations for IRS to assess additional taxes is 3 years from when IRS receives the taxpayer's tax return. Taking an examination past the statute of limitations date may result in disciplinary action against the responsible revenue agent and his or her manager.

Offshore Tax Evasion Takes Longer to Find but Offshore Examinations Yield Larger Assessments Than Other Types of Cases

Comparing offshore and nonoffshore examinations, IRS examination data from fiscal years 2002 through 2005 showed that it takes IRS longer both to develop a potential offshore examination case after a return is filed and to conduct the examination itself. The median of offshore case total cycle time—the time that elapses between a return being filed and IRS's closing of the examination of that return—was almost 500 calendar days longer than for nonoffshore cases, a 126 percent difference. Offshore examinations also required significantly more direct examination time,[6] with an average of 46 hours spent directly on offshore examinations and 12 hours on nonoffshore examinations. IRS officials told us that the longer time needed to complete offshore examinations is because of the inherent difficulty in identifying and obtaining information from foreign sources,

[5] IRS officials noted that although many enforcement problems occur in certain foreign jurisdictions that are characterized by strict financial privacy regimes, the term "offshore" broadly includes the activities of U.S. taxpayers in all foreign transactions.

[6] Direct examination time does not include time spent waiting for a taxpayer's response to a request for information or other such time spent between specific tasks related to the examination.

often dilatory and uncooperative tactics on the part of taxpayers and their representatives, and technical complexity.

About half of all offshore examinations resulted in a recommended assessment of additional taxes due compared to approximately 70 percent of nonoffshore examinations. While fewer offshore examinations resulted in assessments, the median assessment of all types of offshore examinations was nearly three times larger than for nonoffshore examinations. Although assessments were larger, the greater number of hours of direct examination time meant that assessment dollars per hour of offshore direct examination time were about half that of nonoffshore examinations—$1,084 per hour from offshore examinations and $2,156 from nonoffshore examinations.

IRS created guidance for continuing offshore examinations past the 3-year point. Subject to management approval, agents can carry on the examination past the 3-year point based on their judgment that, given additional time, they will ultimately prove that the examination met one of the criteria necessary for IRS to make an assessment after the 3-year statute date has passed.

All of the examinations allowed to extend past the statute date under this guidance represent a gamble on the part of IRS that the examination will ultimately meet one of the exceptions to the statute and an assessment will be allowed under the law. IRS records show that 1,942 offshore examinations were taken past the 3-year statute period from fiscal years 2002 through 2005. IRS ultimately made assessments on 63 percent of these examinations and these assessments were significantly higher than assessments from all other types of examinations, with a median assessment of about $17,500 versus about $5,800 from offshore examinations that were closed within the 3-year statute of limitations. The median assessment for all nonoffshore examinations that went past the statute date was about $4,900 versus about $2,900 from all nonoffshore examinations closed within 3 years. IRS databases do not allow systematic analysis of the approximately 700 offshore examinations that did not result in an assessment, so we do not know if these were accurate returns or if the agent discovered tax evasion but it did not rise to the level of fraud or substantial understatement of income.

IRS Does Not Pursue Some Apparent Offshore Tax Evasion Because of the 3-Year Statute of Limitations

Revenue agents and managers told us that because IRS has only 3 years from the time the taxpayer files a tax return, and offshore cases take longer than nonoffshore cases to identify and develop, some case files are not opened for examination because insufficient time remains under the statute to make the examination worthwhile. They added that, in order to avoid violating the statute, they will often choose case files to examine with more time remaining under the 3-year statute of limitations over case files that have less time remaining and with more likely or more substantial possible assessments. Similarly, IRS revenue agents and managers sometimes close cases without examining all issues rather than risk taking the examination past the statute period, losing revenue, and facing disciplinary action.

Congress has lengthened or made exceptions to the statute in the past. For example, Congress changed the statute in 2004 to provide IRS with an additional year to make assessments in the case of unreported listed transactions.[7] Since many offshore schemes exhibited enforcement problems similar to those of unreported listed transactions, it follows that a similar statute extension could be granted for certain offshore transactions.

IRS officials and individuals from the tax practitioner and policy communities told us of both advantages and disadvantages of an exception to the statute for taxpayers involved in offshore financial activity. For example, an advantage was increased flexibility for IRS to direct enforcement resources to egregious cases. A disadvantage was lack of closure for taxpayers. In our report discussed earlier, we suggest that Congress make an exception to the 3-year civil statute of limitations assessment period for cases involving offshore activity. In e-mail comments on a draft of our report, IRS expressed agreement that a longer statute makes sense and should enhance compliance.

[7] Listed transactions are the same as, or substantially similar to, a transaction specifically identified by IRS as a tax avoidance transaction. For a transaction to be a listed transaction, IRS must issue a notice, regulation, or other form of published guidance informing taxpayers of the details of the transaction. IRS listed 31 such transactions as of January 2007.

QI Program Provides Some Assurance That Tax Is Properly Withheld and Reported but Limitations Exist

For tax year 2003, withholding agents reported that individuals and businesses residing abroad received about $293 billion in income from U.S. sources. The QI program provides IRS some assurance that tax is properly withheld and reported to IRS. However, a low percentage of U.S source income flows through QIs. In addition, although QIs are subject to external reviews, the auditors conducting these reviews are not required to follow up on indications of fraud or illegal acts. Further, IRS does not make effective use of the data it receives from withholding agents to ensure that withholding agents perform their duties properly.

To address our objectives for the QI program, we reviewed various IRS documents and interviewed IRS and Department of the Treasury (Treasury) officials and private practitioners involved in the development and implementation of the QI program. We also reviewed various studies and reports on foreign investment and banking practices. A GAO investigator created a shell corporation and opened a bank account for that corporation to test the due diligence exercised by withholding agents. We also analyzed IRS data on U.S. source income that flowed overseas for tax years 2002 and 2003. The qualified intermediary data were reported by withholding agents and edited by IRS, and do not include an unknown amount of activity that was unreported. We determined that these data were sufficiently reliable for the purposes of describing the qualified intermediary program by (1) performing electronic testing for obvious errors in accuracy and completeness and (2) interviewing agency officials knowledgeable about the data, specifically about how the data were edited. We reviewed the auditing requirements contained in the QI agreement and other standards, such as the U.S. *Government Auditing Standards*[8] and the international standard on agreed-upon procedures (AUP) and visited IRS's Philadelphia Campus, which is responsible for processing the information returns submitted by QIs.

Background

Money is mobile and once it has moved offshore, the U.S. government generally does not have the authority to require foreign governments or foreign financial institutions to help IRS collect tax on income generated from that money. In 1913, the United States enacted its first legislation establishing that U.S. persons and nonresident aliens were subject to withholding at source before the investment income leaves U.S. jurisdiction. Subsequent legislation made withholding applicable to

[8] GAO-07-162G.

dividends and certain kinds of bond income earned by nonresident aliens, foreign corporations, foreign partnerships and foreign trusts and estates. The Internal Revenue Service issued a comprehensive set of withholding regulations for nonresident aliens in 1956. These regulations have been changed over the years to reflect statutory changes or perceived abuses by taxpayers.

To attract foreign investment, the tax rules were further adapted to exclude several types of nonresident alien capital income from U.S. taxation, such as capital gains from the sale of personal property, interest income from bank deposits and "portfolio interest," which includes U.S. and corporate debt obligations. The latter exemption helps finance the U.S. national debt by offering a U.S. tax free rate of return for foreigners willing to invest in U.S. bonds.

Most of the U.S. source income flowing offshore likely is paid to nonresident aliens but some may be paid to U.S. persons. The income may be paid directly to nonresident aliens located offshore, for example when a company pays dividends to a foreign stockholder, or may flow through one or more U.S. or foreign financial intermediaries, such as banks or brokerage firms. Whether this income paid to nonresident aliens is subject to U.S. tax and, if so, how much depends on a number of factors, including the type of income and whether the recipient is a resident of a country with which the United States has negotiated a lower tax rate. If U.S. source income is subject to U.S. tax, the payor of that income has to report information about the recipient and the type and amount of income to IRS, and in some cases would be required under U.S. law to withhold the taxes due from the recipient. Any entity required to perform these withholding and reporting duties is known as a "withholding agent." The difference in taxation, withholding, and reporting for nonresident aliens and U.S. persons can motivate some U.S. individuals or businesses to seek to appear to be nonresident aliens.

Among the types of U.S. source investment income paid to nonresident aliens, some is exempt from U.S. tax and some is taxable. Payors must report this income to IRS and withhold where appropriate. For example, some types of income paid to nonresident aliens, such as bank deposits and portfolio interest[9] are exempt from taxation by U.S. statute. Payors of this income do not have to withhold tax on this income but are required to report certain information to IRS about the amounts of income paid and to whom. Other types of investment income paid to nonresident aliens, such as the gross proceeds on the sale of personal property, such as securities in a U.S. corporation, are also exempt from U.S. tax but financial intermediaries are neither required to withhold taxes on the income nor report information on the payment of the income to IRS. Some U.S. investment income, such as dividends, is subject to a statutory tax rate of 30 percent.[10] Payors of this income generally are to withhold the 30 percent tax if the recipients do not reside in a nation that has negotiated a treaty with a lower tax rate or cannot show they are in fact residents in the treaty country. The payors also have to report to IRS certain information covering the amount of income paid and to whom. About $5 billion of this capital income was withheld for tax year 2003, implying that about $83 billion of this income was exempt from tax or was taxed at lower tax treaty rates (known as treaty benefits).

IRS established the QI program in 2000. Under the QI program, foreign financial institutions sign a contract with IRS to withhold and report U.S. source income paid offshore. The QI program, and the larger withholding regime, is rooted in the 1980s when Congress expressed concerns about tax evasion by U.S. persons using foreign accounts, treaty benefits claimed by those who were ineligible, and the effect of tax havens and secrecy jurisdictions on the U.S. tax system. With these considerations in mind, and a general view that the old regulations were simply not being followed, IRS began a long, consultative process of developing new rules to balance a number of objectives, including a system to routinely report income and withhold the proper amounts, dispense treaty benefits, meet the U.S. obligation to exchange information with foreign tax authorities and encourage foreign investment in the United States.

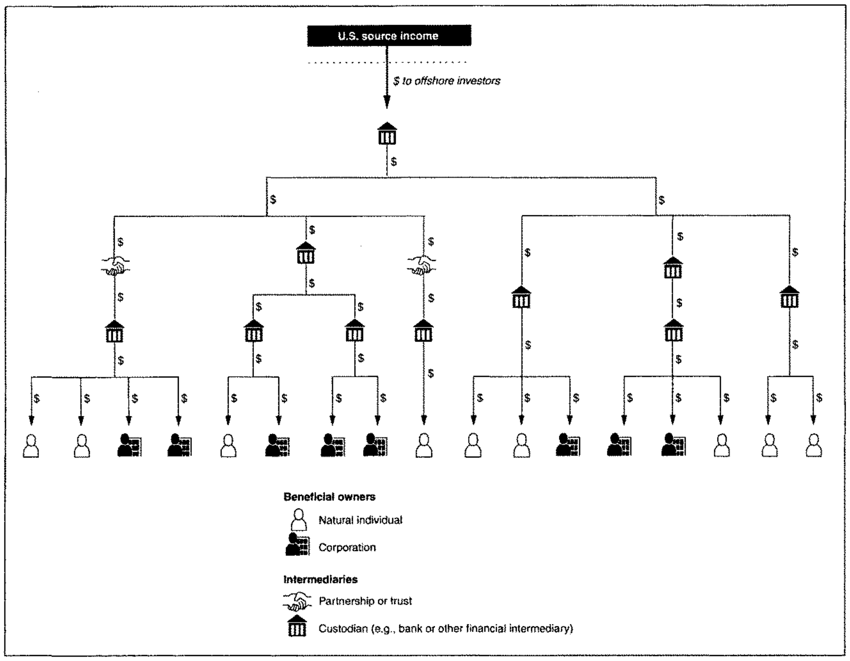
Chains of payments are routine in modern global finance, and the QI system of reporting is designed to reflect this normal course of business.

[9] Interest includes interest paid by U.S. obligors general, interest paid on real property mortgages, interest paid to controlling foreign corporations, interest paid by foreign corporations, interest on tax-free covenant bonds, deposit interest, and Original Issue Discount (OID) which is the profit earned by purchasing a bond at a price less than its face value.

[10] Dividends include those paid by U.S. corporations, dividends qualifying for reduced withholding under a tax treaty, and dividends paid by foreign corporations.

For example, a small local bank in a foreign country may handle the accounts of several owners of U.S. investments. The bank may aggregate the funds of each of these individual investors into an omnibus account that it, in turn, invests in a regional bank. The regional bank may handle a number of omnibus accounts that it, in turn, aggregates and invests in some U.S. securities. The return on these securities will flow out of the United States and reverse this chain of transactions until each of the original investors gets their pro rata share of profit. See figure 1 for examples of tiered financial flows.

Figure 1: Tiered Financial Flows



Source: GAO analysis of IRS data.

Although QIs generally agree to be withholding agents for their customers, QIs may opt out of primary withholding and reporting responsibilities for designated accounts—including those owned by U.S. persons, ceding those responsibilities and liabilities to financial institutions upstream in that chain of payments. Eventually, the responsibilities and liabilities associated with these accounts may fall to the last payor within the United States (and therefore within the jurisdiction of IRS). Even though this income may be paid to account holders in QIs or nonqualified intermediaries (NQI), the reporting and withholding might be executed by U.S. institutions.[11]

The United States maintains a network of bilateral treaties designed to set out clear tax rules applying to trade and investment between the United States and each nation in order to promote the greatest economic benefit to the United States and its taxpayers. Each treaty is intended to eliminate double taxation of taxpayers conducting economic activity in the United States and another nation by allocating taxing rights between the two countries, establishing a mechanism for dealing with disputes between the two taxing authorities, providing exchange of information between the two taxing authorities, and reducing withholding taxes. Reductions of withholding taxes are negotiated with each treaty partner individually and the benefits are reciprocal—so U.S. residents may benefit from a reduced tax rate for investing abroad, just as foreign investors may be for investing in the United States. As of January 2007, 54 tax treaties were signed, including for all members of the Organization of Economic Cooperation and Development (OECD).

The QI Program Provides Some Additional Assurance That Tax Is Properly Withheld and Reported

Compared to U.S withholding agents, IRS has additional assurance that QIs are properly withholding the correct amount of tax on U.S. source income sent offshore. QIs accept several responsibilities that help ensure that their customers qualify for treaty benefits.

First, because QIs are in overseas locations, they are more likely to have personal contact with nonresident aliens or other persons who may claim exemptions or treaty benefits than would U.S. withholding agents. This direct relationship may increase the likelihood that the QI will collect adequate ownership information and be able to accurately judge whether its customers are who they claim to be.

Second, QIs accept enhanced responsibilities for providing assurance that customers are in fact eligible for treaty benefits and exemptions. All

[11] An NQI is any intermediary that is not a U.S. person and not a qualified intermediary who is a party to a withholding agreement with the IRS. It can also refer to a qualified intermediary that is not acting in its capacity as a qualified intermediary with respect to a payment. See Treasury Regulations 1.1441-1(c)(14).

withholding agents are expected to follow the same basic steps when determining whether to withhold taxes on payments of U.S. source income made to nonresident alien customers. The withholding agents must determine the residency of the owner of the income and the kind and amount of U.S. source income, which governs the customers' eligibility for no (if the type of income is exempt from U.S. tax) or reduced taxation (if a lower taxation rate has been set in a treaty). However, under their contract, QIs must obtain acceptable account opening documentation regarding the customer's identity. When determining whether a customer qualifies for treaty benefits, the kinds of documents QIs may use are approved by IRS based upon the local jurisdiction "know your customer" (KYC) rules. When customers wish to claim treaty benefits, they must also submit an IRS Form W-8BEN, known as a withholding certificate, or other acceptable documentation. On the withholding certificate the customer provides various identifying information and completes applicable certifications, including that the customer is a resident of a country qualifying for treaty benefits and that any limitations on benefits (LOB) provisions in the treaty are met.[12] Because QIs agree to follow specified account opening procedures in all cases, regardless of whether a QI performs withholding itself or it passes the responsibility to another withholding agent, there is enhanced assurance that the residency and nationality of the account holder has been accurately determined and thus correct withholding decisions will be made.

Third, and importantly, QIs agree to contract with independent third parties to review the information contained in a sample of accounts, determine whether the appropriate amount of tax was withheld, and submit a report of the information to IRS. These reviews are discussed in greater detail later in this statement. In contrast, U.S. withholding agents generally have not yet been subject to external reviews for this purpose. IRS officials believe that those U.S. withholding agents that participated in IRS's 2004 Voluntary Compliance Program[13] were effectively subject to

[12] The LOB provisions seek to prevent nonresidents of the two treaty countries from taking advantage of the preferential tax treatment in the favorable tax treaty by forming a conduit entity in the treaty country but then funneling the profits back (to the United States or another non-treaty country). Accordingly, the LOB provisions contained in many tax treaties between the United States and other countries disallow the availability of treaty benefits to recipients that do not maintain significant contacts with the treaty jurisdiction in question.

[13] The Voluntary Compliance Program, announced in Rev. Proc. 2004-59, was a program in which IRS invited U.S. withholding agents to disclose and resolve issues arising from the implementation of the final withholding regulations.

external review because under the program they had to provide IRS essentially the same information that IRS would have reviewed in an audit. IRS is preparing to audit all of the U.S. withholding agents that did not participate in the Voluntary Compliance Program. However, because U.S. withholding agents generally rely on identity documentation from downstream intermediaries, even when U.S. withholding agents have been audited by IRS, there is less assurance that nonresident aliens actually qualified for the benefits.

Although account opening and withholding procedures for QIs may give IRS greater assurance that treaty benefits are properly provided by QIs than by U.S. withholding agents, QIs provide IRS less information to use in targeting its enforcement efforts than do U.S. withholding agents. One of the principal incentives for foreign financial institutions to become QIs is their ability to retain the anonymity of their customer list. QIs report customer income and withholding information to IRS in the aggregate for groups of similar recipients receiving similar benefits. This is known as "pooled reporting." NQIs also can pool results when reporting to upstream withholding agents, but nevertheless, must identify all of the individual customers for which they have provided treaty benefits.[14] Although pooling restricts the information available to IRS on individuals receiving treaty benefits, to the extent that QIs do a better job of ensuring treaty benefits are properly applied up front, IRS has less need for after-the-fact enforcement. The accuracy of the pooled reporting by QIs is also subject to the external reviews of QIs' contractual performance.

QIs Account for a Small Portion of U.S. Source Income and Individuals May Inappropriately Receive Treaty Benefits as Owners of Corporations

Although the QI program provides IRS some assurance that treaty benefits are being properly applied, a low percentage of U.S. source income flows through QIs and U.S. taxpayers may inappropriately receive treaty benefits and exemptions as owners of foreign corporations.

[14] Income owned by U.S. taxpayers held offshore may not be pooled and must be reported to IRS individually, either by the QI or the last U.S. payer in a chain of payments.

The Majority of U.S. Source Income Flows Outside the QI System

As shown in table 1, for tax year 2003, 87.5 percent of U.S. source income reported to IRS was reported by U.S. withholding agents, not QIs.[15] Thus, the overwhelming portion of this income flowed through channels that provide somewhat less assurance of proper withholding and reporting than exists under the QI program. More than 90 percent of the U.S. source income QIs paid their customers for tax year 2003, or nearly $34 billion, flowed through QIs that each handled $4 million or more of U.S. source income. These QIs and the income they handled were subject to external review (as discussed later in this statement, smaller QIs can obtain a waiver from external reviews). Overall, QIs withheld taxes from U.S. source income at more than twice the rate of U.S. withholding agents, 3.7 percent versus 1.5 percent.

Table 1: Income and Withholding Flows by Type of Intermediary for Tax Year 2003

Dollars in billions

	U.S. withholding agents					QIs				
Amount of U.S. source income reported by withholding agent	**Number of returns**	**Total gross income**	**Total tax withheld**	**Withholding rate (percentage)**	**Percentage total income**	**Number of returns**	**Total gross income**	**Total tax withheld**	**Withholding rate (percentage)**	**Percentage total income**
$4 million or more	5,503	$223.3	$2.4	1.1	76.1	716	$33.8	$1.1	3.2	11.5
Less than $4 million and equal or greater than $1 million	8,553	16.9	0.5	3.2	5.8	805	1.7	0.1	8.6	0.6
Less than $1 million	1,977,001	16.5	1.0	5.9	5.6	40,648	1.2	0.1	10.6	0.4
Subtotals	**1,991,057**	**$256.7**	**$3.9**	**1.5**	**87.5**	**42,169**	**$36.6**	**$1.4**	**3.7**	**12.5**

Source: GAO analysis of IRS data.

Note: Numbers may not total because of rounding.

The jurisdiction of recipients of U.S. source income is a major determinant of the applicable withholding rate and the degree of cooperation IRS may expect from foreign governments in enforcing U.S. tax administration. Bilateral tax treaties are one means of reducing withholding taxes that

[15] Tax year 2003 is the most recent year for which reliable data is available.

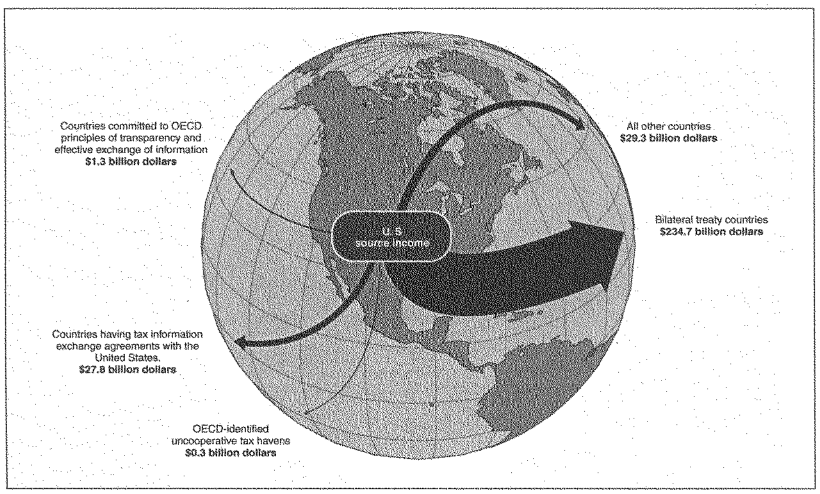
treaty partners may impose on their residents. In general, a treaty provides enhanced assurance that both nations' tax rules will be properly applied. When a treaty does not exist, tax administration can be furthered by agreements to exchange information. As of November 2006, 15 nations had Tax Information Exchange Agreements (TIEA) with the United States.[16] To countervail harmful tax practices, the OECD encourages countries to develop and practice administrative transparency and effective exchange of tax information in their local tax administrations. A number of countries have made formal commitments to work toward these principles. However, because of their continued unwillingness to agree to these two principles, five countries are on the OECD's list of "uncooperative tax havens."[17] Finally, 165 other jurisdictions receive U.S. source income but do not fall into any of these categories.

Although the vast majority of U.S. source income flows outside the QI system, the preponderance flows through countries with which the United States has tax treaties, as shown in figure 2.

[16] Since we performed our analysis, according to the Department of the Treasury, the number of countries with TIEAs reached a total of 22. Although, Mexico has a TIEA, it also has a tax treaty with the U.S. and has been reported as such in the following figure and table.

[17] The Marshall Islands is one of the 15 nations with TIEA agreements in force. However, it is classified by OECD as an "uncooperative tax haven" and has been reported as such in the following figure and table.

Figure 2: U.S. Source Income Flowing Offshore by Type of Jurisdiction, Tax Year 2003



Sources: GAO analysis of IRS data, and PhotoDisc (image).

As shown in table 2, for tax year 2003 about 80 percent of U.S. source income flowed through treaty countries with 88 percent of that flowing through U.S. withholding agents. The data indicate that persons in the treaty countries received the preponderance of U.S. source income and the lowest withholding rates, because of a combination of reduced withholding rates negotiated by treaty and residents receiving certain kinds of income that are exempt by statute. About $28 billion flowed through TIEA countries, and recipients received significant withholding tax reductions–without mutually beneficial treaties. Persons in jurisdictions committed to OECD's principles, that is, "committed jurisdictions," and OECD-identified "uncooperative tax havens" accounted for relatively little U.S. source income. Withholding agents in other and undisclosed countries not falling into any of these categories received about $29 billion in U.S. source income for tax year 2003, and dispensed about $8 billion in withholding tax reductions that year.

Table 2: U.S. Withholding Agents' and QIs' Withholding Rates by Jurisdiction, Tax Year 2003

Dollars in billions

	U.S. withholding agents			QIs		
	Gross income	Withholding	Withholding rate (percentage)	Gross income	Withholding	Withholding rate (percentage)
Treaty countries	$212.7	$2.9	1.3	$22.0	$0.9	4.0
TIEA countries	24.9	0.7	2.7	3.0	0.1	2.3
OECD committed jurisdictions	1.2	0.1	5.4	[a]	[a]	2.6
OECD uncooperative tax havens	0.2	[a]	9.3	[a]	[a]	6.9
Other countries	9.9	0.2	1.6	0.3	[a]	1.2
Undisclosed	7.8	0.1	1.4	11.3	0.4	3.5
Not Listed	[a]	[a]	24.2	0.1	[a]	2.1
Unidentified	7.5	[a]	1.1	11.1	0.4	3.5
Unknown	0.3	[a]	8.6	0.1	[a]	12.1
All countries	**$256.7**	**$3.9**	**1.5**	**$36.6**	**$1.4**	**3.7**

Source: GAO analysis of IRS data.

Notes:

Treaty countries: Australia, Austria, Bangladesh, Barbados, Belgium, Canada, China, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Korea, Latvia, Lithuania, Luxembourg, Mexico, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Thailand, Trinidad & Tobago, Tunisia, Turkey, Ukraine, United Kingdom, and Venezuela.

TIEA countries: Antigua and Barbuda, Aruba, Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Dominica, Grenada, Guernsey, Isle of Man, Jersey, St. Lucia, U.S. Virgin Islands.

OECD committed jurisdictions: Anguilla, Bahrain, Belize, Cook Islands, Gibraltar, Malta, Mauritius, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, American Samoa, San Marino, Seychelles, St. Kitts & Nevis, St. Vincent & Grenadines, Turks and Caicos, and Vanuatu.

OECD uncooperative tax havens: Andorra, Liberia, Liechtenstein, Marshall Islands, and Monaco.

Due to rounding, the amount of gross income shown in this table differs slightly from the amount of gross income shown in fig. 2.

[a]Rounded down to less than $0.1 billion.

A close look at the data points to some potential problems with the withholding and reporting activities for tax year 2003. Both U.S. withholding agents and QIs reported transactions in unknown or unidentified jurisdictions. For example, for tax year 2003, $19 billion of income was reported ($7.8 billion through U.S. withholding agents and $11.3 billion through QIs), on which $500 million was withheld ($100 million through withholding agents and $400 million through QIs) from undisclosed countries. In a separate analysis, we calculated that $5 billion of treaty benefits and exemptions were given that were not associated with any particular country. And other data analysis indicates that both U.S. withholding agents and QIs reported transactions with "unknown recipients" across all jurisdictions. For tax year 2003, U.S. withholding agents and QIs reported a combined $7 billion of U.S. source income paid to offshore unknown recipients, from which $233 million was withheld at a rate of 3.4 percent. The transactions with unknown or unidentified jurisdictions and with unknown recipients indicate a significantly reduced rate of withholding without proper documentation or reporting to IRS, since eligibility for a reduced rate of withholding must be determined by the claimants' documented residency and type of investment.

Foreign Corporations May Provide U.S. Taxpayers a Mechanism for Evading Taxation

U.S. tax law enables the owners of offshore corporations to shield their identities from IRS scrutiny, thereby providing U.S. persons a mechanism to exploit for sheltering their income from U.S. taxation. Under U.S. tax law, corporations, including foreign corporations, are treated as the taxpayers and the owner of their income. Because the owners of the corporation are not known to IRS, individuals are able to hide behind the corporate structure. In contrast to tax law, U.S. securities regulation, and some foreign money laundering and banking guidelines treat shareholders as the owners. Even if withholding agents learn the identities of the owners of foreign corporations while carrying out their due diligence responsibilities, they do not have a responsibility to report that information to IRS. However, if it provides them with actual knowledge or reason to know that the claim for reduced withholding in the withholding certificate or other documentation is unreliable for purposes of establishing residency, new supporting documentation must be obtained.

Bilateral treaties may reduce or eliminate U.S. taxes on income that would otherwise be taxable to nonresident alien recipients, including foreign corporations, but generally not for U.S. persons. Similarly, the U.S. tax exemption for foreign recipients of portfolio interest, created to encourage foreign investors to purchase U.S. government and corporate debt, eliminates their tax on this type of income. The exemption is not available to U.S. persons, or to persons who own 10 percent or more of the debtor corporation or partnership as well as certain other restrictions.

Withholding agents generally may accept a withholding certificate at face value, and so may grant treaty benefits or a portfolio interest exemption to a foreign corporation that is owned by a U.S. person or persons. IRS regulations permit withholding agents (domestic and QIs) to accept documentation declaring corporations' ownership of income at face value, unless they have "a reason to know" that the documentation is invalid.[18] Consequently, it may be possible for U.S. persons to establish a corporation offshore, submit a withholding certificate to the withholding agent(s) and receive a reduced rate of withholding. In these situations where the foreign corporation is owned by a U.S. person or persons, it is incumbent upon the owners to report their corporate ownership and any income appropriately taxable to them on their own U.S. tax returns. There is no independent third-party reporting of that income to IRS. Generally, compliance in reporting income to IRS is poor when there is not third party reporting to IRS.

Foreign corporations received at least $200 billion, or 68 percent, of the $293 billion in total U.S. source income for tax year 2003 (see table 3). From this income, almost $3 billion was withheld (an effective withholding rate of 1.4 percent) representing more than $57 billion of treaty benefits and exemptions. About half of all foreign corporate investment in the United States that year was in debt instruments which are paid U.S. tax free to qualified investors. The preponderance of tax withheld from corporations was derived from dividends.

Table 3: Foreign Corporate U.S. Source Income, Withholding, and Benefits, Tax Year 2003

Dollars in billions

Type of income	Gross income	Tax withheld	Withholding rate (percentage)	Benefits
Interest[a]	$96.3	$0.2	0.22	$28.7
Dividends[b]	42.4	1.9	4.56	10.8
Miscellaneous[c]	61.8	0.7	1.14	17.8
Total income	**$200.5**	**$2.8**	**1.42**	**$57.3**

Source: GAO analysis of IRS data.

[a]Interest includes interest paid by U.S. obligors general, interest paid on real property mortgages, interest paid to controlling foreign corporations, interest paid by foreign corporations, interest on tax-free covenant bonds, deposit interest, and Original Issue Discount.

[18] As discussed earlier, however, under their contract with IRS, QIs are implicitly expected to use KYC documentation when judging whether a customer's withholding certificate is valid.

[a]Dividends include those paid by U.S. corporations, dividends qualifying for reduced withholding under a tax treaty, and dividends paid by foreign corporations.

[b]Miscellaneous income includes royalties, pensions, compensation for personal services, REIT distributions, notional principal contracts and other income.

To test the level of due diligence exercised by withholding agents, a GAO investigator using an assumed identity created a shell corporation and then sought to establish an overseas bank account for that corporation. Our investigator approached a European QI to open an account. The QI required our investigator to provide documentation sufficient to establish his identity as an officer of the corporation and documentation showing the source of the funds to be invested. Further, a representative from the QI contacted the investigator and questioned him in detail to ensure compliance with KYC standards and requested to meet with him in person. The investigator discontinued the effort and did not open an account with the QI. Our investigator also contacted an NQI in the Caribbean to open an account. The NQI requested that the investigator provide documentation of his identity and a letter explaining the purpose of the corporation. In addition, the NQI contacted a U.S. bank where the investigator had an account and requested a letter of reference. The NQI opened an account for our investigator. We did not then make an investment to earn U.S. source income in part because of the relatively large minimum investments required by QI and NQI firms we contacted. Thus, we were able to open a solely owned foreign corporation that was not actually an active business but do not know whether a QI or NQI intermediary would then have questioned a withholding certificate had we made an investment and claimed treaty benefits.

QI External Reviews and IRS Use of Program Data

Because QIs agree to have external auditors perform oversight of their compliance with required procedures, IRS has greater assurance that taxes are properly withheld and treaty benefits are properly dispensed by QIs than by U.S. withholding agents. However, within their limited scope, QIs' auditors are not responsible for following up on possible indications of fraud or illegal acts that could have an impact on the matters being tested as they would under U.S. *Government Auditing Standards*.[19] In addition, IRS obtains considerable data from withholding agents but does not make

[19] GAO-07-162G.

effective use of the data to ensure that withholding agents perform their duties properly.

External Reviews

In designing the QI program, IRS, Treasury, and intermediaries and their representatives had the objective of achieving an appropriate balance to obtain appropriate assurance that QIs meet their obligations without imposing such a burden that intermediaries would not participate in the program. As discussed earlier, IRS generally does not have the legal authority to audit a foreign financial intermediary, but IRS requires specific periodic procedures to be performed by external auditors to determine whether QIs are documenting customers' identities and accurately withholding and reporting to IRS. The QI agreement requires each QI to engage and pay for an external auditor to perform "agreed upon procedures" (AUP) and submit a report of factual findings to the IRS's QI program office for the second and fifth years of the agreement. The QI selects the external auditor, but IRS must approve it after considering the external auditor's qualifications and any potential independence impairments.

IRS selected AUPs as the type of engagement to monitor QI compliance because of their flexible and scalable attributes. AUPs differ from a full audit in both scope of work and the nature of the auditor's conclusions. As shown in table 4, in performing a full audit, an auditor gathers sufficient, appropriate evidence to provide assurance regarding the subject matter in the form of conclusions drawn or opinions expressed, for example, whether the audited entity is in material compliance with requirements overall. Under AUPs the external auditor performs specific work defined by the party requesting the work, in this case, IRS. In general, such work would be specific but less extensive, and less expensive, than the amount of work an auditor would do to provide assurance on the subject matter in the form of conclusions or an opinion. Thus, withholding agents would likely be more willing to participate in the QI program with a required AUP review than a full audit, which they would have to pay for under the program requirements. AUPs can provide an effective mechanism for oversight when the oversight needs relate to specific procedures.

Table 4: Comparison of Key Features of Audits and Agreed-Upon Procedures

Audit	AUPs[a]
Auditor gathers sufficient, appropriate evidence to provide assurance, draw conclusions or express an opinion on the subject matter.	Auditor performs specific procedures and provides the requestor with a report of factual findings based on the procedures performed.
Auditor determines nature and extent of procedures necessary to provide assurance.	Party or parties requesting the report determine and agree to the procedures performed by the auditor.
Report distribution usually not limited.	Report distribution limited to party or parties requesting the report.

Source: GAO analysis of audit and AUP characteristics as defined by U.S. *Government Auditing Standards* and International Auditing and Assurance Standards Board standards.

[a]These are attributes of AUPs performed under international accounting standards.

IRS developed a three-phase AUP process to focus on key performance factors to address specific concerns while minimizing compliance costs. In phase 1 procedures, the external auditor is required to examine all or a statistically valid sample of accounts with their associated documentation and compile information on whether the QI followed withholding requirements and the requirements of the QI agreement. IRS reviews the data from phase 1 AUPs and determines whether significant concerns exist about the QI's performance. If concerns exist, IRS may request that additional procedures be performed. For example, additional procedures may be requested if the external auditor identified potential problems while performing phase 1 procedures. IRS defines the work to be done in a phase 2 review based on the specific concerns surfaced by the phase 1 report. Phase 3 is necessary only if IRS still has significant concerns after reviewing the phase 2 audit report. In phase 3, IRS communicates directly with the QI management and may request a face-to-face meeting in order to obtain better information and resolve concerns about the QI's performance. IRS cited high rates of documentation failure, underreporting of U.S. source income and under-withholding as the three most common reasons for phase 3 AUPs.

Data from the 2002 audit cycle shows that IRS required phase 2 procedures for about 18 percent of the AUPs performed. IRS moved to phase 3 procedures for 35 QIs, which is around 3 percent of the 2002 AUPs performed. Of the QIs that had phase 3 reviews, IRS met face-to-face with 13 and was ultimately satisfied that all but 2 were in compliance with their QI agreements. The remaining 2 were asked to leave the QI program.

Since the QI program's inception in 2000, there have been 1,245 terminations of QI agreements. Of the 1,245 terminations, 696 were the result of mergers or consolidations among QIs and not related to noncompliance with the QI agreements. Aside from the 2 terminations mentioned above, the remaining 549 terminations were of QIs that failed to file either an AUP report of factual findings or requests for an AUP waiver by the established deadline.

IRS grants waivers of the AUP requirement if the QI meets certain criteria. A QI may be eligible for a waiver if it can demonstrate that it received not more than $1 million in total U.S. source income for that year. In order to be granted a waiver, the QI must file a timely request that includes extensive data on the types and amounts of U.S. source income received by the QI. Among items required with the waiver request are a reconciliation of U.S. source income reported to the QI and U.S. source income reported by the QI to IRS; the number of QI account holders; and certifications that the QI was in compliance with the QI agreement. IRS evaluates the data provided with the waiver request to determine if AUPs are necessary despite the relatively small amount of U.S. source income, and will deny the waiver request if the data provided raises significant concerns about the QI's compliance with the agreement. About 3,400 QIs (around 65 percent of the QIs at that time) were approved for audit waivers in 2005. The largest 5 percent of the QIs accounted for about 90 percent of the withholding based on data from the 2002 audit cycle.

One notable difference between the AUPs used for the QI program and AUPs that would be done under U.S. *Government Auditing Standards* is that the QI contract is silent on whether external auditors have to perform additional procedures if information indicating that fraud or illegal acts that could materially affect the results of the AUP review come to their attention. Absent specific provisions in the contract, the auditors perform the QI AUPs in accordance with the International Standard on Related Services (ISRS) 4400.[20] Our U.S. *Government Auditing Standards*, known as the Yellow Book, are more stringent on this topic than the ISRS standards.

[20] The International Auditing and Assurance Standards Board (IAASB) is an independent body that establishes and provides guidance on auditing, assurance and other related services, including ISRSs, for its member organizations. Member organizations agree to comply with IAASB standards.

Yellow Book standards state that auditors should be alert to situations or transactions that could indicate fraud, illegal acts, or violations of provisions of contracts. If the auditor identifies a situation or transaction that could materially affect the results of the engagement the auditor is to extend procedures to determine if the fraud, illegal acts, or violations of provisions of contracts are likely to have occurred and, if so, determine their effect on the results of the engagement. The auditor's report would include information on whether indications of fraud or illegal acts were encountered and, if so, what the auditors found. Therefore the report would provide IRS with the information necessary to pursue the indications of fraud or illegal acts through phase 2 procedures.

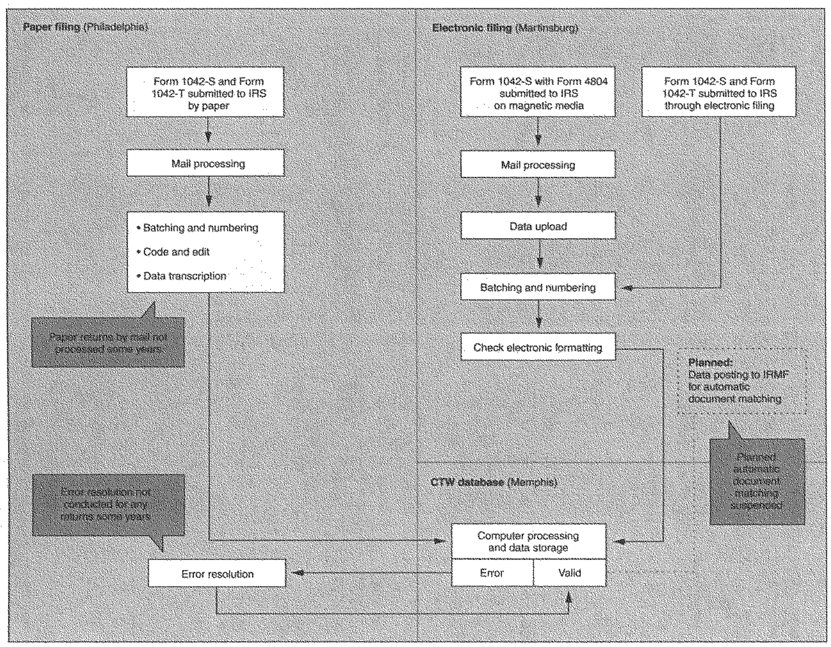
IRS Does Not Make Full Use of Available Data to Ensure Compliance with Withholding and Reporting Requirements

Data that IRS needs to effectively administer the QI program are not readily available for use and in some instances no longer exist. Consequently, IRS has difficulty ensuring that refunds claimed by withholding agents are accurate and is less able to effectively target its enforcement efforts.

All withholding agents, whether QIs or not, are to report withholding information on their annual withholding tax returns (Forms 1042) and information returns (Forms 1042-S). Forms 1042 are filed on paper. Forms 1042-S may be filed electronically or on paper. The law requires withholding agents filing more than 250 returns to file electronically; consequently, most U.S. financial institutions file the information returns electronically, while most QIs file on paper. When returns are paper filed, IRS personnel must transcribe information from the paper returns into an electronic database in order to efficiently and effectively make use of the data. Data on both paper and electronically filed returns must also be reviewed for errors.

Data from Forms 1042 have been routinely transcribed and checked for errors. However, since the inception of the QI program, IRS has not consistently entered information from the paper Forms 1042-S into an electronic database. In years when data were not transcribed, the unprocessed paper 1042-S forms were stored at the Philadelphia Service Center in Philadelphia and then destroyed a year after receipt in accordance with record retention procedures. Additionally, for certain tax years, the electronically filed Forms 1042-S did not go through computerized error resolution routines. For tax year 2005 IRS's Large and Midsize Business Division transferred $800,000 in funding to the service center to fund transcribing paper Forms 1042-S and performing error resolution for all Forms 1042-S. IRS officials anticipate funding 2006 transcription and error resolution although as of March 2007, this had not yet occurred. Figure 3 shows the dual processing procedures IRS uses for receiving, checking and validating the Form 1042-S data it receives.

Figure 3: IRS Processing of Paper and Electronic 1042-S Forms



Source: GAO analysis of IRS information.

Notes: The forms are Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding; Form 1042-T, Annual Summary and Transmittal of Forms 1042-S; and Form 4804, Transmittal of Information Returns Reported Magnetically.

CTW is Chapter Three Withholding; IRMF is Information Returns Master File.

Because the Form 1042-S data have not been routinely transcribed and corrected, IRS lacks an automated process to use the Form 1042-S information return data to detect underreporting on the Form 1042 or to verify refunds claimed. Forms 1042 are due in March and the withholding agents might report owing IRS more if they under-withheld the amount of tax their customers' owed, or might claim a refund if they over-withheld. After performing simple consistency and math checks on the Forms 1042, IRS accepts the returns as filed and either bills withholding agents that did not include full payment or refunds amounts to those whose Forms 1042 indicates they over-withheld taxes due.

Because the Forms 1042-S information returns have not been routinely transcribed, IRS has not been able to automatically match the information return documents to the annual tax return data, which is one of IRS's most efficient and effective tools to ensure compliance. IRS had planned to perform such automatic document matching, but IRS suspended the plans for matching the Form 1042-S and Form 1042 data since funding has not been available to routinely transcribe Form 1042-S data. Therefore, when Forms 1042-S had been electronically filed or transcribed, IRS has only been able verify the accuracy of Forms 1042 by individually retrieving the 1042-S data stored in the Chapter Three Withholding (CTW) database, a time-consuming and seldom used process. When Forms 1042-S were not transcribed, IRS was only able to verify Forms 1042 by manually retrieving and reviewing the paper 1042-S. Further, for years when transcription did not occur, if a QI filed an amended return after the paper Forms 1042-S were destroyed, IRS could not even perform a manual verification and had to take the amended return claiming a refund at face value provided other processing criteria were met. IRS has no information to determine whether or how often such erroneous or fraudulent refunds might occur.

Properly transcribed and corrected 1042-S data would have other uses as well. For instance, IRS officials said that such data could be used to check whether the AUP information submitted by QI withholding agents is reliable. For U.S. withholding agents, Form 1042-S information might be used to determine whether to perform audits. Several other units within IRS, as well as Treasury, the Joint Committee on Taxation and congressional tax-writing committees also could use these data to research and evaluate tax policy and administration issues and to identify possibly desirable legislative changes. We are considering recommendations in a forthcoming report on the QI program regarding IRS's data management.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions you or other members of the committee may have at this time.

Contact and Acknowledgments

For further information regarding this testimony, please contact Michael Brostek, Director, Strategic Issues, at (202) 512-9110 or brostekm@gao.gov. Contacts for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Jonda Van Pelt, Assistant Director; Jeffrey Arkin; Susan Baker; Perry Datwyler; Amy Friedheim; Evan Gilman; Shirley Jones; David L. Lewis; Donna Miller; John Mingus; Danielle Novak; Jasminee Persaud; Ellen Rominger; John Saylor; Jeffrey Schmerling; Joan Vogel; and Elwood White.

United States Government Accountability Office

GAO

Report to the Committee on Finance, U.S. Senate

March 2007

TAX ADMINISTRATION

Additional Time Needed to Complete Offshore Tax Evasion Examinations

GAO Accountability * Integrity * Reliability

GAO-07-237

GAO
Accountability · Integrity · Reliability

Highlights

Highlights of GAO-07-237, a report to the Committee on Finance, U.S. Senate

Why GAO Did This Study

Much offshore financial activity is not illegal, but numerous illegal offshore schemes have been devised to hide or disguise the true ownership of income streams and assets. IRS studies show lengthy development times for some offshore cases, which suggests that time or the lack thereof could be an impediment to effectively addressing offshore schemes.

GAO was asked to (1) compare offshore and nonoffshore examination cases and determine whether the 3-year statute of limitations reduces offshore assessments, (2) compare enforcement problems posed by offshore cases to those where Congress has previously granted an exception to the statute, and (3) identify possible advantages and disadvantages of an exception to the statute for offshore cases. To address these objectives, GAO analyzed IRS data, reviewed examination files and other documents, and interviewed IRS officials and others in the tax practitioner and policy communities.

What GAO Recommends

To provide IRS with additional flexibility in combating offshore schemes, Congress should consider a longer statute period for taxpayers involved in offshore activity. In e-mailed comments on a draft of this report, IRS expressed agreement that a longer statute makes sense and should enhance compliance.

www.gao.gov/cgi-bin/getrpt?GAO-07-237.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

March 2007

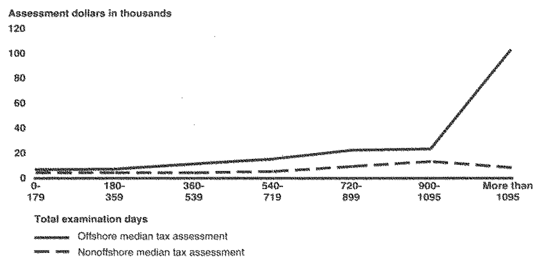
TAX ADMINISTRATION

Additional Time Needed to Complete Offshore Tax Evasion Examinations

What GAO Found

Examinations involving offshore tax evasion take much more time to develop and complete than other examinations for reasons such as technical complexity and the difficulty of obtaining information from foreign sources. When examinations are completed, the resulting median assessment from an offshore examination is almost three times larger than from other types of examinations. However, due to the 3-year statute, the additional time needed to complete an offshore examination means that IRS sometimes has to prematurely end offshore examinations and sometimes chooses not to open one at all, despite evidence of likely noncompliance. Although data were not available to measure the effect of the statute on assessments, IRS agents and managers told GAO that overall assessments for offshore cases are lower than they would be if IRS had more time to work these cases.

Median Assessment Amount by Number of Examination Days, Examinations Closed with an Assessment, Fiscal Years 2002–2005



Source: GAO analysis of IRS data.

Some offshore examinations exhibit enforcement problems similar to those where Congress has granted a statute change or exception in the past. For example, Congress changed the statute for certain abusive tax shelters that involved technical complexity and dilatory tactics on the part of taxpayers.

Through discussions with IRS officials and others in the tax practitioner and policy communities, GAO identified advantages and disadvantages to such an exception. Advantages included increased flexibility for IRS to direct enforcement resources to egregious cases of noncompliance and a possible deterrent to future noncompliance. Disadvantages included increased uncertainty and lack of closure for taxpayers. Our commenters also discussed design options to mitigate some of the disadvantages of a statute extension, such as making an exception apply to all taxpayers having offshore accounts/entities, and thereby, mitigating taxpayer uncertainty and lack of closure.

Contents

Figures

Abbreviations

AIMS	Audit Information Management System
ATS	abusive tax shelter
FTB	California Franchise Tax Board
IBC	international business corporation
IRC	Internal Revenue Code
IRS	Internal Revenue Service
LAO	California Legislative Analyst's Office
LDC	Lead Development Center
LLC	limited liability corporations
LLP	limited liability partnership
SB/SE	IRS Small Business/Self Employed division
TIGTA	Treasury Inspector General for Tax Administration

GAO

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

March 30, 2007

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate

The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

In recent years, the Internal Revenue Service (IRS) has observed a significant increase in offshore activity among U.S. taxpayers. More and more taxpayers have been observed attempting to "expatriate" their income and assets. Making investments or doing business internationally is legal, but numerous schemes have been devised in which the true ownership of income streams and assets has been hidden or disguised using offshore activity, which is not legal. Some schemes can be as simple as taking unreported income and personally traveling to a tax haven country and depositing the cash into a bank account. Other schemes are more elaborate, involving numerous domestic and foreign trusts, partnerships, nominees, foreign financial accounts, offshore credit/debit cards, and multilayered transactions. Like all forms of noncompliance, offshore schemes add to the tax gap—the difference between taxes owed and taxes paid on time—and shifts more of the tax burden onto compliant taxpayers. Such schemes also can fuel a perception that the tax system is not equitable and can erode honest taxpayers' faith in the voluntary compliance system. When IRS discovers an offshore scheme, it has 3 years from when the tax return was filed in which to work on uncovering the scheme and assessing any additional tax. This is known as the 3-year statute of limitations on assessments.

In recognizing the serious problem posed by offshore tax evasion, you asked us to identify any impediments that may exist to better combating these schemes. An IRS study shows lengthy examination times for some offshore examinations, which suggests that time or the lack thereof could be an impediment to effectively addressing offshore schemes. This report focuses on this possible impediment. Our objectives were to (1) compare the length of and recommended assessments yielded by offshore and nonoffshore examinations and determine whether the 3-year statute of limitations reduces recommended offshore assessments, (2) determine whether or not enforcement problems posed by offshore examinations are similar to enforcement problems that led Congress to grant exceptions to the statute in other situations, and (3) identify possible advantages and disadvantages of an exception to the statute for offshore examinations.

To do our work, we (1) analyzed IRS data, reports, publications, and other documentation providing insight into the characteristics, complexity, and size of the offshore tax evasion problem;[1] (2) compared IRS data on the amount of time required to complete examinations involving an offshore component[2] with those lacking such a component and the recommended assessments from those examinations; (3) reviewed selected IRS files to illustrate examinations of returns involving offshore components; (4) researched the history of the federal statute of limitations for assessments to include legislation proposed between 2003 and 2006 that included references to either offshore tax evasion or the statute of limitations; (5) interviewed representatives of California's taxing authority, the California Franchise Tax Board (FTB), and reviewed documents related to a recent change in California's statute related to certain abusive tax shelters; (6) interviewed revenue agents and managers with expertise in offshore cases to develop an understanding of IRS enforcement activities; and (7) interviewed IRS officials and others in the tax practitioner and policy communities about their views on extending the examination period for returns involving offshore schemes. We assessed the reliability of the IRS data that we used and found that it was sufficiently reliable for our purposes. The universe of IRS examinations with an offshore component included individual taxpayers, smaller and larger corporations, and other taxable entities. The database of all nonoffshore examinations we used for comparison similarly included a full range of taxpayers. Details on our methodology can be found in

[1]Tax evasion is any method of willfully avoiding or reducing taxes that is not permitted by law. Tax evasion is distinguished from "tax avoidance" which denotes the legal interpretation of the tax laws to legitimately minimize tax liability. In this report, we use the term "tax evasion" to describe the target of the actions IRS takes to (1) identify underreported or unreported tax liabilities, either as a result of tax evasion or abusive transactions or claims subject to disallowance under existing law, and (2) assess the correct amount of taxes owed by the taxpayer and any penalties that may apply. Separate from the assessment of taxes owed by the taxpayer, tax evasion is itself a crime punishable under IRC 7201.

[2]IRS assigns a "project code" to those examinations whose main component is offshore tax evasion, and for the purposes of this review, those case files with one of six offshore project codes are considered offshore tax evasion.

appendix I. We did our work from June 2005 through February 2007 in accordance with generally accepted government auditing standards.

Results in Brief

Identifying possibly noncompliant returns, gathering appropriate evidence, and completing an examination takes much more time for IRS for tax returns involving abusive offshore transactions than other types of returns. Where IRS is able to complete examinations involving abusive offshore transactions, they generally result in larger assessments than other types of examinations. IRS officials told us that because the same 3-year statute of limitations that applies to nonoffshore examinations applies to offshore examinations, the additional time needed to complete an offshore examination means that IRS sometimes has to end offshore examinations before the examination is complete, and sometimes chooses not to open an examination at all, despite evidence of likely noncompliance. Although data were not available to measure the effect of the statute of limitations on assessments, IRS revenue agents and their managers told us that overall assessments for offshore examinations are lower than they would be if IRS had more time to work these examinations.

Some offshore examinations exhibit enforcement problems similar to those where Congress has granted a change or exception to the statute in the past. For example, the issues that led to the creation of the statute exception for certain abusive tax shelters are similar to those exhibited by offshore examinations. Past statute changes and exceptions provide precedent for changing the statute for offshore examinations.

Through discussions with IRS officials and others in the tax practitioner and policy communities, we identified both advantages and disadvantages of extending the statute of limitations. Among the advantages were increased flexibility for IRS to direct enforcement resources to egregious cases of noncompliance and a possible deterrent effect against future noncompliance. Disadvantages included increased uncertainty and lack of closure for taxpayers as well as increased taxpayer perceptions of unfairness unless an extension to the statute for assessments is matched by an extended refund period. Our commenters also discussed design options to mitigate some of the disadvantages of the statute extension, such as making an exception apply to all taxpayers having offshore accounts/entities, and thereby, mitigating taxpayer uncertainty and lack of closure. Maintaining symmetry between the statutes for assessments and refunds was also mentioned as mitigating taxpayer perceptions of unfairness about extending the statute for assessments.

In this report, we suggest that Congress make an exception to the 3-year civil statute assessment period for taxpayers involved in offshore financial activity. In comments on a draft of this report, IRS officials commented that a longer statute for offshore examinations makes sense and should enhance compliance. IRS also provided comments on several technical issues and legal issues, which we incorporated in this report where appropriate.

Background

It is perfectly legal for U.S. taxpayers to hold money offshore. It is illegal, however, for a taxpayer to not disclose substantial offshore holdings, to not report income earned in the United States and "hidden" through offshore arrangements, and to not report income earned offshore to IRS on the taxpayer's tax return. If U.S. taxpayers own an offshore business such as a foreign corporation, they are required to disclose that holding to IRS on their tax return. When applied to abusive transactions, IRS generally uses the term "offshore" to mean a country or jurisdiction that offers financial secrecy laws in an effort to attract investment from outside its borders.[3] When referring to a financial institution, "offshore" refers to a financial institution that primarily offers its services to persons domiciled outside the jurisdiction of the country in which the financial institution is organized.

Abusive offshore schemes are often accomplished through the use of limited liability corporations (LLC), limited liability partnerships (LLP), international business corporations (IBC), and trusts, foreign financial accounts, debit or credit cards, and other similar instruments. According to IRS, the schemes can be complex, often involving multiple layers and multiple transactions used to hide the true nature and ownership of the assets or income that the taxpayer is attempting to hide from IRS.

IRS has multiple programs and techniques used to select potentially noncompliant tax returns for examination. One source is a computer model designed to predict returns that, if audited, would be most likely to result in additional taxes owed. Other sources that prompt an examination include referrals from inside or outside IRS, information from third parties, and indications of fraud or noncompliance from other audits.

[3] IRS officials noted that although many enforcement problems occur in certain foreign jurisdictions that are characterized by strict financial privacy regimes, the term "offshore" broadly includes the activities of U.S. taxpayers in all foreign transactions.

Once IRS has identified a return for an examination, the classification process begins. Classification is the process of determining whether a return should be selected for examination, what issues should be examined, and how the examination should be conducted. IRS guidance on classification states that classification should be conducted by an experienced examiner.

Examination is the accumulation of evidence for evaluating the accuracy of the taxpayer's tax return. Examiners gather facts to correctly determine a taxpayer's tax liability. Evidence can include the taxpayer's testimony and books and records as well as the examiner's own observations and documents from third parties. Methods for accumulation of evidence include analytical tests, documentation, inquiry, inspection, observation, and testing. IRS procedures call for examiners to pursue an examination to the point where a reasonable determination of correct tax liability can be made. In turn, examiners prepare audit reports, which should contain all information necessary to ensure a clear understanding of the adjustment, if any, and document how the tax liability was computed. These reports serve as the basis for assessment actions. An assessment records the taxpayer's liability due.[4]

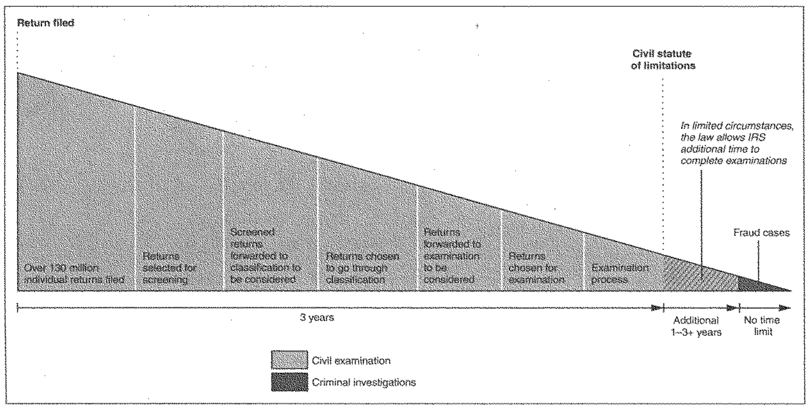
IRS examinations are generally of one of three types—correspondence, office, or field. The simplest examinations usually cover one to two tax issues handled by a lower-graded examiner through correspondence. More complex examinations are done by meeting with taxpayers or their representatives in IRS offices. The most complex examinations are done through revenue agent field visits to taxpayer locations. Only about 16 percent of all IRS examinations from 2002 through 2005 were conducted through field examinations, but 98 percent of offshore examinations were of this type. About three-fourths of nonoffshore examinations are handled through correspondence.

IRS does not classify every return that is filed, nor does it examine every case file that is classified, even if IRS determines that examining the tax return would likely yield an assessment of additional taxes owed. Figure 1 provides a notional representation of the process of taking the over 130 million individual income tax returns that were filed in fiscal year 2004

[4]Analyses in this report involve recommended assessments at the close of the examination. Recommended assessment amounts can be reduced if the taxpayer takes his or her case to IRS Appeals or to Tax Court.

through the steps that lead to audits of a much smaller number of those returns.

Figure 1: Notional Representation of IRS Audit Selection Process



Source: GAO analysis of IRS data.

In most cases, the law gives IRS 3 years from the date a taxpayer files a tax return to complete an examination and make an assessment of any additional tax. For example, if a taxpayer filed a tax return on April 15, 2000, IRS had until April 15, 2003, to finish any examination of that return and make an assessment of additional taxes owed by the taxpayer. This statute of limitations for assessments is in effect for all examinations with exceptions allowing longer periods for certain taxpayer actions or omissions such as fraud or substantial understatement of gross income (in excess of 25 percent of the amount of gross income stated on the return). Taxpayers may also waive the 3-year assessment limitation through written consent.

Offshore Examinations Take Longer Than Other Examinations, so the 3-Year Statute Can Lead to Lower Assessments Than Would Otherwise Be Possible

In general, it takes longer for IRS to identify and examine tax returns involving abusive offshore transactions than IRS needs in nonoffshore cases because of the added complexity of examining offshore transactions. Where IRS is able to complete examinations involving abusive offshore transactions, they generally result in larger assessments than other types of examinations. IRS has policies in place to avoid violating the statute of limitations, and IRS enforcement personnel told us that these policies, in conjunction with the longer time needed to complete offshore examinations, mean some cases are never opened in the first place while others are not fully worked because the time allowed under the current statute is running out. As a result, they said, overall assessments for offshore cases are lower than they would be if IRS had more time to work these cases.

Offshore Cases Take Longer for IRS to Develop and Examine

IRS officials told us that cases involving offshore tax evasion present special, time-consuming challenges that other types of cases do not. Tax evasion, both domestic and offshore, often involves schemes with many layers of deception. IRS officials told us that for domestic tax evasion, revenue agents are able to issue summonses to domestic financial institutions to uncover the layers of deception the taxpayer created to hide the source and existence of the funds. In offshore cases, IRS generally does not have summons power over offshore financial institutions, and is often unable to determine the owner of an offshore account or business, or determine the source of the funds. Even in cases where IRS is able to determine information about offshore funds, an IRS manager told us that this process of discovery is much more time consuming than for nonoffshore cases.

Unlike much nonoffshore tax evasion, most possible offshore tax evasion cases are not discovered through IRS's computerized analysis of tax returns, but rather through investigations of promoters of offshore schemes. Officials told us that several divisions of IRS forward leads on the promoters of offshore schemes they discover to revenue agents, who develop the cases in order to discover the extent of the promoter's use of offshore schemes. This process takes far longer than computer analysis-based methods of identifying potential noncompliance.

After developing information that a promoter of offshore schemes illegally sold schemes to help taxpayers avoid their tax liability, IRS can refer that information to the Department of Justice, which can then file a complaint in the United States District Court requesting the court to issue an injunction against the promoter. In some cases, the injunction will compel the promoter to disclose the clients who purchased the scheme. IRS officials told us that it can take years to get a client list from a promoter and, even with a client list, there is still much work that IRS needs to do before the clients of the offshore schemes can be audited. For example, IRS officials told us that they may only get limited information about the clients of offshore promoters, and often that information is limited to a name and perhaps the city and state where the client lives, so considerable time may be spent finding the individuals listed by the promoter.

Time spent developing information on a return before putting it into the queue for examination shortens the time available to close the examination before the 3-year civil statute of limitations expires. Table 1 compares the median number of days spent in development for offshore and nonoffshore examinations from 2002 to 2005.[5] As shown in the table, the median offshore case took 184 more calendar days than the median nonoffshore case to move from filing to examination. Comparing just field examinations, which constituted over 98 percent of offshore examinations in fiscal years 2002 through 2005, the difference in median development time was 96 days. Some examinations lead to additional examinations of the same taxpayer's returns, such as when a revenue agent identifies noncompliance on one return and then reviews prior year returns looking for the same problem, or when a taxpayer files a new return while an examination is underway. To avoid overstating development time, this comparison includes only the number of days between the start of the examination and the filing date of the last return filed before the examination began.[6]

[5]A small number of examinations take an especially short or an especially long time to develop and complete. Because of this, we generally use medians in this report as the representation of the central tendency of the data we analyzed.

[6]Because we chose to count development time for only the return filed immediately before the examination start date, the median development time information in table 1 understates development time for examinations that were in fact prompted by an earlier return from the same taxpayer. This makes our estimate of development time conservative for both offshore and nonoffshore examinations.

Table 1: Median Development Days by Examination Type, Fiscal Years 2002–2005

Examination type	Median days in development, all examinations	Median days in development, field examinations only
Offshore	504	504
Nonoffshore	320	408

Source: GAO analysis of IRS data.

Note: Medians in this table are not based on analysis of all examinations. Our calculations included only one examination where a single taxpayer is the subject of two or more related examinations.

Once offshore cases are developed and moved into examination, the examinations take longer than nonoffshore cases. Considering all types of examinations together, the median offshore examination took 90 more days than the median nonoffshore examination. Considering field examinations alone, the median offshore field examination was 70 days longer than the median nonoffshore field examination, as shown in table 2. IRS officials told us that this is due to examination complexity and the difficulty of identifying and obtaining information from foreign sources.

Table 2: Median Examination Days by Examination Type, Fiscal Years 2002–2005

Examination type	Total number of examinations	Median number of days, all examinations	Number of field examinations only	Median number of days, field examinations
Offshore	6,720	275	6,597	279
Nonoffshore	4,134,870	185	653,239	209

Source: GAO analysis of IRS data.

The total time that elapses between a return being filed and IRS's closing of the examination of that return is referred to as total cycle time and provides another type of comparison between offshore and nonoffshore cases. As shown in table 3, the median offshore examination took almost 500 more calendar days overall to close than the median nonoffshore examination, a 126 percent difference. The median offshore case took 82 percent of the statute time versus 36 percent for nonoffshore cases. Considering just field examinations, the median cycle times for offshore and nonoffshore examinations were closer in length, but the median offshore examination was still 194 days longer, a difference of 28 percent.

Table 3: Median Total Cycle Time by Case Type, Fiscal Years 2002–2005

	All examinations		Field examinations only	
Case type	Median cycle time, in days	Percentage of statute time used by IRS to close case	Median cycle time, in days	Percentage of statute time used by IRS to close case
Offshore	896	82	896	82
Nonoffshore	397	36	702	64

Source: GAO analysis of IRS data.

Note: The median day figures in tables 1 and 2 are drawn from different populations, so they do not add up to the median day figures in table 3.

Completed Offshore Examinations Yield Larger Recommended Assessments Than Other Examinations

About half of all offshore examinations resulted in a recommended assessment of additional taxes due compared to approximately 70 percent of nonoffshore examinations. While less frequent, assessments from all types of offshore examinations—correspondence, office and field—had a median that was nearly 3 times larger than from nonoffshore examinations. Considering just field examinations, recommended assessments from offshore examinations also had a median that was much larger than nonoffshore examinations, though by a smaller margin, as shown in table 4.

Table 4: Median Assessments by Examination Type, Fiscal Years 2002–2005

	All examinations		Field examinations only	
Examination type	Number of examinations resulting in an assessment	Median assessment, in dollars	Number of examinations resulting in an assessment	Median assessment, in dollars
Offshore	3,247	7,933	3,166	7,848
Nonoffshore	2,899,957	2,877	359,272	4,529

Source: GAO analysis of IRS data.

While yielding larger assessments, the greater amount of time spent on offshore examinations means that their yield per hour of direct examination time is lower.[7] Considering all types of examinations

[7]Direct examination hours are different from total cycle time or examination days in that they do not include time between actions by IRS, such as time spent waiting for a response from the taxpayer or from a financial institution.

together, including both those that resulted in an assessment and those that did not, offshore examinations yielded less per hour of direct examination time than nonoffshore examinations because the number of hours spent on those examinations is nearly 4 times longer, on average. From 2002 to 2005, IRS examiners spent an average of 46 hours on all types of offshore examinations, compared to an average of only 12 hours for all types of nonoffshore examinations. Considering only field examinations, average hours per examination were 47 for offshore examinations versus 62 for nonoffshore examinations, and the difference in dollars per hour of direct examination time is greater.[8]

Table 5: Assessment Dollars per Examination Hour by Examination Type, Fiscal Years 2002–2005

	Total dollars per hour of examiner time, all examinations	Total dollars per hour of examiner time, field examinations only
Offshore	1,084	1,073
Nonoffshore	2,156	2,824

Source: GAO analysis of IRS data.

Note: Unlike table 4, table 5 considers all examinations, including those that did not result in an assessment.

To Prevent Violating the Statute of Limitations, IRS Does Not Pursue Some Likely Offshore Tax Evasion

IRS has strict policies to prevent examinations from going past the statute of limitations because if an assessment is not made within 3 years, the statute of limitations bars IRS from making any assessment at all. Such instances mean the loss of revenue to IRS and inefficient use of IRS examination resources. IRS policies specify that statute expiration dates for all tax returns be properly determined, that all records be annotated with these dates, and that the cases be closely monitored to prevent accidentally running out of time. Revenue agents and managers told us that IRS strongly emphasizes the importance of keeping track of these dates and avoiding allowing an examination to go past the statute date.

While the 3-year statute of limitations applies in most cases, some exceptions exist under current law. For example, an assessment may be made after the 3-year point if the tax return is false or fraudulent or if

[8]The average of direct time charges on nonoffshore field examinations is affected by a small number of examinations that are both very time intensive and result in very high recommended assessments. We used averages in this comparison because hours per nonoffshore examination are influenced by the large number of very short correspondence examinations, resulting in a median of only 1 hour per case.

there is a sufficiently large omission of gross income. Taxpayers may also agree to waive their statute rights.

In the rare cases where IRS personnel allow an examination to go past the statute without meeting one of the current exceptions to the statute (a "barred statute"), the responsible agent and his or her manager must prepare a Barred Statute Report and face possible disciplinary action because of the examination time spent with no possibility of making an assessment. IRS data for fiscal years 2005 and 2006 showed 39 barred statutes associated with examinations where a manager made an initial determination to recommend a disciplinary action. As shown in table 6, most of these barred statutes ultimately resulted in some type of disciplinary action.

Table 6: Disposition of Cases When a Disciplinary Action Stemming from a Barred Statute Was Initially Recommended, Fiscal Years 2005–2006

Disciplinary action	2005	2006	Total
No action, withdrawn, closed	3	1	4
Counseling, admonishment, reprimand	20	11	31
Suspension, removal, resignation	3	1	4
Total	**26**	**13**	**39**

Source: GAO analysis of IRS data.

Note: These disciplinary actions include all types of examination cases, both offshore and nonoffshore.

IRS has created guidance for continuing offshore examinations past the 3-year point. This guidance permits agents to request permission to carry on the examination past the 3-year point based on their judgment that, given additional time, they will be able to ultimately prove that the examination meets one of the following three conditions:[9]

1. The return is false or fraudulent. IRS defines false or fraudulent as the preparation and filing of false income tax returns by claiming inflated personal or business expenses, false deductions, unallowable credits, or excessive exemptions.

[9]Other exceptions to the statute are in law. These three exceptions are specified in this guidance for carrying an examination past the 3-year statute date without first definitively proving that one of the statute exception conditions applies. IRS may also continue an examination past the 3-year point when taxpayers agree to waive their statute rights.

2. There is a sufficiently large omission of gross income (in excess of 25 percent of the amount of gross income stated on the return) under IRC 6501(e), in which case the tax may be assessed at any time within 6 years after the return is filed.

3. The taxpayer failed to notify the Secretary of the Treasury of certain foreign transfers under IRC 6501(c)(8), in which case the statute of limitations is 3 years from the date IRS receives the required information.[10]

A conclusion to continue an examination beyond the statute must be approved in writing by IRS managers, based on the revenue agent's documentation of the rationale and calculations to support this conclusion. In addition, IRS must have made a timely and proper request to the taxpayer to obtain a consent agreement to extend the statute. The taxpayer's refusal to extend the statute or lack of response must be documented. If this guidance is followed, no disciplinary action will be taken against the IRS managers and agents if the examination ultimately does not prove to meet one of the three conditions for making an assessment after 3 years.

The IRS guidance allowing some examinations to go past the normal statute period based on the revenue agent's judgment that an assessment will be possible after the 3-year point recognizes the limited time available to agents to finalize case-specific facts when the 3-year statute is about to expire. The IRS guidance also notes that the Credit Card Summons project examinations are generally likely to involve unreported income or fraud as well as failure to file information returns reporting foreign transfers. The guidance also states that other offshore examinations share many of the same challenges as Credit Card Summons project examinations including complex examinations and securing documents located outside the United States.[11]

[10] This exception is limited to just certain transfers associated with foreign corporations, partnerships and trusts. The exception is further limited to specific issues related to transactions with these foreign entities, such as the organization or reorganization of foreign corporations and the acquisition of their stock.

[11] At the time of our review, IRS had six offshore projects—Credit Card Summons, Offshore Transactions, Offshore Compliance Initiative Project, Foreign Trusts, Amended Returns with Offshore Voluntary Compliance Issues, and the Offshore Compliance Project.

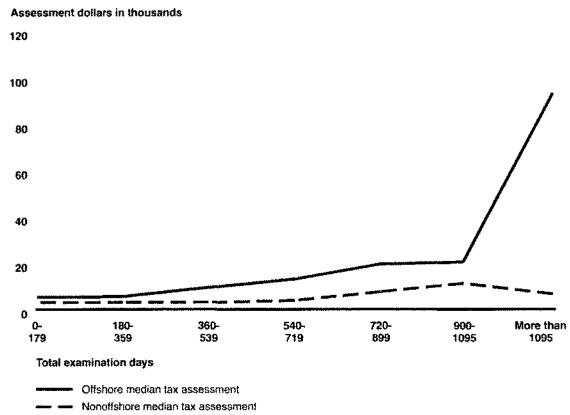
IRS managers told us that this procedure for continuing examinations beyond the statute is cumbersome, time-consuming, and some agents are reluctant to use the procedure because of concerns about barred statutes. Revenue agents told us that this reluctance stems from the culture of IRS examiners where agents are instructed from the time they are hired to never let an examination go past the statute of limitations for any reason. Despite subsequent assurances from IRS guidance, however, revenue agents told us that ingrained reluctance to letting the statute of limitations pass is still paramount.

All of the examinations allowed to extend past the statute date under this guidance represent a gamble on the part of IRS that the examination will ultimately meet one of the exceptions to the statute and an assessment will be allowed under the law. IRS records show that 1,942 offshore examinations were taken past the 3-year statute period from fiscal years 2002 through 2005. IRS ultimately made assessments on 63 percent of these examinations and these assessments were significantly higher than assessments from all other types of examinations, with a median assessment of about $17,500 versus about $5,800 from offshore examinations that were closed within the 3-year statute of limitations and $2,900 from all nonoffshore examinations closed within 3 years.[12] IRS databases do not allow systematic analysis of the approximately 700 examinations that did not result in an assessment, so we do not know if these were accurate returns or if the discovered tax evasion just did not rise to the level of fraud or substantial understatement of income.

For those examinations that closed with an assessment, longer examinations did not change the median assessment amount significantly for nonoffshore examinations. On the other hand, offshore examinations produced much larger median assessments than both shorter offshore examinations and all nonoffshore examinations when the examinations themselves took 3 years or more, as shown in figure 2. A similar relationship is found for field examinations alone, as shown in figure 3.

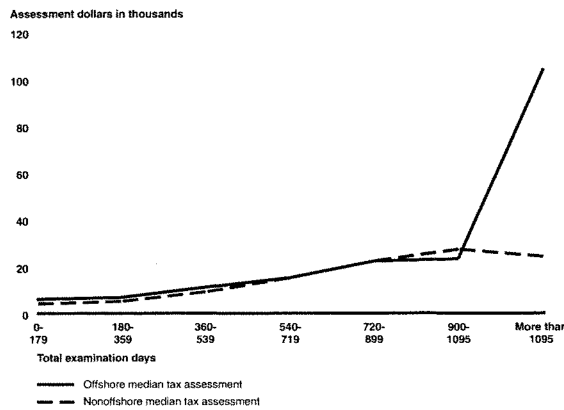
[12]Considering only field examinations, median assessments from offshore examinations during this period that resulted in an assessment were very similar—about $17,300 from examinations that took longer than 3 years and $5,800 from examinations closed in less than 3 years. For nonoffshore examinations, field examinations that took longer than 3 years had a median recommended assessment of about $14,000 and those closed within 3 years had a median recommended assessment of about $3,900.

Figure 2: Median Assessment Amount by Number of Examination Days, All Examinations Closed with an Assessment, Fiscal Years 2002–2005



Source: GAO analysis of IRS data.

Figure 3: Median Assessment Amount by Number of Examination Days, Field Examinations Closed with an Assessment, Fiscal Years 2002–2005



Source: GAO analysis of IRS data.

Similarly, our analysis of assessment dollars generated per hour of examination time (including examinations both with and without assessments) showed that the yield increased markedly for offshore examinations that take more than 3 years. While average assessment dollars per hour of direct offshore examination time are about half of the average for nonoffshore examinations, the reverse is the case for examinations that go over three years—$6,458 per hour for offshore examinations compared to $3,432 per hour for nonoffshore examinations. The comparison is nearly the same for field examinations alone—$6,465 per hour for offshore field examinations and $3,454 per hour for nonoffshore field examinations.

Revenue agents and managers told us that some developed case files are not opened for examination because insufficient time remains under the statute to make the examination worthwhile. They said that managers and agents have leeway in deciding which examinations to work because there are usually more developed case files waiting for agents than there are agents to work them. IRS wants agents to work examinations with a good likelihood of leading to meaningful assessments; managers told us they look for examinations that have both apparent noncompliance and sufficient time remaining within the statute to fully develop the apparent issues. Revenue agents and IRS managers told us that, in order to avoid violating the statute, they will often choose case files to examine with more time remaining under the 3-year statute of limitations over case files with less time remaining but with more likely or more substantial possible assessments. As a result, they explained that not all case files in the unassigned inventory of case files developed for examination are selected for examination and many case files are "surveyed," or closed without examination.[13]

Two IRS policies could contribute to closing a developed offshore case without an examination. One of these policies requires sorting the unassigned inventory to identify the areas most in need of examination. This policy includes statute year and statute date among the attributes used in sorting unassigned inventory. A second policy requires that an examiner not begin an examination or requisition any return for audit without management approval if fewer than 12 months remain on the statutory period for assessment. As described earlier, offshore examinations typically require more time to develop than nonoffshore examinations, and as a result, offshore examinations in the queue for examination would typically be nearer the end of the assessment period than nonoffshore examinations. IRS managers explained that this attribute of offshore examinations can lead to leaving offshore cases in the queue until the statute period ends and then closing the case without an examination.

Agents and managers also said that they often choose to end an ongoing examination nearing the end of the 3-year assessment period without making a complete assessment rather than risk taking the examination past the statute period, losing revenue, and facing disciplinary action. IRS agents and managers told us that they face difficult choices as an examination nears the end of the 3-year assessment period and the examination is incomplete. On the one hand, the examination can be discontinued. This choice is the safest for individual IRS agents and managers because it avoids the possibility of a Barred Statute Report and

[13]Survey decisions can be made at several levels of management and may also be made by individual agents.

disciplinary actions. However, this choice also results in an assessment that does not accurately reflect the extent of a taxpayer's compliance or noncompliance with tax laws because the examination is incomplete. Continuing the examination can result in an accurate assessment, but only if the examination demonstrates one or more of the exceptions to the statute described earlier. If the examination does not ultimately demonstrate fraud or another basis for an exception, IRS managers and agents wasted IRS resources because they are barred from making an assessment. Revenue agents told us that they believed that in some cases there is "money being left on the table" in the form of unexamined issues that could have led to assessments if there had been sufficient time to examine them.

Even where there is sufficient time to work an examination, only a few years where a taxpayer was using a particular scheme may be open to examination and the early years of a scheme may be past their statute date before the examination even begins. For example, if IRS is examining a taxpayer's 2005 tax return and discovers a significant understatement in the income that the taxpayer reported, the agent can examine some of the taxpayer's previous returns, but unless the revenue agent and manager suspect fraud, in which case there is not a statute of limitations, IRS must abide by the 3-year statute of limitations on assessments and not examine some prior years that taxpayers held money offshore illegally. A senior IRS official told us that this is a particularly significant problem because it is often in the first years of an offshore scheme where the taxpayer moves the most money offshore and the most egregious tax evasion takes place, so IRS is missing out on significant assessments by not being able to look back at previous tax returns.

IRS revenue agents are not able to accurately estimate likely possible assessments for case files or tax years that are unexamined. Similarly, in cases where an examination is started and subsequently closed without some issues being examined due to the statute of limitations, it is not possible to estimate the likely assessment from unexamined issues.

As mentioned earlier, however, we found that 1,942 offshore examinations were allowed, either by IRS decision or by a voluntary statute extension signed by the taxpayer under examination, to exceed the 3-year statute of limitations. Of those, more than 700 were closed without an additional tax assessment. IRS officials told us that many of the offshore examinations that go past the 3-year statute of limitations are very difficult to work due to complex financial arrangements and that even with significantly more time, some particularly complex and well-hidden offshore schemes would remain very difficult to uncover. IRS data did not show the reasons that the 700 offshore examinations that went past the 3-year statute of limitations were closed without an assessment.

Some Offshore Examinations Present Enforcement Problems Similar to Those Where Congress Granted Changes to the Statute

Some offshore examinations exhibit compliance problems similar to those where Congress granted a change or exception to the statute in the past. Offshore examinations take longer than nonoffshore examinations for IRS to develop and examine for reasons such as technical complexity and the difficulty of obtaining information from foreign sources, and as a result, IRS may not complete assessments of all taxes owed. These problems are similar to problems giving rise to other changes and exceptions to the statute at both the federal and state levels over the years. These changes and exceptions provide precedent for changing the statute for offshore examinations.

Offshore Enforcement Problems Are Similar to Those Justifying Past Changes to the Statute

Offshore examinations present IRS with various enforcement problems. As discussed above, offshore examinations take longer to develop and examine. IRS officials told us that this is due to the examinations' complexity and difficulty in identifying and obtaining information from foreign sources. Agents and managers also said that they often choose to end an ongoing examination nearing the end of the 3-year assessment period without making a complete assessment rather than risk taking the examination past the statute period, losing revenue, and facing disciplinary actions. Further, agents and managers explained that some taxpayers or their representatives employ dilatory, uncooperative tactics when dealing with IRS. In addition, we previously testified[14] that the use of offshore schemes can also pose a threat to the integrity and fairness of our tax system by adversely affecting voluntary compliance if honest taxpayers believe that significant numbers of individuals are not paying their fair share of the tax burden.

We reviewed 12 IRS offshore case files and found examples of (1) technical complexity, (2) difficulty in identifying and obtaining information from foreign sources, and (3) taxpayers or their representatives employing dilatory, uncooperative tactics when dealing with IRS. We also found a wide variety of offshore examinations, from

[14]GAO, *Internal Revenue Service: Enhanced Efforts to Combat Abusive Tax Schemes—Challenges Remain*, GAO-02-618T (Washington, D.C.: Apr. 11, 2002).

very simple examinations to much more complex examinations that had been under examination for years. In order to obtain illustrative examples of offshore examinations, we reviewed examinations that took a shorter than average number of days to complete, about an average number of days, and a longer than average number of days. We reviewed case files in two locations and our reviews included both completed examinations and examinations still in progress. These examinations included some that had no changes to the taxpayer. The two examinations described below include one that took a relatively low number of days and one that took a longer than average number of days.

In the first examination, the taxpayer was identified as holding an offshore credit card in a country considered to be a tax haven. The taxpayer maintained that he did not have an offshore credit card. IRS used a summons to obtain records of a domestic rental car transaction that would identify the holder of the offshore credit card. While the name shown on the rental car records was similar to the taxpayer's name, it was not the taxpayer's name. After reviewing the rental car records, the revenue agent concluded that the taxpayer was not the holder of the offshore credit card. The examination had no other issues and resulted in no change in the amount of tax owed by the taxpayer. In conducting this examination, the revenue agent

- sent 4 pieces of correspondence to the taxpayer,
- conducted 1 interview with taxpayer,
- notified the taxpayer of third-party contact, and
- used 1 summons to obtain domestic rental car records; the summons was returned 33 days after it was issued.

In the second examination, the taxpayer had a number of businesses in the United States and in other countries, including at least one business in a tax haven country. It appeared that some of the taxpayer's businesses paid consulting fees to other businesses the taxpayer owned, and consulting fees were paid into an offshore account in a tax haven country through which the taxpayer received funds via a credit card.

IRS found it difficult to determine how much money was in the taxpayer's offshore tax haven business and how the money got there. The money in that business, IRS told us, is the lynchpin of the entire examination, which was still underway at the time of our review. During the 4 years that the examination had been underway, IRS opened examinations on the taxpayer's spouse and on other businesses in other tax years. IRS has not been able to find where some of the money is going, although officials are confident that more is being hidden as the taxpayer had other businesses that made payments to the business in the offshore tax haven country. Over the 4 years of this examination, there have been at least

- 5 powers of attorney,
- 20 summonses,
- 39 contacts with the taxpayer's power of attorney,
- 23 document requests,
- 5 missed appointments by taxpayer or taxpayer's representative,
- 1 statute extension,
- 2 interview requests denied,
- 5 meetings with taxpayer's representative,
- 4 postponed appointments,
- 4 third-party contacts, and
- 2 occasions on which the taxpayer refused to supply information.

The scheme began, as far as IRS can tell, in the late-1990s, but examinations of some early years of the taxpayer's scheme were statutorily barred. This means that, when the examination eventually closes, IRS will not be able to assess any additional taxes on at least some tax years that IRS agents found the taxpayer was holding money offshore unless they determine that fraud was committed.

Enforcement problems exhibited in the 12 cases we reviewed are similar to enforcement problems justifying changes and exceptions to the statute at both the federal and state levels over the years. For example, the statute was recently changed at both the federal and state levels to address specific compliance problems, such as dilatory tactics on the part of taxpayers and the use of technically complex transactions. The following details on legislative actions illustrate instances where changes and exceptions to the statute were granted at both the federal and state levels because of enforcement problems similar to those exhibited by offshore examinations such as (1) time constraints on IRS; (2) taxpayers delaying examinations through dilatory, uncooperative tactics on the part of taxpayers; and (3) failure of taxpayers to provide required information.

Historical Changes and Exceptions

The Revenue Act of 1934[15] provided the current 3-year statute. In making the change in 1934 from 2 to 3 years, the Senate Report noted that experience showed that the 2-year period was "too short in a substantial

[15]Chapter 277, 48 Stat. 683, May 10, 1934.

number of large cases, resulting oftentimes in hastily prepared determinations, with the result that additional burdens are thrown upon taxpayers in contesting ill-advised assessments. In other cases, revenue is lost by reason of the fact that sufficient time is not allowed for disclosure of all the facts."

As discussed above, Congress has also provided exceptions to this 3-year assessment period. For example, the exception for filing a false or fraudulent return dates back to the Revenue Act of 1916.[16] Where this exception applies, the assessment can be made at any time. Similarly, the exception for significant omissions of gross income dates back to the Revenue Act of 1934. Where this exception applies, the tax may be assessed at any time within 6 years after the return is filed. According to the legislative history for the 1934 Act, this provision was added to enlarge the scope of the existing exception allowed for false or fraudulent returns while limiting the exception where a taxpayer may have made an honest mistake and it would be unfair to keep the statute open indefinitely. The exception to the statute of limitations for failure to report certain foreign transactions dates back to the Taxpayer Relief Act of 1997.[17] This exception was included and grouped along with certain other changes designed to simplify formation and operation of international joint ventures.

Recent Federal Exception to the Statute

More recently, Congress changed the statute to provide IRS with additional time to make assessments in the case of unreported listed transactions.[18] With the American Jobs Creation Act of 2004,[19] Congress extended the statute for unreported listed transactions for 1 year after the earlier of (1) the date the information required to be reported is provided or (2) a material advisor meets the requirements for providing a list of investors in the listed transaction.

[16]Chapter 463, 39 Stat. 756, Sept. 8, 1916.

[17]Pub. L. No. 105-34, Aug. 5, 1997.

[18]Listed transactions are the same as, or substantially similar to, a transaction specifically identified by IRS as a tax avoidance transaction. For a transaction to be a listed transaction, IRS must issue a notice, regulation, or other form of published guidance informing taxpayers of the details of the transaction. IRS listed 31 such transactions as of January 2007.

[19]Pub. L. No. 108-357, Oct. 22, 2004.

Listed transactions are complex transactions that manipulate parts of the tax code or regulations and are typically buried among "legitimate" transactions reported on tax returns. Because the transactions are often composed of many pieces located in several parts of a complex tax return, they are essentially hidden from plain sight, which contributes to the difficulty of determining the scope of the abusive shelter problem. Often lacking economic substance or a business purpose other than generating tax benefits, abusive shelters are promoted by some tax professionals, often in confidence, for significant fees, sometimes with the participation of tax-indifferent parties, such as foreign or tax-exempt entities. They may involve unnecessary steps and flow-through entities, such as partnerships, which make detection of these transactions more difficult. The transactions are marketed to wealthy individuals, large corporations, and small business taxpayers. Section 6111 of the Internal Revenue Code requires the promoter or other tax shelter organizer to report such transactions with IRS. Further, Department of the Treasury regulations[20] require promoters to maintain lists of investors who have entered into the transactions and investors to disclose the transactions into which they have entered.

In a March 2006 report, for example, the Treasury Inspector General for Tax Administration (TIGTA) described a type of listed transaction called Son of Boss (Bond and Option Sales Strategies).[21] According to TIGTA, this transaction used flow-through entities, such as partnerships, and various financial products to add steps and complexity to transactions that had little or no relationship to the investor's business or the asset sale creating the sheltered gain. TIGTA further explained that the losses generated from the transactions were often reported among "legitimate" items in several parts of the tax return. TIGTA concluded that taken together, these characteristics, especially the use of flow-through entities, made it very difficult for IRS to detect the Son of Boss abusive tax shelter through its traditional process of screening returns individually for questionable items. TIGTA noted that examinations of abusive tax shelters can take significant amounts of time even for the most experienced examiners because such shelters often involve complex, technical transactions that

[20]Treas. Reg. Sec. 301.6112-1 and Treas. Reg. Sec. 1.6011-4.

[21]Treasury Inspector General for Tax Administration, *The Settlement Initiative for Investors in a Variety of Bond and Option Sales Strategies Was Successful and Surfaced Possible Next Steps for Curtailing Abusive Tax Shelters*, 2006-30-065 (Washington, D.C.: Mar. 31, 2006).

take on different variations and require examining multiple flow-through entities to make a proper tax determination.

At the time of our review, IRS representatives stated that sufficient time had not elapsed to determine to what extent, if any, the 1-year extension for unreported listed transactions improved examination effectiveness. An IRS analyst explained, however, that the 1-year extension resulted in increased disclosures of previously undisclosed listed transactions. This analyst stated that 35 taxpayers made 74 separate disclosures about previously unreported listed transactions and that 8 of these 74 disclosures were duplicates.

California Statute Change

At the state level, California recently extended its statute from 4 to 8 years for taxpayers that invest in an abusive tax shelter (ATS) transaction. Such transactions include IRS listed transactions and other schemes of particular importance to California. According to the California Legislative Analyst's Office (LAO), the key feature of these transactions is that they have no true economic purpose but exist solely for reasons of tax avoidance. Among their characteristics is the use of (1) pass-through entities such as partnerships, (2) third party facilitators, and (3) offshore accounts or facilitators. The LAO further explained that ATS transactions can be quite difficult to identify and often even harder to understand, even for trained tax auditors.

As with IRS, California experienced increased disclosure as a result of extending its assessment period from 4 to 8 years for taxpayers involved in ATS transactions. A California FTB manager stated that the newly enacted 8-year statute had not been applied because most tax shelter examinations are closed within the normal 4-year period or by requesting voluntary waivers. It should be noted that California's assessment period is 1 year longer than the federal 3-year assessment period. The FTB manager also cited two sources of examinations in which the normal 4-year statute had expired but taxpayers were willing to work to resolve their tax shelter issues. These sources were the Self Compliance Letters[22] and the

[22]During 2005, the California FTB formed several new units to reduce the tax gap. Among these new units was the Abusive Tax Shelter Unit, which was formed to identify returns with abusive tax shelters and to foster self-compliance. According to a California FTB manager, this unit instituted a new approach to addressing potential participants in abusive transactions. Based on disclosure information, investor lists, and tax returns, she explained that the unit contacts taxpayers with a self-compliance letter to solicit amended returns that reverse the potentially abusive issues.

California Tax Shelter Resolution Initiative.[23] The California FTB used a self compliance letter to solicit amended returns from taxpayers for at least 1 year in which the 4-year statute had expired. This letter cited the 8-year statute. At the time of our review, 13 taxpayers filed amended returns, which reported tax and interest of about $2.3 million. Additional penalties may apply to these 13 taxpayers. Another 48 taxpayers agreed to file amended returns with estimated taxes and penalties of about $7 million. Under the California Resolution Initiative, the FTB was accepting applications and drafting closing agreements with another 181 taxpayers who had at least 1 tax year for which the 4-year statute had either expired or was about to expire.

Legislative Reports Discuss Reasons for Change

The justification for extending the statute for unreported listed transactions at the federal level and for ATS transactions in California generally involved qualitative factors. A House of Representatives Report[24] accompanying the American Jobs Creation Act of 2004 states that "some taxpayers and their advisors have been employing dilatory tactics and failing to cooperate with IRS in an attempt to avoid liability because of the expiration of the statute of limitations. The Committee accordingly believes that it is appropriate to extend the statute of limitations for unreported listed transactions."

While not enacted, Senate bill 476 (CARE Act of 2003) included a provision similar to the provision of the American Jobs Creation Act of 2004 that extended the statute for unreported listed transactions. A Senate Report[25] accompanying Senate bill 476 states that "...extending the statute of limitations if a taxpayer required to disclose a listed transaction fails to do so will afford IRS additional time to discover the transaction if the taxpayer does not disclose it." Similarly, the California LAO stated that the time extension for ATS transactions will allow the FTB to "more fully

[23]The California Tax Shelter Resolution Initiative provided analogous tax treatment for California taxpayers participating in, or intending to participate in, IRS's Settlement Initiative for an array of transactions, including 16 listed transactions and 5 other transactions that IRS considered potentially abusive. Taxpayers had until January 23, 2006, to submit their settlement applications to IRS. To participate in the California initiative, California taxpayers must have participated in the IRS initiative. They had until March 31, 2006, to file an election to participate in the California initiative. Both the IRS and California initiative required payment of taxes owed and interest. Both also provided penalty waivers and allowed transaction costs such as professional and promoter fees.

[24]House Report 108-548—*Pt. 1 American Jobs Creation Act of 2004* (June 2004).

[25]Senate Report 108-11—CARE Act of 2003 (Feb. 27, 2003).

develop cases that represent ATS activity and result in a greater sustainment rate at the appeal level."

In addition to affording more time for IRS to discover undisclosed transactions, the Senate report accompanying Senate bill 476 also stated that "extending the statute of limitations if a taxpayer required to disclose a listed transaction fails to do so will encourage taxpayers to provide the required disclosure…." In analyzing the legislation that extended the California assessment period from 4 to 8 years, the California FTB noted that "some taxpayers will continue to engage in tax avoidance transactions until the risks and costs of engaging in the transactions are significantly increased."

More generally, tax evasion by some taxpayers can affect the perceptions of other compliant taxpayers about the fairness and equity of our tax system. In its report accompanying Senate bill 476, the Senate Committee on Finance stated that the committee "is aware that individuals and corporations are increasingly using sophisticated transactions to avoid or evade Federal income tax. Such a phenomenon could pose a serious threat to the efficacy of the tax system because of both the potential loss of revenue and the potential threat to the integrity of the self-assessment system." Similarly, the California LAO concluded that tax avoidance "by some taxpayers shifts the relative tax burden towards taxpayers already in compliance. This principle of fairness has ramifications for the tax system itself. A perception that the tax system is not equitable could result in noncompliance and tax avoidance by an increasing proportion of taxpayers."

Precedent Exists for Changing the Statute for Offshore Examinations

The Supreme Court found that statutes of limitations find their justification in necessity and convenience. According to a Supreme Court opinion, statutes of limitations are practical and pragmatic devices to spare the court from litigation of stale claims, and the citizen from being put to his defense after memories have faded, witnesses have died or disappeared, and evidence has been lost.[26] The opinion goes on to say that statutes of limitations are by definition arbitrary. Historically, the assessment statute of limitations has varied in length. For example, the Revenue Act of 1919[27] set the statute of limitations for tax assessments at 5

[26]Chase Securities Corp. v. Donaldson, 325 U.S. 304, May 21, 1945.

[27]The Revenue Act of 1919, ch. 18, 40 Stat. 1057, February 24, 1919.

years. The statute was changed to 2 years in 1932.[28] The current 3-year statute stems from the Revenue Act of 1934.[29] As described above, Congress granted changes and exceptions to the statute over the years to address various types of enforcement problems. Given the similarities between the enforcement problems exhibited by offshore examinations and the enforcement problems giving rise to past changes and exceptions to the statute, precedent exists for changing the statute for offshore examinations.

Changing the Statute Would Necessitate Weighing Advantages and Disadvantages

Changing the statute for offshore examinations would necessitate weighing advantages and disadvantages. If Congress wishes to change the statute for examinations where offshore compliance is the major issue, certain design options, such as limiting any examination and possible assessment to those issues attributable to offshore transactions or only suspending the statute while IRS is waiting for taxpayer responses to IRS data requests, might mitigate some of the disadvantages of the statute extension.

Advantages and Disadvantages of Changing the Statute

Changing the statute for examinations in which offshore transactions are a major enforcement problem will require weighing both advantages and disadvantages. In addition to advantages, such as fairness or deterrence, mentioned earlier as justification for extending the statute for unreported listed transactions and ATS transactions, interested parties from various organizations that represent taxpayers or work with tax issues mentioned other advantages and disadvantages for an exception to the statute for offshore examinations. For example, they mentioned the ability of IRS to look back at several tax years once an offshore scheme is identified as an advantage of such an exception. On the other hand, they mentioned that such an exception would further complicate the tax code by adding another provision that would most likely include complicated criteria addressing offshore transactions. Table 7 summarizes their views on such an exception in general.

[28]The Revenue Act of 1932, ch. 209, 47 Stat. 169, June 6, 1932.

[29]The Revenue Act of 1934, ch. 277, 48 Stat. 683, May 10 1934.

Table 7: Views of Interested Parties in General on Changing the Statute for Offshore Examinations

Advantages	Disadvantages
• Increases perceptions of fairness • Enhances deterrent effect • Allows IRS to look back at several tax years once a scheme is identified	• Complicates tax laws by adding complex criteria • Creates another precedent for future exceptions • Increases uncertainty and lack of closure • Increases recordkeeping costs • Increases difficulty of marshalling a defense as memories fade and records disappear • Duplicates tools already available to IRS (e.g., fraud, consent agreements, etc.) • Increases IRS focus on old returns, which may not be a good use of IRS resources • Increases perceptions of unfairness unless matched by an extended refund period

Source: GAO analysis of comments by interested parties from various organizations that represent taxpayers or that work with tax issues. These organizations included the American Association of Attorney—Certified Public Accountants, American Bar Association, American Institute of Certified Public Accountants, National Association of Enrolled Agents, National Association of Tax Professionals, National Society of Accountants, National Society of Tax Professionals, and the Department of the Treasury (IRS Small Business/Self Employed division, Taxpayer Advocate Service, IRS Office of Chief Counsel, and Department of the Treasury Office of Tax Policy).

In commenting on an exception to the statute for offshore examinations, these interested parties also pointed out advantages and disadvantages for various design options that could be used to implement such an exception. These options relate to (1) the scope of an exception and (2) the way in which IRS is afforded additional time to address the enforcement problems presented by offshore examinations. Scope refers to (1) which taxpayers will be subject to the exception and (2) the extent to which the exception allows IRS to examine a tax return. The way in which IRS is afforded additional time refers to (1) an extension to the statute, such as for an additional 3 years from the filing date of a tax return or (2) a suspension of the statute pending resolution of a compliance problem, such as slow taxpayer response to IRS records requests. A suspension is triggered by a specified event or action. Table 8 presents the views of these interested parties on the advantages and disadvantages of these design options.

Table 8: Views of Interested Parties on Design Options for Changing the Statute for Offshore Examinations

Design option	Advantages	Disadvantages
Exception applies to all taxpayers having offshore accounts/entities	• Increases simplicity when compared to a case-by-case approach • Increases certainty when compared to a case-by-case approach	• Includes taxpayers having legitimate reasons for offshore accounts/entities • Requires clear criteria defining factors such as offshore account and offshore entity
Exception applies on a case-by-case basis	• Exempts taxpayers having legitimate reasons for offshore accounts/entities	• Requires clear criteria defining applicability • Requires safeguards to prevent unwarranted application • Uncertainty for taxpayers as to whether they are covered
Exception applies to entire tax return	• Maximizes potential for assessment	• Expands examination beyond offshore issues • Creates perceptions of unfairness
Exception applies to offshore issues only	• Limits examination to offshore issues	• Requires safeguards to prevent scope expansion to nonoffshore issues
Exception in the form of a statute extension	• Increases time to identify participants • Increases time to develop examination • Increases time for examination	• May ineffectively identify offshore scheme participants • Fails to guarantee information needed for assessment will be provided within the extended time
Exception in the form of a statute suspension	• Focuses on a specific problem • Increases time to address a specific problem	• Requires clear criteria for triggering event • Requires triggering event to occur before additional time allowed

Source: GAO analysis of comments by interested parties from various organizations that represent taxpayers or that work with tax issues. These organizations included the American Association of Attorney—Certified Public Accountants, American Bar Association, American Institute of Certified Public Accountants, National Association of Enrolled Agents, National Association of Tax Professionals, National Society of Accountants, National Society of Tax Professionals, and the Department of the Treasury (IRS Small Business/Self Employed division, Taxpayer Advocate Service, IRS Office of Chief Counsel, and Department of the Treasury Office of Tax Policy).

If Congress wishes to change the statute for examinations where offshore compliance is a compliance problem, several of the design options mentioned by interested parties might mitigate some of the disadvantages of a statute exception for such examinations. To help clarify their suggestions, we also developed some hypothetical examples to illustrate their points. Specific suggestions that we heard included the following:

- Making an exception apply to all taxpayers having offshore accounts/entities may mitigate concerns about taxpayer uncertainty and lack of closure.
- Limiting any examination and possible assessment only to those issues attributable to offshore transactions might mitigate concerns about unfairly exposing taxpayers to open-ended IRS examinations or "fishing expeditions" that could result in assessments for issues unrelated to offshore transactions. For example, an examination triggered by a taxpayer possessing an offshore credit card could enable the IRS to examine depreciation expense for the plant and equipment used in the taxpayer's domestic business, which the taxpayer might perceive as unfair.

- Suspending the statute until a specific issue is resolved, such as taxpayers not responding promptly to IRS requests for records, might mitigate concerns about an across-the-board extension of the 3-year assessment period.
- Specifying a length of time for an initial extension, such as 1 year, and requiring a court or review board's approval for any subsequent extensions might also mitigate taxpayer concerns about potential IRS abuse of an exception to the statute for offshore examinations. This option might allay concerns about unwarranted application by IRS of a case-by-case exception to the statute.
- Establishing a materiality test might mitigate concerns that IRS would focus on taxpayers having insignificant issues. This test could be, for example, (1) any amount greater than a percentage of a specific amount shown on a tax return such as 20 percent of total assets for taxpayers operating a business or (2) any amount greater than an absolute dollar amount such as any amount greater than $10,000. This option might allay concerns about including all taxpayers, particularly those having legitimate offshore transactions that are not substantial in value.
- Limiting the exception to a case-by-case approach might mitigate concerns about taxpayers being unfairly subjected to an extended assessment period when they have legitimate offshore transactions. For example, an exception to the statute could be limited to taxpayers identified on client lists of known promoters of offshore schemes. This option might allay concerns about including all taxpayers, particularly those having legitimate reasons for offshore transactions.
- Maintaining symmetry between the statute for assessments and the statute for refunds by matching any exception to the statute for assessments with the same exception to the statute for refunds might mitigate taxpayer concerns about the unfairness or one-sidedness of an exception to the statute for assessments. If the statute was suspended until taxpayers respond to IRS request for records, for example, the statute for refunds should also be suspended until the taxpayers respond to the request.
- Assuring access to IRS appeals procedures and to the Tax Court might mitigate taxpayers' concerns about the potential for IRS abuse as well as provide due process should they decide to challenge IRS's use of such an exception to the statute. For example, procedures requiring TIGTA to investigate any taxpayer allegations of denial of due process could be mandated.

Conclusions

As with all forms of tax evasion, it is important that IRS pursue offshore tax evasion because it adds to the tax gap, increases the tax burden on honest taxpayers, and poses a threat to the integrity and fairness of our tax system by adversely affecting voluntary compliance when honest taxpayers come to believe that other people are getting away with not paying their fair share. Offshore tax evasion is special, though, in that the examinations that IRS pursues typically take much longer to develop and examine because of the inherent difficulty in identifying and obtaining information from foreign sources, the often dilatory and uncooperative tactics on the part of taxpayers and their representatives, and the technical complexity of the examinations.

Nevertheless, the statute of limitations that applies to offshore examinations is the same as applies to all returns. This leads to some suspected tax evasion that IRS identifies going unexamined when revenue agents and managers choose not to start work on offshore examinations because there is too little time remaining under the statute or choose to cut work off early in order to avoid a barred statute. There are exceptions that permit IRS to continue examinations past the 3-year point and still make assessments, but in many offshore examinations IRS has only 3 years to complete its work. Furthermore, taking an examination past the 3-year point in anticipation of finding fraud or one of the other exceptions permitted under the statute represents a gamble by IRS that the investment of additional examination resources will ultimately result in an assessment being allowed under the law.

Past Congresses have recognized the need for statute exceptions in the face of similar compliance and enforcement obstacles. In the case of the statute exception for unreported listed transactions, Congress delegated to IRS the responsibility for defining the specific circumstances triggering the exception. A statute exception for offshore examinations that balances the additional layers of difficulty for IRS in detecting and examining offshore cases with fairness to taxpayers involved in legitimate offshore financial activity would strengthen IRS's efforts to combat offshore tax evasion. Additional time to complete examinations would give IRS greater flexibility in choosing which examinations to open and when to close them. This would likely lead to fewer examinations where revenue agents abandon the pursuit of apparent noncompliance simply because they are running out of time.

Matter for Congressional Consideration

In order to provide IRS with additional flexibility in combating offshore tax evasion schemes, Congress should make an exception to the 3-year civil statute of limitations assessment period for taxpayers involved in offshore financial activity. Similar to Congress's approach to unreported listed transactions, Congress may wish to establish a process wherein IRS would identify the types of offshore activity to which a statute exception would apply.

Agency Comments and Our Evaluation

We received e-mail and oral comments from IRS's SB/SE division and the IRS General Counsel's office about a draft of this report. The officials making comments noted that a longer statute for offshore examinations makes sense and should enhance compliance. They also discussed how the offshore-to-nonoffshore comparisons in the draft of this report were typically made for all types of examinations, rather than only of field examinations. They observed that field examinations are by far the most common type of examination used for offshore tax evasion cases and suggested that a comparison of just field examinations would also be useful to the reader. We agreed and we changed our discussion of offshore-to-nonoffshore examinations to include comparisons both of all types of examinations collectively and field examinations alone. Also in their comments, IRS officials clarified other technical and legal issues, which we incorporated in this report where appropriate.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to the Chairman and Ranking Member, House Committee on Ways and Means; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties. Copies will be made available to others upon request. This report will also be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staff have any questions, please contact me at (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix II.

Michael Brostek

Michael Brostek
Director, Tax Issues
Strategic Issues Team

Appendix I: Objectives, Scope, and Methodology

The objectives of this report were to (1) compare the length of and recommended assessments yielded by offshore and nonoffshore examinations and determine the effect of the 3-year statute of limitations on recommended offshore assessments, (2) determine whether or not enforcement problems posed by offshore examinations are similar to those where Congress has previously granted an exception to the statute, and (3) identify possible advantages and disadvantages of an exception to the statute for offshore examinations.

To compare the length of and recommended assessments yielded by offshore and non-offshore examination cases and determine the effect of the statute of limitations on offshore assessments, we examined the Internal Revenue Service (IRS) Audit Information Management System Reference (AIMS) database, which holds all IRS's data about completed examinations. The database included a variety of taxpayers, including individuals, businesses, and corporations, including large corporations. We analyzed fiscal years 2002 through 2005, the most recent years for which IRS had data at the time of our evaluation. We grouped all examinations maintained in the AIMS database by whether they were offshore examinations (as determined by the project code under which all examinations are categorized) or not offshore examinations. We found that there were both offshore and nonoffshore examinations represented among all of the types of taxpayers in AIMS with the exception of excise tax examinations, which were only found in the nonoffshore subset. We used the AIMS data to analyze the number of days cases spent in both development and examination and the recommended assessments from both offshore and nonoffshore examinations. We further subdivided the data to compare only field examinations, because these were the most common type of offshore examination. To assess the reliability of the AIMS data, we reviewed AIMS documentation, and conducted electronic testing of key variables. Based on this work, we determined that the AIMS data were sufficiently reliable for our purposes.

We spoke with 17 IRS revenue agents and managers with expertise in the offshore area about their experience in conducting and closing offshore examinations. We also examined 12 offshore examination case files to gain an understanding of the circumstances that IRS revenue agents face in dealing with noncompliant taxpayers. We spoke with IRS representatives to gain an understanding of how cases are identified for examination, and to determine the process by which an offshore case is developed and examined. In addition, we reviewed various IRS documents related to the statute of limitations on assessments, including exceptions to the statute.

To determine whether or not enforcement problems posed by offshore cases are similar to those where Congress granted an exception to the statute in the past, we identified enforcement problems posed by offshore examinations. To do so, we examined IRS's AIMS database, examined case files and spoke with IRS representatives. We also identified enforcement problems where Congress granted an exception to the statute in the past. To do so, we researched the history of the federal statute of limitations for assessments. We also reviewed legislation proposed between 2003 and 2006 that included references to either offshore tax evasion or the statute of limitations. This included the American Jobs Creation Act of 2006 and other legislative proposals related to the statute. In addition, we reviewed reports prepared by the Treasury Inspector General for Tax Administration and California state agencies related to tax avoidance issues and the statute. We supplemented these reviews with discussions with representatives of the California Franchise Tax Board.

To identify advantages and disadvantages of granting an exception to the statute for offshore examinations, we interviewed representatives of various organizations to obtain views on mandating an exception to the statute for offshore examinations. Such an exception would afford IRS more time to develop and examine offshore examinations. These organizations included the American Association of Attorney—Certified Public Accountants, American Bar Association, American Institute of Certified Public Accountants, National Association of Enrolled Agents, National Association of Tax Professionals, National Society of Accountants, and National Society of Tax Professionals. We also interviewed representatives of various organizations within the Department of the Treasury to obtain their views. These organizations included the IRS Small Business/Self Employed division, the Taxpayer Advocate Service, the IRS Office of Chief Counsel, and the Department of the Treasury Office of Tax Policy.

Appendix II: GAO Contact and Staff Acknowledgments

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Acknowledgments

In addition to the contact named above, David Lewis, Assistant Director; Perry Datwyler; Evan Gilman; Shirley Jones; John Mingus; and Jeff Schmerling made key contributions to this report.

Jim Bunning

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON FINANCE
"Offshore Tax Evasion: Stashing Cash Overseas"
May 3, 2007

Thank you, Mr. Chairman.

At one time, United States individual and corporate tax rates were lower than the prevailing rates in the rest of the world. Today, sadly, the United States no longer is a favored destination for capital solely because of our tax policies, and United States taxpayers increasingly have been seeking haven from our relatively high federal tax rates by putting their money to work elsewhere.

Although our capital gains tax rates are now significantly lower than they once were, the rate on long term capital gains in many developed countries is not just lower than ours, it is zero. Long term capital gains are entirely exempt from tax in Germany, South Korea, and the Netherlands.

While the primary focus of this hearing is offshore tax evasion - - criminal activity that I strongly deplore, we should be careful, in our efforts to combat criminal activity, not to worsen the United States' attractiveness as a destination for investment capital or to further constrain the legal right of United States taxpayers to invest outside this country.

In his prepared testimony, Professor Avi-Yonah estimates that United States estimates that approximately $1.5 trillion is held offshore by United States taxpayers. This is a staggering amount. The amount alone illustrates the increasing challenges the IRS will face in administering our complex international tax rules, but the further assumptions Professor Avi-Yonah makes about the extent of current tax evasion by United States taxpayers appears to be based on thin evidence. I would encourage the IRS to develop a good estimate of the true extent of illegal offshore tax avoidance.

I thank the Chairman for holding this important hearing and I look forward to the testimony and discussion today.

Thank you.

U.S. TREASURY DEPARTMENT
OFFICE OF PUBLIC AFFAIRS

TESTIMONY OF TREASURY ACTING INTERNATIONAL TAX COUNSEL JOHN HARRINGTON BEFORE THE SENATE FINANCE COMMITTEE ON OFFSHORE TAX EVASION

Washington, D.C.--Mr. Chairman, Ranking Member Grassley, and distinguished Members of the Committee, thank you for the opportunity to participate this morning and discuss the serious problem of offshore tax evasion.

Introduction

From the standpoint of tax administration, offshore tax evasion historically has been a very difficult area to address. Questionable use of low- or no-tax jurisdictions has been an issue for decades. Globalization, however, has made foreign investment and foreign activities common, with overseas markets becoming an increasingly important source of income for U.S. individuals and businesses.

Individuals invest in foreign entities for a variety of reasons. In most instances, these investments represent legitimate business transactions, using foreign entities in ways that are typical for international commerce. At times, however, foreign entities can be used for tax evasion. For example, some individuals invest through a jurisdiction with a reputation for secrecy and opaqueness, hoping to stymie the Internal Revenue Service (IRS) in its administration of the Internal Revenue Code. Others try to hide income from the IRS by setting up elaborate business structures and financial arrangements, some components of which are located offshore.

These varied scenarios make it clear that a one-size-fits-all approach will not work to stop offshore tax abuse while continuing to permit legitimate cross-border transactions, which are vital to the United States' participation in the global economy. This is why the Treasury Department has undertaken a multi-faceted approach to deal with the problem of offshore tax evasion. I would like to describe the actions we have taken and continue to take, especially regarding information exchange, to deal with this difficult but important issue. It is critical to bear in mind that this has been a long-term problem, and we must continue to take a long-term view in combating offshore tax evasion, while managing expectations about the speed with which progress can be made in addressing it.

The Treasury Department is very concerned about the use of offshore jurisdictions to evade U.S. tax. There plainly have been abuses in this area. We have been aggressively pursuing such abuses, and we intend to continue doing so.

We have sought to target our efforts on the sources of abuse and avoid actions that are so blunt that they hinder the legitimate cross-border trade and investment activities, which are so critical to U.S. business and U.S. jobs. Cross-border transactions are now standard business operations, as globalization has led to increased cross-border investment opportunities. We have to make sure that our tax rules reflect the current economic environment, without hurting the competitiveness of U.S. workers and businesses.

Regulatory and Administrative Actions

As part of our overall effort to improve compliance, the Treasury Department and the IRS have taken a number of important steps on the administrative front and are continuing to work on other avenues to address offshore tax abuses. Although determined tax evaders may flaunt the tax rules, some taxpayers opportunistically seek to take advantage of ambiguous or outdated tax rules. Accordingly, we modify or update U.S. tax rules when we determine that they are being used to perpetrate such abuse. Recent published guidance projects that will improve compliance and that target potential areas of abuse include:

- Foreign Tax Credit: We have taken strong steps to halt misuse of the foreign tax credit. In November 2006, we issued final regulations regarding the proper allocation of partnership expenditures for foreign taxes. In March 2007, we issued proposed regulations that would disallow foreign tax credits tied to participation in certain artificially engineered, highly structured transactions. In August 2006, we issued proposed regulations that would address the inappropriate separation of creditable foreign taxes from foreign source income. We intend to make appropriate modifications and finalize both sets of proposed regulations as soon as possible.

- Transfer Pricing: We have produced, and continue to produce, significant guidance in the area of transfer pricing. In an increasingly globalized economy, cross-border transactions between controlled entities present significant compliance challenges, making guidance in the transfer pricing area an important part of our administrative efforts to address noncompliance. In August 2006, we issued temporary and final regulations addressing the treatment of cross-border services, and followed them up with additional guidance in December 2006. We issued proposed transfer-pricing regulations addressing cost-sharing in August 2005. We intend to finalize both sets of regulations, with appropriate modifications.

- Other Abusive Transactions: We have also shut down arrangements that utilized foreign jurisdictions to perpetuate abuse of the Internal Revenue Code. For example, in October 2006, we published proposed regulations regarding the Federal tax treatment of annuity contracts. These proposed regulations address a type of widely marketed transaction in which taxpayers claimed to be able to defer or avoid gain on the exchange of highly appreciated property for the issuance of annuity contracts. Recent Congressional hearings have highlighted how taxpayers were applying prior law treatment of these contracts to facilitate abusive private annuity arrangements, often involving offshore issuers. The proposed regulations, when adopted as final, will shut down those arrangements.

The IRS has also undertaken several compliance initiatives, including the Offshore Voluntary Compliance Initiative, aimed at taxpayers who used offshore payment cards or other offshore financial arrangements to hide their income, and the Offshore Credit Card Program, designed to identify taxpayers who use offshore bank accounts to hide income and offshore credit cards issued by secrecy jurisdiction banks to repatriate the unreported income. The IRS is continually monitoring this area for opportunities to implement new programs that will stop abusive transactions and improve compliance.

Obtaining Information from Other Jurisdictions

In most cases, however, the problem of offshore tax abuse lies not with our tax rules but with attempts to hide from them. Accordingly, to enforce our tax laws, we have to exchange information with other countries. 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.

In today's global economy, countries must be able to obtain and exchange the information needed to enforce their domestic tax laws. A key element of U.S. tax treaties, therefore, is the provision for exchange of information between the tax authorities. Under tax treaties, the competent authority (i.e., the tax authorities designated under the tax treaty) of one country may request from the other competent authority such information as may be relevant for the proper enforcement of the first country's tax laws. The information provided by the other country is subject to the strict domestic confidentiality protections that generally apply to taxpayer information. Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program.

A tax treaty is not feasible or appropriate in all cases, however. In some cases, there simply may not be the type of cross-border tax issues between the United States and the foreign country that are best resolved by treaty. For example, in the case of a country that does not impose significant income taxes, there may be little possibility of the double taxation of income that tax treaties are designed to address. In cases where a full tax treaty is not appropriate or feasible, the Treasury Department seeks to provide for the bilateral exchange of tax information by entering into a tax information exchange agreement ("TIEA") with the other country.

Information Exchange Generally

There are three primary forms of information exchange.

- Exchange of information on request: Exchange of information on request occurs when the competent authority of one country asks for particular information regarding specific taxpayers from the competent authority of another country.

- Automatic exchange of information: Information that is exchanged automatically is typically information comprised of many individual cases of the same type. Usually, this type of information exchange consists of details of income arising in the source country (e.g., interest, dividends, royalties, or pensions). This information is obtained on a routine basis (generally through reporting of the payments by the payer) by the sending country and is thus available for transmission to its treaty partners.

- Spontaneous exchange of information: Information is exchanged spontaneously when a country, having obtained information in the course of administering its own tax laws, which it believes will be of interest to one of its treaty partners for tax purposes, passes on the information without the latter having asked for it.

Tax Treaties

Tax treaties typically permit all three types of information exchange. Both the United States Model Income Tax Convention (U.S. Model Tax Convention) and the Organization for Economic Cooperation and Development Model Tax Convention on Income and on Capital (the OECD Model Tax Convention) provide for broad information exchange and do not limit the form or manner in which information exchange can take place. For example, Article 26 of the U.S. Model Tax Convention generally provides that "the competent authorities of the Contracting States [the treaty partners] shall exchange such information as may be relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes of every kind imposed by a Contracting State to the extent that the taxation thereunder is not contrary to the Convention, including information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, such taxes." The Article confirms that each Contracting State must maintain and protect the confidentiality of the tax information it receives from the other State, with disclosure permitted only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, such taxes, or the oversight of such functions.

The Article further provides that each Contracting State "shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own purpose." Thus, a treaty partner may not decline to supply information to the other treaty partner merely because the first treaty partner has no domestic interest in the information. For example, a country may not refuse to provide information on request about the holder of a bank account simply because the country does not tax interest and, therefore, does not collect such information.

Article 26 permits a Contracting State to refuse to share information in certain specified cases, however. A Contracting State may refuse (a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State; (b) to supply information that is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State; or (c) to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. The Article specifically prohibits, however, a treaty partner from refusing to obtain or exchange information because of bank secrecy rules.

The information exchange article in the OECD Model Tax Convention has substantially similar provisions to those described above.

TIEAs

Compared to tax treaties, TIEAs are a more recent phenomenon. In 1983, as part of the Caribbean Basin Initiative, Congress granted the Treasury Department the authority to enter into bilateral or multilateral TIEAs with designated countries in the Caribbean and Central America. This authority was extended in 1986 to allow the Treasury Department to enter into bilateral TIEAs with other countries.

There are several items that are essential to the United States when negotiating a TIEA. First, the TIEA must provide for the exchange of information on request for both criminal and civil tax matters. Many jurisdictions are more willing to exchange information with respect to criminal tax matters, but such a restriction would greatly limit the utility of a TIEA from a U.S. standpoint. Second, the TIEA must provide for the exchange of information even if such information relates to a person who is not a resident or national of the United States or the TIEA partner. We may be more interested in the beneficial owner of an entity formed under the jurisdiction of the TIEA partner than we are in the entity itself. Finally, the TIEA must provide for the disclosure of information regardless of local "confidentiality" laws that may prohibit such disclosure, including laws relating to bank secrecy or bearer shares. Indeed, such laws may be one of the principal attractions for offshore tax evaders.

Many of our TIEA partners have small tax administrations, and the TIEAs acknowledge this reality. Accordingly, a TIEA often will specify the details that a request for information under the TIEA should contain and also require the IRS to explain why it is making the request. Although each TIEA partner is usually expected to bear the routine costs of fulfilling its obligations under the agreement, TIEAs often require the requesting party to bear "extraordinary costs." This type of feature is often necessary to induce a small jurisdiction to agree to a TIEA.

Information Exchange Is Not Just a Bilateral Issue

The United States is not the only country that has encountered the problem of offshore tax evasion, but it has been a leader in increasing worldwide standards of information exchange to combat such evasion. We have worked with other countries, particularly through the OECD, to raise international standards of information exchange. Although exchange of taxpayer information is effected on a bilateral basis, pursuant to a tax treaty or TIEA, the information exchange practices of third countries matter significantly. Some of the more complicated cases may involve transactions in several jurisdictions, requiring exchange of information with multiple jurisdictions. Thus, the adoption of high standards of international information exchange facilitates our ability to obtain the information we need through our agreements, thereby promoting the sound and effective administration of U.S. tax laws.

We have made great strides in raising international standards. It is now rare for a country to insist that it can only exchange information in which it has a domestic tax interest. In addition, the countries that assert that they cannot provide information because of bank secrecy are becoming fewer and fewer.

Improving the quality of the information available for exchange (e.g., removing bank secrecy and eliminating the requirement of a domestic tax interest) is one of the most important developments in the last few years. In other words, access to relevant information is more important than the method of exchange (e.g., whether automatic or not). In particular, automatic exchange does no good if the underlying information is too limited to be of help.

We also have to make sure that tax information is properly protected. Under U.S. law, we cannot exchange taxpayer information unless we know the other country will protect the confidentiality of that information.

Exchange of non-taxpayer-specific information is also important. Countries often share experiences and schemes that they have encountered. For example, the Treasury Department recently issued proposed foreign tax credit regulations to shut down abusive foreign tax credit "generator" transactions. We learned about these transactions from foreign tax authorities. This kind of communications can be as important as the more traditional exchange of information.

The IRS has been actively involved in the development of several multilateral information exchange programs. The Joint International Tax Shelter Information Centre (JITSIC) was formed by tax authorities in the United States, the United Kingdom, Canada, and Australia. The objectives of JITSIC are to deter promotion of and investment in abusive tax schemes, particularly through information exchange and knowledge sharing. IRS Commissioner Everson has described JITSIC as having sharply improved IRS knowledge and understanding in a number of important international tax areas.

In addition to JITSIC, in January 2006 the IRS and the tax administrations of nine other countries agreed to the establishment of the so-called "Leeds Castle" Group. Under this arrangement, the commissioners of the revenue agencies of China, India, and South Korea agreed to meet regularly with their counterparts from the United States, the United Kingdom, Japan, Australia, Canada, France and Germany to consider and discuss issues of global and national tax administration in their respective countries. By providing additional opportunities to share information and experience, these organizations are a significant tool in combating offshore evasion.

Taking Stock of Information Exchange

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. Moreover, new efforts today may not bear fruit until years from now. For that reason, we are committed to a multi-year approach to expanding our information exchange network. It is important to take a long-term perspective. At times, there have been criticism that we are devoting too much time and resources to expanding our information exchange network; other times we hear that we are not devoting enough. Because this is an area where steady pressure is essential and missteps (or overreaching) can undo years of work, we have to be careful not to disrupt the steady progress we have made.

It is also important to remember that information exchange is inherently voluntary. We cannot force any country to agree to exchange tax information. Sometimes negotiations on this issue are very difficult. The treaty or TIEA partner may be required to repeal or modify domestic law. In addition, signing a tax treaty or a TIEA is only the first step in the process. A healthy information exchange relationship requires us to maintain good relations with our treaty and TIEA partners. Even an ideally drafted agreement is of limited value if the tax authorities do not have a cooperative relationship. For example, if a treaty or TIEA partner believes that the information exchange relationship is not respected or appreciated by the United States, this may have a chilling effect on exchange of information on request or, particularly, on spontaneous exchange of information.

We have more to do in this area. Nonetheless, we have made great strides in recent years. Several new TIEAs have entered into force with jurisdictions that have figured prominently in previously documented accounts of offshore tax evasion. Within the last two years alone, TIEAs have fully entered into force with the Cayman Islands, the British Virgin Islands, the Bahamas, the Netherlands Antilles, Jersey, Guernsey, and the Isle of Man. We also recently signed a TIEA with Brazil, and the newly signed tax treaty with Belgium provides greater information exchange than we have previously been able to achieve with that country.

Moreover, it must be kept in mind that TIEAs and the information exchange article in tax treaties are enforcement tools. Accordingly, there are limits in what we can say publicly about the manner in which we use them and the frequency with which we make requests, without undermining their deterrent effects. The goal is to enforce our laws, and we do not want to convey inadvertently to tax evaders any specific information about how and with whom we exchange information.

However, it is worth noting a few of the public successes that have resulted in part from our information exchange agreements.

- Recently, the U.S District Court in Washington sentenced an individual to nine years in prison for failing to report $365 million in income. This individual, Walter Anderson, had attempted to evade his tax responsibilities by hiding earnings in offshore entities in the British Virgin Islands, Bermuda, the Channel Islands, and Panama. Information that the IRS and Department of Justice gathered through our TIEA with Bermuda helped in the prosecution of this case.

- In 2004, Almon Glenn Braswell was sentenced to 18 months in prison and ordered to pay over $10 million in back taxes, interest and penalties. Mr. Braswell's use of a Bermuda corporation and bank account as part of his tax evasion scheme was uncovered through requests made under our TIEA with Bermuda.

Conclusion

As both Secretary Paulson and Assistant Secretary Solomon stated in recent testimony before this Committee, the Treasury Department is committed to improving tax compliance without unduly burdening honest taxpayers who currently meet their tax obligations. Tax compliance with respect to offshore transactions is an important aspect of that endeavor. By focusing on information exchange, we seek to reduce offshore tax evasion while achieving these goals.

Thank you again, Mr. Chairman, Ranking Member Grassley, and other Members of the Committee for the opportunity to appear before the Committee today. I would be pleased to answer any questions you may have.

WRITTEN TESTIMONY OF JEFFREY OWENS, DIRECTOR, OECD CENTER FOR TAX POLICY AND ADMINISTRATION BEFORE SENATE FINANCE COMMITTEE ON OFFSHORE TAX EVASION
MAY 3, 2007

Chairman Baucus, Senator Grassley, members of the Committee, it is an honor for the Organization for Economic Co-operation and Development[1] to be invited to testify before you today on the subject of offshore tax evasion. Improving compliance, both on and offshore, is a major objective of our member countries and for many other countries.

By way of background, I am the Director of the OECD's Centre for Tax Policy and Administration ("CTPA"). The CTPA's tax experts support the work of the Committee on Fiscal Affairs, which leads the OECD's work on taxation issues. The Committee brings together senior tax policy and tax administration officials from the United States and 29 other member countries. The OECD is widely recognized as the main international standard setting body in the tax area and provides a valuable forum at which governments can exchange views on tax policy issues and develop best practices in the tax administration area.

The Committee on Fiscal Affairs has a long history of helping governments to design international rules to minimize frictions between national tax systems and to avoid double taxation or double non-taxation of cross-border activities. The OECD Model Tax Convention, which incorporates many of these rules, forms the basis for over 2700 bilateral tax treaties around the world. The Committee also provides comparative information and analysis on the operation of tax systems to help governments make informed choices on how best to design their tax systems. Recent examples of the scope of our work include a report on tax reform trends, the tax treatment of foreign direct investment, the taxation of pensions, encouraging savings through tax preferred accounts, taxing wages, and the political economy of environmental taxes. The OECD has also been at the forefront of encouraging countries to deny the tax deductibility of bribes paid to foreign public officials. Over the last four years we have intensified our work on improving the efficiency of tax administrations resulting in the publication of 26 comparative studies and best practice guidelines on topics ranging from taxpayers' rights to audit selection techniques. One of the unique outputs from this work is a comparative analysis of the structure and performance of revenue bodies in more than forty countries. Throughout this work, the OECD involves non-OECD economies and particularly the BRICS (Brazil, Russia, India, China and South Africa) in a variety of ways and we now have twenty-five non-OECD countries that have set out their positions on the OECD Model Tax Convention.

All of this work is intended to help governments design tax systems that encourage economic growth, produce a fair distribution of the tax burden, minimize tax compliance costs for taxpayers and at the same time ensure that taxpayers pay the right amount of tax, at the right time and in the right place. We at the OECD support tax reforms which lower rates and broaden the tax base. We support tax competition that is based on the service provided but not on the basis of secrecy. The OECD has consistently pursued a pro-competition agenda, including in the tax area. Our work on trade and investment liberalization and export credits are just a few examples. Our project on harmful tax practices is aimed at anti-competitive practices. It is focused on promoting international co-operation through exchange of information and providing a transparent, non-discriminatory fiscal environment within which real tax competition can flourish and where competition on the basis of excessive secrecy is eliminated.

[1] The OECD is made up of 30 market-based democracies: All NAFTA members, four Asian-Pacific countries (Australia, Japan, Korea and New Zealand) and 23 European countries. In the tax area, the OECD has regular dialogue with over 70 non-OECD economies.

Offshore tax evasion is a multifaceted problem which requires a variety of responses at both the national and international levels. There is no silver bullet. A long term strategic approach is required to ensure that the right legislative framework is in place, that tax administrations have the necessary information, tools and resources to address the problem and that bilateral and multilateral co-operation is intensified.

I am pleased to be here today to share with you the OECD's work on these issues and some of the solutions adopted in individual OECD countries.

I. OFFSHORE TAX EVASION: A GROWING PROBLEM

Offshore tax evasion is not about small islands that do not impose income taxes: it is about all countries that lack transparency and that are not prepared to cooperate to counter tax abuse. These practices make it difficult for other countries to enforce their own tax laws. With globally integrated financial markets and modern communication techniques the creation of offshore financial accounts, shell companies and the like are just the click of a mouse away. In this context, countries can no longer rely exclusively on their own sources of information to ensure compliance with their domestic tax laws. This is true for all countries, whether OECD or non-OECD, developed and developing, large or small, that rely on income taxes to fund the necessary governmental expenditures voted for by their national legislatures.

In this new era of "banking without borders", wealthy individuals can easily evade capital income taxes in their country of residence by transferring capital abroad and channeling passive investments through offshore jurisdictions. This type of tax evasion is facilitated by the existence of jurisdictions with strict bank secrecy rules which prevent information exchange with the residence country, the increased recourse to foreign institutional investors and shell companies with opaque structures based in offshore financial centers can make it very difficult for domestic tax authorities to track capital income. With the growth of cross-border capital flows, the potential for abuse created by the lack of access to bank information for tax purposes and the resulting adverse consequences have increased exponentially. At the same time, tax authorities find it more and more difficult to monitor foreign portfolio investments of their residents because of the removal of traditional sources of information on these transactions (e.g. exchange controls). Thus, a decision by one country to prevent or restrict access to bank information for tax purposes is now more likely than ever before to adversely affect tax administrations of other countries.

Furthermore, the progressive elimination of withholding taxes at source on non-residents' portfolio investment income allows more and more taxpayers to escape all forms of capital income taxes. Quite often, even when investing in their own countries, resident investors use foreign financial intermediaries and corporate or trust vehicles based in secrecy jurisdictions or offshore financial centers to disguise themselves as non-residents to evade domestic taxes. Thus, for example, an increasing proportion of investment into Asia is channeled through structures established in the British Virgin Islands. Even more significant is the possible use of bank secrecy jurisdictions to escape domestic taxes on income and wealth originating domestically (business income, substantial gains on the sale of assets, inherited wealth, etc.) that represent the "*principal*" of the foreign investment.

We know the offshore evasion problem is big but we do not have a precise estimate of the amount of tax at risk. Given that the main reason that tax evaders go offshore is the secrecy provided to enable them to hide their assets and income from their tax authorities, this is not surprising. We can approach the issue by looking at the size of the offshore sector and its tremendous growth over the last decade:

- Using data from the BIS, IMF and OECD, we estimate that a total of $5-7 trillion is held offshore.
- Brazil reports a commercial deficit of 4 billion dollars with the Caribbean islands.
- Singapore has now joined Luxemburg and Switzerland as the top private wealth centers of the world.

- The Bahamas is now ranked among the top five locations in the world for offshore mutual funds and trust funds and has also developed a significant inter-bank market.
- The Cayman Islands are the world's fifth largest banking center, and the first among offshore jurisdictions, with a prominent position both in the inter-bank business and in private banking.
- The British Virgin Islands has developed into one of the most successful centers for International Business Companies. Conservative estimates put the number of shell companies at over 300,000.

In recent years, the demand for offshore facilities has considerably expanded, owing to the high growth rates of cross-border investment and to the increased number of wealthy and not so wealthy individuals who are prepared to use the new technological and communication infrastructures to go offshore. There is also a growing use of multiple layers of transactions to structure offshore operations through vehicles located in different countries. The gradual relaxation of reserve requirements, interest rate controls and capital controls in the main "onshore" markets and the creation of offshore banking facilities in some of the main industrial countries (the US and Japan) have reduced the regulatory advantages of offshore financial centers, making them less attractive for conventional banking. In some respects, every country has an offshore element On the other hand, the tax avoidance facilities of offshore financial centers have become more and more important, particularly for foreign direct investment and asset management.[2] The limited initial investments needed to enter the offshore industry have induced new countries, especially the smaller ones, to implement the "offshore package" of financial services and asset protection products to compete for internationally mobile capital. As a result, the number of offshore financial centers has grown significantly.

Of course, many of these offshore holdings and arrangements are undertaken for sound commercial and legitimate tax planning reasons, without any intent to conceal income or assets from the home country tax authorities. The experiences of tax authorities, however, lead them to believe that much of this money is there to evade or avoid tax.

Some recent initiatives in OECD member countries bear this out:

- Ireland collected almost 840 million euros ($1.14 billion) from about 15,000 Irish residents hiding undeclared income in offshore bank accounts. This may not seem like a big number in the US context but it amounts to about 8% of total 2006 income tax collected and almost 30% of 2006 income tax collected from self-employed taxpayers. Ireland is currently negotiating tax information exchange agreements with some of these jurisdictions.

- In Italy, a recent tax amnesty resulted in the disclosure of 75 billion euros ($102 billion) in assets held offshore.

- The United Kingdom has just launched an offshore compliance initiative which the accounting firm, Grant Thornton, estimates could bring in 5 billion pounds ($10 billion) in back taxes, interest and penalties, which is almost 4 % of income tax receipts.

- South Africa has estimated that it is losing 64 billion rand ($ 9.1 billion) to tax havens.

- The Australian government recently approved more than $250 million for a multi-agency operation to address the promotion of and involvement in offshore tax evasion schemes. The potential loss of tax revenue from the schemes involving one promoter alone was estimated as exceeding $ 208 million.

[2] With reference to this latter market, the possibility of reducing inheritance and other capital taxes for individual investors acts as a prime incentive and has led to a large expansion in offshore fund management activity, in particular by the use of investment vehicles such as trusts and private companies.

The debate over improving offshore compliance is part of the broader debate on how to narrow the overall tax gap. Our research reveals that only four OECD countries (Mexico, Sweden, the United Kingdom and the United States) regularly publish estimates of the tax gap.[3] Discussions in the OECD's Forum on Tax Administration suggest that tax administrations will never be able to collect every dollar of tax due. In fact, it can be argued that this should not be the goal since the measures required to do this would be so intrusive as to lead taxpayers to revolt.

On the basis of the limited amount of information available, the US tax gap (approximately 14% of the estimated tax base) is consistent with the VAT gap calculated in the United Kingdom,[4] above the overall tax gap estimates in Sweden (6-9%) and significantly below the gap estimates in Mexico (35%).

II. THE BROADER POLICY IMPLICATIONS OF OFFSHORE EVASION

Offshore tax evasion has effects that go beyond the lost revenue of the tax evaded. Offshore tax evasion undermines the fairness and integrity of national tax systems and adversely affects the willingness of the vast majority of law abiding taxpayers to voluntarily comply with their tax obligations. Public attitudes to tax compliance are heavily influenced by perception and the "voluntary" element of compliance can be badly eroded if a minority of taxpayers, usually those with significant incomes, can evade or are perceived to be evading their taxes by hiding assets offshore.

Furthermore, tax evasion by some restricts the ability of governments to lower tax rates for all. As Treasury Secretary Paulson put it recently in testimony before this Committee, "when people fail to pay their taxes, it serves as a de facto tax increase on everyone else." [5]

Competition on the basis of secrecy and lack of tax co-operation reduces global welfare since decisions on where to locate funds are driven by the ease of evasion and not by the true economic return on capital. This is especially true once the gross returns have been adjusted to reflect the often substantial fees of scheme promoters, arrangers, advisors, offshore trustees, nominees etc.

Excessive bank secrecy and a lack of bilateral tax co-operation is particularly serious for developing countries where offshore tax evasion may erode already weak tax bases, which can seriously undermine their ability to make the vital investments in social services and economic infrastructure upon which sustainable economic development depends. Excessive bank secrecy and an unwillingness of countries to cooperate to counter tax abuse undermine the national fiscal sovereignty of other countries. In a global environment, individual governments can maintain sovereignty over the design of their respective tax systems only insofar as they can count on the cooperation of other governments to share information needed to enforce their tax policy choices: choices which reflect their economic, social and political preferences. This is true even for countries that have a territorial system of taxation because income derived in such countries can still be hidden offshore.

[3] One reason why countries are reluctant to calculate any possible tax gap is that there is no agreed methodology to measure the gap. OECD is currently undertaking work in this area.

[4] VAT accounts for 20% of tax revenue in the UK.

[5] Testimony of Treasury Secretary Henry M. Paulson, Jr. before the Senate Finance Committee on Ways to Reduce the Tax Gap, April 18, 2007.

III. COUNTERING OFFSHORE NON-COMPLIANCE

A. OECD Tax Haven Initiative

The removal of barriers to cross-border trade, the liberalization of financial markets and new communications technologies have had very positive effects on global growth but have also opened up opportunities for money laundering, misuse of corporate vehicles, tax abuses and increased the threat to the stability of the financial system. All of these activities thrive in a climate of secrecy, non-transparency, and lack of bilateral and multilateral co-operation. Not surprisingly, the various initiatives launched by the international community to respond to these threats – the Financial Action Task Force, the Financial Stability Forum and the OECD's tax haven initiative -- have focused on improving transparency, exchange of information and other forms of international co-operation.

The OECD has consistently advocated exchange of information between countries as part of tax treaty policy. However, its efforts to promote exchange of information vis-à-vis offshore jurisdictions were stepped up in the context of its harmful tax practices initiative launched in 1998. The initiative looked at both potentially harmful preferential tax regimes in member countries and at tax havens. In 2000, the OECD reinforced this initiative by publishing a new standard of access to bank information for tax authorities, which included a set of measures that needed to be taken by the small minority of OECD countries that did not meet that standard.[6] Given the time constraints, I will not go into the details of all of our work on harmful tax practices or on improving access to bank information for tax purposes. A number of reports on these topics have been prepared over the years and they are available on our website www.oecd.org\ctp. I would also be pleased to provide more detailed information that may be useful to the Committee after today's hearing.

The term "tax haven"[7] is widely used but means different things to different people. For some, it simply means a low or no tax jurisdiction. For others, it means a secrecy jurisdiction. At the OECD, we decided to establish objective criteria to identify tax havens and these can be summarized as follows:[8]

i. No or nominal taxation on the relevant income. Why? Tax cheats generally don't try to hide money in places where it will be subject to significant taxation. No or nominal taxation is the starting point of the analysis but is never sufficient by itself to identify a tax haven.
ii. Lack of effective exchange of information for tax purposes.
iii. Lack of transparency of the tax or regulatory regime (e.g. excessive banking secrecy; inadequate access to beneficial ownership information, etc.) which may limit the availability of, or the access to, information when it is needed for tax examinations or investigations.
iv. Lack of a requirement that activities be substantial (e.g. shell companies).

Lack of transparency and lack of effective exchange of information are the key attractions for tax cheats because they can place their assets in a jurisdiction with these features in the knowledge that information

[6] OECD (2000), *Improving Access to Bank Information for Tax Purposes;* OECD (2003), *Improving Access to Bank Information for Tax Purposes - The 2003 Progress Report.*

[7] Since 2000, the OECD has referred to offshore financial centers that have committed to improve transparency and to establish effective exchange of information as "Participating Partners".

[8] For more details on the definition of the term tax haven see 1998 OECD Report "*Harmful Tax Competition – An Emerging Global Issue*". Switzerland and Luxemburg abstained on the approval of that 1998 Report and their abstentions also apply to any follow up work undertaken. The report is available on www.oecd.org/taxation.

on their activities will not be disclosed to the tax authorities back home. They are also the key factors in identifying tax havens.[9]

Using the criteria referred to above, in 2000 the OECD issued a list of 35 jurisdictions which met the criteria (see Box I). A decision was taken not to include Bermuda, Cyprus, Cayman Islands, Malta, Mauritius and San Marino because prior to the issuing of the list, these jurisdiction made high level political commitments to implement the principles of transparency and effective exchange of information.

Box I

OECD 2000 TAX HAVEN LIST

Andorra	Liberia
Anguilla – Overseas Territory of the United Kingdom	The Principality of Liechtenstein
Antigua and Barbuda	The Republic of the Maldives
Aruba - Kingdom of the Netherlands[1]	The Republic of the Marshall Islands
Commonwealth of the Bahamas	The Principality of Monaco
Bahrain	Montserrat – Overseas Territory of the United Kingdom
Barbados	The Republic of Nauru
Belize	Netherlands Antilles – Kingdom of the Netherlands[1]
British Virgin Islands – Overseas Territory of the United Kingdom	Niue – New Zealand[2]
Cook Islands – New Zealand[2]	Panama
The Commonwealth of Dominica	Samoa
Gibraltar – Overseas Territory of the United Kingdom	The Republic of the Seychelles
Grenada	St Lucia
Guernsey/Sark/Alderney – Dependency of the British Crown	The Federation of St. Christopher & Nevis
Isle of Man – Dependency of the British Crown	St. Vincent and the Grenadines
Jersey – Dependency of the British Crown	Tonga
	Turks & Caicos – Overseas Territory of the United Kingdom
	US Virgin Islands – External Territory of the United States
	The Republic of Vanuatu

[1] The Netherlands, the Netherlands Antilles, and Aruba are the three countries of the Kingdom of the Netherlands.
[2] Fully self-governing country in free association with New Zealand.

The 2000 Report made it clear that the listing was intended to reflect the technical conclusions of the Committee only and was not intended to be condemnatory. Rather, a further list was to be developed for that purpose (the "list of uncooperative tax havens"). Jurisdictions that made a commitment to implement the principles of transparency and effective exchange of information were not to be included on that list. A total of 33 jurisdictions (including Bermuda, Cyprus, Cayman Islands, Malta, Mauritius and San Marino)

[9] Because the lack of substantial activities criterion proved difficult to apply objectively, it was not used as a basis for determining whether a jurisdiction was unco-operative. See (OECD 2001), *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report.*

made such commitments,[10] leaving only five jurisdictions currently on the OECD's list of unco-operative tax havens (Box II).[11]

Box II

OECD LIST OF UNCO-OPERATIVE TAX HAVENS

Andorra	Monaco
Liberia	Marshall Islands
Liechtenstein	

Since the publication of the 2000 list, all the jurisdictions that have made commitments have been invited to participate in the OECD's "Global Forum on Taxation." The discussions in the Global Forum have lead to the development of high standards in the areas of transparency and exchange of information. These standards are embodied in the "2002 Model Agreement on Exchange of Information in Tax Matters" and in the 2006 report, "Tax Co-operation: Towards a Level Playing Field."

The publication of that report, which was the result of collaboration by 82 countries and jurisdictions, represents a major milestone in the international discussions between offshore and onshore financial centers. For the first time, we have available a comprehensive compilation of the transparency and exchange of information practices of these centers. OECD governments' policies towards offshore jurisdictions can now be based upon facts rather than perception of how far each jurisdiction meets the internationally agreed standards for transparency and information exchange in the tax area. Some of the conclusions that emerge from the Report are:

- There are only 5 countries (Cyprus, Hong Kong, Malaysia, the Philippines and Singapore) that require a domestic tax interest in order to obtain and respond to a request from a treaty partner for information.
- Of the countries that are able to exchange information for both civil and criminal tax purposes, the vast majority of the countries reviewed are able to obtain and provide banking information in response to a request for information related to a criminal tax matter in some or all cases. Only three countries (Guatemala, Nauru and Panama) are unable to obtain bank information for any tax information exchange purposes and a small minority of countries limit their exchanges to serious tax fraud (e.g. Andorra, Liechtenstein, Luxembourg and Switzerland).
- 74 of the countries reviewed reported that ownership information is available for companies and 45 countries reported it was available with respect to partnerships. In most cases, legal ownership information is available. Beneficial ownership information is available in an increasing number of countries.
- All countries reviewed treated as confidential any information received pursuant to tax treaties and tax information exchange agreements (TIEAs).

What is clear from the review undertaken is that considerable progress has been made since 2000. For example, Jersey and Guernsey have implemented high standards of transparency and 12 TIEAs have been signed. There is no longer any OECD country where a domestic tax interest, of itself, is an impediment to exchange of information. Many countries have improved transparency by implementing the FATF

[10] The text of every commitment is available on the OECD website. See www.oecd.org/taxation.

[11] Barbados was not included in the list of unco-operative tax havens because it had transparency, was already engaged in effective exchange of information with OECD countries, and because it is willing to enter into tax information exchange arrangements with the OECD countries with which it currently does not have such arrangements. The Committee also subsequently determined that the Maldives and Tonga should not be considered tax havens.

customer due diligence requirements and several countries have recently required bearer shares to be immobilized or held by an approved custodian. Nevertheless, progress is still needed, particularly in the following areas:

(i) Further progress is required in some jurisdictions and countries to address the constraints placed on international co-operation to counter criminal tax abuses. In today's global environment it is essential for all countries to co-operate with other countries in the fight against all financial crimes, including tax crimes, and this requires the implementation of transparency and the establishment of effective exchange of information mechanisms.

(ii) Further progress is required to address those instances where offshore financial centers require a domestic tax interest to obtain and provide information in response to a specific request for information related to a tax matter. A domestic tax interest requirement, particularly in countries with a territorial tax system such as Hong Kong and Singapore, can seriously limit the information that can be exchanged because it is unlikely that the requesting and requested countries will both have an interest in the same information, taxpayer, tax year, etc.

(iii) Although most countries reported being able to obtain bank information for criminal tax matters, four OECD and several non-OECD countries continue to have strict limits on access to bank information which excessively constrain their ability to respond to specific requests for information in civil and criminal tax cases.

(iv) Further progress is required in some countries to ensure that competent authorities have appropriate powers to obtain information for civil and criminal tax purposes. Although the majority of countries have such powers, some non-OECD countries reported limitations on the use of their information-gathering powers to the onshore sector or otherwise lack the power to obtain information for exchange of information purposes.

(v) Most countries have access to legal ownership information of companies, trusts, partnerships, foundations and other organizational structures. Beneficial ownership information is available in a far fewer, but an increasing, number of countries. Further improvement is necessary. A large number of countries still allow bearer shares. In some countries the availability of ownership information is further complicated by the fact that responsibility for corporate law is in the hands of political sub-divisions. Progress in this area is expected to be assisted by countries' implementation of Recommendations 5, 33 and 34 of the FATF Recommendations and other international initiatives (e.g. EU Second and Third Money Laundering Directives[12]).

As a result of the OECD initiative we now have in place globally endorsed standards, a framework for constructive dialogue with offshore centers, a fact-based evaluation of how countries measure up to the standards and countries have the means (i.e. primarily TIEAs) to implement those standards.

Status of TIEA Negotiations

All of the jurisdictions that made a commitment to the OECD agreed to establish effective exchange of information on a bilateral basis with interested OECD member countries. The United States in particular has a long history of trying to improve exchange of information for tax purposes through the use of TIEAs going back to the Caribbean Basin Initiative launched in 1984 by the Reagan administration.

[12] The EU Second Money Laundering Directive has been transposed into the domestic law of all EU Member States. The EU Third Money Laundering Directive has been adopted by the Council of Economic and Finance Ministers and must be transposed into the domestic law of the Member States by December 15, 2007.

TIEAs are not just important because they permit the IRS to obtain, upon request, ownership, accounting, banking and other relevant information, but also because they send an important signal to those considering cheating on their taxes: you can no longer hide behind the veil of secrecy and lack of cooperation. TIEAs have, therefore, an important deterrent effect.

Since 2000, a total of 12 TIEAs have been signed between OECD countries and offshore jurisdictions: the United States has signed nine,[13] Australia three, the Netherlands and New Zealand one each.[14] More than 40 bilateral negotiations are currently ongoing.

Despite this progress, there are a small number of jurisdictions that have systematically refused requests by OECD countries to negotiate TIEAs, even though they committed to doing so. There have also been some jurisdictions that are prolonging the negotiations in the hope of obtaining full tax treaties, even where the jurisdiction does not impose income taxes and there are some countries that still refuse to endorse the standards (e.g. Andorra, Liberia, Liechtenstein, Marshall Islands, Monaco and Singapore). It is now critical to ensure that all negotiations come to a successful conclusion within a reasonable time period. It is also important to recognize those jurisdictions that have implemented transparency and signed TIEAs with effective exchange of information provisions.

The negotiation of TIEAs is a bilateral process that permits the contracting parties to take account of the totality of their bilateral relations, their respective legal systems and practices and their mutual economic interests. In the vast majority of cases where bilateral arrangements exist for effective exchange of information for both civil and criminal tax matters, the parties derive mutual benefits from the arrangement either as a result of a likely balance in the exchange of information or through other benefits. The nature of such benefits would necessarily depend on the legal systems and particular circumstances of the two parties to the arrangement. One of the obvious benefits for a jurisdiction in signing TIEAs is enhancement of its reputation as a legitimate financial center. Some countries, such as Australia and New Zealand, have agreed to include as part of their TIEA arrangements provisions for the allocation of taxing rights with respect to certain types of income earned by individuals (e.g. pensions, government services, students or business apprentices) and have also provided a mutual agreement procedure to deal with transfer pricing adjustments. Canada, as discussed further below, is proposing to extend an exemption from Canadian tax on active foreign source income to income earned in a country that has signed a TIEA. Other countries may consider providing non-tax benefits such as access to universities. What is clear, however, is that OECD countries are generally unwilling to enter into comprehensive tax treaties with tax havens.

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.

[13] Prior to 2001, the U.S. also signed TIEAs with Antigua and Barbuda, The Bahamas, Barbados, Bermuda, Colombia, Costa Rica, Dominica, Dominican Republic, Grenada, Guyana, Honduras, Jamaica, Marshall Islands, Mexico, Peru, St. Lucia, Trinidad and Tobago, and the U.S. Virgin Islands.

[14] See Annex.

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.[15]

Also relevant in this context is the way that the EU has linked the good governance agenda, tax compliance and development by including in their partnership agreements with developing countries in Africa, the Caribbean and the Pacific goals on transparency and effective exchange of information. These agreements have almost €3 billion in the 10th European Development Fund allocated to incentives for implementing good governance:

> *When preparing new cooperation strategies with the ACP [African, Caribbean and Pacific] countries, the Commission will propose granting additional financial support to countries adopting or ready to commit themselves to a plan that contains ambitious, credible measures and reforms.*
>
> ****
>
> *For the Caribbean and the Pacific regions, the Community's priority will be to promote good financial, fiscal and judicial governance. These regions need to rapidly implement OECD standards on transparency and the effective exchange of information for tax purposes and to eliminate harmful tax practices. Special attention will be paid to such problems as money laundering, organised crime and terrorist financing.*

The next year will be crucial in assessing the willingness of jurisdictions to conclude and implement TIEAs. A failure to effectively implement transparency and exchange of information standards will force OECD countries to examine alternative strategies vis-à-vis these countries.

B. <u>OECD Initiative to Strengthen the Article on Exchange of Information in Income Tax Conventions</u>

The OECD's Committee on Fiscal Affairs continues to work on improving both the legal framework and practical aspects of exchange of information. In 2004, the Committee approved revisions to the exchange of information provisions of the OECD's Model Tax Convention. The key changes were to set out explicitly the requirement to exchange information held by banks, financial institutions, nominees or persons acting in an agency or fiduciary capacity and to require the exchange of information notwithstanding that the country requested to provide the information does not have an interest in obtaining the information to administer its own tax laws. The vast majority of OECD countries already can and do exchange banking information --only Austria, Belgium, Luxemburg and Switzerland cannot. OECD is very pleased to see that the new treaty signed between the United States and Belgium on November 27, 2006 does require exchange of bank information when such information is requested for a criminal or civil tax matter. It is the first tax treaty in which Belgium has agreed to such a provision.

The vast majority of OECD countries believed it was important to revise the Model Tax Convention to send a clear signal to all countries including jurisdictions outside the OECD such as Hong Kong and

[15] For example, the US Treasury announced the commencement of TIEA negotiations with Panama in January 2002 and in December 2006 the United States Trade Representative announced the completion of the Free Trade Agreement negotiations with Panama. The U.S.-Singapore Free Trade Agreement entered into force on May 6, 2003 but the United States still has no tax treaty or TIEA with Singapore.

Singapore, that effective exchange of information requires the ability to exchange bank information, whether or not the requested jurisdiction needs the information for its own purposes.

Countries are choosing to reinforce this signal at the national level as well. Canada has just announced in its 2007 Budget Proposal, "To enhance Canada's network for the sharing of tax information, the *International Fairness Initiative* proposes that Canada require that all new tax treaties and revisions to existing treaties (including treaties currently under negotiation) include the new OECD standards in relation to exchange of tax information." http://www.budget.gc.ca/2007/bp/bpc5ee.html

C. OECD Initiatives on Tax Shelters and Aggressive Tax Planning

When 35 tax commissioners met at the OECD's Forum on Tax Administration in Seoul in September 2006, the main focus was on how to improve international tax compliance. The final communiqué stated that

> *Our discussions in Seoul confirmed that international non-compliance is a significant and growing problem. Cross-border non-compliance can take many forms, up to and including outright tax fraud. Individuals have, for example, used offshore accounts, offshore trusts or shell companies in offshore financial centers or other countries to conceal taxable assets or income, as well as credit cards held in offshore jurisdictions to provide access to concealed assets; businesses of all sizes have created shell companies offshore to shift profits abroad often taking recourse to over or undervaluation of traded goods and services for related party transactions and some multinational enterprises (including financial institutions) have use more sophisticated cross-border schemes and/or investment structures involving misuse of tax treaties, the manipulation of transfer pricing to artificially shift income into low tax jurisdictions and expenses into high tax jurisdictions which go beyond legitimate tax minimization arrangements.*

The Forum on Tax Administration, which is chaired by IRS Commissioner Everson, agreed to pursue this work and to also examine the role of tax intermediaries (accountants, lawyers, investment bankers, etc) in promoting unacceptable tax minimization schemes. This work now encompasses the role that intermediaries play – both positive and negative – in the operation of national tax systems. The outcome of this initiative will be presented to the January 2008 meeting of the Forum, which will be hosted by South Africa.

IV. MEASURES USED BY COUNTRIES TO ADDRESS OFFSHORE TAX EVASION

A. Legislative Initiatives

Beyond the international dimension, countries are also acting at the national level by enacting legislation to address the offshore problem. Several countries (both OECD and non-OECD) have enacted measures to deal with their inability to obtain relevant information from offshore jurisdictions. Some of these types of legislative measures were discussed in the 2004 Progress Report on the OECD's Project on Harmful Tax Practices[16] and include:

- The use of provisions having the effect of disallowing any deduction, exemption, credit or other allowance in relation to all substantial payments made to persons located in tax havens except

[16] Available on www.oecd.org/taxation.

where the taxpayer is able to establish satisfactorily that such payments do not exceed an arm's length amount and correspond to bona fide transactions.

- The use of thin capitalization provisions restricting the deduction of interest payments to persons located in tax havens.
- The use of legislative or administrative provisions having the effect of requiring any resident who makes a substantial payment to a person located in a tax haven, enters into a transaction with such a person, or owns any interest in such a person to report that payment, transaction or ownership to the tax authorities, such requirement being supported by substantial penalties for inaccurate reporting or non-reporting of such payments.
- The use of legislative provisions allowing the taxation of residents on amounts corresponding to income earned by entities established in tax havens in which these residents have an interest and that would otherwise be subject to substantially lower or deferred taxes.
- The use of legislative provisions ensuring that withholding taxes at a minimum rate apply to all payments of dividends, interest and royalties made to beneficial owners receiving such payments from entities established in tax havens.

An example of legislative measures targeted at offshore tax evasion can be found in the 2007 Canadian government budget proposal, which includes an "International Tax Fairness Initiative" consisting of the following key elements:

- Enhancing Canada's ability to collect tax information from other jurisdictions, through revised tax treaties and TIEAs with non-treaty countries.
- Modifying the exemption from Canadian tax for foreign-source active business income which is currently limited to income earned in countries with which Canada has a tax treaty, to also include income earned in a non-treaty jurisdiction which has signed a tax information exchange agreement with Canada. This will give non-treaty countries an incentive to enter into TIEAs with Canada, as Canadian companies will then enjoy exempt surplus treatment in respect of active business income earned in that jurisdiction.
- To increase the incentive for countries to enter into TIEAs with Canada, income earned by foreign affiliates in non-TIEA, non-treaty countries will be taxed in Canada as it is earned. In the case of TIEA negotiations that begin after March 19 2007, this treatment will apply if those negotiations are not successfully completed after the passage of five years from the earlier of the commencement of TIEA negotiations and the date on which Canada proposed the negotiations. In the case of a country that is already in the process of negotiating a TIEA with Canada, this treatment will apply if the negotiations are not successfully completed before 2014. Canada will give public notice of its invitations for TIEA negotiations.
- Providing additional funding for auditing and enforcement by the Canada Revenue Agency (CRA).

See http://www.budget.gc.ca/2007/bp/bpc5ee.html for details.

Spain also offers an interesting example of a country that has designed a legislative framework to deal with offshore tax evasion. Spain has established a list of tax havens that currently identifies more than 45 jurisdictions. Spain will automatically remove a jurisdiction from the list when a TIEA with that jurisdiction or a treaty including a provision following Article 26 of the OECD Model Convention on Income and on Capital enters into force.

The Spanish list is used for a range of different tax purposes. For instance, certain rebuttable presumptions are created under Spanish controlled foreign corporation (CFC) rules for entities located in a listed jurisdiction. In such a situation all of the income is presumed to be passive and the tax rate is presumed to be lower than the threshold rate that triggers the application of the CFC rules. The presumption does not apply if the CFC consolidates its accounts with a Spanish resident company.

Spain's list is also used for other purposes:

- The exemption method that applies to dividends received by Spanish resident corporations does not apply to dividends received from entities in listed jurisdictions.
- The thin capitalization rules prohibit resident corporations from applying a debt-equity ratio other than 3 in cases where the shareholders who directly or indirectly provide debt finance to the corporation are residents of a listed jurisdiction.
- The list is used to deny the exemption from withholding tax applicable to interest paid on public debt, including Spanish government bonds.
- Certain specific reporting rules also apply to Spanish resident taxpayers that have operations in, make payments to, or collect payments from properties or shares in listed jurisdictions.
- Dividends from a Spanish holding company that are derived from exempt income are not exempt from withholding tax if paid to a resident in a listed country. The tax exemption that may apply to capital gains derived from the sale of shares in a Spanish holding company is not available to a person resident in a listed country.
- A Spanish resident investor with an interest in a collective investment undertaking resident in a listed jurisdiction is subject to tax on a deemed gain equal to 15% of the acquisition value of the interest unless the taxpayer can demonstrate that that amount is not correct, in which case the investor is taxed on a mark-to-market basis.
- The exemption of income derived by an individual resident in Spain from dependent personal services exercised abroad for a non-resident entity or permanent establishment is not applicable if the entity or permanent establishment is situated in a listed jurisdiction.
- The deduction for investment in non-resident companies is not allowed for a non-resident company that is resident in a listed jurisdiction.
- Payments made to a transparent partnership (entidad en regimen de atribución de rentas) in a listed jurisdiction but without a taxable presence in Spain are subject to withholding taxes at the general rate, regardless of the residency of its partners.

B. <u>Offshore Compliance Initiatives</u>

Countries are establishing wide-ranging offshore compliance initiatives to better detect and deter offshore evasion. Several tax administrations have had recent successes with such initiatives. As mentioned above, in its most recent investigation alone Ireland collected € 840 million from more than 15,000 taxpayers that came forward to make voluntary disclosures. The success was largely based on four factors:

(i) the availability of necessary powers under its domestic legislation,

(ii) a voluntary disclosure system,

(iii) persuading the banks to write to their customers with offshore accounts concerning the proposed government actions and

(iv) an extensive media strategy.

Before commencing the investigation the Irish tax administration approached certain large domestic banks with offshore operations. The banks were advised that their offshore operations would be investigated and were given a date at which investigations would commence. The banks agreed to co-operate and wrote to their customers informing them that an investigation would soon begin. At the same time the tax administration engaged in an extensive media strategy to ensure that all non-compliant taxpayers would be aware of the benefits of the voluntary disclosure regime.

The United Kingdom also has had some notable successes in its offshore investigations. Following two favorable court decisions that permitted the United Kingdom tax administration to obtain records on UK residents with undeclared offshore accounts, the UK on April 17, 2007 launched an "Offshore Disclosure Facility" (see https://disclosures.hmrc.gov.uk/oaics/). The initiative follows a pattern very similar to that used by the Irish tax administration.

Australia is employing a whole of government approach. In 2004, Australia established a multi-agency taskforce known as Operation Wickenby to counter offshore tax arrangements involving tax avoidance or evasion, and in some cases large-scale money-laundering. It combines the investigative powers of the Australian Taxation Office, the Australian Crime Commission (ACC), the Australian Federal Police, the Australian Securities and Investments Commission and the Commonwealth Director of Public Prosecutions, supported by AUSTRAC (Australian Transaction Reports and Analysis Centre), the Attorney-General's Department and the Australian Government Solicitor, to deal with large scale international tax avoidance and evasion. This approach recognizes the similarities in the means used to commit tax crimes and money laundering. By combining the expertise of the different law enforcement agencies involved in combating these crimes, Australia hopes to more effectively address international tax evasion and money laundering. Some examples of the progress made include:

- Arrests/charges:
    - Three company directors were arrested and charged in Southport, Queensland on 20 July 2006 with two counts each of conspiracy to defraud the Commonwealth of some $6.6 million.
    - In another investigation, one person of interest has been charged with a breach of the ACC Act for allegedly refusing to take the oath and take part in an ACC examination.
    - An individual faced court on 1 February 2007 in relation to serious tax offences. While not yet charged, the individual has advised the Court he will plead guilty to tax related offences and is scheduled to face a pre-sentencing hearing in the Victorian County Court on 2 July 2007.
- Legal challenges:
    - Since the establishment of the ACC, 20 challenges have been finalized in the Federal and High Courts in relation to ACC's Operation Wickenby, and the ACC has succeeded in all of those challenges. The ACC is currently defending a number of matters in the Federal Court in favor of the Commissioner of Taxation that disallowed claims for legal professional privilege.
    - There is also an appeal by a taxpayer against a Federal Court decision in favor of the Commissioner of Taxation on legal professional privilege.
- Audits:
    - More than 100 audits have commenced. Assessments totaling $26.95 million have issued with $24.9 million either collected or under payment arrangements.

V. CONCLUDING REMARKS

Without vigorous and coordinated action by governments to ensure that the right legislative framework is in place, that tax administrations have the necessary information, tools and resources to address the problem, and without greater bilateral and multilateral co-operation, offshore tax evasion will continue to grow and undermine the integrity of national tax systems.

No one country by itself can meet this challenge. The next year will be crucial to see how far offshore centers are prepared to move away from financial services based on concealment to legitimate financial services. For those jurisdictions that have already made this move, the international community and individual countries should provide political recognition of this progress and should ensure the further integration of these jurisdictions in the international financial system.

The U.S. has led the way in the signing of TIEAs and must continue to do so because closing one avenue for tax evasion simply redirects evasion to other offshore centers. A very clear example of this is the way Singapore has used the fact that it is not on the OECD list of tax havens and has restrictive exchange of information provisions in its tax treaties to market itself as the ultimate secrecy jurisdiction.

Jurisdictions like Singapore are rightly proud of their international co-operation in combating money laundering but if we are to succeed in the eradication of offshore tax evasion, we must work together to change the perception of such secrecy jurisdictions that it is acceptable in today's global economy to facilitate tax evasion by the residents of other countries. High level political commitment and action is needed to bring about such a change. Countries around the world stand ready to work with the United States to achieve this goal.

ANNEX
TIEAS SIGNED BY CO-OPERATIVE JURISDICTIONS AND UNCO-OPERATIVE TAX HAVENS

Committed Jurisdictions		
Jurisdiction	**Agreements signed with the US**	**Agreements signed with other OECD countries**
Anguilla		
Antigua and Barbuda	Dec. 2000	Australia, Jan. 2007
Aruba	Nov. 2003	
The Bahamas	Jan. 2000	
Bahrain, Kingdom of		
Barbados[17]	Nov. 1984	
Belize		
Bermuda	Dec. 1988	Australia, Nov. 2005
British Virgin Islands	Apr. 2002	
Cayman Islands	Nov. 2001	
Cook Islands		
Cyprus		
Dominica	May 1988	
Gibraltar		
Grenada	Dec. 1986	
Guernsey	Sept. 2002	
Isle of Man	Oct. 2002	Netherlands, Oct. 2005
Jersey	Nov. 2002	
Malta		
Mauritius		
Montserrat		
Nauru		
Netherlands Antilles	Apr. 2002	Australia & New Zealand, March 2007
Niue		
Panama	Commencement of TIEA discussions in January 2002 but negotiations appear to be stalled.	
Samoa		
San Marino		
Seychelles		
Saint Kitts and Nevis		
Saint Lucia	Jan. 1987	
Saint Vincent and The Grenadines		
Turks and Caicos Islands		
U. S. Virgin Islands	Tax Implementation Agreement, 1987	Exchange of information carried out through US tax treaty network
Vanuatu		

[17] See footnote 11 supra.

Unco-operative Tax Havens		
Jurisdiction	**Agreements signed with the US**	**Agreements signed with other OECD countries**
Andorra		
Liberia		
Liechtenstein		
Marshall Islands	Mar. 1991	
Monaco		Tax Treaty with France, May 1963

Committee on Finance
Offshore Tax Evasion: Stashing Cash Overseas
May 3, 2007

Responses to Chairman Baucus' Supplemental Questions
Jeffrey Owens, Director
OECD Center for Tax Policy and Administration

1. In your written testimony, you stated that an estimated $5-7 trillion is held offshore. Could you please describe what is meant by "held offshore" and provide a general description of how you arrived at that estimate?

   I have approached the problem of estimating the size of the offshore evasion problem by looking at assets offshore. The estimate of $5-7 trillion is derived from pulling together figures taken from publications of the IMF, BIS and OECD.[1] *It is not a precise estimate, and is probably on the low side in comparison to some of the figures put out by other organizations (e.g. The Tax Justice Network). One reason why it may appear low in comparison to these other estimates is that it only refers to amounts held in jurisdictions identified by the OECD as tax havens (both co-operative and unco-operative). So for the purpose of this estimate "held offshore" is a more narrowly defined group of jurisdictions than others may be using in their assessments of the amount of funds held offshore. For example, my figures do not include the "offshore" banking activities undertaken by non-residents in, for example, the UK or the US financial markets.*

   I share your frustration in trying to get an accurate measure of the size of the offshore problem but I suspect if we had the information to measure it accurately we would also be able to tax it properly. That is precisely why we have focused on transparency and exchange of information at the OECD. The IRS can only fulfill its tax assessment and collection functions if it has all the information necessary to determine the amount of tax owed.

2. Please comment on the costs and benefits for the United States of blacklisting countries who are not willing to enter into an exchange of information agreement.

   <u>General observations</u>: *One of the primary benefits of entering into exchange of information agreements is the deterrent effect that having such an agreement has on your taxpayers' behavior. In other words, it makes the risk of getting caught*

[1] For a more detailed discussion of some of the measures involved in the size of the offshore sector, see the forthcoming article by myself and Alessandra Sanelli entitled, "Fiscal Heavens in Latin America and the Caribbean," which is reproduced in the "Tax Systems and Tax Reforms in Latin America", University of Pavia, Italy, 2007.

higher and thus has the effect of discouraging offshore tax evasion through the country with which the agreement was signed. Of course, tax cheats can turn to other offshore locations that have not signed such agreements, which is why it is important to have as wide a network of exchange of information agreements as possible. The United States already has a number of TIEAs and most of its tax treaties, though with a few notable exceptions, provide for broad exchange of information.

Where countries refuse to enter into effective exchange of information agreements, or fail to implement them in good faith, other means must be sought to discourage offshore tax evasion through those unco-operative jurisdictions. Incentives, disincentives, or a combination of the two can be used for that purpose. Incentives such as the convention deduction the U.S. Internal Revenue Code allows under section 274(h)(6) for attendance at business conventions in Caribbean Basin countries that have entered into tax information exchange agreements or the Canadian benefits described in my written testimony can provide an impetus for change.

<u>Costs</u>. A blacklist is a powerful tool for encouraging compliance and one which is used by a number of countries but blacklisting has implications that go beyond taxation. For example, it may strain relations between the United States and the blacklisted countries. The cost of that strain will depend on the strength of the current political and economic relations the United States has with the countries blacklisted. Depending on the tax or other consequences you choose to link with the blacklisting, it also may have a cost for U.S. businesses desiring to engage in <u>legitimate</u> business activities in the blacklisted country (e.g. additional reporting or record keeping requirements, additional withholding taxes). Collateral effects on legitimate business could include greater difficulty in obtaining financing or investment for activities in the blacklisted country given that financial institutions and investors may be more reluctant to do business in blacklisted countries.

<u>Benefits</u>. In terms of benefits, a blacklist provides a very strong incentive for offshore centers to sign TIEAs and would send a clear signal to offshore jurisdictions that facilitating U.S. tax evasion will no longer be tolerated. It also would level the playing field for those jurisdictions that have made the sometimes politically difficult decision to co-operate with the United States to exchange information for tax purposes by reducing any competitive advantage that unco-operative jurisdictions may have gained by refusing to exchange information. There may also be other benefits from a tax enforcement and compliance perspective depending on the consequences associated with the list. For example, if additional reporting requirements are imposed with respect to transactions or activities through blacklisted jurisdictions, the IRS may have better information with which to carry out its audit function.

If the United States decides to adopt a blacklisting approach, it should establish objective criteria for including a country on the list as well as criteria for *removing a jurisdiction from the list. Your question suggests that entering into an exchange of information agreement would be the basis for exclusion from the list, an approach followed by other countries (e.g. Chile and Spain).*

Given the OECD member countries' experience with some of the jurisdictions that committed to enter into exchange of information agreements but have thus far refused to do so, it would also be useful to charge the IRS or Treasury with monitoring or certifying the effectiveness of the exchange of information relationship established. This would ensure that the exchange of information agreement is not an empty gesture but an effective compliance tool.

3. Please explain why a country with no income taxation would desire to enter into a double-taxation treaty with the United States and why this would not be beneficial for the United States.

Double taxation treaties are about providing relief from the double taxation that can arise when a resident of one country derives income from sources in another country and both countries, the country of residence and the country of source, try to tax that income. In the absence of such relief, the double taxation could be a disincentive to making cross-border investments and earning the cross-border income, thereby distorting investment and trade.

There is, however, no double taxation to avoid in the case of income flowing into or out of a country that does not impose an income tax. Such a country has little to lose and much to gain by entering into a double tax treaty with the United States.

The main effect of tax treaties is to restrict the taxing rights of one country on income derived from sources in that country by residents of another country. This is generally done in recognition of the fact that the country of residence of the investor will generally tax the relevant income. A source country is unlikely to want to treat nonresident investors better than its own residents and, for that reason, would normally want to ensure that, while double taxation is relieved through its agreement to limit its taxing rights on outgoing income, this is done in a way that ensures roughly comparable levels of overall taxation of foreign and domestic investors with respect to that income.

If one of two countries that are parties to a tax treaty does not have an income tax, limits to source country taxing rights that are imposed by the treaty have no practical consequence as far as its own tax is concerned; the treaty, however, gives significant benefits to its residents who invest in the other country. Conversely, that other country has to limit its own taxing rights as a source country without its residents deriving any practical benefits with respect to income derived from sources in the first country, since such income is already subject to only one tax, that imposed by the investors' country of residence.

Take the example of portfolio dividends. The Internal Revenue Code provides that such U.S. source dividends paid to nonresident alien shareholders are taxed at 30%. Tax treaties typically reduce that rate of source taxation to 15% on a reciprocal basis. Such a reduction would directly benefit a resident of another country which has no income tax who obtains dividends from a U.S. corporation. But the 15% limitation on source taxation would have no practical benefit for a U.S. resident deriving dividends from that other country since that source country simply does not tax dividends and the dividends are taxed only by the United States as the residence country (i.e. the same result as if the treaty did not exist).

However, the conclusion of a tax treaty may also be influenced by other factors such as the overall economic relations and political ties between the two countries concerned. OECD countries have on average 60 tax treaties each. This suggests that they are not willing to conclude tax treaties with every country in the world, but only with those countries with which they have strong economic links or political ties.

A relevant issue when concluding a tax treaty with a country with no income tax is the potential for abuse or "treaty shopping". Residents of third countries could attempt to channel their investments into the United States through legal entities based in the country with no income taxation in order to benefit from the tax treaty on the one hand, and the lack of income taxation on the other. Unless appropriate measures are taken to counter such abuses, such as the anti-treaty shopping ("limitation on benefits") provisions that are common in U.S. tax treaties, treaties concluded with these countries could be used to obtain undue tax benefits.

It is sometimes argued that the treaty provisions on exchange of information can constitute a justification for entering into a tax treaty with a country that does not tax income. The United States, however, has shown that the conclusion of tax information exchange agreements (TIEAs) is one way to secure the exchange of tax information without having to reduce source taxing rights on income that is not taxed in the hands of foreign investors.

4. Please describe the differences between a tax haven and a tax shelter.

At a very general level, a tax haven is a geographic location with certain characteristics whereas a tax shelter is a tax minimization scheme that may or may not involve a tax haven element. As indicated in my written testimony, the term "tax haven" is widely used but means different things to different people. For some, it simply means a low or no tax jurisdiction. For others, it means a secrecy jurisdiction. For purposes of the OECD's efforts to counter harmful tax practices, the objective criteria to identify tax havens can be summarized as follows:

1. *No or nominal taxation on the relevant income. Why? Tax cheats generally don't try to hide money in places where it will be subject to significant taxation. No or nominal taxation is the starting point of the analysis but is <u>never</u> sufficient by itself to identify a tax haven.*
2. *Lack of effective exchange of information for tax purposes.*
3. *Lack of transparency of the tax or regulatory regime (e.g. excessive banking secrecy; inadequate access to beneficial ownership information, etc.) which may limit the availability of, or the access to, information when it is needed for tax examinations or investigations.*
4. *Lack of a requirement that activities be substantial (e.g. shell companies).*

Lack of transparency and lack of effective exchange of information are the key attractions for tax cheats because they can place their assets in a jurisdiction with these features in the knowledge that information on their activities will not be disclosed to the tax authorities back home. They are also the key factors in identifying tax havens.

A tax shelter was perhaps best described by Professor Michael Graetz as "a deal done by very smart people that, absent tax considerations, would be very stupid." The Internal Revenue Code contains a definition of the term in section 6662(d)(2)(c) ("a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax"). In practice, tax havens and tax shelters may be linked in that tax shelters often involve a "tax indifferent party" which may be resident in a tax haven or a low or no tax jurisdiction.

A tax haven is a foreign jurisdiction which you can try to influence but over which you have no real control. Tax shelters tend to be designed by lawyers, accountants, financial institutions and other "tax intermediaries" usually operating within the country in which they are marketing their schemes. As a result, you may have greater influence on their behavior. The OECD's Forum on Tax Administration, headed by IRS Commissioner Mark Everson, launched a project on the role of tax intermediaries in September, which we hope to finalize in January 2008.

5. Please comment on the costs and benefits for the United States of using an information exchange program that requires the automatic exchange of information.

Automatic exchange of information helps to ensure that passive income earned abroad does not escape the tax due in the country of residence. Cross border investors are numerous, their identities are often unknown to the residence country tax authorities and innovations in technology have made it easier for more people (and of a wider spectrum of income levels) to invest or shift assets abroad. As a result, automatic exchange of information can be an effective tool to ensure that foreign earned passive income does not avoid the tax net altogether.

Automatic exchange of information is most effective when the information can be matched systematically with the information in the databases of the residence country. Since the early 1980's, the OECD has been working with its Member countries to develop standardized formats for automatic exchange so as to facilitate the matching of information. In 1981, we released the paper-based format for automatic exchange, which was replaced in 1992 by a standard magnetic format. In 1997, we approved a standard transmission format that allows exchange of information through electronic means, as well as bridging programs to enable countries to exchange information notwithstanding that they may use different formats. By standardizing the formats and providing detailed guidance as to what should be included in the format, we have tried to eliminate many of the difficulties that arise from differences in language, etc. IRS representatives have played an active role in this work.

Foreign source tax information does not generally include the residence country Tax Identification Number (TINs) which is normally used for matching purposes but we are working to improve the use of TINs in automatic exchange of information.

We have also established a technical working group that meets twice a year to continue to improve the operational aspects of automatic exchange and to exchange best practices in this area. In our discussions, we have seen that countries are now starting to use foreign source information received automatically not only for matching purposes but also in a more strategic manner for risk assessment purposes and in particular to select cases for more in depth tax examinations.

<u>Benefits.</u> The main benefit of automatic exchange of information is its powerful deterrent effect. It encourages accurate reporting of foreign source income in the same way that automatic reporting by certain third parties in the domestic context (e.g. financial institutions) encourages greater compliance. In other words, if the taxpayer knows that the IRS will be receiving the income information from the payers of the income (even if the payer is abroad), the taxpayer is more likely to report the foreign income earned because the perceived risk of getting caught for not reporting the income is greater. To the extent that the taxpayer does not report the foreign income, the benefit of automatic exchange is that it provides the IRS with useful information about foreign income earned by its taxpayers that it would otherwise not know about. For example, the Australian Taxation Office's 2004-05 Compliance Program reported that 1171 checks were completed during the 2003-04 tax year, raising approximately US $2.5 million in liabilities.

<u>Costs</u>. The costs will obviously depend on the existing technological infrastructure and the human resources devoted to process and evaluate the foreign source information. The OECD has not carried out a specific cost/benefit analysis but overall, OECD Member countries that engage in automatic exchange generally consider that the benefits outweigh the costs.

The United States has already been involved in automatic exchange of information for a number of years and receives foreign source information automatically from around 20 countries. To improve its use of the information, it should: 1) publicize the fact that it receives information about U.S. taxpayers' foreign earned income (to achieve the deterrent effect); 2) obtain the necessary software programs, etc. to facilitate matching of the information; 3) consider establishing a strategic approach to using the information even where the capacity for fully automated matching is currently lacking; and 4) not rely exclusively on audit personnel to follow up on possible deficiencies identified through information provided automatically by treaty partners. One of the difficulties in relying on audit personnel for this purpose is that they generally have heavy workloads and specific audit plans and timetables to complete audits, which means they have limited capacity to follow up on foreign information that may involve a taxpayer not currently under audit. For these and other reasons, some countries are carrying out initial assessments at headquarters.

COMMUNICATIONS

Beneficial Role of Low-Tax Jurisdictions in the Global Economy

CF&P Foundation Debunks Tax Haven Myths

Testimony Submitted by Andrew F. Quinlan
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To the Senate Finance Committee Hearing on
"Offshore Tax Evasion: Stashing Cash Overseas"

May 3, 2007

Thank you for the opportunity to share my views with you. My name is Andrew F. Quinlan, President of the Center for Freedom and Prosperity Foundation, an Alexandria, Virginia-based, 501(c)(3) citizen organization that educates Congress and the Administration on tax competition, financial privacy and fiscal sovereignty (www.freedomandprosperity.org).

I also coordinate the activities of the Coalition for Tax Competition, which is made up of more than three-dozen free-market public policy organizations, including taxpayer groups, senior citizen and family organizations, civil liberties activists, and industry and business advocates.

The Committee today is holding a hearing on offshore tax evasion. The hearing, including a witness list that does not include a single person representing the interests of taxpayers, is designed to blame so-called tax havens for the tax gap. This is empty political theatre. Offshore jurisdictions are routinely vilified, largely because they are perceived as a threat by politicians, leftist organizations, and other advocates of bigger government and high tax rates. In almost all cases, however, attacks on these low-tax jurisdictions are either baseless or distorted.

Today's one-sided Finance Committee hearing is designed for all intents and purposes to create momentum for policies that will harm American competitiveness. If lawmakers genuinely wanted to reduce tax evasion they would lower tax rates.

To bring balance, I would like to share with the committee the findings of a study released by the Center for Freedom and Prosperity Foundation. The new study punctures some of the myths surrounding tax havens and their role in the global economy. The CF&P Foundation Prosperitas study entitled "Tax Havens: Myth Versus Reality," is designed to be a user-friendly resource for taxpayers, lawmakers, policy makers and journalists seeking an accurate assessment and description of these low-tax jurisdictions. The CF&P Foundation study was written by Dan Mitchell who currently serves as a senior fellow with the Cato Institute.

Tax Havens: Myth Versus Reality

Executive Summary

So-called tax havens are routinely vilified, largely because they are perceived as a threat by politicians, leftist organizations, and other advocates of bigger government and high tax rates. In almost all cases, however, attacks on these low-tax jurisdictions are either baseless or distorted.

Surprisingly, anti-tax haven demagogues generally are unable to even correctly identify the characteristics that make a jurisdiction a "haven." Is it low taxes? Zero taxes? Financial privacy laws? Incorporation laws that do not require ownership information? The existence of bearer shares? And even the critics that use a more carefully tailored definition – i.e., a jurisdiction that exercises its sovereign right to not enforce the tax laws of another nation – often engage in discrimination when listing the world's tax havens.

The United States, for instance, is a tax haven. Foreigners can – and do – put money in the U.S. and earn interest and capital gains without any obligation to pay tax to the IRS and without being reported to their governments. Many states allow foreigners to set up corporations without disclosing ownership information. Some even allow bearer shares. These policies have helped attract trillions of dollars to the U.S. economy, yet critics of tax havens fail – perhaps deliberately – to note how any campaign against tax havens unambiguously can boomerang against America's self interest.

Critics also ignore how tax havens provide confidentiality to ethnic, religious, racial, sexual, and political minorities, a critical role since the majority of the world's population lives in nations have less-than-stellar attitudes toward human rights. Likewise, tax havens also are a refuge for people in nations suffering from crime, extortion, and corruption.

Tax haven opponents routinely rely on shoddy numbers, ignore academic evidence, and engage in smear campaigns. Public policy, however, should not be based in mistruths and stereotypes fostered in novels and movies. And public policy certainly should not be based on politicians in high-tax nations persecuting nations trying to prop up their inefficient welfare states by engaging in anti-globalization policies.

Introduction

While there are alternative definitions, a tax haven is probably best defined as a jurisdiction that meets at least two criteria: First, it will have at least some tax and/or regulatory policies that are market-friendly and those policies will be perceived to attract economic activity from other jurisdictions. Second, it chooses, in at least some cases and within its right as a sovereign entity, not to help foreign governments tax economic activity inside its borders.

So-called tax havens now are being persecuted. Politicians in high-tax nations resent these jurisdictions because globalization has made it much more difficult to impose confiscatory tax rates. Indeed, tax rates have dropped dramatically since 1980, in part because havens have facilitated greater tax competition among nations. To fight against the liberalizing impact of globalization, politicians from high-tax nations have are working through international bureaucracies such as the Organization for Economic Cooperation and Development in a campaign against tax competition.

In other cases, politicians in national capitals are advocating legislation that would penalize tax havens even though the policies often are self-destructive, based on discriminatory blacklists, and completely incompatible with international trade agreements. In all cases, the anti-tax haven efforts are based on an oftentimes-deliberate misunderstanding of the issues.

The following section addresses some of the myths being propagated by opponents of low-tax jurisdictions. Each point is then briefly discussed and one or more links are provided for those seeking background information:

1. **There is not a significant "offshore evasion" problem.**
2. **Financial privacy plays a key role in protecting human rights.**
3. **OECD hypocrisy.**
4. **The US benefits from tax competition.**
5. **International bureaucracies have no moral authority to interfere with national tax laws.**
6. **Fiscal sovereignty is at stake.**
7. **We should mimic tax havens, not persecute them.**
8. **The problem is high tax rates.**
9. **The OECD tax agenda is completely inconsistent with tax reform.**
10. **Tax competition should be celebrated, not persecuted.**
11. **So-called tax havens are less likely to engage in money laundering according to international experts and U.S. government agencies.**

1) There is not a significant "offshore evasion" problem. According to IRS tax gap estimates, there is no number for "offshore." To be sure, there doubtlessly is some evasion, and it probably is assumed in one or more of the other categories in the IRS estimates, but the supposed problem is relatively trivial. A former Democratic staffer named Jack Blum concocted an estimate of $70 billion. When former House Majority Leader Dick Armey asked CRS to get the methodology for the number, Blum confessed, for all intents and purposes, that he made it up.

March 2007, *Cato Institute*, by Daniel Mitchell, The Tax Gap Mirage
http://www.cato.org/pubs/tbb/tbb_0306-44.pdf

Internal Revenue Service, The Tax Gap
http://www.irs.ustreas.gov/pub/irs-utl/tax_gap_facts-figures.pdf
[Note: Focus especially on pages 8 and 11]

July 23, 2001, CRS letter: Blum's Make-Believe Number http://www.freedomandprosperity.org/Papers/blum-crs-ltr.pdf

2) Financial privacy plays a key role in protecting human rights. A huge share of the world's population does not live in civilized nations that respect the rule of law and property rights. Most people are subject to discrimination if they are religious, racial, ethnic, political, or sexual minorities. Others are victimized by corruption, expropriation, or crime. Tax havens provide a refuge to people who need protection. Even the OECD's Jeffrey Owens admitted that "tax havens are essential for individuals who live in unstable regimes." President Clinton's former International tax Counsel acknowledged "the problems of corrupt governments, or danger to your children and to individuals."

December 2005, *The Liberal Institute of the Friedrich Naumann Foundation*, by Daniel J. Mitchell, The Moral Case for Tax Havens
http://admin.fnst.org/uploads/1044/24-OP-pdf.pdf

October 2, 2003, *Cato Policy Analysis No. 491*, "Threats to Financial Privacy and Tax Competition," by Richard W. Rahn and Veronique de Rugy
http://www.cato.org/pubs/pas/pa-491es.html

November 2001, *CF&P Papers*, By Terence Dwyer & Deborah Dwyer, Transparency Versus Privacy: Reflections On OECD Concepts of Unfair Tax Competition
http://www.freedomandprosperity.org/Papers/Dwyer/dwyer.shtml

3) OECD hypocrisy. Many nations belonging to the OECD are tax havens according to the definition concocted by the Paris-based bureaucracy. Moreover, a just-released IMF study identified the UK as a tax haven. Austria, Belgium, and the Netherlands also are tax havens since they have bank secrecy and/or other provisions that make them a magnet for financial capital. And, as discussed below, the United States is perhaps the world's foremost tax haven. In an exercise of gross hypocrisy, the OECD does not blacklist its own member nations.

May 1, 2007 *Financial Times*, Tax haven London
http://www.ft.com/cms/s/86c3040c-f780-11db-86b0-000b5df10621.html

April 23, 2007, *CF&P's Market Center Blog*, An IMF Study Says the UK is a Tax Haven
http://www.freedomandprosperity.org/blog/2007-04/2007-04.shtml#232

April 2007, *IMF Working Paper*, by Ahmed Zoromé, Concept of Offshore Financial Centers: In Search of an Operational Definition
http://www.imf.org/external/pubs/ft/wp/2007/wp0787.pdf

December 8, 2000, *Tax Notes International*, by Marshall J. Langer, Who Are the Real Tax. Havens?
http://www.freedomandprosperity.org/Articles/tni12-18-00.pdf

4) The US benefits from tax competition. Whether it is because foreigners don't pay tax on US-source interest and capital gains, or whether it is because Delaware, Nevada, and Florida companies are among the world's best offshore vehicles, favorable rules for non-resident aliens have attracted trillions of dollars of foreign capital to the US economy. In other words, the US is a tax haven according to the OECD's definition. America should not have to surrender its fiscal sovereignty and give away its competitive position in the way that the left seeks for other "offshore" jurisdictions. This would destroy jobs and weaken financial markets as money flees the US economy.

November 2001, *CF&P Foundation Prosperitas*, The Adverse Impact of Tax Harmonization and Information Exchange on the U.S. Economy, by Daniel Mitchell (Volume I, Issue IV)
http://www.freedomandprosperity.org/press/p11-27-01/p11-27-01.shtml

Treasury data on the immense amounts of capital funneled into the US economy via Caribbean banking centers
http://www.treas.gov/tic/exhibitsa-d.pdf.

Commerce Department data on total foreign capital in the US
http://www.bea.gov/scb/pdf/2006/07July/0706_IIP.pdf
[Note: Focus especially on lines 35-43 on pages 18 and 19 of publication.]

5) International bureaucracies have no moral authority to interfere with national tax laws. The OECD was just exposed in *The Economist* for corruption. A few years ago, the Paris-based bureaucracy was exposed for its lack of transparency and failure to follow proper accounting. The bureaucrats at the OECD get tax-free salaries, and taxpayer-financed pensions that would make a member of Congress blush (not to mention that the OECD even has its own wine cellar). It surely is ironic that people completely insulated from taxation are persecuting nations for free-market tax systems.

April 19, 2007, *The Economist*, An angel flies into some flak: A think-tank's Mexican boss steers his staid agency into turbulent waters
http://www.freedomandprosperity.org/Articles/economist-oecd-04-2007.pdf

September 18, 2000, *The Heritage Foundation: Backgrounder #1395*, by Daniel J. Mitchell, An OECD Proposal To Eliminate Tax Competition Would Mean Higher Taxes and Less Privacy
http://www.heritage.org/Research/Taxes/BG1395.cfm

December 8, 2000, *The Washington Times*, By Daniel J. Mitchell, OECD's glass house (Second of two parts)
http://www.freedomandprosperity.org/Articles/twt12-08-00/twt12-08-00.shtml

January 2006, *CF&P Foundation Prosperitas,* The Paris-Based Organization for Economic Cooperation and Development: Pushing Anti-U.S. Policies with American Tax Dollars (Vol. VI, Issue I)
http://www.freedomandprosperity.org/Papers/oecd-funding/oecd-funding.shtml

6) Fiscal sovereignty is at stake. Ultimately, the issue is whether any international bureaucracy should have a veto right over any jurisdiction's tax policy, including America's. The OECD has self-appointed itself as a global standard setter, but this anti-democratic action is especially dangerous because the OECD's views are contrary to good tax policy. The OECD is not the only bureaucracy seeking to curtail tax competition. The United Nations also is involved. It seeks the creation of an International Tax Organization (UN bureaucrats also get tax-free salaries).

Fall 2000, *Chicago Journal of International Law*, by John R. Bolton, Should We Take Global Governance Seriously?
http://cjil.uchicago.edu/past-issues/v1n2/bolton.html (Abstract)
http://www.westlaw.com/find/default.wl?rs=CLIE3.0&vr=2.0&cite=1+Chi.+J.+Int%27l+L.+205

Fall 2000, *Chicago Journal of International Law*, by John O. McGinnis, The Political Economy of Global Multilateralism
http://cjil.uchicago.edu/past-issues/v1n2/mcginnis.html (Abstract)
http://www.westlaw.com/find/default.wl?rs=CLIE3.0&vr=2.0&cite=1+Chi.+J.+Int%27l+L.+381

November 2005, *CF&P Foundation Prosperitas*, The OECD's Anti-Tax Competition Campaign: An Update on the Paris-Based Bureaucracy's Hypocritical Effort to Prop Up Big Government (Vol. V, Issue II)
http://www.freedomandprosperity.org/Papers/oecd-hypocrisy/oecd-hypocrisy.shtml

January 4, 2004, *CF&P E-mail Update*, Kofi Annan, UN's Secretary General, Endorses International Tax Organization
http://www.freedomandprosperity.org/update/u01-06-04/u01-06-04.shtml#4

February 7, 2002, *Washington Times*, by Daniel Mitchell, U.N. tax police potential
http://www.freedomandprosperity.org/Articles/twt02-07-02/twt02-07-02.shtml

August 2001, *CF&P Foundation Prosperitas*, United Nations Seeks Global Tax Authority , by Daniel J. Mitchell (Volume I, Issue II)
http://www.freedomandprosperity.org/press/p08-02-01/p08-02-01.shtml

7) We should mimic tax havens, not persecute them. Academics have found that tax havens increase growth in non-tax haven jurisdictions. Academics have found that tax havens score better on global governance indicators. Academics have found that tax havens enjoy faster growth than other nations..

June 2006, *CF&P Foundation Prosperitas*, "Tax Havens, Tax Competition and Economic Performance," by Yesim Yilmaz (Volume VI, Issue III)
http://www.freedomandprosperity.org/Papers/taxhavens/taxhavens.shtml

8) The problem is high tax rates. Experts, including those at the IMF, have discovered that tax evasion unambiguously is a function of tax rates. When tax rates are high, taxpayers find ways to avoid and evade. Jurisdictions that have good tax law should not be held responsible when politicians in other nations impose bad tax policy and cause capital flight.

September 2006, *Paper presented at the 8th INFER Annual Conference, University College Cork, Cork, Ireland*, By Friedrich Schneider, Shadow Economies and Corruption all over the World: What do we really know?
http://www.econ.jku.at/Schneider/ShadEconomyCorruption_2006_Pickhardt.pdf

July 30, 2004, *CF&P's Market Center Blog*, High tax rates lead to tax evasion.
http://www.freedomandprosperity.org/blog/2004-07/2004-07.shtml#301

February 28, 2001, *Wall Street Journal Europe*, By James Sproule, International Commentary: Why Are Your Neighbors Paying in Cash?
http://www.freedomandprosperity.org/Articles/wsje02-28-01/wsje02-28-01.shtml

9) The OECD tax agenda is completely inconsistent with tax reform. The OECD seeks to help governments double-tax income that is saved and invested, and to help them enforce this bad tax law on an extra-territorial basis. This means that the OECD, for all intents and purposes, feels compelled to target and penalize jurisdictions that have tax systems (such as the flat tax or the sales tax) that tax income only one time and only tax income inside national borders. This is both because pro-growth tax systems attract jobs and capital from nations with bad tax law and because nations with good law have no reason to collect the information that high-tax nations need to track - and tax - flight capital. If the OECD and other international bureaucracies succeed in becoming self-appointed global tax police, this will at the very least complicate the fight for fundamental tax reform.

February 7, 2002, *IPI Policy Report - # 171*, by Dan Mitchell, Tax Reform: The Key to Preserving Privacy and Competition in a Global Economy
http://www.ipi.org/ipi/IPIPublications.nsf/PublicationLookupFullText/C9BD6A1A962A316D06256B590025A9A9

October 5, 2006, *CF&P Press Release*, As OECD Lobbies for More U.S. Tax Dollars, Senators Ask Paris-Based Bureaucracy to Clarify Misleading Claim About Taxes
http://www.freedomandprosperity.org/press/p10-05-06/p10-05-06.shtml

November 2005, *CF&P Foundation Prosperitas*, The OECD's Anti-Tax Competition Campaign: An Update on the Paris-Based Bureaucracy's Hypocritical Effort to Prop Up Big Government (Vol. V, Issue II)
http://www.freedomandprosperity.org/Papers/oecd-hypocrisy/oecd-hypocrisy.shtml

10) Tax competition should be celebrated, not persecuted. Tax havens play a vital role in constraining the greed of politicians. So-called tax havens have helped encourage high tax nations to reduce personal income tax rates (by about 25 percentage points since 1980) and corporate income tax rates (by about 20 percentage points since 1980). These tax rate reductions, often adopted with great reluctance by politicians in OECD nations, help explain why the global economy is performing so much better than it did in the 1960s and 1970s when tax rates were much more punitive.

The Heritage Foundations 2004 Index of Economic Freedom, by Daniel J. Mitchell, Chapter 2: The Economics of Tax Competition: Harmonization vs. Liberalization
http://www.heritage.org/research/features/index/chapters/pdfs/Index2004_Chap2.pdf

Links to more than 50 letters from current and past Senators and Congressmen praising Tax Competition
http://www.freedomandprosperity.org/congress/congress.shtml

11) So-called tax havens are less likely to engage in money laundering according to international experts and U.S. government agencies. Dirty money generally is laundered where it is obtained, and criminals avoid taking it offshore since that creates a trail for investigators. Tax havens also fully participate in the war against terror and cooperate in the fight against those who violate the commonly shared laws of civilized nations.

January 2002, *CF&P Foundation Prosperitas*, U.S. Government Agencies Confirm That Low-Tax Jurisdictions Are Not Money Laundering Havens, By Daniel J. Mitchell (Volume II, Issue I)
http://www.freedomandprosperity.org/Papers/blacklist/blacklist.shtml

December 3, 2004, *Pace Law Review*, By Daniel J. Mitchell, Fighting Terror and Defending Freedom: The Role of Cost-Benefit Analysis
http://www.library.law.pace.edu/PLR/25-2/Mitchell.pdf

Please visit CF&P Foundation's web page for more information on tax competition, financial privacy and fiscal sovereignty (www.freedomandprosperity.org).

Thank you.

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Isle of Man
Government
Reiltys Ellan Vannin

Senate Finance Committee Hearing
"Offshore Tax Evasion: Stashing Cash Overseas"
May 3, 2007
Statement for the Hearing Record
Submitted by Mary Williams, Chief Secretary Isle of Man Government

Chairman Baucus, Ranking Member Grassley, Members of the Committee, the Isle of Man Government welcomes the opportunity to submit written testimony to your Committee.

The Isle of Man is sometimes called an "offshore" finance centre or, because of its relatively low levels of income taxation, a "tax haven". Such labels are misleading, and may suggest to some a stereotype of secrecy and weak financial regulation. In recent years the Isle of Man has proved to the world that it does not conform to this stereotype.

The Island is not a secret or closed jurisdiction. Unlike some European countries, the Isle of Man has no bank secrecy laws. A number of external and independent assessments of financial regulation have confirmed that the Island co-operates fully in the pursuit of international financial crime, and that its defences against money laundering comply with the highest global standards.

On taxation, the Isle of Man has led the way in co-operating with global bodies like the Organisation for Economic Co-operation and Development ("OECD") to devise new systems for the exchange of information between tax authorities.
The Manx government's policy is to be both internationally responsible and economically competitive. Its taxation strategy is to comply with changing international standards on information exchange and preferential treatment, while lowering the standard rate of income tax for business.

1. Background to the Isle of Man, Its Economy and Political System

1.1 The Island

The Isle of Man, located in the middle of the Irish Sea at the centre of the British Isles, is 33 miles long and 13 miles wide at its broadest point and has a total land area of 227 square miles. The resident population is approximately 80,000. Regular air and sea services connect the Island to a number of destinations across the United Kingdom ("UK") and the Irish Republic. There are no immigration barriers between the Island and the UK or Ireland, but there is a work permit system. People and things native to the Isle of Man are described by the adjective "Manx".

1.2 Constitution and History

The Island was ruled by Norse, Scots and English Kings in the Middle Ages, and by sovereign Lords of Mann from 1406 until 1765, when it was acquired by the British Crown. The Isle of Man has never has been part of the UK or the European Union ("EU"). It is not represented at Westminster or in Brussels.

The Island is a self-governing British Crown Dependency with its own parliament, government and laws. The UK government, on behalf of the Crown, is ultimately responsible for its international relations and the Queen, as 'Lord of Mann', is the Head of State and is represented on the Island by the Lieutenant Governor. The Island has a special and limited relationship with the EU, under an agreement ('Protocol 3') negotiated when the UK joined Europe in 1972, allowing free trade in agricultural and manufactured products between the Isle of Man and EU members. Apart from matters relating to this agreement, including Customs, the Island is not bound by EU legislation and it pays nothing to, and receives nothing from, EU funds.

The Manx parliament, Tynwald, was founded over 1,000 years ago and is the oldest continuous parliament in the world. The Island has no party political system and the leader of its government, the Chief Minister, is chosen by Tynwald after each general election. The Chief Minister selects nine Ministers to head the major government departments and together they make up the Council of Ministers, the central executive body or Manx 'cabinet', which is accountable to Tynwald.

1.3 Economy

The Isle of Man has had one of Europe's fastest growing economies in recent years, led by the international financial services industry. Business is attracted by the competitive tax regime, professional expertise, supportive government, world-class telecoms infrastructure and sound financial regulation. New growth areas include e-commerce, film industry, international shipping, and space and satellite business, while traditional sectors like tourism (and the famous Tourist Trophy motorcycle races) are still important.

In 2004/05 Gross Domestic Product ("GDP") was over £1.4 billion, up 9.1% on the previous year (6.3% real growth – and the 21st successive year of growth in the Island's economy). GDP per head is £17,309 which represents 106% of the UK equivalent. Economic sectors include: financial services (36% of GDP), construction (9%), manufacturing (7%), professional and scientific services (16%), tourism (6%), and farming/fishing (1%). The Island has a working population of 44,000 and an unemployment rate of 1.6%. Inflation is currently 4%. The Isle of Man produces its own notes and coins with the same value as UK Sterling.

1.4 Public Services and Taxation

Growth in the economy has been matched by investment in public services, funded by direct and indirect taxation. The Island is self-financing.

The information which follows is accurate for the tax year commencing on 6th April 2007, subject to Tynwald (the Island's Parliament) approval of certain Orders and Regulations. The Isle of Man tax year runs from 6 April to 5 April.

1.5 Direct Tax Overview

Income Tax and National Insurance (social security) are the two significant direct taxes levied on the Island. National Insurance contributions, classes and rates are structured in a similar way to the UK's system as there is a reciprocal agreement on pensions and health care.

Resident persons (natural and legal) are taxed on worldwide income while non-resident persons are taxed only on Isle of Man source income.

The Isle of Man has a Double Taxation Agreement ("DTA") with the UK[1] and a limited DTA with the United States which covers international shipping.

1.6 Personal Income Tax

The Island's personal income tax system for individuals is as follows:

- All sources of income are taxed on a current year basis of assessment.
- Joint assessment for married couples is available by election.
- Various personal allowances and other deductions from income are available, such as relief for interest, covenanted payments and approved pension arrangements. The main tax-free personal allowance is £8,850.
- Taxable income in excess of allowances is then subject to a standard rate of tax of 10% (residents only) on the next £10,500 and thereafter at the higher rate of 18%.
- A system of deduction of tax at source on earnings called the Income Tax Instalment Payments Scheme (ITIP) is operated, and there is a similar scheme specifically for persons involved in the building industry.
- Where a person's total income is less than their personal allowance, up to £420 is payable directly to them annually as a tax credit.
- Personal income tax is capped at £100,000 (£200,000 for a jointly assessed married couple).

1.7 Corporate Income Tax

Major changes in our corporate income tax system took effect from 6 April 2006:

[1] The Double Taxation Relief (Taxes on Income)(United Kingdom) Order 1995 GC 55/55, amended by the Double Taxation Relief (Amendment) Order 1994 SD 112/94 which was signed on 31 March 1994.

- The standard rate of corporate income tax is 0% on all income, except for two defined activities: (i) a licensed banking business; and (ii) corporate income from Manx land and property (property development, commercial letting and rents and mineral extraction). Corporate income from these two activities is taxed at 10%.

- Corporate income from all other regulated activities, e.g., insurance, fund management etc. are taxed at the standard rate of 0%.

- Special regimes (Non-resident Company Duty, Exempt Companies, Exempt Insurance Companies, Exempt Managed Banks, International Business Companies and other international regimes) were repealed from 6 April 2007. New entrant applications for any of the special regimes were not accepted from 6 April 2006.

1. 8 Indirect Taxes – Value Added Tax

There is an agreement between the Isle of Man and the UK which means that for Value Added Tax ("VAT"), customs and most excise duty purposes the two territories are treated as if one. VAT is charged on most goods and services at a rate of 17.5%. Most of these indirect taxes and duties are pooled and shared. This negates the need for customs barriers between the two countries. Most, but not all, excise duties are covered by the Agreement. Isle of Man legislation exists which mirrors the equivalent UK law where required.

The Island's indirect taxation relationship with the EU is governed by Protocol 3 to the UK's Act of Accession and means that:

- The Island is part of the customs territory of the Community.
- It is not regarded as a third country for customs purposes.
- It is treated as part of the EU internal market for trade in goods (but not services).

EU legislation in most customs matters applies directly. Although EU VAT and excise legislation does not apply in the Isle of Man, the provisions of the relevant Directives are given legal effect through Manx legislation.

1.9 European Union Conformity

The Isle of Man has agreed to apply provisions equivalent to the EU Directive on the Taxation of Income from Savings[2], which entered into force on 1 July 2005. Similar transitional arrangements to those applying in the member states of Austria, Belgium and Luxembourg are in force. In addition, the Island committed to bring its corporate taxation system in line with the principles of the EU Code of Conduct on

[2] Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, published in Official Journal L 157, 26 June 2003, pages 38-48.

Business Taxation[3]. This reform process has now been carried out, with final completion achieved on 5 April 2007.

1.10 Tax : GDP Ratio

While the Isle of Man is perceived, by some, to be a low income tax jurisdiction, the actual tax-to-GDP ratio, calculated using standard OECD methodology, is in fact higher than in many developed nations as the figures below illustrate.

Isle of Man	34%
United Kingdom	36%
Ireland	30%
United States	26%
Japan	26%
EU 15	41%
OECD	36%

1.11. Isle of Man Government Spending

The provision of generous public services and infrastructure within a legislative framework that does not permit a deficit budget, has earned the Isle of Man the coveted AAA credit rating from both Standard and Poor's and Moody's credit rating agencies.

For the 2007 -2008 taxation year, overall Government spending is estimated at £538 million, an increase of £16 million, or 3.1% over the previous year. This funding is used to provide a variety of services to Isle of Man residents, many in excess of those provided in jurisdictions such as the UK. For example:

- The basic pension plus supplements for a married couple, with the wife qualifying on her husband's contribution, is £209.40, some £69.80 per week higher than the basic pensions of £139.60 per week in the UK.
- Free eyesight tests and dental examinations are provided under the Health Service.
- All tuition fees for Island students accepted into Higher Education courses at UK universities are paid by the Isle of Man Government without any required student contribution, while UK students are responsible for their own tuition fees.
- Free public transportation is provided for those over 60 years and pupils travelling to and from state schools.
- During the past decade significant investment has been made in new infrastructure throughout the Isle of Man. In the last five years alone over £500 million have been committed for such projects as a new acute care hospital, an energy-from-waste facility, new sewerage treatment works, improved schools and a new water treatment plant. Construction is continuing on further water treatment works and a new prison.

[3] The Code of Conduct for business taxation was set out in the conclusions of the Council of Economics and Finance Ministers of 1 December 1997. More information is available on: http://europa.eu.int/comm/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm

- The provision of affordable housing for Island residents has been a high priority and some £200 million has been made available for housing schemes that will see more than 1,000 additional homes built before 2010. A further £85 million has been allotted to repair and refurbish public sector housing and £44 million in grants and loans has been provided to construct homes for first-time buyers.

2. Isle of Man's Position in Respect of Exchange of Information

The Isle of Man is an active, constructive and pragmatic participating partner in the OECD Global Forum on Taxation and is acknowledged by the OECD as a responsible International Finance Centre.

Recognising that exchange of information on request is the appropriate international standard, the Island is continuing Tax Information Exchange Agreements (TIEAs) negotiations which are in the Island's interests and of mutual economic benefit.

A TIEA with the United States was signed on 3 October 2002 and was ratified by Tynwald (the Island's Parliament) in April 2006. The TIEA entered into force on 26 June 2006 when the Department of the Treasury confirmed that the United States had completed its internal procedures.

The Competent Authorities in each jurisdiction are working together effectively to ensure all necessary administrative arrangements relating to the TIEA are in place and operating efficiently and professionally.

A TIEA with the Netherlands was signed on 12 October 2005 and was ratified in May 2006. Discussions for the development of a Double Taxation Agreement are under way.

TIEA negotiations are at various stages with 15 other countries, and further new negotiations are expected to commence during 2007. The Isle of Man expects to sign a number of further TIEAs before the end of this calendar year.

In a Press Release dated 12th October 2005, the OECD welcomed the tax information exchange agreement between the Isle of Man and the Netherlands. OECD Secretary-General Donald J. Johnston hailed the agreement as an important step forward in the global effort to detect and deter abuses of the global financial system: "I congratulate both parties for having strengthened their bilateral co-operation to counter tax abuses. This agreement confirms the Isle of Man's commitment to implement high international standards, thereby reinforcing its stature as a responsible international financial centre".

In addition, our Criminal Justice Acts ("CJA") allow us to assist any country where the conduct constituting a taxation offence under the law of that country would also constitute the same or a similar offence under Isle of Man law or where the conduct constitutes serious or complex fraud. The Isle of Man has a good track record of co-operation with the United States in criminal investigations. For example, the District

Attorney of the County of New York, Robert Morganthau, has expressed his view in writing that the Isle of Man is well-regulated and co-operated in assisting his office in investigations.

To illustrate this point, the Isle of Man's Attorney General has provided assistance in relation to the following CJA requests:

Year	Total CJA Requests (tax and non-tax)	Direct Tax Offences	Indirect Tax Offences
2005	71	8	3
2006	58	8	5
2007 to date	10	4	2

The Isle of Man is a jurisdiction which takes its responsibilities seriously in relation to co-operation with other jurisdictions, as the preceding evidence illustrates.

The Isle of Man also believes that it is seen as being so by the appropriate law enforcement agencies in other jurisdictions, including the United States. The Isle of Man is also aware that this is not always the way the situation is portrayed publicly by non-law enforcement bodies in other jurisdictions. As a responsible and co-operative jurisdiction the Isle of Man is acutely aware and sensitive to the need to avoid comment or action which might harm, or make more difficult, the law enforcement investigations of another jurisdiction. However, it is also aware that this stance, albeit responsible, has lead to situations where the maintenance of appropriate restraint in public comment has inhibited the Isle of Man's ability to defend itself and its reputation against incorrect criticisms that portray it as an uncooperative jurisdiction. The Isle of Man is acutely aware that comment has been made in other testimony to the Finance Committee in relation to what is referred to as the "Wyly case". With the consent of the United States Department of Justice ("DOJ"), the Isle of Man is able to confirm that the CJA have recently been used to enable the Attorney General to provide assistance to the DOJ in relation to the "Wyly case". DOJ has commented that it has received nothing but genuine and timely cooperation from the Attorney General.

In 2003 the following statement was made through the U.S. Embassy in London:

> *"US Customs Agents based in the US Embassy in London have confirmed that, contrary to various recent reports, in all their dealings and requests for assistance, the Isle of Man has been fully co-operative and takes an aggressive position in joint investigations involving money laundering and fraud"*

In order to try to ensure that the factual and objective position is made known to the Finance Committee, the Isle of Man states unequivocally that it has adopted and continues to adopt a stance of full, timely and professional assistance to U.S. law enforcement agency requests for information, through duly constituted gateways for the exchange of information. The lack of further comment on any specific case may simply be due to the Isle of Man's awareness of the requirement to avoid prejudicing any ongoing investigation, rather than any lack of co-operation or unwillingness on the part of the Isle of Man to defend its record for co-operation and assistance.

3. Regulatory Framework

A number of international organisations have assessed the Isle of Man's practices against global standards to ensure that they do not present a weak link in the financial system generally. The Island has been shown to be a well-regulated jurisdiction.

The International Monetary Fund ("IMF") has endorsed the Isle of Man's compliance with international standards in such areas as banking, insurance, securities, anti-money laundering and combating the financing of terrorism.

An IMF Report, dated October 2003, states that the regulatory and supervisory system of the Isle of Man complies well with the assessed international standards. The IMF commended the Isle of Man for the attention it has given to upgrading the financial, regulatory and supervisory system to meet international supervisory and regulation standards.

The Island's Financial Supervision Commission is a member of the Offshore Group of Banking Supervisors (of the Basel Committee on Banking Supervision) and of the International Organization of Securities Commissions (IOSCO). The Basel Committee and IOSCO are the main bodies responsible for the setting of international standards in the banking and securities sectors respectively.

The Financial Action Task Force ("FATF") has carried out its own review of the Island's defences against money-laundering. Its positive report concluded that the Island is a co-operating jurisdiction with measures in place which are close to full adherence with FATF recommendations.

The Financial Stability Forum ("FSF") has also considered the effect which offshore centres generally can have on global financial stability. The Isle of Man was placed in the top group of centres reviewed.

The Isle of Man has also worked closely with the United Nations Office for Drug Control and Crime Prevention, particularly in support of its Offshore Initiative.

The Island has received confirmation that it has been moved to a list of countries approved by the U.S. Internal Revenue Service ("IRS") under its Withholding Tax legislation. Broadly, the legislation requires local financial institutions to apply for Qualified Intermediary Status if they wish to invest in U.S. securities and claim exemption from U.S. withholding tax for their clients.

4. Blacklists

The Isle of Man has been labelled in the past either as a "tax haven" or as having "harmful tax practices", or both. Whilst not accepting the legitimacy or methodology that formed the basis of such labelling the Isle of Man nevertheless wishes to ensure that its international reputation is that of a well-regulated country that is prepared to comply with appropriate worldwide economic and fiscal standards. As a consequence, the Isle of Man has played both an active role in, for example, the OECD Global Forum on Taxation and has rapidly updated its domestic legislation and practices to meet international benchmarks.

Certain countries have included so-called "subjective tests" in their fiscal legislation in relation to the OECD "tax haven" list. This list is acknowledged to be out of date. The OECD has now posted a covering memorandum to its 2000 Harmful Tax Practices Report that states:

"The report includes a list of tax havens on page 17. That list should be seen in its historical context and as an evaluation by OECD member countries at a particular point in time of which countries met the criteria set out in the 1998 Report, Harmful Tax Competition: An Emerging Global Issue. 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. This statement does not reflect any judgment on the tax or other policies underlying country lists."

The Committee's attention is respectfully drawn to the testimony of Mr. Jeffrey Owens from the OECD in relation to blacklisting:

> *"Lack of transparency and lack of effective exchange of information are the key attractions for tax cheats because they can place their assets in a jurisdiction with these features in the knowledge that information on their activities will not be disclosed to the tax authorities back home. They are also the key factors in identifying tax havens."*

The Isle of Man has a transparent tax system, provides prompt and effective cooperation to countries which request assistance in accordance with the CJA and is able to provide tax information on the basis of TIEAs.

5. Summary

The Isle of Man is committed to delivering effective regulation. It fully complies with international standards. It is at the forefront of the development by small jurisdictions of a network of TIEAs, based on mutual economic benefit. It has a transparent tax code, and does not have banking secrecy laws. It has shown itself consistently to be a co-operative jurisdiction in terms of the international fight against criminal activity. It should be seen as "part of the solution, not part of the problem".

Submitted May 17, 2007

Senate Finance Committee Hearing
"Offshore Tax Evasion: Stashing Cash Overseas"
May 3, 2007
Statement for the Hearing Record
Submitted by Deputy Mike Torode, Chief Minister of the States of Guernsey

Chairman Baucus, Ranking Member Grassley, Members of the Committee, I have the honour to provide you with this written testimony on behalf of Guernsey on the subject of offshore tax evasion.

Guernsey understands that the main purpose of the hearing was to consider overcoming difficulties caused in collecting U.S. tax revenue as a result of U.S. taxpayers holding assets and conducting transactions outside the United States, particularly in countries that are colloquially and pejoratively referred to by some as "tax havens".

As Guernsey has been included in the list of "offshore secrecy jurisdictions" in bill S.681 introduced by Senator Levin and as a "tax haven country" in bill S.396 introduced by Senator Dorgan, I am grateful for this opportunity to set out Guernsey's views and to comment on information provided in the testimonials to the Finance Committee.

Preliminary

Please note the list of "tax havens" contained in Box I of Mr. Jeffery Owens' testimony (on page 6), and the subsequent revised list at Box II (on page 7). Guernsey does not appear in the latter as a result of its co-operation with the Organisation for Economic Co-operation and Development ("OECD") initiative on harmful taxation.

The OECD stated in its 2006 Global Forum Report on Tax Competition that *"if a country chooses to use a list of countries derived from the OECD list [list of tax havens published in 2000] 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. The 2000 OECD list should be seen in its historical context [the 2000 report described the list as follows: "this listing is intended to reflect the technical conclusions of the Committee only and is not intended to be used as the basis for possible coordinated defensive measures"] and as an evaluation by OECD Member Countries at a particular point in time of which countries met the criteria set out in the 1998 report. More than five years have passed since the publication of the OECD list and positive changes have occurred in individual countries transparency and exchange of information laws and practices since that time."*

In the following testimony, I shall provide some detail on Guernsey's governance and economy, and then outline its involvement in, and cooperation with, various international reviews and initiatives in recent years. In conclusion, I shall comment on the testimony already given.

Introduction to Guernsey

Guernsey is one of the Channel Islands located 60 miles south of the English coast and 30 miles from the west coast of Normandy in France. It has a population of approximately 60,000 and is some 24 square miles in area. The Bailiwick of Guernsey includes the smaller islands of Alderney and Sark which are partially self-governing dependencies of Guernsey. Guernsey criminal law and financial services regulation extends to and is enforced in both.

Guernsey is a dependency of the British Crown. However, it is not part of the United Kingdom ("UK"), England or Great Britain. It is self governing with its own Parliament of 47 members known as the States of Deliberation. It enjoys full independence except in the areas of international relations and defence which are the Crown's responsibility exercised by and through Her Majesty's Ministers. Where international commitments are made on Guernsey's behalf, it must be consulted by the UK in advance. The Island is not represented in the UK Parliament and Acts of Parliament do not apply to it except with Guernsey's consent.

The Crown constitutionally acts by and through its Privy Council which is not a UK Ministry. The UK's Department with responsibility for insular affairs is the Ministry of Justice (formerly the Department for Constitutional Affairs) presided over by a Privy Councillor, presently Lord Falconer.

Guernsey is not a member of the European Union ("EU") but has a special relationship with the EU by virtue of Protocol 3 to the UK's 1972 Treaty of Accession.

Guernsey has domestic competence in legislative and fiscal matters. With respect to Tax Information Exchange Agreements ("TIEAs"), the UK has formally entrusted to Guernsey the right to negotiate, conclude, and implement TIEAs with OECD and EU Member States.

Guernsey is in monetary union with the UK, and hence operates within its banking and payment systems but, at the same time, Guernsey issues its own currency notes and coins.

Guernsey has a strong and diverse economy which includes financial services, light industry, horticulture and tourism. Guernsey's position in the English Channel encouraged its development as a trading community long before its development as a finance centre. That development occurred naturally rather than as a result of governmental decisions to create Guernsey as an international finance centre. It was an attractive place to conduct financial business because of its long history of commercial activity, its political and economic stability, and its relatively low income tax regime (20%). But of course other factors have more recently contributed to this activity, including the development of a skilled and experienced workforce, good communications links and, in particular, a sophisticated and responsive judicial system. Allied to this is a responsive approach of Guernsey's government to assist and encourage reputable business, and to embrace and apply developing international standards of regulation and conduct to such business.

While the economy continues to be predominantly service-sector driven, the financial services sector is dominant and very much tied to global markets. This sector is based on a balanced range of providers broadly comprising: banking; investment funds; insurance; fiduciary services (trust and company administration); pensions and employee benefits; and accountancy and legal services. It has its own independent stock exchange (the Channel Islands Stock Exchange) and a training facility with programs tailored to the needs of its financial service sector. Businesses work with an independent regulator, the Guernsey Financial Services Commission ("GFSC"). Guernsey is committed to meeting international standards.

Guernsey's Regulatory System

The GFSC was one of the world's first unitary regulatory bodies, and is now responsible for the regulation of banks, insurers and insurance intermediaries, investment firms, trust companies, company administrators and company directors in the Bailiwick.

Guernsey is also one of the world's few jurisdictions to regulate company and trust service providers to the same international standards expected for regulating banks, insurers and investment firms. This regulation has been in place since 2000.

In addition, the approval of the GFSC is required to incorporate companies in Guernsey which is one of the world's few jurisdictions where beneficial ownership information is obtained by the authorities. Guernsey company law does not permit Guernsey companies to issue bearer shares. Guernsey does not possess, and never has possessed, secrecy legislation of any kind.

The GFSC is committed to compliance with established international standards on regulation and supports the Attorney General and Guernsey's law enforcement agencies in ensuring the highest standards of criminal justice. This includes the standards established by the Financial Action Task Force ("FATF"), the Basel Committee on Banking Supervision, the International Organization of Securities Commissions ("IOSCO"), the International Association of Insurance Supervisors and the Offshore Group of Banking Supervisors. Guernsey will continue to meet these standards as they develop.

All business entities must meet minimum criteria for licensing contained in the relevant laws. By pursuing a policy of selectivity in vetting new entrants to the finance sector the GFSC has been able to reduce the risks of poor quality businesses being established in Guernsey. The key regulatory issue for the GFSC is whether applicants for licences are fit and proper (that is, whether applicants, their owners and their directors are honest, competent and solvent) and whether licensees continue to be fit and proper.

Guernsey has qualified intermediary status following the U.S. Internal Revenue Service approval of Guernsey's "know your customer" provisions for the purposes of its rules on withholding tax.

International Reviews and Initiatives

A review of financial regulation in Guernsey ("the Edwards Report", posted at: www.archive.official-documents.co.uk/document/cm41/4109/4109.htm) was undertaken in 1998 by the UK Government with cooperation from Guernsey. The Edwards Report identified several key factors, such as stable government, international reputation and a responsive administration which resulted in Guernsey becoming established as an international finance centre. This clearly illustrated, as noted earlier in my statement, that there are a number of non-fiscal factors that have historically attracted businesses to Guernsey.

There have been a number of independent reviews since 1998 that have concluded that Guernsey has a comprehensive anti-money laundering, counter terrorist financing and regulatory system and that this system is enforced. For example, a FATF review, as part of its non-cooperative countries and territories programme in 2000, concluded that Guernsey is a cooperative jurisdiction. Guernsey continues to have in place and enforces a comprehensive and robust regime for cooperating with other jurisdictions.

Indeed, Guernsey's regulatory, anti-money laundering and counter-terrorist financing framework was commended in a report published in October 2003 by the International Monetary Fund ("IMF"). The report shows Guernsey's high standards of compliance with global regulatory, anti-money laundering and counter-terrorist financing standards. Guernsey looks forward to welcoming a further routine review by the IMF in 2008.

Guernsey was assessed by the IMF in 2003 to have a high level of compliance for each of the international standards against which the Bailiwick was judged: the Basel Core Principles for Effective Banking Supervision; the Insurance Core Principles of the International Association of Insurance Supervisors; the Objectives and Principles of Securities Regulation of IOSCO; and the FATF 40+8 Recommendations. Guernsey's legal framework for company and trust service providers was also found by the IMF to be fully consistent with the Offshore Group of Banking Supervisors Statement of Best Practice for Company and Trust Service Providers. All of these standards have been adopted by Guernsey as the foundations on which to build its reputation as a leading finance centre.

The U.S. Department of State stated in its 2007 International Narcotics Control Strategy Report that: *"Guernsey has put in place a comprehensive anti-money laundering regime, and has demonstrated its ongoing commitment to fighting financial crime. Bailiwick officials should continue both to carefully monitor Guernsey's anti-money laundering program to assure its effectiveness, and to cooperate with international anti-money laundering authorities."* This Guernsey is doing energetically.

To ensure that Guernsey continues to be effective against financial crime it has recently commissioned the Police and Customs & Immigration Services to carry out a wide ranging review of their activities in order to ensure that they have sufficient resources, the necessary skills and legislation to effectively and pro-actively counter those who seek to abuse the Island's financial services to place and launder the proceeds of their criminality. This review will further enhance Guernsey's excellent track record of international co-operation particularly with the United States on whose behalf Guernsey has currently restrained approximately $150,000,000 of assets pending the completion of on-going judicial proceedings.

Guernsey also plays an active role within international groups such as The Egmont Group and the Camden Assets Recovery Inter-Agency Network ("CARIN") on which the United States also participate as equal members. Guernsey hosted the Egmont Plenary in 2004.

Guernsey's Relationship with the European Union

Guernsey is not within the EU's fiscal territory nor its single market for financial services. However, within this constitutional context Guernsey's Parliament has repeatedly indicated its willingness to participate in a constructive dialogue about the development of international standards, which must be respected by all jurisdictions. As a matter of high policy Guernsey does not assist the evasion or unlawful avoidance of taxation lawfully due in other territories. Guernsey therefore responded to the elements of the EU Tax Package that were relevant to Guernsey – the Directive on Taxation of Savings and the Code of Conduct on Business Taxation.

In relation to the EU Savings Directive, Guernsey agreed to implement measures equivalent to those in the Directive adopting measures based on a retention (withholding) tax on EU resident individual savings income which provides those investors with the choice to opt out of the tax by authorising disclosure of information to their home authority. Guernsey has since signed 27 bilateral savings tax agreements with each of the EU Member States to implement the measures.

With regard to the Code of Conduct, Guernsey's Parliament, in June 2006, agreed to a revised corporate taxation structure which is fully compliant with the Code.

The OECD and TIEAs

In 2002, following acceptance by the OECD of important principles, Guernsey gave a commitment to enter into agreements to exchange information on request for tax purposes. The principles included recognition by the OECD of the importance of a "level playing field" and that Guernsey already had existing legislation facilitating exchange of information in criminal tax matters. In return, Guernsey undertook to reflect the OECD's principles of exchange of information on request and transparency both in a general political commitment and in TIEAs to be negotiated with individual jurisdictions. Guernsey's first priority for concluding a TIEA was with the United States. A TIEA was signed on 19th September 2002 and has been fully in force for more than a year.

Comments for Consideration by the Finance Committee

Guernsey/United States Tax Information Exchange Agreement

As stated above Guernsey concluded a TIEA with the US, which was signed in September 2002, and came into force fully on 1st January 2006 (the text of the TIEA is posted at: www.gov.gg/tax). At the time of its signing, Treasury Secretary Paul O'Neill made the following comments:

"The United States and Guernsey already have a close and cooperative working relationship on law enforcement matters, including criminal tax matters. We are well aware of Guernsey's commitment to cooperation in targeting criminal tax abuse of the world's financial systems. This new agreement will formalise and streamline our current cooperation in criminal tax matters and will allow exchange of information on specific request in civil tax matters as well. This agreement is an important development, and further demonstrates Guernsey's long standing commitment to cooperating with the United States on law enforcement matters and to upholding international standards in this area. I have spoken on numerous occasions about our obligation to enforce our tax laws, because failing to do so undermines the confidence of honest taxpayers in the fairness of our tax system. Access to needed information is vital to our efforts to ensure enforcement of our laws....Today's agreement with an important financial centre of Europe demonstrates our commitment to securing the cooperation of all our neighbours, not just those near our shore but those more distant too."

This means that Guernsey is able to exchange information, in accordance with the terms of the TIEA, in respect of both civil and criminal tax matters. It should be noted, however, that Guernsey has a long history of providing information to other territories, including the United States in respect of criminal tax matters.

The terms of the TIEA substantially follow the OECD Model TIEA. In summary, Guernsey is able to provide and request information in respect of:

- Information held by banks and other financial institutions, and any other persons, including those acting in an agency or fiduciary capacity (including nominees and trustees); and
- Information regarding the *beneficial* (as opposed to merely legal) ownership of companies, partnerships and other persons.

This information is provided in respect of anyone who is liable to U.S. tax regardless of their residence.

In order to ensure that it had the necessary legislative backing for the TIEA, Guernsey introduced significant additional information-gathering powers. These are contained in Sections 75A to 75Q of the Income Tax (Guernsey) Law 1975, as amended. These rules may be viewed at www.gov.gg/tax.

Information on Guernsey's tax information exchange arrangements and our legal and administrative frameworks for tax purposes can be found in Annex IV of the OECD report on "Tax Cooperation: Towards a Level Playing Field – 2006 Assessment by the Global Forum on Taxation."

In summary therefore, for any circumstances where the United States requires information held in Guernsey for a bona fide tax investigation, the Guernsey authorities have the necessary structure and powers in place to obtain and provide that information.

It should also be noted that Guernsey is currently in discussion with a number of other OECD countries regarding the possibility of concluding further TIEAs. At present, negotiations are ongoing with nine OECD members.

Other Significant Areas of Cooperation with the United States

Guernsey's Attorney General enjoys an excellent working relationship with the U.S. Department of Justice in Washington and with a number of U.S. Attorney's Offices around the country including Florida, New York and Arizona as well as agencies such as the Federal Bureau of Investigation and the U.S. Postal Inspection Service.

Guernsey has assisted with approximately 38 letters of request in the last 7 years. One notable example in 2004 involved the restraint of approximately $144,000,000 either held in, or under administration in, Guernsey. Whilst the defendant was convicted in respect of a number of counts involving fraud and money laundering the case also demonstrates Guernsey's willingness to assist in non-conviction based asset forfeiture actions in the United States, a process in relation to which many jurisdictions do not provide assistance. Indeed, Guernsey's senior prosecutor has been invited during the last two years to attend and participate in the annual conference of the U.S. Department of Justice Asset Forfeiture Department in recognition of the valued cooperation provided.

An example of funds being repatriated involved a case being prosecuted by the South Manhattan District Attorney's Office in 2000 where the sum involved was $1.8 million. District Attorney Robert Morgenthau personally thanked Guernsey for its assistance during a meeting in New York. More recently, requests from Florida and Texas to enforce U.S. forfeiture orders are being actioned that will result in significant sums being sent back to the United States. One example alone involves $2,870,000.

Assistance is also rendered to the U.S. Securities and Exchange Commission in relation to their enquiries into, for example, insider dealing. An application to restrain funds on their behalf is presently being actioned.

I would also refer to a publication showing how states and territories will receive assistance in and from Guernsey which is further evidence of our record of cooperation. The document can be found at www.gov.gg/ccm/cms-service/download/asset/?asset_id=1437010. Statistics provided by Guernsey's Financial Intelligence Service indicate that an average response to a mutual assistance request originating from the United States will receive an initial reply within 3.2 working days.

Comments on Testimony to the Finance Committee

Guernsey notes the testimony given by Acting International Tax Counsel John Harrington and by Jeffery Owens of the OECD. Both are clearly experienced and authoritative professionals in the area of international tax matters, and their views thus warrant careful note.

Both set out important criteria for ensuring effective exchange of information and for determining whether jurisdictions have taken sufficient steps to achieve this.

For example Mr. Harrington emphasized:

- Exchange in both civil and criminal tax matters is needed;
- Information should be available in respect of non-U.S. residents;
- Domestic confidentiality (e.g. bank secrecy) must be over-ridden; and
- There should be no requirement for a domestic tax interest in the country subject to the request.

Guernsey's TIEA with the United States, signed almost five years ago, meets all of these requirements.

Mr. Owens also highlighted secrecy, non-transparency and lack of bi-lateral and multi-lateral cooperation as barriers to improving the efficiency of global tax collecting. As detailed above, Guernsey's efforts in this regard are equal to and, in some cases, better than many OECD centres.

In addition, Mr. Owens helpfully set out (on page 5 of his written testimony) a number of criteria which the OECD believes provide an objective definition of what might constitute a "tax haven". Guernsey clearly does not fall within these criteria, as outlined. Although there are low rates of tax on certain income, as Mr. Owens points out, this alone is never sufficient to categorize a territory as a tax haven.

Guernsey is particularly pleased to note Mr. Owens mention that Guernsey has "implemented high standards of transparency".

The efforts Guernsey has made are also evidenced when considering the areas Mr. Owens also highlights, on page 8 of his testimony, his belief that further work might be needed. Guernsey is already able to fulfil all of these criteria, as a result of its commitment to meeting international standards.

Finally, Guernsey would endorse Mr. Owens' observations:

- That jurisdictions which have already moved to providing "legitimate financial services" should be encouraged and rewarded by political recognition and integration into international financial systems, (on page 15 of his testimony); and
- That it would be counter-productive to blacklist countries (as proposed by Senator Levin's bill), where those countries have worked with OECD and the United States on information exchange.

"Blacklisting" is supported by Professor Avi-Yonah in his testimony, and for the reasons outlined by Mr. Owens, Guernsey would argue that this would be inappropriate, so far as it is concerned, because, as can be seen from the above, Guernsey is a well-regulated and co-operative financial centre. It is therefore suggested that, if the United States Treasury does indeed seek to draft such a blacklist, it should exclude those countries that have concluded a comprehensive TIEA with the United States, including Guernsey. Not only would such action demonstrate the good faith of the United States towards its treaty partners, but it would act as a strong stimulus to those countries and territories who do not meet such standards of cooperation to do so.

Finally, there are one or two aspects of Professor Avi-Yonah's testimony which need clarification at least in so far as they relate to Guernsey.

On page 4 of his written testimony, he suggests that most of the U.S. existing information exchange agreements provide only for criminal tax matters. As has been outlined, Guernsey's TIEA provides for full exchange in respect of civil and criminal tax matters.

On page 6, at paragraph b, he proposes that all TIEAs should be re-negotiated to include automatic exchange, civil tax matters, and to remove secrecy and a requirement for "dual criminality". Whilst the TIEA does not include automatic exchange (and, indeed, in his testimony, Mr. Harrington expressed reservations on the effectiveness of automatic exchange), it does cover the other aspects suggested.

Conclusion

Guernsey's Parliament has formally endorsed and continues to endorse, as part of its key corporate policy, the need to demonstrate responsible and cooperative behaviour with regard to other jurisdictions, global issues and accepted international standards.

It is hoped that the above comments will assist the Committee in its deliberations, and that it can be seen that Guernsey should be regarded as a well regulated, co-operative and responsible international financial centre rather than a "tax haven". In particular, it is suggested in the strongest possible terms that Guernsey's name should not appear on any list of non-cooperative jurisdictions which might in the future be formulated by the U.S. Treasury Department.

We thank the Finance Committee for the opportunity to comment on these globally important issues and look forward to working with the Committee on these matters.

Submitted May 17, 2007

States of Jersey

Senate Finance Committee Hearing
"Offshore Tax Evasion: Stashing Cash Overseas"
May 3, 2007
Statement for the Hearing Record
Submitted by Senator Frank Walker, Chief Minister of the States of Jersey

Chairman Baucus, Ranking Member Grassley, Members of the Committee, I am honoured to provide you with this written testimony on the subject of offshore tax evasion. I do so on behalf of the Island of Jersey which as you may know gave its name to the State of New Jersey. This testimony is submitted in the light of Bills S. 396 and S. 681 and the testimonies submitted to the Committee at the hearing on the 3rd May 2007.

What follows sets out what we do, our commitment to international standards including those concerned with transparency and information exchange, how our financial services regime has been reviewed and accepted as compliant with international standards by a number of international organisations, and the extent of our international cooperation.

<u>Summary</u>

Jersey is a long standing international finance centre providing a wide range of financial and professional services and in compliance with international standards. **It is no part of Jersey's policy to assist directly or indirectly the evasion of taxes properly payable in other jurisdictions. Such business is actively discouraged.**

Jersey has obtained international recognition of its compliance with international standards, and of its cooperation in the pursuit of those engaged in financial crime, including fiscal crime. Jersey is applying standards on a par and in some areas ahead of those in place in major OECD countries.

Jersey has entered into a tax information exchange agreement (TIEA) with the United States which is in accord with the OECD's model agreement on tax information exchange, and which agreement is being effectively implemented.

The Jersey authorities have developed good relationships with the US administration; not just on tax matters, but on financial crime matters generally.

It is important that the action taken by jurisdictions such as Jersey to comply with international standards and to engage in international cooperation should be recognised, and the good relationship that exists with the United States should not be damaged by unfair discriminatory legislation.

Jersey is keen to maintain and enhance the good relationship it has with the United States and will be pleased to extend that relationship to the Senate Committee if invited to do so.

Introduction

The Island of Jersey is located some fourteen miles from the coast of France and eighty-five miles from the coast of England. It is an Island of forty-five square miles in area with a population of nearly ninety thousand people. The Island's economy traditionally has depended on agriculture and tourism. Now, however, the Island's economy is largely dependent on the provision of a wide range of financial and professional services on a worldwide basis and in compliance with international standards.

The Island is a dependency of what is now the British Crown and has owed formal allegiance to the Kings and Queens of England since 1204. It is self-governing with its own legislative assembly, called "The States of Jersey", consisting of fifty-three members. It has no representation in the Westminster Parliament whose Acts only extend to Jersey if expressly agreed by the Island that they should do so. Jersey is not a member of the European Union ("EU") but has a special relationship with the Union which is defined in a protocol attached to the United Kingdom ("UK") Treaty of Accession to the EU. Exercising the prerogative reserved to the Crown, the UK is responsible for the Island's defence and general international representation. A framework for developing the Island's international identity, recently signed by me and by Lord Falconer on behalf of the UK Government, is attached. It records principles which underlie the good relationship between Jersey and the UK.

The Island sets its own taxes, and its fiscal independence is founded on eight hundred years of custom and usage. Successive Monarchs between the 13th and 17th centuries granted to the Island freedom from English taxation. The Island receives no financial assistance from the UK and pays its way in all respects in providing its citizens with public services of an acceptable standard comparable with that provided in neighbouring countries. In recognition of the Island's fiscal independence, the British Government has entrusted the Island with the right to negotiate, conclude and perform international tax agreements. The Island's present income tax system has been in place since 1940 and has as its premise the taxation of those who are resident in the Island and thus within its jurisdiction. It presently includes a maximum rate of tax on the incomes of individuals and corporations of 20% for those who are resident for tax purposes, with exemptions and lower tax arrangements available to those on small incomes. In common with the practice in many other countries, including it is understood the United States, by concession non-residents in receipt of Jersey bank interest are not assessed to tax on that income.

Currently the taxing of incomes accounts for nearly 90% of total tax revenues. However the Island will be making significant changes to its fiscal regime in 2008, including the introduction of a 3% Goods and Services Tax, partly to remain competitive in the light of the lowering of corporate income tax rates by other jurisdictions and partly to meet its good neighbour policy in respect of EU member states. All these changes are compliant with the EU Code of Conduct Group on Business Taxation requirements in respect of the removal of harmful tax practices.

The Provision of Financial Services

The Island has provided financial services for non-residents for at least the past fifty years. Those providing financial services over that period have developed considerable professional expertise. The services provided are complementary to those provided by the City of London with which Island-based financial institutions and professionals work extremely closely. These are legitimate services, no different from those performed in London, New York, Tokyo or Frankfurt which can be said to play an important role in facilitating international investment. The range of financial and professional services provided from Jersey is extensive. In the early years of the Island's development as an international finance centre, private banking and the serving of the interests of individuals predominated. The focus has now changed, and the range of activities has expanded and has become much more corporately/institutionally focussed. The main areas of business now include:

- personal and corporate banking services;
- global custody and security services;
- treasury operations;
- mutual fund management and administration;
- trustee services and company administration;
- investment management and advice;
- bond note and securitisation issuance;
- all classes of insurance and re-insurance;
- pensions and employee benefits; and
- accountancy and legal services.

Contrary to the view often held, the business activity undertaken in Jersey does not arise solely because of the Island's fiscal attractions. Examples of business attracted to the Island for non-tax reasons include the use of a trust vehicle for succession purposes or by those who are resident in jurisdictions with a highly unstable political regime and who wish their assets to be held in a politically stable jurisdiction. The review of financial regulation in Jersey undertaken in 1998 by the UK Government ("the Edwards Report" posted at: www.archive.official-documents.co.uk/document/cm41/4109/4109.htm), with which Jersey cooperated, quoted the following main reasons why business is attracted to Jersey under six main headings:

- Stability - political, economic and fiscal;
- Respectability - selection of business, institutions of stature, comprehensive and up-to-date legislative framework, international regulatory standards;
- Security - secure relationships with the UK and EU, confidentiality for legitimate business through customary law;
- Fiscal - standard income tax rate of 20% and no capital taxes;
- Flexibility - speed of response to market needs, government/industry "partnership", approachability of government; and
- Quality - quality of service reflecting skills/experience of the workforce, the judicial system, high standard of international communication links, proximity to City of London and other European finance centres.

The Island has long taken the view that its long-term future as an international finance centre, upon which the well being of the Island's citizens depends, is best secured by the development of a reputation for quality legitimate business. The Island has never seen the need to enact bank secrecy legislation as other countries have done, and has applied the normal rules of client confidentiality that apply in common law jurisdictions such as the United States.

Jersey has also placed great weight on financial businesses having a physical presence in the Island (i.e., no brass plate banks). The importance attached to a good reputation is also to be seen in the decision taken in the 1970's to licence only banks that are in the world's top 500 banks who also have a concern for their own reputation. At the end of December 2006 Jersey had forty-six licensed banks holding deposits of £190 billion. Jersey's banking services are used mainly by customers drawn from Europe, Africa and the Middle East. Of the total bank deposits only 11% has a North American origin, much of which is inter-bank and other institutional business.

Transparency and Information Exchange

Jersey is extremely concerned at its inclusion in the initial list of offshore secrecy jurisdictions in the Bill S. 681 introduced by Senators Levin, Coleman and Obama "to restrict the use of offshore tax havens and abusive tax shelters to inappropriately avoid U.S. Federal income taxation".

It is stated in the Bill that Jersey has been included in the initial list because it has been previously and publicly identified by the Internal Revenue Service ("IRS") as a secrecy jurisdiction in Federal court proceedings. Jersey has provided the IRS with assistance over the years and has a formal Tax Information Exchange Agreement ("TIEA") with the United States which recognises that "Jersey has long been active in international efforts in the fight against financial and other crimes, including recent efforts against terrorist financing". Jersey would welcome hearing from the IRS on the cases where they have not been able to obtain information from Jersey in respect of Federal court proceedings.

Annex IV of the Organisation for Economic Co-operation ("OECD") report "Tax Cooperation: Towards a Level Playing Field" published in 2006 sets out the status of the legal and administrative frameworks for transparency and exchange of information in the 82 countries reviewed of which Jersey was one. Table A2 in that annex is a summary of the domestic laws that permit information exchange in tax matters. For Jersey the information provided is as follows:

- Fraud Investigation Law – allows for assistance including exchange of information in cases of serious or complex fraud including tax fraud;
- Mutual Legal Assistance Law – allows for assistance including exchange of information in criminal matters, including tax matters;
- Anti-Money Laundering – allows for international cooperation with respect to money laundering which includes the laundering of the proceeds of tax crimes.

Jersey is fully committed to the principles of transparency and information exchange promoted by such international bodies as the OECD, Financial Action Task Force ("FATF") and International Organization of Securities Commissions ("IOSCO").

Third-party endorsements of the Island's compliance with international standards of financial regulation, anti-money laundering and combating financing of terrorism is to be found in:

- The review of the Island's financial regulation undertaken in 1998 by the Edward's Report;
- The FATF style mutual evaluation undertaken in 1999 by a team drawn from the United States, France and Malta which concluded that Jersey was close "to complete adherence" with the then FATF Forty Recommendations;
- The FATF decision in 2000 to exclude Jersey from its list of non-cooperative countries and territories;
- The Financial Stability Forum's ("FSF") decision in 2000 to place Jersey in Group 1 of the Offshore Financial Centres ("OFCs") reviewed. This group included jurisdictions which were described as cooperative, with a high quality of supervision which largely adhere to international standards;

- The International Monetary Fund ("IMF") report in 2003 when the Island was assessed as part of the OFC assessment programme which concluded that the Island was generally compliant with all the main international standards.

Further evidence of the Island's commitment to the principles of transparency and information exchange can be found in:

- The signing of a TIEA with the United States in November 2002. To quote Treasury Secretary O'Neill's statement at the signing ceremony, "The United States and Jersey already have a close and cooperative relationship on law enforcement matters, including criminal tax matters. We are well aware of Jersey's commitment to cooperation in targeting criminal abuse of the world's financial systems. This new agreement will formalise and streamline our current cooperation in criminal tax matters and will allow exchange of information on specific requests in civil tax matters as well. This agreement is an important development, and further demonstrates Jersey's long standing commitment to cooperating with the United States on law enforcement matters and to upholding international standards in this area";

- Jersey's current active engagement in responding to two requests for information from the IRS under the terms of the TIEA. This TIEA covers both criminal and civil tax matters, and is in accord with Jersey's commitment to the OECD in February 2002 to implement the principles of transparency and information exchange enunciated by that organisation and embodied in the OECD Model Agreement on Exchange of Information in Tax Matters. Contrary to the testimony of Avi-Yonah (footnote eleven) the TIEA is fully in accord with the OECD Model Agreement. The TIEA also fully covers the three items referred to in the testimony of John Harrington as essential to the United States when negotiating a TIEA;

- The excellent working relationship, which has continued for many years, between the Law Officers in Jersey and both the Department of Justice ("DOJ") and the District Attorney's office in New York ("NYDA"). Assistance has been given to both the DOJ and the NYDA in many cases over the years; examples are the Hanover Bank case where representatives of the Law Officers worked closely with the DOJ in investigating and providing evidence against two UK fraudsters who were convicted of a multi million dollar prime bank fraud in South Carolina following which substantial sums were later confiscated in the United States; the Enron investigation; and more recently an investigation resulting in an indictment being laid against Paolo Maluf by a Grand Jury in New York on March 8 2007 when NYDA Robert Morgenthau thanked the Attorney General in Jersey and his team, commenting that the investigation was conducted through the cooperation of law enforcement agencies across three continents;

- The excellent Jersey-United States relationship which is illustrated by individual asset sharing agreements arising out of cooperation given in criminal matters. On one occasion the Island was in receipt of a cheque for $1 million delivered personally by the United States Ambassador to the UK as a share of seized assets arising from the pursuit of a money laundering case which was only successful because of information supplied from Jersey; on others, arrangements for sharing have been agreed and Jersey expects to be sending to the DOJ approximately $1.5 million from the local enforcement of an external confiscation order in a drugs case shortly, once some technicalities have been resolved;

- The International Narcotics Control Strategy Report 2007 produced by the U.S. Department of State Bureau for International Narcotics and Law Enforcement Affairs which states "Jersey's authorities have extensive license to cooperate with other domestic and international law enforcement and regulatory agencies...the Bailiwick of Jersey has established an anti-money laundering programme that in some instances exceeds international standards....";

- The acceptance of Jersey for qualified intermediary status. The IRS has approved Jersey's "know your customer" provisions for the purpose of its rules on withholding tax;

- The support extended by Jersey to the EU in the application of the EU Taxation of Savings Income (Council Directive 2003/48/EC) whereby the Island has entered into agreements with each of the twenty-seven EU Member States;

- The current active negotiation of TIEAs with fifteen jurisdictions, many of which negotiations are now very close to being brought to a satisfactory conclusion;

- The testimony of Jeffrey Owens in which he states that "Jersey and Guernsey have implemented high standards of transparency";

- Jersey's acceptance by IOSCO (presently as one of forty-one jurisdictions) as a party to the Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information;

- The 34 Memorandum of Understanding entered into by the Jersey Financial Services Commission with other financial service regulators, which include the US Commodity Futures Trading Commission and the US Securities and Exchange Commission;

- An official declaration of 1990 whereby decisions and recommendations of the OECD extend to the Island, and Jersey is in compliance with the OECD's Codes of Liberalisation of Current Invisible Operations and of Capital Movements.

Jersey is absolutely signed up to the view that international cooperation is essential if those engaged in financial crime, including fiscal crime, are to be successfully pursued. Jersey therefore is an active member of the OECD Sub-Group on Level Playing Field Issues, and is actively involved in the work of the OECD's Global Forum. Jersey fully supports the view expressed by Jeffrey Owens in his testimony to the Finance Committee when he refers to the future progress needed in a number of areas. Jersey fully satisfies the OECD requirements in respect of these areas and looks forward to other jurisdictions achieving the same standards.

In achieving the desired objective on information exchange it is important that there is information to exchange. As the OECD has stated, having information available on beneficial ownership of corporate vehicles (as that term is defined by the OECD, including companies, trusts, foundations, etc.) is of particular importance. Jersey has established high standards in this respect. A critical point to make is that Jersey requires, and has required for over thirty years, that information on the ultimate beneficial ownership is made known to the authorities before a Jersey company can be incorporated. This information is held confidentially but is available to domestic and foreign investigators under appropriate circumstances in accordance with the law. Furthermore Jersey trust and company services providers cannot be in business without a licence granted by the independent regulator, the Jersey Financial Services Commission, among the conditions of which is that the trust and company service provider has in its possession information on the ultimate beneficial owner of the company, or the trustees/beneficiaries of the trust, which they administer, which information is obtainable by the Jersey authorities. This is in marked contrast to the shortcomings in many other jurisdictions, including some political sub-divisions of jurisdictions, to which shortcomings reference is made in Jeffrey Owens' submission.

It is in this respect in particular that the term tax haven is one that defies precise definition. The ability of non-residents to incorporate companies and have those companies administered without information being called for on beneficial ownership, and the opportunity for those non-residents forming such companies to be exempt from liability to tax (e.g. in respect of bank interest) in the countries in which the company is formed and administered, is not something that is limited to those jurisdictions that traditionally have been included in FSF, OECD or IMF lists of OFCs or tax havens. For this reason, the Netherlands, the UK and the United States have been identified by some as tax havens, and professionals in such jurisdictions often promote their company formation/administration services on the grounds that they are able to do all that is traditionally associated with offshore centres but from a jurisdiction that does not have the stigma of that description.

Jersey's view, shared by many commentators in the United States and elsewhere, is that a degree of competition in tax rates can be helpful in encouraging investment and wealth creation. The proper pursuit of transparency and information exchange should not be in conflict with the maintenance of fair tax competition. Such competition together with conditions of tax neutrality, political stability and investor protection, can provide a more favourable investment climate generating investment decisions from which many communities can benefit; and, from Jersey's experience, have benefited.

Conclusion

Jersey agrees with Treasury Acting International Tax Counsel John Harrington when he says in his testimony that there is no one-size-fits-all approach when it comes to fighting tax evasion, not least because there is no easy identification of an OFC or tax haven that allows an objective list of such jurisdictions to be compiled. Thus the OECD has stated in its Global Forum Report on Tax Competition, published in 2006, that "If a country chooses to use a list of countries derived from the OECD list [list of tax havens published in 2000], 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. The 2000 OECD list should be seen in its historical context [the 2000 report described the list as follows: "this listing is intended to reflect the technical conclusions of the Committee only and is not intended to be used as the basis for possible coordinated defensive measures"] and as an evaluation by OECD Member Countries at a particular point in time of which countries met the criteria set out in the 1998 report. More than six years have passed since the publication of the OECD list and positive changes have occurred in individual countries transparency and exchange of information laws and practices since that time." The FSF, which also produced a list of OFCs in 2000, stated in its press release of March 2005 that "with the first phase of the IMF's assessment programme now almost complete, the 2000 list has served its purpose and is no longer operative."

What is required in Jersey's view is for all concerned to focus on the principles of transparency and information exchange and to make sure that through domestic legislation and practice, and information exchange agreements, the principles are fully and effectively applied. Jersey has taken the necessary steps to develop an effective relationship with the United States not just on tax matters but on financial crime generally. It is important that Jersey should be recognised appropriately for the action that it has taken. More particularly it is important that those jurisdictions such as Jersey that have engaged positively with the United States are not disadvantaged by being treated the same as those who have not established such relationships.

It is also important that jurisdictions such as Jersey are not discriminated against by comparison with other jurisdictions engaged in the provision of financial services to non-residents according to some subjective listing under the title of offshore financial centres or tax havens. Such non-discrimination is seen by the Jersey authorities as a key condition upon which the present spirit of cooperation is engendered, maintained and enhanced. To quote from the testimony of Jeffrey Owens "The next year will be crucial to see how far offshore centres are prepared to move away from financial services based on concealment to legitimate financial services. For those jurisdictions that have already made this move, the international community and individual countries should provide political recognition of this progress and should ensure the further integration of these jurisdictions in the international financial system." Jersey made that move some time ago and should have political recognition of this move.

The Jersey authorities are keen to maintain and further enhance the good relationship they have with the United States, and will be more than happy to extend that relationship to the Senate Committee if called upon to do so. As stated by John Harrington in his testimony "A healthy information exchange relationship requires us to maintain good relations with our treaty and TIEA partners. Even an ideally drafted agreement is of limited value if the tax authorities do not have a cooperative relationship. For example, if a treaty or TIEA partner believes that the information exchange relationship is not respected or appreciated by the United States, this may have a chilling effect on exchange of information on request or, particularly, on spontaneous exchange of information". Jersey is determined to work to strengthen the existing good relationship with the United States and is confident that its endeavours will be fully reciprocated because this will be to our mutual advantage.

Submitted 17 May 2007

ANNEX

Framework for developing the international identity of Jersey

Following the statement of intent agreed on 11 January 2006, the Chief Minister of Jersey and the UK Secretary of State for Constitutional Affairs have agreed the following principles. They establish a framework for the development of the international identity of Jersey. The framework is intended to clarify the constitutional relationship between the UK and Jersey, which works well and within which methods are evolving to help achieve the mutual interests of both the UK and Jersey.

1. The UK has no democratic accountability in and for Jersey which is governed by its own democratically elected assembly. In the context of the UK's responsibility for Jersey's international relations it is understood that -

   - The UK will not act internationally on behalf of Jersey without prior consultation.
   - The UK recognises that the interests of Jersey may differ from those of the UK, and the UK will seek to represent any differing interests when acting in an international capacity. This is particularly evident in respect of the relationship with the European Union where the UK interests can be expected to be those of an EU member state and the interests of Jersey can be expected to reflect the fact that the UK's membership of the EU only extends to Jersey in certain circumstances as set out in Protocol 3 of the UK's Treaty of Accession.

2. Jersey has an international identity which is different from that of the UK.

3. The UK recognises that Jersey is a long-standing, small democracy and supports the principle of Jersey further developing its international identity.

4. The UK has a role to play in assisting the development of Jersey's international identity. The role is one of support not interference.

5. Jersey and the UK commit themselves to open, effective and meaningful dialogue with each other on any issue that may come to affect the constitutional relationship.

6. International identity is developed effectively through meeting international standards and obligations which are important components of Jersey's international identity.

7. The UK will clearly identify its priorities for delivery of its international obligations and agreements so that these are understood, and can be taken into account, by Jersey in developing its own position.

8. The activities of the UK in the international arena need to have regard to Jersey's international relations, policies and responsibilities.

9. The UK and Jersey will work together to resolve or clarify any differences which may arise between their respective interests.

10. Jersey and the UK will work jointly to promote the legitimate status of Jersey as a responsible, stable and mature democracy with its own broad policy interests and which is willing to engage positively with the international community across a wide range of issues.

Signed 1 May 2007

Secretary of State for Constitutional Affairs

Chief Minister, Jersey