A Program for International Tax Reform

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122 Tax Notes 1021-1026 (February 23, 2009)
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A. A Time for Action

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. It also needs to revise the legal structure that allows foreign-based and U.S.-based companies to exploit the U.S. economy while paying far less than their fair share of income taxes.

Some of the steps needed to achieve international tax reform, such as major revisions in the U.S. tax treaty network, will require time and difficult negotiations with U.S. treaty partners. It is important, however, that those negotiations begin soon. Other steps can and should be taken quickly, through regulatory changes or relatively minor tweaks to antiavoidance legislation already set for adoption by Congress. Some changes will require major legislation, but that can wait until prospects for passage improve through the negotiation of cooperative agreements among the major trading partners of the United States.

Reform of tax rules and procedures is not going to be very effective unless it is combined with major changes in the way financial intermediaries and accounting firms conduct their business. In the past, those major players have been able to block even the most timid attempts to require transparency and accountability. In the aftermath of the capital markets meltdown, however, governments around the world have an opportunity to require that banks and other financial intermediaries disclose the beneficial owners of the accounts they hold and the beneficial owners of any entities with which they conduct business. Governments should seize this opportunity to require the major accounting firms to be legally responsible to the shareholders and bondholders of the businesses they audit when they give a clean bill of health to a company just weeks before its collapse. Regulatory reform of financial intermediaries and accounting firms should be high on the national agenda without reference to its implications for international tax reform. The tax imperative simply adds another reason in support of swift regulatory changes.

Fixing the international tax rules, if successful, will raise effective tax rates on tax evaders and will create additional tax revenues. The conventional wisdom is that raising taxes during a recession is bad economic policy because higher taxes tend to reduce aggregate demand for goods and services at a time when the government should be doing what it can to stimulate demand. There are at least three major caveats to that wisdom.

1. Large government deficits will not provide a useful stimulus to an underperforming economy unless the various financial agents have confidence that the deficits are temporary. The United Kingdom is learning that hard lesson right now. The prospect of long-term deficits tends to raise interest rates and to undermine the value of a country’s currency. There is no reason to believe that the large federal deficits looming over the U.S. economy will be temporary unless the tax system is fixed. And no fix of the tax system will mean much if the leaky international tax system is not repaired.

2. Most of the repairs that need to be made to the international tax system would prevent or reduce the shifting of capital outside the United States. Capital flight does not promote economic growth in the United States, and measures designed to curtail capital flight do not undercut an economic stimulus program. Indeed, they may be a useful, even necessary, component to such a program.

3. Higher taxes do not curtail domestic demand if the government spends the tax money quickly. All that happens is that the spending decisions are made by the government rather than by private individuals. When the goal is to expand domestic production, putting the matter in the hands of the government may be highly desirable, given that consumers are likely to spend a good portion of any tax savings on goods and services produced in China or other foreign countries. In contrast, the U.S. government can direct the spending to local infrastructure improvements.

In brief, the economic problems facing the United States provide a strong argument for fixing the tax system as quickly as possible and offer no credible basis for postponing tax reform until those economic problems are solved.

International tax reform is complex as a technical matter and is immensely difficult as a political matter. As discussed below, the technical issues can be resolved successfully with leadership from the United States and its major trading partners. The political obstacles are more difficult to overcome. The beneficiaries of the current flawed system — financial institutions, international law firms, accounting firms, and, of course, the tax
cheats themselves — are politically powerful and are committed to preserving their favored status.

Reform of international tax rules has been hampered by the success of members of the international business community in shielding their activities from public view. Few major international tax cases get litigated — most are settled with no reports on the settlements available to the public. The United States negotiates with foreign governments on behalf of U.S.-based multinationals with no public disclosure of the outcomes of those negotiations. The IRS enters into long-term agreements with taxpayers on how they will determine their transfer prices in the future, again with no public disclosure. The United States recently negotiated tax treaties with Belgium, Canada, and Germany that require mandatory and totally secret arbitration of some tax disputes at the request of the taxpayer.

In brief, the operation of the U.S. international tax regime is hidden from public scrutiny by a cloak of secrecy. Greater transparency is required. Of course, the revised rules requiring greater transparency need to take account of the legitimate business needs for confidentiality on some matters. There is no sound basis, however, for not disclosing the names of taxpayers who enter into agreements with the government or for concealing the legal rules that result from those agreements.

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.

An important additional reason for optimism about the prospects for meaningful reform has been the success of various public interest groups in characterizing tax evasion as a serious social offense that undermines the ability of government to create societies that are more equal, more cooperative, and less abusive of the disadvantaged. This criticism has been picked up by Pope Benedict XVI, who recently condemned offshore tax evasion as socially unjust.

B. Taxing Americans on Offshore Income

American citizens and residents are required by law to report all of their income, from whatever source derived. There is no exemption in the tax code for income earned abroad. To prevent tax avoidance, the tax code also provides that individuals are currently taxable on some income they earn through a foreign corporation under their control or through a foreign trust. Also, U.S. citizens and residents earning income through a foreign investment fund must pay tax on that income currently or pay an annual interest charge when the income is distributed to them. These rules are not perfect. Nevertheless, the basic rules for taxing Americans on their foreign income are satisfactory and not a major cause for concern.

The real concern is evasion. Tax fraud has been part of the American scene since the adoption of the personal income tax in 1913. As Will Rogers once said, "The income tax has made liars of more Americans than golf." Still, international tax fraud, once a wart on an essentially sound tax system, is now almost out of control. According to recent testimony before the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, losses to Treasury from offshore tax abuses exceed $100 billion annually. Formerly reputable banks, such as the Swiss banking giant UBS, have been caught engaging in massive tax evasion schemes within the United States. Obviously, the government needs to do a much better job of catching tax cheats and punishing their facilitators.

Part of the solution to offshore tax evasion by Americans is to improve the fraud squad at the IRS. Given the enormity of its responsibilities, the IRS has been seriously underfunded and understaffed for over a decade. It also has had a great deal of difficulty retaining the highly skilled professionals needed to combat international tax fraud. The brain drain from the IRS has a number of causes. One significant effect is the morale problems created by 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. Appropriate staffing of the international positions at the IRS should be a high priority for the new administration.

The more fundamental problem in combating international tax evasion is the international infrastructure that the tax evasion community has constructed to facilitate it. This infrastructure has to be dismantled, brick by brick, secret document by secret document. The United States cannot destroy that infrastructure by itself. It needs the cooperation of its major trading partners and even some of the offshore banking centers that have catered to tax cheats in the past. In 1998, with the publication by the OECD of its report on harmful tax competition, the major industrialized states took a big step forward in attacking tax evasion. The European Union also made an effort to deal with international tax cheats with the adoption of its savings directive in 2005.

Unfortunately, the OECD and EU efforts have not been very successful in reducing tax haven abuses. They were moderately successful in altering the terms of debate over acceptable international conduct. There seems to be general agreement, for example, that financial transactions should be transparent, despite the reality that most such transactions remain opaque. There is also an acknowledgment that withholding at source is a key to the effective exercise of a country’s source jurisdiction, notwithstanding the failure of the EU to actually adopt an effective withholding system.

The OECD and EU efforts failed for a very simple reason — they were widely perceived as hypocritical. Both organizations were willing, even eager, to confront the offshore financial institutions located in the Caribbean. Despite initial claims to the contrary, they proved unwilling to dismantle the part of the tax evasion infrastructure under their own control. No country can expect
the willing cooperation of other governments in combating tax evasion if it is not willing to do itself what it is asking those other governments to do. In brief, Europe and the United States cannot lead a cooperative effort at combating international tax evasion unless they are willing to dismantle their own rather extensive practices that facilitate that evasion.

For the United States, cleaning the muck from its own tax evasion stables will be a Herculean task. The United States cannot be a creditable voice against international tax evasion as long as it invites tax cheats to invest in the United States without fear that the particulars of their transactions will be disclosed to their home government. In particular, the United States needs to end its de facto bank secrecy regime that allows foreigners to make deposits in U.S. banks without disclosure to the home government of the income earned on those deposits. It needs to eliminate the elaborate system of qualified intermediaries whereby U.S. companies can borrow money through a foreign financial institution without that institution being required to disclose the beneficial owners of the money that was lent. And the United States needs to eliminate practices of states, such as Delaware and Wyoming, that invite tax cheats’ investments in tax evasion through abuse of tax havens by allowing these people to keep secret their identity as a stockholder or depositor.

If the United States can face down its own facilitators of tax evasion and become a creditable proponent of international tax reform, the prospects for international cooperation on combating tax evasion will suddenly become very promising. Many countries now recognize that evasion is exceedingly harmful to their interests — to their ability to operate an income tax system that mitigates inequalities and funds their spending programs. They are reluctant to crack down on their own facilitators of tax evasion, however, without some assurance that other governments will be doing the same. The root of this prisoner’s dilemma is cooperation, and that cooperation cannot begin without untainted leadership from the United States.

C. Taxing U.S. Business Income

The United States is a world-class producer of goods and services and is the most lucrative market on the planet. Yet it collects a relatively small percentage of its tax revenues from businesses that earn income from the exploitation of the U.S. economy. The low revenue yield is partly because of a multitude of domestic incentives and loopholes. But another major reason is that foreign and domestic businesses can engage in activities within and without the United States without paying significant federal income taxes on their resulting profits. Those businesses frequently achieve their low-tax results through tax planning opportunities that are permitted, unfortunately, under current law. To fix the problem, significant changes in the legal regime are necessary.

One change we need is a revision of U.S. tax treaties and domestic law regarding the taxation of imports. In effect, most income from imports is not taxed by the United States because of a combination of its tax treaty rules and its domestic tax laws. The potential revenue loss is huge. Changing the domestic rules is relatively easy as a technical matter, whereas changing the treaty rules will be a long and arduous process. The basic treaty rules were adopted in the 1960s and 1970s through multinational deliberations under the auspices of the OECD. The United States was a leader in forging the current consensus that severely limits the ability of the source country to tax income from imports. U.S. treaty negotiators thought, incorrectly, that a limit on U.S.-source jurisdiction would expand U.S. residence jurisdiction. In fact, the United States collects only a small amount of revenue from U.S.-based businesses on income derived from their foreign business activities.

U.S. tax treaties also need to be changed to eliminate the zero rates on interest and royalty income earned in the United States. These treaty rates, combined with poor domestic rules for allocating expenses between domestic and foreign sources, allow businesses operating in the United States to strip earnings from their U.S. domestic operations and attribute those profits to offshore operations. The flawed treaty rules also allow for forms of tax planning that border on fraud. The United States can expect swift and strong support from much of the developing world for any international effort to restore to countries the ability to tax income arising within their borders. Some OECD countries also may be supportive of a resurgence of source jurisdiction. Getting a consensus from all OECD countries, nevertheless, will be difficult, at least in the short term.

Another area of needed reform is the U.S. transfer pricing rules. Those rules, first adopted in 1968, were modified considerably in the 1990s in collaboration with other OECD members. The modified rules certainly are an improvement over the 1968 rules. Still, the transfer pricing rules do not work. They are mere invitations to negotiate rather than rules of law. Many specific changes in the transfer pricing regulations are needed to deal with avoidance issues and to put teeth into the penalty provisions. More fundamental changes are needed, however, to prevent widespread abuse.

One desirable major change would be to improve the transfer pricing penalty provisions, making their application nearly automatic for taxpayers who have not kept contemporaneous records supporting their transfer prices. The current level of penalties is fine; the problem is that well-represented taxpayers almost always can avoid the imposition of any penalty even if their transfer pricing practices are indefensible.

An even more important change in the transfer pricing rules would be to give the IRS a default rule that it could impose on noncomplying companies without the need for the detailed, transaction-by-transaction analyses that currently are necessary to sustain a transfer pricing adjustment in the courts. For example, the revised regulations might authorize the IRS to employ the California combined reporting system to compute the U.S.-based income of recalcitrant taxpayers who have failed to comply with the relevant transfer pricing rules. In general, the California system aggregates the income of all of the related persons engaged in a common enterprise and attributes half of the profits to the market states and the remaining half to the production state.

Other default rules might be considered. The key is to have some default rule that protects the revenue and is easy for the IRS to impose. Having a workable default
rule would give the IRS significantly increased leverage over noncomplying taxpayers, resulting in improved settlements and the occasional victory in the courts.

Another necessary change is a full reform of the rules governing the classification of legal entities. Those rules have been flawed for many decades. They were made infinitely worse, however, by the adoption of the check-the-box regulations during the Clinton administration. It appears that the Clinton Treasury Department did not understand the devastating impact of check-the-box regs on the international tax system until after the regulations were adopted. At that point, the Clinton administration was prevented by House Republicans (and, perhaps, by its own reluctance to admit major error) from fixing the regulations. Although full repeal of check the box is not necessary, a major repair ought to be an early priority of the new Treasury. The goal should be to require that legal entities be characterized in a consistent manner by the United States and by the country where the entities were established. The tax avoidance and evasion games revolving around hybrid entities — games that allow double and triple deductions for the same expenses — need to be ended.

Toward the end of the Clinton administration, Treasury issued a report defending the subpart F provisions of the Internal Revenue Code. Those provisions allow, in general, for current taxation of income earned by a U.S.-based multinational on some tainted income earned through a foreign affiliate (controlled foreign corporation). They were adopted during the Kennedy administration to deal with well-documented abuses and were strengthened by the landmark Tax Reform Act of 1986. Over the past decade, however, companies flying the banner of “competitiveness” have succeeded in severely limiting the scope of those provisions. Those important antiavoidance provisions need to be restored and expanded to cope with the extensive offshore tax shelter activities of American businesses.

When adopted in 1962, the subpart F rules reflected a compromise between the Treasury view that U.S.-based companies should be taxable on their worldwide income, whether that income is earned through foreign branches or through foreign affiliates, and the industry view that forming a foreign corporation should shield the U.S. parent company from taxation on income earned through the foreign corporation. Under pressure from business interests, which falsely claimed that current taxation of their income earned through foreign affiliates would harm their competitive position, Congress took the halfway step of allowing income earned through a foreign affiliate to be exempt until repatriated except in cases when the income was of a kind that was easily deflected to a low-tax jurisdiction.

The original proposal of the Kennedy administration for worldwide taxation of U.S.-based multinationals retains substantial support among tax reformers. That support is warranted because such a system is fair and less complex than the alternatives, reasonably transparent, and economically efficient. The weakness is that current taxation of the entire income of foreign affiliates is unlikely to be supported by some of the key trading partners of the United States, at least in the short term. The United States should be seeking alliances with its major trading partners so that the major economic powers can present a united front to the international tax evaders. At this point in history, a program for worldwide taxation may not be the best vehicle for achieving that united front. In any event, it does offer an important aspirational goal against which to judge alternative reform proposals.

The Kennedy compromise embodied in subpart F actually can work rather well if the rules defining tainted income are sufficiently robust. It is precisely because the post-1986 subpart F rules had a bite that they are disliked intensely by much of the international business community.

Tainted income of a foreign affiliate can be defined in two ways. One way, employed in subpart F, is to identify each category of tainted income and subject that income to current taxation. All other income earned through a foreign affiliate would be exempt until repatriated. The alternative approach, proposed by Sen. John Kerry, D-Mass., during the 2004 presidential campaign, is to tax all income earned through a foreign affiliate currently unless it constituted an identified category of business income subject to tax abroad. The second approach is easier to administer and less subject to abuse. The first approach is likely to be more acceptable to U.S. trading partners. At some point, the two approaches tend to merge, because a robust subpart F approach ought to have some residual rule that would require current taxation on income that avoided tax in the country where it was derived.

Tainted income rules of the type described above clearly work best in cooperation with other countries. Around two dozen countries now have adopted rules that tax some income earned by their domestic companies through CFCs.

The point of CFC rules is not to raise revenue. No country raises significant revenue from the operation of these rules. The point is to reduce or eliminate the incentive for shifting domestic income to an offshore tax haven by reducing or eliminating the tax benefit from such conduct.

The CFC rules of the United States have two effects. They reduce the incentive for U.S.-based multinationals to shift offshore the income they have actually earned in the United States, and they reduce the incentive to shift income earned in some other foreign country to a tax haven. The first effect is good for the United States whereas the second primarily benefits U.S. trading partners. If those trading partners also have CFC rules, the United States benefits from the reduced incentive that foreign-based companies have to avoid or evade U.S. taxes on income earned in the United States. The United States should seek to achieve this symbiotic relationship with its major trading partners through cooperative arrangements and the coordination of CFC rules.

The CFC regimes of the various countries are not coordinated and, as a result, are significantly less effective than they could be in curtailing international tax avoidance and evasion. A major goal of U.S. international tax policy should be to foster greater international cooperation and harmonization regarding CFC rules and to pressure major countries that have not yet adopted those rules to join the CFC club.
The United States should consider some transitional rules in moving from the lax system of the past to a tighter system in which tax haven abuses are eliminated. A key issue in the design of transition rules is the proper treatment of the amounts that many U.S.-based multinational companies are holding in offshore tax havens after decades of tax avoidance and/or evasion. Unlocking that huge cache of offshore tax avoidance money might be helpful to the U.S. economy.

Many members of the international business community, of course, would like a repeat of the failed repatriation program that Congress and the Bush administration offered in 2004. They have the remedy for the offshore lock-in problem exactly backwards. The right answer, from a fairness and economic efficiency perspective, is not to exempt repatriations but to impose a one-time 35 percent capital tax on the entire amount of the offshore money, whether or not repatriated, and then allowing the taxed money to be repatriated freely, with no further tax.

Taxing the tax avoidance money and then allowing it to be repatriated without further tax certainly leads to a fair result — it puts the tax avoiders in the same position as the U.S. companies that dutifully paid their fair share of taxes over the years. Perhaps more importantly in these troubled economic times, the move would get high grades on efficiency grounds. Economists have long asserted that the ideal tax from an efficiency perspective is a one-time capital levy that cannot be avoided. A lump sum levy on corporate tax avoidance funds would have no undesirable effects on corporate behavior, and it also might even work to discourage companies from shifting income offshore in the first place.

The suggested tax on offshore tax avoidance money would raise considerable revenue, perhaps as much as $350 billion. That revenue could be used for domestic public works projects, which could stimulate the domestic economy without the undesirable effects of unbridled deficit spending.

In recent years, the attacks from the international business community on the subpart F rules have taken the form of proposals for converting the current U.S. system into a territorial tax system. In theory, the goal of a territorial system is to tax only the income earned within a country’s borders. The practical reality, however, is that a territorial system would be an easy target for tax haven abuses and would have been adopted long ago but for the political opposition from the multinational companies that are the major supporters of a territorial system.

D. Conclusion

Over the years, the international business community has been successful in creating an infrastructure that has facilitated international tax evasion and avoidance. The key steps that the U.S. government needs to take to regain control over its tax system:

- a worldwide network of tax havens willing to bend the rules and create novel tax evasion products intended to frustrate tax collectors and shield their clients from taxation in the countries where their income actually was earned;
- a lack of appropriate government regulation of financial institutions engaged in offshore activities;
- inadequate supervision of questionable practices by the major public accounting firms;
- tax enforcement of existing laws by national tax departments, including the IRS, largely because of inadequate resources but also resulting from inappropriate political pressures;
- a broad tax treaty network that allows tax planners to minimize taxation in source countries and assists taxpayers in reporting their income to different countries in an inconsistent manner;
- mechanical adjudication of tax cases by courts that put form over substance;
- a cloak of secrecy over the actual practices of multinational firms, allowing them to enter into special deals with tax departments with no useful reporting to the public;
- a legal structure that permits members of a multinational enterprise to separate their interrelated operations into separate corporations, with the highly profitable corporations organized in tax havens the corporations structured to show low profits or losses organized in the countries where their profits are actually earned; and
- national laws that may, on the surface, appear to limit tax evasion and avoidance opportunities but that contain trap doors inserted at the urging of the international business community that substantially limit the practical effects of those laws.

The infrastructure described above was not built in a day and is not the product of some grand international conspiracy. It was constructed over a long time, piece by piece, sometimes by people who felt they were serving the public interest, more often by taxpayers looking out for themselves. Now it needs to be dismantled, and dismantled rather quickly. As discussed above, here are the key steps that the U.S. government needs to take to regain control over its tax system:

- banks and other financial institutions need to be required to disclose the names of their customers, including the beneficial owners of the funds they transfer or manage;
- these financial institutions need to be subject to real audits by accountants who are actually attempting
to disclose, in a transparent manner, the real financial position of their clients and are not at the same time selling their clients tax avoidance packages;

• the IRS needs to be given substantially greater resources to go after tax cheats (both evaders and abusive avoiders) and bring them to justice;

• some of the detailed rules provided in the U.S. tax treaty network need to be revised to allow effective taxation of income in the country where the income arose;

• treaties and treaty practices need to be revised to require regular and automatic exchanges of information with treaty partners that would allow the United States and its treaty partners to discover that evasion is likely to be occurring and to bring the evaders to justice;

• legislation already before Congress to deal with identified abuses should be enacted, with a high priority on legislation that would codify the judicial substance-over-form doctrine;

• U.S. laws that were designed to attract investment in the United States by foreign tax cheats need to be revised, so that the United States can gain the moral authority needed to lead an international campaign against tax evasion and abusive avoidance schemes;

• domestic tax laws that facilitate tax avoidance need to be reworked, particularly code provisions and regulations relating to the allocation of deductions and to the threshold tests for taxing income from imports;

• the rules for taxing income earned in the United States need to ensure that all income that the United States is allowed to tax by treaty is actually taxed by the United States under its domestic tax laws;

• the transfer pricing rules need to be revised to fix known flaws, to provide for more effective penalties for noncompliance, and to give the IRS a relatively simple default method that it can apply when a taxpayer has failed to offer contemporaneous documentation of its transfer pricing practices;

• the indefensible check-the-box rules need to be revised to prevent widespread abuses, including the avoidance of many antiavoidance rules and the taking of inconsistent tax positions in different countries; and

• the rules designed to prevent taxpayers from deflecting income to a tax haven through the use of a CFC or other legal entity under their control need to be strengthened substantially and coordinated with the comparable rules adopted by other countries.

For the reform agenda outlined above to succeed, the United States needs to take immediate advantage of the worldwide sentiment for greater supervision of international financial institutions. That sentiment is unlikely to survive the next economic recovery. Several countries, most notably France, have indicated that they want the era of tax evasion through offshore tax shelters to end. The time will never be better for forcing international financial institutions not only to get out of the tax fraud business themselves but to cooperate with governments in combating international tax evasion and abusive avoidance by their customers and corresponding banks.

Also, the United States needs to take the lead in fostering far greater international cooperation on combating tax evasion. The international business community has successfully defended the existing infrastructure on the grounds that antiavoidance rules would hurt the competitive position of American companies in the global market. The best political response to that claim is to make the antiavoidance rules as universal as possible. Some countries, of course, will refuse to cooperate. But many countries are anxious to cooperate as part of a coordinated movement for major international tax reform. As long as most of the countries where income actually is earned are prepared to become part of the solution to international tax evasion and avoidance, the crusade against those practices can succeed. The time to accomplish the change we need is now.