Tax Havens: International Tax Avoidance and Evasion

Abstract *– The federal government loses both individual and corporate income tax revenue from the shifting of profits and income into low-tax countries, often referred to as tax havens. Tax havens are located around the world with concentrations in the Caribbean and Europe. Corporate profit shifting may cost up to $60 billion in revenue and remedies are likely to involve tax law changes. Individual income tax losses more often arise from tax evasion, and are facilitated by the lack of information reporting; remedies involve administrative changes, especially in requirements for information reporting. Losses may be as much as $70 billion per year.*

The federal government loses both individual and corporate income tax revenue from the shifting of profits and income into low-tax countries. The revenue losses from this tax avoidance and evasion are difficult to estimate, but the U.S. Senate Subcommittee on Investigations (2008) has suggested that the annual cost of offshore tax abuses may be around $100 billion per year. International tax avoidance can arise from wealthy individual investors and from large multinational corporations; it can reflect both legal and illegal actions.

Tax avoidance is sometimes used to refer to a legal reduction in taxes, while evasion refers to tax reductions that are illegal. Both types are discussed in this paper, although the dividing line is not precise. A multinational firm that constructs a factory in a low-tax country rather than in the United States to take advantage of low corporate tax rates and deferral of U.S. tax is engaged in avoidance, while a U.S. citizen who sets up a secret bank account in the Caribbean and does not report the interest income is engaged in evasion. Many activities, particularly by corporations, often referred to as avoidance, could be classified as evasion. One example is transfer pricing, where firms charge low prices for sales to low-tax affiliates but pay high prices for purchases from them. If these prices, which should be at arms-length, are set artificially to reduce total taxes paid, this activity might be viewed as evasion, even if such pricing is not overturned in court because evidence is lacking.

Most of the international tax reduction of individuals reflects evasion, and this amount has been estimated by Guttentag and Avi-Yonah (2005) at $40–70 billion a year. This

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evasion occurs in part because the United States does not withhold tax on many types of passive income (such as interest) paid to foreign entities; if U.S. individuals can channel their investments through a foreign entity and do not report these earnings on their U.S. tax returns, they evade a tax that they are legally required to pay. In addition, individuals investing in foreign assets may not report income from them. Estimates of corporate tax reductions also vary substantially, ranging from $10–60 billion.

In addition to the differences between corporate and individual activities and between tax evasion and avoidance, there are variations in the features used to characterize tax havens. Some restrictive definitions limit tax havens to those countries that, in addition to having low or non-existent tax rates on some types of income, also are characterized by a lack of transparency and information sharing, allow for bank secrecy, and require little or no economic activity for an entity to obtain legal status. The Organisation for Economic Development and Cooperation (OECD) used such a narrow definition in their tax shelter initiative. A broad definition might characterize as a tax haven any low-tax country with a goal of attracting capital, or simply any country that has low or non-existent taxes on capital income. This paper addresses tax havens in both their broader and narrower senses.

International tax avoidance issues can also be differentiated by the measures that might be taken to reduce the associated revenue losses. In general, revenue losses from individual taxes are associated with evasion and narrowly defined tax havens, while corporate tax avoidance occurs in both narrowly and broadly defined tax havens and can arise from either legal avoidance or illegal evasion. Evasion is often a problem of lack of information, and remedies may include resources for enforcement, increased information sharing, and possibly withholding. Avoidance may be more likely to be remedied with changes in the tax code.

Several legislative proposals address international tax issues, including proposals by President Obama, H.R. 3970 (110th Congress), the Stop Tax Haven Abuse Act (S. 506 and H.R. 1265, 111th Congress) arising out of investigations of the Senate Permanent Committee on Investigations, and draft proposals circulated by the Senate Finance Committee, with the Senate bills largely aimed at individual evasion. In addition, S. 386 (111th Congress) would include tax evasion in its money-laundering provisions and provide additional Justice Department funding, and S. 569 would require states to determine the beneficial owners of corporations formed under their laws.

The first section of this paper reviews what countries might be considered tax havens. The next two sections discuss corporate profit shifting mechanisms and evidence on the magnitude of profit shifting activity. The following two sections provide the same analysis for individual tax evasion. The paper concludes with overviews of alternative policy options.

I. WHERE ARE THE TAX HAVENS?

The Organization for Economic Development and Cooperation (1998) initially defined the features of tax havens as no or low taxes, lack of effective information exchange and transparency, and no requirement for substantial activity. Other lists are provided in legislative proposals and by researchers.

A. Formal Lists of Tax Havens

The Organisation for Economic Cooperation and Development (2000) created an initial list of tax havens. The same list, excluding the U.S. Virgin Islands, was used in S. 396 (110th Congress), which would treat firms incorporated in certain tax havens as domestic companies. The Stop Tax Haven Abuse Act (S. 506, H.R. 1265, 111th Congress) uses a list taken from IRS court filings, but has many countries in common with the OECD list. The OECD excluded some low-tax jurisdictions thought by many to be tax havens, such as Ireland and Switzerland. These countries were included in a study of tax havens by Hines and Rice (1994).

Table 1 shows 50 countries appearing on various lists, arranged by geographic location. These tax havens tend to be concentrated in certain areas, including the Caribbean and West Indies and Europe, locations close to large developed countries.

B. Developments in the OECD Tax Haven List

The OECD list, the most prominent list, has changed over time. Nine of the countries in Table 1 did not appear on the Organization for Economic Development and Cooperation (1998) list. Countries not appearing on the original list tend to be more developed larger countries, including some OECD members (e.g., Switzerland and Luxembourg). As dis-

Table 1
Countries Listed on Various Tax Haven Lists

Caribbean/West Indies	Anguilla, Antigua and Barbuda, Aruba, Bahamas, Barbados,[d,e] British Virgin Islands, Cayman Islands, Dominica, Grenada, Montserrat,[a] Netherlands Antilles, St. Kitts and Nevis, St. Lucia, St. Vincent and Grenadines, Turks and Caicos, U.S. Virgin Islands[a,e]
Central America	Belize, Costa Rica,[b,c] Panama
Coast of East Asia	Hong Kong,[a,b] Macau,[a,b] Singapore[b]
Europe/Mediterranean	Andorra,[a] Channel Islands (Guernsey and Jersey),[e] Cyprus,[e] Gibralter, Isle of Man,[e] Ireland,[a,b,e] Liechtenstein, Luxembourg,[a,be] Malta,[e] Monaco,[a] San Marino,[a,e] Switzerland[a,b]
Indian Ocean	Maldives,[a,d] Mauritius,[a,c,e] Seychelles[a,e]
Middle East	Bahrain, Jordan,[a,b] Lebanon[a,b]
North Atlantic	Bermuda[e]
Pacific, South Pacific	Cook Islands, Marshall Islands,[a] Samoa, Nauru,[c] Niue,[a,c] Tonga,[a,c,d] Vanuatu
West Africa	Liberia

Notes: The Dharmapala and Hines (2009) paper cited above reproduces the Hines and Rice (1994) list. That list was more oriented to business issues; four countries, Ireland, Jordan, Luxembourg, and Switzerland, appear only on that list. The Hines and Rice list is older and is itself based on earlier lists; some countries on those earlier lists were eliminated because they had higher tax rates. St. Kitts may also be referred to as St. Christopher. The Channel Islands are sometimes listed as a group and sometimes Jersey and Guernsey are listed separately. S. 506 and H.R. 1245 specifically mention Jersey, and also refer to Gurensey/Sark/Alderney; the latter two are islands associated with Guernsey.

[a]Not included in S. 506, H.R. 1245, 111th Congress.
[b]Not included in original OECD tax haven list.
[c]Not included in Hines and Rice (1994).
[d]Removed from OECD's List, which subsequently determined they should not be included.
[e]Not included in OECD's "gray" list as of July 8, 2009; currently on the OECD "white" list. Note that the "gray" list is divided into countries that are tax havens and countries that are "other financial centers." The latter classification includes three countries listed in Table 1 (Luxembourg, Singapore, and Switzerland) and five that are not (Austria, Belgium, Brunei, Chile, and Guatemala). Of the four countries moved from the "black" to the "gray" list, one(Costa Rica) is in Table 1 and three (Malaysia, Uruguay, and the Philippines) are not.

Sources: Organization for Economic Development and Cooperation (2000); Dharmapala and Hines (2009); Tax Justice Network (2007), The OECD's "gray" list as of April 2, 2009 is posted at http://www.oecd.org/data oecd/38/14/42497950.pdf. The countries in Table 1 are the same, with the exception of Tonga, as the countries, in U.S. Governmental Accountability Office (2008b).

cussed in the paper by Nicodème (2009) in this Forum, the OECD subsequently focused on information exchange and removed countries from the blacklist if they agreed to cooperate. OECD initially examined 47 jurisdictions and identified some as not meeting the tax haven criteria; it also excluded six countries with advance agreements to share information (Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, and San Marino). The 2000 OECD blacklist included 35 countries. The OECD also subsequently found that three countries should not be on the list (Barbados, the Maldives, and Tonga). Over time, as more tax havens made agreements to share information, the blacklist dwindled until it included only three countries: Andorra, Liechtenstein, and Monaco. As noted below, all countries were eventually dropped from the black list; many of those countries are on a gray list of those committed to but not having implemented changes.

Sharman's (2006) study of the OECD initiative finds the reduction in the number of countries on the OECD list was not because of actual progress towards cooperation, but reflected the withdrawal of U.S. support in 2001. As a result the OECD focused on information exchange upon request and did not require reforms until all parties had agreed to cooperate. That is, countries only had to commit to reform. This analysis suggests that the large countries were not successful in this initiative to rein in tax havens. Spencer and Sharman (2008) also suggest little real progress has been made in reducing tax haven practices.

Interest in tax havens has increased recently. The Joint Committee on Taxation (2009a) discusses the scandals surrounding the Swiss bank UBS AG (UBS) and the Liechtenstein Global Trust Group (LGT), which led to legal actions by the United States and other countries and focused greater attention on international tax issues, primarily information reporting and individual evasion. The provision of public funds to banks has also heightened public interest. The tax haven issue was revived at a meeting of the G-20 industrialized and developing countries that proposed sanctions; Faiola and Jordan (2009) report that a number of countries indicated commitments to information sharing.

The OECD currently has three lists: a "white list" of countries implementing an agreed-upon standard, a "gray" list of countries that have committed to such a standard, and a "black" list of countries that have not committed. On April 7, 2009 the last four countries on the "black" list (not included on the original OECD list), Costa Rica, Malaysia, the Philippines and Uruguay, were moved to the "gray" list. The gray list includes countries not identified as tax havens but as "other financial centers." Stewart (2009) reports that Hong Kong and Macau were omitted because of objections from China, but are mentioned in a footnote as having committed to the standards; he also noted that new commitments brought 11 jurisdictions, including Austria, Liechtenstein, Luxembourg, Singapore, and Switzerland onto the gray list.

Many countries on the OECD's original blacklist protested the resulting negative publicity. Many now point to having agreed to negotiate tax information exchange agreements (TIEA), and some have negotiated such agreements. The identification of tax havens can have legal ramifications if laws and sanctions are contingent on that identification, as in the Stop Tax Haven Abuse Act in the United States and potential sanctions by international bodies.

C. Other Jurisdictions with Tax Haven Characteristics

Major countries, such as the United States (including three states, Delaware, Nevada, and Wyoming), the United Kingdom, the Netherlands, Denmark, Hungary, Iceland, Israel, Portugal, and Canada have been charged with having tax haven characteristics. A number of smaller countries or areas in countries, such as Campione d'Italia, an Italian town located within Switzerland, have also been characterized as tax havens.

Altshuler and Grubert (2006) and van Dijk, Wyzig, and Murphy (2007) describe the Netherlands as a corporate tax haven, as it allows firms to reduce taxes on dividends and capital gains from subsidiaries and has many treaties that reduce taxes. O'Brien (2006) reports that Bono and the U2 band moved their music publishing company from Ireland to the Netherlands after Ireland changed its tax treatment of music royalties.

Gnaedinger (2009a) reports that the Luxembourg Prime Minister urged other EU members to challenge the United States for tax havens in Delaware, Nevada, and Wyoming. One website offering offshore services[1] mentions, in their view, several overlooked tax havens: the United States, the United Kingdom, Denmark, Iceland, Israel, Portugal's Madeira Island, Hungary, Brunei, Uruguay, and Labuan (Malaysia). For the United States, the website notes the lack of reporting and exemption of certain passive income paid to foreign entities, the limited liability corporation organizational form which allows a flexible tax exempt corporate vehicle, and the ease of incorporating in certain states (Delaware, Nevada, and Wyoming). Another website offering[2] lists Austria, Campione d'Italia, Denmark, Hungary, Iceland, Madeira, Russian Federation, United Kingdom, Brunei, Dubai, Lebanon, Canada, Puerto Rico, South Africa, New Zealand, Labuan, Uruguay, and the United States. A third website[3] includes in its list of tax havens Delaware, Wyoming, and Puerto Rico, along with the Netherlands, Campione d'Italia, Sark, the United Kingdom, and Canada.

The *Economist* (2009) reported a study that experimented with setting up sham corporations; the author incorporated in Wyoming and Nevada, the United Kingdom and several other places, demonstrating that one can incorporate without identifying beneficial owners. McIntyre (2009) discusses three U.S. practices that aid international evasion: failure to collect information on interest income paid to foreign entities, the system of foreign institutions that act as qualified intermediaries (see the discussion below) but do not reveal their clients, and the practices of states such as Delaware and Wyoming that allow people to keep secret their identities as stockholders or depositors.

Gnaedinger (2009b) reports that Eduardo Silva, of the Cayman Islands Financial Services Association, claimed that Delaware, Nevada, Wyoming, and the United Kingdom were the greatest offenders with respect to, among other issues, tax fraud. He suggested that Nevada and Wyoming were worse than Delaware because they permit company bearer shares, allowing anonymous ownership. Indeed, S. 569 would require disclosure of beneficial owners in the United States

Any low-tax country could be a potential income shifting location. In addition to Ireland, three other countries in the OECD not included in Table 1 have tax rates below 20 percent: Iceland, Poland, and the Slovak Republic.[4] In addition, most non-OECD eastern European countries have tax rates below 20 percent.[5]

The Tax Justice Network (2005) probably has the largest list of tax havens, and

[1] See http://www.offshore-fox.com/offshore-corporations/.

[2] See http://www.mydeltaquest.com/english/.

[3] See http://www.offshore-manual.com/taxhavens/.

[4] See http://www.oecd.org/document/60/0,3343,en _2649_34897_ 1942460 _1_1_1_1,00.html.).

[5] See http://www.worldwide-tax.com/index.asp#partthree.

includes some specific cities and areas. In addition to the countries listed in Table 1, they include: in the Americas and Caribbean, New York and Uruguay; in Africa, Mellila, Sao Tome e Principe, Somalia, and South Africa; in the Middle East and Asia, Dubai, Labuan (Malaysia), Tel Aviv, and Taipei; in Europe, Alderney, Belgium, Campione d'Italia, City of London, Dublin, Ingushetia, Madeira, Sark, Trieste, Turkish Republic of Northern Cyprus, and Frankfurt; and in the Indian and Pacific oceans, the Marianas. The only country listed in Table 1 and not included in their list was Jordan.

II. METHODS OF CORPORATE TAX AVOIDANCE

U.S. multinationals are not taxed on income earned by foreign subsidiaries until it is repatriated to the U.S. parent as dividends, although some passive and related company income that is easily shifted is taxed currently under anti-abuse rules referred to as Subpart F. (Foreign affiliates or subsidiaries that are majority U.S.-owned are referred to as controlled foreign corporations and many of these related firms are wholly owned.) Income that is repatriated (or, less commonly, earned by branches and taxed currently) is allowed a credit against U.S. tax for foreign income taxes paid. (A part of a parent company treated as a branch is not a separate entity for tax purposes, and all income is part of the parent's income.)

Foreign tax credits are limited to the amount of tax imposed by the United States, so that they, in theory, cannot offset taxes on domestic income. This limit is imposed on an overall basis, allowing excess credits in high-tax countries to offset U.S. tax liability on income earned in low-tax countries, although separate limits apply to passive and active income. Other countries either employ this system of deferral and credit or, much more commonly, exempt active income earned in foreign jurisdictions. Most countries have some form of anti-abuse rules similar to Subpart F.

If a firm can shift profits to a low-tax jurisdiction from a high-tax one, its taxes will be reduced without affecting the economic activity of the company. Since the United States taxes all income earned within its borders as well as imposing a residual tax on income earned abroad by U.S. persons, tax avoidance relates both to U.S. parent companies shifting profits abroad to low-tax jurisdictions and the shifting of profits out of the United States by foreign parents of U.S. subsidiaries. Grubert (2003) suggested that about half the difference between profitability in low-tax and high-tax countries of U.S. multinationals was due to transfers of intellectual property (or intangibles) and most of the rest through the allocation of debt. However, Pak and Zdanowicz (2002), examining import and export prices, suggest a very large effect of transfer pricing in intermediate goods. Some evidence of the importance of intellectual property can also be found from the types of firms that repatriated profits abroad following a temporary tax reduction enacted in 2004; Redmiles (2008) shows that a third of the repatriations were in pharmaceuticals and medicine and almost 20 percent in the computer and electronic equipment industry.

A. Allocation of Debt and Earnings Stripping

A common profit-shifting method is to borrow more in high-tax jurisdictions and less in low-tax jurisdictions. A more specific practice is earnings stripping, where either debt is associated with related firms in high-tax countries or unrelated debt is not subject to tax by the recipient. For example, a foreign parent may lend to its U.S. subsidiary or an unrelated foreign borrower that is not subject to U.S. tax on interest income might lend to a U.S. firm.

The U.S. tax code contains provisions to address interest deductions and earnings stripping. It allocates the U.S. parent's interest to determine the foreign tax credit limit. Foreign source income is reduced when part of U.S. interest is allocated to it and the maximum amount of foreign tax credits taken is limited, a provision that affects firms with excess foreign tax credits. There is no allocation rule, however, to address deferral, so that a U.S. parent could operate its subsidiary with all equity finance in a low-tax jurisdiction and take all of the interest on the overall firm's debt as a deduction. President Obama's budget includes a proposal to disallow deductions for a portion of the parent's interest and other overhead costs until the income is repatriated.

While allocation-of-interest approaches could address debt shifting by U.S. multinationals, they cannot be applied to U.S. subsidiaries of foreign corporations. To limit earnings stripping in either case, the United States has thin capitalization rules. (Most of the United States' major trading partners have similar rules.) Section 163(J) of the Internal Revenue Code applies to a corporation with a debt-to-equity ratio above 1.5 and net interest exceeding 50 percent of adjusted taxable income (generally taxable income plus interest plus depreciation). Interest in excess of the 50 percent limit paid to a related corporation is not deductible if the corporation is not subject to U.S. income tax. This restriction also applies to interest paid to unrelated parties and not taxed to the recipient.

The possibility of earnings stripping received more attention after a number of U.S. firms inverted, that is, arranged to move their parent firm abroad so that the U.S. operation became a subsidiary of the foreign parent. The American Jobs Creation Act (AJCA) of 2004 addressed inversions by treating firms that subsequently inverted as U.S. firms for a period of time. Proposals for increased earnings stripping restrictions were considered but not adopted. The AJCA mandated a Treasury Department study on this and other issues; that study (U.S. Department of the Treasury, 2007) focused on U.S. subsidiaries of foreign parents and was not able to find clear evidence of the magnitude of these effects.

Treasury's mandated study noted relatively straightforward evidence that U.S. multinationals allocate more interest to high-tax jurisdictions, but found the assessment of earnings stripping by foreign parents of U.S. subsidiaries more difficult, because the entire firm's accounts are not available. The Treasury study compared these subsidiaries to U.S. firms, but was not able to provide conclusive evidence of profit shifting out of the United States due to high leverage rates for U.S. firms, except for inverted firms.

B. Transfer Pricing

A second way that firms can shift profits is through the pricing of goods and services sold between affiliates. To properly reflect income, prices of goods and services sold by related companies should be the same as prices that would be paid by unrelated parties. By lowering the price of goods and services sold by parents and affiliates in high-tax jurisdictions and raising the prices of their purchases, income can be shifted from the high-tax jurisdiction.

An important and growing transfer pricing issue is transfers of intellectual property rights, or intangibles. If a patent developed in the U.S. is licensed to a low-tax foreign affiliate, income will be shifted if the royalty or other payment is lower than the true value of the license. For many goods, similar products are sold or other methods (such as cost plus a mark up) can be used to determine whether prices are set appropriately. However, intangibles such as new inventions or new drugs tend not to have comparable products, and it is very difficult to know the royalty that would be paid in an arms-length transaction. Therefore, intangibles present particular problems for policing transfer pricing.

Investment in intangibles is favorably treated in the United States because research costs, other than tangible assets, are expensed and eligible for a tax credit. Advertising to establish brand names is also deductible. These treatments tend to produce an effective low, zero, or negative tax rate for overall intangible investment even when earnings are fully taxed, because of the magnitude of the up-front benefits. Thus, there are significant incentives to make these investments in the United States. If profits on successful investments in intangibles can then be shifted to a low-tax jurisdiction, these investments can be subject to significantly negative tax rates.

Transfer pricing rules with respect to intellectual property are further complicated because of cost sharing agreements, where different affiliates contribute to the cost. If an intangible is already partially developed by the parent firm, affiliates contribute a buy-in payment. It is difficult to determine arms-length pricing in these cases where a technology is partially developed and the outcome is risky. McDonald (2008) found some evidence that firms with cost sharing arrangements were more likely to engage in profit shifting. As discussed by Nadal (2009), Treasury Decision 9441 issued new proposed regulations that, among other features, would provide for periodic examination of outcomes cases involving intangibles.

C. Contract Manufacturing

When a subsidiary is set up in a low-tax country and profit shifting occurs, as in the acquisition of rights to an intangible, a further problem occurs: this low-tax country may not be a desirable place to actually manufacture and sell the product. For example, an Irish subsidiary's market may be in Germany and it would be desirable to manufacture in Germany. But to earn profits in Germany with its higher tax rate does not minimize taxes. Instead, the Irish firm may contract with a German firm, who will produce the item for cost plus a fixed markup. Subpart F ensures that certain profits from sales income are taxed on a current basis, so the arrangement must be structured to qualify as an exception from this rule. Chip (2007) discusses the complex and changing regulations on this issue.

D. Check-the-Box, Hybrid Entities, and Hybrid Instruments

Another technique for shifting profit to low-tax jurisdictions was greatly expanded with the "check-the-box" provisions. These provisions were originally intended to simplify questions of whether a domestic firm was a corporation or a partnership. Their application to foreign circumstances through the "disregarded entity" rules, however, has led to the expansion of hybrid entities, where an entity can be recognized as a corporation by one jurisdiction but not by another. For example, a U.S. parent's subsidiary in a low-tax country can lend to its subsidiary in a high-tax country, with the interest deductible because the high-tax country recognizes the firm as a separate corporation. Normally, interest received by the subsidiary in the low-tax country would be considered passive or "tainted" income subject to current U.S. tax under Subpart F. However, under check-the-box rules, the high-tax corporation can elect to be disregarded as a separate entity. From the U.S. perspective there is no interest income paid because the two are the same entity. Check-the-box and similar hybrid entity operations can also be used to avoid other types of Subpart F income, for example from contract manufacturing arrangements. As discussed by Sicular (2007), this provision, which began as a regulation, has been effectively codified, albeit temporarily.

Hybrid entities relate to issues other than Subpart F. Calianno and Cornett (2006) discuss a "reverse hybrid" entity—the entity is structured so that it is a partnership for foreign purposes but a corporation for U.S. purposes—that allows U.S. firms to receive foreign tax credits without recognizing the underlying income. A U.S. parent can set up a holding company in one country that is treated as a disregarded entity, which owns a corporation treated as a partnership in another foreign jurisdiction. Under flow through rules, the holding company is liable for the foreign tax and, because it is not a separate entity, the U.S. parent corporation is also liable and thus receives the foreign tax credit, while the income can be retained in the foreign corporation which is viewed as a separate entity from the U.S. viewpoint.

In addition to hybrid entities that achieve tax benefits by being treated differently in the U.S. and the foreign jurisdiction, there are also hybrid instruments that can avoid taxation by being treated as debt in one jurisdiction and equity in another. These instruments are discussed by Foley (2007) and Kraymal (2005).

E. Cross-Crediting and Sourcing Rules for Foreign Tax Credits

Income from a low-tax country can escape taxes because of cross-crediting: the use of excess foreign taxes paid in one jurisdiction or on one type of income to offset U.S. tax on other income. At one time, the foreign tax credit limit was calculated on a country-by-country basis, although that rule proved to be difficult to enforce given the use of holding companies. Foreign tax credits are separated into different baskets to limit cross-crediting; these baskets were reduced from nine to two (active and passive) in 2004.

Because firms can choose when to repatriate income, firms with income from jurisdictions with taxes in excess of U.S. taxes can use their excess credits to offset U.S. tax due on income from low-tax jurisdictions. A study by the U.S. Government Accountability Office (2008a) suggested that because of crediting and deferral U.S. multinationals typically pay virtually no U.S. tax on foreign source income.

The ability to reduce U.S. tax due to cross-crediting is increased, it can be argued, when U.S. source income is treated as foreign source income, raising the foreign tax credit limit. This sourcing rule relates to the U.S. tax law and does not affect foreign taxes paid; hence, it is beneficial to firms with excess foreign tax credits. This income includes U.S. export income because a tax provision allows half of export income to be allocated to the country in which the title passes. Another important type of income considered foreign source and thus shielded from U.S. tax with foreign tax credits is royalty income from active businesses. This benefit can occur in high-tax countries because royalties are deductible from income. (Note that the shifting of income due to transfer pricing of intangibles, advantageous in low-tax countries, is a different issue.) Interest income is another type of income that may benefit from this foreign tax credit rule.

Since royalties arise from investment in the United States, one could argue that it is appropriately U.S. source income, or that it should be put in a different foreign tax credit basket so that excess credits generated by dividends cannot be used to offset taxes on such income. Two studies, by Grubert (2005) and by Grubert and Altshuler (2008) have discussed this sourcing rule in the context of a proposal to eliminate the tax on active dividends. In that proposal, the revenue loss from exempting active dividends from U.S. tax would be offset by gains from taxes on royalties.

III. THE MAGNITUDE OF CORPORATE PROFIT SHIFTING

This section examines the evidence on the existence and magnitude of profit shifting and the techniques that are most likely to contribute to it.

A. Evidence on the Scope of Profit Shifting

There is ample, and readily understandable, evidence of profit shifting to low-tax countries that is inconsistent with an economic motivation. This section examines the profit share of income of U.S.-controlled corporations compared to their share of gross domestic product (GDP). Three groups of reference countries are considered. The first is the remaining G-7 countries; they account for 32 percent of pre-tax profits and 38 percent of rest-of-world GDP. The second group is larger countries from Table 1 (GDP of at least $10 billion) plus the Netherlands, which account for 30 percent of earnings and 5 percent of rest-of-world GDP. The third group of smaller tax haven countries accounts for 14 percent of earnings and less than 1 percent of rest-of-world GDP.

As indicated in Table 2, profit-to-GDP ratios in the large G-7 countries range from 0.2–2.6 percent. Overall, this income as a share of GDP is 0.6 percent. Outside the United Kingdom and Canada, the share is 0.2–0.3 percent and does not vary with country size (Japan, for example, has over twice the GDP of Italy). Table 3 reports the share for the larger tax havens for which data are available. U.S. profits as a percentage of GDP are considerably larger than those in Table 2. In the case of Luxembourg, these profits are 18 percent of output; profit shares are also very large in Cyprus and Ireland. In all but two cases, profit shares are well in excess of those in Table 2. Table 4 examines the small tax havens listed in Table 1 for which data are available. In three of the islands off the

Table 2
U.S. Company Foreign Profits Relative to GDP, G-7

Country	Profits of U.S. Controlled Foreign Corporations as a Percentage of GDP
Canada	2.6
France	0.3
Germany	0.2
Italy	0.2
Japan	0.3
United Kingdom	1.3
Weighted Average	0.6

Source: Based on data from Mahoney and Miller (2004) and Central Intelligence Agency World Factbook, at https://www.cia.gov/library/publications/the-world-factbook. Most GDP data are for 2008 and based on the exchange rate for that year, but for some countries earlier years and data based on purchasing power parity were the only data available.

Table 3
U.S. Foreign Company Profits Relative to GDP, Larger Countries (GDP At Least $10 billion) on Tax Haven Lists and the Netherlands

Country	Profits of U.S. Controlled Corporations as a Percentage of GDP
Costa Rica	1.2
Cyprus	9.8
Hong Kong	2.8
Ireland	7.6
Luxembourg	18.2
Netherlands	4.6
Panama	3.0
Singapore	3.4
Switzerland	3.5
Taiwan	0.7

Source: See sources for Table 2.

Table 4
U.S. Foreign Company Profits Relative to GDP, Small Countries on Tax Haven Lists

Country	Profits of U.S. Controlled Corporations as a Percentage of GDP
Bahamas	43.3
Barbados	13.2
Bermuda	645.7
British Virgin Islands	354.7
Cayman Islands	546.7
Guernsey	11.2
Jersey	35.3
Liberia	61.1
Malta	0.5
Marshall Islands	339.8
Mauritius	4.2
Netherland Antilles	8.9

Source: See sources for Table 2.

U.S. coast (in the Caribbean and Atlantic), profits exceed total GDP, and are well in excess of GDP in four jurisdictions. In other jurisdictions they are a large share of output. These numbers clearly indicate that the profits in these countries do not appear to derive from economic motives related to productive inputs or markets, but rather reflect income easily transferred to low-tax jurisdictions.

Evidence of profit shifting has been presented in other studies. Grubert and Altshuler (2008) report that profits of controlled foreign corporations in manufacturing relative to sales in Ireland are three times the group mean. The U. S. Government Accountability Office (2008a), hereafter GAO, reported higher shares of pretax profits of U.S. multinationals than of value added, tangible assets, sales, compensation or employees in low-tax countries. Sullivan (2004a) reports the return on assets for 1998 averaged 8.4 percent for U.S. manufacturing subsidiaries, but 23.8 percent in Ireland, 17.9 percent in Switzerland, and 16.6 percent in the Cayman Islands. More recently, Sullivan (2008b) noted that of the ten countries that accounted for the most foreign multinational profits, the five countries with the highest manufacturing returns for 2004 (the Netherlands, Bermuda, Ireland, Switzerland, and China) all had effective tax rates below 12 percent while the five countries with lower returns (Canada, Japan, Mexico, Australia, and the United Kingdom) had tax rates in excess of 23 percent. Note that effective tax rates for some countries differ depending on the source of data; according to the U.S. Government Accountability Office (2008b), the Netherlands would be classified as a low-tax country based on data on controlled foreign corporations but as high-tax based on U.S. Bureau of Economic Analysis data. Econometric studies of profit shifting focusing on this issue are reviewed in Hines (1999), Joint Committee on Taxation (2008a), and U.S. Department of Treasury (2000).

B. Estimates of the Cost and Sources of Corporate Tax Avoidance

There are no official estimates of the cost of international corporate tax avoidance; nor are there official estimates of the individual tax gap, a point made by the U.S. Department of Treasury Inspector General for Tax Administration (2009). Nevertheless, the magnitude of corporate tax avoidance has been estimated in several studies using a variety of techniques. Some address only avoidance by U.S. multinationals and not by foreign parents of U.S. subsidiaries, and some focus only on a particular source of avoidance.

Estimates of the potential revenue cost of income shifting by multinational corporations vary, with some estimates as high as $60 billion. The U.S. Department of the Treasury (1999) provides the IRS estimate of the international gross tax gap (not accounting for increased taxes collected on audit) related to transfer pricing based on audits of returns. They estimate a cost of about $3 billion, based on examinations of tax returns for 1996-1998. This estimate reflects not legal avoidance, but non-compliance. One limitation is that an audit does not detect all non-compliance, and it would not detect avoidance mechanisms which are, or appear to be, legal.

If most of the profit in low-tax countries has been shifted there to avoid U.S. tax rates, the projected revenue gain from ending deferral would provide an idea of the general magnitude of the revenue cost of profit shifting by U.S. parent firms. The Joint Committee on Taxation (2008b) projects the revenue gain from ending deferral to be about $11 billion in FY2010. This estimate could overstate the cost of tax avoidance because some of the profits abroad accrue to real investments in countries that have lower tax rates than the United States and do not reflect artificial shifting. It could be an understatement because it does not reflect the tax that could be collected by the United States rather than foreign jurisdictions on profits shifted to low-tax countries. For example, Ireland has a tax rate of 12.5 percent and the United States a 35 percent rate, so that ending deferral (absent behavioral changes) would only collect the excess of the U.S. tax over the Irish tax on shifted revenues, or about two thirds of lost revenue.

The U.S. Office of Management and Budget's (2009) estimates for ending deferral are slightly larger, over $14 billion. Grubert and Altshuler (2008) estimate for 2002 that the corporate tax could be cut to 28 percent if deferral were ended, and based on corporate revenue in that year the gain is about $11 billion. That year would likely produce a low estimate because of the recession; if the share remained the same, the gain would be around $13 billion for 2004 and $26 billion for 2007.

Researchers have looked at differences in pretax returns and estimated the revenue gain if returns were equated. Sullivan (2004b), using U.S. Commerce Department data, estimates that, based on differences in pre-tax returns, the revenue cost for 2004 was between $10–20 billion, and $75 billion in profits were artificially shifted to low-tax countries. If all of that income were subject to U.S. tax, it would result in a gain of $26 billion for 2004. Some income might already be taxed under Subpart F, some might be absorbed by excess foreign tax credits, and the effective tax rate may be lower than the statutory rate. He concludes that the estimate of between $10–20 billion is appropriate. Sullivan (2008a) subsequently reports an estimated $17 billion increase in revenue loss from profit shifting between 1999 and 2004, which may be due to the check-the-box rules. Altshuler and Grubert (2006) suggest that Sullivan's methodology may involve some double counting; however, their own analysis finds that multinationals saved $7 billion more between 1997 and 2002 due to the check-the-box rules. However, some of this gain may have been at the cost of high-tax host countries rather than the United States.

Christian and Schultz (2005) using tax return data on asset returns estimated $87 billion was shifted in 2001, which at a 35 percent tax rate implies a revenue loss of about $30 billion. This estimate may be too large because of the inability to determine how much was shifted out of high-tax foreign jurisdictions rather than the United States. Economic theory also indicates that the returns should be lower, the lower the tax rate, so the results could understate the overall profit shifting and the revenue loss.

Pak and Zdanowicz (2002) used export and import prices to estimate that the lost revenue due to transfer pricing of goods alone was $53 billion in 2001. This estimate should cover both U.S. multinationals and U.S. subsidiaries of foreign parents. In a paper in this forum, Clausing (2009) regresses profits on tax rates with cross country data (1982–2004) and estimates a total revenue loss in 2002 of over $85 billion. Her methodological approach differs from others that involve direct calculations based on returns or prices and is subject to the econometric limitations associated with cross country panel regressions. In theory, however, her estimate included both outbound shifting by U.S. parents of foreign corporations and inbound shifting by foreign parents of U.S. corporations, covering all techniques.

Clausing and Avi-Yonah (2008) estimate the revenue gain from moving to formula apportionment based on sales of $50 billion per year. This estimate is not an estimate of the loss from profit shifting (since sales and income could differ for other reasons) but it is suggestive of the magnitude of total effects from profit shifting. Shackelford and Slemrod (1998), who applied formula apportionment based on an equal weight of assets, payroll, and sales found a similar result.

It is difficult to develop a separate estimate for U.S. subsidiaries of foreign multinational companies because there is no way to observe the parent firm and its other subsidiaries. Several studies, reviewed by the U.S. Department of the Treasury (2007) and Grubert (2008), find these firms have lower taxable income and some have higher debt-to-asset ratios than domestic firms. There are many other potential explanations of these differing characteristics. In addition, domestic firms that are used as comparisons also have incentives to shift profits when they have foreign operations. No quantitative estimate has been made. Blouin, Collins and Shackelford (2005) found no differences in taxes of firms before and after acquisition by foreign versus domestic acquirers, but the problem of comparison remains and their sample was very small. Some evidence of earnings stripping for inverted firms was reported in U.S. Department of Treasury (2007) and Seida and Wembe (2007), who estimate $0.7 billion in revenue loss from four firms that inverted. Inverted firms may, however, behave differently from foreign firms with U.S. subsidiaries.

C. Importance of Different Profit Shifting Techniques

Some studies have attempted to identify the importance of different profit-shifting techniques. Grubert (2003) has estimated that about half of income shifting was due to transfer pricing of intangibles and most of the remainder to shifting of debt. Altshuler and Grubert (2006) find that multinationals saved $7 billion more between 1997–2002 due to the check-the-box rules.

Some of the estimates discussed above conflict with respect to the source of profit shifting. The Pak and Zdanowich (2002) estimates suggest that transfer pricing of goods is an important mechanism of tax avoidance, while Grubert (2003) suggests that the main methods of profit shifting are leverage and intangibles. The estimates for pricing of goods may, however, reflect errors or money laundering motives rather than tax motives. Pak and Zdanowich (2004) find that much of the shifting was associated with trade with high-tax countries; for example, Japan, Canada, and Germany accounted for 18 percent of the total. At the same time, about 14 percent of the estimate reflected transactions with countries that appear on tax haven lists: the Netherlands, Taiwan, Singapore, Hong Kong, and Ireland.

Some evidence that points to the importance of intangibles can be developed by examining the sources of dividends repatriated during the "repatriation holiday" enacted in 2004, reported by Redmiles (2008). This provision allowed, for a temporary period, dividends to be repatriated with an 85 percent deduction, leading to a tax rate of 5.25 percent. The pharmaceutical and medicine industry accounted for $99 billion in repatriations or 32 percent of the total. The computer and electronic equipment industry accounted for $58 billion or 18 percent of the total. Thus, these two industries, which are high tech firms, accounted for half of the repatriations. Mock and Simon (2008) found benefits highly concentrated in a few firms. Also, as shown in Table 5,

Table 5
Source of Dividends from "Repatriation Holiday": Countries Accounting for at Least 1 Percent of Dividends

Country	Percentage of Total
Netherlands	28.8
Switzerland	10.4
Bermuda	10.2
Ireland	8.2
Luxembourg	7.5
Canada	5.9
Cayman Islands	5.9
United Kingdom	5.1
Hong Kong	1.7
Singapore	1.7
Malaysia	1.2

Source: Calculated from Redmiles (2008).

which lists all countries accounting for at least one percent of the total of eligible dividends (and accounting for 87 percent of the total), most of the dividends were repatriated from countries that appear on tax haven lists.

IV. METHODS OF AVOIDANCE AND EVASION BY INDIVIDUALS

Individual evasion of taxes may take different forms, facilitated by growing international financial globalization and ease of making transactions on the Internet. With little or no information reporting, individuals can purchase foreign investments directly (outside the United States), such as stocks and bonds, or put money in foreign bank accounts and not report the income. They can also use structures such as trusts or shell corporations to evade tax on investment income, including income on investments made in the United States, taking advantage of U.S. tax laws that exempt interest income and capital gains of non-residents from U.S. tax. Rather than using withholding or information collection, the United States largely relies on the Qualified Intermediary (QI) program where beneficial owners are not revealed. To the extent any information gathering from other countries is done, it is through bilateral rather than multilateral information exchanges. The European Union has developed a multilateral agreement but the United States does not participate.

A. Tax Provisions Affecting the Treatment of Income by Individuals

U.S. firms or individuals may avoid tax on U.S. source income because the U.S. does not withhold taxes on many sources of income paid to foreigners. In general, interest and capital gains are not withheld. Dividends, non-portfolio interest (e.g., interest payments by a U.S. subsidiary to its parent), capital gains connected with a trade or business, and certain rents are taxed, although treaty arrangements reduce or eliminate tax on dividends. The Joint Committee on Taxation (2009a) discusses how new techniques have, through derivatives, transformed dividends subject to withholding into exempt interest.

The elimination of tax on interest income was unilaterally initiated by the United States in 1984, and other countries began to follow suit, as discussed by Avi-Yonah (2008). Currently, fears of capital flight are likely to keep countries from changing this treatment. However, this elimination has been accompanied with a lack of information reporting that allows U.S. citizens, who are liable for these taxes, to avoid them whether on income invested abroad or income invested in the United States channeled through shell corporations and trusts. Citizens of foreign countries can also evade taxes, and the U.S. practice of not collecting information contributes to the problem for other countries.

Guttentag and Avi-Yonah (2005) describe a typical way that U.S. individuals can easily evade tax on domestic income through a Cayman Islands operation. The individual, using the Internet, can open a bank account in the name of a Cayman corporation that can be set up for a minimal fee. Money can be electronically transferred without any reporting to tax authorities, and investments can be made in the United States or abroad. Investments by non-residents in interest-bearing assets and most capital gains are not subject to a withholding tax in the United States.

Foreign trusts may involve a trust protector who is an intermediary between the grantor and the trustees, but whose purpose may actually be to carry out the desires of the grantor. Some taxpayers argue that these trusts are legal, but in any case they can be used to protect income from taxes, including those from

U.S. investments, while retaining control over and use of the funds.

B. Limited Information Reporting Between Jurisdictions

The international taxation of passive portfolio income by individuals is easily subject to evasion because there is no multilateral reporting of interest income. Even bilateral information sharing treaties, or TIEAs, have limits. Avi-Yonah (2009) notes that most agreements are restricted to criminal matters, which are a minor part of the revenues lost and pose difficult issues of evidence. These agreements may require that activities related to the information sought constitute crimes in both countries, which can be a substantial hurdle in cases of tax evasion. The OECD has adopted a model agreement dealing with the "dual criminality" requirements. TIEAs usually allow for information only upon request, requiring the United States and other countries to identify potential tax evaders in advance and they do not override bank secrecy laws. (However, some countries are abandoning secrecy agreements.)

In some cases, countries have little or no information of value. Jackson (2009), for example, discusses the possibility of an information exchange agreement with the British Virgin Islands, a country with more than 400,000 registered corporations. Its laws require no identification of shareholders or directors and no financial records. Even if the country signed an agreement, it is not clear what information could be exchanged.

C. U.S. Collection of Information on U.S. Income and Qualified Intermediaries

Under the Qualified Intermediary (QI) program the United States itself does not require U.S. financial institutions to identify the true beneficiaries of interest and exempt dividends. The IRS set up the QI program in 2001, under which foreign banks that received payments must certify the nationality of their depositors and reveal the identity of any U.S. citizens. Sullivan (2009) and the Joint Committee on Taxation (2009a) discuss this program and its origins. Although QIs are supposed to certify nationality, apparently some rely on self-certification. They are also subject to audit. UBS, the Swiss bank involved in a tax abuse scandal for helping clients set up offshore plans, was a QI.

A non-qualified intermediary must disclose the identity of its customers to obtain the exemption for passive income such as interest and or the reduced rates arising from tax treaties, but there are questions about the accuracy of disclosures.

D. European Union Savings Directive

The European Union has developed an option under which both member countries as well as some other countries must either have information reporting or a withholding tax. Three member states, Austria, Belgium, and Luxembourg, have elected the withholding tax. While this multilateral agreement aids these countries' tax administration, the United States is not a participant.

V. ESTIMATES OF THE REVENUE COST OF INDIVIDUAL TAX EVASION

Estimates of individual tax evasion rely on data reported on assets. Individual evasion is difficult to estimate, given limited information on untaxed assets held abroad.

Guttentag and Avi-Yonah (2005) estimate $50 billion in individual tax evasion, based on an estimate of $1.5 trillion of non-U.S. holdings held by high net worth individuals, using a 10 percent rate of return and a 33 percent tax rate. They also summarize two other estimates of $40 billion by the IRS, and $70 billion by an IRS consultant in 2002.

To the extent that the earnings are interest, the 10 percent rate of return may be too high, while if it is dividends and capital gains, the tax rate is too high. Using a tax rate of 15 percent (currently applicable to capital gains and dividends) would lead to an estimate of about $23 billion. For equity investments, if a third of the return is in dividends, half of capital gains is never realized, and the tax rate is 10 percent, the estimate falls to $15 billion. During 2002 and beginning in 2011, the relevant tax rate on capital gains and dividends is 20 percent, implying a loss of $20 billion. For interest, since investors can earn tax free returns in the neighborhood of 4–5 percent on domestic state and local bonds, to earn a 5 percent after-tax return at a 35 percent tax rate would require a pre-tax yield of about 7.7 percent. The estimate of revenue loss would then be $40 billion.

The Tax Justice Network (2005) has estimated a worldwide revenue loss for all countries of $255 billion from individual tax evasion, basically using a 7.5 percent return and a 30 percent tax rate. These assumptions would be consistent with a $33 billion loss for the United States, using the $1.5 trillion figure.

V. ALTERNATIVE POLICY OPTIONS TO ADDRESS CORPORATE PROFIT SHIFTING

Since much of the corporate tax revenue loss arises from activities that either are or appear to be legal, this loss is difficult to address with actions other than tax law changes. Outcomes would be better with international cooperation. Possibilities for international cooperation appear greater for individual evasion than for corporate avoidance.

A. Broad Changes to International Tax Rules

The first set of provisions would introduce broad changes in international tax rules, and include significant restrictions in deferral or allocation of income and capital.

1. Repeal Deferral

One approach to mitigate the rewards of profit shifting is to repeal deferral, or to institute true worldwide taxation of foreign source income. Firms would be subject to current tax on the income of their foreign subsidiaries, although they would continue to be able to take foreign tax credits. According to the estimates cited above, this change currently would raise from $11–14 billion per year.

Traditionally, economic analysis has suggested that eliminating deferral would increase economic efficiency, although recently some have argued that this gain would be offset by the loss of production of some efficient firms from high-tax countries. These economic issues are discussed in Gravelle (2008, 2009).

Repeal of deferral would largely eliminate the planning techniques discussed in this paper. There are concerns, however, that firms could avoid the effects of repeal by inverting, that is, having their parent incorporate in other countries that continue to allow deferral. This technique was restricted in 2004: firms with 80 percent continuity of ownership would be treated as U.S. firms for the next ten years and firms with at least 60 percent continuity of ownership would be subject to tax on the transfer of assets. More permanent restrictions might need to be considered. Mergers would be another method to counter eliminating deferral, although mergers involve real changes in organization that would not likely be undertaken to gain a small tax benefit. Another possibility is that more direct portfolio investment (i.e., buying shares of stock by individual investors) in foreign corporations will occur. There has been a significant growth in this form of direct investment, although the evidence suggests this investment has been due to portfolio diversification and not tax avoidance (Gravelle 2008, 2009).

2. Targeted or Partial Elimination of Deferral

Some narrower proposals to address deferral and tax avoidance would tax income in tax havens currently, or tax some additional income of foreign subsidiaries. These proposals include:

- Eliminating deferral for specified tax havens;
- Eliminating deferral in countries with tax rates that are below the U.S. rate by a specified proportion;
- Eliminating deferral for income on the production of goods that are in turn imported into the United States;
- Eliminating deferral for income on the production of goods that are exported; and
- Requiring a minimum payout share.

Eliminating deferral for tax havens would address some of the problems associated with transfer pricing and leveraging. Defining tax havens would be crucial and to be comprehensive would need to include low tax rate countries and countries with special regimes (such as the Netherlands). Listing specific tax haven countries might make cooperative approaches, such as tax information sharing treaties, more difficult.

An alternative would be to restrict deferral when tax rates are lower than the U.S. rate. The French, who have a territorial tax, tax income earned in jurisdictions with tax rates one-third lower than the French rate. For the U.S., this ratio would indicate a tax rate lower than 24 percent. Such a rule might not, however, capture countries like the Netherlands.

A proposal directed to "runaway" plans would eliminate deferral for investments abroad involved in the production of goods that are exported to the United States. S. 1284 (110th Congress) would expand Subpart F income to include income attributable to imports of goods produced by foreign subsidiaries of U.S. firms into the United States. Administering this proposal would require tracing sales to a third party for resale. Administrative issues also arise with a more restrictive proposal made by Senator Kerry during the 2004 presidential campaign. He proposed to eliminate deferral except when goods are produced and sold in the controlled foreign corporation's jurisdiction. This approach would be likely to significantly restrict opportunities for artificial profit shifting, since most of the income in tax havens or low-tax jurisdictions does not arise from real activity and these jurisdictions are too small in many cases to provide a market.

A final option that would not go as far as eliminating deferral altogether would be to require some minimum share of equity income to be paid out as dividends.

3. Allocation of Deductions and Credits with Respect to Deferred Income/Restrictions on Cross-Crediting

President Obama and H.R. 3970 (110th Congress) proposed to disallow a share of the parent company's deductions and credits until income is repatriated. According to U.S. Department of the Treasury (2009) and Joint Committee on Taxation (2009b) estimates, this proposal would raise $9–10 billion (after revising the check-the-box rules). The disallowed deductions would reflect the share of foreign deferred income in total income and would primarily reflect interest deductions. (President Obama's proposal does not allocate research and experimentation expenses). The foreign tax credit allocation rule would allow credits for the share of foreign taxes paid that is equal to the share of foreign source income repatriated. Disallowed deductions and credits would be carried forward.

The allocation-of-deductions provision would decrease the tax benefits of sheltering income in low-tax jurisdictions, encourage repatriation of income relative to current law, and presumably reduce profit shifting, as well as decreasing the benefits of real investment abroad. The foreign tax credit allocation rule could have offsetting effects. It would make foreign investment abroad less attractive because it would increase the tax on income when repatriated, it would discourage investment in low-tax jurisdictions that could no longer be sheltered by foreign tax credits, and it could discourage repatriation of earnings on existing activities because of the potential tax to be collected.

The allocation of credits accomplishes some of the restrictions on cross-crediting that could also be achieved by increasing the number of baskets or providing a per country basket limit, but is probably simpler.

4. Formula Apportionment

Apportioning income through a formula would be a major change in the international tax system. With formula apportionment, income would be allocated to different jurisdictions based on shares of some combination of sales, assets, and employment, an approach used by the U.S. states and the Canadian provinces. In the past, a three-factor apportionment formula was used, but some states have moved to a single factor based on sales. Shackleford and Slemrod (1998) estimate a 38 percent revenue increase from an equally-weighted three-factor system. Clausing and Avi-Yonah (2008) estimate that a sales-based formula would increase corporate tax revenue by about 35 percent, or $50 billion annually from 2001–2004.

The ability of a formula apportionment system to address some of the problems of shifting income becomes problematic with intangible assets. Some of these problems are addressed by Altshuler and Grubert (2009). If all capital were tangible, a formula apportionment system based on capital would at least lead to the same pre-tax rate of return for tax purposes across high-tax and low-tax jurisdictions. Real distortions in the allocation of capital would remain, since capital would still flow to low-tax jurisdictions, but paper profits could not be shifted easily. An allocation system based on assets becomes more difficult when intangible assets are involved, as it is probably as difficult to estimate the stock of intangible investment (given lack of information on the future pattern of profitability) as it is to allocate it under arms-length pricing. With allocation based on sales, profits that might appropriately be associated with domestic income as they arise from domestic investment in R&D would be allocated abroad. Moreover, new avenues of tax planning, such as selling to an intermediary in a low-tax country for resale, would complicate the administration of such a plan. Whether the benefits are greater than the costs is in some dispute.

If the Untied States adopted formula apportionment there could be double taxation of some income and no taxation of other income. The European Union has been considering an apportionment formula based on property, gross receipts, number of employees, and cost of employment. This proposal and its consequences for different countries are discussed by Devereux and Loretz (2008). If the European Union adopted such a plan it would be easier for the United States to adopt a similar apportionment formula without as much risk of double or no taxation with respect to its major trading partners.

5. Eliminate Check-the-Box, Hybrid Entities, and Hybrid Instruments; Foreign Tax Credit Splitting From Income

Proposals have been made to eliminate the check-the-box rules, and to adopt rules that would require that legal entities be characterized in a consistent manner by the United States and the country in which the entity is established (McIntyre, 2009). President Obama's plan would not allow a foreign subsidiary to treat its own subsidiary as a disregarded entity. It also includes a provision to prevent foreign tax credits without U.S. taxation of the associated income, which can currently be accomplished with reverse hybrids. The U.S. Department of Treasury (2009) estimates a gain of $8–9 billion for the first proposal and $2 billion for the second, but the Joint Committee on Taxation (2009b) estimates $3 billion and $1 billion. In general, this particular class of provisions that undermine Subpart F and the matching of credits and deductions with income could be addressed by rules that require legal entities to be characterized in a consistent manner by the United States and the host country and the denial of tax benefits that arise from inconsistent treatment of instruments.

B. Narrower Provisions Affecting Multinational Profit Shifting

A number of narrower provisions affecting profit shifting could be considered. The 2004 House proposal would have eliminated the debt-to-asset test and lowered the interest share standard to 25 percent for ordinary debt, 50 percent for guaranteed debt, and 30 percent overall for earnings stripping. President Obama's plan lowers the interest share to 25 percent for inverted firms for related party non-guaranteed debt.

One issue surrounding the cross-crediting of the foreign tax credit is the use of excess credits to shield royalties from U.S. tax on income that could be considered U.S.-source income. Grubert (2005) and Grubert and Altshuler (2008) discuss two options: sourcing these royalties as domestic income for the foreign tax credit or putting them into a separate foreign tax credit basket. The same approach could be used for the income from exports to be allocated to the country in which the title passes. President Obama's proposal includes a provision to restrict the crediting of taxes that are in exchange for an economic benefit (such as payments that are the equivalent of royalties).

McIntyre (2009) has proposals to deal with transfer pricing, including making transfer pricing penalties nearly automatic for taxpayers who have not kept contemporaneous records, and using formula apportionment as a default for transfer pricing for non-complying taxpayers, so the IRS does not have to conduct a detailed transaction by transaction assessment for the court. President Obama's proposals would clarify that intangibles include workforce in place, goodwill, and going concern value and that they are valued at their highest and best use. The plan would allow the IRS Commissioner to aggregate intangibles if that leads to a more appropriate value. These proposals would likely have small effects. Any significant solution to the transfer pricing problem, especially for intangibles, is difficult to devise short of the elimination of deferral.

A final proposal relevant to international tax avoidance and evasion is a codification of the economic substance doctrine, where tax savings arrangements without economic substance can be disallowed by the courts. The proposal, included in President Obama's budget, would require a transaction to meet both an objective test (profit was made) and a subjective test (profit was intended). Penalties would be imposed if the test were not passed. Supporters argue that the stricter test would reduce tax avoidance and make treatment more consistent across the courts. Some tax attorneys have argued that more specific rules might provide a roadmap to structuring arrangements that will pass the test.

President Obama's plan would revise the rule on reorganizations when property as well as stock is received to treat distributions as dividends in the case of cross-border transactions.

VI. OPTIONS TO ADDRESS INDIVIDUAL EVASION

Most options for addressing individual evasion involve information reporting and enforcement. There are options that would involve fundamental changes in the law, such as shifting from a residence to a source basis for passive income. That is, the United States would tax this passive income earned in its borders, just as is the case for corporate and other active income. This change involves many other economic and efficiency effects that are probably not desirable. The remainder of the proposals discussed here do not involve any fundamental changes in the tax law, but rather focus on administration and enforcement.

The options discussed below are drawn from many sources, including academics and practitioners, organizations, the Internal Revenue Service, and legislative proposals. These are discussed in Tax Justice Network (2009), Guttentag and Avi-Yonah (2005), and Sullivan (2009) and have been addressed in congressional testimony by Avi-Yonah (2008, 2009), Blessing (2009), Shay (2009), Shulman (2009), Blum (2008), and McIntyre (2009).

A. Information Reporting

Expanded information reporting can involve multilateral efforts, changes in the current bilateral treaties, or unilateral changes.

1. Multilateral Information Sharing or Withholding; International Cooperation

The option likely to recover most of the evaded revenues would be to join in the EU Directive, which would require information reporting on all income paid to foreign entities by U.S. banks and other institutions. If the beneficial owner cannot be identified, withholding could be imposed (a refund would be allowed if evidence of reporting to the home country could be shown). Further cooperation with the OECD and the G-20 has been suggested. Proposals have also been made for the U.N. to develop a global cooperation standard, set up a panel to determine compliant states, and deny recognition to non-compliant jurisdictions. Proposals have also been made for the International Monetary Fund and World Bank country assessments to address tax compliance.

2. Expanding Bilateral Information Exchange

An increase in the scope of bilateral information treaties to provide for regular and automatic exchanges of information would require U.S. banks to increase their collection of information. One suggestion is to adopt the model OECD Tax Information Exchange Agreement. This information exchange would relate to civil as well as criminal issues, would not require suspicion of a crime other than tax evasion, and would override bank secrecy laws. Non-tax havens could be induced to make agreements to obtain ownership information and collect information on interest payments by banks and financial institutions. Treasury has proposed such a plan for 16 countries, but Guttentag and Avi-Yonah (2005) suggest there is no reason to restrict the provision in this way. Treasury could use existing authority not to exchange information that might be misused by non-democratic foreign governments. Sullivan (2009) suggests that automatic information exchange might be the only way to stop evasion, which would require renegotiating existing agreements and a major policy change. The Stop Tax Haven Abuse Act requires automatic information exchange for a country to stay off the tax haven list.

3. Unilateral Approaches: Withholding/Refund Approach; Increased Information Reporting Requirements

The United States could impose withholding taxes on interest income and other exempt income received from U.S.

sources by foreign intermediaries, and provide a refund upon proof that the beneficial recipient was eligible. Alternatively, withholding could be imposed unless the names of customers including beneficial owners were provided. President Obama's proposals would impose withholding requirements with a refund mechanism, but only on non-qualified intermediaries.

The Stop Tax Haven Abuse Act would require banks and QIs to file 1099 information returns for U.S. owners, based on beneficial ownership (already required to be known under anti-money-laundering rules) any financial institution that establishes a trust, corporation, or bank account in a tax haven country would be required to report it to the IRS. President Obama's proposals contain similar provisions and also require information reporting by U.S. financial intermediaries, by QIs on transfers of funds, and by U.S. persons and QIs on the formation or acquisition of a foreign entity. The Stop Haven Abuse Act would also require reporting by U.S. shareholders and persons forming, sending or receiving assets from Passive Foreign Investment Corporations (PFICs).

B. Other Measures That Might Improve Compliance

1. Carrot and Stick Approaches to Tax Havens

Since little of the benefit of tax havens flows to their sometimes needy residents, transitional aid to move away from these activities might be paired with withholding for non-cooperating tax havens. The Stop Tax Haven Abuse Act would extend to tax enforcement the money laundering sanctions of the Patriot Act, ranging from increased reporting on transactions to prohibitions. Sullivan (2009) points out that the U.S. government has used the Patriot Act sparingly, however, and questions whether this change would be a credible threat.

2. Qualified Intermediaries

Several proposals relating to the QI program have been made. These proposals include independent verification of owners of foreign corporations, reporting of non-U.S. income of U.S. taxpayers, electronic submission of information, withholding for bearer bonds, and strengthened audits with U.S audit oversight and a ban on auditors who sell tax shelters. Another possible change is to require QIs to share information about foreign customers to U.S. treaty partners (although this might be too severe a requirement). Shell corporations should not be accepted as the beneficial owner and penalties for failure to enforce could include withholding on capital gains as well as interest and dividends. The IRS could require U.S. payors to issue form 1099s when they know or suspect the beneficial owner is a U.S. citizen (rather than the W8-BEN which provides evidence of foreign status). President Obama's proposals would require that QIs can qualify only if all of their affiliates are QIs.

3. Burden of Proof

Several proposals would shift the burden of proof to taxpayers in a variety of ways, especially when large amounts are involved, and some proposals would allow criminal penalties.

4. Treat Shell Corporations as US Firms

The Stop Tax Haven Abuse Act would treat any firm that is publicly traded or has assets over $50 million (including hedge funds) as a U.S. corporation. This provision would not affect subsidiaries of multinational firms because decisions are made by the parent firm. Sullivan (2009) argues that such a provision would have a devastating effect on the U.S. hedge fund industry, where offshore firms generally attract tax exempt U.S. investors and foreigners who wish to avoid filing tax returns, as well as U.S. tax evaders, and that legislative relief for U.S. tax exempt investors (pension funds, university endowments) would be likely.

5. Restrictions on Foreign Trusts

Any powers held by trust protectors could be attributed to the trust grantor, any U.S. person who benefits could be treated as a formal beneficiary, a future or contingent beneficiary could be treated as a current one, loans of assets and property would be distributions, and art and jewelry would be contributions.

6. Treat Dividend Abuse

The Stop Tax Haven Abuse Act would treat dividend equivalents as dividends. President Obama's plan treats equity swaps as dividends.

7. Statute of Limitations

Several proposals would extend the statute of limitations from three to six years, or possibly 10 years.

8. IRS Resources

Suggestions include expansion of IRS resources for overseas tax abuses, eliminating pressures on agents to give up difficult cases because of short term performance goals, and sharing suspicious activity reports filed by financial institutions under anti-money laundering acts with the civil side of the IRS.

9. Make Civil Cases Public to Improve Visibility and as a Deterrent

All settlements involving offshore schemes in excess of $1 million could be excluded from the restrictions that require settled civil cases to be confidential.

10. Revise Rules for FBAR (Foreign Bank Account Reports)

The FBAR report on foreign bank accounts is filed separately from the tax return. Several proposals would require this form to be filed with the tax return, along with due diligence on the part of tax preparers to determine if it should be filed. Reporting large transactions could also be required.

11. John Doe Summons

The Stop Tax Haven Abuse Act provides that the court is to presume tax compliance is at issue in cases involving offshore secret accounts, allowing the IRS to issue John Doe summons for large investigative projects.

12. Strengthening Penalties

Increased penalties are included in several proposals. These include: penalties for failure to file FBARs; basing the FBAR penalty on the highest amount in a period rather than on a particular day; and increased penalties on abusive tax shelters, failure to file information on foreign trusts, and certain offshore transactions. President Obama's proposals would double accuracy-related penalties for foreign transactions and increase penalties for trusts and permit them to be imposed if the amount in the trust cannot be established. Legal opinions that take the position that a transaction is more likely than not to prevail for tax purposes could no longer shield taxpayers from penalties.

The Fraud Recovery and Investment Act, S. 386, would introduce criminal penalties. Coder (2009) suggests that some tax attorneys have questioned whether these proposals are too harsh or might undermine amnesty or voluntary compliance. The attorneys are concerned that money laundering charges would not have to be approved through the Department of Justice's tax division, that penalties of up to 20 years gives prosecutors too much power, that the provisions may trap taxpayers who want to participate in IRS voluntary disclosure, and that they would also discourage "quiet disclosure" where taxpayers simply report past information.

13. Address Tax Shelters; Codify Economic Substance Doctrine

The proposed Stop Tax Haven Abuse Act would make a number of additional changes to address tax shelters, including prohibiting the patenting of tax shelters, developing a bank examination procedure, disallowing fees contingent on tax savings, removing communication barriers between enforcement agencies, codifying regulations (including the economic substance doctrine), clarifying that prohibition of disclosure by tax preparers does not prevent congressional subpoenas, and providing standards for tax shelter opinion letters.

14. Regulate State Incorporation Rules.

U.S. Limited Liability Companies (LLCs) could be required to have a taxpayer ID number, and record-keeping and identification of beneficial owners of corporations and LLCs (and perhaps partnerships and trusts) would be required.

VII. CONCLUSION

The sources of problems and possible remedies differ substantially for the avoidance and evasion of corporations as compared to those of high income individuals, although both occur because of the presence of low tax countries, often referred to as tax havens.

Corporations benefit from shifting profits artificially into low tax countries because of deferral of tax on income (which can be indefinite) and using foreign taxes generated on high tax income to reduce taxes on income from low-tax countries. Anti-abuse rules aimed at remedying some of this shifting (Subpart F) have been undermined in recent years by "check-the-box" regulations and restrictions on these approaches might be successful in reducing some corporate tax avoidance. Nevertheless, some significant profit shifting, especially relating to transfers of intangible assets between U.S. multinationals and their subsidiaries, may only be addressed with fundamental changes in the U.S. tax law, such as ending deferral.

The main problem with collecting taxes from individuals is evasion: failure to report asset income earned abroad, including income derived from U.S. sources and funneled through sham corporations and trusts in low-tax countries. While recent initiatives to reduce bank secrecy and provide voluntary information sharing by tax haven countries may help, these changes will likely have limited effects because the tax authorities must identify the specific taxpayers for information on request. The most effective remedy for international tax evasion by individuals is automatic, multilateral information sharing, which has already been initiated in the European Union. More limited measures, such as requiring more oversight of and information from foreign banks that act as qualified intermediaries, may also be effective.

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