HEARING ON BANKING SECRECY PRACTICES AND WEALTHY AMERICAN TAXPAYERS

HEARING

BEFORE THE

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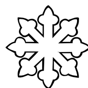

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HEARING ON BANKING SECRECY PRACTICES AND WEALTHY AMERICAN TAXPAYERS

TUESDAY, MARCH 31, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:03 a.m. in room 1100, Longworth House Office Building; Hon. Richard E. Neal (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE CONTACT: (202) 225–5522
March 24, 2009
SRM–1

Neal Announces Hearing on Banking Secrecy Practices and Wealthy American Taxpayers

House Ways and Means Select Revenue Measures Subcommittee Chairman Richard E. Neal (D–MA) announced today that the Subcommittee on Select Revenue Measures will hold a hearing on issues involving banking secrecy practices and wealthy American taxpayers. **The hearing will take place on Tuesday, March 31, 2009, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

Oral testimony at this hearing will be limited to invited witnesses. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

FOCUS OF THE HEARING:

The hearing will focus on limitations of the withholding taxes imposed by the United States on U.S. source investment earnings received by foreign persons, the Qualified Intermediary (QI) program established by the IRS to enforce those withholding taxes, the limitations of our tax treaties, and the extent to which these may have contributed to non-compliance by U.S. taxpayers. It will use the current UBS case as an example of the problems in the existing system.

BACKGROUND:

The United States imposes withholding taxes when U.S. source investment earnings are paid to a foreign person. Those withholding taxes were largely designed to collect tax on income earned in the United States even though the income is earned by a foreign person not subject to the jurisdiction of our laws. Those withholding taxes also play a role in preventing non-compliance by U.S. persons holding investment assets in accounts overseas.

The IRS has established the QI program that authorizes foreign financial institutions to collect withholding taxes on behalf of the U.S. Government. The program was implemented to improve compliance for tax withholding and reporting on U.S. source income that flows offshore through foreign financial institutions. The recent UBS case indicates that there are problems with the QI program that permitted tax avoidance by U.S. persons. Further, even with jurisdictions in which the United States has a tax treaty, effective information exchange can sometimes be undermined by local laws providing for banking secrecy that conflict with U.S. law.

According to the most recent tax year data available (2003), more than $293 billion in U.S. source income was sent to individuals and businesses residing abroad. Much of this money flows through U.S. withholding agents, but some also flows through QI's. Both U.S. withholding agents and QI's are responsible for withholding taxes, and in the absence of proper identification, must do backup withholding. Recently, the GAO found that withholding on these accounts was much lower.

In announcing the hearing, Chairman Neal stated, **"This will be our first hearing to address the troublesome issue of international tax avoidance. The global economic and financial crisis has put pressure on these inter-**

national jurisdictions to be less secretive and more cooperative. The United States and other countries simply can no longer afford to lose billions of dollars each year in potential revenue to these secrecy jurisdictions. I expect this hearing to be the start of a process that leads to bold and decisive action being taken to end opportunities for tax avoidance through foreign accounts."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, http://waysandmeans.house.gov, select "*Committee Hearings*." Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record*." Once you have followed the online instructions, complete all informational forms and click "submit" on the final page. ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business **Tuesday, April 14, 2009. Finally,** please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

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1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at http://waysandmeans.house.gov

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman NEAL. Let me call this hearing to order.

I encourage all to take their seats. I want to welcome all of you this morning to this hearing of the Select Revenue Measures Subcommittee on the issue of bank secrecy and tax avoidance.

President Kennedy noted that the very word "secrecy" is repugnant in a free and open society. Fostered by today's technology those comments are truer than ever, but bank secrecy has long held a certain charm. In fact, mystery writers have utilized the

Swiss Bank as the central focus of intrigue. Where else would you think to store the secrets of the holy grail but in a Swiss bank account, as was the case in the novel the "Da Vinci Code".

But events of the last year have chipped away at this polished veneer to reveal some rather unseemly criminal behavior. It's been 1 year now since a Swiss banker admitted that he and his bank assisted, wealthy U.S. taxpayers in hiding money in offshore accounts that number somewhere between 250 and 50,000 previously hidden U.S. accounts.

The bank has not denied its part and will pay a $780 million fine. Despite the best efforts of the IRS and the Justice Department, the names of those U.S. taxpayers have not been divulged. Swiss law has prevented the bank from doing so, and the treaty is of no help. It seems that there are fewer and fewer willing to stand up for such confidentiality in the face of criminal behavior. On the eve of the gathering of leaders of the wealthiest nations, who, incidentally, generate 80 percent of the world's wealth, the short list of international issues to be discussed includes tax havens. And when Prime Minister Brown, Gordon Brown, addressed the congress in a joint session earlier this month, he singled out off-shore tax havens as a threat and received bipartisan applause.

Secretary Geithner just last week stated the Treasury will be launching a new initiative on tax havens, one to be underscored by the President at the G20 meeting this week. The international effort to pressure uncooperative tax havens will be a diplomatic battle, but Congress must be a partner in this effort, and this hearing today will explore issues relating to withholding and reporting, the role of foreign banks in the collection of U.S. taxes, and how we can better utilize tax treaties and agreements, which I happen to think constitutes the key.

It is my hope that this hearing will provide us some guidance to enhance and strengthen the current system, the system, which according to one witness today allows $50 billion of lost tax revenue per year. Following this debate, I'm hopeful that we can file bipartisan legislation to implement the recommendations we hear today. Now, let me recognize my friend, Mr. Tiberi, for his opening statement.

Mr. TIBERI. Thank you Chairman Neal. Thank you for your leadership.

I share many of the concerns that you outlined in your statement and look forward to working together on responsible, common-sense steps that will make our efforts to crack down on individuals who commit tax fraud more effective. Thank you also to our witnesses. I appreciate your willingness to join us today and look forward to your testimony.

Tax evasion through the use of undeclared off-shore bank accounts or by any other means is a Federal crime. I think we all are in agreement here today that criminal tax evasion should be pursued aggressively and punished. Not going after the dishonest few who commit criminal acts to the fullest extent possible is unfair to honest, hardworking Americans who pay their taxes and strive to comply with our country's tax laws.

The ongoing events surrounding UBS AG and its admitted criminal role in helping a number of wealthy U.S. individuals evade U.S.

taxes have brought a spotlight to bear on international tax enforcement and the tools that we have at our disposal to help ensure compliance. Among those tools is the qualified intermediary program; and under the QI program, foreign financial institutions agree to verify the status of foreign investors and collect and remit the appropriate U.S. withholding tax, if any. Recent events have demonstrated a number of areas where the QI program may be strengthened. I hope that we will discuss some of those today.

Additionally, the U.S. has entered into dozens of tax treaties, and bilateral mutual legal assistance treaties with other nations as well as approximately 20 tax information exchange agreements. In short, the United States is not alone in the effort to ensure the compliance with our tax laws. A number of frameworks currently exist across government in the private sector. As we proceed with this discussion, we should keep in mind that there are willing partners on the international front and continuing to improve the work through our formal network of information exchanges, which is the responsible way to move forward.

Steps that undermine our international standing could threaten key information exchanges and invite unintended consequences that could do significant harm to our economy's capital markets. This hearing is an important opportunity to examine the serious tax compliance issues we face, find out where our current enforcement regime may have fallen short, explore new tools that may help us fight tax evasion, and close the international tax gap. As we all know the tax gap is defined roughly as what is legally owed, but not collected.

I sincerely hope our efforts today will remain focused on the issues of compliance. The line between illegal tax evasion and legal tax practices used by U.S. taxpayers around the world is distinct. To blur that line may only make our compliance efforts that much more difficult.

Thank you again, Chairman Neal, and thank you for your leadership on this important issue.

Chairman NEAL. I thank the gentleman for his good comments, and let me welcome our witnesses here today on our first panel, the Honorable Doug Schulman, Commissioner of the Internal Revenue Service.

Thank you, Commissioner, for joining us today.

I want to advise Members that the Commissioner may not be able to answer specific questions regarding pending legal matters, including the UBS case. I know the Members of the panel here, they're likely to try any way.

On our second panel, we will hear from Stephen Shay, a tax partner at Ropes & Gray in Boston, who was formerly the International Tax Counsel at the Treasury Department.

And we will also welcome back to the Subcommittee Professor Avi-Yonah of the University of Michigan Law School who was a recognized expert in international tax issues, and has served as a consultant to the Treasury Department and OECD.

Finally, we will hear from Peter Blessing, a law partner at Sherman and Sterling in New York. Mr. Blessing specializes in international tax issues and we are fortunate to have his expertise here today.

Let me note, for the record, that we did extend an invitation to the Swiss government and to UBS to appear before the Subcommittee today, both respectfully declined.

Without objection, any other Members wishing to insert statements as part of the record may do so. All written statements by the witnesses will be inserted into the record as well. I'd like to recognize Commissioner Schulman for his opening statement.

STATEMENT OF HON. DOUGLAS SHULMAN, COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. SHULMAN. Thank you, Mr. Chairman, Ranking Member Tiberi, Members of the Subcommittee.

It's a pleasure to be here today to talk to you about the unprecedented focus that the Internal Revenue Service has placed on detecting and bringing to justice those who unlawfully hide assets overseas to avoid paying tax.

In today's economic environment where the Federal Government is necessarily running deficits to restore economic growth, it's more important than ever that citizens feel confident that individuals and corporations are playing by the rules and paying the taxes that they owe. When the American public is confronted with stories of financial institutions helping U.S. citizens to maintain secret overseas accounts involving sham trusts to improperly avoid U.S. tax, they should be outraged, as am I. But they should also know that the U.S. Government is taking unprecedented measures and there is much more in the works.

As you know, Mr. Chairman, Federal law prohibits the disclosure of information about civil and criminal tax investigations. While the Subcommittee may have seen press accounts and documents entered in the public record about some recent investigations, these relate to ongoing civil litigation where the strategies, techniques and opinions of the IRS, and I might note specifically the IRS Commissioner, are central elements to the litigation; and, therefore, the Department of Justice has asked that I not comment on the UBS case specifically.

With all the recent publicity, the press has also been full of speculation about those who are advising U.S. taxpayers who have undeclared offshore accounts and income. My advice to those taxpayers is simple. They should come in under the IRS' voluntary disclosure program. We have been steadily increasing pressure on offshore financial institutions that facilitate concealment of taxable income by U.S. citizens, and that pressure will only increase.

The IRS recently issued guidance to its exam personnel who are addressing voluntary disclosure requests involving unreported offshore income. We issued this guidance to make sure that our personnel had standard procedures when someone voluntarily came in. We believe that this is firm but fair resolution of these cases. Taxpayers who come in will pay a significant price, but they will also avoid criminal prosecution if they come in voluntarily.

Mr. Chairman, there is no silver bullet or one strategy that will alone solve the problem of offshore tax avoidance. Rather it's an integrated approach that we have been developing. My written testimony explores a variety of elements of that approach. Let me highlight a few. First, since becoming Commissioner, I have made inter-

national issues a top priority. I have both increased the number of audits in this area and prioritized stepped-up hiring of international experts and investigators.

We have had some success with some high profile cases that you mentioned and we're getting some other results. Several so-called tax haven countries have pledged to reform bank secrecy laws, and in the last month have agreed to comply with international standards for tax and data sharing. The President's 2010 budget will allow us to increase our resources in this area and it includes robust funding for a portfolio of IRS–International tax compliance initiatives.

The IRS is also looking at how to improve the qualified intermediary program, or QI program. The QI program is an important tool for the IRS, because it gives us a line of sight into the activities of U.S. taxpayers who do business with foreign banks. As with any large and complex program, we have to strive to continuously improve the program where we see weaknesses. Several measures that we are considering now with the Treasury Department include: expanding the information reporting requirements to include other income besides just the income from U.S. securities; strengthening documentation rules to ensure that beneficial owners of accounts cannot hide behind sham trusts; subjecting trusts or private corporations to U.S. withholding tax, if we don't have a clear line of sight to the beneficial owners; and, additionally, we've already proposed changes that would shore-up the independent review of the qualified intermediary program in substantial ways.

As you can see, the IRS and Treasury are considering a wide range of measures to ensure that the QI program works as intended, but there's always going to be situations when we discover a potential of violation of tax law after the fact. In these cases, we need some other administrative and legislative changes. We are exploring increased use of and potentially more information reporting requirements around money being transferred in and out of the United States. And we've also asked Congress in the past, and we'll continue to ask for an extension of the statute of limitations when we're working on cases that involve off-shore tax evasion.

Mr. Chairman, these are important steps forward, but there will be much more to come. The President's budget committed to identifying $210 billion in savings over the next decade from international enforcement and reforming other tax policies in the international arena. The Administration will have more detailed and specific announcements in the near future.

We are also looking closely at a variety of legislative proposals that have been introduced by Members of Congress and we look forward to continuing dialog over the coming months.

Thank you for this opportunity to provide an update of IRS activities to combat illegal tax avoidance schemes. Because this is a global problem it will require a closely coordinated strategy among nations dedicated to ending this evasion that deprives our country of precious resources and erodes citizens' confidence in the fairness of our tax administration system.

I'd be happy to respond to questions.

[The prepared statement of Mr. Shulman follows:]

Statement of The Honorable Douglas Shulman, Commissioner, Internal Revenue Service

PREPARED TESTIMONY OF
DOUG SHULMAN
COMMISSIONER
INTERNAL REVENUE SERVICE
HOUSE WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUE MEASURES
MARCH 31, 2009

Introduction

Mr. Chairman, Ranking Member Tiberi and Members of the Subcommittee, I want to thank you for the opportunity to testify today on the Internal Revenue Service's ongoing efforts to detect and stop unlawful offshore tax avoidance.

Mr. Chairman, international issues are a major strategic focus of the IRS. It is of paramount importance to our system of voluntary compliance with the tax law that citizens of this country have confidence that the system is fair. We cannot allow an environment to develop where wealthy individuals can go offshore and avoid paying taxes with impunity. As you will hear from my testimony today, the IRS is aggressively pursuing these individuals and institutions that facilitate unlawful tax avoidance.

These issues are so important to the agency that I have both increased the number of audits in this area over the last five months and prioritized stepped-up hiring of international experts and investigators. This occurred during a time when agency staffing levels were effectively frozen because of the Continuing Resolution.

While it is true that IRS agents and investigators will ultimately generate net enforcement revenues for the government, we view our international compliance strategy to date as much more focused on protecting the over $2 trillion in revenue that the IRS collects than the incremental enforcement revenue that we collect from these specific activities. We cannot allow corrosive behavior to undermine the fundamental fairness of our tax system. Going forward, the administration will be outlining further initiatives to step up international tax enforcement and improve our revenue collection.

Moreover, seen through the prism of the current economic crisis, it is outrageous that wealthy individuals are hiding assets overseas and unlawfully avoiding US tax. It is an affront to the honest taxpayers of America, many of whom are struggling to pay their bills, who play by the rules and expect others to do the same.

IRS Enforcement: Tightening the Net

Mr. Chairman, I am pleased to be here today to describe the unprecedented focus that the Internal Revenue Service has placed on detecting and bringing to justice those who unlawfully hide assets overseas to avoid paying tax.

In today's economic environment, it is more important than ever that citizens feel confident that individuals and corporations are playing by the rules and paying the taxes that they owe.

When the American public is confronted with stories of financial institutions helping US citizens to improperly avoid US tax, they should be outraged, as I am. But they should also know that the US government is taking new measures, and there is much more in the works.

An Integrated Approach

There is general agreement in the tax administration community that there is no "silver bullet" or one strategy that will alone solve the problems of offshore tax avoidance. If such a solution existed, it would have been implemented a long time ago. Rather, an integrated approach is needed, made up of separate but complementary programs that will tighten the net around these tax evaders.

As previously noted, the IRS has taken an aggressive and focused approach to international tax compliance that has included increasing its resources in this area by hiring specialists devoted strictly to this international effort. We also have a number of important enforcement tools that are described in greater detail below.

International Collaboration

International collaboration is essential in the fight against offshore tax avoidance. On this topic there is clear consensus among our closest economic partners.

To help stem the tide of tax evasion, the United States currently has tax treaties and cooperative tax information exchange agreements (TIEAs) with over 70 jurisdictions. We continue to expand the number of countries with which we have agreements and to renegotiate agreements to improve information exchange. However, in some instances the process to obtain names of account holders is inefficient, and in those cases we use other legal and investigative techniques described below.

The Joint International Tax Shelter Information Center – or JITSIC – has also proved to be another important arrow in our quiver. JITSIC's primary focus has been on the bilateral exchange of specific abusive transactions and their promoters and investors. The results, to date, have been promising. The U.S. has received information regarding transactions of which it had not been previously aware.

Indeed, in light of the complexity of the transactions, and considering the inherent difficulty normally associated with obtaining taxpayer-specific shelter information from foreign countries, it is unlikely that these transactions would have been uncovered and understood, but for JITSIC.

We need to redouble our commitment to international cooperation, and explore new and different ways to work with our counterparts overseas. Of direct relevance to today's discussion, we recently announced plans to build upon the initial success of JITSIC to specifically focus on international cooperation to combat offshore tax avoidance.

Qualified Intermediary Program (QI)

In detecting and attacking unreported off-shore accounts, we have a combination of tools at our disposal – all of which we are using simultaneously.

One of our best is the Qualified Intermediary program. The QI program gives the IRS an important line of sight into the activities of foreign banks and other financial institutions. It also provides information reporting that the IRS did not receive before this program was implemented. Most major financial institutions worldwide are QI participants, although a large number of smaller financial institutions do not participate in the program.

The QI system is an opt-in system that encourages foreign investment in the US by allowing foreign banks to deal on an aggregate basis with US withholding agents for all of their foreign customers investing in US securities. In exchange for QI status, the bank must follow detailed documentation procedures to ensure that the IRS receives information about their US customers investing in US securities.

Indeed, the QI program is critical to facilitating sound tax administration in a global economy. By bringing foreign financial institutions more directly into the U.S. tax information reporting system, we can better ensure that U.S. persons are properly paying U.S. tax, and that foreign persons are subject to the proper U.S. withholding tax rates.

Nonetheless, there are issues in the QI program that must be addressed. We need to shore up the QI program and enhance, improve and strengthen it. And we are.

In mid-October 2008, we issued a set of proposed QI amendments for comment which we believe will make QI audits more useful and help give us a clearer line of vision and transparency that we need in tax administration. Under the proposed changes, financial institutions that are QIs must provide early notification of material failure of internal controls. They must also improve evaluation of risk of circumvention of U.S. taxation by U.S. persons. And they must include audit oversight by a U.S. auditor.

The IRS and Treasury Department are also considering additional changes to the QI program to expand the information reporting required for U.S. customers holding accounts overseas, which I will describe later in my testimony.

Whistleblowers/John Doe Summons/Criminal Investigation

Informants are another part of IRS' enforcement net. Since the inception of the Whistleblower Office in 2007, the IRS has received hundreds of tips on financial institutions and individuals with foreign accounts and international compliance issues. Some of these have become significant cases.

Dozens of these tips involve the names of individuals with offshore accounts; others involve the names and practices of financial institutions in those countries that typically have strict bank secrecy laws.

And keep in mind that the value here is far greater than just the names of specific individuals. With additional development, these tips provide information that can lead to a John Doe summons – our next important tool.

The IRS generally uses the John Doe summons authority to identify individuals, groups or classes of US taxpayers: (1) whose member identities are unknown; (2) who may be involved in specific areas of tax noncompliance; and (3) who cannot be identified through other means.

For example, we would employ this type of summons when we strongly suspect US taxpayers are using offshore bank accounts to avoid paying taxes, but do not know their identities.

While the John Doe summons is a powerful tool in the civil arena, the IRS has also deployed significant resources to criminal tax investigations. The IRS is increasing its resources devoted to investigating the misuse of foreign entities and the use of foreign bank accounts to hide taxable income and is currently pursuing hundreds of criminal leads involving U.S. taxpayers potentially involved in offshore tax evasion.

The IRS has established a group of Criminal Investigation agents that focuses solely on international matters. As a part of this effort, the IRS participates in an interagency team led by the Department of Justice to review suspicious activity reports focusing on individuals and businesses based in foreign countries.

Another group of IRS Criminal Investigation agents on the West Coast focuses on international matters that arise on the Pacific Rim. This project is part of a long-term strategy for enhancing bilateral law enforcement cooperation to combat offshore tax evasion, money laundering, and related financial crimes.

In FY 2008, IRS-developed cases related to foreign and offshore issues resulted in 61 criminal convictions, and the average term for those going to jail was 32 months. For the first fourth months of FY 2009, there were 20 convictions, and the average jail term was 84 months.

Effect of IRS Actions on Offshore Tax Avoidance

In recent months and years, the IRS has concluded a number of significant cases where U.S. citizens have been caught attempting to hide assets and income overseas.

A much less quantifiable, but no less certain effect has been the creation of an environment in which offshore tax evaders fear detection and prosecution.

The tax evader on the run is especially vulnerable. Every instance where that individual withdraws or moves money creates a paper trial. That is because foreign banks are providing new information to the IRS or the IRS is investigating similarly situated taxpayers. This generates greater scrutiny of the transaction and increases the potential for suspicious activity to be spotted.

These actions also create greater legal jeopardy for those who break cover. Once these activities occur, it is far more likely that the IRS will uncover them through whistleblowers, other non-tax related investigations or through JITSIC and our treaty partners.

Getting Right With the Government

I would be remiss if I did not take this opportunity to directly address those that may have undeclared offshore accounts and income, wondering what they should do.

My advice to US taxpayers who have undeclared offshore accounts and income is very simple. The IRS has been steadily increasing the pressure on offshore financial institutions that facilitate concealment of taxable income by US citizens. That pressure will only increase under my watch. Those who are unlawfully hiding assets should come and get right with their government through our voluntary disclosure process.

We recently provided guidance to our examination personnel who are addressing voluntary disclosure requests involving unreported offshore income. We believe the guidance represents a firm but fair resolution of these cases and will provide consistent treatment for taxpayers. The goal is to have a predictable set of outcomes to encourage people to come forward through our voluntary disclosure practice while they still can.

In the guidance to our examination personnel, we draw a clear line between those individual taxpayers with offshore accounts who voluntarily come forward to get right with the government and those who continue to fail to meet their tax obligations.

People who come in voluntarily will pay back-taxes and interest for six years, and pay either an accuracy or delinquency penalty on all six years. They will also pay a penalty of 20 percent of the amount in the foreign bank accounts in the year with the highest aggregate account or asset value. This gives taxpayers – and tax practitioners – certainty

and consistency in how their case will be handled. And, under long-standing IRS policy, those who truly come in voluntarily can avoid criminal prosecution.

This penalty framework is in effect for the next six months, after which we will re-evaluate the situation.

At the same time, we have also provided guidance to our agents who have cases of unreported offshore income when the taxpayer did not come in through our voluntary disclosure practice. In these cases, the IRS will devote the time and resources needed to fully develop these cases, pursuing both civil and criminal avenues, as appropriate, and will consider all available penalties.

For taxpayers who continue to hide their head in the sand, the situation will only become more dire. They should come forward now under our voluntary disclosure practice and get right with the government.

Next Steps

Mr. Chairman, while tangible progress has been made to combat offshore tax evasion, our experience shows that there are areas where improvements can be made. I am pleased to discuss several proposals that we are currently considering to improve our existing administrative programs.

I can also tell you that offshore issues are high priority to the President and the Administration. The President's budget committed to identifying $210 billion in savings over the next decade from international enforcement, reforming deferral and other tax reform policies. The Administration will have more detailed and specific announcements in this area in the near future.

For today's hearing, I wanted to focus on some areas affecting offshore issues. I would like to start with some changes we are considering in the QI program.

Some measures that the IRS and Treasury Department are considering include:

- Expanding information reporting requirements to include more sources of income for US persons with accounts at QI banks
- Strengthening documentation rules to ensure that the program is delivering on its original intent
- Requiring withholding for accounts with documentation that is considered insufficient

Additionally, the IRS has already proposed changes that would shore up the independent review of the QI program in substantial ways. This proposal is currently out for comment, and the IRS looks forward to reviewing these comments.

As you can see, the IRS and Treasury Department are considering a wide range of measures to ensure that the QI program is working as intended. However, there will always be instances where the IRS discovers a potential violation of the tax law after the

fact. In these cases, there may administrative and legislative changes that may be helpful to the IRS as we investigate potential wrongdoing.

Finally, as you know, in past testimony we have stated that in cases involving offshore bank and investment accounts located in bank secrecy jurisdictions, it would be helpful for Congress to extend the time to assess a tax liability with respect to offshore issues from three years to six years or more.

Conclusion

Mr. Chairman, I want to thank you for this opportunity to provide an update on IRS' activities to combat illegal tax avoidance schemes relating to offshore accounts and transactions. Because this is a global problem, it will require a closely coordinated strategy among nations dedicated to ending this scourge that deprives our country of precious resources and erodes confidence in the fairness of effectiveness of our tax administration system. I would be happy to respond to your questions.

Chairman NEAL. Thank you very much, Commissioner.

I read your testimony last night. I thought it was really on target, and like many as I come across data in the last few weeks, I was surprised to hear that there were 50,000 previously undisclosed bank accounts that UBS held by U.S. taxpayers; and, I think some clarity here would be helpful.

It's been estimated that these accounts hold $14 billion in assets. Now, many of those accounts may be simple checking accounts for U.S. workers in Switzerland, but those accounts still are probably earning interest income.

Do you support proposals to modify the QI regime so that QIs would report on all U.S.-held bank accounts, and not just those accounts which include U.S. securities?

Mr. SHULMAN. As I mentioned, we are having discussions about a variety of issues. That's certainly one of the issues on the table. It would be helpful for the IRS and we'll be coming out, hopefully in the next month or so with a full range of pieces. But in general I support a wider range of reporting around the bank accounts held by individuals overseas.

Chairman NEAL. And a year ago the GAO in reviewing the QI program found it troubling that there were large sums flowing to unknown jurisdictions and unknown recipients with a withholding rate at about 4 percent when it should be 30 percent, it makes it seem as if the QI isn't complying with know your customer rules if they don't know where and with whom the payment ends up, which I also think is very important.

What has the IRS done since the program audit by GAO to find an answer for this anomaly or to ensure that QIs actually know their customers and to collect the tax?

Mr. SHULMAN. There's a couple things we've done. You know, a combination of some of the external auditor reports as well as some of our stepped up investigations where we've been looking closer at banks that are facilitating either legal or illegal accounts being held overseas.

One is we made a proposal in November that the external auditor that audits the QI program for the IRS, a) has to report to the IRS if there's indications of fraud and b) needs to have some nexus to a U.S. audit firm so that there can be some supervision of the work by an entity which the IRS has some authority over. Those proposals are out for comment now. We have received a lot of comments. We are reviewing them.

Second is what I would refer to in my testimony, which is, I think, there's a real need. In the past we relied on country-by-country "know your customer" rules. It's clearly the responsibility of a financial institution to look at documentation of anyone opening an account with them. We're looking at some substantially stepped-up proposals to make sure that when bank accounts are opened by QI that have a U.S. taxpayer involved, that there's more documentation around who are the real owners of those accounts.

So that we can look through trusts, private corporations, where there's a lot of issues, someone sets up a trust in a foreign jurisdiction, the bank will need to look through. If there's any indication that there's a U.S. taxpayer that either we are going to need to see that information or we'll have automatic withholding.

Chairman NEAL. As promised, the nexus between secrecy and the number people you believe are avoiding the responsibility, do you want to quantify a number for us about how much is out there?

Mr. SHULMAN. You know, let me talk to you about the problems with quantification since we had a conversation about this before.

First of all, when the IRS quantifies a number it has some weight, because we put out the tax cap proposals. The most reliable way for us to quantify any sort of gap between taxes owed and taxes paid is for us to do randomly selected audits. Usually, our audits are selected based on some criteria that targets people who, we think, would have non-compliance. We will also set up research programs where we randomly select audits and we go into audits. The problem with doing this overseas is we need to work through embassies, local law enforcement officials, and when there's accounts hidden, it's much harder to find than a U.S. citizen on U.S. soil.

With that said, I've challenged our team to do some of the kinds of extrapolation that some of the witnesses have done on your next panel to see if we are going to come up with our best estimate. What I would say, though, is a couple of things. Any enforcement program, and especially this kind of an enforcement program, that sends a message when there's somebody who has the means to hide assets offshore—sends a message to average U.S. citizens, a teacher, a fireman, a policeman who are paying their taxes—that there's some sort of inequity, that they're paying their taxes because it's reported on the W–2, and someone's hiding their assets offshore.

I think it's a matter of fundamental fairness that we have risk enforcement programs, and we go after people hiding assets offshore. It's also about protecting the two and a half trillion dollar revenue base, and having U.S. citizens feel that there's fundamental fairness in the system so that they'll continue to voluntarily come forward and pay taxes. And so whether the number is two billion, five billion or ten billion, I think we will continue to have a focus in this area because it protects the overall revenues for the U.S. Government.

Chairman NEAL. The other witnesses are invited to speculate at the right moment as well.

And with that I would like to acknowledge Mr. Tiberi.

Mr. TIBERI. Thank you, Mr. Chairman.

Commissioner, it appears to me that if a U.S. taxpayer was intent on evading taxes, and tell me if I'm wrong on this, the best way to do it would be to find a foreign bank that's not a QI that doesn't have a U.S. presence somewhere in the world, how do you together with us prevent that scenario from happening?

Mr. SHULMAN. Yes, clearly, if we're going to have a comprehensive approach to the problem of off-shore tax evasion, we need to focus on strengthening the QI program and also encouraging people to come into the QI program. And so, we need to have the QI program work, and make sure that people are participating through the QI program, we have information on them and they pay the proper amount of taxes.

I think we also need to encourage other institutions to become QIs. Some of the items under discussion are looking at some disincentives around not being a QI. For instance, more withholding if funds are being transferred to a non-QI versus a QI, information reporting to the U.S. Government about those kinds of wire transfers that are going out to non-QIs, so there needs to be a comprehensive approach that includes both. I think you're absolutely right on that and I'd agree with you.

Mr. TIBERI. I mentioned in my opening statement the cooperation that's out there that currently exists, are you working through those channels as well with other foreign counterparts?

Mr. SHULMAN. Yes, absolutely. I would agree with you wholeheartedly that we need to have bilateral discussions, multilateral discussions. This is not just a U.S. issue. You know, a lot of countries are focused and worried about illegal, offshore tax avoidance.

Clearly, the Treasury Department participates in a variety of forums. As you know, when the Secretary went a few weeks ago to the G20 and the President will be at the G20. There's a forum of tax administrators in the OECD, which I'm an active participant in. We also have a smaller group called the Leads Castle Group, where just tax commissioners come together and discuss these issues. And we have something called the Joint International Tax Shelter Information Center called JITSIC, which was originally formed by the IRS and several other countries to co-locate staff to have more open dialog around tax shelter issues. We've recently expanded that to look at some other issues including off-shore tax avoidance; and so I'm a big fan that this is not a go it alone strategy. That we need to be actively engaging other countries and this is part of a diplomatic dialog among nations.

Mr. TIBERI. Can you expand upon the issue of the tax statute of limitations that you talked about extending for how long and why?

Mr. SHULMAN. Yes. There's a few proposals out there and a number of them would work pretty well for us. The proposal we have on the table is just simply to extend from 3 years to six years the statute of limitations.

Mr. TIBERI. And why is that important?

Mr. SHULMAN. The reason it's important is when we're conducting an investigation in the U.S. we have all the authority of the U.S. And people understand, you know, our ability to go and do an audit, do an investigation. We know how to find people. We have agents who can go out and see them. And, generally, once you cross a border, a) it's harder to find folks and b) when we're doing exchanges of information or trying to get information, it can take longer.

People who are operating in the international arena generally have very sophisticated legal counsel and other advisors who know exactly where the statute of limitations end and can play run out the clock with us, and it's just harder to find information. It takes longer to do investigations. We sometimes have to work through law enforcement agencies in other countries which can take time to go through the administrative process to get it done. And so it's really a matter of us having a reasonable amount of time to follow the trail, which can be harder to follow once you cross the border.

Mr. TIBERI. So just to summarize, Commissioner, do you believe that together with some tools that we can give you along with some things that you can do with some of your counterparts and foreign governments and financial services companies around the world that we can get out this better?

Mr. SHULMAN. Yes.

Mr. TIBERI. Thank you. I yield back.

Chairman NEAL. Thank the gentleman.

The gentleman from New York, Mr. Crowley, is recognized to inquire.

Mr. CROWLEY. Thank you, Commissioner Shulman, for being here today and discussing these issues.

Along with Chairman Neal I recognize the need to address the tax gap and ensure all appropriate owed taxes are paid and welcome the hearing today on QI. But that brings me to what I would like to discuss with you today. And let me start by saying my office has not yet really had the opportunity to fully vet this with you and your staff, as this is relatively new to our office as well. But this looks like an issue that I would like to work with you and your office on and you can agree or disagree, depending on where we go with this question.

I understand that Americans investing abroad for the most part are taxed at the maximum withheld rate in most foreign countries at first, as those tax collection agencies are not familiar with the identity of the investor, the American overseas. A meeting for the American invested in the U.K., the U.K. tax authority would withhold the maximum on any dividends earned regardless of any tax treaties, as the U.K. wouldn't know at first what the nationality of the foreign investor was. Then the American taxpayer can file a tax reclamation form in that foreign country to reclaim any taxes withheld above the limits of any tax treaty between the two nations.

Afterward, that American can then file an IRS form 1116 to claim a U.S. tax credit for any foreign taxes that were legally paid abroad. The form 1099 dividend form is the form issued by brokerage houses to U.S. taxpayers that lists the amount of foreign tax paid and as the basis for the American taxpayer, that claimed U.S. tax credit on form 1116 for foreign taxes paid, my question is this form. Form 1099–DIV, issued by the IRS only asks the amount of foreign tax paid, not the actual amount of foreign taxes legally owed and paid, not taking into account taxes paid and then reclaimed by the taxpayer.

Therefore, I could be investing in a foreign country, have the maximum withheld, reclaim a fair amount of it due to a U.S. tax treaty. But, on the 1099–DIV form, I can still report the total amount of taxes paid before reclaiming what was owed to me and collect a credit based on that total amount paid before reclamation.

I'm not saying that this is tax fraud by brokerage houses or U.S. investors individually, but rather maybe the need for an updated 1099 dividend form to reflect the actual taxes legally paid. This could help us better tailor this U.S. tax credit to apply only to those foreign taxes actually paid for taxes actually owed and not reclaimed.

Could you give us your thoughts on this issue as a possible candidate to help us narrow the tax gap without increasing taxes or

scaring away investors, both for individual investors and for hedge funds and other entities as such.

Mr. SHULMAN. Well, you know, I think as you noted, the intent of a foreign tax credit is to make sure that people aren't subject to double taxation. They're not paying the same tax in a foreign country and here. Clearly, there's opportunity, and I haven't explored this issue and would be happy to explore it with your office.

We've talked a lot about foreign tax credit generators in the business context where kind of some of the intent of foreign tax credits and the confusion around it can have people not just get rid of double taxation, but actually end up with some sort of tax benefit. So, in general, what I would say is the QI program gives us a way to work with foreign banks when people invest overseas and allows us to set up a set of rules around them doing proper reporting and withholding. And so I think strengthening the QI program and the avenue you're going down should help with that.

Clearly, if people are claiming a credit for foreign taxes paid, but then they get money back and not doing that, that's an issue. It's not one that I've explored fully yet.

Mr. CROWLEY. We'd like to work with you and your office on it.

Mr. SHULMAN. Be happy to work with you on that.

Mr. CROWLEY. Thank you, Commissioner.

Chairman NEAL. Thank you very much.

The gentleman from Nevada, Mr. Heller, recognized to inquire.

Mr. HELLER. Thank you, Mr. Chairman. Thank you. And thank you for the opportunity for the Committee to look into an issue related to international tax compliance, specifically the recent stories that have come to light regarding big bank secrecy practices in Switzerland.

I share the serious concerns nearly all Members have that the practices that occurred must come to a halt. To do that some changes certainly need to be made. Those who broke the law need to be brought to justice; however, I do have some concerns that this particular issue is being used to advance another agenda, an agenda that's not really about compliance with the law, more about international tax policy.

While our Committee has jurisdiction and every reason to look into issues of international tax competition, I think that someone might be trying to use this one example to dramatically alter international tax policy. We do have a problem in our government along with the Swiss government. Financial institutions are in a process of correcting that problem. Again, those who broke the law should face the penalties clearly, but this example should not be the springboard to massive new regulations.

The banking secrecy practice is being examined today, already against the law, should not be a platform to creating new blacklists and financial enemies right at the time when international financial cooperation is so desperately needed to address our economy to continue fighting the drug war that is creeping across our borders, and to continue our fight in the global war on terror.

Commissioner, thank you very much for being here.

I just want to raise the concerns that have been raised about this blacklisting approach. There are some that believe that it threatens

critical information exchanges with other countries, undermines our international standing and invites retaliation that could do harm to U.S. capital markets.

Would you care to give us your opinion and thoughts on this issue?

Mr. SHULMAN. Yes. I think the U.S. is not. You know, there's a broad discussion happening at the G20 about the so-called black list. I don't think you've seen anybody, you know, certainly in my office or in the U.S. endorse or not endorse it.

My personal opinion is that where we need to focus is not around necessarily names of countries, but are on characteristics that could help facilitate evasion. And so bank secrecy, lower tax rates, the QI program where there's not incentives, not having good information exchange agreements, and so we're very focused on finding places where there's evasion and going after them.

We haven't been focused on necessarily naming countries, which I fully recognize. You know, I've got a view as IRS Commissioner, but when you want to get into putting names of country on lists, it's a much broader, diplomatic discussion involving State Department, Treasury, ultimately the White House, and others.

Mr. HELLER. Would you discuss, just kind of changing directions here a little bit, the voluntary disclosure guidance program that you issued on March 26th?

Mr. SHULMAN. Yes. We issued direction to our field about how to handle cases of voluntary disclosure where people are coming in with off-shore bank accounts.

I mean, clearly, we have been seeing some results as we have been stepping up the pressure. People have been availing themselves. We wanted to have a consistent approach so that our agents in the field who work these cases, know exactly what to do and what was supported in getting a resolution.

We also wanted to have predictability for taxpayers. The way this works is taxpayers who come in truly voluntarily—not taxpayers that we've contacted or are under criminal investigation—will have to pay 6 years in back taxes, plus interest. They'll have to pay either a delinquency or inaccuracy penalty, depending which applies, and then they'll have to pay a penalty in lieu of all other penalties of 20 percent of the highest account balance in their bank account or their investment or bank account over the last 6 months.

We also issue guidance, and, again, we think this is firm. We think it's fair, and any time you're having a voluntary disclosure program what you want to do is make sure that people aren't getting away Scot free and that regular citizens who have actually been paying their taxes all along don't feel that they've been shortchanged and that we're giving somebody a sweetheart deal. So it needs to be tough, but it also needs to be attractive enough that we bring people in, because ultimately our goal is to get people into the system.

The other thing we issued in this guidance is that this is 6-month guidance, after which we will reevaluate. And people who we find who don't come in voluntarily, we've instructed our agents to fully work those cases and explore all criminal and civil pursuits and investigations that they can.

Mr. HELLER. Thank you.

Chairman, I yield back.

Chairman NEAL. I thank the gentleman.

Mr. Doggett, the gentleman from Texas is recognized to inquire.

Mr. DOGGETT. Mr. Chairman, thank you very much, and thank you especially for holding this hearing. It deals with a very important topic to every American taxpayer, business, or individual who's playing by the rules and paying their fair share of taxes, when other people, as the Commissioner has pointed out in his testimony—the firefighter, the police officer, doing their fair share—and some individual or corporation goes off-shore to avoid doing their fair share. This hearing as the questions from our colleague just indicated, also provides us the first opportunity to look more closely at the tools to address this issue that are advanced in the stop tax haven legislation that I introduced last session with Senator Levin.

At that time, Senator Barack Obama was one of our cosponsors as was Rahm Emanuel, and you, Mr. Chairman, here on this Committee, we've refilled that legislation joined by Chairman Neal and sitting Commissioner in the same chair you are, Treasury Secretary Geithner endorsed the legislation when he was here testifying to us a few weeks ago.

That would of course be consistent with your own testimony when you testified earlier this month in front of Senator Levin's Subcommittee on permanent investigations; and, I believe your testimony, sir, would be good news for the IRS to have the enforcement tools available that are included in the stop tax havens legislation. Is that correct?

Mr. SHULMAN. That is correct.

Mr. DOGGETT. And you believe it would be good for the IRS to have stop tax havens adopted?

Mr. SHULMAN. It certainly would give us a variety of more tools. And as I mentioned before, that bill is out there. Senator Baucus has just introduced a bill, and we're working pretty aggressively now to make sure that the Administration is going to come forward with a full package. So we very much welcome it.

Mr. DOGGETT. And so since little or nothing had been done in the prior Administration, I am delighted to hear that you are, I believe, the approach Senator Baucus has, who's far different than stop tax havens, but it is important for us to work together to try to get the strongest tools possible.

I applaud your comments about fundamental fairness and inequity to American taxpayers and the way this jeopardizes our system when some individuals and some multinational corporations engage in these kind of shenanigans. As it relates to specifically to the inquiry that you just received about so-called black lists, I want to explore with you. As you know, the original countries that are listed in the stop tax haven legislation grow out of enforcement actions by the IRS by your office.

What circumstances, generally, cause you to go in and question the use of an off-shore account in a place like the Cayman Islands or Panama, or some other tax-dodging place?

Mr. SHULMAN. Well, the lists that you mention came out of an initiative that we did where we issued a John Doe summons.

Mr. DOGGETT. What is that?

Mr. SHULMAN. I'm sorry. A John Doe summons is when we think there's a class of taxpayers, we have no other way to get at it, and we have some evidence that there's a class of taxpayers. And rather than naming a taxpayer by name; you know, Mr. Doggett, we're looking for your information. We have an identifiable class of taxpayers, and so we've actually recently issued a John Doe summons on a class of taxpayers in the case that was mentioned before, just saying we think there's a bunch of people. We don't have their names, but we're looking for a bank to come forward with that information.

The list was never really intended to say these countries have problems all the way across the board. So whether they do or not, it was intended for a very specific credit card initiative where we had evidence there were credit cards being issued from those jurisdictions and we're looking in general for all the names of the credit card holders.

Mr. DOGGETT. As you know, the stop tax haven legislation that Secretary Geithner endorsed authorizes the Treasury to take countries on and off that list. Are there any of those John Doe summonses that involve countries where you have subsequently seen improvement under bank secrecy laws and a John Doe summons would no longer be necessary?

Mr. SHULMAN. Well, those John Doe Summons are closed. We don't have any kind of broad, open John Doe summons around with countries named that are open right now. You know, I guess what I'd say I think the world has paid attention to, both the legislative interests in this issue, the international focus on this issue and the IRS has stepped up enforcement in this issue.

In the last month, you've seen a number of jurisdictions that either had bank secrecy or didn't have good information exchange agreements step forward and say that they're going to start working on information exchange agreements. And so I'm quite hopeful with some of the progress. That progress alone isn't going to solve this problem, but is certainly a step in the right direction.

Mr. DOGGETT. Mr. Chairman, may I pose just one more question about qualified intermediaries?

Under the program I'd like to know if any institution has ever been kicked out of the program, what the procedures are for expelling someone from the program; and, specifically, given all that we know that has occurred, why UBS has not been kicked out of the program.

Mr. SHULMAN. Yes. As I mentioned in my opening statement, I can't speak specifically about UBS, but let me answer the rest of your questions.

Institutions can be kicked out, and the two criteria are material failure and no remedy. My goal is to actually protect the integrity of the system, keep people in the system, because once you've kicked them out of the system, then we don't have necessarily a line of sight and agreement between the IRS and that institution.

We have terminated a number of QIs, close to a hundred in the past, and the specific question you asked about UBS I just would refer you to the deferred prosecution agreement with the Justice Department that actually has a number of issues around the QI

program in there. But, again, when there's a material failure and there's no remedy, we will kick people out. The goal though is actually to get remediation, keep people in the system, so we keep the line of sight on U.S. taxpayers.

Mr. DOGGETT. Thank you, Mr. Chairman.

Thank you, Commissioner.

Chairman NEAL. Thank you, Mr. Doggett.

The gentleman from Illinois, Mr. Roskam.

Mr. ROSKAM. Thank you, Mr. Chairman.

Commissioner, could you just elaborate a little bit more. I sensed sort of healthy, honest tension in the exchange and I don't want to over interpret it. But can I give you a couple of minutes to highlight for us what some of the concerns may be about what some people are characterizing as a black list for countries and how that has an impact on your job as a commissioner that's interacting with other nations seeking cooperation.

Can you speak to that generally?

Mr. SHULMAN. Well, I mean, sure.

I think, you know, the issue of black lists have been played out pretty accurately and well in the press. I mean some will tell you a black list is great, because it shames the country into compliance. Some will tell you that a black list is horrible because, you know, there's a lot of other diplomatic issues. There's a lot of cooperation. You don't want to put countries on a list.

My view is that what's important is that we need to have a whole integrated set of tools to combat off-shore tax avoidance. I mean, the first most important one, as I've said it's a priority for the IRS, and the President said it's a priority for the Administration. People take notes.

Second is we're in the process of stepping up and hiring more examiners, more lawyers, more agents, more special agents for criminal investigations, placing more people in other countries. We need to use data better, both data exchanges from other government agencies, third party data, as well as data from other government agencies.

We need to strengthen the QI program. We need to look at legislation, and there's a variety of legislative proposals on the table. We need better coordination amongst nations, both formal dialog, but also increased informal dialog and discussion, so we're seeing trends that are happening. And we need to keep focused on our litigation and our enforcement efforts that have been having some impact.

And so I guess what I'd say is I think this will be continue to be a discussion at the G20. It's a discussion that's happening now at the level of the President. It doesn't need to happen at the level of the IRS Commissioner. But regardless of the outcome of that discussion there's really a whole suite of things we need to do to tighten the net around those using the international capital markets to hide assets overseas.

Mr. ROSKAM. Fair enough. Thank you.

You mentioned earlier that part of the approach here is in the voluntary program, the imposition of a special penalty and so forth. Can you walk us through sort of the IRS thinking about penalties? Now, in the interest of disclosure I asked Secretary Geithner about

his own tax situation and he told this Committee that he was encouraged by the IRS to seek a waiver of the penalty.

I'm not asking you to comment on the secretary's individual situation, because I know you can't, but can you give us a glimpse into the decisionmaking at the IRS about generally how you make decisions about imposing penalties and not imposing penalties as it relates to other policy questions or other compliance issues.

Mr. SHULMAN. Yes. I mean at the end of the day, for instance in the off-shore case, this is going to be a broader initiative, and I'm a big fan. You know, we have limited resources. We have to triage those resources. We have to decide where we're focusing both on our service agenda, on our technology, on our enforcement agenda. I'm a big believer that when we can set up a unified program with a group of taxpayers it brings them back into the system and has them be compliant taxpayers in the future, that settlement initiatives are a good idea.

What you're seeing now in this off-shore case isn't really a public settlement initiative. It's guidance to the field that was then made public. There, what we're doing is we're trying to say, "Come in." It will be predictable, and you will avoid criminal prosecution. And that's the kind of thing you'll see when we're doing broad initiatives for sets of taxpayers.

For penalties in general, obviously, Congress sets the penalties, but the IRS is given administrative discretion. I'm a believer that each individual taxpayer that comes in needs to be looked at individually. We have no discretion about waiving taxes or interest, but when it comes to penalty, our agents—and the discretion is put into the hands of individual agents who are looking at those cases—have the ability to look at facts and circumstance; look at whether actions were willful or not willful, whether they were honest mistakes or whether someone was trying to evade taxes, and they have the ability to abate penalties in individual circumstances.

They can abate or not abate. There are avenues for appeals, both within the chain of command of the agent as well as to go to our appeals function. And then there's obviously tax court and litigation where these issues can get played out. And so the penalty regime is an important part of tax administration.

We've got some discretion, and taxpayers have a variety of avenues they can go to if they think that discretion isn't being used properly.

Mr. ROSKAM. Thank you, Mr. Chairman.

I yield back.

Chairman NEAL. Thank the gentleman.

The gentleman from Florida, Mr. Meek, is recognized to inquire.

Mr. MEEK. Thank you, Mr. Chairman, and Commissioner it's good to see you again and I enjoyed the discussion we had last week on this topic. And I know that just by this hearing today we will be able to zero in more on those individuals who are putting us in this room at this particular time to talk about this issue.

You know, in 2003, some $293 billion was sent to individuals and businesses residing abroad, and I think that's something that especially in these very hard times we have companies that are here in the United States of America that have obtained their share of

taxes by U.S. law, that we make sure that we level that playingfield.

I just want to change the channel here, not too far, but on a recent action that you were able to take; and, as it relates to the theft loss of those that have been victims of these Ponzi schemes that have been going on, especially brought to light in recent days, we know that there has been some confusion, because we know that there's been a lot of action in the stock market. Many investors lost great sums of money based on the stock market and the reaction that it's had to this economy.

But, as it relates to some 13,000 plus Americans that found themselves in the situation, not only in the well-known case of the Madoff case, but several other Ponzi schemes that had been uncovered since the regulators have been looking at these individuals a little closer now have lost their entire life savings in many cases, giving statements that they had a certain amount of money, paid taxes on those dollars. And, many of those individuals reside in Florida and throughout the country.

I know that you have taken action recently and I had an opportunity to read your testimony from the March 17th hearing that took place over in the Senate and you addressed some of the issues that you found that were wrong and that needed to be dealt with. And you dealt with them, I believe, with a 5-year theft loss, which I think looking at that is a step in the right direction.

But there's still work that's undone. The reason why I'm homing in on this is because 2,000 of these individuals reside in Florida, and 562 of them reside in the two counties that I represent in south Florida. And we have a number of seniors, Commissioner, and I don't need to tell you. But we have a number of seniors, even with the five-year theft loss that IRS has ruled on that's in play in this particular case. But we have a number of seniors at 85, 90 years old, finding themselves in a situation of having to move out of their homes.

I have legislation that is H.R. 1159 that's going to set it back by 10 years to allow them to be able to claim theft loss on those dollars that they paid taxes on. They thought they had, but was not necessarily there. Also, their issues as it relates to foundations that were not addressed in the ruling that are providing services to many of these seniors that found themselves in a very bad situation, I was hoping if you could elaborate and clarify a little further on the action that you took and as it relates to the seniors with a 10-year. And that's an act that the Congress is going to have to move on, which I'm pushing a legislative hearing on soon, and also talking with the Administration on.

How would it assist seniors to move it from five versus ten years? I guess that's my question.

Mr. SHULMAN. Yes. The actions we took were really making sure that the Treasury and the IRS lawyers give clear interpretation of the current laws on the books around investment theft losses. We thought this was important, because when you're having a declining stock market, when you're in a serious economic slump, that's when Ponzi schemes come to light, because there's no longer money flowing in, so they can't be paying out money to old investors.

What we did was just interpret the law, said it's investment theft loss. Once you have an investment theft loss, you go into the typical NOL carry-back language, which is three years generally. The American Recovery Act actually provided for five-year carry back, if you have less than 50 million of income, and so our interpretation said that that was the case. We also put out a revenue procedure that put a safe harbor in place, because a lot of times it takes many years to litigate these cases to find out how much you're going to actually recover from the trustees and etcetera; and, really, the place people get money back is from SIPIC and from the IRS. And so our safe harbor said that you could take 95 percent of your loss, minus SIPIC and what you reasonably expected to regain.

And so ours was pure interpretation. As we had a chance to talk about, we'll obviously follow whatever law Congress puts in place; and, you know, I can't really opine on, you know, we don't have the authority to do a 10-year carry back. We have an authority just to interpret the laws as they're on the books.

Mr. MEEK. But, if I can, Mr. Chairman, basically Commissioner what I'm trying to get to the 10 year carry back will assist seniors at a greater level to be able to recover, because if you're in your 50s and 40s you have an opportunity to do so. Will I be correct in saying that?

Mr. SHULMAN. I mean I would think so. I mean, obviously, 10-year carry back can go back from 10 years instead of five. All I'm saying is it's kind of not in my bailiwick to make the call on.

Mr. MEEK. I understand.

Mr. Chairman. Thank you so very much, Commissioner.

Mr. Chairman, as you know, this is an issue and concern of many of us that represent people of age and I'm hoping that we can work with Administration and work with others, but I would like to commend the Commissioner and IRS for making the ruling that they have under this situation; and, I look forward, Mr. Chairman, to working with you on the reason why we're here today in getting to the bottom of some of this off-shore business.

Chairman NEAL. Thank the gentleman, and part of this hearing today was scheduled based on Mr. Meek's prompting.

So, the gentleman from Kentucky, Mr. Davis, is recognized to inquire.

Mr. DAVIS. We just call it the Kentucky seat now after the three Members. Thanks, Mr. Chairman.

Commissioner, I appreciate you coming in and the time you've invested in getting to know us, as well as talking about a number of issues. I think as my colleague from Illinois said, there is occasionally a bit of creative tension on the Committee, on a variety of issues, and certainly on this one.

But I think there is unanimity across the board on really dealing with tax evasion and effective compliance mechanisms so the agency can function, and legitimate revenue can be gotten into the agency.

To the extent that you agree that international exchange of information in particular are a key element of the ongoing efforts to fight tax evasion, do you feel it's reasonable for us to be concerned about a blacklist, in the sense that it might make listed countries

willing—or less willing to provide the IRS with information that you need to combat this evasion effectively?

Mr. SHULMAN. You know, I guess I don't have a lot to add to what I've said in general about blacklists. I always focus on characteristics of jurisdictions where we might see tax evasion, rather than listing those jurisdictions, things like bank secrecy, things like lack of information exchange, things like non-transparent laws and cooperation with the U.S.

And so clearly there's pieces of a blacklist that could be quite useful to the IRS, because you could then change some presumptions and target specific rules around there. And I fully understand the diplomatic issues around a blacklist, which are pretty large.

Mr. DAVIS. Well, I guess the reason that I was asking is I was wondering if you could confirm for the record. The U.S. currently has tax information exchange agreements with several countries that are included on the Levin-Doggett proposal proposed blacklist, including the Cayman Islands and New Jersey.

And I guess taking this just one step further, could you also confirm for the record, in that same vein, that our Nation actually has full-fledged tax treaties with at least three countries that are on that proposed blacklist, Switzerland, Luxembourg, and Cypress.

Mr. SHULMAN. You know, I don't want to get this wrong, so if you'd let me just come back to you, and I'll give you the list of all the countries that we have, and submit it for the record, I would be happy to do that.

Mr. DAVIS. Okay. Thank you, Mr. Chairman. I yield back.

Chairman NEAL. Thank you, Mr. Davis.

I want to thank the Commissioner for the time that he has spent with us, and also the time that he spent preparing for the hearing today.

And we look forward to working with you on these issues. You can see that there was pretty good attendance this morning. There's a lot of interest. Media accounts, I think, day after day, indicate the nature of the problem, and we hope you will continue to be part of the narrative as we seek to solve it.

And with that, I'd like to call our second panel.

Mr. SHULMAN. Thanks for your leadership on this, Mr. Chairman.

Chairman NEAL. Thank you.

Let me thank our second panel, and the Chair recognizes Mr. Shay.

STATEMENT OF STEPHEN E. SHAY, TAX PARTNER, ROPES & GRAY

Mr. SHAY. Thank you, Mr. Chairman, Ranking Member Tiberi, and Members of the Committee. My name is Stephen Shay. I'm a partner at the law firm Ropes & Gray in Boston.

With the Chairman's permission, I will submit my testimony for the record, and just summarize my principal observations. I also want to make clear I'm appearing in an individual capacity, and what I'm going to say does not represent the views of my law firm or my clients.

The key points I'd like to make with respect to the focus of this hearing are that in order to attract foreign capital, and for historic

administrative reasons, the United States taxes very little U.S. source investment income paid to foreign persons.

We exempt from withholding tax most capital gains of non-residents on sales of securities, and U.S. interest paid to unrelated non-resident lenders. Our source withholding tax principally imposes tax on payments of dividends to non-residents. We do not impose U.S. withholding tax on payments of foreign source income to foreign persons.

Our source withholding regime for U.S. source income payments is designed to determine whether the owner of the income is a foreign person and, if so, what withholding rate should apply.

Generally, the United States does not have enforcement jurisdiction over a foreign financial institutions— that is not owned by U.S. persons and that does not carry on business itself, in the entity, in the United States.

The QI system was developed to overcome these jurisdictional limitations, and allow a U.S. withholding agent, that is, a U.S. institution making a payment to what it thinks is a foreign person, to rely on documentation received from foreign banks that are acting as qualified intermediaries.

The QI system relies on the foreign bank that has the direct relationship with the foreign customer to exercise normal banking know-your-customer disciplines in assuring that the documentation it received, and that it provides the U.S. withholding agent in turn, was correct.

The QI regime prescribes audits by the bank's external auditors to confirm that its processes are being used appropriately.

Because some of the income that we exempt is exempted on a unilateral basis, not just to residents and other treaty countries that have given reciprocal exemptions, it is not possible to rely on the other countries' governmental audits to check the QI system.

So this is a feature of the extent of our unilateral exemption, particularly of portfolio interested source.

As noted by others, the qualified intermediary regime is a opt-in system, and—where the foreign bank elects to participate—applies to accounts that are designated as QI accounts.

Accordingly, under current law rules, it is possible for a QI to act as a QI and also have accounts that are not covered by the QI requirements, including accounts for U.S. persons.

The cross-border withholding system for payments to foreign persons is not designed itself to provide information reporting on U.S. persons. It is just designed to screen for and apply the appropriate withholding tax rate to foreign persons.

In this regard, one of the key decisions made in implementing these rules was to follow traditional tax rules and respect a foreign corporation under U.S. principles. As a non-transparent beneficial owner of income without regard to whether it was owned by U.S. persons.

When a payor of these payments is within the U.S. tax jurisdiction, payments of interest, dividends and gross proceeds from sales of securities to a U.S. person are subject to domestic information reporting and back-up withholding rules. These have become a very important part of our compliance system.

It is possible, however, for a U.S. person to have an account at a foreign financial institution that is not subject to third party information reporting.

Under the structure of the rules just described, some U.S. persons are able to masquerade as foreign persons, or hide behind foreign corporations, without reporting this income.

As a jurisdictional matter, the United States can only obtain information on U.S. persons' foreign accounts at foreign financial institutions if the foreign financial institution agrees to participate, for example, through a QI system, or through information requests on a bilateral basis with other countries.

In my testimony, I have set out a series of proposals, some of which have been made by others—many of which have been made by others, that I think would be feasible ways to overcome the limitations I've described.

In the interest of time, I'll be happy to answer any questions on those. Thank you, Mr. Chairman.

[The prepared statement of Mr. Shay follows:]

Statement of Stephen E. Shay, Tax Partner, Ropes & Gray, Boston, Massachusetts

TESTIMONY OF PETER H. BLESSING BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES
MARCH 31, 2009

Chairman Neal, Ranking Member Tiberi, and Members of the Subcommittee, thank you for inviting me to testify. I am a lawyer in private practice with the law firm Shearman & Sterling LLP. I also teach International Taxation as an adjunct professor in the J.D. program of Columbia Law School. I serve as First Vice Chair of the Tax Section of the New York State Bar Association, member of the Executive Committee of the USA Branch of the International Fiscal Association, and Council member of the American Bar Association Tax Section (former chair of its Committee on Foreign Activities of U.S. Taxpayers). I have authored a treatise on U.S. income tax treaties.[1] My comments today are made as a practitioner and not on behalf of any organization or institution.

I. The Problem

The principal problem that my remarks will address is the tax gap attributable to unreported investment income and what is being done or might be done. The extent of the problem has been the subject of much speculation and is not readily susceptible of accurate measurement, though attempts have been made. While the range of estimates is broad, the numbers are in any event large. The problem has come to the fore in certain well-publicized incidents involving non-U.S. banking institutions holding unreported funds of U.S. taxpayers.[2]

The reasons for the problem have been better articulated. The problem is not a new one, but has become much larger in amount as the result of a variety of factors such as a more globally stable economic environment and ease of ability to open accounts and transfer funds, and marketing by persons in offshore jurisdictions. The problem has received wider vetting more recently as the result of factors such as the budget gap and search for revenues in the U.S. and abroad, as well as enhanced attention to compliance and enforcement in the U.S. and abroad.

II. Working Towards a Solution

As a preliminary matter, I wish to emphasize that the last few months have shown that much is already being done to address the problem, through mechanisms and procedures in place. The U.S. is not alone in this endeavor and today more than ever there is real and productive joint activity and a tangible opportunity for greater cooperation in the future. Second, Treasury and the IRS have been taking meaningful steps recently to reduce the likelihood and dimension of future incidents. Perhaps the most important factor in that regard, and I particularly wish to emphasize this, is the appropriation of substantial additional amounts in the IRS budget for enforcement, as contemplated by the Obama Administration's budget.

[1] Income Tax Treaties of the United States (Warren, Gorham & Lamont, 1995).

[2] *See, e.g.*, Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the U.S. Senate ("PSI"), "Tax Haven Banks and U.S. Tax Compliance" (July 17, 2008), 2008 TNT 139-15.

Faced with a problem of the magnitude addressed here, there can be a temptation to take action, and dramatic action, quickly. However, precisely because the problem is global and implicates the operations of the global financial system, proposed solutions must be tempered with hard examination and review. Tax measures adopted in response to legitimate concerns can have unanticipated and unhappy consequences from the standpoint of economic efficiency. One must be careful not to fight yesterday's war, in this context especially because there is a real economic efficiency cost to reporting requirements and behavioral deterrents and proscriptions. I would only caution that these considerations not be overlooked in the important job of crafting provisions to address the problem.

It never will be possible to eliminate criminal or fraudulent behavior in respect of financial accounts, even such behavior on a very large scale. As recent events have shown, that phenomenon is certainly not limited to the cross-border sector. But better controls can both serve as a deterrent and facilitate the early detection of such activity. The challenge is to have controls that do not place an undue burden on the benefits that come with free flows of capital across borders.

The issue of taxation in respect of cross-border capital flows has many facets. A hugely important one is which items of income should be subject to tax by the source country, which goes hand in hand with the question of how the income should be sourced. For example, the issue of whether source country withholding tax should be imposed on dividends at all given that no withholding tax is imposed in interest received by foreign persons or often (under treaties) on royalties, even though both types of payment generally are deductible, has been raised over the years. The Stop Tax Haven Abuse Act introduced by Senator Levin and Representative Doggett would address the substantive rules of withholding tax in respect of certain types of income (from swaps, etc.) but there would be financial market consequences that must be considered.

Another aspect of the question is whether a withholding tax system similar to that in, e.g., Switzerland, in which amounts are withheld pending submission of proof of residence of the beneficial owner (rather than not withholding based on a self-certification). Professor Avi-Yonah has suggested a variation of this approach in previous testimony before this Subcommittee, which in practice would apply only to non-treaty countries, including, in general, tax havens.

With reference to enforcement matters, the objective of exchange of information is the collection of tax. Apart from our income tax treaty with Canada, there are few provisions in our bilateral income tax treaties offering assistance in the collection of tax owed by our residents. That is typical of income tax treaties generally, and reflects the "revenue rule" whereby the U.S. courts, as the equivalent bodies in many foreign countries, have generally declined to permit the domestic legal system to be used to enforce the tax laws of another country, although certain cracks in the rule have appeared in limited contexts. Given our global economy and the volume of cross-border capital flows, a reconsideration of the considerations policies behind the revenue rule may be appropriate in the context of our tax treaty policy.[3]

[3] A development in this regard is the proposed EU Directive referred to in footnote 13 below.

In the remainder of my statement, however, I will focus on compliance initiatives.[4] In particular, I will address tax treaty information exchange procedures and the IRS-initiated qualified intermediary procedures, both of which I understand to be of particular interest to you in connection with this hearing.

III. Information Exchange in Civil Tax Matters

I first will briefly address certain issues in respect of the bilateral agreements entered into by the United States and used by the IRS[5] to attempt to obtain tax information from other countries in connection with compliance and enforcement. I will not address agreements relating to criminal matters, or multilateral agreements.[6] It should be noted that these agreements are directed at information available to another country, as opposed to information available to a taxpayer or third party recordkeeper. The Internal Revenue Service and the Department of Justice rely on the summons power under sections 7602 and 7609 of the Internal Revenue Code to compel the production of information from private parties.

A. Background

There are two principal forms of bilateral agreements primarily used by tax authorities for the exchange of information. These are the article of income tax treaties that governs the exchange of information (included as Article 26 in the U.S. Model Income Tax Treaty) and Tax Information Exchange Agreements ("TIEAs").

1. Article 26 of U.S. Model Treaty.[7] Article 26 of the U.S. Model Income Tax Treaty, "Exchange of Information and Administrative Assistance," calls for the relevant authorities of the contracting countries to exchange tax information as necessary for carrying out provisions of the treaty or the domestic laws of the parties. Any information received is to be treated as confidential "in the same manner as information obtained under the domestic laws" of the requesting country and is to be used only in connection with proceedings relating to the taxes in question. While the requested country is to "use its information gathering measures to obtain the requested information, even though that [country] may not need such information for its own purposes," that country is not required to supply information that is not obtainable "in the normal course" of its administration. Though there are limits on the obligation of a country to provide certain information, such as information that would disclose trade or business secrets, those

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[4] In connection with a public hearing before the Senate Committee on Finance on July 24, 2008, the Staff of the Joint Committee on Taxation prepared an informative report, "Selected Issues Relating to Tax Compliance with Respect to Offshore Accounts and Entities," JCS-65-08 (July 23, 2008).

[5] The Department of Justice also may attempt to use these agreements in (criminal) tax cases handled by it, but for various reasons the agreements have not proven very useful in practice.

[6] For example, the Convention on Mutual Administrative Assistance in Tax Matters is a multilateral agreement sponsored by the OECD and the Council of Europe that was written in 1988 and has been signed and ratified by thirteen countries. This Convention contains an exchange of information provision; however, it is subordinate to EU Directives and therefore has limited applicability at this point, given that the parties are all European except for the U.S.

[7] U.S. Treas. Dep't, Model Income Tax Treaty, Nov. 15, 2006, art. 26.

limits are not to be construed in a way that allows the requested country to decline to supply information because that information is held by a bank or other financial institution.

As is evident by the scope of information subject to production under a typical such provision, bank secrecy rules currently may excuse production. This limitation also may be explicitly stated (e.g., diplomatic notes to Art. 28 of the treaty with Luxembourg, article 26(3) of the treaty with Switzerland). Reflective of these exceptions, Austria, Belgium, Luxembourg and Switzerland entered reservations to the Exchange of Information article of the OECD Model Income Tax Convention. However, in the last weeks, each of these countries notified the OECD that they are withdrawing that reservation.

2. TIEAs. TIEAs are agreements between two countries establishing policies and procedures regarding the exchange of information between the two contracting parties, generally in situations in which the parties do not have a comprehensive bilateral income tax treaty containing provisions such as referred to above. They generally describe what information must be included in a request for information and timing guidelines, as well as specific definitions of precisely what taxes are covered and which taxpayers are covered by the agreement. TIEAs also usually include provisions allowing the requesting party to enter the territory of the requested party if necessary to interview individuals or examine records, and they describe the conditions under which a request for information may be declined (such as when the disclosure of the information would be contrary to the public policy of the requested party). The first one was entered into in 1984 between the U.S. and Barbados, but the agreements have become a widespread tool for the U.S. and other OECD countries, in particular, to obtain information needed for tax enforcement.

The OECD Agreement on Exchange of Information on Tax Matters,[8] which is not itself a binding instrument, contains two models for TIEAs, one that is a traditional bilateral agreement and another that contemplates an "integrated bundle of bilateral treaties" creating a multilateral agreement. The Agreement includes provisions typical of TIEAs historically, and goes a bit further in some areas. For example, many TIEAs include provisions that a requested state cannot deny a request for information solely because that information is held by a bank or financial institution, but the OECD model includes a requirement that each contracting party is to ensure that its authorities have the authority to obtain and provide upon request information held by banks or other financial institutions. Another important provision is the requirement that requests can only be made in cases where the identity of the taxpayer is known, a case has been made, and all other means available within the requesting state to obtain the information have been pursued and exhausted.

Another document worth mentioning in this context is the EU Savings Tax Directive.[9] This savings tax directive was adopted in 2003 and went into effect in 2005. Recognizing that coordination of national systems is not sufficient, the agreement is intended to result in an EU-

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[8] Organisation for Economic Cooperation and Development (OECD), Agreement on Exchange of Information on Tax Matters (Paris: OECD, Apr. 2002) developed by the OECD Global Forum Working Group on Effective Exchange of Information.

[9] European Union Council Directive 2003/48/EC, 3 June 2003.

level system wherein all member states will exchange tax information automatically to all other member states on any interest paid on savings to residents of those other member states. It includes rules concerning the details of the information to be reported, as well as the frequency and mechanics of reporting. In response to the discovery of several loopholes within this directive, such as through the use of trusts, foundations and other investment vehicles, a proposal to amend it was proposed in November 2008, as discussed below.

B. Recent Developments

In the last number of months, there have transpired certain developments relating to the exchange of information in tax cases that merit particular note.

1. TIEA Between the U.S. and Liechtenstein.[10] On December 8, 2008, the U.S. and Liechtenstein signed a TIEA, the first ever executed by Liechtenstein, that improves on various of the shortcomings that exist in other agreements, primarily in the area of protections based on bank secrecy laws. For example, the TIEA does not contain the provision present in the OECD model allowing bank secrecy policies to continue to the extent they do not "unduly prevent or delay" the effective exchange of information. In connection with the execution of this TIEA, the U.S. extended Liechtenstein's treatment as a jurisdiction satisfying the requirements of the "qualified intermediary" program[11] through the end of 2009 with the understanding that, in that time, Liechtenstein will enact legislation loosening its bank secrecy laws as required to comply with the TIEA. The TIEA will allow the U.S. to ask for information relating to 2009 and subsequent years.

2. ICG Report on Withholding Procedures.[12] This report was prepared by the Informal Consultative Group ("ICG"), which includes representatives from the financial industry as well as from some OECD member countries, established by the OECD's Committee on Fiscal Affairs, and discusses the relevant procedural problems and makes recommendations for consideration by the CFA on best practices that might be adopted by countries, to facilitate the claiming of treaty benefits by investors, minimize administrative costs and allocate them properly, and allow source and residence countries to ensure proper compliance. The report recommends a system that looks very similar to the U.S. qualified intermediary system. Recommendations include that withholding be relieved at source rather than a refund procedure, and that countries develop systems for pooled reporting by intermediaries who would enter into contractual arrangements with the source country and would be subject to audit by an approved independent reviewer. Differences from the QI system are that the identities of beneficial owners of payments would be disclosed to the source countries, and a "reason to know" (rather than "actual knowledge") standard would be applied.

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[10] Agreement Between the Government of the United States of America and the Government of the Principality of Liechtenstein on Tax Cooperation and the Exchange of Information Relating to Taxes, Dec. 8, 2008. *See* Press Release of the U.S. Treas. Dep't on 8 Dec. 2008 (HP-1320).

[11] This program is discussed further below.

[12] OECD, Report of the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors on Possible Improvements to Procedures for Tax Relief for Cross-Border Investors (Jan. 12, 2009).

3. New Proposed EU Directives. In November 2008, the European Commission announced a proposal to amend the existing EU Savings Tax Directive.[13] This proposal specifically targets certain loopholes that have allowed taxpayers to avoid paying taxes in their home jurisdiction, such as through the use of trusts or foundations and through the restructuring of certain income to render it outside the existing directive's definition of interest payments. The proposal includes trusts and foundations within its scope and would extend the directive to include "income equivalent to interest payments." It remains to be seen how the EU member states, as well as certain non-EU countries such as Liechtenstein and Switzerland, both of which signed onto the 2003 Directive, will respond to this proposal.

On February 2, 2009, the European Commission also announced a proposal for a new Directive on mutual assistance for the recovery of claims relating to taxes.[14] This Directive would replace the existing directive on the exchange of information dating from 1977. A key element of the information exchange segment of this proposal is that it would not allow tax authorities to use bank secrecy as a basis for refusing to cooperate in a request for tax information.

4. Domestic Legislation. A bill sponsored by Senator Baucus[15] contains certain reporting, due diligence, statute of limitation and penalty provisions in respect of funds transferred to or held in offshore accounts. Further, a bill for the Stop Tax Haven Abuse Act[16] has been introduced by Senator Levin and by Representative Doggett in the Senate and House, respectively, targeting certain offending jurisdictions through a variety of measures. Section 101 of the bill lists 34 "offshore secrecy jurisdictions." The bill would require special treatment for dealings in respect of those countries, including extensive reporting requirements for U.S. financial institutions doing certain types of business in these jurisdictions. The bill would also target certain loopholes in the Internal Revenue Code relating to foreign trusts and would increase penalties for the promotion of abusive tax shelters. The bill would amend the USA PATRIOT Act to extend provisions aimed at fighting money laundering so that they would also apply to foreign jurisdictions and financial institutions that "impede U.S. tax enforcement."

5. Retreat from Bank Secrecy Reliance. In response to the pending G-20 blacklist and pressures from particular countries, including the U.S., France and Germany, a number of countries have recently announced that they will adopt "OECD standards" of exchange of tax information and will not claim bank secrecy as preventing production. Nevertheless, these statements usually are coupled with the caveat that a new agreement must be negotiated, which could result in delay.[17] Some have been cautiously worded to the effect that no fishing expeditions are permitted and that "justified" requests will be honored.

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[13] Commission of the European Communities, Proposal for a Council Directive amending Directive 2003/48/EC on taxation of savings income in the form of interest payments (Brussels: Nov. 13, 2008), 2008/0215.

[14] Commission of the European Communities, Proposal for a Council Directive on administrative cooperation in the field of taxation (Brussels: Feb. 2, 2009), 2009.

[15] Discussion Draft, TNT 46-19.

[16] S. 506, H.R. 1265 (introduced March 2, 2009).

[17] The Swiss Ministry of Finance, however, has already been given permission to start negotiations.

C. Problems That Should be Addressed

Although significant progress has been made, the commitments that countries have made generally are to conform to the standard OECD provision. The information exchange provisions therein, as in existing U.S. income tax treaties and TIEAs, as a general rule, contain certain shortcomings. In addition, the time to get from "here" to "there" could be substantial. Certain relevant issues are as follows.

1. As noted in the press, various countries have agreed orally that they will not rely on bank secrecy provisions as a defense against providing information (as they had previously in cases not involving asserted crimes or tax fraud), at least in certain contexts, and not to limit exchange of information to cases involving asserted cases of criminal conduct or tax fraud. Not all countries have agreed. Information exchange provisions must be clearly worded to prevent invocation of domestic bank secrecy or similar provisions to the extent possible, certainly to the extent tax avoidance is at issue, and to eliminate any express or implied restriction to cases involving criminal conduct or tax fraud.

2. In the case of certain existing agreements, the agreements will have to be revised. If that process requires negotiation, the issues that need to be negotiated should be clearly identified and the projected schedule for the process of negotiation and subsequent ratification should be agreed.

3. In some cases, domestic implementing legislation will be required. A problem experienced by the U.S. and other OECD countries is that certain countries have signed TIEAs but have not followed through with domestic measures required to make the agreement effective. It is important that a timetable be agreed to and if implementation is frustrated, including by excessive delays, to consider sanctions or other measures.

4. Most countries, including the U.S., do not wish to be the recipient of an information request that is open-ended (as in a John Doe summons) and which might be characterized as a fishing expedition. Information exchange provisions typically do not condone requests covering a class of unidentified persons, as opposed to specific identification of the individual, at a minimum. There are situations, however, when reasonable efforts to achieve compliance may require the use of broader requests. Related to this is whether information will be supplied if the case involves only suspected tax avoidance rather than a case where significant evidence has been collected.

5. A nagging problem is the amount of time required for the production of specifically requested information. In the context of an examination, delays in producing the material requested can be determinative.

6. If information is located outside of the territory of the requested country, it is not required to be produced under the standard language. Given the global nature of capital flows and business, consideration should be given to expanding the scope to reach this information if available to the requested country.

7. Typically, only information necessary to carry out the requested country's domestic tax laws is required to be produced, and not information available but relating for example only to the requesting country's tax law. This can be a significant shortcoming.

8. It often can be important to the proof of a case to have access to testimony and to original documents rather than just copies. An optimal provision would accommodate these needs. Such a provision is included in the U.S. Model Income Tax Treaty and, e.g., the treaty with Sri Lanka, but is not included in the OECD Model Income Tax Treaty or U.S. treaties based thereon.

9. Various technical issues can exist under the provisions, such as whether the category of relevant persons is defined broadly enough.

10. The exchange of information should be automatic and electronic to the greatest extent possible. Automatic exchange avoids subsequent waiting and permits, with today's computerization of data, the ability to store, categorize for retrieval, and search the information and to use it as a matter of course. If the information can be assimilated, it would avoid the need to later engage in what might be termed a fishing expedition. Although in the past the sheer volume of information would have been a counter-consideration, to the extent information can be furnished in electronic form that should not be a serious drawback.

D. Use of Black Lists and Possible Sanctions

Recent developments have shown that, used carefully, black lists can be a very effective tool to convince certain countries that information exchange is in their best interest. In particular, the announcement that a new blacklist would be considered by the G-20 nations and circulation of a preliminary list of countries considered for that list was evidently instrumental in causing a number of countries to agree to OECD standards on information exchange. The sanctions for inclusion on the list were not established but some considered are disallowance of a deduction for payments to a resident of such a country or encouraging international financial institutions to withdraw investments from blacklisted jurisdictions.

As discussed above, the Stop Tax Haven Abuse Act contains a proposed blacklist of 34 countries. The provision permits the Secretary of Treasury to add countries. It imposes certain conditions to removal of a listed county. Under Section 102 of the Act, the consequences of being a listed country would be the same as those of being a money laundering jurisdiction and could include the prohibition of or imposition of conditions upon the opening or maintaining in the U.S. of a correspondent account for any financial institution based in the listed country. The Act also extends other sanctions currently available to combat money laundering to the fight against tax evasion, aimed at foreign jurisdictions and financial institutions that "impeded U.S. tax enforcement." This would include increased record keeping and information reporting requirements by U.S. financial institutions dealing with offending jurisdictions.[18]

[18] *See also* The Fraud Enforcement and Recovery Act of 2009, which would subject the transfer of funds with an intent to avoid tax to the criminal money laundering statute.

The Internal Revenue Code already includes a provision that authorizes the Secretary of Treasury, if he determines that the exchange of information between the U.S. and a foreign country is inadequate to prevent evasion of U.S. income tax by U.S. persons, to deny the benefit of the portfolio interest exemption to persons within such foreign country or to an address or for an account within such country. While the provision has been in force since 1993, it does not appear to have been employed.

It must be emphasized that a blacklist must be used with care. There should be a gap of time between when a country is proposed to be included on such a list and the final decision to include the country, in order to permit affected countries to decide whether to change the information-limiting rules. Likewise, once a country is included, there should be flexibility for the Secretary to remove the country if compliance has been achieved.

Not all of the countries listed in the Stop Tax Haven Abuse Act seem appropriately included, and developments have occurred since the list was formulated. Not only may the list be overinclusive in certain respects, it may be underinclusive in certain other respects. The list has inconsistencies with countries identified by the OECD. Again, it is important to maintain flexibility in adding and removing countries from such a list.

A blacklist is not without its drawbacks, such as the determination by a blacklisted country to withdraw any cooperation whatsoever or the possibility of retaliation by a blacklisted country through, e.g., prohibiting awarding government contracts to a U.S. company. Nevertheless, the downside of a blacklist may be deemed insufficiently problematic to offset the upside potential.

E. Greater Reliance on Financial Institution Reporting

As an alternative to relying primarily on other countries to provide information, in theory a system of increased reporting by financial institutions handling payments to U.S. persons could be implemented. The rationale would be that, while the U.S. government cannot force another country to cooperate, it can force a financial institution that handles U.S. source payments or otherwise is subject to its jurisdiction (or even if not can be subjected to indirect sanctions) to comply with its rules.

The currently operative regime in that respect is the qualified intermediary regime discussed below. As discussed below, the scope of the required information could be expanded.

A more radical approach is proposed in the Stop Tax Haven Abuse Act. Under that Act, financial institutions would be required to file voluminous reports covering virtually all financial transactions involving an "offshore secrecy jurisdiction." The reporting required provision would seem to impose an overwhelming burden on financial institutions, and their ability to comply and the costs of compliance are factors that should be weighed.

F. Two-Way Street

The information exchange process is of great interest to U.S. tax authorities, but for similar reasons it is of great interest to many foreign tax authorities. Just as the U.S. would like to have another country identify the beneficial owner of an account and to affirmatively apprise the U.S.

tax authorities of accounts beneficially owned by U.S. persons, foreign tax authorities would like the converse.

Issues that may present themselves in this regard include that the IRS Form W-8BEN is not required to be filed with the IRS, so that the IRS has no record of the identity of payees in the QI system. The IRS in theory obtains the identity of payees that are not in the QI system on Form 1042S, but the GAO Report indicates that the information often has not been processed in a way to make it accessible.

Further, the U.S. does not collect information concerning the beneficial owners of entities, including disregarded entities.

A third example is that there is no reporting in respect of bank deposit interest (other than payments to Canadian persons.[19] An attempt during the Clinton Administration to extend bank interest reporting broadly[20] was abandoned.

IV. QI Program

A. General

A qualified intermediary ("QI") is a foreign financial intermediary (or foreign branch of a U.S. intermediary) that has entered into a QI Agreement with the IRS and acts in accordance with that Agreement, governing certain withholding and reporting obligations in respect of U.S. source income.[21] In general, a QI agrees to assume certain documentation and reporting requirements in exchange for simplified information reporting for its foreign account holders and the ability not to disclose account information (which may be proprietary and disclosure may result in information going to a competitor). The QI Agreement has a 5-year term, but may be renewed if the QI is in good standing.

A QI may assume primary withholding responsibility and/or primary Form 1099 reporting and backup withholding responsibility for a payment. In such a case, which will be disclosed on the Form W8-IMY provided to a downstream payor, the payor may treat the QI as a payee, and the QI must satisfy whatever withholding is required.[22] Alternatively, a QI may determine not to assume primary foreign person withholding and/or not to assume primary Form 1099 reporting and backup withholding. In such a case, the QI acts like a typical "nonqualified" intermediary or foreign flow-through entity, and the downstream payor is required to report and, if applicable, withhold based on the payee-related documentation attached to the Form W8-IMY.

According to a 2000 IRS News Release, the IRS views the QI program as the cornerstone of the revised withholding tax rules that came into effect January 1, 2001. Although the preponderance

[19] Reg. § 1.6049-8.

[20] REG-126 1100-00, 2001 TNT 11-17.

[21] The terms of the QI Agreement are set forth in Revenue Procedure 2000-12, as amended.

[22] A similar procedure is provided for a "Withholding Foreign Partnership" and for a "Withholding Foreign Trust."

of cross-border payments by dollar amount is not made via QIs, that number is likely skewed by certain large payments. The IRS has over 5,000 QI Agreements currently in force.

The benefits available to a QI are, first, simplified information reporting procedures for the QI, as only withholding rate pool information is provided to U.S. custodians (or other downstream intermediaries). Second, the Agreement permits collective refund procedures (thus not requiring customers to individually file for refunds). Third, the identity of non-U.S. customers need not be disclosed to withholding agents (who might be competitors) or to the IRS.

The benefits derived by the Treasury and IRS from the QI program are that the IRS has a greater degree of assurance that proper withholding is being made. A QI agrees to undertake additional obligations that are not imposed on normal withholding agents. Of particular importance, they agree to: (i) follow specified account-opening procedures based upon the "know your customer" rules of the applicable jurisdiction (which rules will have been reviewed and approved by the IRS as adequate); and (ii) have the procedures they follow be subject periodically to an external audit (currently, during the second and fifth years of the agreement) pursuant to standards set by the IRS.

In considering alternatives to a QI program, the most obvious would be to require disclosure of the identity of the beneficial owner to be made at each level down the withholding chain, and reported to the IRS, as in the case for nonqualified intermediaries. The IRS, however, would lose the benefit of the review available at the point in the chain where direct contact with the beneficial owner is most likely to exist. Another alternative would be to withhold on investors from countries with which the United States does not have a bilateral income tax treaty and require evidence of residence to obtain a refund. This approach, however, would be considered overly frictional and disruptive of desirable capital flows. A third approach, which would not really be an alternative, would be to modify the program, such as to require that Forms W-8BEN be furnished to the IRS (see below).

B. Assessment and Shortcomings

The U.S. Government Accounting Office reported on the QI program in December 2007 in its report "Tax Compliance: Qualified Intermediary Program Provides Some Assurance That Taxes on Foreign Investors Are Withheld and Reported, but Can Be Improved."[23] The GAO Report concluded that 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 sent offshore than other withholding agents." The reasons given are the QI's working relationship with the ultimate beneficial owner, the enhanced responsibilities of a QI as compared with other withholding agents, and the external audit procedure.

The GAO Report suggested certain measurement and procedural enhancements. The GAO Report first thought it would be useful to know in what proportion of cases withholding agents rely solely on self-certified documentation without ability to otherwise verify. It also found it troubling that large sums reported by QIs could not be associated with a particular jurisdiction,

[23] GAO-08-99 (Dec. 19, 2007), 2008 TNT 18-47. This report elaborated on the GAO testimony given May 3, 2007: GAO, "Tax Compliance: Challenges in Ensuring Offshore Tax Compliance," GAO-07-731G (July 2007).

and suggested that the IRS investigate and take corrective action. As far as actual changes to the procedures, the GAO Report suggested that the "Agreed-upon Procedure" ("AUP") standards[24] be enhanced by requiring the external auditor to report any indications of fraud or illegal acts that could significantly affect the results of the review, not just indications of "know your customer rule" violations and information received as the result of self-reporting by the QI. Finally, the GAO Report recommended that QI Agreements require electronic filing of data (with exceptions made by IRS waiver), and that the IRS improve its data processing capabilities.

Certain other shortcomings with the operation of the QI program may be noted.

1. Financial institutions have a conflict of interest, in that their customer relationships may be adversely affected by compliance.

2. U.S. owners of foreign securities are not required to be reported.

3. Interposed foreign entities have been used to provide a W-8BEN showing a non-U.S. person. This problem is of course not unique to QI withholding.

4. External "audits" have not been entirely effective. They are required only to be in accordance with AUP standards, which means that they do not constitute an audit or a review and therefore are not an expression of an opinion by the auditor. Related to this is that the standard of audit may be too rigid to permit auditors to exercise discretion and there is no requirement to act upon the findings of an audit.

C. Announcement 2008-98

In response to the GAO Report (and a few months after further criticism in the July 2008 PSI hearing), the IRS issued Announcement 2008-98, which proposed changes to the model QI Agreement and to the audit procedures.[25] These changes, proposed to apply to calendar year 2010 and thereafter, would include the following:

1. Provide that a QI must notify the IRS within 60 days of the time that the QI becomes aware of "a material failure of internal controls" relating to its performance under the QI Agreement, any employee allegation of such failures, and any investigation by regulatory authorities of such failures. Failure by the QI to so notify would be an event of default under the QI agreement.

2. Require the external auditor to associate a U.S. auditor with the audit and to require the U.S. auditor to accept joint responsibility for performance of the audit procedures.

3. Require the auditor to examine the account holder files selected for testing to ascertain whether there are indicia (e.g., signing authority) that a U.S. person might control an account purporting to be foreign controlled. The definition of an "account holder's file" would

[24] International Standard in Related Services 4400, "Engagements to Perform Agreed-upon Procedures Regarding Financial Information" (ISRS 4400).

[25] The audit procedures are set forth in Revenue Procedure 2002-55.

be substantially expanded to include "any documents, reports or other information generated or received for purposes of anti-money laundering, know-your-customer, tax or other laws, and any other account information."

4. Require the auditor to add additional procedures for fact gathering, including, e.g., identifying the persons charged with the oversight of performance under the QI Agreement and the authority given them to prevent, detect and correct failures, and requiring the auditor to report to the IRS relevant facts.

The IRS has received comments on this announcement from certain audit firms and QIs. Clearly, a balance will need to be struck between the interests of a viable review and audit procedure and the increased costs associated with the proposed procedures, which may be beyond the ability of smaller QIs to comply. In particular, certain of the additional procedures in effect would cause the audit to go beyond an AUP, which had previously been agreed among the QIs, audit firms and IRS, raising issues as to how the review may be conducted under the accounting profession's audit standards. Nevertheless, it seems clear that strengthening of the external review process is appropriate.

D. Concluding Remarks on QI Program

I have the following concluding comments and suggestions in respect of the QI program.

1. The QI program overall is well-conceived and plays a key role in the U.S. withholding tax system, and should be supported, including with adequate funding.

2. QIs should be required to report U.S. owners holding only foreign securities.

3. Consideration should be given to requiring QIs (and as appropriate nonqualified intermediaries) to use information available to them under money-laundering or other rules to identify cases in which the beneficial owner(s) of a non-US entity providing a W-8BEN appears to be a U.S. person or persons (looking through, as appropriate, entities up the ownership chain).

4. Consideration should be given to requiring QIs to provide the Forms W-8BEN to the IRS. Such a requirement would be consistent with the recommendations made in the ICG Report on Withholding Procedures and would permit the U.S. to share this information with its treaty partners. A concern is whether such a requirement would eliminate the attractiveness of the program for financial institutions.

5. The external review process should be strengthened. In what form the proposals made in Announcement 2008-98 are adopted and with what effective date should be monitored closely. While the wording of the proposals appears unclear and even overly broad in places, and the requirement of a US auditor overlay may well be too costly, the proposals do represent an attempt to address the concerns in the GAO Report and some of the concerns expressed in hearings before Congress.

In addressing these issues, consideration also must be given to the effect of a change in the playing field on the willingness of financial institutions to participate in the

program. Clearly there are burdens associated with being a QI and the changes considered would increase the burdens and, to the extent potential investors are less willing to invest through a QI, could reduce the benefits to those institutions. Recognition also must be given to the face that the scale of operations of smaller institutions makes them particularly sensitive to increased costs.

Statement of Stephen E. Shay

Committee on Ways and Means, Subcommittee on Select Revenue Measures
United States House of Representatives

Hearing On Issues Involving Banking Secrecy Practices And Wealthy American Taxpayers

March 31, 2009

Mr. Chairman, Ranking Member Tiberi and Members of the Committee:

My name is Stephen Shay. I am a partner in the law firm Ropes & Gray in Boston. I specialize in U.S. international income taxation and was formerly an International Tax Counsel for the Department of the Treasury. I have advised U.S. custodian banks, foreign private banks, foreign governments and foreign investment funds with U.S. and non-U.S. sponsors, and occasionally foreign high net worth individuals, on cross-border income tax and withholding issues.[1] With the Chairman's permission, I would like to submit my testimony for the record and summarize my principal observations in oral remarks.

As stated in the notice for the hearing, the focus of today's hearing is "on limitations of the withholding taxes imposed by the United States on U.S.-source investment earnings received by foreign persons, the Qualified Intermediary ("QI") program established by the IRS to enforce those withholding taxes, the limitations of our tax treaties, and the extent to which these may have contributed to non-compliance by U.S. taxpayers."

I discuss below the law relevant to U.S. withholding on payments to foreign persons, including that governing the QI system, documentation and reporting, and information exchange under treaties. I also discuss the relationship of these cross-border withholding rules to the information reporting rules upon which we rely to encourage income tax reporting of investment income.[2] Understanding the different roles for information reporting and cross-border withholding and the context in which they apply is essential to evaluating their strengths and weaknesses in relation to the purposes for which they were adopted and their use in preventing offshore tax evasion by U.S. persons.

Because of the complexity of these rules and their interaction I have structured my testimony as follows. In the next part of my testimony, I provide some broader context to the

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[1] I have attached a copy of my biography to this testimony. The views I am expressing are my personal views and do not represent the views of either my clients or my law firm. I would like to acknowledge with thanks the substantial assistance of Kathleen Gregor and Laura Damerville in the development of this testimony and of Jennifer Neilsson and Revital Bar Or in its preparation and review. Any errors are my own.

[2] This discussion is not intended to be comprehensive. As noted by William Burke, an examination of all of the elements of the information reporting rules applicable to cross-border transactions would require a treatise. William L. Burke, *Tax Information Reporting and Compliance in the Cross-Border Context*, 27 VA TAX REV. 399, 401 n. 5 (2007).

issues raised in this hearing and provide an overview of the major elements of my testimony. I then outline a series of short-term proposals and longer term options for change. Succeeding sections of the testimony include more detailed discussions of these topics. The technically minded may read the entire testimony; however, for those with shorter attention spans the key points I will make are as follows:

- The United States taxes very little U.S.-source investment income paid to foreign persons.
- The United States does not have jurisdiction to require foreign banks and financial institutions to report foreign accounts of U.S. persons that only earn foreign income and can only obtain information on these accounts through foreign financial institutions that act as QI withholding agents for U.S. investment income or through information exchange requests with treaty or TIEA partners.
- Because of the above, some U.S. persons are able to masquerade as foreign persons or hide behind foreign corporations without reporting their income (from unreported accounts or under controlled foreign corporation or passive foreign investment company rules).
- There are feasible ways to reduce the opportunities for U.S. tax evasion in this context:
    - Expand the responsibilities of QIs in relation to U.S. customers, whether or not they hold assets in a QI account.
    - Increase IRS enforcement resources devoted to cross-border enforcement, including resources to allow QIs to submit information electronically.
    - Consider prospective elimination of the foreign-targeted bearer obligation exception to beneficial owner documentation or QI reporting (but retain the portfolio interest exemption from withholding). This would effectively require that participants in the distribution and holding of foreign targeted debt be QIs.
    - Expand the network of treaties and TIEAs under which information may be exchanged with respect to U.S. persons' non-U.S. income and support collection and sharing of tax information subject to accepted taxpayer information confidentiality protections.
    - Support OECD initiatives to identify and promote best practices for electronic information exchange and procedures for implementing rate reductions at source.

At the end of my testimony I also discuss options for expanding source taxation of investment income that would require analysis and consultation with industry and governments, but which should at least be considered (whether accepted or rejected) in connection with any international tax reform.

I. OVERVIEW OF ISSUES AND PROPOSALS

A. Fiscal Policy, the Tax Gap and the International Tax Gap

We are in the midst of the most severe economic downturn in generations. At the same time, we have made commitments at home and abroad that extend beyond the revenues raised under our current tax system. The recently updated Congressional Budget Office (CBO) Budget and Economic Outlook projects Federal budget deficits under current laws and policies equal to 11.9% of Gross Domestic Product (GDP) for the 2009 fiscal year and 7.9% of GDP for next year and declining to 2% of GDP in 2012 to 2019,[3] before taking into account investments requested by President Obama in health care, the environment and other programs in his 2010 budget.

Large deficits are an appropriate prescription in these unusual times. Although any decision regarding the amount we borrow as a country should be analyzed as would any financing decision,[4] we must anticipate that there is a limit to our ability to borrow without triggering inflation and a decline in confidence in the dollar.[5] Moreover, government borrowing resulting from operating (as opposed to capital) deficits in particular merely postpones the need to raise taxes to pay the principal and interest arising from that borrowing.

While there is a widespread consensus that raising taxes would be unwise in the current economic environment, it also is clear that long-term economic health requires that we repair our Federal income tax system in order to be able to have the resources to meet the needs of present and future generations. Taking steps to address the so-called tax gap, the difference between taxes due and taxes actually collected, is an important element of putting our fiscal house in order.[6] Although there are no easy panaceas, there are cost effective steps that can be taken to reduce the tax gap even as we recognize that it can not be eliminated altogether.

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[3] CONGRESSIONAL BUDGET OFFICE, A PRELIMINARY ANALYSIS OF THE PRESIDENT'S BUDGET AND AN UPDATE OF CBO'S BUDGET AND ECONOMIC OUTLOOK 1 (Mar. 2009).

[4] *See* Neil H. Buchanan, *Is It Sometimes Good to Run Budget Deficits? If So, Should We Admit It (Out Loud)?* 26 VA. TAX REV. 325 (2006).

[5] *See, e.g.*, Alice M. Rivlin and Isabel Sawhill, *Growing Deficits and Why They Matter*, RESTORING FISCAL SANITY: HOW TO BALANCE THE BUDGET 10 (Jan. 2004), *available at* http://www.brookings.edu/es/research/projects/budget/fiscalsanity/full.pdf.

[6] The 2001 Internal Revenue Service's (IRS) tax gap estimate of $345 billion only reflects legal-source income. I.R.S. News Release, *I.R.S. Updates Tax Gap Estimate [for Tax Year 2001]*, IR-2006-28 (Feb. 14, 2006), *available at* http://www.irs.gov/newsroom/article/0,,id=154496,00.html. The IRS defines "gross tax gap" as "the difference between the aggregate tax liability imposed by law for a given tax year and the amount that taxpayers pay voluntarily and timely for that year." ALAN PLUMLEY, I.R.S. OFFICE OF RESEARCH, 2005 IRS RESEARCH CONFERENCE: PRELIMINARY UPDATE OF THE TAX YEAR 2001 INDIVIDUAL INCOME TAX UNDERREPORTING GAP ESTIMATES 15 (June 2005), *available at* http://www.irs.gov/pub/irs-soi/05plumley.pdf. *See also* Burke, *supra* note 2; Leandra Lederman, Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted? 2 (Feb. 2009) (unpublished abstract), *available at* http://ssrn.com/abstract=1347668.

The last comprehensive IRS estimate of the tax gap was for the 2001 fiscal year. The estimate, a gross gap of $345 billion and net gap of $290 billion,[7] did not include all unreported income from offshore activity. Indeed, there has been no IRS estimate to date of what the Treasury Inspector General for Tax Administration ("TIGTA") calls the "international tax gap," defined as "taxes owed -- but not collected on time -- from a United States (U.S.) person or foreign person[8] whose cross-border transactions are subject to U.S. taxation."[9]

The TIGTA included in its recent report estimates of the portion of the international tax gap attributable to offshore noncompliance of U.S. taxpayers ranging from $40 billion to $70 billion based on what are essentially back-of-the-envelope estimates (or educated guesses) by the IRS (for the low estimate dating from 2004) and Marty Sullivan (for 2004).[10] The TIGTA acknowledges in its report that the IRS has not developed an accurate and reliable estimate of the international tax gap based on empirical evidence.[11]

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[7] The $345 billion estimate of the gross gap did not take into account taxes that were paid voluntarily, but late, and recoveries from IRS enforcement activities. According to former Treasury Assistant Secretary Eric Solomon, the "net tax gap" was an estimated $290 billion in tax year 2001. *Testimony before the Senate Finance Committee on Ways to Reduce the Tax Gap* (Apr. 18, 2007) (statement of Eric Solomon, Treasury Assistant Secretary for Tax Policy), *available at* http://www.treas.gov/press/releases/hp360.htm.

[8] For this purpose, U.S. person and foreign person are as defined in section 7701 of the Code. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code"), or to regulations thereunder.

[9] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, OFFICE OF INSPECTIONS AND EVALUATIONS, A COMBINATION OF LEGISLATIVE ACTIONS AND INCREASED IRS CAPABILITY AND CAPACITY ARE REQUIRED TO REDUCE THE MULTI-BILLION DOLLAR U.S. INTERNATIONAL TAX GAP 1 (Jan. 27, 2009) (hereinafter TIGTA REPORT), *available at* http://www.treas.gov/tigta/iereports/2009reports/2009IER001fr.html. *See also* Martin A. Sullivan, *Economic Analysis: U.S. Citizens Hide Hundreds of Billions in Cayman Accounts*, 103 TAX NOTES 956 (May 24, 2004).

[10] TIGTA REPORT, *supra* note 9, at App. VI. These income amounts presumably included capital gains and foreign income not subject to U.S. withholding tax if paid by a U.S. person thinking they were paying to a foreign person. In other words, as discussed in the text below, amounts that are outside the U.S. withholding regime.

[11] TIGTA REPORT, *supra* note 9, at 4. While there is much to be done in attacking the international tax gap, these estimates are extremely uncertain and may be high. The findings of the Government Accountability Office ("GAO") in reviewing the disclosures of individuals participating in the IRS's 2003 Offshore Voluntary Compliance Initiative ("OVCI") include the following:

> The type and extent of individual taxpayers' illegal offshore activity varies. In 2004, we reviewed OVCI to provide information to Congress on the characteristics of taxpayers who came forward regarding their noncompliant offshore activities, and to understand how those taxpayers became noncompliant. According to IRS data, OVCI applicants were a diverse group, for instance with wide variations in income and occupation. In each of the 3 years of OVCI we reviewed, at least 10 percent of the OVCI applicants had original adjusted gross incomes (AGI) of more than half a million dollars, while the median original AGI of applicants ranged from $39,000 in tax year 2001 to $52,000 in tax year 2000. Applicants listed over 200 occupations on their federal tax returns, including accountants, members of the clergy, builders, physicians, and teachers (citations omitted).

Tax Compliance: Offshore Financial Activity Creates Enforcement Issues for IRS 2-3 (Mar. 17, 2009) (statement of Michael Brostek, Director, Government Accountability Office Strategic Issues Team, Committee on Finance, U.S.

B. U.S. Residents' Offshore Tax Evasion

This hearing is about the potential for tax evasion by U.S. citizens and residents through use of foreign bank accounts and how the tax system should respond. There should be a shared sense of outrage that some U.S. citizens and residents would seek to evade their civic and legal responsibility to pay their fair share of taxes – whether by hiding money overseas or by intentionally failing to report income or by overstating deductions.[12] Those who would aid and abet others' failure to pay tax for their own gain, as well as those who do not pay their taxes, are equally culpable. These contributors to the tax gap cause Americans who pay their taxes to suffer higher rates, which is unfair and economically inefficient.

There are important reasons to attack offshore evasion and avoidance that are independent of the need for revenue, namely, that confidence in the fairness of our tax system is eroded and support for voluntary compliance is consequently undermined if we let U.S. citizens and residents evade their taxes by simply establishing an unreported foreign bank account to receive or earn unreported income. *But this is just as true for other elements of the tax gap.*

The Government does not have infinite resources and it is important that we be analytical in their allocation and target them at the greatest need.[13] In the international area, we should support cost-effective proposals, which the United States can adopt either directly or in cooperation with other countries, which would reduce international tax evasion by U.S. residents. A number of proposals are discussed below. Any such measures have to work in tandem with our withholding rules and procedures for payments to foreign persons in a manner that allows the United States to continue to benefit from foreign capital.

In considering these proposals, it must be emphasized that the objective of promoting voluntary compliance is undermined if we pursue the relatively easy targets of noncompliant foreign banks without also taking on "low hanging fruit" compliance measures at home. We also should actively analyze and pursue expanding information reporting on payments to Sub S corporations and partnerships and other cost effective proposals, as well as addressing cross-border payments.[14] To do otherwise invites cynicism.

Senate) (hereinafter Statement of Michael Brostek). It is clear that some of the largest evaders did not participate in the OVCI, as evidenced by the conviction of Mr. Olenicoff for evading taxes on approximately $200 million of income. Joann M. Weiner, *News Analysis: Disqualifying UBS From the QI Regime*, 121 TAX NOTES 1097, 1098 (Dec. 8, 2008). Nonetheless, realism requires recognition that we do not really know how large the problem is and we do know it is difficult to attack.

[12] The tax gap includes unintentional errors, which are common in a tax system as complicated as ours. The prescriptions for this portion of the tax gap is the tax law simplification and continued efforts by the IRS to provide excellent customer services to taxpayers.

[13] *See, e.g.*, Joseph Bankman, *Eight Truths About Collecting Cash From the Cash Economy*, 117 TAX NOTES 506 (Oct. 30, 2007); Lederman, *supra* note 6 (describing standards for when information reporting is cost effective).

[14] *See* NATIONAL TAXPAYER ADVOCATE'S 2007 ANNUAL REPORT TO CONGRESS 501, *available at* http://www.irs.gov/pub/irs-utl/arc_2007_vol_1_legislativerec.pdf (hereinafter NATIONAL TAXPAYER ADVOCATE'S 2007 ANNUAL REPORT TO CONGRESS); Lederman, *supra* note 6, at 12-16; Jay A. Soled, *Homage to Information Returns*, 27 VA. TAX REV. 371 (2007).

At the end of my testimony, I suggest that consideration be given to longer-term structural changes in source taxation of cross-border income that would require consultation and coordination with other countries. These options should be considered and accepted or rejected as part of a broader review of tax reform alternatives.

C. Taxing U.S. Payments to Foreign Persons and Preventing Tax Evasion By U.S. Persons: Reconciling Conflicting Policies

According to the GAO, in 2003, $293 billion in U.S.-source fixed or determinable income potentially subject to withholding was paid to foreign persons.[15] U.S. payors with withholding responsibility were required to receive documentation of the payees' foreign status either in the form of a self-certification under penalties of perjury from the "beneficial owner" of the income or through a QI in a position to verify the identity and status of the beneficial owner (unless the source of the payments was bearer obligations targeted to foreign persons). Notwithstanding that these were payments of U.S.-source income, the vast majority were eligible for exemption or reduced rates of withholding. Of the $293 billion in 2003 payments, the amount withheld was approximately $5 billion.[16]

Under tax rules described in Part II below, the United States effectively exempts from U.S. tax most U.S. investment income paid to foreign persons.[17] This has broad implications relevant to this hearing:

(1) Because of the lack of potential tax revenue from cross-border withholding taxes, it is not cost-effective to devote disproportionate resources to enforcing the withholding tax on investment income paid to foreign persons.[18]

(2) Other countries, including most U.S. treaty partners, follow a similar practice of exempting much non-dividend investment income from source taxation with the result that there is substantial scope for tax evasion internationally.[19]

(3) Debt obligations issued in the global fixed-income markets assume no source taxation.[20]

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[15] Of this amount, a relatively small portion, approximately 12.5% is reported to have been paid to QIs. Statement of Michael Brostek, *supra* note 11, at 10.

[16] U.S. GOV'T ACCOUNTABILITY OFFICE, REPORT TO THE COMMITTEE ON FINANCE, U.S. SENATE, TAX COMPLIANCE: QUALIFIED INTERMEDIARY PROGRAM PROVIDES SOME ASSURANCE THAT TAXES ON FOREIGN INVESTORS ARE WITHHELD AND REPORTED, BUT CAN BE IMPROVED 19 (Table 2) (Dec. 19, 2007) (hereinafter GAO QI REPORT), *available at* http://www.gao.gov/products/GAO-08-99.

[17] While dividends are subject to U.S. withholding tax, it is possible to hold non-dividend paying equities or to take steps such as trading around dividend dates or using appropriately designed and implemented notional principal contracts to avoid the withholding tax.

[18] Nonetheless, in December, the IRS LMSB Division established a new Tier 1 audit issue for "U.S. withholding agents' section 1441reporting and withholding on U.S. source FDAP income." Background may be found on the IRS web site at: http://www.irs.gov/businesses/corporations/article/0,,id=205415,00.html.

[19] It is not clear that the European Savings Directive has had a material effect on this fact. While change is occurring, it remains true that the "tax cultures" of many other countries generally do not support voluntary tax compliance to the same extent as in the United States.

(4) These facts encourage U.S. persons to masquerade as foreign persons.

What can and should be done about this? There are significant constraints. While the outer limits of its jurisdiction are not always clear, generally the United States does not have enforcement jurisdiction over a foreign financial institution that is not owned by a U.S. person and does not carry on a U.S. business (in the relevant entity).[21] Accordingly, it is possible for a U.S. person to have an account at a foreign financial institution that is not subject to U.S. third party information reporting. The rules for collecting withholding on payments to foreign persons are coordinated with the domestic information reporting and backup withholding rules, but these rules do not apply in a range of cases with respect to foreign accounts.[22] As discussed in succeeding paragraphs, the QI system performs an important withholding function and may be expanded to assist in this regard, but not every foreign bank is a QI and the determined evader can migrate to such a bank. The backstop to these systems is information exchange between countries. While specific information requests are indeed time consuming and manpower intensive, they are important both in uncovering information and as a prophylactic measure.[23] Below, I consider a set of proposals taking into account these constraints. There is no single silver bullet.

The actions of UBS that gave rise to and are described in the UBS deferred prosecution agreement[24] are seen by some as an indication of the failure of the qualified intermediary ("QI") program.[25] For reasons described below, the QI program is an essential part of the U.S. withholding system so long as the United States continues to have a patchwork of withholding tax exceptions and reduced rates. The development of the QI regime was an important advance in enhancing cross border compliance. While it needs to be strengthened in certain respects, it is important to understand the role it plays in the withholding system.

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[20] Because of interest gross-up clauses, it is likely that the interest on such debt instruments would re-price if this were changed in relation to outstanding debt obligations.

[21] RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW §§ 411-13, 431 (1987).

[22] *See infra* note 72.

[23] The U.S. Treasury's Acting International Tax Counsel stated in testimony before the Senate Finance Committee Hearing on Offshore Tax Evasion that information obtained under a treaty led to at least two high-profile U.S. tax evasion convictions. *Testimony before the Senate Finance Committee on Offshore Tax Evasion* (May 3, 2007) (statement of John Harrington, Treasury Acting International Tax Counsel) (hereinafter Statement of John Harrington), *available at* http://ustreas.gov/press/releases/hp385.htm. One of these was the conviction of Walter C. Anderson, who was sentenced to 9 years in prison in 2007 for failing to report $365 million in income and trying to use offshore entities to evade U.S. federal and municipal taxes of over $200 million. *See* Carol D. Leonnig, *9-Year Sentence for Tax Evasion; Mogul Avoided Paying IRS, D.C. $200 Million*, WASH. POST, Mar. 28, 2007, at B1. The other conviction, in 2004, was that of Almon Glenn Braswell, who attempted to evade more than $10 million in corporate income taxes by using an offshore corporation and bank account, but his scheme was uncovered through requests made by the U.S. under the TIEA. *See* David Rosenzweig, *Man Whom Clinton Pardoned Enters Plea*, L.A. TIMES, Mar. 3, 2004, at B3.

[24] Deferred Prosecution Agreement, United States v. UBS, Case No. 09-60033-CR-COHN (S.D.Fla. Feb. 19, 2009)

[25] *See, e.g.* Lee Sheppard, *News Analysis: Don't Ask, Don't Tell, Part 4: Ineffectual Information Sharing*, 122 TAX NOTES 1411 (Mar. 23, 2009).

The payments made to QIs generally go through foreign clearing organizations, banks or other financial institutions that pool vast amounts of securities in the omnibus accounts that are an essential part of the efficiency of the domestic and global securities payments systems. Domestic information reporting and back-up withholding were designed from the outset with the understanding that the financial institution closest to the customer, whether a bank, broker or other such institution, would have the obligation to information report. The last payor in the chain would have the customer's name and taxpayer identification number and thereby be in a position to deliver a Form 1099 to the customer showing his income or gross proceeds and to file a copy with the IRS. Before development of the QI system in the 1990s, however, no analogous system for cross-border payments existed.

Until the development of the QI system a U.S. withholding agent has no realistic way to know whether the beneficial owner at the other end of a payments chain was a U.S. or foreign person or whether that person was entitled to treaty relief. It was an open secret that U.S. withholding agents were treating foreign banks as though they were the beneficial owners of omnibus accounts that they held for customers and that the withholding agents were failing to withhold tax contrary to regulations. In light of the reality of the financial payments systems for securities, accurately depicted in a GAO chart attached as an Appendix to this testimony, the regulation was totally unrealistic and went unobserved.[26]

The QI system was developed at the behest of U.S. custodian banks to reduce their exposure to the increasingly intolerable risk of withholding liability with respect to portfolio interest paid to foreign banks that were not in fact beneficial owners of the interest income. Working closely with the Internal Revenue Service over a period of several years, regulations were developed that allowed the U.S. withholding agents to rely on documentation received from QIs as well as direct customers unless they had a reason to know it was not correct. One of the key decisions made in those regulations was to follow traditional U.S. tax rules and respect a foreign corporation as a nontransparent beneficial owner without regard to whether it was owned by one or a few U.S. persons.[27] The QI system was an integral part of these regulations and in essence relied on a foreign bank with a direct relationship with a foreign customer to exercise normal banking "know-your-customer" disciplines in assuring that the documentation it received and relied upon was correct. The QI regime prescribed audits by the bank's external auditors to

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[26] One reason that this issue was not focused on when the first regulations implementing portfolio interest were developed was because the repeal of the withholding tax on portfolio interest was driven by a desire of U.S. securities firms and the U.S. Treasury to be able to issue debt in the Eurobond market other than through the Netherlands Antilles treaty structure for Eurobonds. James P. Holden, Jr., Note and Comment, *Repeal of the Withholding Tax on Portfolio Debt Interest Paid to Foreigners: Tax and Fiscal Policies in the Context of Eurobond Financing*, 5 VA. TAX REV. 375, 367-77 (1985). A major point of contention was whether bearer obligations would be permitted to be targeted to foreign buyers. Having won this concession, the financial industry either did not anticipate problems arising from the beneficial owner documentation requirement or strategically determined not to address the issue.

[27] As discussed below, a closely held foreign corporation holding investment assets generally would be either a controlled foreign corporation or a passive foreign investment company as to U.S. shareholders. Consequently, the foreign corporation's income would be subject either to current inclusion or its rough economic equivalent in the income of its U.S. shareholders.

back stop the system.[28] As the GAO has recognized, the QI system improved the ability to identify U.S. persons:

> 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. Because QIs are in overseas locations, they are more likely to have personal contact with NRAs 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 account ownership information and be able to accurately judge whether its customers are who they claim to be.[29]

When it was first conceived, it was uncertain whether foreign banks would participate in the QI system. However, substantial IRS efforts to explain the new system persuaded foreign banks that if they did not participate they would face full 30% withholding on all interest and dividends if they did not provide individual customer documentation. Providing individual customer documentation, which would require disclosure of customer names to other banks and in many cases would be impractical. In 2005, there were over 5000 QIs.[30] An important question is how much burden and risk of liability can be placed on QIs without causing material participants to leave the QI system.[31]

The inability of a withholding agent to pierce through layers of payees also has prompted the banking industry to push for international adoption of rules that are structurally similar to the QI system.[32] Importantly, an informal business and governmental consultative group at the OECD is considering the practicality of procedures to surmount one of the criticisms of the QI regime, namely, that beneficial owner information is not made available to the source country and is not readily usable by the country in which the investor resides. This is an important project and deserves the strong support of the U.S. Government.

As noted above, the United States imposes little source taxation on investment income of nonresidents. The ability of nonresidents to invest in U.S. fixed income and non-dividend paying

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[28] *See* I.R.S. Announcement 2008-98, 2008-44 I.R.B. 1087; I.R.S. Notice 2001-66; 2001-2 C.B. 396.

[29] GAO QI REPORT, *supra* note 16, at 12.

[30] *Testimony before the Senate Committee on Homeland Security and Governmental Affairs' Permanent Subcommittee on Investigations Hearing on Tax Haven Financial Institutions: Their Formation and Administration of Offshore Entities and Accounts for Use by U.S. Clients (July 17, 2008)* (statement of Douglas Shulman Commissioner of Internal Revenue) (hereinafter Statement of Douglas Shulman), at 6, available at http://hsgac.senate.gov/public/_files/STMTShulmanIRSREVISED.pdf.

[31] The GAO reports that 549 QI agreements have been terminated because of failures to satisfy agreed-upon procedure (AUP) requirements since inception of the program and that 5% of the QIs account for 90% of the withholding (based on data from the 2002 audit cycle, which may not be representative). GAO QI REPORT, *supra* note 16, at 26 – 27.

[32] *See* ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, CENTRE FOR TAX POLICY AND ADMINISTRATION, REPORT ON POSSIBLE IMPROVEMENTS TO PROCEDURES FOR TAX RELIEF FOR CROSS-BORDER INVESTORS, *available at* http://www.oecd.org/dataoecd/34/19/41974569.pdf.

equities and earn returns free from U.S. tax without reliance on a treaty (and treatment of a foreign corporation as a beneficial owner), and the limits on enforcement jurisdiction over foreign financial institutions creates an incentive for U.S. citizens and residents to masquerade as foreign persons or invest through foreign corporations without reporting income under the CFC and PFIC rules. It is feasible and important to take additional steps to frustrate evasion by U.S. persons

After 10 years of experience with the QI system, it likely is possible to enhance the scope of responsibilities of a QI in relation to U.S. citizens and residents without causing foreign financial institutions to forego acting as QIs. It is necessary, however, to recognize that these institutions operate under the regulatory and legal regimes of their home countries. It will be important for the IRS and Treasury to consult with these institutions and their home country authorities to cause any new requirements to satisfy such laws. For example, it may be necessary for U.S. customers to make limited waivers of electronic privacy or banking confidentiality laws in order for the foreign bank to be able to provide information to the IRS.

The GAO Report highlights that substantial amounts of payments are made to unknown recipients in various countries by both U.S. withholding agents and QIs. One would expect that a substantial portion of these payments are made on foreign targeted "bearer" debt instruments as to which beneficial owner information in not required to be provided to a withholding agent or QI, as discussed further below. "Bearer paper" is an anachronism; traded debt obligations are recorded on book entry systems of clearing organizations and banks.[33] The rationale for the rules relating to bearer debt obligations, other than the fact that they have become embedded in the Eurobond offering system, is that the foreign targeting procedures are an adequate defense against U.S. tax evaders. These rules make it easier on banks and securities firms to deal with such securities and that such securities are marketed in the same manner as bearer securities were in the past. There is no government or QI related auditing of the processes designed to prevent U.S. owners who are not exempt recipients from obtaining such securities. In my experience foreign financial institutions' back offices seem to have little understanding of the rules relating to bearer debt obligations beyond the fact that that they must be disclosed in offering documents for foreign targeted issues and that special notice rules apply to sales to U.S. persons. It should be considered whether it is feasible to move these issues into the QI regime for registered obligations.

The best fallback is the ability to ask a treaty or TIEA partner for information. Information authorized to be exchanged from government to government under treaties and TIEAs is relatively unconstrained. With few exceptions, the U.S. practice has been to require that information be obtained by a treaty partner without regard to local bank secrecy or similar restrictions and be provided in a form admissible in court. When making requests of TIEA partners that do not have an income tax, it is important for the IRS to provide those governments with context for the information requests and explain what information is requested and why. In my experience, such communication materially facilitates the ability of the foreign government to assist.

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[33] *See* NYSBA TAX SECTION REPORT ON ISSUES RELATING TO RESTRICTIONS IMPOSED ON OFFERS AND SALES OF BEARER BONDS BY THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 ("TEFRA") 5-8 (Oct. 1, 2007).

With the preceding as background, I summarize several proposals for consideration that are discussed at greater length in Part IV of this statement.

D. Summary of Proposals for Change

Certain proposals for reforming the U.S. reporting and withholding systems are set out here and are examined in greater detail in Part II below. These proposals could be implemented in the shorter term, and would aid the IRS in enforcement and reduce the opportunity for evasion of taxes by U.S. persons. These proposals include:

- Revising the QI system to require QI information reporting on all accounts over a reasonable threshold held by U.S. persons, including information reporting with respect to payments to a closely-held foreign corporation in which U.S. beneficial owners hold more than 10% of the company.
- Increasing IRS enforcement resources devoted to cross-border enforcement, including resources to allow QIs to submit information electronically.
- Considering prospective elimination of the foreign-targeted bearer obligation exception to beneficial owner documentation or QI reporting (but retain the portfolio interest exemption from withholding). This would effectively require that participants in the distribution and holding of foreign targeted debt be QIs.
- Expanding the network of treaties and TIEAs under which information may be exchanged with respect to U.S. persons' non-U.S. income and support collection and sharing of tax information subject to accepted taxpayer information confidentiality protections.
- Supporting OECD initiatives to identify and promote best practices for electronic information exchange and procedures for implementing rate reductions at source.

Set out at the end of this testimony are long-term options for consideration as part of international tax reform. These options are intended to take into account that technological advancement may make it feasible to implement source taxation on a much more sophisticated and nuanced basis than in the past. These options represent an exploration of opportunities to increase the scope of source taxation of returns to capital in coordination with other countries in a manner that more closely approximates the taxation of net income that was possible historically. While this likely would reduce the incentives and opportunities for evasion by U.S. persons, the primary purpose behind such options would be a broader collection of tax revenue from cross-border investment. Those options, discussed at the end of this testimony, must be considered in light of economic conditions and ramifications for capital market and foreign relations, as well as the feasibility of incorporation into the existing international financial system.

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II. Current Law Source Taxation of Nonresidents' U.S.-source Investment Income.

A. Overview of U.S. Residence Taxation

The United States taxes the worldwide income of its resident aliens, citizens, and domestic corporations. The United States then grants a credit against U.S. taxes, subject to limitations, on net foreign-source income on which the taxpayer has paid or deemed to have paid foreign income taxes. The general purpose of the credit system is to prevent double taxation, which is why the foreign tax credit is limited to the amount of tax the United States would have imposed on the taxpayer's foreign source income in the same category. The rules for determining the source of income are important under this regime.[34]

One of the many ways that a U.S. person can earn foreign source income is by owning shares, directly or through a transparent entity, of a foreign corporation (meaning an entity formed under foreign law and treated as a corporation for U.S. tax purposes). If the foreign corporation's income is not subject to one of the many anti-deferral rules, the income is not subject to U.S. taxation until it is repatriated. In other words, income from dividends and redemptions are included in a shareholder's income under the same timing mechanisms as for a domestic corporation unless an anti-deferral rule applies.[35]

Two of the main anti-deferral rules are subpart F (controlled foreign corporation (CFC) rules) and the passive foreign investment company (PFIC) rules. A CFC is a foreign corporation over half whose total combined voting power or total stock value is owned by one or more U.S. persons, each of whom is considered to own at least 10-percent of the total voting stock.[36] A CFC's "subpart F income"[37] is imputed to such shareholders as ordinary income. If the shareholder is a corporation owning at least 10-percent of the voting stock, then the shareholder can claim an indirect credit for foreign tax imposed on the CFC's income.[38]

A PFIC is a foreign corporation where 75-percent or more of its gross income is passive income or where 50-percent of its assets are classified as passive.[39] A U.S. shareholder of a PFIC must either make a qualified electing fund (QEF) election to be taxed currently on the

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[34] *See* John P. Steines, Jr., International Aspects of U.S. Income Taxation 1 (2d ed. 2005); American Bar Association, Report of the Task Force on International Tax Reform, 59 Tax Law. 649, 692-672 (Spring 2006).

[35] *See* I.R.C. §§ 301, 302.

[36] *See* I.R.C. § 957.

[37] "Subpart F income includes . . . foreign base company income. The central elements of foreign base company income are (1) foreign personal holding company income, and (2) foreign base company sales and services income." *See* American Bar Association, *supra* note 34, at 699-700. Foreign personal holding income generally includes what is generally thought of as "passive" or investment income. *Id.* Generally, foreign base company sales and services income includes sales and service income "where relatively little activity is conducted . . . within the borders of a related base company's residence." Steines, *supra* note 34, at 521.

[38] *See* I.R.C. § 960.

[39] *See* I.R.C. § 1297.

PFIC's income on a flow-through basis,[40] or report gain on disposition of the stock as ordinary income with an interest charge designed to negate the benefit of deferral. Indirect foreign tax credits on PFIC income are available to corporate shareholders that own 10-percent or more of the PFIC.

B. Taxation of Nonresidents' U.S.-source Income: FDAP and ECI.

The ability of the United States to tax the investment income of non-U.S. persons is constrained by the scope of its jurisdiction and its interest in attracting foreign capital to the United States. Because of the limitations on its jurisdiction, the United States taxes foreign persons only on U.S.-related income that has a U.S. source. Foreign persons that carry on a U.S. trade or business are taxed on the net income that is effectively connected with that trade or business (ECI). If a non-U.S. person is a resident of a country with which the United States has an income tax treaty, that person's income must be attributable to a so-called "permanent establishment" in the United States for it to be subject to U.S. taxation.

Non-U.S. persons earning income not connected with a U.S. trade or business are taxed on U.S.-source interest, dividends and other fixed or determinable, annual or periodical (FDAP) income with a U.S. source at a rate of 30% (or a lower treaty rate) on the gross amount of the income. Most gains on the sale of a security, other than a U.S. real property interest, are not considered FDAP and are not taxed by the United States. Generally, payments of interest on a debt obligation are deemed to have a U.S. source when the issuer of the debt is a U.S. tax resident or a U.S. corporation.[41] Dividends are deemed to have a U.S. source when they are paid by a domestic corporation.[42] Within the scope of its taxing authority, the United States has made a conscious decision to exempt broad categories of non-dividend payments to non-U.S. persons of U.S.-source investment income from taxation.

C. U.S.-Source Interest.

The most significant of these exemptions for withholding are those for payments of bank deposit and portfolio interest and payments of interest to foreign governments.

1. Bank Deposit, Short-Term and Portfolio Interest.

To encourage non-U.S. persons to use U.S. banks and savings institutions, the United States has exempted interest earned by such persons on U.S. bank deposits from taxation.[43] An important exemption also exists for interest payments to foreign persons on obligations payable

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[40] *See* I.R.C. §§ 1293-1296.

[41] *See* I.R.C. § 861(a)(1).

[42] *See* I.R.C. § 861(a)(2). Dividends from a foreign corporation can also be deemed to have a U.S. source. *See* I.R.C. § 861(a)(2). For example, dividends of a foreign corporation are treated as having a U.S. source if a significant portion of the foreign corporation's income is treated as effectively connected with the conduct of a U.S. trade or business. *See* I.R.C. § 861(a)(2)(B).

[43] *See* I.R.C. §§ 871(i)(2)(A); 881(d); CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS at ¶4035(a) (3d ed. 2006).

183 days or less from original issue.[44] Similarly, a more general statutory exemption for interest payments on portfolio indebtedness received by non-U.S. persons makes lending to U.S. persons more attractive.[45]

In repealing the tax on portfolio interest, Congress was concerned that the unilateral exemption would facilitate tax evasion by U.S. persons.[46] Congress included several restrictions on the portfolio interest exception in order to prevent such evasion that depended primarily on whether the interest was paid on a registered or bearer obligation.

a) Registered obligations.

As discussed in greater detail below, under those restrictions the payor of interest on a registered obligation[47] must receive a statement that the beneficial owner of the obligation is a non-U.S. person in order for the payment to qualify for the exemption from withholding for portfolio interest.[48]

b) Bearer obligations.

Payments of interest on an obligation that is not in registered form (that is in bearer form) are only exempt from taxation as portfolio interest if there are arrangements reasonably designed to prevent the sale or resale of the obligations to U.S. persons, interest on such an obligation is payable only outside the United States, and there is a statement on the face of the obligation to the effect that any U.S. person who holds the obligation will be subject to limitations under U.S.

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[44] The exemption arises from a convoluted chain of statutory definitions. *See* DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS ¶ 19056 (5th ed. 2007).

[45] This exemption is subject to several limitations. For example, interest received by a 10% shareholder of the issuer is not exempt from taxation. *See* I.R.C. § 871(h)(3). The same is true for interest received by a controlled foreign corporation from a related person. *See* I.R.C. § 881(c)(3)(C).

[46] My co-authors and I observed in 2002,

> [t]he exemptions for bank deposit and portfolio interest have traditionally been justified by the argument that the imposition of a tax on the gross amount of interest income in a liquid capital market with ready alternative investments would result in the burden of the tax being borne by U.S. borrowers (including the U.S. government) through higher interest rates. Whether such an effect would arise with respect to non-U.S. persons resident in treaty countries who are already entitled to reduced rates of tax on interest payments without any statutory exception is not clear. Nevertheless, this concern reflects a widespread international reluctance to tax interest from unrelated foreign payors.

Stephen E. Shay, J. Clifton Fleming & Robert J. Peroni, *The David R. Tillinghast Lecture "What's Source Got to Do With It?" Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 122-23 (2002).

[47] A obligation is in registered form if (i) it is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder to the issuance by the issuer of a new instrument tot he new holder; or (ii) the right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent); or (iii) the obligation is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred through both of the methods described in (i) and (ii) above. Treas. Reg. § 5f.103-1(c)(1); *see also* I.R.S. Notice 2006-99, 2006-46 I.R.B. 907.

[48] *See* I.R.C. §§ 871(h)(2)(B)(ii); 881(d).

income tax laws.[49] In addition, in enacting the portfolio interest exception, Congress gave the I.R.S. authority to exclude from that exception payments of interest to individuals resident in countries with which the United States has information exchange inadequate to prevent tax evasions by U.S. persons.[50] Enforcement of the limitations on the portfolio interest exception has been difficult, as discussed below.

2. Investment income paid to foreign governments.

Foreign governments benefit from a special statutory exemption from taxation for income that is received from passive investments.[51] This exemption goes beyond that available for portfolio interest. Income that a foreign government receives from U.S. stocks, bonds or other securities, financial instruments held in the execution of governmental financial or monetary policy and bank deposit interest is generally exempt from the 30% (or lower treaty rate) tax on FDAP income.[52] Like the exemption for portfolio interest, the foreign government exemption was enacted to encourage foreign investment in the U.S. at a time when the U.S. was in need of financing.[53] The exemption for foreign governments is not required under principles of sovereign immunity, as such immunity has generally been limited "to cases where a foreign government (or a government-owned entity) is acting in a 'sovereign' capacity, as opposed to in a private or commercial capacity."[54] Indeed, the foreign government exception does not apply to income derived from the conduct of any commercial activity that is received by or from a controlled commercial entity or that is derived from the disposition of any such entity.[55] Foreign governments benefit from special investment and trading exceptions to the commercial activities rules, although "[t]hese important exceptions to the definition of 'commercial activities' generally are not available in respect of activities under taken as a dealer, or investments (including loans) made by a 'banking, financing or similar business.'"[56] The exemption from gross taxation of passive investment income of foreign governments has facilitated the tremendous investment in the U.S. by foreign governments and sovereign wealth funds.[57]

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[49] *See* I.R.C. §§ 871(h)(2)(A); 881(d); 163(f)(2)(B).

[50] *See* I.R.C. § 871(h)(6). This authority has not been used and, in light of gross-up clauses in debt indentures, might have unforeseen consequences if exercised.

[51] *See* I.R.C. § 892.

[52] *See id.*

[53] *See* NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON THE TAX EXEMPTION FOR FOREIGN SOVEREIGNS UNDER SECTION 892 OF THE INTERNAL REVENUE CODE 5 (June 2008), *available at*: http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1157rpt.pdf.

[54] *Id.* at 4.

[55] *See* I.R.C. § 892(b).

[56] NEW YORK STATE BAR ASSOCIATION TAX SECTION, *supra* note 53, at 20 (citing Treas. Reg. § 1.892-4T(c)(1)(ii)); *see also* Treas. Reg. § 1.892-4T.

[57] The Chinese government, with approximately $1 trillion invested in U.S. Treasuries, is the largest holder of U.S. government debt. *See, e.g.*, Michael Wines, *China's Leader Says He is 'Worried' Over U.S. Treasuries*, NEW YORK TIMES (March 13, 2009). Sovereign wealth funds have invested hundreds of billions of dollars in the U.S. *See, e.g.*, NEW YORK STATE BAR ASSOCIATION TAX SECTION, *supra* note 53, at 23.

D. U.S.-source portfolio dividends.

Payments of dividends to non-U.S. persons that are treated as income from sources within the United States are generally subject to the gross tax on FDAP income.[58] Under most treaties, the tax is reduced from 30% to 15% on portfolio dividends.[59]

E. Gains from personal property.

Although dividends paid by a U.S. corporation to a non-U.S. person are subject to taxation, the gain from the sale of securities in that U.S. corporation generally is not taxed if that gain is not effectively connected with a U.S. trade or business (or deemed to be if the stock is a U.S. real property interest). Unlike the case with portfolio interest, which benefits from an exception to the gross tax on FDAP income, gains received by a non-U.S. person from the sale of personal property (other than U.S. real property interests) are generally not subject to U.S. federal income taxation because they are not treated as FDAP income in the first place.[60] Thus, capital gains realized by foreign persons from the sale of U.S. stocks and securities that are not effectively connected with a U.S. trade or business are not subject to taxation.

The decision not to tax capital gains seems to rest largely on considerations of administrative feasibility as, absent knowledge of a taxpayer's basis, the United States would not be able to determine the correct amount of gain subject to taxation.[61]

F. Notional principal contracts.

Just as the exemption of capital gains from treatment as FDAP income was the product of administrative concerns, the taxation of income from notional principal contracts ("NPCs"), commonly known as "swaps" reflects a similar compromise that is not necessarily related to the limitations on U.S. jurisdiction or the need for foreign investment. Income from NPCs is not treated as FDAP subject to taxation because NPC payments generally are sourced according to the residence of the payee.[62] Therefore, a payment on an NPC from a U.S. person to a foreign person is considered to have a foreign-source. These sourcing rules do not reflect any clear policy regarding the sourcing of income, but rather reflect an administrative solution to the difficulty of determining the nature of the income arising from a swap.

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[58] *See* I.R.C. § 871(a)(1)(A). There are exceptions to this rule. If a U.S. corporation receives at least 80% of its gross income from the active conduct of a foreign trade or business, a portion of dividends paid by that corporation will not be subject to taxation. *See* I.R.C. § 871(i)(2)(B).

[59] Art. 10, U.S. Model Income Tax Convention on . . . (Nov. 2006).

[60] *See* Treas. Reg. § 1.1441-2(b)(2).

[61] The historical justification for excluding capital gains from the definition of FDAP is based largely on the practical difficulties of withholding tax on a net basis, not on notions of fairness or equality in our treatment of U.S. and non-U.S. payees. Shay, Fleming & Peroni, *supra* note 46, at 122.

[62] *See* Treas. Reg. § 1.863-7(b)(1).

III. Administration of Residence and Source Taxation of Investment Income.

A. Defending residence taxation of investment income.

The United States has two parallel systems for enforcing the payment of tax at the source by its residents and non-residents earning U.S.-source income. The enforcement of tax on non-wage income of U.S. residents focuses primarily on information reporting, with a backup withholding system designed to assure that the IRS obtains a correct TIN and therefore is able to match information on income paid to U.S. residents with their tax returns. Conversely, the basis of enforcement of tax on U.S.-source income of nonresidents focuses primarily on withholding at the source as a result of the United States' limited jurisdiction to enforce payment of tax by nonresidents. However, the withholding system for non-residents is strewn with exemptions (see below), and the interplay of the two systems in the context of international transactions and banking has presented opportunities for tax evasion by U.S. residents. As an initial matter, a brief summary of the two systems of enforcement in helpful in giving context to the problems and proposed solutions faced in this arena.

1. Information reporting and exempt recipients.

The purpose of the U.S. information reporting regime is to promote compliance with tax rules. Every person engaged in a trade or business in the U.S. must file certain information returns and payee statements with the IRS (these encompass both Forms 1099 and Forms W-2).[63] Payee statements are statements that must be given to the taxpayer to enable him to file his own income tax return accurately and timely.[64] Most information returns have a corresponding payee statement, and the data required to be provided on each is generally identical.

The largest exception to the information reporting requirements are for payments made to exempt recipients. Exempt recipients include corporations, exempt organizations, individual retirement plans, the U.S. government, a state or U.S. possession government, a foreign government, an international organization, a foreign central bank of issue, the Bank for International Settlements, or any wholly-owned agency or instrumentality of the above.[65] These rules exclude payments to corporations in general, regardless of their jurisdiction or beneficial ownership.

2. Documentation and back-up withholding.

In certain circumstances, payors of non-wage income must withhold against payments to U.S. persons under the backup withholding rules of section 3406. Congress adopted the backup withholding system largely to prevent domestic taxpayers from failing to pay taxes on certain types of income, such as dividends and interest.[66] In contrast to withholding on payments to foreign persons described above, section 3406 is not aimed at foreign taxpayers, but is instead meant to be a collection mechanism for domestic taxpayers.

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[63] *See* I.R.C. § 6041; Treas. Reg. §§ 1.6041-1, 1.6041-2.

[64] *See* I.R.C. §§ 6041-6050T

[65] Treas. Reg. § 1.6041-3(p).

[66] *See* Joel D. Kuntz & Robert J. Peroni, U.S. International Taxation ¶ C2.08 (1991 & Supp. 2008).

Backup withholding is required on certain "reportable payments" made to payees for whom an information return was filed which had either a missing (none provided by payee or has invalid characters such as alphas or hyphens) or an incorrect taxpayer identification number (name/number combination does not match IRS or SSA files). The rate for all backup withholding is currently 28%.[67]

A payor can eliminate the need for backup withholding by requiring that the payee furnish the payee's taxpayer identification number and, in the case of dividends and interest, certify that backup withholding does not apply because of prior underreporting.[68] This is typically achieved by obtaining an IRS Form W-9 from the payee. Alternatively, if a payee is a foreign person, the payee can provide documentation of foreign status as described below. Importantly, if a payor is subject to withholding obligations under section 1441 (or any other provision of the Code) backup withholding does not apply.[69]

The combination of information reporting and backup withholding is designed to ensure that U.S. persons pay an appropriate amount of tax on investment income, by giving the IRS sufficient information needed to audit payments or requiring collection of the tax at the time of payment.[70] Although designed for domestic taxpayers, backup withholding plays a role in certain international transactions.[71] U.S. payors and certain non-U.S. payors who are qualified intermediaries as described below must back-up withhold in circumstances where a person is considered a U.S. person. However, because the information reporting and backup withholding regimes are narrower in the case of transactions involving foreign financial institutions making payments outside the United States in respect of foreign accounts, certain U.S. persons have taken advantage of the divergence of application of these rules by using foreign accounts and other offshore arrangements to circumvent the U.S. reporting and backup withholding regimes.[72]

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[67] *See* I.R.C. § 3406 (imposing a 28% withholding tax, calculated with reference to I.R.C. § 1(c)). Pursuant to the Economic Growth and Tax Relief Reconciliation Act of 2001, the withholding rate declined to 28% in 2006 and thereafter. *See* Pub. L. No. 107-16, § 101(c)(10), 115 Stat. 38, 44 Under the sunset provision of that act, the rate reverts to 31% (the rate before the 2001 Act went into effect) in 2011. *See* Pub. L. No. 107-16, § 901, 115 Stat. 38, 150.

[68] *See* I.R.C. §§ 3406(a)(1)(A), 3406(a)(1)(D).

[69] *See* I.R.C. § 3406(g)(2).

[70] *See* JOINT COMMITTEE ON TAXATION, SELECTED ISSUES RELATING TO TAX COMPLIANCE WITH RESPECT TO OFFSHORE ACCOUNTS AND ENTITIES, JCX-65-08 at 19-24 (2008).

[71] *See* Lynnley Browning, *Pressured by I.R.S., UBS Is Closing Secret Accounts*, N.Y. TIMES, Jan. 8, 2009, at B1.

[72] *See* JOINT COMMITTEE ON TAXATION, *supra* note 70, at 25-26. *See also* Cynthia Blum, *Sharing Bank Deposit Information With Other Countries: Should Tax Compliance or Privacy Claims Prevail?*, 6 FLA. TAX. REV. 579, 590-602 (2004) (describing tax evasion by U.S. persons through offshore arrangements). Backup reporting is not required if foreign source income is paid outside the United States by someone who is not a U.S. payor or middleman. Treas. Reg. § 1.6049-5(b)(6). For "backup" withholding, a U.S. payor or middleman includes (1) a foreign corporation that is a controlled foreign corporation, (2) a foreign partnership if, during its tax year, either U.S. persons hold more than fifty percent of the interest in its income or capital or it is engaged in the conduct of a trade or business in the United States to any extent, (3) a foreign person if fifty percent or more of its gross income for three tax preceding years is ECI, and (4) the United States branch of a foreign bank or foreign insurance company. Treas. Reg. § 1.6049-5(c)(5)(i). An amount will not be considered paid outside the United States for this purpose if the financial institution's customer has communicated with an agent, office, or branch of the financial

B. Overview of collecting tax on foreign persons at source by withholding.

As mentioned above, a separate enforcement regime has been developed to enforce payment of tax on U.S.-source FDAP income of non-U.S. persons. Sections 1441 and 1442 of the Code contain detailed rules for the collection of withholding tax at the rates described in Section II above. This internationally-accepted system of having the payor withhold a gross basis tax at source addresses directly the inability of the source country to collect the tax imposed on income of a nonresident.

1. Who is a withholding agent.

The Code adopts a broad definition of "withholding agent" for purposes of these rules. A withholding agent is any person, whether a U.S. or a foreign person, that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding.[73] The term is defined to include every person in the chain of custody of a payment, not simply the last person to have control of a payment before it is paid to a foreign person. Generally, a person who has custody or control over income and is not acting on behalf of their own account is a potential withholding agent. This is true regardless of whether the person is a natural or legal person or is within or outside the United States.[74] Thus, the joint and several liability of the withholding agent for the tax to be withheld enables the United States to enforce source taxation of payments to those outside its jurisdiction.

2. Income Subject to Withholding and Exceptions

The non-resident alien withholding tax generally applies to all payments to foreign persons of U.S.-source FDAP income, as defined in Section II above.[75] This generally includes all U.S.-source income unless an exception applies. The withholding rules exclude several important items realized by nonresidents from U.S. investments. The exceptions for certain interest and gains apply to all non-residents regardless of their domicile or residency jurisdiction. Thus, no treaty or bilateral agreement is required before a non-U.S. person can take advantage of these broad exceptions if the non-U.S. person is the beneficial owner of the income and then establishes his or its foreign status. However, if a particular payee falls outside the statutory exemptions, the rate of withholding may vary depending on the residency of the payee, whether the payee can take advantage of reduced rates of withholding under a treaty, and the extent of reduction or exemption contained in the treaty.

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institution from within the United States (including by mail, telephone, or electronic communication) concerning the account in more than "isolated and infrequent" circumstances. Treas. Reg. § 1.6049-5(e)(2).

[73] Treas. Reg. § 1.1441-7(a)(1).

[74] *See* MARNIN J. MICHAELS, INTERNATIONAL TAXATION: WITHHOLDING ¶2.10 (2008).

[75] *See id.* at ch. 2.

3. Documentation.

A withholding agent generally withholds tax on a payment unless the foreign person evidences its eligibility for relief from withholding tax.[76] The documentation required to prove foreign status or to qualify for the portfolio interest for accounts with U.S. financial institutions held directly by non-U.S. persons consists of a Form W-8 completed under penalties of perjury. For foreign accounts, regulations under section 1441 (1) shift the burden of investigating beneficial ownership from U.S. custodians to foreign financial institutions with actual customer interface, and (2) provide clear rules requiring withholding in the absence of documentation.[77] The centerpiece of these regulations is the QI regime described in Section C below.

C. Addressing the realities of global capital markets: The QI Regime.

1. Overview of custody and payments systems.

The development of interlinked clearance, settlement and custodial systems adds to the complexity and interrelationships of financial institutions across national boundaries.[78] For example, many foreign financial institutions utilize local custodians to hold securities in a particular jurisdiction.[79] Many institutions will also aggregate client accounts by region, utilizing an omnibus account with a single custodian who then contracts with local custodians for each jurisdiction or region of the securities held in the omnibus account.[80] It is because of the system of omnibus accounts, tiered custodial relationships, and need for intermediary banks to execute cross-border transfers of assets, that the need for the QI regime arose.

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[76] *See* I.R.C. § 1441(a); Treas. Reg. § 1441-1(b).

[77] *See* Treas. Reg. § 1. 1441-1(e)(5). Before the 1997 withholding regulations were finalized, the portfolio interest rules required that a Form W-8 be provided from the beneficial owner of the income. *See* Treas. Reg. § 35a.9999-5 (1997).

[78] For a general overview of the international payments, clearance and settlement systems, see HAL S. SCOTT, INTERNATIONAL FINANCE chs. 9-10 (14th ed. 2008). Although the U.S. systems of transfers, Fedwire and CHIPS play a key role in international financial transactions, other countries systems generally must be used in conjunction with U.S. systems, and, at a minimum, a transaction requires both an originating bank and a receiving bank. The receiving bank might be in the recipient's jurisdiction, or a regional banking center. If the latter, a second transfer is generally required, typically on a separate payments system. For example, a payment made by a payor in the United States to a recipient in France might proceed using an intermediary bank as follows: (i) a transfer is first made from the United States by the originating bank ("USBank") to the New York branch of a major European bank headquartered in London ("EuroBank"), using CHIPS; (ii) EuroBank makes an in-house or correspondent transfer on its internal system transferring the value to its London branch; and (iii) the London branch of EuroBank then transfers the funds to the recipient's local bank, ("ParisBank"), via the E.U. Interbank Funds Transfer Services. From a U.S. withholding tax perspective, there are three potential withholding agents, USBank, EuroBank, and ParisBank. Only ParisBank has direct access to the identifying information of the account holder, but it probably is outside the enforcement jurisdiction of the U.S.

[79] *See* SCOTT, *supra* note 78, at Ch. 10.

[80] *See id.*

2. Overview of the QI system.

The final withholding regulations implementing the QI regime effectively shifted the burden of documentation to foreign financial institutions wherever possible.[81]

a) Who qualifies?

Generally, a QI is a non-U.S. financial institution that is subject to know-your-customer rules that have been approved by the Service and has entered into a contractual agreement with the Service to report annually certain aggregate information concerning the beneficial owners of U.S.-source payments and to make any necessary tax payments.[82] The QI must agree to engage an external auditor to verify that it is in compliance with the QI agreement.[83] In return, the QI avoids the burden and competitive drawback of forwarding documentation with respect to each customer that is a beneficial owner of U.S. income subject to withholding to a U.S. withholding agent in order to claim reductions in the U.S. withholding tax. The QI, however, must identify U.S. customers that hold accounts covered by the QI agreement.[84] There are special rules permitting a QI that discovers a U.S. person in such an account to avoid disclosure of the person to the Service if back-up withholding is imposed with respect to the assets in the account (including on gross proceeds).[85]

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[81] *See* T.D. 8734, 1997-44 I.R.B. 5. As my co-authors and I have described:

> [t]his situation was ignored for many years, in part because the U.S. custodian faced the unpalatable choice of either withholding a tax that in most cases would not be appropriate (because the vast preponderance of the foreign financial institution's customers were foreign) or losing the account to another custodian that would accept the Form W-8. The situation eventually became intolerable, even though the probability of attack by the Service was low, because the level of tax risk to the custodians far exceeded profits from the business. Significantly, the final regulations eventually provided rules for nonqualified intermediaries to be able to supply the required documentation in a manner that did not expose foreign customers to backup withholding if they did not disclose their identities. This significantly relaxed potential pressure on the intermediary financial institutions.

Shay, Fleming & Peroni, *supra* note 46, at 124 n. 160 (citing Stephen E. Shay, Leonard Terr, Thomas O'Donnell & Percy Woodard, *Proposal: Alternative Portfolio Documentation Procedures* 2-3 (July 8, 1992) (describing issues faced by U.S. custodial banks holding omnibus accounts for foreign financial institutions) (unpublished manuscript, on file with the Tax Law Review)).

[82] *See* Treas. Reg. § 1.1441-1(e)(5).

[83] *See* Rev. Proc. 2002-55, 2002-35 I.R.B. 435 (providing final audit guidelines for external audits of QI compliance with QI agreement documentation procedures).

[84] *See* Rev. Proc. 2000-12, 2000-1 C.B. 387 (Model Agreement § 2). A foreign financial institution that executes a QI agreement does not have to identify U.S. customers that hold accounts not covered by the QI agreement. *Id.* at § 6.04.

[85] *See id.*

Chairman NEAL. Thank you. In fact, during the questioning period, I'll have an opportunity to raise that with you.

Professor.

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

Mr. AVI-YONAH. Chairman Neal, Ranking Member Tiberi, and honored Members of the Committee and the staff, thank you very much for inviting me today to testify before you again on this issue.

I think the UBS method shows that there are serious problems with the QI initiative as it is currently drafted. Basically, though, as we all know, UBS enabled American citizens to hide behind sham corporations in various other secrecy jurisdictions other than Switzerland, and thereby for a while escape the notice of the IRS.

And to some extent still, because they claim that under Swiss bank secrecy law, they can't disclose the identity of the other new American accountholders, even when specifically requested by the IRS to do so.

Now stepping back for a moment, what is the basic problem with the QI program from my perspective? The QI program was set up in order to enable foreigners to invest in the U.S. through the QI, without the U.S. withholding agent knowing the identity of those foreigners.

If a foreign person invests directly into United States, then the—in principle, the U.S. withholding agent has the ability to collect information about that foreign person. The U.S.—in the end the payments come from the United States.

There is a U.S. withholding agent, and when the U.S. withholding agent makes a payment, even a payment that is exempt, let's say, under the portfolio interest exemption, there is the potential of collecting information about—and the Form W–8BEN, from that person to know the identity of that person, whether or not there is a treaty.

And then—if there is a treaty, then there is the potential for the IRS to get that information from the American financial institution, in exchanging under the treaty information exchange.

Now the QI program was essentially set up so that this would not happen. Under regulations proposed by the Clinton Administration, but not yet finalized, American banks were supposed to collect information about payments that are exempt under the portfolio interest exemption.

And under the version proposed by the Bush Administration, that would still apply, but only to 16 designated countries. I think it should apply to every country and that these regulations should be finalized.

But under the QI agreement, once you go with the QI—once a foreigner goes with the QI, then the QI only reports to the American withholding agents, essentially summary or pooled information about all the beneficiaries that it knows are eligible for let's say, the reduced withholding tax and dividends.

And the American withholding agent knows only that, only the pooled information, and therefore there's no information available for treaty information exchange.

And I think that this is a problem, and what it enables, is essentially for Americans to pretend that they are foreigners, submit Form W–8BEN to the QI.

Now here's—they should—Mr. Shay identifies the QI is not supposed to look behind this corporation to see whether there's an American behind it.

Now there's some debate in the background material about when—if the QI has actual knowledge that the corporation is owned by an American, whether they should be—my view is that if a QI has actual knowledge that there's an American, then it should treat it as an American and do back-up withholding and information reporting.

But it's not entirely clear that under the current regulations and the modern QI agreement, they have the obligation to do that. Maybe they can just accept the corporate form as hiding the American sufficiently. And I think to that extent, that should be changed.

Now the fundamental issue, though, is that I think that we are doing this wrong, in the sense that—the reason that we're doing it the way we're doing it, is that we want to essentially enable residents of other countries to evade those countries' taxes.

And that's how the QI agreement is set up. And the idea is they will not invest in the United States if they are subject to residence based taxation.

And I think that the solution to this, and in general to the issue of source based withholding, is that we will prevent people—capital from flying away from the United States, if we are willing to cooperate with other residence countries and they are willing to cooperate with us.

We should have under the G–20, let's say, full information exchange with other countries. We should not try to cooperate with tax evasion by residents of other countries. We should expect other countries that have income taxes to cooperate with the information exchange with us.

Fundamentally the whole tax haven and secrecy jurisdiction issues is about cooperation by the rich countries in the world. It's not really about the tax havens themselves.

Thank you very much.

[The prepared statement of Mr. Avi-Yonah follows:]

Statement of Reuven S. Avi-Yonah, Irwin I. Cohn Professor of Law, University of Michigan Law School

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 twenty 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 Cravath, Swaine & Moore. I have also served as consultant to the U.S. Treasury Office of Tax Policy and as member of the executive committee of the NY State Bar Tax Section. I am currently Chair 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 thirteen books and over 80 articles on various aspects of U.S. domestic and international taxation, and have fifteen 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 Representatives Neal and Tiberi and the Subcommittee staff for inviting me to testify today on the issues underlying the recent dispute involving Swiss banking secrecy and American taxpayers. 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 UBS Case.**

On June 19, 2008, Bradley Birkenfeld, a senior banker in UBS's private banking division, pled guilty in U.S. District Court, Southern District of Florida, to conspiracy to evade U.S. taxes. Mr. Birkenfeld, a U.S. citizen who worked at Zurich-based UBS's private banking unit from 2001 to 2006, told a judge he helped real estate developer Igor Olenicoff dodge $7.2 million in U.S. Federal income taxes on $200 million in assets hidden in Liechtenstein and Switzerland.

The Press Release by the IRS stated that:

According to statements and documents filed with the court, Birkenfeld's services to American clients violated a 2001 agreement that the Swiss bank entered into with the United States. Under the terms of the agreement, the bank would identify and document any customers who received reportable U.S. source income or would withhold and anonymously pay a 28 percent withholding tax. This agreement was a major departure from historical Swiss bank secrecy laws under which Swiss banks concealed bank information for U.S. clients from the IRS.

When the bank notified its U.S. clients of the requirements of this agreement, many of the bank's wealthy U.S. clients refused to be identified, to have taxes withheld from the income earned on their offshore assets or to sell their U.S. investments. These accounts were known at the Swiss bank as the United States undeclared business.

In evidence provided by Birkenfeld to the court, managers and bankers at the firm, including Birkenfeld, assisted the U.S. clients in concealing their ownership of the assets held offshore by helping these wealthy customers create nominee and sham entities. This was done to prevent the risk of losing the approximately $20 billion of assets under management in the United States undeclared business, which earned the bank approximately $200 million per year in revenues. To this end, Birkenfeld, managers and bankers at the Swiss bank, and U.S. clients prepared false and misleading IRS forms that claimed that the owners of the accounts were sham off-shore entities and failed to prepare and file IRS forms that should have identified the true U.S. owner of the accounts.[2]

Subsequently, On February 18, 2009, UBS entered into a deferred prosecution agreement on charges of conspiring to defraud the United States by impeding the IRS. UBS agreed to pay $780 million and to provide the IRS with the identities and account information of 250 U.S. residents. However, UBS refused to provide any information about the identity of an estimated 52,000 other U.S. clients holding bank accounts with $14.8 billion in assets in Switzerland, citing Swiss bank secrecy law. It claimed that the terms of its 2001 "Qualified Intermediary" (QI) agreement with the IRS protected it from having to reveal the identity of its U.S. clients. The IRS is currently in litigation with UBS over this matter.

The Extent to Which U.S. Residents Move Assets Offshore.

UBS's U.S. clients relied on four simple realities: First, in today's world, anyone can open a bank account in Switzerland 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 U.S. or from abroad, and in most cases there would not be any reporting of such transactions to tax authorities. Finally, the funds in the Swiss account can then be used for investments in the U.S. and in other high tax jurisdictions, and there would generally be no withholding taxes on the resulting investment income, no Swiss 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 Switzerland, both the underlying funds that were deposited in the UBS accounts, and the investment income, were generally purely domestic transactions, and the tax evaded was U.S. income tax on U.S. source income beneficially owned by U.S. residents.

[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] BANKER PLEADS GUILTY TO HELPING AMERICAN REAL ESTATE DEVELOPER EVADE INCOME TAX ON $200 MILLION, http://www.usdoj.gov/usao/fls/PressReleases/080619-01.html.

The ability to use 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 U.S. 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 U.S. 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 percent of total taxes owed.[3] 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 percent to under 50 percent.[4]

No one, including the IRS, has a good estimate of the size of the international tax gap.[5] 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" 10 percent was held offshore (as compared with, for example, 20–30 percent offshore for Europe and 50–70 percent offshore for Latin America and the Middle East).[6]

If one translates this estimate into approximately $1.5 trillion held offshore by U.S. residents, and if one assumes that the amount held offshore earns 10 percent 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]

3. **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 U.S. 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 U.S. share ownership in a foreign corporation that earns primarily passive income. Since the U.S. shareholder does not have to control the foreign corporation, it is difficult for the IRS to adequately monitor how many U.S. 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).

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[3] Internal Revenue Service, The Tax Gap, www.irs.gov/pub/irs-utl/tax_gap_facts-figures (2005).

[4] 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).

[5] See TIGTA, IRS Lacks Estimate for International Tax Gap, 2009 WTD 28–25 (Feb. 12, 2009).

[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, U.S. Citizens Hide Hundreds of Billions in Cayman Accounts, 103 Tax Notes 956 (2004).

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 U.S. 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 U.S. and the tax haven, which would never be the case for pure tax evasion. In addition, they typically require the U.S. 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.

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 a shell that is de facto controlled by a U.S. person.

The problem is exacerbated by the "Qualified Intermediary" (QI) program, set up by the IRS in 2000. This program is described by Shay, Fleming and Peroni as follows:

Generally, a U.S. withholding agent that makes payment of income subject to withholding to a foreign person reports the amount of the payment and the identity of the payee to the Service on a Form 1042–S attached to the withholding agent's own return on Form 1042. The information from Form 1042–S is one of the most important elements of information provided to certain treaty partners under the Service's program for routine exchange of information under income tax treaties.

Under the current QI regime, the QI does not pass on to the withholding agent the identity of beneficial owners claiming treaty relief but does retain the information. Assuming, as is the case most of the time, that the QI has not assumed withholding responsibility, the withholding agent makes payments to accounts grouped according to withholding pools and files a single Form 1042–S for the pool without identifying the individual payee. Thus, for example, the withholding agent files a single Form 1042–S for the pool of accounts eligible for the 15 percent treaty dividend rate. **In this case, the identity of the payee remains unknown unless the Service makes a specific request for the identity of payees.** The pooling approach, which is central to the efficiency and attractiveness of the QI regime to a foreign financial institution, cuts off the potential practical utility of pooled information for exchange under income tax treaties. This is because the information is not broken down by taxpayer and therefore is unsuitable for exchange with a treaty partner. Similarly, the United States for years limited its information exchange of bank deposit interest to accounts held by Canadians and, after strong lobbying by banks, recently proposed only a limited extension of collection of this information from foreign persons resident in a limited number of selected treaty countries. Why is this significant? Domestically, the United States relies on comprehensive information reporting for payments of interest, dividends, and gross proceeds from the sale of securities to individuals and other nonexempt recipients. If a taxpayer does not supply a correct taxpayer identification number, the threat of a back-up withholding tax on the payment, currently at a rate of 30 percent, provides a significant backstop to the information reporting rules. The final withholding tax regulations integrate the domestic information reporting and back-up withholding rules with the Chapter 3 withholding rules so that payments to foreign intermediaries acting for U.S. persons are covered by the domestic information reporting system. There are limits on the reach of these rules, however. Generally, U.S. persons, controlled foreign corporations, and foreign corporations more than 50 percent of whose income is effectively connected with a U.S. trade of business must apply the information reporting and back-up withholding rules. The QI regime also preserves Form 1099 reporting with respect to U.S. persons that are not exempt from information reporting under domestic rules. **As a practical matter, however, the comprehensive**

U.S. regime for enforcement of tax on income from capital stops at the water's edge.[8]

Fundamentally, the QI regime represents a bargain: The QI agrees to verify the identities and residency status of the beneficial owners of its accounts. In exchange, the U.S. agrees to trust the QI and as a result neither the U.S. withholding agent nor the IRS (unless it specifically requests) gets any information that can be transmitted to our treaty partners under the exchange of information provisions of our tax treaties.[9]

Essentially, the U.S. was telling foreign investors that instead of putting their money into the U.S. directly, in which case it might be subject to exchange of information and revealed to their country of residence, they could use the QI program to ensure that neither the U.S. withholding agent nor the IRS has the information. Thus, the IRS could tell the treaty partner with a straight face that it did not have the information the treaty partner needed to enforce its tax laws on its own residents, even though it was the IRS itself that entered into the agreement that prevented it from having the requisite information.

As the UBS case shows, however, the QI program can easily be abused. Since the IRS does not have the information on beneficial ownership from the QI, it has to trust the QI to either report accounts held by U.S. residents on Form 1099 or perform backup withholding. Not surprisingly, a QI like UBS is tempted to accept funds from U.S. residents and not comply with information reporting or backup withholding, since it knows the IRS will in all likelihood not audit it (since an audit may give the IRS the information on foreign residents that the QI program was designed for it not to have).

In my opinion, a better way to deal with our treaty partners is to help them enforce their tax laws on their own residents, and expect them to help the U.S. enforce its laws on its residents. Cooperation, not competition, is the solution to the offshore tax abuse problem.

6. **Recommendations to Address Offshore Tax Abuses.**[10]

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.[11] 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 called for more resources and political support to be given to the IRS.[12]

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 U.S. taxpayers to report ownership of foreign bank accounts and stock in foreign corporations. If the UBS case is any indication, such increased attention may generate many dollars in tax revenue for every dollar spent on enforcement.

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

[8] Stephen E. Shay, J. Clifton Fleming Jr. and Robert J. Peroni, The David R. Tillinghast Lecture, "What's Source Got to Do With It?" Source Rules and U.S. International Taxation, in The Tillinghast Lectures 1996–2005, 301–302 (2001) (emphases added).

[9] The U.S. currently has one of the most extensive tax treaty networks in the world, comprising of 67 full fledged treaties and 23 Tax Information Exchange Agreements. John Venuti et al., Current Status of U.S. Treaties and International Tax Agreements, 38 Tax Management Int'l J. 174 (March 2009).

[10] In addition to these recommendations, Congress should enact and the President should sign S. 506/H.R. 1265, the Stop Tax Havens Abuse Act, introduced on March 2, 2009 by Sen. Carl Levin, D–Mich., Sen. Sheldon Whitehouse, D–RI, Sen. Claire McCaskill, D–Mo. and Sen. Bill Nelson, D–Fla. in the Senate and by over 40 Members led by Rep. Lloyd Doggett, D–Tex. and Rep. Rosa DeLauro, D–Conn in the House.

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

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

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 U.S. TIEAs, and where they fall short, the U.S. should renegotiate the TIEAs to incorporate these principles.

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 U.S. on their own residents. To ensure such information is available, the Treasury should 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 interest itself is exempt from withholding under the portfolio interest exemption.[13] The Treasury has 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 U.S. bank accounts).

c. **Cooperation with OECD and the G20.**

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 U.S. had traditionally played a leading role in and whose work benefits both governments and the private sector. The U.S. should cooperate with the OECD and other appropriate international and regional organizations, such as the G20, 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.[14]

d. **Incentives to tax havens.**

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

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 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.

3. **Sanctions on non-cooperating tax havens.**

In the case of non-cooperating tax havens, I support the U.S. Treasury using its existing authority to prospectively deny the benefits of the portfolio interest exemption to countries that do not provide adequate exchange of information.[15] This step is necessary, in my opinion, to prevent non-cooperating tax havens from aiding U.S. residents to evade U.S. 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.

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[13] Cynthia Blum, Sharing Bank Deposit Information with Other Countries: Should Tax Compliance or Privacy Claims Prevail, 6 Fl. Tax Rev. 579 (2005).

[14] See Reuven S. Avi-Yonah, The OECD Harmful Tax Competition Report: A Tenth Anniversary Retrospective, forthcoming in Brooklyn J. Int'l L. (2009)

[15] See IRC section 871(h)(6). If this step is taken, Treasury should adopt Limitation on Benefits regulations to ensure against abuse of the portfolio interest exemption by nonresidents in cases that it does apply. For a model, see Treas. Reg. 1.881–3 (the conduit financing regulations).

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 automatic and comprehensive exchange of information or impose a withholding tax on interest paid to EU residents.[16] 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 and G20 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. **Withholding and Information Reporting.**

The IRS should revise its regulations (under IRC secs. 1441–1442) to provide that U.S. 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 U.S. persons. In addition, the QI program should be revised to require QIs to automatically provide information on actual beneficial ownership of all accounts to the IRS.

7. **7. Conclusion.**

The UBS saga indicates that the international tax gap is a significant component of the overall tax gap. In order to maintain any kind of tax system, the U.S. 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.

Chairman NEAL. Mr. Blessing.

STATEMENT OF PETER H. BLESSING, PARTNER, SHEARMAN AND STERLING

Mr. BLESSING. Chairman Neal, Ranking Member Tiberi, and Members of the Subcommittee, thank you for asking me to testify today.

I will focus on two issues in respect to detecting unreported investment income in overseas accounts, in particular tax treaty information exchange agreements and the qualified intermediary procedures.

There are two principal types of bilateral agreements that are chiefly used by the tax authorities for information exchange. These are the comprehensive income tax treaties and secondly, the tax information exchange agreements, which are stand alone agreements.

However, under each of these, typically the information that's required to be exchanged is limited to what's available in the normal course of the tax administration of the requested country as a matter of sovereignty and domestic law, but this can include bank secrecy provisions.

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

Very recently, in response to the pending G–20 blacklist of uncooperative countries and pressure from particular countries, including the United States and France and Germany, a number of countries that previously had relied on their bank secrecy provisions have announced they'll override their domestic limitations, and not claim bank secrecy as preventing production, subject to implementing this in new agreements.

This experience shows that used carefully, multilateral action by countries, including blacklists or threatened blacklists, can be an effective tool to convince certain countries that information exchange in is their best interest.

I'm not suggesting that every blacklist necessarily is helpful. The Stop Tax Haven Abuse Act contains a proposed unilateral blacklist of 34 countries for a very different purpose. One concern is that the safeguards be there for designating countries.

Furthermore, the Act would be—the Act would represent a substantial shift in enforcement burden onto financial institutions, which would be required to report voluminous information covering virtually all financial transactions involving an offshore secrecy jurisdiction. The benefits of the provision must be weighed against the compliance cost.

Turning now to the QI program, of great interest is a report on withholding procedures released in January of this year, which was prepared by the informal consultative group established by the OECD Committee on fiscal affairs.

Notably, the group's report recommends a system that looks very much like the U.S. QI system. In that system, a foreign financial institution enters into an agreement with the IRS, pursuant to which it may accept primary withholding and documentation obligations subject to external audit, in exchange for a simplified pooled reporting and non-disclosure of client identities to the IRS, and to—most importantly, to its competitors down—upstream in the chain of information.

A significant difference from the QI system is that the identities of beneficial owners of payments would be disclosed to the source countries, something Professor Avi-Yonah was just suggesting would be a good thing.

This would address the flip side of information exchange, namely the needs of a country to obtain information about its residents. The United States would benefit from another country affirmatively apprising the U.S. tax authorities of accounts beneficially owned by U.S. residents and citizens.

The United States in turn would be expected to do the converse. However, there's a problem here. For example, the IRS W–8BEN is not currently required to be filed with the IRS under the QI program, so the IRS has no—or otherwise, for that matter, so the IRS has no record of the identity of payees of the QI system.

For non-QI payments, there is reporting to the IRS in 1042–S, but as the GAO report noted, the IRS is not currently able to process that effectively for use.

The U.S. Government Accounting Office reported in the QI program in December of 2007. While it concluded that the QI program contains features that give the IRS some assurance that QIs are more likely to properly withhold and report tax on U.S. source in-

come than other withholding agents, it suggested that the audit standards be enhanced by requiring the external auditor to report any indications of fraud or illegal activity that could significantly affect the results of the review.

In response, the IRS issued proposed changes to the model QI agreement and the audit procedures in November of 2008, as Commissioner Shulman noted, to broaden the requirement and the required self-reporting by the QI and increase the procedures required to be performed, and documentation required to be examined by the auditor.

The IRS has received comments on the proposal from certain audit firms and QIs. Clearly, a balance will be needed to be struck between the interests of a viable review and audit procedures, and the increased costs associated with the proposed procedures, which may be beyond the ability of smaller QIs to meet.

In conclusion, I believe that the QI program overall is well conceived, plays a key role in the U.S. withholding tax system, and should be supported, including with adequate funding. Attention is appropriately being paid to strengthening the external review process.

A particular limiting factor is that external "audits" are required only to be in accordance with the agreed upon procedure standard, which means that they do not constitute an audit or review, and therefore are not an expression of an opinion by the auditor.

I would be happy to take any questions. Thank you very much.

[The prepared statement of Mr. Blessing follows:]

Statement of Peter H. Blessing, Partner, Shearman and Sterling, New York, New York

b) What accounts are covered?

The QI's responsibilities apply only to those accounts it has with a withholding agent and that it has designated as accounts for which it acts as a QI. A QI is not required to act as a QI for all accounts that it holds, but if it designates an account as one for which it will act as a QI, it must act as a QI for all payments made to that account.[86] As a practical matter, a QI that utilizes omnibus custodial relationships as described above may not be able to "opt-out" of QI treatment on an account by account basis, thus becoming a withholding agent with respect to both U.S. and non-U.S. account-holders held through a single omnibus account.

c) What documentation is required?

In order to reap the benefits of the QI system, a financial institution must have the ability to reliably correlate reportable payments (or amounts) with documents substantiating of the identity of its account holders. Accordingly, a QI must collect, review and maintain documentation pursuant to section 5 of the Model Agreement and, in the case of direct account holders, in accordance with applicable know-your-customer rules.[87]

If the account holder provides a valid Form W-8 (other than Form W-8IMY) or valid documentary evidence that supports the account holder's status as a foreign person, a QI is permitted to treat a foreign account holder (including an account holder that is a collective investment vehicle) as the beneficial owner of a payment.[88] Such documentation enables a QI to treat a documented foreign account holder as entitled to a reduced withholding rate unless the account holder is a bank, broker, intermediary, or agent. As a result of these rules, if a direct foreign account holder is the beneficial owner of a payment, a QI can effectively shield the account holder's identity from U.S. custodians.[89]

d) What are the QI's duties in relation to a QI account?

Depending on who the beneficial owner of assets is, the U.S. imposes one of the two types of withholding tax discussed above which the QI must withhold (or arrange for another to withhold) and submit to the IRS: non-resident withholding tax for beneficial owners that are non-U.S. persons and backup withholding under section 3406 for certain improperly documented accounts of U.S. individuals or other presumed to be individuals.[90]

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[86] *See id*; *see also* DENIS A. KLEINFELD & EDWARD J. SMITH, LANGER ON PRACTICAL INTERNATIONAL TAX PLANNING ch. 78 (4th ed. 2004 of Supp. 2007).

[87] For a detailed description of the documentation requirements of QIs, see Marnin J. Michaels, David M. Balaban, Philip Marcovici, Thomas A. O'Donnell & Peter J. Connors, *Nine Months of Working with The QI Agreement: What Has The IRS Wrought?* 11 J. INT'L TAX'N 4 (2000).

[88] "Valid documentary evidence" is defined as: (i) any documentation obtained under the appropriate know-your-customer rules, (ii) any documentation described in Treas. Reg. § 1.1441-6 that establishes entitlement to a reduced withholding rate under an income tax treaty, or (iii) any documentation described in Treas. Reg. § 1.6049-5(c) that establishes an account holder's status as a non-U.S. person for purposes of the Code. *See* Rev. Proc. 2000-12, 2000-1 C.B. 387 (Model Agreement, § 2.12).

[89] Michaels, Balaban, Marcovici, O'Donnell & Connors, *supra* note 87, at 9.

[90] *Id.* at 6.

The final withholding regulations contain at least three important concessions to limit the identification of the ultimate foreign account holders and the requirements for information reporting or disclosure.[91] The concessions are meant to avoid administrative burdens and excess withholding (and the resulting need to for a foreign investor to file a U.S. tax return to claim a refund), and reflect the strength of the tension between the desire to assure relief is only granted where appropriate and the efficiency of capital markets.

> First, the regulations treat a foreign corporation as the beneficial owner of its income, irrespective of whether it is located in a tax haven, and its owner(s) need not be identified.[92] Although this may seem a strange concept to many foreign bankers who view the shareholder as the beneficial owner under know-your-customer rules, it is consistent with U.S. tax principles. This was a significant decision by the Service to limit the extent to which the withholding tax rules would be used as a means to catch U.S. tax evaders (or to obtain information that could be exchanged with treaty partners regarding their residents' investments in U.S. securities through offshore entities).
>
> Second, the regulations employ so-called presumption rules to permit a withholding agent to presume that an investor is a foreign person and thereby avoid imposition of back-up withholding in the absence of documentation of foreign status.[93] This permits a presumptively foreign payee to accept a 30% withholding tax on income (instead of 28% withholding on gross proceeds under the backup withholding regime) as the sole price for not providing withholding documentation. The absence of exposure to backup withholding is a significant structural element of the withholding rules. Non-U.S. investors seeking confidentiality (and presumably tax-evading U.S. investors as well) may use a foreign tax haven corporation as a private investment company to hold equity securities and thereby only

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[91] *See* Shay, Fleming & Peroni, *supra* note 46, at 125-26.

[92] Treas. Reg. § 1.1441-1(c)(6).

[93] Treas. Reg. § 1.1441-1(b)(3)(iii)(D). The final withholding tax regulations have carefully avoided applying back-up with-holding on gross proceeds in such a way as would compel disclosure of the identity of investors, whether U.S. or foreign, that are not direct payees. For example, if a Cayman Islands limited partnership provides a withholding exemption foreign partnership certificate (generally on a Form W-8IMY) to a U.S. withholding agent without documentation from its partners, the U.S. withholding agent must presume that the undocumented investors are non-U.S. payees and withhold 30% of income subject to withholding if paid to a foreign person. Treas. Reg. § 1.1441-5(d)(3). The non-U.S. payee presumption, however, insulates that investor from back-up withholding on gross proceeds, which does not apply to payments to foreign persons. *See, e.g.*, Treas. Reg. § 1.6045-1(g)(1)(i) (and cross-references) for this conclusion. The U.S. withholding agent must report to the Service on Form 1042-S the amount paid to an undocumented foreign payee. *See* Treas. Reg. § 1.1461-1(c). If a foreign partnership is organized in a tax haven and is not tax-resident in a country with a treaty with the United States, there is no way to relate the Form 1042-S information to the nondisclosed partners.

> suffer 30% withholding tax on dividends in order to avoid disclosure of their identities to the Service.[94] If the average dividend return on a broad range of equities is 3%, then the withholding tax is 90 basis points. The marginal cost of nondisclosure under these assumptions is only 45 basis points when the 30% withholding rate is compared with a treaty rate on dividends of 15%.[95] The calculus for the confidentiality-minded investor would be dramatically different if the threatened withholding were 30% of gross proceeds from the sale of securities.
>
> Third, as discussed above, the final withholding tax regulations provide that a foreign beneficial owner customer of a QI may claim exemption from withholding on interest without disclosing her identity to the Service (or the U.S. withholding agent).[96]

Even with these concessions, the introduction of the QI system and the new withholding regime took a first step towards defending against U.S. taxpayers taking advantage of source tax exemption.[97]

D. <u>Information Exchange Under Treaties and TIEAs.</u>[98]

As discussed above, the QI regime is not the primary system that the United States uses to enforce its tax laws outside its borders – nor was it ever meant to be. Because of the limits of U.S. jurisdiction, international cooperation is necessary to the effective administration of U.S. tax law overseas. Such cooperation is achieved through two mechanisms: income tax treaties and tax information exchange agreements ("TIEAs"). Although other enforcement tools are available, they are often more cumbersome and less effective that tax treaties and TIEAs.[99]

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[94] A U.S. tax evader resident in the United States might arrange with a fiduciary in a country with confidentiality protections to organize a corporation to hold investment assets. Although a U.S. tax evader resident outside the United States might be presumed to avoid contacts with treaty countries that could (and would) exchange information with the United States if requested, it is not beyond imagination that a U.S. citizen resident, but not ordinarily resident, in the United Kingdom (and therefore taxed on a remittance basis) would hold investments, including U.S. securities, through a corporation organized in a tax haven. In this case, the United Kingdom would not have information in its files to exchange with the United States that would link the U.S. citizen with the investments.

[95] OECD Model Tax Convention, n. 62, art. 10(2)(b), 1 Tax Treaties (CCH) P 10,507.

[96] Shay, Fleming & Peroni, *supra* note 46, at 125-27.

[97] *See id.* at 127.

[98] I would like to thank Luca Dell'Anese and Benjamin Rogers for their research regarding the issues discussed in this Section.

[99] One alternative is to request information under a Mutual Legal Assistance Treaty ("<u>MLAT</u>"). *See* I.R.S. Manual § 9.4.2.6. However, even if the U.S. has signed an MLAT with the country from which it wishes to request information, an MLAT only applies to U.S. criminal violations specifically listed in the MLAT. *See id.* Requests for information under an MLAT also must be approved by several IRS officials, and they must then go through the U.S. Department of Justice, as the U.S. Attorney General is the competent authority under MLATs. *See id.* U.S. tax

TIEAs and tax treaty requests usually go directly from U.S. tax authorities to the other country's competent authority. Most treaties and TIEAs bypass bank secrecy and apply at all stages of a civil or criminal tax case.

There are three types of tax information exchange that can occur under TIEAs or information exchange articles in tax treaties.

1. Automatic exchange.

The first, "automatic exchange of information," also known as "routine exchange of information," usually involves information about many individual cases of the same type transmitted between countries on a routine basis.[100] The information is normally about items of income arising in the country transmitting the information (typically interest, dividends, or royalties) as to which there is information reporting in that country.[101] Thus, for example, as discussed further below, the United States routinely exchanges information regarding interest, dividends and royalties paid to nonresidents reported on Form 1042-S with treaty partners.

2. Specific exchange.

The second, "exchange of information on request," also known as "specific exchange of information," occurs when the competent authority of one country requests particular information regarding specific taxpayers from the competent authority of the other country.[102]

3. Spontaneous exchange.

The third type of information exchange is "spontaneous exchange of information," which occurs when one country obtains information in administering its own tax laws, recognizes that the information will be of interest to a treaty or TIEA partner, and spontaneously transmits the information to that country.[103]

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authorities can also use letters rogatory for gathering tax information from foreign countries. A letter rogatory, when used by the U.S. authorities, is a request made formally by a U.S. federal court to a foreign court asking the foreign court to summon and examine a witness and transmit the witness's testimony for use in a U.S. court proceeding. *See* I.R.S. Manual § 35.4.5.3.2. With a few exceptions, most foreign courts only will release evidence in response to letters rogatory in the post-indictment or post-complaint stage of a case. *See* I.R.S. Manual § 9.4.2.6.4. Foreign courts also may refuse to cooperate with a letter rogatory for a variety of reasons under local law, such as bank secrecy or a general policy of not honoring letters rogatory regarding tax or fiscal matters. *See* I.R.S. Manual § 35.4.5.3.2. Many countries also have varying requirements as to whether letters rogatory should be sent through diplomatic channels or directly from court to court. *See id.* A third alternative in civil tax cases is to use a letter of request under the Hague Evidence Convention. *See* Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, July 27, 1970, 23 U.S.T. 2555, 847 U.N.T.S. 231. However, the difficulties of letters rogatory often remain for letters of request. Also, many jurisdictions are not signatories to the Hague Evidence Convention and many civil law countries that are signatories hold the view that tax matters are not within the scope of the convention. *See* I.R.S. Manual § 35.4.5.3.3.

[100] *See* I.R.S. Manual § 4.60.1; Statement of John Harrington, *supra* note 23.

[101] *See* I.R.S. Manual § 4.60.1.

[102] *See id.*

[103] *Id.*

Both routine and spontaneous information exchanges normally are done on a reciprocal basis, that is, routine and spontaneous exchanges normally would not be made with a country that would not reciprocate or be in a position to reciprocate. Tax treaties generally permit all three types of information exchange, laying the groundwork for broad information exchange without limiting the form and manner in which such exchange can take place, while TIEAs often are limited in scope to exchange of information on request.

E. FBARs.

The importance of tax information exchange has only been highlighted by the recent experience with Report of Foreign Bank and Financial Accounts forms ("FBAR"). The FBAR is a form that is filed with the Department of Treasury separately from an individual's tax return. U.S. citizens and residents and persons in and doing business in the U.S. who have a financial interest in or signature or other authority over any foreign financial accounts are generally required to file an FBAR if the aggregate value of such accounts exceeds $10,000 at any time during a calendar year.[104] FBARs report foreign account numbers, types, and values.[105] The penalties for failing to file the FBAR are stiff: criminal penalties for willfully failing to file an FBAR include a maximum fine of $250,000 or 5-year imprisonment.[106] If the failure to file is in connection with a pattern of other illegal activity involving more than $100,000 in a 12-month period, the maximum fine goes up to $500,000 or 10-year imprisonment.[107] There are also criminal penalties for filing a false FBAR and civil penalties may apply. Although the number of FBARs received increased nearly 82% from 2001 through 2007, compliance as of 2002 was roughly estimated at less than 20%.[108] A review of applicants coming forward in the Offshore Voluntary Compliance Initiative ("OVCI"), which attempts to bring taxpayers hiding funds offshore into compliance, also indicates a high level of noncompliance, although some of that noncompliance may be due to confusion or a lack of awareness.[109]

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IV. POLICY ISSUES AND RESPONSES

A. Short-Term Defenses Against U.S. persons Masquerading as Foreign Persons

In considering proposals that would affect the securities markets, it is important that the IRS follow its usual practice of consulting market participants to avoid actions that would disrupt markets. The criteria that should be used to evaluate these short-term proposals include an

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[104] *See* TD F 90-22.1, Report of Foreign Bank and Financial Accounts (2008).

[105] *See id.*

[106] *See* 31 U.S.C. § 5322 (2006).

[107] *See id.*

[108] JOINT COMMITTEE ON TAXATION, *supra* note 70, at 19-20.

[109] U.S. GOV'T ACCOUNTABILITY OFFICE, TAX COMPLIANCE: OFFSHORE FINANCIAL ACTIVITY CREATES ENFORCEMENT ISSUES FOR IRS, GAO-09-478T 5 (2009).

evaluation whether the proposal: (i) will meaningfully affect compliance to an extent that justifies the additional burden for the Government and taxpayer or reporting entity, (ii) be capable of implementation on a cost effective basis; and (iii) allow the affected market to work in a reasonable manner without disruption? I have not considered whether legislation is required for these proposals and recommend allowing use of regulatory authority where it already exists.

The short-term proposals discussed below focus primarily on initiatives that will aid the IRS in enforcement of existing laws and expansions of the QI program to shut down existing opportunities for exploitation.

1. Expand obligations of QIs to provide information reports and identify U.S. persons.

By expanding the QI responsibilities to encompass a broader informational reporting responsibility with respect to U.S. persons, there would be fewer opportunities for U.S. taxpayers to evade their responsibilities. The first proposal is to require that QIs engage in information reporting on all accounts over a reasonable threshold where a U.S. person is the beneficial owner and the QI has more than a threshold number of accounts for U.S. persons. The second, related proposal is that QIs include U.S. persons holding more than 10% of a non-U.S. corporate entity or foreign trust in the new information reporting regime.

a) Require QIs to Identify U.S. Account Holders, and Submit Information Reports With Respect to Such Interests.

Expanding QIs' responsibilities to include information reporting has been suggested in the past, and concerns have generally focused on feasibility of such a system, and worries that additional responsibilities would discourage participation in the QI program.[110] However, the experience of the past 10 years suggests that the benefits of becoming a QI likely outweigh the burden of reasonably calibrated additional responsibilities.[111] Furthermore, the experience of domestic institutions with 1099 reporting has shown that economics of scale can greatly reduce (or at least spread the cost of) the burden of reporting.[112] For these reasons, the IRS should be authorized to require information reporting from QIs who have a certain minimum number of U.S. account-holders with respect to accounts above a certain value threshold.

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[110] Several proposals have been made in recent months to expand QIs' responsibilities. *See* GAO QI REPORT, *supra* note 16, at 35; PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, U.S. SENATE, TAX HAVEN BANKS AND U.S. TAX COMPLIANCE 16 (July 17, 2008) (hereinafter PSI TAX HAVEN REPORT), *available at* http://hsgac.senate.gov/public/_files/071708PSIReport.pdf; Stop Tax Haven Abuse Act, S. 506, 111th Cong. (2009). Additionally, Reuven S. Avi-Yonah, my co-panelist today, suggests that an expansion of QI responsibilities to include 1099 reporting and backup withholding when a QI believes or has reason to believe payments are being made to a U.S. person.

[111] This is shown by the number of banks participating in the QI system: over 5,000 QI agreement are currently in place. *See* Douglas Shulman, *supra* note 30 at 6.

[112] *See* U.S. Gov't Accountability Office, Report to the Committee on Finance, U.S. Senate, Tax Compliance: Costs and Uses of Third-Party Information Returns 3-5 (Nov. 2007), *available at* http://www.gao.gov/new.items/d08266.pdf.

The need for a minimum threshold is necessary not only to preserve participation in the QI program, but also to prevent discrimination against U.S. persons living abroad with legitimate needs for a bank account in a non-U.S. jurisdiction. Instituting an account value threshold, in addition to setting a minimum number of accounts, will enable banks to offer accounts to smaller holders, such as students and working expatriates, without triggering additional burdens.

The type and nature of information reporting should be determined through consultation with the IRS to ensure the ability to have electronic transmission and processing. Information gathered in non-electronic form, or without TINs, compromises the ability of the IRS to adequately utilize such information.[113]

b) Information Reporting U.S Persons Holding More Than 10% of a Non-U.S. Corporate Entity or Foreign Trust

In addition to direct account holders, consideration should be given to requiring QIs to identify and provide the IRS with identifying information with respect to U.S. persons it has reason to know own more than 10% of a non-U.S. corporate entity or beneficial interest in a foreign trust holding an account with the institution. Setting a minimum ownership level at 10% will allow the IRS to coordinate the information with Form 5471 reporting with respect to foreign corporations.

2. *Other procedural measures:*

a) Extend statute of limitations

Recent proposals for reform, such as a recently circulated discussion draft of a bill in the Senate,[114] have included an extension of the period of limitations on assessment of tax when a taxpayer failed to report a foreign bank account or underreported income from such an account. These proposals should be extended to include taxpayers failing to report income or interests held through non-U.S. corporate entities and trusts.

The original purpose of an extension of the normal three-year statute of limitations to six years was based on a principle of IRS notice.[115] Typically, where a taxpayer has substantially understated or omitted income, an extension of the statute of limitations to six years is appropriate, because the IRS would require additional time to identify such an omission.[116] This is supported by the defense granted to taxpayers where sufficient information and disclosure was made on a return to put the IRS on notice of the omitted income.[117]

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[113] *See supra* Section III.D.

[114] *See* Discussion Draft, A Bill to Amend the Internal Revenue Code of 1986 to Improve Tax Compliance With Respect to Offshore Transactions, and for Other Purposes, S. 111th Cong. § 3 (as circulated Mar. 24, 2009).

[115] *See* Colony v. Comm'r, 357 U.S. 28, 36 (1958) (reviewing the predecessor to section 6501 and finding that "Congress was primarily concerned with providing for a longer period of limitations where returns contained relatively large errors adversely affecting the Treasury").

[116] *See* I.R.C. § 6501(e); Treas. Reg. § 301.6501(e)-1.

[117] *See* Treas. Reg. § 301.6501(e)-1(a)(1)(ii); *Colony*, 357 U.S. at 35-40.

The principles justifying an extended statute of limitations clearly apply in the context of foreign bank accounts held by U.S. persons, where the IRS must rely on even less information than with respect to purely domestic income and assets. To the extent that a U.S. person has failed to disclose income from a foreign bank account, regardless of the materiality of the omission, the six-year extension should apply to allow the IRS sufficient time to utilize international information resources, including requests for information under treaties and TIEAs. As noted above, information from TIEAs, treaties and QIs is currently not submitted electronically, and generally does not include any sort of identifying number. Allowing the IRS additional time would allow it to use unmatched information.

b) Increase IRS audit resources; Electronic Submission of QI Information

Any effort made to increase IRS enforcement resources devoted to cross-border enforcement, would better enable the IRS to track down individuals circumventing the U.S. domestic information reporting system. Included among any such initiatives would be creating IRS resources and systems to enable QIs to submit information electronically as well as initiatives for electronic information gathering from treaty partners discussed below.[118] This should be considered in conjunction with any increased informational reporting responsibilities placed on QIs.

3. Prospectively eliminate (after 2010) the foreign-targeted bearer obligation exception to beneficial owner documentation or QI reporting.

Consideration should be given to prospectively treating all foreign targeted obligations that pay U.S.-source interest as or in the same manner as registered obligations. This would at require collection of the same beneficial owner withholding documentation as would be required for a QI.[119]

4. Expand Treaty and TIEA Information Exchange.

The United States should continue to negotiate additional treaties and TIEAs as a means of expanding the scope of bilateral information exchange with other countries. In this regard, the IRS should adopt regulations expanding reporting of bank deposit interest by residents of countries in addition to Canada.[120] This was proposed in the Clinton Administration, but was not pursued during the Bush Administration.[121]

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[118] A similar proposal was introduced in the GAO QI REPORT. *See* GAO QI Report, *supra* note 16, at 35.

[119] *See* NYSBA TAX SECTION, *supra* note 33, at 37-38 (commenting that a proposal to expand scope of the definition of registered security to encompass dematerialized securities may be problematic in certain jurisdictions where it is difficult to obtain W-8s from investors but concludes this should not be a significant concern in that context).

[120] Treas. Reg. § 1.6049-8.

[121] REG–126100–00, 66 Fed. Reg. 3925 (Jan. 17, 2001).

B. Longer term source taxation issues

A second set of options should be considered as part of a broader tax reform. These options would explore the opportunities to increase the scope of source taxation of returns to capital in coordination with other countries in a manner that more closely approximates taxation of net income than has been possible historically. The following options should be considered in relation to their economic effects, ramifications for capital markets and foreign relations, and feasibility for incorporation into the existing international financial system.

1. International Standards For Electronic Information Exchange.

The Treasury Department should strongly support initiatives at the OECD and bilaterally to permit international information exchange electronically that is coded in a manner that permits information recipient countries to match information with that in its master information files.[122] This would effectively enable the United States to institute matching programs for non-U.S. income earned by its residents. Matching information to tax returns is critical to the IRS's successful enforcement of existing tax laws and shutting down evasion techniques utilized by U.S. persons.

As with the development of increased information reporting by QIs, careful consultation with the IRS regarding how to most effectively share information should be considered. Without a numbering system to fully integrate the exchange with its existing matching system, the efficacy of information exchange is limited. However, the use of other matching systems, such as passport numbers or other local forms of identification may be able to be integrated with the IRS current information systems. It also will be essential to protect the confidentiality of taxpayer information that is exchanged.

2. Expansion of Source Taxation of Investment Income

Consideration could be given expanding the source taxation of capital income, except as relieved by treaties, in coordination with major trading partners. This would be a dramatic change in U.S. policy and would have to satisfy a high burden of to justify pursuit. The fundamental insight is that it should be possible with new technologies to move away from the excessive gross basis taxation and achieve a more reasonable net basis taxation. This is particularly true of gains, with the anticipated advent of basis reporting.

Concerns regarding the flow of capital to the United States would have to be addressed.[123] Given the current economic realities these concerns are real. An international tax

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[122] *See, e.g.*, Press Release, U.S. Senate Committee on Finance, *Grassley, Baucus Call for Review Of IRS Use of Foreign-Source Income Information* (May 17, 2006) *available at* http://finance.senate.gov/press/Bpress/2005press/prb051706.pdf. The OECD also has began investigating ways to increase compatibility and coherence of information shared across national boundaries. *See* Remarks by Angel Gurría, Secretary-General, OECD, Remarks at the G7 Finance Ministers Dinner (February 13, 2009), *available at* http://www.oecd.org/document/50/0,3343,en_2649_34487_42184370_1_1_1_1,00.html.

[123] As my co-authors and I noted in 2002:

> The exemptions for bank deposit and portfolio interest have traditionally been justified by the argument that the imposition of a tax on the gross amount of

reform in a country that continues to tax income, however, should consider the ramifications for tax evasion and avoidance of broad unilateral exemptions of withholding at source without identification of the income's beneficial owner.

* * *

I would be pleased to answer any questions the Committee might have.

> interest income in a liquid capital market with ready alternative investments would result in the burden of the tax being borne by U.S. borrowers (including the U.S. government) through higher interest rates. Whether such an effect would arise with respect to non-U.S. persons resident in treaty countries who are already entitled to reduced rates of tax on interest payments without any statutory exception is not clear. Nevertheless, this concern reflects a widespread international reluctance to tax interest from unrelated foreign payors.

Shay, Fleming & Peroni, *supra* note 46 at 122-23.

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Biography

Stephen E. Shay is a tax partner with Ropes & Gray in Boston, Massachusetts. Stephen has extensive experience in the international tax area, advising clients that include large and medium-sized multinational companies, financial institutions, and global investors on issues such as foreign tax credits, deferral of U.S. taxation, foreign currency gains and losses, withholding taxes and financial product issues. Stephen regularly advises clients on transfer pricing issues and has successfully resolved numerous transfer pricing controversies with the IRS. Stephen also works with Ropes & Gray's Private Client Group advising high net worth clients on cross-border income tax planning. Stephen has been recognized as a leading practitioner in *Chambers Global: The World's Leading Lawyers*, *Chambers USA: America's Leading Lawyers*, *The Best Lawyers in America*, Euromoney's *Guide to The World's Leading Tax Advisers* and Euromoney's, *Guide to The Best of the Best.*

Stephen has been a Lecturer in Law at the Harvard Law School in 2003 and in 2005 through 2008 teaching a course on international aspects of U.S. income taxation. Stephen was the Jacquin D. Bierman Visiting Lecturer in Taxation at Yale Law School in 2004. Stephen has served as Associate Reporter for the American Law Institute's Federal Income Tax Project on Income Tax Treaties with Reporters David R. Tillinghast and Professor Hugh Ault. He also is a Council Director of the American Bar Association Tax Section and has served as Chairman of the Tax Section's Committee on Foreign Activities of U.S. Taxpayers.

Before joining Ropes & Gray in 1987, Stephen was the International Tax Counsel for the United States Department of the Treasury. Prior to joining the Treasury Department as an Attorney Advisor in 1982, Stephen was associated with Reavis & McGrath and Coudert Brothers in New York City. Stephen received J.D. and M.B.A. degrees from Columbia University in 1976 and his B.A. from Wesleyan University in 1972.

Stephen has authored or co-authored numerous articles and has testified before Congress on international tax policy issues. Stephen's principal publications and testimony are set out below.

Publications and Testimony

Testimony, Committee on Finance, U.S. Senate, Hearing on The Foundation of International Tax Reform: Worldwide, Territorial, and Something in Between (June 26, 2008)

Testimony, Committee on Ways and Means, U.S. House of Representatives, Hearing on Fair and Equitable Tax Policy for America's Working Families (September 6, 2007)

American Bar Association Tax Section, Task Force on International Tax Reform, "Report of the Task Force on International Tax Reform," 59 Lawyer 649 (2006) (principal draftsman)

Testimony, Subcommittee on Select Revenue Measures of the Ways and Means Committee, U.S. House of Representatives, Hearing on U.S. International Competitiveness (June 23, 2006)

Testimony, President's Advisory Panel on Federal Tax Reform, Panel on International Income Taxation (May 13, 2005)

"Exploring Alternatives to Subpart F," 82 TAXES 29 (Mar. 2004).

"The David R. Tillinghast Lecture: 'What's Source Got to Do With It?' Source Rules and U.S. International Taxation," 56 Tax Law Rev. 81 (2003) (co-authored with Robert J. Peroni and J. Clifton Fleming Jr.)

Testimony, Finance Committee, United States Senate, Hearing on International Competitiveness (July 16, 2003)

"Reform and Simplification of the U.S. Foreign Tax Credit Rules," 31 Tax Notes Int'l 1145 (September 29, 2003) and 101 Tax Notes 103 (October 6, 2003) (co-authored with Robert J. Peroni and J. Clifton Fleming Jr.)

"Notice 2002-41 Guidance for Withholding Foreign Partnerships," 31 Tax Mgmt Int'l J. 560 (November 8, 2002) (co-authored with Elaine B. Murphy)

Testimony, Ways & Means Committee, U.S. House of Representatives, Hearing on WTO Extraterritorial Income Decision (February 28, 2002)

"Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income," 5 Fla. Tax Rev. 299 (2001) (co-authored with J. Clifton Fleming, Jr. and Robert J. Peroni)

"An Alternative View of Deferral: Considering a Proposal to Curtail, Not Expand, Deferral," 20 Tax Notes Int'l 547 (January 31, 2000) (co-authored with J. Clifton Fleming, Jr. and Robert J. Peroni)

"Deferral: Consider Ending It, Instead of Expanding It," 86 Tax Notes 837 (Feb. 7, 2000) (co-authored with J. Clifton Fleming, Jr. and Robert J. Peroni)

"Taking Territorial Taxation to Task," 20 Tax Notes Int'l 1178 (April 17, 2000) (co-authored with Robert J. Peroni and J. Clifton Fleming, Jr.)

"Qualified Intermediary Status, Act III: Rev. Proc. 2000-12's Final Qualified Intermediary Agreement and Amendments to Final Withholding Rules," 29 Tax Mgmt. Int'l J. 403 (July 14, 2000) (co-authored with Susan C. Morse and Christopher J. Peters)

"Qualified Intermediary Status, Act II: Notice 99-8 and The Role of A Qualified Intermediary," 28 Tax Mgmt. Int'l J. 259 (May 14, 1999) (co-authored with Susan C. Morse)

"Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income," 52 SMU Law Rev. 455 (Spring 1999) (co-authored Robert J. Peroni and J. Clifton Fleming, Jr.)

"Qualified Intermediary Status: A New Withholding Role for Foreign Financial Institutions Under Final U.S. Withholding Regulations," 27 Tax Mgmt Int'l J. 3 (1998) (co-authored with Susan C. Morse)

"Selected International Aspects of Tax Reform Proposals," 51 U. Miami L. Rev. 1029 (1997), reprinted in American Bar Association Section of Taxation, Tax Systems Tax Force, "A Comprehensive Analysis of Current Consumption Tax Proposals" (1997) (co-authored with Victoria P. Summers)

"Revisiting U.S. Anti-Deferral Rules," TAXES (December, 1996)

"Chapter 6, Taxation Policy," co-authored with Elinore J. Richardson, Esq., in Pritchard, ed., Economic Development, Foreign Investment and the Law: Issues of Private Sector Involvement Foreign Investment and the Rule of Law in a New Era, (Kluwer 1996)

"IRS Makes Flip Transactions Taxable," 5 Int'l Tax Rev. 17 (July/August 1994)

"Re-examining Chapter 3 income tax withholding and the role of the withholding agent," Alpert and van Raad, eds., Essays on International Taxation (Kluwer 1993)

"Final Section 367(e) Regs. Improve on Temp. Regs., But Policy Concerns Remain," 4 J. Int'l Tax'n 244 (June, 1993)

"Final Dual Consolidated Loss Regs. Still Have Some High Hurdles," 4 J. Int'l Tax'n 52 (February, 1993) (co-authored with Rom P. Watson)

"Dispute Resolution Faces Numerous Obstacles," 3 Int'l Tax Rev. 15 (April, 1992)

The American Law Institute, Federal Income Tax Project - United States Income Tax Treaties (American Law Institute 1992) (Associate Reporter to Reporters David R. Tillinghast, Esq. and Professor Hugh J. Ault)

"Report on Legislative Proposal to Repeal Section 1491," American Bar Association Tax Section Committee on Foreign Activities of U.S. Taxpayers, Subcommittee on Section 367 and 1491 Transactions (principal draftsman with Frank R. Ortolani, Jr.)

"Comments on Proposed Regulations Under Section 367(e)," American Bar Association Tax Section Committee on Foreign Activities of U.S. Taxpayers, Subcommittee on Section 367 and 1491 Transactions (principal draftsman with Jay H. Zimbler)

"Section 864(e) and the Allocation of Expenses Under the Temporary Regulations," 18 Tax Mgmt. Int'l J. 239 (1989)

"The Post-TAMRA Treatment of U.S. Shareholders of PFICs: Part I," 70 J. Tax'n 296 (June, 1989)

"The Post-TAMRA Treatment of U.S. Shareholders of PFICs: Part II," 70 J. Tax'n 374 (June, 1989)

"Section 864(e) and the Allocation and Apportionment of Interest Expense Under the Proposed Regulations," 17 Tax Mgmt. Int'l J. 51 (February, 1988)

"The Controversial CFC Interest Netting Rule in the Proposed Interest Allocation Regulations," 17 Tax Mgmt. Int'l J. 25 (January, 1988)

Chairman NEAL. Thank the panelists.

Mr. Shay, you and others have suggested that QIs need to know more about the beneficial owners of foreign corporations than is currently required, which results in QIs basically accepting it at face value.

What exactly would you require of QIs in order to be in compliance with this additional mandate?

Mr. SHAY. I think, Mr. Chairman, that in fact QIs often do know a fair amount about beneficial owners of corporations, because of the know-your-customer rules when they're closely held.

But for purposes of this discussion, I think what I would recommend is, subject to working through with the IRS fairly carefully, is consideration of requiring a QI to provide information about thresholds U.S. owners of foreign corporations. In my testimony we said 10 percent or more owners of U.S. corporations—for a couple of reasons.

If that information is provided to the IRS, then it can then cross check and be sure that those U.S. persons have complied with their income tax obligations with respect to those corporations.

If those corporations were either closely controlled or hold primarily passive assets, under our existing U.S. rules, they should have included income currently in their U.S. taxable income, so this would be an effective check. There may be circumstances where it would make sense to go beyond that.

One other comment I would make. In my testimony, I have highlighted the important role that QIs play in the withholding system. This would be an additional burden for a foreign corporation that's participating.

It is a judgement call, but my judgement is that being a qualified intermediary now is sufficiently important for foreign banks in the international capital markets, that they would be willing to take on some additional burden.

I urge the Committee to give the IRS flexibility to work out the detail, so that the system doesn't cause QIs to leave the system.

Chairman NEAL. Thank you, Mr. Shay.

Mr. Blessing, you nuanced part of this—in your testimony, you nuanced part of this question that I'm about to raise. I'm interested in the EU Savings Directive that is explained in your testimony, and you did speak to this issue.

Do you think that the U.S. could participate in such an automatic reporting regime, or would it overwhelm our banks and financial institutions, so that it would be deemed overburdensome?

Mr. BLESSING. The EU Savings Directive is a very different type of system, which requires the reporting of interest to EU—by EU participants to external parties, to non-EU parties.

In the U.S. reporting system, I don't think that there's anything quite comparable. We do require reporting of most payments. We have declined to require reporting of bank payments by domestic banks. That was not—at the time, there was some concern that that would be a burden on the systems.

But the primary concern, I believe, was that there would be a impact on the capital flow to banks. In other words, U.S. domestic banks lobbied against that provision, because they were concerned that they would not receive the same deposits if they were required

to report the interest. I don't think the systems is a problem anymore, my own view.

Chairman NEAL. And Professor Avi-Yonah, you seem to be the lone voice against the QI system today. We've heard your testimony that the dark secret before the QI system was implemented was that no one had any idea where the payments were going, and at least with QI they have some idea.

Would you support this system with modifications that were outlined by the Commissioner today?

Mr. AVI-YONAH. Yes. I didn't mean to imply that I think the QI system is worthless. I think there is a world imaginable in which we would not need the QI system, and I think that would be a preferable world, in which we in fact withhold on all payments that are not, for example, to treaty countries, that is we would repeal the portfolio interest exemption, or at least the Treasury Secretary applies his ability to suspend it to all payments to countries that don't participate in full exchange of information.

But that—I appreciate following Mr. Blessing's testimony just now, we can't really under current circumstances, do that unilaterally without triggering a capital outflow for the United States.

I think that can only be done in cooperation with the Europeans, with other Members of the G–20, because they are already on record, because of the Savings Directive and other initiatives, OECD initiatives, that they would be interested in extending such a regime to fundamentally deal with the tax haven problem.

But as long as that is not done, I think we need something like the QI program, but I think that the issue with the QI was always about, to some extent, sharing information—not sharing information from the QI to the foreign—to the U.S. withholding agent, who may be a competitor.

And that I accept. But when we had the previous hearing where the GAO presented the QI report, the QI representatives all said, "We are fully willing to share information with the IRS. That is, this is not about not sharing information with the IRS."

Well, lo and behold, UBS is not willing to share information with the IRS, even when asked—even when given a John Doe summons. And the other QIs also, I don't think they're really willing to share information with the IRS.

I think we could live with the QI program if the QIs have to share all the Forms W–8BEN with the IRS, and if they provide information about U.S. people that they know about, and provide—and also share the information about foreign people, in which case it's available under the shared information, and that I don't think will kill the QI program.

Chairman NEAL. Thank you, Professor. Mr. Tiberi.

Mr. TIBERI. Thank you, Chairman. Mr. Blessing, in your testimony the tax information exchange agreements, and if we look at those and other agreements that we have with other foreign entities, whether they be foreign governments or financial institutions, would you predict any backlash if we pursued a policy of blacklisting specific countries, rather than maybe strengthening those agreements and adding folks to those agreements?

Mr. BLESSING. I think that a unilateral blacklist is a very different concept than a multilateral——

Mr. TIBERI. And that's what——

Mr. BLESSING [continuing]. Blacklist.

Mr. TIBERI [continuing]. I'm talking about. Yes, that's what I mean.

Mr. BLESSING. I think what I'd comment on was that the G–20 approach, which was a multilateral approach, was very effective. It represents 80 percent of the economies of the world in terms of trade.

Mr. TIBERI. Right.

Mr. BLESSING. And together, countries can do a lot. Together, the pressure was enormous, and the facts speak for themselves. A number of countries that previously had relied on their banks—EU Chrissy—dropped their objections, under that pressure.

A unilateral blacklist could—well, the first thing is it's not going to raise revenue. It may have some other benefits, for example, the benefit of changing the burden of proof and so forth, but it's not going to raise revenue, because obviously the deposits will go to another country.

And it's very hard to administer. It's one thing to threaten. It's another thing to actually select the countries in a fair way, have a system that permits them to be added and taken off.

And it's a very onerous process, and much of a sledgehammer. So I'd be very cautious about blacklists.

Mr. TIBERI. Thank you. And to just extend that a little bit. We had heard earlier about the number of countries that don't apply—that aren't involved in the Q1—the QI program. I keep saying Q1, the name of a band back home—the QI program, and the number of foreign banks that aren't involved.

How do we get them engaged more, either through these agreements, or other mechanisms? Because obviously, very easy for someone who wants to break the law, to try to go outside one of these participating countries, or participating financial institutions. How do we expand the scope?

Mr. BLESSING. It is a bit of a Catch-22, because on the one hand, we're trying to tighten—we as a country are trying to tighten the reporting, rightfully so, and the audit procedures, and so forth, which imposes additional expense—will impose additional expense. And I do fear that, at least for smaller QIs, at least what I have heard, is that they may not be able or willing to continue to participate.

For the larger QIs, I think it's still beneficial. Certainly, Steve Shay has just testified to that effect as well. I think it's—what we can do to encourage more? It's—I think the process that's taking place in the OECD generally, may lead in that direction.

I referred to this OECD report by the informal consultative group. Now that's a number of years away from any real action, but it is very, very, telling and interesting that they have selected the type of program that we have—is our QI program—as the model going forward that countries would optimally implement.

Right now it's just a discussion draft, but it was put together by Members of a number of OECD countries and, most importantly, the financial community as well.

Mr. TIBERI. Can you comment on that, sir?

Mr. SHAY. It is—as a number of us said in testimony, the QI is an opt-in system. Let me take a slightly different approach to your question.

I think it's fair to say that until recently, efforts to make coordinated international attack on cross-border evasion have been frustrated by lack of interest by countries, politics, and basically a general lack of urgency.

Today, after what has been happening in the last several months, if a bank, even if it's not a QI, is found to have a U.S. tax evader, I think there's a sense of obloquy that is attached to that, that may not have been as true not long ago. And I think that's a very positive development.

So I think part of—and this goes to Commissioner Shulman's multi-strategy approach—part of this is simple shaming. What happened in a major bank did not pass what we in the practitioner community call the Wall Street Journal test. It showed up on the front page of the Wall Street Journal, and it was extremely——

Chairman NEAL. You should know I have failed that test many times.

Mr. SHAY. Well, we can also call it the Boston Globe test. Thank you, sir.

Mr. TIBERI. Thank you. Thank you, Mr. Chairman. I yield back.

Chairman NEAL. Thank you, Mr. Tiberi. The gentleman from Nevada, Mr. Heller.

Mr. HELLER. Thank you very much, Mr. Chairman, and I want to thank the gentlemen for being here this morning.

Questions were asked specifically, and you can tell, the four out of five questions that have been asked, at least on this side, have dealt with specifically the blacklisting.

You heard the Commissioner's response to Mr. Davis' question as to whether tax information exchange agreements with several companies are included in the Levin-Doggett blacklist, and I think I can confirm that there are.

Also, I think I can confirm for the record that there are actually full-fledged tax treaties with at least three countries, that are on the Levin-Doggett blacklist.

So I guess my point is, and Mr. Blessing, you did answer that question, but I share the concern that the blacklisting approach could invite retaliation from listed countries that could do significant harm to our struggling economies' capital markets, given that the U.S. itself sometimes is described as a tax haven, with respect to its treatments of non-residents, especially considering the fact that the U.S. does not impose tax on U.S. Treasury Bond interest paid to foreign investors.

Do you think that there could be potential backlash from other countries that could disrupt our capital markets at this delicate time for our economy? And I'd like the Professor and Mr. Shay to answer this question.

Mr. Blessing, thank you for answering the question earlier.

Mr. AVI-YONAH. Well, I mean, let me say a couple of things about blacklists in general. First of all, we are not the inventor of blacklists, not even of unilateral blacklists.

Lists in general are employed by most other countries in the world, for example, in the context of their so called CFC regimes,

stuff like that. Most countries, unlike us, designate countries that are eligible to be exempted from their anti-deferral regimes, and other countries that are specifically included, that is that income from those countries will be subject to the anti-deferral measures, because of their judgement that these countries are "tax havens."

So we haven't invented this at all. In addition, of course the history of this goes back to the OECD list from 1998, 1999, and that list was remarkably effective. It started with, I think, 42 countries, and ended up with four countries, and that is because the other countries all agreed to participate in the OECD standards about sharing information.

The problem is that they said they would, and then they didn't. And this is why the G–20 now proposes to put a lot of these countries back on the list. And I think that those efforts are all to the good, and this the only tool that would really make countries cooperate, is listing them. I mean, not the only tool, but this is a pretty effective tool, as has been shown historically.

Now frankly, I don't think that that's where they show the capital market comes from at all. The capital—investors cannot leave their money in tax havens. That's the basic point. The money has to go to the rich countries, the big countries, because that's where the investment opportunities are.

If you leave your money in the tax havens because you are a money launderer or a drug lord, it earns a negative interest rate, because you have to pay the bank interest in order to keep the money there, and not have it disclosed.

If the money goes into one of the rich countries, the rich countries, the G–20, you know, 85 percent of the world economy are all in agreement about this. And I don't see that making further progress on this, even unilaterally, would have any negative impact on the United States at all.

Mr. HELLER. So Professor, can I interpret from your answer that you support blacklisting?

Mr. AVI-YONAH. I support the Levin-Doggett bill, and I think it should be enacted tomorrow and signed by the President.

Mr. HELLER. Mr. Shay.

Mr. SHAY. I would note, as a matter of history, that tax information exchange agreements first were authorized in the Caribbean Basin Initiative in the early eighties. A carrot approach was used.

Countries that entered in to a tax information exchange agreement were given a more favorable treatment of deductions by Americans who attended conventions in those countries.

There was second carrot, which has since gone away, which was an advantage under the foreign sales corporation legislation. And that did encourage a number of Caribbean countries to enter into tax information exchange agreements.

More recently, the efforts of the OECD, in the harmful tax competition exercise in the late 'nineties also encouraged countries both to become parties to tax information exchange agreements, and to provide information under them.

So I think both those have brought about a lot of progress.

I also would just note that real progress in this area will call for international cooperation, and not just at the level of exchange

agreements, at the level of collecting information, including by the United States.

I endorse the proposals, I think of both my colleagues here,to expand the collection of information on non-resident bank accounts, so that it can be exchanged with treaty partners, so that we can get them to give us information.

But all of that will only work effectively if we create a system that will allow us to do it electronically, and to bring it into the IRS electronic matching systems.

This is difficult stuff. It's going to take real work. It's not going to happen in the short term, but directionally, I can see a lot of—particularly in Peter's testimony, things that he is highlighting that are very favorable, and I encourage this Committee to support it.

Mr. HELLER. Thank you, Mr. Chairman.

Chairman NEAL. Thank the gentleman.

Mr. Doggett is recognized to inquire.

Mr. DOGGETT. Mr. Chairman, thank you. And thank you. I think the testimony that each of you offered is important as we craft this legislation. Since the most ringing endorsement for my proposal was Senator Levin joining Secretary Geithner and Senator Obama endorsing that proposal was from you, Professor Avi-Yonah, I want to direct most of my questions to you.

One thing we haven't really explored fully yet in the hearing that I think is important, the immense dimensions of the problem we're dealing with. And you address this in your written testimony, but do I understand that the best estimates are that about one and a half trillion dollars is kept offshore by U.S. residents?

Mr. AVI-YONAH. That is an estimate that was done by the Boston consulting group and Merrill Lynch some six years ago, so it's not up to date.

Mr. DOGGETT. So it's a very conservative estimate. Six years ago, Merrill Lynch estimates one and a half trillion dollars offshore by U.S. residents. Is that individuals only, or corporations as well?

Mr. AVI-YONAH. This is high net worth individuals.

Mr. DOGGETT. All right.

Mr. AVI-YONAH. So it's not corporations.

Mr. DOGGETT. And your conservative analysis using that data and other studies, is that what we're talking about for individuals only, not corporations, is $50 billion of tax evasion every year?

Mr. AVI-YONAH. Yes. I mean, this is conservative because what I did was simply take the one and a half trillion, assume 10 percent, you know, income on that, which seems reasonable, so that's 150 billion, and then apply the U.S. tax rate, so that's about 50 billion.

But that assumes that the one and a half trillion are all aftertax income——

Mr. DOGGETT. Right.

Mr. AVI-YONAH [continuing]. That has been subject to tax already. If it was some earned overseas, transferred, you know, to Switzerland or the Caymans, and never disclosed, then part of the one and a half trillion principal is also——

Mr. DOGGETT. Exactly. And I think that is why Senator Levin, Senator Carl Levin, has estimated that when you add in the cor-

porations to these individuals, and recognize that data is—that we're using is 6 years old, that the amount may be a 100 to 150 billion dollars every year that is lost in tax evasion.

Mr. AVI-YONAH. The truth is that nobody knows. I mean, there's a whole range of estimates.

Mr. DOGGETT. It's hard to get a precise number.

Mr. AVI-YONAH. Right.

Mr. DOGGETT. But what we do know is that it's big. It's very big. And my reaction, and I think the reaction of that firefighter or that police officer, or that small business on main street in Bastrop, Texas, is that if there's that much tax evasion, we don't just need a sledgehammer, we need something bigger than that, because it's very unfair. It does strike to fundamental fairness, as the Commissioner of the Internal Revenue Service said.

Now let me ask you as well, while your testimony has focused on individuals, we know that with the click of a mouse, an individual can become a corporation. And that's one of the ways, as several of you mentioned, through hiding behind corporations, that individuals can dodge their tax liability.

It is also particularly galling, I think, that some of the biggest recipients of taxpayer money in the bailout that has occurred over the last few months—Morgan Stanley, 158 of these subsidiaries, Citigroup, 90 of these offshore tax-dodging entities, Bank of America, 59. Now that doesn't compete with the over 300 that Enron had before it failed, but it's a very significant amount of use of these international tax subsidiaries to dodge taxes.

Let me ask you if you agree that there is a serious problem, not just for individuals, but for corporations using foreign subsidiaries to dodge their tax responsibilities, which my business on main street in Bastrop or Lockhart or Smithville cannot do?

Mr. AVI-YONAH. Well, there is a difference that I do want to draw between things that are clearly illegal tax evasion, and things that are tax avoidance using legal loopholes.

I think what most corporations, certainly the ones that you've mentioned do, is not illegally hide their taxes. I mean, as was mentioned before, there are rules on the—in the codes that say that any foreign corporation that's owned by an American over certain thresholds subjects that American to taxes in one way or another.

Mr. DOGGETT. Well, I couldn't agree with you more. It's not only what's illegal, but what's legal that should not be legal because it's inequitable to businesses here in the United States.

While most of the questions that you have received this morning have been about the blacklist portion as it is termed of the Stop Tax Haven bill, I want to ask you about another very important part of it that relates to corporations.

One of the provisions of the bill is to treat a corporation that is incorporated abroad as a domestic United States corporation, if substantially all the executive officers and senior management are located primarily here in the United States.

I think this is an important provision to restore tax fairness, by recognizing that if you have a shell corporation abroad, and it's really a United States company, that just having a paper certificate and a sunny tax haven, is not enough to make you foreign.

Do you agree that this type of provision is needed to restore tax equity, by not letting corporations play these type of illegitimate games to avoid taxes?

Mr. AVI-YONAH. Yes, I personally think that this is a very good improvement on existing law. I first made this suggestion back in 2001 in response to the so-called inversion transaction, when American corporations set up shell parent corporations in Bermuda, without changing anything in terms of the actual place of managing control of the corporation. And this was done in joint—endorsed by the Joint Committee on taxation as one of their options of reforming the law.

Most countries in the world have some kind of management control standard. And I think under the limitations that are in the bill, this is a very sensible provision that will add greatly to the enforcement of our tax laws.

Mr. DOGGETT. Thank you, Mr. Chairman.

Chairman NEAL. I thank the gentleman. I want to also thank our witnesses today for their commentary, it was very thoughtful. There may be some written questions, and we would hope that you would be able to answer promptly if requested. And if there are no other comments? Hearing none, then the hearing stands adjourned. Thank you.

[Whereupon, at 11:44 a.m., the Subcommittee was adjourned.]

[Submissions for the Record follow:]

Statement of Brian G. Dooley & Associates

As a certified public accountant assisting the small business owner and legal immigrants located in Orange County, California, I am concern that the large tax penalties for *late filing* foreign trust information returns and *late filing* of the FBAR causes non-compliance.

In California, literally million of legal residents and citizens have family in foreign countries. Often their inheritance is held in a foreign trust, which has a foreign bank account.

Most of these legal immigrants are unaware of the reporting requirement. They often prepare their own returns using computer software or have a general practioners without knowledge of the reporting requirements.

Many tax compliant taxpayers discover that they failed to file a FBAR, a Form 3520 or a Form 3520–A. Voluntary disclosure does abate disproportionately harsh tax penalties. A thirty-five percent to fifty percent penalty of principle far exceeds the tax liability.

Abatement of penalties requires both "reasonable basis" and lack of "willfulness."

The courts have held that lack of knowledge of a tax law is not a "reasonable basis."

Thus, the other wise compliant taxpayer remains non-tax compliant in future years fearing discovery of a past year tort.

I am writing to respectfully request that the IRC be amended to allow abatement of the penalties if the taxpayer can show lack of willfulness with no requirement for reasonable basis.

Economic Substance Statue

The Stop Tax Haven Abuse Bill prevents the preparation of complete and accurate tax returns by not allowing taxpayers and their tax preparers to apply the statue.

Further, the Bill may avoid such activities as an IRA, which are only formed and funded for tax reasons. Most tax election has no purpose other than the tax benefit.

The change is important to allow taxpayers that discover that they are in a tax shelter to not report an abusive transaction; and instead to report the transaction under the economic substance doctrine.

Imposing a penalty after forcing a taxpayer to improperly report a transaction appears to be an abuse by the government.

Respectfully submitted,

Brian Dooley
Brian G. Dooley, CPA, MBT

Statement of Isle of Man Government

Chairman Neal, Ranking Member Tiberi and Members of the Subcommittee, thank you for the opportunity to share with you information about the Isle of Man. The Isle of Man is pleased to provide facts about the regulation of its financial services industry and its practices regarding transparency and international co-operation in tax matters to guide the Subcommittee in its review of offshore U.S. tax evasion.

I. Summary of Statement

The Isle of Man is a well-regulated, co-operative and transparent jurisdiction. It is not a "tax haven" or an "offshore secrecy jurisdiction" and does not condone, encourage or facilitate tax evasion by U.S. citizens or any other foreign or domestic taxpayers. The Isle of Man has been evaluated by international organizations including the International Monetary Fund ("IMF"), Financial Action Task Force ("FATF") and the Organisation for Economic Co-operation and Development ("OECD") and commended for being compliant on all matters of financial regulation and international co-operation to prevent evasion of taxes. In fact, on April 2, 2009, the G20 noted the OECD list of countries assessed by the OECD Global Forum against the international standard for the exchange of tax information. This listed the Isle of Man alongside the United States as having substantially implemented the internationally agreed tax standard, which requires the exchange of information on request in all tax matters for the administration and enforcement of domestic tax law without regard to a domestic tax interest requirement or bank secrecy for tax purposes.[1] The Isle of Man respectfully requests that if the Subcommittee does proceed with legislation that includes any blacklist of tax havens or offshore secrecy jurisdictions, such a list should not include those jurisdictions, such as the Isle of Man, that the OECD has determined have substantially implemented the internationally agreed tax standard.

II. About the Isle of Man

Located in the middle of the Irish Sea at the centre of the British Isles, the Isle of Man has a total land area of 227 square miles. The resident population is just over 80,000 (2006 interim census).

Constitutionally, the Isle of Man is a self-governing British Crown Dependency with its own ancient parliament (Tynwald), government and laws. The United Kingdom, on behalf of the Crown, is ultimately responsible for the Isle of Man's international relations, although in recent years, reflecting significant differences in UK and Manx law and policies, the Isle of Man has—in agreement with the United Kingdom and its international partners[2]—represented its own interests internationally, notably by concluding a significant number of bilateral tax agreements. The Isle of Man is financially autonomous and receives no financial assistance either from the United Kingdom or the European Union ("EU"). The Isle of Man is not represented in the United Kingdom or European Parliaments.

The Isle of Man's relationship with the EU is set out in Protocol 3 to the United Kingdom's Act of Accession (1972). In essence, in accordance with Article 299(6)(c) of the treaty establishing the European Community, the Isle of Man is outside the EU except for EU law and policy on the customs union and the free movement of goods. In all other matters, including tax and financial services, the Isle of Man is in the position of a "third country" or non-Member State with respect to the EU.

III. The Isle of Man Is Well-Regulated, Co-operative and Transparent

The Isle of Man takes seriously its role as a world-class location for financial services and investment.

- A. Isle of Man Regulation of Financial Services

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[1] This list is posted at: http://www.oecd.org/document/57/0,3343,en_2649_34487_42496569_1_1_1_1,00.html

[2] The Isle of Man has, for example, signed agreements giving effect to the European Commission's Taxation of Savings Interest Directive with all 27 Member States. Likewise, it has so far negotiated and signed 14 TIEAs with partner countries inside and outside the EU.

Business is attracted to the Isle of Man by local expertise in professional services, a supportive government, a world-class telecommunications infrastructure, sound financial regulation and a competitive tax system. New growth areas include e-commerce, the film industry, international shipping, aviation, and space and satellite businesses, whilst traditional sectors, like tourism (including the famous Tourist Trophy motorcycle races) remain important.

The Isle of Man has enacted legislation covering all financial services sectors, as well as related areas such as audit, accounting, company law and anti-money laundering. The Isle of Man's legislation in these fields is modern and based on the highest international standards. Although the Isle of Man is outside the EU for financial services and related fields, its legislation in all these areas is based broadly on corresponding EU secondary legislation.

The Isle of Man's Financial Supervision Commission ("FSC") was established in 1983 as an independent statutory body to license and regulate financial activities in the Isle of Man. The FSC regulates and supervises all deposit-taking, investment business, services to collective investments, trust services, company services, fiduciary services and money transmission services in or from the Isle of Man. These powers include the maintenance and development of the regulatory regime for regulated activities, the oversight of directors and persons responsible for the management, administration or affairs of commercial entities, and the operation of the Companies Registry.

A number of international organisations have assessed the Isle of Man's regulatory practices against global standards and have determined that the Isle of Man is well regulated, co-operates fully in the pursuit of international financial crime and that its money laundering legislation complies with the highest global standards, including those applied by the EU and its Member States.

- B. Isle of Man Co-operation in Tax Matters and Financial Crime

The Isle of Man's co-operative approach is based on openness and "constructive engagement" with its partners around the world. As a non-sovereign Crown Dependency of the United Kingdom, an important G20, OECD and EU Member State, the Isle of Man cannot represent its own interests on a basis of sovereign equality, either with G20, OECD or EU Member States. Formally, therefore, the Isle of Man must rely on the United Kingdom to represent and defend its interests and reputation in these organisations of sovereign states.

Increasingly, however, by agreement with the United Kingdom under a "framework for developing the international identity of the Isle of Man" signed in May 2007, the Isle of Man is "entrusted" to represent and defend its own laws and policies internationally, in full consultation and co-operation with the United Kingdom.[3] It is in this context that the Isle of Man has adopted a policy of constructive engagement with all its major international partners, including the EU and the United States.

Within the context of the OECD's work on transparency and effective exchange of information, the Isle of Man is at the forefront of the development of a comprehensive network of Tax Information Exchange Agreements ("TIEAs"), based on mutual economic benefit.

To date, the Isle of Man has 14 TIEAs, based on the OECD's Model Agreement on exchange of information on tax matters, 12 of which are with OECD members, including the United States. These agreements are ratified by Tynwald, the Isle of Man's parliament. The Isle of Man is in TIEA negotiations with a number of other countries, including members of the OECD and the G20, in respect of further TIEAs.

The Isle of Man believes its consistent and long-standing actions in respect of tax agreements and its commitment to adhering to internationally accepted standards of financial regulation provide tangible evidence of its co-operation with the international community. This is supported by the statement of Jeffrey Owens, Director of the OECD's Centre for Tax Policy and Administration, who welcomed the Isle of Man's TIEA with Germany (March 2009) as a further step in efforts to bring greater transparency and fairness to cross-border financial transactions. "The time has now come for all jurisdictions that have made commitments to the international standards of transparency and exchange of information to follow the Isle of Man's lead in implementing them," Owens said. "I am particularly pleased with the excellent progress the Isle of Man has made in extending its network of these agreements."

- C. Isle of Man Transparency

[3] http://www.gov.im/lib/docs/cso/iominternationalidentityframework.pdf

The Isle of Man has no bank secrecy laws, customs or practices that impede the ability of the United States or other TIEA partners to request and receive tax information. The Isle of Man has access to the beneficial ownership information that makes tax information exchange an effective tool for other countries to enforce their domestic tax laws. The Isle of Man has successfully responded to all requests for information by the United States under the TIEA between the Isle of Man and the United States.

As noted earlier, all company and trust service providers are licensed and regulated pro-actively to ensure that high levels of due diligence are applied in all areas of the business. The Isle of Man's customer due diligence ("CDD") regulations as set forth in its Anti-Money Laundering and Countering the Financing of Terrorism Handbook require both identification and relationship information. Licenceholders must collect relevant CDD information to identify: (i) the customer; (ii) the beneficial ownership and control of the customer; (iii) the nature of the customer's business and the customer's economic circumstances; (iv) the anticipated relationship with the licenceholder; (v) and the source of funds. Licenceholders must, in all cases, know the identity of underlying principals and/or beneficial owners at the outset of a business relationship. This is irrespective of the geographical origin of the client, or of any introducer or fiduciary, or of the complexity of a legal structure.

When requested, regulated intermediaries must provide relevant information to the regulators and law enforcement authorities who have appropriate powers to assist in domestic and cross-border investigations. Access to this beneficial ownership information ensures that the Isle of Man can provide the United States with accurate and usable information under the TIEA.

The regulation of corporate and trust service providers is also a clear example of the Isle of Man's proactive effort to identify a potential threat to its reputation and enact pioneering legislation to prevent financial fraud. In so doing, and in regulating business that still remains unsupervised in most major jurisdictions, the Isle of Man has acted to ensure that its reputation as a well-regulated and transparent jurisdiction is protected.

IV. International Assessments and Recognition of the Isle of Man

A number of international organisations have assessed the Isle of Man's regulatory practices against global standards and have determined that the Isle of Man is well regulated, co-operates fully in combating international tax evasion and financial crime, and that its anti-money laundering legislation complies with the highest global standards, including those applied by the EU and its Member States.

On April 2, 2009, the OECD issued a detailed progress report on jurisdictions' efforts to implement the OECD's internationally agreed standard requiring the exchange of information on request in all tax matters for the administration and enforcement of domestic tax law without regard to a domestic tax interest requirement or bank secrecy for tax purposes. In this report, the Isle of Man was listed alongside the United States as having "substantially implemented the internationally agreed tax standard."

Just prior to the publication of this new OECD report, Jeffrey Owens, Director of the OECD's Centre for Tax Policy and Administration, issued a statement on March 27, 2009 further commending the Isle of Man's co-operative efforts. "At a time when many countries have been promising change, Guernsey, Jersey and the Isle of Man have been delivering," Owens said. "I am particularly pleased that the Isle of Man now has 12 TIEAs with OECD countries in accordance with the OECD standard. This is an important milestone in implementing its commitment to international co-operation."

In 2003, the IMF conducted a full assessment of the Isle of Man's compliance with all of the international standards referred to above. The Isle of Man was found to have a "high level of compliance." The IMF report commended the Isle of Man for its attention given to: "upgrading the financial regulatory and supervisory system to meet international supervisory and regulation standards in banking, insurance, securities, and anti-money laundering and combating the financing of terrorism."

A further review by the IMF was undertaken in September 2008 as part of its ongoing programme of assessment. The results are to be published shortly, and the Isle of Man is confident that the IMF will again confirm positive findings.

Under the auspices of the FATF, the Isle of Man has been assessed on two occasions in respect of anti-money laundering measures and has been found to be co-operative and in compliance with all key FATF recommendations. The Isle of Man has never been listed as non co-operative by the FATF. All anti-money laundering actions on the Isle of Man are co-ordinated through an industry-wide Joint Anti-Money Laundering Advisory Group.

The Financial Stability Forum ("FSF") has considered the effect that offshore centres generally can have on global financial stability. The Isle of Man was placed in the top group of centres reviewed based on responses from FSF members (Group 1 Category of offshore jurisdictions).

The Isle of Man Financial Supervision Commission is a member of the International Organisation of Securities Commissions ("IOSCO") and is a full signatory to the benchmark IOSCO Multilateral Memorandum of Understanding. As such, the Isle of Man has been judged fully competent in having the legislative ability to provide full co-operation in dealing with market manipulation and abuse, insider dealing and other securities malpractices. The Isle of Man Financial Supervision Commission has established a strong track record of co-operation in this area.

The Isle Man Financial Supervision Commission is a member of the Enlarged Contact Group, which is a discussion forum for global regulators of collective investments that considers policy developments and market issues and is a member of the Offshore Group of Banking Supervisors (of the Basel Committee on Banking Supervision).

The Isle of Man Insurance and Pensions Authority is a member of the International Association of Insurance Supervisors ("IAIS") and the Offshore Group of Insurance Supervisors. Its regulation has been assessed against the IAIS Insurance Core Principles, as part of the IMF's assessment. In addition, the Isle of Man has made contributions to the development of IAIS guidance papers.[4]

The Isle of Man's regulators have also exchanged individual memoranda of understanding ("MOUs") with international regulators in a number of international jurisdictions which underpin its ability to co-operate on supervisory, regulatory and enforcement matters, including in the cross-border supervision of international financial services groups.

The Financial Supervision Commission, which regulates financial services activities in and from the Isle of Man (with the exception of insurance and pensions) has entered into MOUs with equivalent regulators in Bahrain, Bermuda, Cayman Islands, Cyprus, Czech Republic, Dubai, Gibraltar, Guernsey, Iceland, Ireland, Jersey, Malta, Mauritius, Qatar, South Africa, United Arab Emirates, United Kingdom and the United States.

The IPA has entered into MOUs with regulators in Bahrain, Dubai, Hong Kong, Malta, Qatar, and the United Kingdom. In addition, the IPA will, in due course, also become a signatory to the IAIS Multilateral Memorandum of Understanding, which is currently in the early stages of implementation.

In addition, the Isle of Man's financial services legislation includes extensive powers for its regulators to exchange information with other regulators' relevant organisations. These powers ensure that information can be exchanged whether or not specific MOUs are in place.

The UK Treasury has granted the Isle of Man "designated territory" status, which provides the legal basis for the marketing and sale of Isle of Man investment funds in the United Kingdom. This status is subject to regular review by the UK Financial Services Authority ("FSA") on behalf of the UK Treasury.

The Isle of Man has been placed on a list of jurisdictions approved by the U.S. Internal Revenue Service under its Qualified Intermediary ("QI") program. Broadly speaking, the legislation requires local financial institutions to apply for QI status if they wish to invest in U.S. securities and claim exemption from U.S. withholding tax for their clients.

The Isle of Man operates compensation programs for depositors, investors and policyholders, as well as a financial services ombudsman program within the Isle of Man's Office of Fair Trading.

V. Legislative Solutions

The United States is rightly concerned that it collects the taxes owed by its citizens. The Isle of Man shares this concern and does not seek to impede legislative efforts to improve compliance and enforcement of U.S. tax law.

As a TIEA partner with the United States, the Isle of Man is, however, concerned that some proposals under discussion in Congress would incorrectly "blacklist" the Isle of Man as an "offshore secrecy jurisdiction" or a "tax haven." In particular, the "Stop Tax Haven Abuse Act," introduced by Representative Lloyd Doggett and cosponsored by several members of the Ways and Means Committee, was discussed at several points during the Subcommittee's hearing on March 31, 2009. This bill, enrolled as H.R. 1265 in the House and S. 506 in the Senate, uses a list of jurisdic-

[4] Particularly the IAIS Guidance Paper on the Regulation and Supervision of Captive Insurers. http://www.iaisweb.org/_temp/17_Guidance_paper_No_3_6_on_regulation_and_supervision_of_captive_insurers.pdf

tions in a 2005 IRS "John Doe" summons, which includes the Isle of Man, to identify jurisdictions that are treated as "offshore secrecy jurisdictions." Such a provision ignores the previously stated facts about the Isle of Man and runs counter to the recent OECD determination.

It is important to note that Internal Revenue Service Commissioner Douglas Shulman, the Administration's chief tax enforcer, declined to endorse the blacklisting approach in the Stop Tax Haven Abuse Act when asked at the hearing. He instead expressed a preference for identifying the characteristics of jurisdictions that could help facilitate evasion. Commissioner Shulman identified these characteristics as bank secrecy, lack of information exchange, non-transparent laws, and nonco-operation with the United States. The Isle of Man strongly endorses this approach, which takes into account current facts and would properly target U.S. compliance and enforcement efforts, ensuring that co-operative partners like the Isle of Man are not mislabeled as rogue jurisdictions. Placement on a blacklist, however temporary, would harm the rightfully earned reputation of the Isle of Man without justification.

Commissioner Shulman also criticized the source of the list in the Stop Tax Haven Abuse Act, stating that the "John Doe" summons list was never intended to say these countries have problems. Rather, the summons list was intended for a very specific credit card initiative where the Internal Revenue Service had evidence there were credit cards being issued from those jurisdictions.

The Isle of Man would again respectfully request that if the Subcommittee does proceed with legislation that includes any blacklist of tax havens or offshore secrecy jurisdictions, such a list should not include those jurisdictions, such as the Isle of Man, that the OECD has determined have substantially implemented the internationally agreed tax standard.

Respectfully submitted by:
James Anthony Brown
Chief Minister
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Douglas
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IM1 3PG
April 14, 2009

Statement of Lyndon S. Trott

1.1 Guernsey is a well-regulated financial centre committed to maintaining international financial stability and transparency. Guernsey has consistently demonstrated this commitment through international co-operation and information exchange.

1.2 As a general principle, Guernsey does not support the use of "blacklists" and endorses the views of the U.S. Department of the Treasury that the use of such lists "to simplify what is a complex area—can lead to misunderstanding and mistakes." [1] Guernsey has consistently argued that each jurisdiction should be considered on its own merits as assessed against internationally recognised standards. Guernsey is not a "tax haven" or an "offshore secrecy jurisdiction." In any event, there is no internationally agreed definition of either.

1.3 By any objective measure, Guernsey is not a "tax haven" or an "offshore secrecy jurisdiction" for the following reasons:

- Guernsey has never had any form of banking secrecy legislation;
- Guernsey has entered into 13 Tax Information Exchange Agreements ("TIEAs") so far, including one with the United States, and is committed to continuing to be a leader in this field;
- Guernsey has well-developed powers to investigate financial crime and tax evasion and regularly assists other jurisdictions in such investigations;
- Guernsey has had mutual legal assistance legislation in force since 1998 and regularly exchanges information under that legislation;

[1] Letter from Deputy Assistant Treasury Secretary (International Tax Affairs) Michael Mundaca to General Accountability Office ("GAO") Director (Tax Issues) James R. White, commenting on GAO report: *Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions,* December 18, 2008.

- Guernsey provides assistance to jurisdictions so that requests for information comply with Guernsey law and does not attempt to obstruct investigations; and
- Guernsey has a well-developed regulatory regime which complies with all recognised international standards.

1.4 Guernsey is a participant in the Global Tax Forum, an initiative of the Organisation for Economic Co-operation and Development (the "OECD"). The OECD recognises that Guernsey has substantially implemented the OECD standard on information exchange in tax matters by entering into 13 TIEAs. Further agreements are under negotiation and Guernsey intends to continue to conclude such agreements in the near future. The OECD published a list of co-operative jurisdictions on 2 April 2009, which places Guernsey alongside jurisdictions such as the United States, France, Germany, and the United Kingdom in having effective tax information exchange.[2] Guernsey is delivering on its international commitments to transparency and co-operation.

1.5 In the event that the Subcommittee on Select Revenue Measures decides to develop anti-tax haven abuse legislation that uses a list of "tax havens" or "offshore secrecy jurisdictions," then Guernsey respectfully suggests that the only appropriate list to follow is the list most recently issued by the OECD, the leading global authority on international tax practices, of jurisdictions that have not substantially implemented the OECD standard for effective exchange of tax information.

1.6 Guernsey's reputation as a premier provider of international financial services has been built on a number of foundations, including:

- an effective regulatory regime that meets or exceeds all international standards on financial regulation, anti-money laundering and combating the financing of terrorism;
- international co-operation on regulation and the investigation of financial crime;
- regular, external, and independent reviews—in the majority of cases at Guernsey's express invitation and in all cases with Guernsey's full co-operation and assistance;
- a highly skilled and educated workforce; and
- proximity to the European mainland.

1.7 The authorities in Guernsey have substantial investigatory powers. They work closely with their counterparts in other jurisdictions in investigating regulatory, taxation, and criminal matters and assisting in freezing and recovering the proceeds of crime. Guernsey has consistently provided assistance to the United States in investigating crime, freezing assets, and recovering the proceeds of crime.

Lyndon S. Trott
Chief Minister
States of Guernsey
14 April 2009

Background Information

A. Guernsey's Status and International Relationships

1. The Government of Guernsey

1.1 Guernsey is the principal island of the Bailiwick of Guernsey, a British Crown Dependency.[3] It has never been a colony or a British dependent or overseas territory. Its status constitutionally is, and always has been, distinctly different from that of the British Overseas Territories. Guernsey has its own directly-elected legislative assembly, the States of Deliberation, comprising 47 independent members, and its own administrative, fiscal and legal systems. Its government, the States of Guernsey, is principally conducted through 10 Government Departments overseen by the Policy Council, constituted by the Chief Minister and the 10 Ministers. Guernsey's right to raise its own taxes is a long-established constitutional principle.

2. Guernsey's Relationship with the United Kingdom

2.1 Guernsey is not, and never has been, represented in the UK Parliament, which therefore does not legislate on behalf of Guernsey without first obtaining the consent of Guernsey's administration. The extension to Guernsey of an Act of Parliament by Order in Council is occasionally requested. However, the usual practice is for the States of Deliberation, which always has been legislatively independent from the United Kingdom regarding insular affairs, to enact its own legislation. Pri-

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[2] This list is posted at: www.oecd.org/document/57/0,3343,en_2649_34487_42496569_1_1_1_1,00.html.

[3] This section is drawn from Ogier, D, The Government and the Law of Guernsey, 2005. Further information on Guernsey is available at: www.gov.gg/aboutguernsey.

mary legislation ("Laws") requires Royal Sanction from Her Majesty in Council ("the Privy Council").

2.2 The British Crown acts on behalf of Guernsey through the Privy Council on the recommendations of Ministers of the UK Government in their capacity as Privy Counsellors. For example, the UK Ministry of Justice acts as the point of contact between Guernsey and the British Crown for the purpose of obtaining Royal Sanction for Laws, but is not otherwise involved in Guernsey's internal affairs. The Judicial Committee of the Privy Council is Guernsey's final appellate court.

3. Guernsey's International Affairs

3.1 The United Kingdom is responsible for Guernsey's external relations and defence. In recent years, Guernsey has increasingly acted internationally on its own behalf, particularly in relation to matters for which it has complete autonomy.[4] The UK Government has recognised the appropriateness of Guernsey further developing its international identity.

B. Guernsey's Taxation System

1.1 Guernsey has a well-developed taxation system. Taxes in Guernsey are set on the basis of the need to fund public services and the need to ensure that Guernsey's economy remains strong. Taxation in Guernsey is managed by the Director of Income Tax who is responsible for administering legislation relating to Income Tax and Foreign Retention Tax in support of the European Union ("EU") Directive on the Taxation of Savings Income (2003/48/EC). There is no capital gains or any other taxes on capital in Guernsey. Guernsey's personal income tax is set at 20 percent, a rate which has remained unchanged for over 40 years. Guernsey does not have a Value Added Tax but does have a range of indirect taxes and duties. As part of its commitment to eliminating harmful tax competition, Guernsey has complied fully with the EU Code of Conduct on Business Taxation. Guernsey's tax system is relatively uncomplicated and effective, which minimises the compliance costs on business.

C. Guernsey's Economy and the Financial Services Sector

1. Development of the Finance Sector

1.1 Guernsey's financial services sector began to grow in the 1960s with the establishment of operations in Guernsey by UK merchant banks and the establishment of investment funds which they sponsored. By 1987, the banking, insurance and collective investment fund sectors had developed to such an extent that the States of Guernsey acted to establish an independent regulatory body staffed by dedicated professionals. This was in accordance with internationally accepted best practices at the time. The Guernsey Financial Services Commission (the "Commission") was established in 1988. During the 1990s, Guernsey emerged as one of the world's largest captive insurance centres. Today, Guernsey is Europe's largest captive insurance centre, and the fifth largest in the world. The Channel Islands Stock Exchange ("CISX"), which is based in Guernsey and is the only stock exchange in the Channel Islands, commenced operations in 1998. The CISX has been recognised by the U.S. Securities and Exchange Commission, the Financial Services Authority ("FSA") and Her Majesty's Revenue and Customs ("HMRC"). As the sector continues to develop, an increasing number of professional firms exist to service the finance industry, particularly in the accounting, legal and actuarial professions. There are presently more than 8,000 people employed in financial services in Guernsey.

1.2 Financial services account for approximately 35 percent of Guernsey's Gross Domestic Product. Guernsey also has well-developed industries in business services, electronic commerce, information technology and light manufacturing.

1.3 Guernsey's financial services industry is diverse and includes banking, collective investment funds, insurance and fiduciary services. The workforce in Guernsey is highly skilled and provides a full range of services, including administration of funds, corporate administration, public listing of companies on European stock exchanges, investment advice, and insurance brokerage services. In many respects, Guernsey's success as a financial service centre exists because many of Guernsey's professionals are recognised as world leaders in their particular fields with a high level of skills and expertise.

1.4 Due to its long-established financial services industry, Guernsey has developed considerable expertise in administering collective investment funds, captive insurance, and trust and company structures. In addition, Guernsey operates a "full-service" finance centre. It does not merely provide a domicile for activities undertaken elsewhere.

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[4] For example, co-operation agreements with the 27 EU Member States (in relation to Directive 2003/48/EC on taxation of savings income) and agreements for the exchange of information relating to tax matters.

1.5 Guernsey has been ranked 12th in the latest Global Financial Centres Index ("GFCI"), released in March 2009. Since the previous survey published in September 2008 the Island has moved up four places. The report is produced by the Z/Yen Group for the City of London and ranks financial centres based on external benchmarking data and current perceptions of competitiveness and resilience in the face of the global financial downturn.

2. Regulation of Financial Services in Guernsey

2.1 The Commission was one of the world's first unitary regulatory bodies, and is responsible for the regulation of banks, insurers and insurance intermediaries, investment firms, trust companies, company administrators and professional company directors providing directorship services by way of business in Guernsey. It has been given wide-ranging powers to supervise and investigate regulated entities under a variety of regulatory laws. It also takes appropriate enforcement action when necessary. The Commission considers that the prevention of financial instability is a key function of effective regulation.

2.2 Guernsey is one of the few jurisdictions in the world to regulate trust and company service providers in a manner consistent with the prudential regulation of banks, investment firms and insurance companies. It has regulated trust and company service providers in this way since 2001.

2.3 In performing its regulatory and supervisory work according to international standards, the Laws and Regulations administered by the Commission comply with those established by:

- The Basel Committee on Banking Supervision;
- The International Association of Insurance Supervisors ("IAIS");
- The International Organization of Securities Commissions ("IOSCO");
- The Offshore Group of Insurance Supervisors ("OGIS");
- The Offshore Group of Banking Supervisors ("OGBS"); and
- The Financial Action Task Force ("FATF").

2.4 The International Monetary Fund ("IMF") conducts a regular independent and external review of Guernsey's compliance with those international standards. The next IMF review is likely to occur later this year.

2.5 The Commission is actively involved with international regulatory and supervisory organisations. Guernsey was a founding member of IAIS, OGIS, and OGBS. The Commission is also a full member of IOSCO and a member of the enlarged contact group on the Supervision of Collective Investment Funds.

D. Co-operation on Taxation, Regulation, Financial Intelligence and Anti-Money Laundering

1. Information Exchange 1.1 On 21 February 2002, Guernsey publicly committed to complying with the OECD's principles of effective exchange of tax information.[5] Guernsey signed its first TIEA, with the United States, on 19 September 2002. It has been fully operative since 2006. Guernsey has subsequently concluded TIEAs with the Netherlands (25 April 2008), the seven Nordic Council countries (Denmark, the Faroe Islands, Finland, Greenland, Iceland, Norway and Sweden) (28 October 2008), the United Kingdom (20 January 2009), France (24 March 2009), Germany (26 March 2009) and Ireland (26 March 2009). Guernsey is actively pursuing TIEA negotiations with other countries with a view to finalising agreements as soon as practicable.

1.2 Guernsey's commitment to transparency and international co-operation has been recognised by the OECD and the European Commission. The OECD published a progress report listing co-operative jurisdictions on 2 April 2009, which places Guernsey alongside jurisdictions such as the United States, France, Germany, and the United Kingdom in having effective tax information exchange. At a press conference held on 7 April 2009 the OECD recognised:

"Guernsey . . . [has] made a real commitment, not just before the G20, but years ago and they have implemented those commitments."

1.3 Guernsey currently has two double tax arrangements, one with the United Kingdom, signed in 1952, and the other with Jersey, signed in 1955. The agreements provide for the exchange of information in order to prevent fiscal evasion or avoidance. For many years, Guernsey has been able to provide information from its tax files to the UK tax authorities, and has done so on a regular basis, both spontaneously and as requested by the United Kingdom. Exchange of information under the double tax arrangement with the United Kingdom has led to the opening of investigations or advancement of existing investigations by HMRC.

[5] See letter at www.oecd.org/dataoecd/61/13/2067884.pdf.

2. Mutual Legal Assistance

2.1 The European Convention on Mutual Legal Assistance (1959) and the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crime (1990) have both been extended to Guernsey.

2.2 Mutual legal assistance is provided by the Law Officers of the British Crown under a range of Guernsey Laws. Between 1999 and 2007, over 90 requests for information specifically related to taxation matters were received, of which 46 were from the United Kingdom, 28 from other EU Member States, 7 from the United States and 9 from other foreign jurisdictions. In 2008, there were 34 requests of all types. Guernsey does not approach requests to see if they can be rejected but rather offers assistance to other jurisdictions to enable them to perfect their requests so they comply with the form required by the relevant Guernsey Laws.

3. Banking Secrecy and Transparency

3.1 Guernsey has never had banking secrecy laws and does not perpetuate a regime of banking secrecy. As in the United Kingdom, general principles of Guernsey law preserve the confidentiality of information properly regarded as private. Against such due respect for privacy, however, must be balanced compliance with domestic law provisions requiring persons to divulge information to relevant authorities (*e.g.*, the Director of Income Tax has extensive information-gathering powers and the Commission has wide-ranging powers of supervision and investigation).[6] Relevant authorities in Guernsey then share appropriate information with partners internationally.

3.2 Guernsey's company law has introduced a new requirement that all private companies in Guernsey appoint a local resident agent who is under an ongoing duty to identify the beneficial owner of that company. That information must be made available to law enforcement and regulatory bodies upon request. Guernsey believes that it is the first jurisdiction in the world to introduce such a regime. This further strengthens the pre-existing Anti-Money Laundering and Combating the Financing of Terrorism ("AML/CFT") regime which requires corporate service providers to identify the beneficial owner of the companies they administer as part of the anti-money laundering regime.

3.3 Guernsey has a long-standing commitment to transparency and international co-operation. This was recognised by U.S. Treasury Secretary Paul O'Neill at the signing of the TIEA between Guernsey and the United States in 2002. Treasury Secretary O'Neill said:

The United States and Guernsey already have a close and cooperative relationship on law enforcement matters, including criminal tax matters. We are well aware of Guernsey's commitment to cooperation in targeting criminal abuse of the world's financial systems.

This new agreement will formalize 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.

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 shores but those more distant too. I hope that Guernsey's cooperation with the United States in negotiating this tax information exchange agreement will serve as an example to other financial centres in its region and around the world.

4. Regulatory Transparency and Information Exchange

4.1 The Commission has the legal authority to disclose information to other supervisory authorities. It can also disclose information to other authorities for the purposes of preventing, detecting, investigating and prosecuting financial crime. In addition, the Commission may obtain information from licensees on behalf of foreign supervisory bodies. The Commission shares information with supervisory authorities and other bodies spontaneously, as well as on request. Although it has 15 Memoranda of Understanding ("MoUs") with international partners (including the U.S. Commodity Futures Trading Commission, U.S. Federal Deposit Insurance Corporation and the FSA), an MoU is not required to allow information exchange. In light of the links between UK financial services businesses and Guernsey, it is common for the Commission to co-operate and exchange information with the FSA.

[6] See Income Tax (Guernsey) Law, 1975, Part VIA (inserted by the Income Tax (Guernsey) (Amendment) Law, 2005).

4.2 Regarding transparency of transactions, the AML/CFT legislation and rules made by the Commission require financial services businesses to undertake customer due diligence on their potential customers and to look through legal persons, such as companies, legal arrangements and trusts to undertake customer due diligence on beneficial owners, settlors, beneficiaries and other underlying principals, and to maintain both customer due diligence and transaction records. In addition, rules made under the Protection of Investors Law require investor transaction records to be maintained (for example, contract notes). The Attorney General (HM Procureur) and the Commission have powers under the legislation they administer to obtain that information on behalf of foreign authorities and to disclose it to those authorities.

5. Guernsey's Financial Intelligence Service

5.1 The Financial Intelligence Service ("FIS") is responsible for the collation and dissemination of intelligence relating to financial crime in Guernsey.[7] Formed in 2001, the FIS is operationally independent, although it is staffed and funded by the law enforcement agencies of the Guernsey Police and the Customs and Excise, Immigration and Nationality Service ("Customs"). The strategic aims of the FIS are:

- The provision of quality intelligence with regard to all financial crime, with a special emphasis on combating money laundering and countering the financing of terrorism;
- The provision of full international co-operation, within the law, to competent and relevant overseas authorities; and
- The provision of services to enhance the co-ordination and the development of criminal intelligence to combat financial crime.

5.2 The staff of law enforcement (the FIS, the Fraud and International Team, and the Commercial Fraud and International Affairs Team) are highly skilled specialists and experienced in the investigation of financial crime. The FIS also is the point of contact for those seeking assistance in relation to financial crime and receives requests for assistance from both local law enforcement and overseas agencies. Since 1997, Guernsey's law enforcement team has been a member of the Egmont Group of Financial Intelligence Units. Where the FIS receives intelligence enquiries of a criminal nature that are proportionate and justified, the FIS does not require an MoU in order to exchange information. However, where an authority in another jurisdiction does require an MoU to allow information exchange, the FIS will enter into such an agreement if there is an operational need. At present, the FIS is party to 13 MoUs with international partners, including the UK Serious Organised Crime Agency ("SOCA").

5.3 The FIS is the designated authority to receive suspicious transaction reports ("STRs") in Guernsey. The FIS investigates all STRs with most being disseminated to relevant local and overseas agencies. In 2008, there were 519 disclosures and 465 requests for assistance received, of which 63 percent came from outside Guernsey. STRs largely relate to suspicions of tax evasion, large cash transactions, and unexplained lifestyles. STRs relating to suspected terrorism are relatively rare and comprise only a small portion of reports received. The high number of reports demonstrates the high level of awareness of AML/CFT obligations in the finance industry in Guernsey. Over 75 percent of STRs do not relate to local Guernsey residents. Where there is evidence of tax evasion, it is Guernsey policy to disseminate all STRs to the appropriate jurisdiction as it would any other STR relating to any other criminal activity. Recent legislation allows intelligence to be disseminated to the SOCA to assist civil investigations in the United Kingdom (and elsewhere). The FIS also regularly provides STRs to EU Member States and OECD countries.

5.4 To counter the significant threat posed by sophisticated international money laundering, Guernsey has introduced new legislation to give law enforcement even greater powers to freeze and recover the proceeds of crime through both criminal and civil action. The laws also make it easier for law enforcement to prosecute money laundering offences. Guernsey regularly assists other jurisdictions that request assistance in obtaining evidence, tracing and freezing assets, and recovering assets related to criminal proceedings. Guernsey has had considerable success in freezing and recovering assets on behalf of many other jurisdictions, including the

[7] See the FIS website available at: www.guernseyfis.org. Also available at that website are the FIS annual reports which provide data on the FIS' activities in each year.

United Kingdom,[8] other EU Member States[9] and the United States. In many cases, substantial sums were involved and repatriated to the requesting nation. A significant portion of matters in which Guernsey provides assistance relate to taxation.

6. AML/CFT Framework

6.1 Guernsey's AML/CFT regime complies with the FATF standards. The Guernsey authorities are committed to ensuring that money launderers, terrorists, those financing terrorism and other criminals, including those seeking to evade tax, cannot launder those criminal proceeds through Guernsey, or otherwise abuse Guernsey's finance sector. The AML/CFT authorities in Guernsey endorse the FATF's 40 Recommendations on Money Laundering and the FATF's Nine Special Recommendations on Terrorist Financing. Guernsey has introduced new legislation, amended existing legislation, and the Commission has introduced rules and guidance in order to continually keep compliant with the FATF's developing standards.

6.2 All businesses and individuals are required by the AML/CFT legislation to report possible money laundering when they suspect or have reasonable grounds to suspect that funds are the proceeds of criminal activity. This includes tax evasion. The same obligation to report suspicion applies to assets where there are reasonable grounds to suspect or they are suspected to be linked or related to, or to be used for terrorism, terrorist acts or by terrorist organisations or those who finance terrorism. Businesses and individuals reporting suspicion are protected by law from any breach of confidentiality.

6.3 Extensive AML/CFT countermeasures apply to all financial service businesses operating in Guernsey, plus trust and company service providers, all of which are subject to regular on-site inspections by the Commission. The international standards set by the FATF did not apply to trust and company service providers until June 2003. However, the revised AML/CFT framework that entered into force in Guernsey on 1 January 2000 subjected trust and company service providers to AML/CFT regulation well before the FATF requirements. As a result, since 2000 trust and company service providers have been required to identify the beneficial owners of companies, the identity of settlors and beneficiaries of trusts and the identity of any other underlying principals.

7. Stolen Asset Recovery Initiative

7.1 In March 2008, the World Bank and the United Nations Office on Drugs and Crime invited Guernsey to participate in the Stolen Asset Recovery Initiative ("StAR Initiative"), a project endorsed at the G20 meeting in Washington in November 2008. The StAR Initiative is an integral part of the World Bank's anti-corruption strategy and will enhance co-operation, build relationships and help developing counties recover stolen assets. Guernsey has a continuing involvement in the project and has been asked, and agreed, to participate in two further projects under this initiative.

Statement of Michael J. McIntyre and Robert S. McIntyre

We thank the subcommittee for the opportunity to present our views on how the United States can reduce international tax evasion by wealthy Americans. One of us, Michael J. McIntyre, is a professor of law at Wayne State University in Detroit. He has written extensively on international tax matters. The other of us, Robert S. McIntyre, is the Director of Citizens for Tax Justice.

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

We will discuss here three important ways that wealthy Americans evade taxes on their investment income. The first is by transferring assets to offshore tax havens that maintain secrecy to avoid IRS detection. The second is by fraudulently

[8] The number of requests from the United Kingdom amount to 49 percent of the total number requests for assistance.

[9] The number of requests from other EU Member States amount to 30 percent of the total number of requests for assistance.

taking advantage of the exemption provided under Internal Revenue Code Section 871(h)(1) for portfolio interest paid to foreign persons. The third is by posing as foreign persons and taking advantage of U.S. income tax treaties, typically treaties with countries that maintain bank secrecy rules. After our discussion of each problem area, we offer solutions that the Congress could pursue to reduce tax evasion in that area.

1. Transfer of Assets to Offshore Tax Havens

A. *Statement of the Problem*

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

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

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

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

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

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

so forth. That is, the Cayman government has agreed to be of assistance when the U.S. government has already fingered the tax cheat. It is unwilling to be helpful in identifying U.S. tax cheats in the first instance.

B. *Suggested Solutions*

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

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

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

ii. Broaden TIEAs to include automatic information exchanges

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

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

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

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

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

2. The Exemption for Portfolio Interest

A. *Statement of the Problem*

The exemption for portfolio interest was added to the Code by the 1984 tax act. Under that exemption, nonresident alien individuals and foreign corporations receiving interest paid on qualifying bonds issued by U.S. persons are not subject to the

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

30-percent tax under Code section 871(a). The bonds may be in bearer form or in registered form. A qualifying bond must be issued in a fashion that reduces the risk that it will to be held by U.S. persons. The issuer does not need to have actual knowledge, however, of the identity or even the nationality of the holder for the exemption to apply.[2]

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

Congress and the Treasury Department were aware that many of the purchasers of portfolio-interest bonds sold on the Eurobond market would be tax cheats. Indeed, the portfolio-interest rules were designed to facilitate tax evasion by investors in portfolio-interest bonds. As noted above, the beneficial owners of the bonds were not required to identify themselves to the bond issuers.

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

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

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

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

The bank secrecy rules of countries such as Switzerland, Belgium, and Luxembourg complicate the problem of determining whether Americans have been investing illegally in portfolio-interest bonds. These countries might provide information to U.S. tax authorities under their tax treaty with the United States if the U.S. tax authorities are able to produce compelling evidence that one or more identified Americans had engaged in tax fraud. As a practical matter, however, it seems high-

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

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

ly unlikely that the U.S. tax authorities have obtained any useful information from treaty partners that have strong bank secrecy rules.

B. *Suggested Solutions*

i. Eliminate the portfolio-interest exemption

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

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

ii. Limit the portfolio-interest exemption to complying taxpayers

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

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

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

3. Treaty Shopping by American Investors

A. *Statement of the Problem*

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

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

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

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

which it sought to prevent a taxpayer from obtaining treaty benefits under the "Limitation on Benefits" article.

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

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

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

B. *Suggested Solutions*

i. Tentative withholding tax on payments to uncooperative states.

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

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

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

ii. Eliminate zero rate in new and revised treaties

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

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

iii. Terminate bad treaties

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

4. Conclusion

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

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

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

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

Statement of Raymond Baker, Director of Global Financial Integrity

The U.S. is at a critical juncture. Recent events have underscored the severity of the problem of offshore financial centers, banking secrecy, and loopholes in current U.S. laws as well as how these enable illicit financial practices such as tax evasion and fraud.

Abusive offshore schemes are depriving the U.S. of approximately $100 billion a year at a time when the economy is in a recession and the resources are strained.

President Barack Obama has stated that he firmly supports action to crackdown on tax havens and illicit financial practices and has endorsed the Stop Tax Haven Abuse Act sponsored by Senator Carl Levin (S. 506) and Congressman Lloyd Doggett (H.R 1265) introduced March 2, 2009.

Calls to confront tax havens have come from several quarters, including the IMF, the Vatican, and leaders from Germany, France, and the UK. The G–20 has also issued strong words of intent to address the economic crisis when it convenes April 2nd in London.

This presents the U.S. with the dual task of working as part of a global coalition to address a global economic crisis, while also attending to legislative and regulatory reform at home. President Obama's announcement of a new Task Force to review and offer recommendations for changes to the U.S. tax code which would reduce tax evasion and substantially close the estimated $300 billion per-year tax gap signals that this second task is indeed a priority for the new Administration. GFI applauds those efforts.

In considering measures to improve compliance by U.S. taxpayers and improve the overall system of tax collection, Global Financial Integrity recommends the following provisions be included in legislation being considered by Congress aimed at curtailing tax haven abuse. The following measures are crucial to achieving success in improving tax assessment and collection and in curtailing fraud.

Automatic Information Exchange

1) Section 101 of the Stop Tax Haven Abuse Act states, "a jurisdiction shall be deemed to have ineffective information exchange practices unless the Secretary determines, on an annual basis, that—'(i) such jurisdiction has in effect a treaty or other information exchange agreement with the United States that provides for the prompt, obligatory, and *automatic exchange* of such information as is forseeably rel-

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

evant for carrying out the provisions of the treaty or agreement or the administration or enforcement of this title." (emphasis added).

Beneficial Ownership Requirement

2) The Incorporation Transparency Act (S. 659) would require States to obtain a list of the beneficial owners of each corporation or limited liability company (LLC) formed under its laws, conduct annual updates of beneficial ownership information, and provide this information to civil or criminal law enforcement upon receipt of a subpoena or summons.

Close Loopholes in the Existing Tax Code

3) Section 108 of the Stop tax Haven Abuse Act would ensure that non-U.S. persons pay U.S. stock dividends by ending the practice of using complex financial transactions to recast taxable dividend payments as allegedly tax free dividend equivalent or substitute dividend payments.

Deterrence

4) Section 102 of the Stop Tax Haven Abuse Act would expand Treasury Department authority under section 311 of the Patriot Act (31 U.S.C. 5318 (a) to impose sanctions on foreign jurisdictions, financial institutions or transactions found to be "impeding tax collection."

5) Section 301–302 of the Stop Tax Haven Abuse Act would strengthen penalties for promoting abusive tax shelters and knowingly aiding or abetting a taxpayer in understating tax liability by specifically:

1. Increasing fines for promotion of abusive tax shelters from 50 percent of the promoter's gross income from the activity to an amount "not to exceed" 150 percent of the promoter's gross income from the prohibited activity.

2. Increasing the maximum fine of $1,000 ($10,000 for a corporation) to an amount "not to exceed" 150 percent of the aider-abettor's gross income from the prohibited activity.

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