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Abstract

This article explores arguments in favour of establishing an international taxation database to counter tax haven secrecy. The current OECD approach is a 'request of information process', which can be limited by local jurisdictional requirements. At its best, the 'request of information process' is an automatic transfer system based on the despatch of data in bulk format either upon request, at defined points in time, or following detection in the relevant offshore jurisdiction. This process lacks scope for timeliness in detection and enforcement. There is also scope for errors in analysing data for its potential use as evidence in other legal systems.

Keywords

international tax base, tax, tax base, tax abuse, tax haven secrecy, OECD, tax havens, ActionAid, tax law enforcement, taxpayers, international tax

ARGUMENTS FOR AN INTERNATIONAL TAX BASE

ENRICO MERCURI*

This article explores arguments in favour of establishing an international taxation database to counter tax haven secrecy. The current OECD approach is a 'request of information process', which can be limited by local jurisdictional requirements. At its best, the 'request of information process' is an automatic transfer system based on the despatch of data in bulk format either upon request, at defined points in time, or following detection in the relevant offshore jurisdiction. This process lacks scope for timeliness in detection and enforcement. There is also scope for errors in analysing data for its potential use as evidence in other legal systems.

INTRODUCTION

Recent events concerning secrecy jurisdictions are setting the stage for the potential of historic change. At a precursor to the G8 summit beginning 24 June 2013, the UK's Overseas Territories and Crown dependencies agreed to become signatories to the *OECD Multilateral Convention on Mutual Assistance in Tax Matters*. They also agreed to publish national action plans to reveal owners of so called 'shell companies'. Such publication of information by these jurisdictions is unprecedented and there remain a number of hurdles to its implementation. Nevertheless, it is a significant step by secrecy jurisdictions towards following the stance established by the OECD.

An international tax database can have two effects: to confirm whether a tax loss risk exists, and when it does, assist governments with evidence to address tax abuse within their home jurisdiction using domestic private international law. The international tax database mechanism relies on access to information between jurisdictional partners, with a vested interest in larger scale information sharing. Enforcement is a consequence of sound information management, rather than being the legal means to acquire the information at the onset.

* BA (Hons), LLB, MJuris, Dip FS. The opinions expressed in this paper are my own and are not provided in any context other than for academic purposes.

WHY TAX HAVENS?

This article considers the benefits of establishing an international database to support the private international laws of different jurisdictions. This proposal is not itself a solution to the problems tax havens are accused of participating in or facilitating. It is a means of increasing the amount of information available to revenue authorities. This increase should lead to better informed administrative decisions and greater efficiencies both for revenue authorities and taxpayers alike.

The discussion starts with a review of publications which support the view that transfer of information between jurisdictions is essential for the effective and equitable function of the international economy. The analyses are written by a wide spectrum of organisations: government, non-government, social welfare based and lobby groups. The common theme is the impact of illicit and unaccounted for transfers of funds on an international basis using tax havens.

The publications state or imply that there is a bond between tax haven secrecy and the illicit capital flows linked to tax abuse. From a quantitative perspective, the secrecy surrounding the operations of tax havens prevents a thorough evaluation. In this case, some publications recognise the incomplete nature of their data sources and derive conclusions based on available information.

The view represented by these publications is opposed by neo-liberalist commentators who view it as anti-capitalist and against the basic tenets of human freedom.¹ This opposing perspective is influenced by the free enterprise political philosophy of Milton Friedman but will not be analysed in this article.² Such a review would examine the pro-tax haven argument including relevant policy analysis,³ tax competition⁴ and the inefficiencies created by governmental interference.⁵

The need to mitigate risks potentially incurred by a repository of international tax data would include: breach of confidentiality by individuals, online security breaches and inefficient use of stored information by relevant governments. These risks will need appropriate safeguards in managing staff and technological breaches on an

¹ See for example the Cato Institute, *About* (2013) <<http://www.cato.org/about/>> and The Centre for Freedom and Prosperity (CFP) which publishes its own journal *Prosperitas*, *CFP* (2013) <<http://freedomandprosperity.org>>.

² See the reference to Friedman for example in Mark A. Zupan, 'The Virtues of Free Markets' (2011) 31 *Cato Journal*.

³ Chris Edwards and Veronique de Rugy, 'Policy Analysis. International Tax Competition, A 21st-Century Restraint on Government' (No 431, (2002) The CATO Institute).

⁴ *Ibid.*

⁵ *Ibid.*

international scale. It would also need guidelines for use of the information by recipients.

Defining the term 'tax haven' is difficult as there is no internationally accepted interpretation of the term.⁶ Various attempts have been made to articulate the meaning. The Australian Taxation Office stated the following in 2011:⁷

Tax havens are countries with secretive tax or financial systems. They also have minimal or low taxes for non-residents. The global community recognises that every country is entitled to run its tax system as it sees fit. This means a country may, for example, choose to create a low-tax regime to attract international investment. Problems can arise, however, when a country's tax or financial system is secretive. This lack of transparency can be harmful to the tax systems of other countries if it enables people to conceal their assets and avoid tax in their own country. To be able to enforce its own tax regime, particularly where its residents engage in international dealings, a country will often require access to information held by other governments, regulators or banks. The Organisation for Economic Co-operation and Development (OECD) uses two yardsticks to assess whether a country is a tax haven: lack of transparency [and] lack of effective information exchange.⁸ These criteria are adopted by Australia, which is a member of the OECD.

A list of tax havens was published in 2008 by the Government Accountability Office (GAO) of the United States' Congress.⁹ Palan, Murphy and Chavagneux say that the

⁶ Richard Murphy, 'Tax Havens, Secrecy Jurisdictions and the Breakdown of Corporation Tax' (2011) 57 *Real-World Economics Review* 56-59 <<http://www.paecon.net/PAEReview/issue57/Murphy57.pdf>>. The terms 'tax haven' and 'secrecy jurisdiction' are often used interchangeably. This is evident in the publications reviewed in this article. For a comparison between the two terms, see Murphy's article.

⁷ Australian Taxation Office, *Tax Havens and Tax Administration* (18 October 2011) ATO <<http://www.ato.gov.au/individuals/content.aspx?doc=/content/46908.htm>>.

⁸ Commonwealth of Australia, *Tax Havens and Tax Administration* (2011) <<http://www.ato.gov.au/corporate/content.aspx?doc=/content/46908.htm>>.

⁹ GAO, 09-157 *International Taxation Congressional Record* (2008) <<http://www.gao.gov/new.items/d09157.pdf>>. Data used to derive the tax haven list is drawn from OECD information, academic literature and a US District Court Order granting leave for the Internal Revenue Service (IRS) to serve a 'John Doe' summons, including a list of offshore tax haven or financial privacy jurisdictions. The footnotes of *International Taxation Congressional Record* have the following content on the issue:

OECD removed the Marshall Islands from its List of Unco-operative Tax Havens, (August 7, 2007) which includes a link to 35 Jurisdictions Committed to Improving Transparency and Establishing Effective Exchange of Information in Tax Matters.

Dhammika Dharmapala and James R Hines Jr, 'Which Countries Become Tax Havens?' (NBER Working Paper No 12802, Cambridge, December 2006); and United States of

term 'tax havens' has been difficult to define over recent decades. Nevertheless, the list of tax havens has barely changed.¹⁰

The philosophical position of the present article is examined elsewhere.¹¹ For there to be just international social outcomes, just laws must exist in the Aristotelean and Aquinian tradition. These laws need to be placed in the context of the current informal international taxation regime as described by Reuven Avi-Yonah.¹² The conformity of laws to this regime is essential to achieve international tax justice principles.

Particularly, it is necessary to recognise three conditions for a just tax law outlined by Martin T Crowe in his treatise.¹³ Namely, the requirements of a requisite authority, a just cause and the just distribution of the tax burden. Finally, in line with the International theme of this article, a fourth condition is added: a transparency condition which supports just law in its international dimension.¹⁴ This last condition is the element supporting the establishment of an international tax database.

PUBLICATIONS SUPPORTING THE ESTABLISHMENT OF AN INTERNATIONAL DATABASE

The publications selected assert the existence of an international problem of capital flight and tax evasion. This section begins by identifying these publications and summarising their contents. These analyses will be placed in overall context and relevance to the proposed solution.

America v John Does 210 mc 00130 (Cal, 2006) <http://taxtrials.com/wp_content/uploads/2011/12/John-Does-ED-CA.pdf>.

¹⁰ Ronen Palan, Richard Murphy and Christian Chavagneux, *Tax Havens: How Globalization really works* (Cornell Studies in Money, 2009).

¹¹ Enrico Mercuri, 'The obligation to obey tax laws' (2011) 21 *Revenue Law Journal* <<http://epublications.bond.edu.au/rlj/vol21/iss1/5/>>.

¹² Reuven Avi-Jonah, *International Tax as International Law* (Cambridge Tax Law Series, 2007). This book's thesis is that a coherent international tax regime exists, embodied in both the tax treaty network and in domestic laws, and it forms a significant part of international law (both treaty-based and customary).

¹³ Martin Timothy Crowe, *The Moral Obligation of Paying Just Taxes* (The Catholic University of America Press, 1944).

¹⁴ Enrico Mercuri, 'The obligation to obey tax laws ' (2011) 21 *Revenue Law Journal*. According to Aristotle, law is just and according to Aquinas is a genuine law when directed for the benefit of others. Crowe states tax law is a singular legal virtue aimed at the common good. This occurs today when that law is enacted in an international environment in which comprehensive financial knowledge and transactional information are readily ascertainable.

All publications considered suffer for various reasons from inadequate data to prove whether tax havens are not just passive recipients and storehouses of international capital but also have an active role in facilitation of illicit transfers. Addressing this accusation is a critical step in evaluating whether tax havens have a valid role in the international financial community.

Consequently, only robust and relevant data can address the issue appropriately and fairly. An example of this data quality, albeit with its own restrictions, was provided by the Bank of International Settlements (BIS) in the publication by Johannesen and Zucman. Comparable data quality can come from multilateral compliance activity by member jurisdictions who are data donors as well as recipients of international tax database information.

JOHANNESSEN AND ZUCMAN¹⁵

The 2012 quantitative analysis by Johannesen and Zucman is based on data provided by BIS. The data is provided at the bilateral level, for example, deposits held by French residents in Swiss banks.¹⁶ The data has its limitations. It is impossible to distinguish between deposits owned by households from deposits by non-financial corporations, mutual funds and insurance companies. The data only shows immediate ownership, as opposed to beneficial ownership, and it only shows bank deposits. There is no information on equity or bond portfolios entrusted to tax haven banks.

Notwithstanding the limitations, the authors comment that the data demonstrates the degree to which the G20 imposition of bilateral treaties since the 2008 global financial crisis has been successful.¹⁷ The authors conclude:

Most tax evaders, our results suggest, did not respond to the treaties. A minority responded by transferring deposits to havens not covered by the treaty. Overall, the G20 tax haven crackdown caused a modest relocation of deposits between havens but no significant repatriation of funds: the era of banking secrecy is not over.

In conclusion, funds were never substantially repatriated and remain deposited in tax havens. Specifically, the least compliant tax havens have gained new business

¹⁵ Niels Johannesen and Gabriel Zucman, 'The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown' (2012) 26 *Journal of Economic Literature*.

¹⁶ Ibid. Johannesen and Zucman comment that this represents a significant though understandable distortion, given the importance of the use of trusts and other hybrid entities in protecting tax evasion activity. Particularly, 25% of deposits are registered as belonging to other tax havens.

¹⁷ Niels Johannesen and Gabriel Zucman, above n 15.

while the most compliant have lost some.¹⁸ This publication states that both the G20 tax haven crackdown and the next largest initiative, the European Union Savings Tax Directive, have failed to address the problem. Johannesen and Zucman conclude that the OECD should promote automatic exchange of information, rather than request based transfers: 'treaties providing for automatic exchange of information could put an end to banking secrecy and make tax evasion impossible'.¹⁹

NORWEGIAN REPORT: TAX HAVENS AND DEVELOPMENT²⁰

The Norwegian government by Royal Decree commissioned a report on capital flight from poor countries and analysed the role of tax havens. The report states use of automatic exchange of information is needed when dealing with tax evasion. The concluding comments of the report outline a trend towards profit shifting through transfer pricing. The net outflow from Norway is 30% of the potential tax revenue from foreign multinational enterprises.²¹ The report concludes that, given the timeframe, a more robust analysis would have been desirable. The results are 'indicative rather than finished and fully quality controlled'.²² The report concludes:²³

Potentially, multinational corporations can withhold large amounts of money from taxation by shifting profits out of the country. Empirical research on multinational corporations and tax must therefore be characterised as a neglected field in Norway.

This view is characteristic of attempts to measure what is often described as the 'tax gap'. According to the IRS, the tax gap is defined as:²⁴

The amount of tax liability faced by taxpayers that is not paid on time. It will be seen that measuring the tax gap is not only restricted by time constraints (as in this report) but is also restricted significantly by a lack of data able to be retrieved from tax havens.

The report identifies various weaknesses from the perspective of developing countries,²⁵ including the lack of registration, lack of automatic exchange of

¹⁸ Ibid.

¹⁹ Ibid.

²⁰ Norwegian Independent Commission on Capital Flight from Developing Countries, *Tax Havens and Development: Status, Analyses and Measures* (2009) Anti-Corruption Resource Centre <<http://www.u4.no/recommended-reading/tax-havens-and-development-status-analyses-and-measures/>>.

²¹ Ibid.

²² Ibid.

²³ Ibid.

²⁴ IRS, *The Tax Gap* (2012) IRS <<http://www.irs.gov/uac/The-Tax-Gap>>.

information on ownership, and lack of insight into transfer pricing within companies. The Table on page 91²⁶ emphasises the problem of a lack of information as to the 'real owner of any form of asset'.²⁷ The report outlines the need to access publicly available records of beneficial ownership.

The EU Savings Directive specifies that countries in the European Economic Area (EEA) must automatically exchange data on interest income received by individuals. The Directive is distinguished from the provisions of normal tax treaties, as it does not require a request from the country of taxpayer domicile before information is transferred. Several countries have refused to implement the Directive. The foreign recipients of interest payments in these jurisdictions face the choice to pay a modest withholding tax, or data about their interest receipts will be sent to their country of domicile.

The Savings Directive only applies to interest income earned by individuals. Capital incomes from sources other than interest are excluded and reporting can be avoided in these cases. The transfer of interest-bearing assets to a jurisdiction are not covered by the directive²⁸ and establishing a legal entity to own interest-bearing assets will not require reporting. The next two publications consider the degree of involvement of large UK and US corporates utilising tax haven subsidiaries.

ACTIONAID REPORT²⁹

This report analyses the degree to which the FTSE top 100 companies are involved in use of tax havens as part of their international strategy. The authors are critical of the tax avoidance implications of FTSE top 100 companies in tax havens. Tax avoidance

²⁵ Norwegian Independent Commission on Capital Flight from Developing Countries, *Tax Havens and Development: Status, Analyses and Measures* (2009) Anti-Corruption Resource Centre < <http://www.u4.no/recommended-reading/tax-havens-and-development-status-analyses-and-measures/> >.

²⁶ Norwegian Independent Commission on Capital Flight from Developing Countries, *Tax Havens and Development: Status, Analyses and Measures* (2009) Anti-Corruption Resource Centre < <http://www.u4.no/recommended-reading/tax-havens-and-development-status-analyses-and-measures/> >.

²⁷ Ibid. Box 8.1 Tax treaties and efforts to combat tax evasion.

²⁸ See Niels Johannesen and Gabriel Zucman, 'The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown' (2013) 26 *Journal of Economic Literature*; commenting on the failure of G20 initiatives to transfer deposits except in the case of haven to haven transfers.

²⁹ Action Aid, *Addicted to tax havens: The secret life of the FTSE 100* (October 2011) Action Aid <www.actionaid.org.uk/taxhavens>.

is seen as having a negative social impact and deprives developing countries of badly needed tax revenue for their populations. The article includes statistics:

- The FTSE 100 largest companies contain 34,216 subsidiaries, joint ventures and associates;
- 38% of the related overseas companies are located in tax havens;
- 98 of the FTSE 100 largest companies declared tax haven located companies;
- Banking is the biggest user of tax havens. The big four banks have 1,649 tax haven companies. For example, Barclays has 174 subsidiaries in the Cayman Islands;
- The advertising company WPP holds 611 tax haven companies;
- The group makes far more use of tax havens than their American counterparts; and
- There are over 600 subsidiaries in Jersey; 400 in the Caymans; and 300 in Luxembourg.

The report also looks at the involvement of banks in the global financial crisis which began in 2007. It refers to the G20 leaders meeting in London during April 2009 and its identification that the catalyst of the crisis was a toxic mix of complex financial products routed through tax havens. The banking industry and the financial sector generally are seen as the trigger of the crisis through its marketed products. In particular, the banking industry is accused of benefiting from tax avoidance per se and from carrying forward losses incurred during the global financial crisis. According to this view, losses are magnified during global financial crises only to be offset during more profitable times.

The report also identifies the oil and mining sector as the other big user of tax havens. BP and Shell are cited as having almost 1,000 tax haven companies between them. The extractive industries generally are identified as having a large impact on developing countries where natural resources are fundamental to the economy. The other industry groups noted include British American Tobacco with 200 companies mainly in developing countries and UK supermarkets which all have a presence in tax havens.

GAO INTERNATIONAL TAXATION REPORT³⁰

This report was requested of the Government Accountability Office (GAO) by US Senators Byron Dorgan (D-ND) and Carl Levin (D-MI) and released on 16 January 2009. It updates a similar report delivered to the senators in 2004.

The report is parallel in content to the ActionAid report discussed above on identifying the tax haven presence of the top 100 publicly traded US corporations. 83 out of the 100 corporations reported having subsidiaries in jurisdictions defined by GAO as tax havens. The GAO asserts the caveat that it did not attempt to determine if corporations or contractors engaged in transactions with their subsidiaries to avoid or evade taxation.

On this basis, it provides data that questions the reasons behind the large number of subsidiaries which have limited connection to the commercial activity of the parent company. It is left to the reader to consider impropriety in the disproportionate number of subsidiaries in tax havens and link them to revenue loss. The US Senator Carl Levin adopts this view.³¹ Selected findings by GAO are as follows:³²

- Four of the 83 corporations with subsidiaries in tax havens held more than 100 subsidiaries within tax havens;

³⁰ GAO International Taxation Large US Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions. GAO, 09-157 *International Taxation Congressional Record* (2008) <<http://www.gao.gov/new.items/d09157.pdf>>.

³¹ Dorgan Levin, *Release GAO Study on Offshore Tax Haven Subsidiaries* (16 January 2009) Levin <<http://www.levin.senate.gov/newsroom/press/release/?id=69d106de-06c0-4513-88f5-5e737a7caa9b>>.

Senator Levin states:

We need to put an end to the use of offshore secrecy jurisdictions as tax havens. We must get to the bottom of activities such as the following: Citigroup has set up 427 tax haven subsidiaries to conduct its business, including 91 in Luxembourg, 90 in the Cayman Islands, and 35 in the British Virgin Islands. Hundreds more tax haven subsidiaries operate under strict secrecy laws in places like Switzerland, Hong Kong, Panama, and Mauritius. But not all large U.S. companies are major tax haven users and there is great contrast between competitors. For example, Pepsi has 70 tax haven subsidiaries, while Coca Cola has 8; Morgan Stanley has 273, while Fannie Mae has 0; and Caterpillar has 49, while Deere has 3.

Levin chairs the US Permanent Subcommittee on Investigations, which has made offshore tax abuse a major subject of its investigations.

³² GAO, 09-157 *International Taxation Congressional Record* (2008) <<http://www.gao.gov/new.items/d09157.pdf>>.

- The spread of subsidiaries in tax havens for the 83 corporations ranges from one for nine corporations to 427 for one corporation (Citigroup);
- Corporations had subsidiaries in 36 of 50 jurisdictions defined as tax havens;
- One tax haven was the resident jurisdiction for 569 subsidiaries of the relevant US corporations. 372 of these were owned by four corporations; and
- 34 of the 100 corporations reviewed were also on the list of 100 largest publicly traded US federal contractors.

There is no question there is a significant presence of US corporations in tax haven jurisdictions. The presence of US contractors in this research brings home the potential of tax abuses to the US government itself. Entities profiting from US government contracts are also potentially avoiding their revenue tax responsibilities to the US government on profits earned.

PUBLISH WHAT YOU PAY NORWAY³³

This report examines the international corporate structure and geographic location of participants and their related entities in extractive industries (EI). The report says:³⁴

Publish What You Pay Norway wanted to establish the number of subsidiaries extractive companies use, where they are located and how many of them are incorporated in so-called 'secrecy jurisdictions'.

The data sources of this research are British company registers and the US and Canadian stock exchanges. The authors argue that given the secretive nature of EI, Country-by-Country reporting (CBCR) is urgently needed. The report emphasises that it does not claim any of the companies featured use tax avoidance techniques.³⁵ Moreover, the disclaimer specifically states there is nothing to suggest these companies have acted in a way that constitutes tax evasion.

The report lists tax avoidance techniques by multinational enterprises:³⁶

- Creating subsidiary companies to act as the ultimate owners of brands and assets in opaque jurisdictions, for example the Netherlands;

³³ Nick Mathiason, *Publish What You Pay Norway Piping Profits* (2011) Publish What you Pay <<http://www.publishwhatyoupay.org/sites/publishwhatyoupay.org/files/FINAL%20pp%20norway.pdf>>.

³⁴ Ibid.

³⁵ Ibid.

³⁶ Ibid.

- The payments of large management fees by revenue producing companies in one country are transferred to another group company that is based in a tax haven;
- Shrouding revenues made by a revenue generating company through inter-company trading activity in transfer pricing; and
- Thin capitalisation where a loan is issued by a group subsidiary member to revenue generating subsidiary, sometimes very steep interest rates.

Key statistics from the report are:

- Ten of the world's EI giants have 6,038 subsidiaries;
- 2,038 of these or 34.5% are incorporated in jurisdictions with high levels of corporate secrecy as defined by the Financial Secrecy Index;³⁷
- Delaware is the preferred location for global headquarters for EI, 915 subsidiaries are located there;
- The Netherlands hosts 358 of the subsidiaries;
- Chevron is the most opaque company reviewed in the report. 62% of Chevron's subsidiaries are located in tax havens; two thirds of its US subsidiaries are located in Delaware and 21 subsidiaries or 27% of the total are located in either Bermuda or the Bahamas;
- 57% of Conoco Phillips' 536 subsidiaries are located in tax havens;
- 52% of Exxon's 170 subsidiaries are located in tax havens;
- Between the three EI companies cited immediately above, 783 subsidiaries are located in tax havens; and
- Glencore International AG has 46% of its 46 subsidiaries located in tax havens.

The research leading to this report is publicly available on the TRACE database.³⁸ The information stored on the database relates to the 13 EI corporations and their 6,038 subsidiaries. The details recorded are:

- The parent company;

³⁷ Tax Justice Network, *Financial Secrecy Index* (2009) Financial Secrecy Index <<http://www.financialsecrecyindex.com/2009results.html>>.

³⁸ Publish What You Pay Norway, *What is TRACE* (2012) Publish What You Pay Norway <<http://www.publishwhatyoupay.no/trace/about-trace/what-trace>>.

- Subsidiary name;
- Location in which the subsidiary is incorporated;
- Individual state where United States' subsidiary is located;
- Percentage of the subsidiary owned by the parent company;
- Each subsidiary has its own entry which include data fields for:
- Number of employees;
- Turnover;
- Costs;
- Profits;
- Tax paid; and
- A notes field which can record movements in reserves per annum and details of joint ventures.

None of these fields contains information provided by EI participants in the article.

This leaves a gap in fully understanding the compliance risk this relatively small sample of companies poses. For this reason, the report calls on the assistance of interested parties to fill the gap. Information will be provided on a volunteer basis, potentially without the support of legislative power and intelligence sources. Moreover, research is restricted to one industry sector of particular interest. Nevertheless, this attempt at formulating a database represents a first step towards full and frank disclosure and highlights the central theme of transparency through information exchange.

CAYMAN ISLANDS REPORT³⁹

This report by GAO, dated July 2008, is an analysis of the Cayman Islands and its relevance to US tax law enforcement challenges. The Caymans are described as an offshore financial centre whose financial activity per annum is measured in the trillions. One particular address is cited as 'Ugland House, George Town, Grand Cayman, Cayman Islands' which houses one tenant. This is Maples and Calder law firm, which provides registered office services for 18,857 registered entities.

Congress asked the GAO to study the following aspects of the Cayman Islands:

³⁹ GAO US Government Accountability Office, *Cayman Islands: Business and Tax Advantages Attract US Persons and Enforcement Challenges Exist* (24 July 2008) GAO <<http://www.gao.gov/products/GAO-08-778>>.

- The nature and extent of US persons' involvement with Uglund House registered entities and the nature of their business;
- The reasons why US businesses conduct business in the Cayman Islands;
- What information is available to the US Government regarding the activities of US persons in the Cayman Islands; and
- US Government compliance and enforcement efforts.

As a result, GAO interviewed US and Cayman government officials, representatives of Maple and Calder and reviewed relevant documentation. As with the GAO report, no recommendations were made by GAO in this report. Comments by IRS officials include:

The IRS has generally targeted abusive transactions in areas like hedge funds, offshore credit cards and promoter activity; and there have been several criminal investigations and prosecutions related to activities in the Cayman Islands. There are 45 instances over the last 5 years where IRS field agents have requested information regarding suspected criminal activity linked to the Cayman Islands.

The report highlights a number of characteristics including employment of Cayman Island entities to defer taxes. This is a consequence primarily that the US only taxes profits upon distribution to the US shareholder. Unless profits are repatriated from a Cayman Island entity, it becomes possible to defer tax owing until payment is made to the parent. Deferral is limited in controlled foreign corporation (CFC) cases. The income earned is known as subpart F income.⁴⁰ Another reason for basing entities in jurisdictions like the Caymans is to avoid entity level taxation. This was confirmed in GAO enquiries with specific reference to aircraft leasing.

One indicative measurement of Cayman deferral activity was the response to a relatively recent tax law; *American Jobs Creation Act of 2004*.⁴¹ For a limited time Congress approved a received dividend deduction for certain repatriated earnings by foreign subsidiaries of US companies. Approximately 5.5% of the \$362 billion repatriated between 2004 and 2006 was from Cayman Islands controlled corporations.

According to GAO, US corporations avoid US tax obligations using certain Cayman Island entities to avoid the unrelated business income tax (UBIT). US tax exempt entities including: charitable trusts, pension funds, foundations and endowments are subject to UBIT, if income is earned by a US partnership where the tax exempt entity

⁴⁰ Ibid.

⁴¹ *American Jobs Creation Act of 2004*, 26 USC 1 §422 (2004).

is a partner. Many US investment vehicles such as hedge funds are organised as limited partnerships as these entities are generally not taxed. The tax applies at the investor level.

Consequently, tax exempt entities invest in hedge funds organised as foreign corporations and are paid dividends which avoid payment of UBIT. If the investment fund is incorporated in a jurisdiction like the Cayman Islands, which does not have corporate income tax, the fund does not pay tax and investment returns to investors are not subject to corporate income tax. The US Securities Exchange Commission (SEC) adds that the growth in hedge funds is driven by investment from US tax exempt entities. This is an example of growth in a sector primarily determined by tax benefit rather than commercial considerations.

Another comment made by GAO is the complexity of US tax law which may be interpreted aggressively by US persons. This is seen in emerging strategies to reduce tax paid in the US. GAO postulates that tax returns lodged by major corporations are the opening bid in an 'extended negotiation with the IRS to determine a corporation's tax liability'.⁴² This adversarial approach taken by corporations is an evident concern to GAO.

In relation to large corporations, GAO expresses its concern at the behaviour of multinationals in their transfer pricing strategies. Citing a US Department of the Treasury report,⁴³ the GAO states taxpayers take advantage of ambiguities in rules and guidance to avoid US taxes by moving profits offshore. In particular, cost sharing arrangements between related parties and services transactions are a source of profit shifting. Moreover, GAO mentions a relevant, though unsighted, working paper by Treasury's Office of Tax Analysis. The working paper finds that data is consistent with (though not proof of) the existence of potential shifting from inappropriate transfer pricing.

GAO comments the full extent of illegal offshore activity is unknown.⁴⁴ However, a risk factor is the limited transparency related to foreign transactions. This limited transparency contributes to the risk of some persons using offshore entities to hide illegal activity from US regulators and enforcement officials. Linked to this lack of

⁴² Ibid.

⁴³ Department of the Treasury, *Report to The Congress on Earnings Stripping, Transfer Pricing and US Income Tax Treaties* (2007) Treasury < <http://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf> >.

⁴⁴ GAO US Government Accountability Office, *Cayman Islands: Business and Tax Advantages Attract US Persons and Enforcement Challenges Exist* (24 July 2008) GAO 32 < <http://www.gao.gov/products/GAO-08-778> >.

transparency, GAO cites the US District Court cases of *United States v Taylor*⁴⁵ and *United States v Petersen*.⁴⁶ In these cases the defendants pleaded guilty to crimes related to tax evasion. Their schemes used a web of US and offshore entities to hide the beneficial owners of assets and conduct false business activities. These actions resulted in tax losses which were claimed as deductions for clients in the US.

An example is the abuse of Special Purpose Vehicles (SPVs) which can be used for a variety of purposes and abused accordingly. The collapse of Enron showed an example of these abuses. At the time Enron filed for bankruptcy it had 441 entities in the Cayman Islands. Maples and Calder partners advised GAO they incorporated these entities under the instruction of US law firms. GAO filed the necessary report related to suspected illegal activities and indicated the accounting fraud perpetrated by Enron was not intrinsically offshore in nature, but was committed from within the US. This statement points to inadequacies in detection at both the domestic and international levels.

GAO identifies another gap in information; that Cayman Island financial institutions are not required to file reports with IRS concerning US taxpayers. This restricts IRS access to information to self-reporting. The risk of inaccuracy and deliberate misreporting are emphasised accordingly. Finally, GAO lists the challenges posed by offshore activities:

- Lack of jurisdictional authority to pursue information;
- Difficulty in identifying beneficial owners due to complexity of offshore transactions between multiple entities; and
- Time consuming processes involved in offshore examinations.

GAO concludes that notwithstanding the Cayman Islands adherence to international standards, their entities are open to abuse by hiding legal ownership of assets and related income as well as exploiting US tax laws. In addition, the limitations of self-reporting and specific enquiry⁴⁷ mean that the Cayman Islands and similar jurisdictions remain attractive to those who wish to engage in possibly illegal activity.

⁴⁵ *United States v Taylor* 487 US 326 (2008).

⁴⁶ *United States v Petersen* 18 US 2113 (2008).

⁴⁷ Specific enquiry includes a GAO discussion of Tax Information Exchange Agreements (TIEAs). The reference to specific enquiry as a limitation can be overcome through the multilateral exchange of information provided by an international.

GAPS IN THE PUBLICATIONS

The term 'gap' is defined as assertions unsupported by adequate empirical evidence to demonstrate on the balance of probabilities that:

- There are accurately quantifiable amounts of tax evaded through illicit financial transactions; and
- There is statistically robust, readily accessible data to link relevant transactions to a tax mischief.

The term gap is used to assert an inadequacy on the part of revenue agencies to generate sufficient evidence to mount their cases against tax evasion. The gaps lead to the conclusion that the ideal way to arrive at such evidence is the creation of an international tax database to decrease the information gap. Gaps in the publications include:

Data Limitations

These include difficulties in breaking down aggregate data so it is not possible to distinguish between non-financial corporations, mutual funds and insurance companies. Nor is it possible to identify beneficial ownership – a crucial aspect of trust arrangements; and equity or bond portfolios held by tax haven banks are not identifiable. This makes the job of linking a benefit to possible tax evasion difficult.

Limited Time to Conduct a Thorough Analysis

Often linked to a lack of resourcing.

Limits to Publicly Available Data

As noted in Publish What You Pay Norway (PWYP Norway), publicly available information can provide a significant amount of aggregate data on US and UK corporations, including the number of subsidiaries and their location. The link between the location and a quantitative evaluation of tax evaded is not made because of the limitations of available data. Consequently, the concern with evasion is expressed but not proven.

Data Analysis

Some publications do not interpret the data they collate. This can be due to the brief itself being restricted. GAO specifies it did not provide interpretative work which could support legislative change. Empirical proof was not generated and the work was restricted to the geographical location of entities.

Data Collation

An attempt is made in PWYP Norway to establish a database containing the results of the research and making the database available to the public. Contributions to the data are requested on a purely voluntary basis from interested parties, rather than from the use of information from governmental sources. The gap in data is caused by the element of voluntary participation.

Scope of the Data

The article on the Cayman Islands identifies a focal point of activity in one tax haven. How much the characteristics of this tax haven are transferrable to others is mentioned but not analysed in detail. The size of activity through this tax haven is nevertheless substantial and has attracted the specific attention of Congress and GAO. While it is useful to examine the characteristics of this jurisdiction, there is the risk of making generalised assumptions about other tax havens.

TAX TECHNICAL BENEFITS OF AN INTERNATIONAL DIALOGUE

This article advocates a strengthening of the role of compliance officers in revenue agencies in the effort to address tax evasion. International initiatives have sought to engage tax havens through a mixture of international dialogue and legislation aimed at tax abuses. Examples of the legislative approach include the European Union Savings Directive and the US based FATCA legislation. The proposal of a database should be seen as an adjunct to these initiatives by providing much needed real time information for officers to use in applying their particular private international law provisions.

Consequently, compliance officers would have access to greater amounts of information on taxpayers than is currently available under request of information arrangements. For example, information surrounding transactions could come contemporaneously from a combination of international agencies. They would be stored together allowing a greater opportunity for comparative analysis of larger taxpayers. Moreover, data files from other jurisdictions would allow comparisons to detect potential inconsistencies in information provided to different agencies.

From an Australian perspective, compliance officers would be able to access file notes from other jurisdictions. Such file notes could contain answers to audit questions and historical data. It would also be possible to identify key decision makers and their advisors. Therefore, it would be possible to examine commercial strategies and their tax implications for Australia. Examples of useful information are: valuation methodologies used for transfer pricing assessment or internal communication leading to understanding whether the dominant purpose behind a strategy is tax

driven or otherwise. Data can be donated by informants. Acceptance of such information coupled with immunity (or anonymity) of the donor may prove valuable in allowing revenue agencies to pursue tax evasion.

CONCLUSION

Some of the information gaps identified may be addressed through a greater intensity of exchange of information. Existing data warehouse technology can be used to achieve this. The proposed database should not be seen as related to a new international body lobbying for change. Much of this international research and policy work has been done through the efforts of the OECD. This proposal seeks to build on that work. In particular, the notion of automatic exchange of information identified by the OECD would have its counterpart in real time access. The benefit of this concept is in extending the efficiency and impact of private international law efforts through gathering evidence quickly and internationally. Participation by countries will evolve over time and be driven by their need to shore up their own revenue. Membership would be predicated on contribution of information as well as access to it.

The incentive to change recalcitrant practices will come from a tax haven's client base and its adoption of policies of greater compliance in jurisdictions where business is conducted. As revenue authorities gain more information about their global practices, companies will face a greater risk of penalties and prosecution attracted by defective tax strategies. For example, it may become too risky to use tax havens as conduits while negotiating an advance compliance agreement with a non-tax haven jurisdiction. In addition, taxpayers may during settlement negotiations choose to divulge information in relation to their tax haven based entities.

A benefit of an international database would be the volume of information stored and the ability to mine that information for specific detail. For example, it would be possible during a review of taxpayer affairs to examine another jurisdiction's position on a taxpayer's international transfer pricing structure. Rather than a jurisdiction initiating a transfer pricing audit on domestic information, it could consider another jurisdiction's position and potentially initiate a Mutual Assistance Program (MAP) dialogue with that jurisdiction. Such an administrative alternative may save unnecessary taxpayer and revenue administration costs. In some cases this may avoid protracted compliance action or litigation to conclude the matter.

Verification of information is another possible avenue for the database. An example is examining the contract terms of the marketing hub of a multinational company with other contracted entities. These contracts may already have been provided to another jurisdiction and loaded onto the database. By examining terms and conditions with parties related to the marketing hub against those with unrelated

parties, a revenue authority will be able to ensure the accuracy of comparable contracts provided and confirm arm's length pricing.

The database may also support current exchange of information dialogue. By giving revenue agencies access to greater information at the onset, subsequent exchange of information requests will be more informed and specific in questions asked. This will lead to corresponding efficiencies and cost savings. This proposal is a first step in a process of real time information exchange between co-operating jurisdictions. Membership is likely to be limited at first until the benefits to members have been evaluated.