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THE UNITED STATES FIGHT AGAINST HARMFUL TAX COMPETITION

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Summary

The United States taxes its citizens on their worldwide income. Since the U.S. taxpayers are not always very complaisant the government has had to create ways to disclose and control transactions and penalise non-compliant taxpayers.

The United States has been, and is one of the world's leading countries in the fight against harmful tax competition, ever since it decided to implement the Controlled Foreign Corporation legislation in 1934. This legislation consists of different sets of legislation that work together to let the IRS tax a shareholder on the income of a foreign company. This is done even though the shareholder has not yet received any dividends from that company.

Treaty shopping has been countered with a limitation on benefits clause in every new international income tax treaty. This clause requires a company to fulfil certain requirements to be eligible for treaty protection.

The IRS is also very active in the area of inter-company pricing where it allocates gross income, deductions, and credits between related taxpayers to the extent necessary or to clearly reflect the income of related taxpayers.

Other recent developments involve trying to create a blacklist of tax havens and a set of regulations about disclosure. Tax shelter promoters are now required to register confidential corporate tax shelters. Promoters also have to maintain a list identifying each investor who has bought an interest in a potentially abusive shelter. Corporate taxpayers who participate in a tax shelter are also required to report their participation to the IRS.

The new disclosure requirements have received a lot of criticism from various directions for involving too many transactions in the reporting requirement. The legislation is also unclear and creates uncertainty. This will lead to excessive work for taxpayers as well as the IRS.

An Office of Tax Shelter Analysis will be created to handle all information about tax shelters and there will be penalties for both taxpayers and promoters who do not follow the new disclosure regulations.

The OECD is an organisation active in the fight against harmful tax competition. Their work involves setting criteria for identifying and listing potentially harmful tax regimes. The criteria they use are not too different from the ones used by the United States. The main difference between the OECD and the United States is the focus by the OECD on countries and their tax systems and the focus by the United States on the individual taxpayer.

Preface

I would like to thank my supervisor, Professor Sture Bergström and my ssistant upervisor, Anette Bruzelius. Their help and guidance during the writing of this thesis has been very valuable.

I would also like to thank Lars-Erik Wenehed for allowing me access to the library at Comtax in Helsingborg and Susanna Korth for proof reading this thesis.

Finally I would just like to say that this has been an interesting topic to write about and I hope that the readers will find it interesting as well.

Magnus Lovén

Abbreviations

APA	Advance Pricing Agreement
CFC	Controlled foreign Corporation
FIC	Foreign Investment Income Companies
FPHC	Foreign Personal Holding Companies
LOB	Limitation On Benefits
IRC	Internal Revenue Code
IRS	Internal Revenue Service
OECD	Organisation for Economic Co-operation and Development.
PFIC	Passive Foreign Investment Income Companies
PHC	Personal Holding Companies
SvSkT	Svensk Skattetidning
U.S.	United States

1 Introduction

The first federal income tax the United States levied on its citizens was adopted in 1864.[1] Since then a lot of things have happened in the field of taxation. The tax rates have increased for individuals as well as for corporations and today's global economy with multinational corporations and computers that can move money all around the world with a single click on a button has created increased opportunities for tax evasion.

To prevent tax evasion and tax avoidance governments world-wide have had to create ways to counter this problem. The United States has been very active in this area and was the first country to implement legislation on Controlled Foreign Corporations. The United States has continued on this path and recently implemented its new disclosure legislation.

1.1 Purpose

The purpose of this thesis is to give an overview of how the United States tackles the problem of harmful tax competition. The thesis will investigate and comment on what the United States has done in recent years. This work will further compare the approach by the United States to the approach by the OECD.

1.2 Limitation

This thesis will focus on the latest developments in the United States. A few of the more important pieces of legislation have been chosen as all of the legislation that affects tax shelters and tax havens have not been possible to bring up. Out of the legislation chosen, focus has been put on the disclosure section. The OECD will only be used as a comparison and will not be thoroughly commented on.

1.3 Method

This thesis is based on accepted legal material. This includes books, articles, and sections of the Internal Revenue Code. I have further used posted reports and articles on the OECD, the IRS, and the Treasury Departments homepages to get the latest developments. I have also made sure that my material is up to date by visiting the Boalt Hall Law Library in Berkeley, CA.

[1] Ault Hugh J, Comparative Income Taxation:A structural analysis, 1997, p. 131.

1.4 Outline

This thesis will start by giving a general overview of international taxation in the United States where its distinctive traits are explained. The work by the OECD in the area of tax competition will also be briefly examined. The thesis continues by explaining some of the more important and recent ways the United States has chosen to counter harmful tax competition. Special attention is given to the regulations on disclosure. In chapter six the United States and the OECD approach is compared and in chapter seven some final thoughts are given.

2 The United States International Taxation in General

The international taxation in the United States is influenced by its foreign policy objectives. One of those objectives is achieving tax neutrality.[2] A tax system is tax neutral if it neither discourages nor encourages a particular activity. This is usually done through capital-export neutrality, capital-import neutrality or national neutrality. Capital-export neutrality ensures that a taxpayer´s choice of investing abroad or at home is not affected. Capital-import neutrality ensures that all firms doing business in a market are taxed at the same rate. National neutrality ensures that the total U.S. returns on capital which are shared between the taxpayer and the U.S. Treasury, are the same whether the capital is invested in the United States or abroad. The U.S. tax system has elements of all three standards of neutrality.[3]

The United States income tax is a global tax based on nationality that taxes its citizens and residents regardless of source or type of income. This means that United States citizens and corporations are taxed on their income no matter where on earth it was earned, although primary taxation authority is generally given to the country of territorial connection.[4]

To prevent double taxation, the United States uses a foreign tax credit system that allows U.S. taxpayers to reduce the U.S. income tax on their foreign income taxes that they pay on that income. Foreign taxes can only be credited against U.S. taxes on foreign sourced income and do not reduce taxes on U.S. sourced income. There is further a foreign tax credit limitation in the fact that tax credits are calculated separately for different categories of income in so called "tax credit baskets". Each basket can only be used against taxes of the same kind. Taxes not used to deduct U.S. taxes one year can be used up to five years later.[5]

One last distinctive trait worth mentioning about the United States is the extremely low audit rate. There was in 1995 only a 1.67 percent chance that a tax return from an individual would be audited.[6] Larger corporations were audited between 20 and 50 percent of the time depending on the size of their assets. The low audit rate together with the fact that American tax payers

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[2] Description and Analysis of Present-Law Rules Relating to International Taxation, Joint Committee on Taxation, JCX-40-99, june 28 1999.
[3] Abrams Howard E and Doernberg Richard L, Essentials of United States Taxation, 1999, p. 4-3 – 4-5.
[4] Doernberg Richard L, International Taxation in a Nutshell, third edition, 1997, p. 9.
[5] Description and Analysis of Present-Law Rules Relating to International Taxation, House Committee on Ways and Means, june 30 1999, p. 5.a—5.b.
[6] Ault Hugh J, Comparative Income Taxation:A structural analysis, 1997, p. 147.

tend to be both aggressive and resourceful in their tax planning creates a dangerous combination. It was estimated that in 1992 individuals only paid approximately 83 percent of taxes actually owed.[7]

[7] Ault Hugh J, Comparative Income Taxation:A structural analysis, 1997, p. 148.

3 The OECD and Harmful Tax Competition

The OECD is an international organisation consisting of 30 member states[8]. It is meant to be a setting in which governments can discuss, develop, and perfect economic and social policy. Its member states produce two thirds of the world's goods and services and the organisation carries a lot of weight in the international community.[9] This is why it is such a good forum for discussing harmful tax competition. The United States, who is a member, realizes that it can not stand alone in the fight against harmful tax competition and takes an active role in the OECD as a complement to its internal legislative efforts.

The OECD provides a forum for co-operation and analysis by national tax authorities to prevent double taxation, to minimise tax avoidance, evasion and competition and to reduce tax-induced distortions of trade and investment flow*s*. Its work so far includes the OECD Model Tax Convention, intra-enterprise Transfer Pricing Guidelines, and co-operation with non-OECD countries to extend OECD norms and standards outside the OECD area.

In 1998 the OECD published a report on harmful tax competition.[10] The 1998 report resulted in the creation of a number of guidelines and recomendations. The report also resulted in the creation of the OECD Forum on Harmful tax practices. In 2000 The Forum went on to issue a report[11] that sets out the progress made in identifying and curtailing harmful tax practices both within and outside the OECD.[12] The report identifies potentially harmful tax preferential regimes and jurisdictions meeting the criterias in the 1998 report. The OECD hopes that this report will encourage a process of dialogue and consultation and possibly a decline of harmful tax competition in the future.[13]

The OECD lists four key factors in identifying tax havens for the purpose of its 1998 report.[14] They are the presence of no or nominal taxes, lack of

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[8] Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Island, Italy, Japan, Korea, Luxemburg, Mexico, The Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and The United States.
[9] http://www.oecd.org/about/general/index.htm 2001-04-03
[10] Harmful Tax Competition : An emerging global issue, OECD, 1998.
[11] Progress in Identifying and Eliminating Harmful Tax Practices, OECD, june 2000.
[12] http://www.oecd.org/media/release/nw00-66a.htm 2001-04-04
[13] OECD Supports U.S. Governments Tax Haven Blacklist, Tax Notes International, april 10 2000, p. 1661.
[14] Harmful Tax Competition: An emerging global issue, OECD, 1998, p. 23.

effective exchange of information, lack of transparency and no substantial activities. The most important factor is the tax rate.[15]

The OECD also mentions four key factors in identifying and assessing harmful preferential tax regimes.[16] They are the presence of no or effective tax rates, ring fencing of regimes, lack of transparency and lack of effective exchange of information.

[15] Harmful Tax Competition: An emerging global issue, OECD, 1998, p. 22.
[16] Harmful Tax Competition: An emerging global issue, OECD, 1999, p. 27.

4 The United States Struggle to Counteract Tax Havens

4.1 Controlled Foreign Corporations

The United States was the first country to implement legislation about so called Controlled Foreign Corporations (CFCs) and has been the world leader in the area ever since.[17] This means that specific regulations, under special circumstances, let the IRS tax a shareholder on the income of a foreign company, even though the shareholder has not yet recieved any dividends from that company. This kind of legislation is especially needed in the United States because they tax their citizens on their worldwide income.[18] Without the regulations on CFCs it would be easy for an American citizen to postpone taxation on his international investments by accumulating and hiding income in foreign companies located in different low tax countries.

The CFC legislation consists of different sets of rules that are ment to counter different kinds of abusive corporations and tax schemes**.** They have been implemented at different times and all work together to form the network of today. The first CFC legislation called PHC[19] was enacted in 1934 and shortly afterward was expanded into the FPHC[20]. This first set of tax rules was relatively easy to evade which led to the enactment of Subpart F[21] and the FIC[22] in 1962.[23] The latest development occured in 1986 with the enactment of PFIC[24].

An American company with at least sixty percent passive income and owned by five or fewer American shareholders having at least 50 percent voting or value power is caught under the PHC rules.[25] According to the PHC a company is taxed on its taxholders undistributed dividends and the shareholder is taxed on dividends leading to double taxation. The PHC did not affect investments through foreign companies and the need for further legislation became obvious. The enactment of the FPHC regulations meant that American shareholders now could be taxed directly on their investments in foreign companies.[26] The legislation was however only affecting

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[17] Wenehed, CFC-Lagstiftning, 2000, p. 239.
[18] Wenehed, CFC-Lagstiftning, 2000, p. 240.
[19] Personal Holding Companies. IRC Sec. 541-547.
[20] Foreign Personal Holding Companies, IRC Sec. 551-558.
[21] Named from its place in the IRC(See Wenehed, 2000, p. 260). IRC Sec. 951-964.
[22] Foreign Investment Income Companies. IRC Sec. 1246.
[23] Price Waterhouse, U.S. corporations doing business abroad, 1992, p. 17.
[24] Passive Foreign Investment Companies. IRC Sec. 1291-1298.
[25] Wenehed, CFC-Lagstiftning, 2000, p. 245-249.
[26] Moore and Outslay, U.S. Tax Aspects Of Doing Business Abroad, 2000, p. 332.

companies controlled directly by individuals. Taxation could be avoided by using a foreign corporation as an intermediary.[27]

Subpart F includes both corporations and individuals. To tax the shareholder under the subpart F provisions, more than 50 percent of the total combined voting power of the stock, or more than 50 percent of the stock´s total value need to be owned by United States shareholders.[28] A shareholder in the sence of the subpart F regulation is any United States person who own at least 10 percent or more of the total combined voting power of the corporate stock.[29] If these tests are fulfilled the shareholder must include in their income their pro rata share of the CFCs subpart F income and other income stated in the IRC Sec. 951(a).[30]

The FIC regulations was implemented together with subpart F to try to tax foreign investment companies. The FIC taxation has however since then been replaced by the PFIC regulations. A PFIC is a foreign corporation who meets either a gross income test or an asset test.[31] The gross income test is met if 75 percent or more of the gross income of the foreign corporation is passive income. Passive income is income that would be foreign personal holding company income according to the IRC § 954(c).[32] The asset test describes a PFIC as a corporation with at least 50 percent of the corporation´s assets (by value) held for the production of passive income.[33] The PFIC regulations are special in that they do not mention anything about the size of american ownership.[34] The shareholders also find themselves in a special situation, since they have the option to chose between when to pay the tax under PFIC. The shareholder can choose to be taxed on a running basis on the corporations income, to be taxed on unusually large dividend payments or be taxed when stocks are sold. The choise of postponed taxes involves payment of interest.

The fact that a shareholder has been taxed on didvidends not yet distibuted means that he will not be taxed again when he eventually recieves the dividends to avoid double taxation except under PHC taxation. The shareholder also recieves a foreign tax credit for any taxes payed in the country of residence for the foreign corporation.[35]

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[27] Wenehed, 2000, p.280.
[28] IRC Sec. 957(a).
[29] IRC Sec. 951(b).
[30] See also Moore and Outslay, U.S. Tax Aspects Of Doing Business Abroad, 2000, p. 279.
[31] IRC Sec. 1297(a).
[32] IRC Sec. 1297(a) and § 1297(b)(1). See also Moore and Outslay, 2000, p. 357.
[33] IRC Sec. 1297(a)(2). See also Ault and McDaniel, Introduction to United States International Taxation, 1998, p. 192.
[34] Abrams and Doernberg, Essentials of United States Taxation, 1999, p. 195.
[35] Ault and McDaniel, Introduction to United States International Taxation, 1998, p. 110 and 117.

4.2 Treaty Shopping and the Limitation on Benefits Clause

A tax treaty between two countries is most commonly used to avoid international double taxation.[36] However a treaty can also contain articles aimed at avoiding treaty shopping or other forms of treaty abuse. One such article is article 22 concerning limitation on benefits (LOB) in the 1996 United States model income tax convention. This is the United States way to prevent so called treaty shopping. One way to define treaty shopping is to see it as ”the use, by residents of third S[t]ates, of legal entities established in a Contracting State with a principle purpose to obtain the benefits of the tax treaty between the United States and the other Contracting State”.[37]

Without an LOB article the United States would end up with a treaty with the world, including countries it had never entered or intended to enter any agreements with, as soon as they signed any tax treaty with another country. To avoid this situation it is nowadays customary to include an LOB clause in all new tax treaties entered into, and to renegotiate all treaties allready in force lacking this article.[38]

Once an LOB article is in force a resident of a contracting state does not automaticly qualify for treaty protection. A resident must pass a LOB test every year and treaty benefits can be excluded both from the other treaty country as well as from the country of residence. This means that the United States can deny its own residents benefits such as non-discrimination and relief from double taxation.[39]

The LOB test means that a resident must meet one of a number of alternative conditions.[40] Individuals, public entities, companies regularly traded on recognized stock exchanges, tax exempt organizations and pension funds are qualified.[41] A legal entity not yet qualified under article 22(2) can try to meet an ownership and base erosion test which must both be satisfied.[42] Under the ownership test the legal entity must be owned, directly or indirectly, by persons who themselves are entitled to treaty benefits under article 22(2), by at least 50 percent. The base erosion test is intended to make sure that the tax base is not eroded by requiring that less than 50 percent of the entity´s income is payed to nonresidents as deductible payments.

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[36] Weeghel, The improper use of tax treaties, 1998, p. 257.

[37] Doernberg and Raad, The 1996 United States Model Income Tax Convention:Analysis, commentary and comparison, 1997, p. 172.

[38] Cunningham, Article 23 of the Proposed United States – Ireland Tax Treaty, International Bureau of Fiscal Documentation, vol. 51 no. 12 1997 , p. 547.

[39] Stitt and Yu, Has the Chase to End Treaty Abuse Gone too Far?, Tax Notes International, September 4 2000, p. 1058.

[40] Article 22, U.S. 1996 Model Income Tax Convention.

[41] Article 22(2)(a - e) U.S. 1996 Model Income Tax Convention.

[42] Article 22(2)(f) U.S. 1996 Model Income Tax Convention.

Taxpayers that has not yet satisfied any of the tests may, if passing three requirements, recieve treaty benfits with respect to certain income connected to active trade or business.[43] The resident must be engaged in an active trade or business and the income must be connected to that trade or business. The trade or business must also be substantial in relation to the activity in the other State generating income.

If a corporation still do not qualify, there is a last option to apply for treaty benefits from the competent authority of the state where the benefits are applied for.[44]

Just because a corporation or income is qualifyed according to article 22 does not however mean that benefits will be automaticly recieved. Any requirements in the individual articles entitling benefits must still be investigated.

The LOB article has recieved some criticism for going too far and create problems for, or even discriminate against U.S. corporations owned by third-country residents.[45] These companies will never meet the publicly traded or ownership and base erosion tests and ”whether a resident meets the ”trade or business test” can sometimes be a subjective determination”[46]. There is a risk that even legitimate U.S. companies will be left with relief from the competent authority as their only way out, just because they are owned by non-residents.

4.3 Intercompany pricing

The regulation on intercompany- or transfer- pricing is found in IRC Sec. 482 where it has been found, although in different versions, since 1921.[47] Today the paragraph authorizes the IRS to allocate gross income, deductions and credits between related taxpayers to the extent necessary or to clearly reflect the income of related taxpayers. The paragraph can only be used by fiscal authorities and its use does not require a purpose of tax avoidance from the taxpayer.

To avoid allocation of funds, related corporations need to perform transactions at an arm´s length basis.[48] This means that a transaction

[43] Article 22(3) U.S. 1996 Model Income Tax Convention.
[44] Article 22(4) U.S. 1996 Model Income Tax Convention.
[45] Stitt and Yu, Has the Chase to End Treaty Abuse Gone too Far?, Tax Notes International, September 4 2000, p. 1059.
[46] Stitt and Yu, Has the Chase to End Treaty Abuse Gone too Far?, Tax Notes International, September 4 2000, p. 1059.
[47] Ault and McDaniel, Introduction To United States International Taxation, 1998, p. 139.
[48] Abrams and Doernberg, Essentials of United States Taxation, 1999, p.139.

between related corporations[49] is compared to how a similar transaction between unrelated corporations[50] would be handled. That is at arms length.

To compare a controlled transaction to an uncontrolled transaction one needs to look at different factors and use different methods depending on the situation. There are a number of methods to chose from, and according to the best method rule the goal is to select the method that will provide the most reliable data and measure of comparability.[51] The controlled transaction does not have to be identical to the uncontrolled transaction, but must be ”significantly similar to the controlled transaction so that the uncontrolled transaction provides a reliable measure of an arm´s length result”[52].

Any chosen method may result in a range of results and it is up to the corporation to choose a result from within that range. However should the result chosen fall outside the range the IRS may make adjustments based on any value within the range.[53]

The Regulations list five methods to use in the case of transactions involving tangible property and three methods to use in the case of transactions involving intangible property. The corporation may also choose to use an unspecified method. This method may however come under harder scrutiny and be more likely to be subject to penalties.

The first method concerning tangible property[54] is the comparable uncontrolled price method, where price and the similarity of the product are compared with uncontrolled transactions. The next method is the resale price method. Here you compare the gross profit margin of sales in uncontrolled transactions and the resale price for the related party. The difference is the transfer price on the related sale. Under the cost plus method the cost of goods sold is found in the use of normal accounting principles followed by an appropiate gross profit markup. The next named method regarding tangible property is the comparable profits method. This method looks at the profit level indicators of uncontrolled parties and uses an equivalent level of profits for controlled parties. The last metod is the profit split method where one examines the combined profit or loss, and allocate this to each member of the party, depending on the level of contribution to the profit or loss.

[49] Controlled transactions.
[50] Uncontrolled transactions.
[51] Treas. Reg. Sec. 1.482-1(c).
[52] Fuller, International Tax Developments, International Bureau Of Fiscal Documentation, No. 7/8 1995, p. 302.
[53] Treas. Reg. Sec. 1-482(e) and Ault and McDaniel, 1998, p. 142.
[54] Treas. Reg. Sec. 1-482-3(a).

Intangibles[55] are much harder to compare resulting in difficulties finding an arm´s length price.[56] The comparable uncontrolled transaction method is similar to the comparable uncontrolled price method as it try to find the charge for comparable uncontrolled transactions. The next methods are the comparable profits method and the profit split method which work the same way as for the tangible property.

Should the taxpayer report a price that is 200 percent higher or 50 percent lower than the ”correct price”, according to the best method, he is said to have made a ”substantial valuation mistreatment”.[57] This is also the case if the total intercompany pricing adjustment exceeds the lesser of $5.000.000 or 10 percent of the taxpayer´s total gross receipts. A substantial valuation mistreatment means that the IRS will impose a 20 percent penalty on the taxpayer. If the taxpayer is found to have made a gross valuation mistreatment instead, he will suffer a 40 percent penalty. This is the case if the price used is 400 percent higher or 25 percent lower than the ”correct price” or the total adjustment is the lesser of $20.000.000 or 20 percent of the taxpayer´s gross receipts.

Any penalties due to a wrongfully reported income or cost may be avoided if the taxpayer has acted in good faith or had reasonable cause for the statement.[58] Penalties may be ”avoided if the taxpayer ´reasonably` (though wrongly) used one of the stipulated methods and has contemporaneous documentation supporting the method chosen and why such method was reasonable”[59].

The risk of being hit by these severe penalties forces companies to spend a lot of money on investigating and documenting the best method and making sure that they follow the intercompany pricing regulations. This is something that may be especially hard for smaller companies who work internationally and do not have the resources to perform a thorough and costly investigation.

Due to the uncertainty and the risks involved in chosing intercompany pricing methods it is possible to obtain an Advance Pricing Agreement[60]. Here the company may obtain an advance ruling allowing them to use a specific proposed methodology for a certain period of time without the risk of penalties.[61] This procedure may take up to 12 months and will most likely be costly.[62]

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[55] Treas. Reg. Sec. 1-482-4(c).
[56] Ault and McDaniel, Introduction to United States International Taxation, 1998, p. 146.
[57] IRC Sec. 6662.
[58] IRC Sec. 6664.
[59] Ault and McDaniel, Introduction to United States International Taxation, 1998, p.154.
[60] APA.
[61] Abrams and Doernberg, Essentials of United States Taxation, 1999, p. 169-170.
[62] Bjarnås Sören, Global taxering enligt en amerikansk modell-en rapport från USA om utvecklingen inom internprissättningsområdet, SvSkT. 6-7/1994, p. 444.

Further complications may occur if the tax offices in other countries do not agree with the IRS and their way of allocating income. If an agreement can not be reached the company may be hit by double taxation.

4.4 Blacklisting

One of the more exciting developments in recent years in the fight against tax havens was the attempt by former President Bill Clinton to establish a blacklist for tax havens. The Presidents budget proposal for the 2001 fiscal year, released on February 7, 2000, would have given the U.S. Treasury department the power to publish a list of identified tax havens.[63] The proposal was not found in the final budget which was later passed by the Congress of the United States. Despite this it is still interesting to investigate what the proposal contained and the effects it could have had.

The Treasury Department would have been given almost free hands to create the blacklist. The criteria used to determine a country´s status ”would include, but ”not be limited to,” the following two factors: (1) whether the jurisdiction imposes no or nominal taxes, either generally or on a specific class of capital income, and (2) whether the country has strict confidentiality rules and/or ineffective information exchange practices.”[64].

A country that ended up being blacklisted could waive its confidentiality rules on tax information or enter into an agreement to exchange tax information, and thereby be taken off the blacklist. This is a conveniant move that would ensure that manufacturing tax havens like Ireland would never show up on any blacklist.[65]

All monetary transactions as well as transfers of tangible and intangible property from the United States to a blacklisted country would have to be reported on the different taxpayers tax returns. A failure to comply with this obligation would result in a 20 percent penalty. Payments under the amount of US $10.000 would not fall under the reporting requirements. For larger amounts the taxpayer could assure that payment information would be available to the U.S. Internal Revenue Service upon request to be excused from reporting.[66]

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[63] Goulder, U.S. Budget Would Blacklist Tax Havens, Tax Notes International, Feb. 14 2000, p. 699.
[64] Goulder, U.S. Budget Would Blacklist Tax Havens, Tax Notes International, February 14 2000, p. 699.
[65] Sheppard, U.S. Budget Business Provisions:A blacklist for havens, Tax Notes International, February 21 2000, p. 815.
[66] Goulder, U.S. Budget Would Blacklist Tax Havens, Tax Notes International, February 14 2000, p 699.

The U.S. would further deny any foreign tax credits that could have been the result from taxes paied in a tax haven. A separate foreign tax credit basket[67] would be created that would separate taxes paied in tax havens from taxes paied in other countries not named on the blacklist.[68] The result would be double taxation and comparing tax havens with countries associated with international terrorism, since the U.S. already denies tax credits for taxes paid to countries like Libya and Iraq.[69]

The OECD has made possitive comments on the blacklist proposal from the United States. The OECD finds that the proposal is in line with current OECD work in the area, and that ”The criteria the Treasury would use to determine what countries are tax havens mirror those factors the OECD has developed and widely publiziced.”[70].

4.5 Disclosure

4.5.1 Overview

The recent regulations on disclosure are the United States latest effort to stop the rapid growth of abusive corporate tax shelters, which Treasury Secretary Lawrence H. Summers sees as ”the most serious compliance issue threatening the American tax system today”[71]. The global economy and rapid technological advances like the internet has made it relatively easy for corporations and individuals to move money undetected around the world. For example it is estimated that more than 80 percent of the internet sites promoting so-called asset protection are advocating tax fraud.[72]

Governments today need to find a way to find out about these international fraudulent schemes and transactions to protect their tax revenues. There are calculations that shows that cracking down on tax shelters could raise as much as $22.9 billion over 10 years in the United States alone.[73]

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[67] See ”The United States International Taxation In General” for information on tax credit baskets.
[68] Sheppard, U.S. Budget Business Provisions:A blacklist for havens, Tax Notes International, February 21 2000, p. 815.
[69] Goulder, U.S. Budget Would Blacklist Tax Havens, Tax Notes International, February 14 2000, p. 700.
[70] Goulder, OECD Supports U.S. Government´s Tax Haven Blacklist, Tax Notes International, April 10 2000, p. 1660.
[71] Tackling The Growth of Corporate Tax Shelters:Treasury Secretary Lawrence H. Summers remarks to the federal bar association, Washington DC, Treasury News from the Office of Public Affairs, february 28 2000, p. 1.
[72] Lupi-Sher L. David, The U.S. IRS´s Fight Against Abusive Offshore Trusts, Tax Notes International, 17 july 2000, p. 177.
[73] Consider Shelter Crackdown Seperately: Summers Urges U.S. Taxwriters, Tax Notes International, February 21 2000, p. 859.

It is hard to create an exact definition of a corporate tax shelter. There are however a few characteristics that are often found upon closer examination.[74] A lack of any significant economic substance or risk to the participating parties, or the fact that the financial accounting treatment of a shelter item has been inconsistent with the claimed Federal income taxes, may point towards a corporate tax shelter. So does the use of tax indifferent parties, high transaction costs, contingent or refundable fees, confidentiality and the possibility to sell the same shelter product to several customers.

The previous efforts by the IRS, the Treasury and Congress to stop corporate tax shelters were not enough. Most attacks on the corporate tax shelters targeted specific transactions on an ad hoc basis using legislation, administrative guidance and litigation. Although a significant number of visible shelter and transaction schemes were closed down as they were discovered, new ones were created to replaced the old ones, and a significant number were never even discovered at all.[75] This approach also had disadvantages as it was time consuming, costly, complicating the tax law and creating uncoherent legal cases. After a while taxpayers were able to pick between the different court cases to find rulings to justify their actions.[76]

The current approach consists of a set of regulations that are ment to work together and simultaneously attack the corporate tax shelters from different directions. Promoters are forced to register confidential corporate tax shelters and to maintain lists of investors. Corporate taxpayers are required to disclose large transactions that have characteristics common to corporate tax shelters and penalties for non compliance with the regulations will be increased. The IRS has also created an Office of Tax Shelter Analysis that will focus on this problem area and review information gathered through the new regulations.

4.5.2 Corporate Tax Shelter Registration

The IRC section 6111 requires the registration of confidential corporate tax shelters by their promoters. The registration is supposed to be done before the first offering of sale in such shelters occurs. Any offer to participate is treated as an offer of sale. This will give the IRS information on all new shelters as soon as they pop up which allows the IRS a chance to scrutinize and crack down on abusive shelters right away.

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[74] The Problem of Corporate Tax Shelters:Discussion, Analysis and Legislative Proposals, Department of the Treasury, july 1999, p. v-vi.

[75] Tackling The Growth of Corporate Tax Shelters:Treasury Secretary Lawrence H. Summers remarks to the federal bar association, Washington DC, Treasury News from the Office of Public Affairs, february 28 2000, p. 2.

[76] Penalty and Interest Provisions, Corporate Tax Shleters: Acting Assistant Secretary Jonathan Talisman before the Senate Committee on Finance, March 8 2000.

A promoter includes tax shelter organizers and any other person who participates in the organization, management or sale of a tax shelter, or any person related to such tax shelter organizer or such other person. Should there be no domestic promoters and no foreign promoters have registered the shelter, any domestic person who even discusses participation in the shelter must perform the registration.[77]

To qualify as a confidential corporate tax shelter that demands registration under section 6111 there are three requirements that all needs to be satisfied. First of all a significant purpose of the structure of the transaction needs to be the avoidance or evasion of Federal income tax. Further the transaction should be offered to any potential participants under conditions of confidentiality. The last requirement is that the promoter could receive fees in the excess of $100.000.

The avoidance or evasion of Federal income tax is considered a significant purpose of the structure of a transaction if the transaction is the same as, or substantially similar, to one of the specified types of transactions that the IRS has determined to be a tax avoidance transaction. So is the case if the present value of the participant´s reasonably expected pre-tax profit from the transaction is insignificant relative to the present value of the participant´s expected net Federal income tax savings from the transation.[78] The last situation when tax evasion is the significant purpose is when the transaction has been structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction, and the tax shelter promoter reasonably expects the transaction to be presented to more than one potential participant.[79]

Reporting is however not required if the participant enters into the transaction as part of the ordinary course of business and it is clear that the transaction and tax reduction is allowed in the IRC for this reason. Avoidance of Federal income tax also does not require reporting if the promoter determines that it is beyond all doubt that the benefits from the transaction would not be allowed. In the case of doubt a promoter has two options. He may request a ruling from the IRS as to wether the transaction needs to be registered or not, or he can register the shelter and add that it is being filed on a protective basis.[80]

When determining whether an offer of sale is made under confidentiality all facts and circumstances are looked upon. Confidentiality may exist even without legally binding oral or written agreements. Implied understandings

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[77] Coporate Tax Shelter Registration, Federal Register, vol. 65 no. 42, march 2 2000, temporary regulations, T.D. 8876, p. 11217.
[78] Also called the significant purpose test.
[79] Coporate Tax Shelter Registration, Federal Register, vol. 65 no. 42, march 2 2000, temporary regulations, T.D. 8876, p. 11215-11216.
[80] Coporate Tax Shelter Registration, Federal Register, vol. 65 no. 42, march 2 2000, temporary regulations, T.D. 8876, p. 11216.

or the fact that the promoter is aware that the transaction is protected from disclosure in any other way is enough. A written agreement between the participant and the promoter, that waives all confidentiality and shows that the transaction is not made under conditions of confidentiality may sometimes be the only way out.[81]

All facts and circumstances are also looked upon when determining whether a promoter receives fees in excess of $100.000, which is assumed unless the promoter proves otherwise. All fees or part of fees with any connection to the confidential corporate tax shelter are considered.[82]

Registration of a confidential corporate tax shelter involves providing a detailed description of the tax shelter, including the structure of the tax shelter and the tax benefits.[83]

4.5.3 Maintaining Lists

The IRC section 6112 requires any person who organizes or sells any interest in a potentially abusive tax shelter to maintain a list identifying each investor who has bought an interest in that potentially abusive shelter.

A potentially abusive tax shelter under the IRC section 6112 is a transaction for which a significant purpose of the structure of the transaction is the avoidance or evasion of income tax. This includes any shelter that is registered under the IRC section 6111 and any other entity, plan or arrangement, if specified in regulations, that has a potential for tax avoidance or evasion.

There is no requirement that a promoter must make §100.000 in fees or that the transaction should be subject to confidentiality as under the confidential corporate tax shelter regulations. This means that a transaction may be subject to the listed requirement but not the registration requirement.

As under the IRC section 6111 a procedure excists for obtaining an advance ruling as to wether a list needs to be maintained.

The list is supposed to be made available upon request from the Secretary of the Treasury and the information must be saved at least seven years. The information required on the list includes a detailed description of the tax shelter that describes both the structure of the tax shelter and the intended tax benefits for participants in the tax shelter, the amount of money invested or to be invested by each person, a summary of likely tax benefits for each

[81] Coporate Tax Shelter Registration, Federal Register, vol. 65 no. 42, march 2 2000, temporary regulations, T.D. 8876, p. 11216.
[82] Id.
[83] Id.

investor and copies of any additional written material. Each list must also identify every other tax shelter that the organizer offers that presents a somewhat similar structure or tax benefit.[84]

4.5.4 Requiring Corporate Taxpayers to Report Participation in Tax Shelters

The IRC section 6011 requires any corporate taxpayer that has participated in a reportable transaction, to file a disclosure statement together with their Federal income tax return if the their income tax is affected by this transaction. The first time a disclosure statement is filed a copy must also be sent to the IRS Office of Tax Shelter Analysis in Washington. Reportable transactions are ”listed transactions” and ”other reportable transactions”.

Listed transactions are transactions identified in IRS Notice 2000-15 and transactions that are similar to the ones on the list. The transaction must however reduce the taxpayers Federal income tax by more than $1 million in any single year or by a total of more than $2 million for any combination of tax years to be treated as a reportable transaction.[85]

Other reportable transactions are transactions that will reduce the Federal income tax by more than $5 million in any single year, or by a total of $10 million for any combination of years, and has at least two out of six listed characteristics.[86]

These characteristics are:

1. The taxpayer has participated in the transactions under conditions of confidentiality.
2. The taxpayer has obtained or been provided with certain contractual protections.
3. The promoter has received at least $100.000 in fees.
4. There is a difference of at least $5 million between book income and income tax treatment.
5. The characterisation of transaction for Federal income tax purposes differs from the expected characterisation for tax purposes in another country

[84] Coporate Tax Shelter Registration, Federal Register, vol. 65 no. 42, march 2 2000, temporary regulations, T.D. 8875, p. 11211-11212.

[85] Cryan, Erickson, Keenan and Su, A Guide to the New Corporate Tax Shelter Regulations, Tax Notes, vol. 87 nr. 1, april 3 2000, p. 107-108.

[86] Coporate Tax Shelter Registration, Federal Register, vol. 65 no. 42, march 2 2000, temporary regulations, T.D. 8877, p. 11205-11207.

A transaction that has at least two of the previous characteristics is however not a reportable transaction if it also has one out of four other distinctive traits.[87] This does not affect listed transactions in IRS Notice 2000-15.

Non-reportable transactions:
1. The taxpayer has participated in the transaction in the ordinary course of business and would have participated even without tax benefits.
2. The taxpayer has participated in the transaction in the ordinary course of business, and there is a understanding that tax benefits from the transaction are allowable under the IRC for the same reasons.
3. There is no reasonable basis for denial of the tax benefit.
4. The transaction is identified in published guidance as being excepted from discloure.

The taxpayer must keep all records related to the transaction until the expiration of the statute of limitations. This includes marketing materials, written analyses, correspondence and so on.[88]

4.5.5 Penalties

A corporation or a promoter can be subject to penalties for not following the disclosure provisions.

If a promoter fails to register a confidential corporate tax shelter he could be penalised by an amount equal to the greater of 50 percent of the fees paid to all promoters of the tax shelter or $10.000. If the failure to register is deemed intentional the penalty will instead be 75 percent of the fees.[89]

If a promoter fails to maintain a list of investors in potentially abusive tax shelters he shall pay a penalty of $50 for each person that is not put on the list, unless the promoter can show that he had reasonable cause for his actions and that the failure was not due to willful neglect. The penalty shall not exceed $100.000 for any single calendar year.[90]

If a corporation can show that it has acted in good faith under the IRC Sec. 6664, penalties may be reduced or waived even though it has not acted according to the specified regulations. But if a corporate taxpayer fails to disclose its participation in a corporate tax shelter, and there is an underpayment of taxes, it may reduce or eliminate the corporations chances

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[87] Coporate Tax Shelter Registration, Federal Register, vol. 65 no. 42, march 2 2000, temporary regulations, T.D. 8877, p. 11205-11207.
[88] Coporate Tax Shelter Registration, Federal Register, vol. 65 no. 42, march 2 2000, temporary regulations, T.D. 8877, p. 11205-11207.
[89] IRC Sec. 6707.
[90] IRC Sec. 6708.

to show that it has acted in good faith, and it will most likely have to pay the penalties.[91]

4.5.6 Office of Tax Shelter Analysis

The new Office of Tax Shelter Analysis is expected to serve as a clearing house for all information relating to tax shelter activity. The activities of the office will include reviewing all disclosures under the new disclosure regulation, identifying participating taxpayers and assessing the overall extent of tax shelter activity by corporate taxpayers. The Office of Tax Shelter Analysis will also work to identify potentially improper tax shelter transactions at the earliest possible time.[92]

The IRS experts on tax shelters and their knowledge will be gathered at one place and it will be easier to keep a limited group of employees up to date with education etc. This group of people will work as a resource to use by other IRS offices around the country.

4.5.7 Comments

It was obvious that something had to be done to fix the problem with corporate tax shelters. The old ad hoc system was not a sustainable solution. The question is however if the new system has gone too far by putting too much pressure on legitimate companies and tax shelter promoters, and requiring disclosure in too many situations.

The new tax shelter disclosure regulations attack the problem by requiring people participating in corporate tax shelter transactions to create, maintain and provide the IRS with information about the transactions and people associated with the transactions. The new regulations has recieved a lot of criticism from various representatives of business organisations and law and accounting firms. There is a widespread concern that the regulations will hit a number of transactions that the legislator did not intend to hit.[93] This will create a lot of extra work for both businesses who need to supply information, and for the IRS who needs to review the information. Here will follow a few of the areas that have received the most criticism.

As mentioned earlier[94] corporate taxpayers must disclose their participation in reportable transactions. The ”two out of six” test to define ”other

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[91] Corporate Tax Shelter regulations:disclosure of reportable transactions, Tax Executive, july 2000, v52 i4 p. 307.
[92] Penalty and Interest Provisions, Corporate Tax shelters:Acting Assistant Secretary Jonathan Talisman before the Senate Committee on Finance, 8 March 2000, p. 12.
[93] Ayayo Herman P, U.S. Senate Finance Committee Releases Comments on Corporate Tax Shelter Draft, Tax Notes International, july 10 2000, p. 127.
[94] See 4.5.4.

reportable transactions" may however involve a lot of ordinary business transactions in the reporting requirement. Large corporations will for instance often have a book/tax difference greater than $5 million as defined in characteristic number four and the test will be a one in five test instead. The fifth test may further result in automatically making every transaction that involves a foreign party a reportable transaction since it is most likely that the foreign persons tax position will differ from that of an American. [95]

The list of non reportable characteristics is intended to remedy the excessive involvment of transactions under the "two out of six" test. The first characteristic is for instance intended to relieve transactions entered into during the ordinary course of business if the taxpayer would have participated even without the tax benefits. However, in too many transactions today, tax benefits are an important factor. The second and third characteristics are also problematic as to the uncertainty of the meaning of "understanding" and "reasonable basis".[96]

There has also been critisism aginst the tax shelter registration and the list maintenance regulations. The significant purpose test[97] has been attacked for being too narrow. The regulation treats a transaction as lacking economic substance if the reasonably expected pre-tax profits of the transaction are insignificant relative to the reasonable expected tax benefits. It is by many seen as wrong to focus on pre-tax profit as it should not be the only factor to be considered. It is also unclear as to how much profit could be insignificant, and no consideration is given to routine transactions that are not intended to produce a profit.[98]

The list maintenance regulation is among other things criticized for not containing minimum thresholds on tax savings or fees. The current system will involve a lot of ordinary tax planning that is of no real interest to the IRS.[99]

As we have recently seen the legslation is unclear and creates a great deal of uncertainty for taxpayers. This will most likely lead to excessive disclosure from taxpayers who just wants to be on the safe side. The IRS may find itself getting burried in information it neither needs nor wants. Valuable resourses will have to be used just sorting out the useful information from routine transactions.

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[95] Corporate Tax Shelter Regulations: disclosure of reportable transactions, Tax Executive, july 2000, v52 i4, p. 307.
[96] Grigsby McGee and Harrison Jack F, Walking the Tightrope: the new tax shelter disclosure regulations, Tax Executive, july 2000, v52 i4, p. 299.
[97] See 4.5.2.
[98] Grigsby McGee and Harrison Jack F, Walking the Tightrope: the new tax shelter disclosure regulations, Tax Executive, july 2000, v52 i4, p. 299.
[99] Id.

5 Comparing The United States and the OECD Approach

One clear distinction between the OECD and The United States approach to fight harmful tax competition is the focus by the OECD on the state where the investment is made and the focus by the U.S. on the taxpayer.

The OECD works by putting pressure on any states that exercise harmful tax competition. The OECD can not force any country to change their internal legislation but can put considerable political pressure on a single country. Cooperation and the creation of dialogue are important goals for the OECD as they try to convince countries to change their tax systems.

The OECD´s biggest strength is its member states. The organisation has a lot of the industrialized countries as members and they carry a lot of economic power. Their strenght is however also a weakness as it can be difficult for 30 member states to agree on an issue. It can be a slow process but will be easier after agreeing on the guidelines in the 1998 report.

The United States on the other hand can implement regulations with U.S interests in the forefront without taking too much consideration to other countries. This means that the United States can focus on how to best get their taxpayers to pay their taxes. This has been done by focusing on the taxpayer himself and specific transactions. The United States does not by itself try to convince other countries to change their taxation levels through internal legislation.

There was a try by the U.S. to create a blacklist of tax havens. This blacklist was however never created. The need for this blacklist seems to be only complementary to the other U.S. regulations on tax havens. If a country is in danger of ending up on the blacklist, transactions to that country would most likely be caught under other disclosure requirements anyway. It can also be more politicaly conveniant to attack a specific transaction than an independent country.

There are a number of advantages of going after your own taxpayers instead of other countries. It is much easier to enforce regulations agains your own taxpayers. You can use various coersion methods not otherwise available as they are within U.S. jurisdiction.

Looking at the actual regulations that characterize transactions that need to be disclosed and comparing them to the OECD factors that point towards a tax haven, one sees some similarities. The OECD finds that the most important factor to look at is the level of taxation. The U.S. regulations do not explicitly mention the taxation levels required to get out of reporting

requirements. Tax benefits from a transaction, which are important, are however most commonly received due to a lower taxation in the other country.

Both the United States and the OECD have in common that they do not focus on only one factor, they use several factors and look at the whole picture. Another circumstance that the OECD uses is the lack of effective exchange of information by tax haven jurisdictions. The United states investigates if a transaction is entered into under confidentiality. This involves confidentiality from the promoter and the transaction as a whole is investigated.

The OECD also investigates the absence of a requirement that the taxpayer activity is substantial as this may suggest that a jurisdiction may be attempting to attract investment and transactions that are purely tax driven.[100] The United States uses a significant purpose test and investigates if a significant purpose of the transaction is the avoidance of evasion of taxes. This test together with the exception of ordinary business transactions from reporting means that paper constructions are not sufficent since companies need to perform actual business activities in the country.

What kind of business activities a company performs are also an important factor in taxing a taxpayer under the CFC regulations and disqualifying taxpayers from tax treaty protection according to the limitation on benefits clause.

The different approaches to the same issue is due to the fact that the actual counteracting measures need to be taken at the national, rather than at the multilateral level. The OECD would go too far if it started taking far reaching meassures against harmful tax competition on a multilateral level and the United States would not have sole power to pressure other states. Since the Unites States is a member in the OECD it will also continue its work in that forum and put tax havens under pressure from another direction.

[100] Harmful Tax Competition:An emerging global issue, OECD, 1998, p. 24.

6 Final Comments

Since the United States taxes it´s citizens and corporations on their worlwide income, it is vital for the IRS to find out about about U.S. taxpayers foreign investments. What you do not know about you can not tax. This is why the new disclosure regulations are so important to the IRS.

The disclosure may also have secondary effects like helping with the compliance problem and reducing the disrespect for the tax code. If taxpayers have to report their beneficial foreign investments to the IRS they may be less likely to get involved in such transactions at all. The risk of getting audited may also increase for entering into such transactions which will further deter involvment.

The fact that promoters of tax shelters are also targeted and may suffer penalties may reduce the inventiveness by these promoters. It is however hard to tell about the future since taxpayers are very industrious. There will always be a demand for lowering taxes and people will always find ways to avoid regulations. The only questions is when that will happen.

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