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I. INTRODUCTION

The United States system of income taxation is predicated upon the voluntary self-assessment and payment of tax. Voluntary compliance, in turn, depends upon the confidence of United States citizens that the taxation system is basically fair, that the tax burden essential to maintain the government is shared by all in proportion to their net income, and that those who cheat are discovered and prosecuted. Circumstances that allow certain taxpayers to escape their proper tax liability successfully tempt others to seek tax evasion devices for themselves, and, more importantly, demoralize the conscientious majority who pay their just share of taxes but also perceive the system as unfair. One cause of the widespread erosion of confidence in the equity of the United States income tax system is the recent spurt in tax evasion schemes utilizing foreign haven secrecy laws to escape detection by United States tax officials.[1]

Tax avoidance, which consists of ethical planning utilizing legal methods to avoid unnecessary taxation, has long been respectable.[2] On the other hand, tax evasion is a felony, punishable by fine and imprisonment, that occurs when a taxpayer willfully and deliberately uses illegal means to escape his tax liability.[3] Identifying the dividing line between aggressive but acceptable tax avoidance and illegal tax evasion has occupied the attention of

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1. *See Crime and Secrecy: The Use of Offshore Banks and Companies: Hearings Before the Permanent Subcomm. on Investigations of the Senate Comm. on Governmental Affairs*, 98th Cong., 1st Sess. 16, 255-56 (1983) (testimony and statement of Roscoe L. Egger, Jr., Comm'r, Internal Revenue Service) [hereinafter cited as *Senate Crime and Secrecy Hearings*].

2. As Judge Learned Hand stated:

> [A] transaction, otherwise within the tax law, does not lose its immunity, because it is actuated by a desire to avoid . . . taxation. Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). A similar tax planning creed prevails in the United Kingdom: "No man in this country is under the smallest obligation—moral or other—to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores . . . ." Ayrshire Motor Pullman Motor Serv. v. Inland Revenue Commissioners, 14 T.C. 754, 763-64 (1920).

3. I.R.C. § 7201 (imposing a fine up to $100,000 and imprisonment up to five years for attempted tax evasion).

many.[4] The distinction is difficult to enunciate,[5] especially in the international tax field, because of the inherent intricacy of United States statutory law and its interaction with differing foreign counterparts, both of which are frequently subject to further modification by bilateral treaties.[6]

This Article will not explore these definitional refinements, but will focus on certain schemes at one end of the spectrum that are clearly illegal. To illustrate the flagrancy of international tax fraud schemes, the Article will first discuss one particular device: the use of false foreign addresses for the receipt of United States investment income that aids the evasion of tax liability by enabling United States residents to masquerade as foreign residents and foreign persons to pose as residents in preferentially-treated foreign jurisdictions.[7] The Internal Revenue Code sections facilitating the successful operation of this device will be explored: (1) section 861 excludes from United States income tax all interest earned on deposits with United States banks and savings and loan institutions as long as that interest is paid to a foreign inves-

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4. For a series of essays on the distinction between tax avoidance and tax evasion by rapporteurs from Canada, Denmark, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland, the United Kingdom, and the United States, see TAX AVOIDANCE, TAX EVASION (1982) (International Bar Association publ.).

5. The definitional dilemma has been phrased as follows:

> The term *tax avoidance* itself has unfortunate connotations; it is considered as referring to an attitude of unethical and, indeed, unlawful behaviour, although it is actually a neutral term. In the pejorative sense, the term *tax evasion* should be used, which indicates an action by which a taxpayer tries to escape his legal obligations by fraudulent means. The confusion arises from the fact that sometimes taxes are avoided—by the use of perfectly legal measures—against the purpose and spirit of the law. Where this is the case, the taxpayer involved is abusing the law and he is blamed for it, although no penal measures can be taken against him.

van Hoorn, *The Use and Abuse of Tax Havens*, in TAX HAVENS AND MEASURES AGAINST TAX EVASION AND AVOIDANCE IN THE EEC 1, 1 (1974).

6. *See* R. GORDON, TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS—AN OVERVIEW 59-61 (1981) (a report to the Treasury) [hereinafter cited as the GORDON REPORT]. Gordon, eschewing a black and white distinction, prefers to establish four categories of tax conduct ranging from totally legal to fraudulent. *Id.*

7. A House of Representatives Subcommittee has documented this device well. *See generally Improper Use of Foreign Addresses to Evade U.S. Taxes: Hearings Before a Subcomm. of the House Comm. on Government Operations*, 97th Cong., 2nd Sess. (1982) [hereinafter cited as *House Subcomm. Hearings on Foreign Addresses*].

tor not doing business within the United States, and (2) sections 1441 and 1442 reduce or eliminate the United States thirty percent withholding tax on portfolio income remitted to residents of countries that have bilateral tax treaties with the United States. The Article next will examine the bank and commercial secrecy laws of representative countries to ascertain, in a broader context, the manner in which United States investigations of a variety of fraudulent tax evasion practices are blocked. The Article also will review and evaluate the recent major steps taken by the Treasury Department, the judiciary, and Congress to repulse this assault on the integrity of the tax system. Finally, the Article will conclude with recommendations for additional proposals to consider.

II. Basic Pattern of United States Taxation of International Transactions

Certain fundamental principles of the United States income taxation of international transactions must be examined in order to understand how these principles are manipulated in the foreign address ploy. The United States taxes its citizens, residents, and domestic corporations on all income earned within and without the United States.[8] United States income taxes also are imposed on the income received by nonresident alien individuals and foreign corporations from United States sources if that income is not effectively connected with the conduct of a trade or business within the United States.[9] In addition, the nonresident aliens and foreign corporations are taxed on income that is effectively connected with the conduct of a trade or business within the United States, whether or not the income derived from the conduct of that trade or business is United States-sourced or foreign-sourced income.[10] If income is effectively connected with the conduct of a trade or business within the United States, it is taxed on a net basis,[11] after allowance for relevant deductions, at the graduated rates generally applicable to United States

8. *See* I.R.C. §§ 1, 11, 61 (1976 & Supp. V 1981). The authority of Congress to tax United States citizens on their worldwide income was established in Cook v. Tait, 265 U.S. 47, 56 (1924), which involved a United States citizen who was permanently domiciled in Mexico and receiving income from property situated in Mexico.

9. I.R.C. §§ 871(a), 881 (1976).

10. *Id.* §§ 872(a), 882(b).

11. *Id.* §§ 871(b)(1), 882(a)(1) (1976 & Supp. V 1981).

taxpayers.[12]

If a nonresident alien or foreign corporation receives interest, dividends, rents, salaries, wages, premiums, annuities, and other fixed or determinable annual or periodical income from United States sources (United States portfolio income), the receipt of which is not effectively connected with the conduct of a trade or business within the United States, the gross amount of such items is taxed at a flat rate of thirty percent unless a treaty rate applies.[13] The United States currently is a party to approximately thirty income tax treaties that reduce or eliminate the flat thirty percent rate on the various items comprising United States portfolio income.[14] A withholding system is utilized to collect the thirty percent flat tax on United States portfolio income paid to foreign recipients. The tax, therefore, is commonly referred to as a withholding tax.[15] Often, the thirty percent withheld represents the total tax the foreign recipient owes to the United States, and the foreign investor will not file a United States tax return with respect to such United States portfolio income.[16] If the fixed or determinable periodical income is effectively connected with a trade or business conducted within the United States, it is not subject to the thirty percent withholding tax; rather, it is to be reported as part of the trade or business income. This type of income will be taxed on a net basis, after allowing for deductions and credits, at the graduated rates applicable to the particular trade or business, provided that a true and accurate United States income tax return is filed.[17]

The following items are exempted from the thirty percent withholding tax: (1) original issue discount on obligations maturing in

12. In determining effectively connected taxable income, deductions are allowed "only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States . . . ." *Id.* §§ 873(a), 882(c)(1)(A) (1976).

13. *Id.* §§ 871(a), 881(a).

14. *See infra* note 96 and accompanying text.

15. I.R.C. §§ 1441, 1442 (1976) (applicable to individuals and corporations respectively).

16. *See* Description of H.R. 7553 Relating to Exemptions from U.S. Tax for Interest Paid to Foreign Persons 4 (Staff of the Joint Committee on Taxation Comp. June 18, 1980) (prepared for the Hearings Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means) [hereinafter cited as the 1980 Joint Committee Description].

17. I.R.C. §§ 874(a), 882(c)(2) (1976).

six months or less;[18] (2) capital gains from United States sources, subject to certain qualifications;[19] (3) interest and dividends paid by United States persons and corporations that earn at least eighty percent of their gross income from foreign sources;[20] and (4) all income received by foreign governments or international organizations that is derived from United States investments.[21]

Section 861(c) interest is one additional category of United States investment income payable to foreign investors that is exempt by statute from the thirty percent withholding tax. This last category will be examined in detail for its tax evasion potential.

III. The Use of False Foreign Addresses to Evade Tax on United States Portfolio Income

A. Exclusion from Tax of Certain Interest Paid to Foreign Recipients

One of the items of fixed or determinable income subject to the thirty percent withholding tax is interest. Special rules determine whether or not interest is United States-sourced; the residence of the debtor is determinative. Thus, interest paid by United States residents usually is deemed United States source income and is

18. *Id.* §§ 871(a)(1)(A), (C), 881(a)(1), (3) (1976).

19. Gains from the sale or exchange of "patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property" in which the amount of payment is contingent on the productivity or use of the property sold are more in the nature of royalties and do not qualify for exempt capital gain treatment. *Id.* §§ 871(a)(1)(D), 881(a)(4). Capital gains from the disposition of a "United States real property interest" are treated as though the foreign individual or corporation were engaged in a trade or business within the United States and as if such gains were effectively connected with such trade or business. *See id.* § 897 (Supp. V 1981). The purpose is to render such capital gains taxable. Finally, the exemption from tax on capital gains is lost by a nonresident alien individual who is present within the United States for 183 days or more during a taxable year. *Id.* § 871(a)(2) (1976).

20. *See id.* § 861(a)(1)(B), (2)(A) (1976). The 80% foreign income test is generally applied to the three-year period ending with the close of the taxable year of the United States payor.

21. *Id.* § 892. On August 15, 1978, the Treasury issued proposed regulations under this section to clarify its position that the exemption: (1) does not apply to income received by foreign governments from United States commercial activities, as distinguished from investment income; and (2) does not apply to income collected by a foreign government that accrues to the account of any private individual.

subject to the thirty percent withholding tax.[22] There is, however, a significant exception to these source rules for interest arising from deposits with persons carrying on a banking business, from deposits or accounts at savings and loan institutions chartered by the federal government or any state, and from amounts held by United States insurance companies.[23] This interest will be referred to as "section 861(c) interest" or "bank interest." If section 861(c) interest is paid to a nonresident alien individual or to a foreign corporation[24] and is not effectively connected with the conduct of a trade or business within the United States, the interest item is excluded from the classification of United States source income and automatically treated as foreign-sourced income.[25] Because bank interest payable to a foreign person is foreign-sourced income, it is exempt from the thirty percent statutory withholding tax and all other United States taxes. United States institutions paying this interest item to a foreign recipient need not withhold any part of the interest nor file any informational reports concerning the amount of payments with the Internal Revenue Service.[26] The rationale for not requiring withholding or filing is that section 861(c) interest represents foreign-sourced income paid to a foreign person and is, therefore, outside the jurisdiction of the United States.

B. Abuse of Section 861(c)

The policy underlying the original exemption of section 861(c) interest from tax was to attract foreign capital to United States banks.[27] Evidence is mounting that some United States residents

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22. *Id.* §§ 861(a)(1), 862(a)(1) (1976 & Supp. V 1981).
23. *Id.* § 861(a)(1)(A), (c) (1976).
24. *Id.* § 861(a)(1) (1976 & Supp. V 1981).
25. *Id.*
26. *See* Treas. Reg. § 1.861-1 to -8 (1957).
27. The exemption from tax currently in I.R.C. §§ 861(a)(1)(A) and 861(c) for bank deposit interest and savings and loan interest paid to foreign investors has been an accepted part of the United States tax law since the 1920s. Until the Tax Reform Act of 1976, this tax exemption was enacted by Congress for short periods of three to four years and was extended, after review, from time to time. During its consideration of the 1976 legislation, the House Ways and Means Committee voted to eliminate the entire 30% withholding tax on all United States portfolio income paid to foreign recipients. During debate on the House floor, the 30% withholding was reinstated generally for all portfolio income, but the House agreed to extend the tax-free treatment of interest on de-

are posing as foreign persons, establishing interest-bearing savings or checking accounts at United States banks or savings and loan institutions, directing that the interest income be sent to them at an address of convenience in a foreign country, and omitting that interest as income on their United States tax returns.[28] The failure of a United States resident to report this interest earned on deposits with United States banks or savings and loan institutions, whether or not it is sent to that resident at a foreign address, constitutes willful tax evasion. The scheme appears to succeed only because many barriers impede tax officials from detecting the transaction. At the United States end of the transaction, the financial institution paying the bank interest is not required to withhold tax or report the transaction, thereby making it difficult, if not impossible, for the Internal Revenue Service to identify the recipient of bank interest sent abroad. The anonymity afforded to section 861(c) interest paid to foreign addressees contrasts with the disclosure procedures applicable to the same bank interest payable by the same United States bank to the same United States residents at domestic addresses. Interest paid to residents is reported on Form 1099 with the taxpayer's identification number (TIN). The IRS computer matches the Form 1099 with the taxpayer's return, which bears the same TIN, to verify

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posits with banks, savings and loans, and other institutions described in § 861(c) on a permanent basis.

Senator Packwood proposed an amendment, H.R. 10612, 94th Cong., 2d Sess. (1976), to Title X of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified in various sections of 26 U.S.C.), to extend the exemption from tax for § 861(c) interest paid to foreign investors for only three years, until December 31, 1979. The Treasury Department opposed the three-year extension contained in the Packwood Amendment and supported a permanent exemption from tax for section 861(c) interest paid to foreign investors. The Treasury position ultimately prevailed. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1041, 90 Stat. 1520, 1634 (codified at 26 U.S.C. § 861). The rationale for the permanent exemption, as it developed during the 1976 debate on the Packwood Amendment was: "[t]oo many Americans are unemployed due to a lack of capital growth through sufficient investments. The Senate Finance Committee bill [for a permanent exemption] will motivate greater capital flow to this country and will subsequently economically benefit all Americans." Record Vote Analysis of Vote Number 418 on the Packwood Amendment (Staffs of the Senate Republican Conference and the Senate Republican Policy Committee Comps. 1976), *partially reprinted in House Subcomm. Hearings on Foreign Addresses*, *supra* note 7, at 330.

28. *See House Subcomm. Hearings on Foreign Addresses*, *supra* note 7, at 5 (statement of Dean T. Scott).

that the return includes the full amount of such interest.

No one can place a precise dollar figure on the amount of the section 861(c) interest that is paid to United States residents improperly utilizing false foreign addresses. In an effort to determine the extent of revenue loss from this device, congressional investigators sent questionnaires to representative United States financial institutions and found that no uniform procedure existed to segregate accurately the amount of section 861(c) interest from the other categories of interest (for example, bond interest) sent abroad.[29] The April 1982 Federal Reserve Board data on United States commercial banks showed, however, that foreign persons and foreign corporations, excluding foreign banks, held approximately $18.5 billion in interest-bearing savings accounts and certificates of deposit (time deposits) and $5 billion in interest-bearing checking accounts (demand deposits).[30] By October of 1983, the aggregate figure amounted to $30.4 billion.[31] No comparable figures on the amount of foreign-owned, interest-bearing accounts and deposits located in savings and loan associations, mutual savings banks, and insurance companies, all of which pay tax-exempt section 861(c) interest, were obtainable because they are not under the jurisdiction of the Federal Reserve.

Although it is entirely possible that most foreign address recipients of United States bank interest are in fact nonresident aliens and, therefore, are lawfully entitled to receive such interest without identification and to exclude it from United States tax, a survey of the practices of representative banking institutions has indicated that many payors rely solely upon the foreign address submitted by the depositor and have little or no internal safeguards to verify a depositor's true residency[32] when paying out massive sums to foreign addressees. One Florida savings and loan institution stated:

> Since, under Section 861 as amended, interest on savings and loan accounts held by non-resident aliens is excluded from the term "income from sources within the United States," we do not view any of this interest as reportable to IRS or subject to withholding. We accept as valid evidence of non-resident alien status

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29. *Id.* at 13.
30. *Id.* at 5.
31. 69 FED. RESERVE BULL. 946, app., at A57 (1983).
32. *See House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 17 (statement of Dean T. Scott).

the account holder's indication of foreign address on his/her signature card.[33]

The vice president of that institution testified:

> If an account holder gives a foreign address as his residence on the account signature card, we accept that as evidence of non-resident alien status. If the account holder uses a United States mailing address but tells us that he or she is a non-resident alien, we accept his or her statement and type country of residence on the card.
>
> . . .
>
> We have no practical and effective means of verifying the account holder's claim of non-resident alien status and accept his or her statement without question.[34]

In 1981 this Florida financial institution paid $29 million as section 861(c) interest to persons with foreign addresses.[35] Similarly, in 1981 a New York City branch of a German bank paid over $21 million as section 861(c) interest on deposits to recipients with foreign addresses. The branch stated that because the Internal Revenue Code classified such interest as "foreign source income, not subject to withholding," it had "no formal procedure . . . to determine the amount of tax that should be withheld on income accruing to particular persons or accounts with addresses in foreign countries."[36] These two examples are representative of the practices of many banking institutions.[37]

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33. Letter from R. Benner, Senior Vice President of AmeriFirst Federal Savings and Loan Ass'n, to B. Rosenthal, Chairman of the Commerce, Consumer, and Monetary Affairs Subcomm. of the Comm. on Government Operations (Mar. 16, 1982), *reprinted in House Subcomm. Hearings on Foreign Addresses*, *supra* note 7, at 124.

34. *House Subcomm. Hearings on Foreign Addresses*, *supra* note 7, at 129 (statement of R. Benner).

35. *Id.* at 133.

36. Letter from K. Zimmerling, Executive Vice President of The Dresdner Bank, to B. Rosenthal (Apr. 15, 1982), *reprinted in House Subcomm. Hearings on Foreign Addresses*, *supra* note 7, at 100.

37. In 1981 a savings bank in New York classified and paid approximately $5 million as section 861(c) interest. The bank did not withhold any tax or file any information reports. Tax-exemption classification rested upon the depositor's representation, when opening the account, that he was neither a United States citizen, a United States resident, nor engaged in business in the United States. The bank did not mention any procedures established to verify the self-serving form statements that depositors could make. *See* Letter from J. Ashendorf, Assistant Vice President of the Bowery Savings Bank, to B. Rosenthal (Mar. 19, 1982), *reprinted in House Subcomm. Hearings on Foreign Addresses*, *supra*

Although the lack of reporting makes it impossible to tabulate precise data on the amount of revenues lost from the misuse of foreign addresses by United States residents, Treasury officials concede "that this reporting exemption [for § 861(c) interest] results in one less obstacle to tax evasion by U.S. persons who may establish foreign accounts through which to receive bank deposit and similar interest."[38]

C. Reduction of Withholding Rates for United States Portfolio Income Paid to Residents of Treaty Countries

Sections 1441 and 1442 of the Internal Revenue Code establish withholding procedures applicable to United States portfolio income not effectively connected with a United States trade or business and payable to nonresident alien individuals and foreign corporations. For convenience, this income will be referred to as "section 1441 income." The statutory withholding rate is thirty percent of the gross amount.[39] Depending upon the treaty partner and the item of income, certain tax treaties provide a lower percentage withholding rate, and some treaties, in fact, totally eliminate the withholding obligation.

The present United States treaty position is to reduce the thirty percent withholding tax to zero on all United States investment interest paid to residents of the other treaty state.[40] There is no withholding on interest generally under United States treaties with Austria, Denmark, Finland, Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, Malawi, the Netherlands, the Netherlands Antilles, Norway, Poland, Sweden, Union of Soviet

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note 7, at 134-35.

38. *See House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 50 (statement of A. Granwell, International Tax Counsel to the Department of the Treasury). One IRS audit estimated that 85% of payments made to Swiss addresses were to nonqualified recipients. *Id.* at 36-37.

39. I.R.C. § 1441(a) (1976).

40. The term "investment interest" refers to all United States-sourced interest that is not attributable to a trade or business conducted within the United States through a permanent establishment located in the United States. *See* Treasury Department's Model Income Tax Treaty, May 17, 1977, art. 11, *reprinted in* 1 TAX TREATIES (CCH) ¶ 153, at 228 (Apr. 1982). The United States position is based on the premise that such interest will be taxed by the recipient's country of residence. Because the treaties are bilateral in nature, the treaty partner must grant a similar complete exemption from its tax for all interest paid to United States residents that is subject to taxation by the United States.

Socialist Republics, the United Kingdom, and Zambia.[41] Moreover, the thirty percent statutory withholding rate on interest is reduced to fifteen percent under treaties with Belgium, Burundi, Canada, Rwanda, and Zaire; to twelve percent under the treaty with Korea; to ten percent under treaties with France, Japan, and Rumania; and to five percent under the treaty with Switzerland.[42]

D. Improper Use of Addresses in Treaty Countries

1. *Income Paid to Foreign Persons*

Clearly, the country of residence of the United States portfolio income recipient is the critical factor in determining the actual amount of tax to be withheld. The IRS has established two different procedures for applying the treaty-reduced withholding rates to United States portfolio income paid to foreign persons. One procedure applies to dividend income and the other to nondividend section 1441 income. With respect to dividends, the regulations provide for an "address method" to determine the appropriate withholding rate.[43] Under the address method, if a recipient of United States dividends submits an address in a country that has a tax treaty with the United States, he generally is presumed to be a resident of that foreign country and can obtain the reduced withholding rates specified by the treaty with that country.[44] The regulations provide that the withholding agent may apply the lower treaty rates in reliance on the foreign address of the stockholder unless the withholding agent has knowledge that the stockholder is not in fact a resident of the treaty country under which he is claiming benefits.[45]

When dividends are paid to a stockholder with an address in a foreign country that has a tax treaty with the United States, the withholding agent need not demand any formal documentation of the recipient's status as a bona fide resident of the treaty country. No independent proof that the recipient is lawfully entitled to the

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41. *See* 1980 Joint Committee Description, *supra* note 16, at 5.

42. *Id.*

43. Treas. Reg. § 1.1441-3(b)(3) (1966) (withholding agent entitled to rely on address of owner in the case of dividends paid to stockholder whose status is unknown).

44. *See House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 11 (statement of Dean T. Scott).

45. *Id.* at 46 (statement of A. Granwell). *See* Treas. Reg. § 1.1441-3(b)(3) (1966).

treaty-lowered withholding rate is required. It is not surprising to learn that withholding agents adhere to the regulations literally in disbursing dividends and grant the reduced treaty rates on the basis of the stockholder's foreign address without further inquiry.[46]

When disbursing nondividend section 1441 income, such as corporate bond interest, the regulations require withholding agents to obtain a Form 1001 from the foreign recipient to determine whether the thirty percent statutory rate or the lower treaty rate prevails. This requirement is a simple certification signed by the recipient, under penalty of perjury, in which the recipient states his country of residence and claims the benefit of the reduced withholding rates under that country's treaty with the United

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46. The House Subcommittee staff investigating the misuse of foreign addresses circulated a questionnaire to approximately 100 withholding agents and major corporations, inquiring whether the payor reduced withholding rates based upon only the foreign address of the recipient. Typical responses were: (1) "If the client maintains a non-U.S. address, the account is coded as foreign," *House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 76 (Wall Street private banking company); (2) "In the case of dividend income, pursuant to [Treasury regulations] . . . , we rely on the address" of the recipient, *id.* at 92 (New York City bank); (3) "The amount of tax to be withheld on any dividend . . . , is determined on the basis of the address of record of the recipient of the payment unless we receive appropriate documentation that the withholding should be at a different rate," *id.* at 96 (New York City bank); (4) "[We base] the rate of withholding for dividends only on the address of record of the payee," *id.* at 115 (New York City bank); (5) "The firm requires no collateral evidence of an income recipient's representation of his country of legal residence," *id.* at 138 (major investment broker); (6) "Generally . . . [we] determine the applicable rate of withholding tax imposed on [dividend] payments made on the basis of the foreign address of the recipient," *id.* at 141 (major investment house); (7) "[T]he Company requires the recipient to demonstrate actual residence . . . by supplying its foreign address in the case of dividends," *id.* at 144 (United States multinational corporation); (8) "[W]ith respect to payments made to foreign payees, the procedures set forth in . . . [IRS] Publication 515 are followed. These procedures indicate that with respect to dividends a payor may rely on the payee's address of record," *id.* at 147 (major United States international oil company); (9) "As the instructions in Publication 515 provide, the amount of tax to be withheld and reported . . . with respect to dividends is generally based on the payee's address of record," *id.* at 163 (major electronics company); and (10) "For dividend . . . payments, we reduce withholding rates based on the foreign address of the recipient. . . . Other than notice of address, we do not require any additional evidence from recipients to demonstrate their actual residence in a tax treaty country." *Id.* at 168 (major data processing company).

States.[47] Form 1001 is filed with the withholding agent, but not with the Service. Under the Treasury procedures, withholding agents may accept the recipient's representation as to his country of residence and are not required to independently corroborate the claimed foreign residency unless the agent has actual knowledge that the representations are not correct.[48] Generally, payors indicate that they rely upon the self-certification contained in Form 1001 to determine the recipient's country of residence and the appropriate reduced treaty rates applicable to nondividend section 1441 income.[49]

2. *Foreign Nominee Accounts*

Withholding agents also must determine the applicable rate for section 1441 income paid to foreign nominee accounts, which are held ostensibly in the name of one entity, such as a bank or brokerage house, for the benefit of another who is the true owner. The regulations do not specifically distinguish or establish any different withholding procedures for nominee payments and do not expressly require United States payors to search out and identify the beneficial owners of foreign nominee accounts.[50] Paying agents, consequently, can and do rely on the address of record of the foreign nominees or the address of the foreign nominee contained in the Form 1001 to determine the proper withholding rates on dividends and nondividend section 1441 income.[51] A nominee with an address in a treaty country, therefore, obtains

47. *See* I.R.S. Form 1001 (Ownership, Exemption, or Reduced Rate Certificate), *reprinted in House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 322-23. Form 1001 contains the name and address of the owner of the income; the United States identification number "if any"; a description of the type of income involved; and a conclusory statement to the effect that "I certify that the information entered hereon is correct; and, if a reduced or exempt rate of tax applies, I further certify that I have complied with all requirements to qualify for such a reduced or exempt rate of tax." *Id.* Once filed with the withholding agent, the Form 1001 is valid for three years.

48. *See House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 45 (statement of A. Granwell).

49. *Id.* at 92, 94, 114-15, 138, 144, 148, 163, 168 (letters from private companies).

50. *See id.* at 11 (statement of Dean T. Scott).

51. *Id.* at 71, 74, 78, 88, 92, 116, 142, 144, 148, 164, 168 (letters from private companies). A major stock brokerage firm, not included in the above tally, claimed it lacked the capacity within its computer system to provide data on foreign nominee accounts. *Id.* at 138.

the benefit of treaty-reduced withholding rates, without regard to the beneficial owners' country of residence.

Withholding agents are not necessarily at fault for this anomalous situation. In selling its marketable securities,[52] the United States Treasury Department treats foreign nominees with the same standards that withholding agents customarily apply.[53] The Treasury itself relies on the country of residence of the nominee to determine the appropriately reduced treaty rate applicable to the interest it pays. The Treasury makes no independent inquiry regarding the identity or residence of the beneficial owners of the nominees.[54]

It is acknowledged that the practice of blind payments to foreign nominees at the withholding agent level is subject to abuse. Two of the institutions responding to the House Subcommittee questionnaire asserted that they did not accord reduced treaty rates to foreign nominees and instead withheld tax at the statutory thirty percent rate.[55] Two other respondents stated that if the foreign address of the registered owner consisted of a recipient with an "in care of" address and not the address of a formal nominee, there is sufficient doubt raised to demand the application of the thirty percent statutory rate rather than the reduced treaty rate associated with the country in which the "in care of" address was located.[56]

To justify applying the treaty rate associated with the country of the foreign nominee without regard to the residence of the beneficial owners, a few payors have pointed to the United States-Switzerland treaty and accompanying regulations that require the foreign nominee to withhold any additional United States taxes which might be due if the true owners of the account are not entitled to the Swiss rates accorded the nominee.[57] One institution, acting as a custodian for many European banking institutions that serve as nominees, commented that it could not possibly know the identities of the clients of those European banks.[58]

Theoretically, foreign nominees could collect, on behalf of the

52. The term marketable securities includes bills, notes, and bonds.

53. *House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 6 (statement of Dean T. Scott).

54. *Id.* at 225 (letter from W. Thomas, Department of the Treasury).

55. *Id.* at 95, 160 (letters from private companies).

56. *Id.* at 144, 163.

57. *Id.* at 74, 78, 92.

58. *See id.* at 78.

United States, the additional taxes due on the difference between the treaty rate applicable to the nominee's country and the higher rate applicable to the beneficial owners' country of residence. Switzerland and Belgium, however, appear to be the only treaty countries that effectively require their financial institutions acting as nominees to follow this practice.[59] The foreign governments collecting these additional withholding taxes ultimately remit them to the United States.[60] The treaty partners imposing this additional collection requirement on their nominees perceive the procedure as a costly accommodation to the United States.[61] The Swiss government may eliminate the procedure if its banking industry loses nominee business to banks in those countries that do not respond as rigorously to United States requests for such accomodation.[62]

3. *Ineffective Reporting*

Unlike the situation with section 861(c) interest, the Treasury has certain reporting requirements for section 1441 income paid to foreign recipients.[63] It is questionable, however, whether the

59. IRS, Internal Audit Report: Review of Service Programs Relating to International Transactions (Aug. 25, 1981), *reprinted in House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 53, 61 (analyzing loss of revenue due to dividend payments to foreign nominees for 1976 and 1977).

60. In 1981, Switzerland remitted $95 million in additional withholding monies to the United States. *See House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 24, 37 (statement of Roscoe L. Egger, Jr., Commissioner of the Internal Revenue Service).

61. *Id.* at 61 (IRS letter).

62. The Swiss government has expressed the most concern about competition from Germany. The German government does not compel its banks, when acting as nominees, to collect additional tax on behalf of the United States if the beneficial owners of the nominee accounts are ineligible for the lower United States-German treaty withholding rates. The Swiss have stated to United States investigators that German banks, therefore, have a "competitive advantage" over Swiss banks. "It is clear that the competitive advantage that the Swiss refer to is the evasion of U.S. tax from the use of nominee accounts." *See id.* at 237 (IRS Memorandum).

63. At the close of each calendar year, withholding agents must file Form 1042. A summary of the total amount of tax to be withheld, the amount actually withheld, and the amount deposited with the government is to be listed by month. Withholding agents also must annually file a separate Form 1042S that lists the names of each foreign recipient of section 1441 income. In effect, Form 1042S transmits the same data contained in the investor's self-certification Form 1001. *See id.* at 45 (statement of A. Granwell).

reporting forms are of much value because they contain no United States taxpayer identification numbers. The number is not obtained on the presumption that the recipients of the section 1441 income are foreign persons. Without a tax identification number, the present IRS data processing system cannot collate or assimilate the reported information to match it with other data in its possession.[64]

In summary, Treasury officials have conceded that the entire system for paying noneffectively connected United States portfolio income to foreign investors under the various provisions of the Code, as modified by treaties and as implemented by current administrative procedures, fosters tax evasion. The International Tax Counsel for the Treasury Department stated his overall appraisal:

> The procedure . . . for insuring the collection of tax on fixed or determinable income paid to foreign persons is . . . insufficient for the task. The address system of withholding of tax on U.S. source dividends is particularly vulnerable to abuse. Such system permits tax evasion by persons who are not legitimate treaty beneficiaries but who merely establish post office boxes or nominee accounts in countries with which we have a tax treaty providing for reduced rates of tax on dividends. The only real check on this abuse is provided by certain of our treaty partners who collect and remit additional taxes to the United States if they determine that a particular dividend recipient is not a *bona fide* treaty beneficiary. However, much abuse goes undiscovered and, even with respect to amounts remitted by our treaty partners, substantial costs in terms of delay and uncollected interest are inevitably incurred. The Form 1001 filing procedure which applies to fixed or determinable income other than dividends is similarly subject to abuse in that it requires persons claiming treaty benefits only to submit an unverified self-serving statement to a withholding agent, who is entitled to rely on such statement for purposes of reducing the amount of tax withheld.[65]

64. *Id.* at 11 (statement of Dean T. Scott).

65. *Id.* at 46 (statement of A. Granwell) (emphasis added).

E. Amount of Potential Revenue Loss from Foreign Address System Abuse

Officials suspect that the revenue loss from abuse of the foreign address system is substantial.[66] As the following table indicates, the discrepancy in rates creates the temptation for United States residents.

TABLE I

Potential Range of Tax Evasion by United States Taxpayers Using False Foreign Addresses[67]

Categories of U.S. Investment Income	U.S. Tax Due If Income Reported (assuming 50% marginal bracket)	Address In Treaty Country X	U.S. Tax Withheld Under Treaty X	Address In Non-Treaty Country	U.S. Tax Withheld (no treaty)
A. $1,000 interest from U.S. bank account	$500	No W/H Per § 861	0 (deemed foreign-sourced)	No W/H Per § 861	0 (deemed foreign-sourced)
B. $1,000 interest from U.S. Treasury Bills	$500	Treaty X W/H Rate 5%	$50	30% W/H Per § 1441	$300
C. $1,000 dividends from U.S. corporations	$500	Treaty X W/H Rate 15%	$150	30% W/H Per § 1441	$300

66. *See, e.g., id.* at 9 (statement of Dean T. Scott).

67. Table I illustrates the potential for tax evasion when a United States taxpayer sets up a foreign address for the purpose of receiving, but not reporting, interest from a United States bank account (§ 861(c) interest); interest from United States Treasury Bills (nondividend § 1441 income); and dividends from United States corporations (dividend § 1441 income). Assuming the taxpayer is in a 50% marginal bracket, all of such items are reportable and taxable at the 50% rate. If the taxpayer does not report § 1441 income that is sent to an address in a nontreaty country, it is subject to the 30% withholding rate, resulting in a 20% potential bracket advantage if such income remains undetected. If § 1441 income is sent to an address in a treaty country, lower withholding rates apply, which increase the potential bracket advantage if such income remains undetected. If § 861(c) interest is sent to a foreign address, whether or not within a treaty country, there is zero withholding and the bracket advantage can be the entire 50% rate of tax if the transaction remains undetected. Table I illustrates these various points and uses a hypothetical treaty country X that is assumed to have a reduced withholding rate of 5% on § 1441 interest and 15% on § 1441 dividends.

The potential also exists for evasion of federal tax owed by foreign investors on United States portfolio income through the intentional use of false treaty-country addresses. Foreign persons residing in a country that has no tax treaty with the United States may be establishing false mail addresses in treaty countries with more favorable treaty rates on portfolio income. By using the false address, they intend to escape part of the United States withholding tax on portfolio income otherwise properly due.[68]

As Table II indicates, the volume of United States portfolio income sent to foreign addresses is rapidly rising.

TABLE II

Section 1441 Income Sent Abroad[69]

Sent to Foreign Addresses	1978	1979	1980
§ 1441 dividends	$2.9 billion	$2.7 billion	$3 billion
§ 1441 interest	$1 billion	$1.4 billion	$2.1 billion
Total § 1441 income (including dividends, interest, and other reported amounts)	$4.5 billion	$5.1 billion	$6.6 billion

Almost ninety percent of the United States investment income sent abroad in 1978 was transmitted to addresses in those countries having tax treaties with the United States.[70] Switzerland, the Netherlands, and the Netherlands Antilles received approximately one-half of the dividends and one-third of the section 1441 interest paid to foreign addresses.[71]

The discrepancy in the estimates of the amount of section 1441 tax revenue lost on foreign payments to ineligible "foreign" recipients is cause for dismay. It confirms the suspicion that the gov-

68. *House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 12 (statement of Dean T. Scott).

69. *Id.* at 12-13.

70. *Id.* at 12.

71. *Id.* These three countries have treaties with the United States that provide for low withholding rates on § 1441 payments remitted to their residents. They historically have been considered tax havens and possess varying degrees of bank secrecy or other internal commercial laws and customs that afford anonymity to those who operate within their borders. *See infra* notes 126-61 and accompanying text.

ernment has no reliable information on the size of the leak. In 1982 the IRS estimated the annual tax loss at between $375 million and $800 million.[72]

F. Revenue Losses from Withholding Agent Error

The volume of foreign payments is so great and the mechanics for determining the appropriate rate so cumbersome and lax that withholding agents make mistakes. These mistakes have also caused revenue loss on section 1441 income paid to foreign investors.[73] The Service lacks the procedures necessary to verify the accuracy of information filed by the withholding agents and guarantee that the agents have not underwithheld.[74] The costliness of agent error is illustrated by a special audit which shows that in 1977 and 1978 the Treasury lost $123 million in revenue because of underwithholding. Each withholding agent must determine, based on the treaty country, the provisions of the treaty, and the particular item of income, which of the following eight possible rates to apply: (1) zero; (2) two percent; (3) five percent; (4) ten percent; (5) fourteen percent; (6) fifteen percent; (7) twenty-seven

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72. *See House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 14 (statement of Dean T. Scott). The House Subcommittee Staff analyzed only payments of dividends and corporate bond interest made to foreign addresses and concluded from these two items alone that the annual losses to the United States Treasury were: (1) $203 million from mistakes of withholding agents in using the wrong withholding rates; (2) $94 million on dividends paid to unqualified recipients at Swiss addresses; (3) $72 million on dividends paid to unqualified recipients at addresses in other tax treaty countries; (4) $122 million on corporate bond interest paid to unqualified recipients using foreign addresses in Switzerland and the Netherlands Antilles; and (5) $310 million as a result of United States taxpayers who do not report § 1441 dividend and bond interest income that they have sent to false foreign addresses in nontreaty countries where it is subject to a maximum flat withholding tax of 30% (presumed to be less than the marginal rate of up to 50% applicable to such United States taxpayers). The Staff figures do not include lost revenues resulting from situations in which United States taxpayers use a false foreign address for interest income paid on United States Treasury securities (presumably the Treasury does not file the standard 1042 forms, required of ordinary withholding agents, that were the basis of this study), for royalties, or for capital gains. Also, this estimate does not include any amount for the loss of revenue due to § 861(c) interest sent to United States residents at improper foreign addresses because there are no records for such interest.

73. *See id.* at 16.

74. *Id.* at 59 (IRS report).

percent; and (8) thirty percent.[75] According to the survey, as long as the agent reports that one of the eight valid percentage rates was used, the IRS computer accepts it as correct.

An examination of selected accounts included in the audit discovered serious discrepancies: on dividends of $16 million paid to East German addressees, the agent withheld at a fifteen percent rate instead of the correct statutory rate of thirty percent;[76] on dividends of $985 million sent to Swiss addressees, the proper treaty rate of fifteen percent should have yielded $148 million in taxes instead of the actual $100 million withheld; the $16 million in taxes withheld on $187.5 million of section 1441 interest paid to Canadian addressees should have been $28.06 million; and $76 million of section 1441 interest[77] paid to investors in Saudi Arabia should have yielded $23 million in taxes at the proper thirty percent rate instead of the $52,000 actually withheld.[78]

The acknowledged inability of the government to monitor and detect administrative errors of such proportions creates an atmosphere of laxity that does not promote respect for voluntary self-disciplined tax compliance by investors operating in the foreign payments area.

IV. Foreign Secrecy Laws Impede Detection of Abuse of Foreign Addresses

A. Secrecy Havens

The efficacy of the false foreign address evasion device rests on several domestic and foreign factors. A substantive consideration

75. *Id.*

76. *Id.* at 60.

77. This figure excludes interest on Treasury securities and tax-exempt § 861 bank account interest.

78. *House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 16-17 (statement of Dean T. Scott). Moreover, the Service cannot verify that the amounts reported as withheld are actually deposited. This is attributable to the fact that large banks and investment companies act as withholding agents for many different payors (for example, as disbursor of dividends and interest for large corporations) and file a separate Form 1042 for each corporate payor or each category of income, or both. In filing these forms, the withholding agent may use the underlying corporate payor's Taxpayer Identification Number (TIN) or the withholding agent's TIN, but the taxes may be deposited and credited under the TIN of either the underlying corporate payor or the withholding agent itself, or partly under both TINs. The tracing problem becomes formidable. *See id.* at 60 (IRS report).

is the complexity encountered with the interaction of the Code and the provisions of various tax treaties, which results in eight different tax rates on the different items of portfolio income paid to addressees in different countries. In addition, there are several contributing procedural factors: (1) insufficent mechanisms to verify that a particular recipient is a qualified foreign resident at the claimed address; (2) the lack of any official procedure to penetrate a foreign nominee account and determine the identities and addresses of its beneficial owners; (3) the grant of authority to nongovernmental bodies — the withholding agents — to determine and dispense massive tax reductions by reducing tax withheld at the source; and (4) the conceded inability of the government to oversee the withholding system effectively and in a timely manner. The foreign component that permits the schemes to flourish unchecked is the alarming phenomenon of increasingly strict secrecy laws in a multiplicity of foreign jurisdictions. These secrecy laws conceal the transaction and the identity of the taxpayer, and block United States authorities from gaining the information necessary to trace and prove the fraud.[79]

Foreign bank secrecy laws are not new. Congress recognized the difficulties associated with these laws and adopted the Bank Secrecy Act[80] in 1970 to control the flow of illegal monies from the United States to foreign jurisdictions where the monies become untraceable. The House Report leading to the Act commented:

> Secret foreign bank accounts and secret foreign financial institutions have permitted proliferation of "white collar" crime; have served as the financial underpinning of organized criminal operations in the United States; have been utilized by Americans to evade income taxes, conceal assets illegally and purchase gold; . . . have served as essential ingredients in fraud including schemes to defraud the United States . . . .[81]

Congressional investigators reviewing this description have con-

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79. "It is self-evident that if a U.S. taxpayer wished to evade tax payments on dividends, rents and other Section 1441 income, it would be advantageous to select a foreign country with *bank secrecy* and/or low or zero treaty rate withholding." *Id.* at 11 (statement of Dean T. Scott) (emphasis added).

80. Bank Secrecy Act, Pub. L. No. 91-508, 84 Stat. 1114 (1970), *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 1301 (codified at 12 U.S.C. §§ 1730(d), 1829(b), 31 U.S.C. §§ 1051-1122, 15 U.S.C. § 78(g) (1976)).

81. H.R. REP. No. 975, 91st Cong., 2d Sess., *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4394, 4397.

cluded recently that the present abuse of tax haven secrecy laws is "much more pervasive, more sophisticated, and far more difficult for investigators and prosecutors to unravel than ever before."[82] The expanding accessibility of offshore havens and their increased utilization by United States persons[83] point to a rising level of international economic crimes, including tax fraud, in the future.

An abundant collection of literature and analyses exists concerning the advantages offered by,[84] as well as the threats posed by, tax havens.[85] The profile of a typical tax haven country consists of certain fundamental traits: (1) low or no rate of local taxa-

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82. STAFF OF SENATE COMM. ON GOVERNMENT AFFAIRS, 98TH CONG., 1ST SESS., CRIME AND SECRECY: THE USE OF OFFSHORE BANKS AND COMPANIES 4 (Comm. Print 1983) [hereinafter cited as SEN. CRIME AND SECRECY STUDY]. The study uncovered evidence that the offshore secrecy laws are utilized to conceal a wide range of serious crimes, from money laundering of drug trafficking profits to the concealment of income by income tax protestors and the stashing away of profits from operations of child pornography rings. *Id.* at 4-6.

83. For a good review, see generally, Irish, *Tax Havens*, 15 VAND. J. TRANSNAT'L LAW 449 (1982).

84. *See generally* D. DIAMOND & W. DIAMOND, TAX HAVENS OF THE WORLD (1978); R. KINSMAN, GUIDE TO TAX HAVENS (1978); M. LANGER, INTERNATIONAL TAX PLANNING (2d ed. 1979); de Jantscher, *Tax Havens Explained*, 1976 FIN. & DEV. 31; van Hoorn, *Problems, Possibilities and Limitations With Respect to Measures Against International Tax Avoidance and Evasion*, 8 GA. J. INT'L & COMP. L. 763 (1978); Policy and Economic Views of a Caribbean Country v. U.S. Tax Policy (1980) (Netherlands Antilles Position Paper).

85. *See generally* T. CLARK & J. TIGUE, DIRTY MONEY (1973). Government officials are unanimous in their condemnation of tax havens. Roscoe L. Egger, Jr., Commissioner of Internal Revenue, recently stated:

> From the Internal Revenue Service's perspective, the problem with tax havens is clear: tax evasion. The ultimate effect of the numerous subterfuges and machinations which will be described in these hearings is to *evade* taxes . . . .
>
> We share the Subcommittee's concern about the pervasive nature of this situation, and agree that the crimes involved are far from victimless. Again, from our perspective, the real victims in this widespread evasion are the honest taxpayers who have to pay their fair share of the tax burden while a few unscrupulous individuals evade their responsibilities. This situation is decidedly unhealthy for our voluntary self-assessment system of taxation and—because to a considerable degree the activities in these tax havens involve narcotics traffickers and other elements of organized crime, illegal tax protesters and promoters of abusive tax shelters—equally unhealthy for the economic and social structure of our country as a whole.

Senate Crime and Secrecy Hearings, supra note 1, 255.

tion;[86] (2) few or no exchange control restrictions;[87] (3) political stability and an official policy welcoming foreign investment;[88] (4) efficient transportation and communication facilities with developed countries;[89] (5) available local professional personnel with sufficient legal, accounting, and banking expertise;[90] and (6) increasingly, tight secrecy laws to prohibit disclosure of financial and commercial information.[91] Tax havens considered in terms of the first five of these characteristics may serve legitimate international business objectives. The sixth factor makes the tax haven country suspect. Pure secrecy havens, rather than tax havens as such,[92] constitute the breeding ground for economic crime and tax fraud.

Some bank secrecy laws have a legitimate historical genesis. Jurisdictions that once were, or still are, British colonies have bank secrecy laws long antedating the United States income tax. These laws derived from the common law concept of an implied contract between the banker and his customer to maintain the confidentiality of all information acquired in the bank-customer relationship.[93] In contrast, Switzerland, a civil law country, adopted its bank secrecy legislation to protect the politically oppressed. Half a century ago this country became a refuge for those fearing Hitler; the adoption of bank secrecy laws enabled the Swiss financial community to conceal the identity of their Jewish cus-

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86. The Bahamas, Bermuda, the Cayman Islands, Turks and Caicos Islands, Nauru, and New Hebrides (now Vanuatu) impose no income or wealth taxes. Other countries such as Panama and Costa Rica have no tax on local corporations formed and managed within the tax haven and receiving income from outside sources. The British Virgin Islands and the Netherlands Antilles have low income tax rates. The Channel Islands and the Isle of Man have low income taxes and are useful as tax shelters for United Kingdom citizens. *See* SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 8; Irish, *supra* note 83, at 454-61.

87. Irish, *supra* note 83, at 452.

88. *See id.* at 454.

89. *Id.* at 494.

90. *Id.* at 454.

91. *See* SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 2; *see also Offshore Tax Havens: Before the Subcomm. on Oversight of the House Committee on Ways and Means*, 96th Cong., 1st Sess. 2 (1979) (statement of M. Carr Ferguson, Assistant Attorney General, Tax Division, Dept. of Justice) [hereinafter cited as *Offshore Tax Haven Hearings*].

92. Not every secrecy haven has a low tax rate customarily associated with tax havens. *See* CRIME AND SECRECY STUDY, *supra* note 82, at 7.

93. *See* GORDON REPORT, *supra* note 6, at 15.

tomers from Nazi inquiries.[94]

In recent times, however, nations have begun to enact secrecy legislation solely as a lure to attract foreign capital and ventures. Secrecy havens that conceal all activities, both legitimate and illegitimate, are emerging. These havens enable persons to hide from taxing authorities their assets, the true nature of transactions, and their own identities. This Article will examine the secrecy rules of four countries that are representative of the current trend and that United States authorities must confront in their efforts to control tax fraud.

B. United States Position on Exchange of Tax Information with Treaty Partners

Three potential categories of treaty arrangements could provide information on foreign transactions of United States taxpayers to United States authorities: (1) the standard bilateral tax convention providing for the exchange of certain information; (2) separate agreements solely addressing tax matters and arranging for the exchange of information and administrative assistance in the tax area; and (3) mutual assistance treaties addressing criminal matters and calling for the exchange of information on tax violations that constitute crimes.[95] The United States currently is a party to thirty-one bilateral income tax treaties for the avoidance of double taxation.[96] Although each treaty contains tax information exchange provisions, the exact provisions vary in each instrument. The present United States tax objectives, set forth in the United States Treasury Model Income Tax Treaty (Model Tax Treaty),[97] include the exchange of all tax information required to

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94. The original Swiss bank secrecy legislation also was valuable in establishing Switzerland as a political sanctuary for those with assets fleeing repression in Russia, South Africa, Spain, and the Balkans. *See* C. DOGGART, TAX HAVENS AND THEIR USES 1-5 (1979), *cited in* GORDON REPORT, *supra* note 6, at 21.

95. *See Offshore Tax Haven Hearings*, *supra* note 91, at 284 (statement of H. Rosenbloom, International Tax Counsel, Dep't of the Treasury).

96. *See* 1 TAX TREATIES (CCH) ¶ 17-18 (June 1981) (list of income tax conventions).

97. The Treasury Department's Model Income Tax Treaty was first released on May 17, 1977, and revisions were proposed on June 16, 1981. *See* Convention for Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, *reprinted in* 1 TAX TREATIES (CCH) ¶ 158, at 265 (June 1981). The Model Tax Treaty represents the "opening position" of the Treasury Department in tax treaty negotiations. *See Crime and*

implement the tax laws of each contracting state.[98] The Model Tax Treaty, moreover, provides specifically that the treaty partner shall supply such tax information in a form that can be introduced as evidence in civil or criminal judicial proceedings.[99]

Under customary international law, however, certain limitations are placed on the exchange of information between states.[100] The Model Tax Treaty, therefore, has a "non-obtainability" clause relieving the treaty partner from any obligation "to supply information which is not obtainable under the laws or in the normal course of the administration" of the laws of either state.[101] In addition, the treaty partner is not required "to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (*ordre public*)."[102]

The second type of agreement, a separate agreement limited solely to the exchange of tax information, is an interesting concept that has not yet reached fruition. The United States has never entered into such a tax treaty. This minimal type of arrangement, however, could be executed by the United States and a country with which the United States could not reach a fundamental understanding on all of the substantive issues normally

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Secrecy Hearings, *supra* note 1, at 39 (statement of A. Granwell).

98. *See* Rosenbloom & Langbein, *United States Tax Treaty Policy: An Overview*, 19 COL. J. TRANSNAT'L L. 359, 383 (1981); Comment, *The Use of Offshore Tax Havens for the Purpose of Criminally Evading Income Taxes*, 73 J. CRIM. L. & CRIMINOLOGY 675, 688 (1982). The Model Tax Treaty provides that "[t]he competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention." Model Income Tax Treaty, art. 26(1), *supra* note 97 *reprinted* at 265.

99. The Model Tax Treaty requires the treaty partner to provide the requested tax information "in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other state with respect to its own taxes." *See* Model Income Tax Treaty, art. 26(3), *supra* note 97, *reprinted* at 265.

100. *See Offshore Tax Haven Hearings*, *supra* note 91, at 285.

101. Model Income Tax Treaty, art. 26(2)(b), *supra* note 97, *reprinted* at 265.

102. *Id.*, art. 26(2)(c).

covered in a standard bilateral tax treaty.[103]

The third type of agreement that facilitates the exchange of tax information is a mutual assistance treaty under which each contracting state agrees to lend its administrative facilities to the other state for specified investigations, usually investigations of suspected criminal offenses. The mutual assistance treaty is designed specifically to permit one state to collect information within the jurisdiction of the other state without infringing upon sovereignty.[104]

Despite the existence of this framework for the exchange of information with treaty partners, United States officials frequently encounter obstacles in procuring evidence of suspected tax evasion from certain important treaty countries. This Article will examine two treaty partners, Switzerland and the Netherlands, and then survey the barriers the United States meets in trying to obtain information from two representative nontreaty countries, the Bahamas and Panama. All four of these jurisdictions share a common characteristic: one form or another of secrecy laws.

C. Secrecy in Switzerland—A Treaty Partner

1. *United States-Swiss Treaty of 1951*

The United States has had a treaty relationship with Switzerland addressing the avoidance of double taxation since 1951.[105]

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103. *See Offshore Tax Haven Hearings, supra* note 91, at 285.

104. *Id.* at 285-86. The United States is party to four mutual assistance agreements with Colombia, the Netherlands, Turkey, and Switzerland. *See* Procedures for Mutual Assistance in the Administration of Justice in Connection With Matters Relating to the McDonnell Douglas Corporation, Mar. 21, 1979, United States-Netherlands, 30 U.S.T. 2501, T.I.A.S. No. 9348; Agreement on Procedures for Mutual Assistance in the Administration of Justice in Connection With the Lockheed Aircraft Corporation Matter, Apr. 22, 1976, United States-Colombia, 27 U.S.T. 1059, T.I.A.S. No. 8244; Agreement on Procedures for Mutual Assistance in Connection With the Lockheed Aircraft Corporation and the McDonnell Douglas Corporation Matters, July 8, 1976, United States-Turkey, 27 U.S.T. 3419, T.I.A.S. No. 8371; Treaty on Mutual Assistance in Criminal Matters, May 25, 1973, United States-Switzerland, 27 U.S.T. 2019, T.I.A.S. No. 8302. *See infra* notes 125-40 and accompanying text (discussion of the Mutual Assistance Agreement with Switzerland).

105. Convention for the Avoidance of Double Taxation with Respect to Taxes on Income, May 24, 1951, United States-Switzerland, 2 U.S.T. 1751, T.I.A.S. No. 2316. For a description of the interpretation and operation of the 1951 Swiss Convention and the 1976 Swiss Mutual Assistance Treaty, the author has relied heavily upon the excellent analysis of H. David Rosenbloom, Interna-

Article XVI of the 1951 treaty, the provision for the exchange of information, contains the most generous language for information exchange the Swiss government has ever accepted and, simultaneously, contains the most restrictive conditions to which the United States has ever acceded on such an exchange. This article calls for the exchange of tax information in two situations: (1) when it is "necessary for carrying out the provisions of the present Convention"[106] and (2) when it is necessary "for the prevention of fraud or the like in relation to taxes which are the subject of the present Convention."[107] The obligation of the Swiss government to transmit information is subject to several limitations: (1) the information must be "available under the respective taxation laws"[108] of Switzerland and (2) information need not be supplied if it would "disclose any trade, business, industrial or professional secret or any trade process."[109] The Swiss government assumes no responsibilty for furnishing information if, in order to do so, the Swiss would be obliged to "carry out administrative measures at variance with the regulations and practice"[110] of Switzerland or "contrary to its sovereignty, security or public policy."[111] Finally, Switzerland has no duty to "supply particulars which are not procurable under its own legislation."[112]

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tional Tax Counsel of the Treasury Department, in his statement in *Offshore Tax Haven Hearings, supra* note 91, at 284-92.

106. Convention for the Avoidance of Double Taxation with Respect to Taxes on Income, *supra* note 105, art. 26(1), 2 U.S.T. 1751, 1760; T.I.A.S. No. 2316.

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*, art. 26(3), 2 U.S.T. 1751, 1761.

111. *Id.*

112. *Id. See Offshore Tax Haven Hearings, supra* note 91, at 286-87 (statement of H. Rosenbloom). Switzerland has expressly reserved its approval of the exchange of information provision appearing in the Organisation for Economic Co-operation and Development Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, *reprinted in* 1 TAX TREATIES (CCH) ¶ 151, at 207 (June 1980). It has officially stated that:

> [T]he information necessary for the correct application and for the prevention of an abuse of such a convention can be exchanged already within the existing framework of its provisions on the mutual agreement procedure, the reduction of taxes withheld at the source, etc. Switzerland considers a particular provision on the exchange of information as unnecessary since even such an express clause could not, according to the purpose of the convention, provide for more than an exchange of information nec-

Although the Swiss treaty at face value appears to be valuable because it calls for the exchange of tax information "necessary for the prevention of fraud or the like,"[113] Swiss substantive law distinguishes between "tax fraud" (the notion of *steuerbetrug*) and "tax evasion" (the notion of *steuerhinterziehung*).[114] Under Swiss law, tax fraud is a much narrower concept than under United States law; it refers only to "the falsification or concealment of documents suitable or intended for proving a fact of legal significance."[115] Switzerland does not share the United States view that tax fraud encompasses willful failure to file a return, willful failure to report income from all sources, and other intentional efforts to defeat the assessment of proper tax liability.[116] The Swiss have limited the interpretation of the critical treaty language calling for the exchange of information necessary to prevent tax fraud to the narrow category of activities that constitute tax fraud under Swiss law: conduct involving falsification or concealment of documents suitable or intended for proving a fact of legal significance.[117] This interpretation substantially restricts the scope of information that Switzerland will transmit to the United States under the treaty.

Apart from the substantive issue of the proper scope of tax fraud, the Swiss government is hampered at the federal level by internal administrative procedures that affect what tax information is "available" for exchange. Most Swiss income taxes are collected by the twenty-two cantons rather than the central govern-

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essary for the correct application and prevention of an abuse of the convention.

OECD, REPORT OF THE COMMITTEE ON FISCAL AFFAIRS ON THE OECD MODEL CONVENTION 188 (1977). Consistent with this position, Switzerland has executed only three tax treaties, in addition to the treaty with the United States, that provide for any exchange of information. The treaties, with Germany, France, and the United Kingdom, only call for information exchange "necessary to carry out the convention"; all expressly exclude "banking" information from their coverage. *See Offshore Tax Haven Hearings, supra* note 91, at 287.

113. *Offshore Tax Haven Hearings, supra* note 91, at 287.

114. *Id.*

115. *Id.*

116. *Id.* at 287-88.

117. The Federal Supreme Court of Switzerland approved this narrow interpretation of the word "fraud" in the exchange of information provision of the 1951 treaty. *See X v. Federal Tax Administration*, Entscheidungen des Schweizerischen Bundesgerichts [BG] [I] 96 (Bundesgericht 1970), *reprinted in* 1971-1 U.S. TAX CAS. (CCH) ¶ 9435, at 86,569 (unofficial trans.).

ment. The tax collection procedures vary significantly among the cantons themselves, and between the cantons and the federal government. The tax authorities in the cantons have limited powers to collect information from third parties. The laws of the cantons, therefore, often control the "availability" of information because (1) the treaty only requires the Swiss federal government to exchange tax information with the United States that is "available" under the Swiss law and (2) the treaty does not compel the Swiss federal government to undertake "administrative measures at variance with the regulations and practice of Switzerland"[118] or "to supply particulars which are not procurable under its own legislation."[119] The laws of the cantons encompassing the three main banking centers, Zurich, Basel, and Geneva, provide that third party information is available to criminal authorities prosecuting tax fraud cases, even though that same information is not available to tax assessment officials. In view of the strong role of the cantons in the tax collection process and the distinction between the data available to local criminal prosecutors as compared to tax collectors, what information is deemed "available to the Swiss central government" is at best ambiguous. This ambiguity, it is suspected, permits the Swiss government to exercise a certain measure of discretion in electing what tax data to transmit.[120]

Attempts to utilize the 1951 treaty to obtain data relating to suspected tax fraud activities encounter the renowned Swiss "bank secrecy" that is the end-product of a fusion of at least four diverse factors in Swiss law. First, the Swiss consider bank secrecy an inherent part of the individual right of privacy recognized and enforced by Swiss statutes.[121] Second, the Swiss posit that a quasi-contractual or quasi-fiduciary obligation arises at the start of the banker-depositor relationship which requires the banker to maintain the privacy of information gained from this relationship.[122] Third, the Swiss banking law specifically provides possible criminal prosecution for a bank employee making an unauthorized disclosure of confidential banking information.[123] Fi-

118. *See Offshore Tax Haven Hearings, supra* note 91, at 288.

119. *Id.*

120. *Id.*

121. *See generally* Meier, *Banking Secrecy in Swiss and International Taxation*, 7 INT'L LAW. 16 (1973) (discussion of Article 28 of the Civil Code and Articles 41 and 49 of the Code of Obligation).

122. *See Offshore Tax Haven Hearings, supra* note 91, at 288.

123. *Id.* Article 47 of the Swiss Federal Law (relating to Banks and Savings

nally, Switzerland has adopted and rigorously enforces an "economic espionage" law backed by criminal penalties, including imprisonment, for the unauthorized divulgence of confidential information to any foreign person or authority.[124]

2. *United States-Swiss Mutual Assistance Treaty*

The needs of a criminal proceeding may override the Swiss bank secrecy rules and compel the release of otherwise confidential financial information.[125] In recognition of this concept, the United States and Switzerland have executed a Mutual Assis-

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Banks) states:

> 1. Whoever divulges a secret entrusted to him in his capacity as officer, employee, mandatory liquidator or commissioner of a bank, as a representative of the Banking Commission, officer or employee of a recognized auditing company, or who has become aware of such a secret in this capacity, and whoever tries to induce others to violate professional secrecy, shall be punished by a prison term not to exceed six months or by a fine not exceeding 50,000 francs.
> 2. If the act has been committed by negligence, the penalty shall be a fine not exceeding 30,000 francs.
> 3. The violation of professional secrecy remains punishable even after termination of the official or employment relationship or the exercise of the profession.
> 4. Federal and cantonal regulations concerning the obligations to testify and to furnish information to a government authority shall remain reserved.

Id., *reprinted in* SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 230.

124. Article 273 of the Swiss Penal Code states:

> Any person who seeks to obtain a business or manufacturing secret with a view to making it available to foreign authorities, to foreign organizations, private business enterprises, or to their agents, or who makes a business or manufacturing secret available to foreign authorities, to foreign organizations, private business enterprises or to their agents, shall be punished by imprisonment, in serious cases, by penal servitude. In addition to the imprisonment, a fine can be imposed.

DEPARTMENT OF THE TREASURY, TAX HAVEN INFORMATION BOOK 105 (1982) [hereinafter cited as TREASURY TAX HAVEN GUIDE]. The Swiss take their economic espionage law seriously. According to the IRS, the Swiss government recently arrested two French customs agents for alleged economic espionage on Swiss soil. *Id.* Currently, the Swiss government is considering the invocation of the economic espionage provisions against employees of the Lausanne Data Center of the Union Bank of Switzerland for allegedly divulging, to the French fiscal police, the names of French residents violating French law by holding secret undeclared Swiss bank accounts. *See* London Times, Oct. 8, 1983, at 6.

125. *See* TREASURY TAX HAVEN GUIDE, *supra* note 124, at 103.

tance Treaty, effective in January 1977, that aims to lift bank secrecy rules and permit disclosure of information necessary for United States authorities to prosecute criminal acts.[126] The Mutual Assistance Treaty calls for cooperation in locating witnesses, taking testimony, and producing evidence related to commonly accepted major crimes, such as murder, manslaughter, kidnapping, rape, robbery, larceny, embezzlement, blackmail, forgery, perjury, arson, and piracy.[127] Because the norms in Switzerland and the United States differ on when a tax violation is a crime, the Mutual Assistance Treaty expressly excludes assistance or information on tax violations,[128] subject to certain narrow exceptions. Thus, under one exception, information is available for tax violations involved in bookmaking, lotteries, or gambling,[129] and for tax violations related to trafficking in narcotics, poisonous chemicals, or firearms.[130]

One of the chief objectives of the Mutual Assistance Treaty was cooperation "in the fight against organized crime."[131] In this context, the Treaty includes assistance for investigations of income tax violations if certain difficult preconditions are met. For example, treaty assistance is available only if: (1) the tax investigation relates to a person "reasonably suspected . . . of belonging to an upper echelon of an organized criminal group or of participating significantly as a member, affiliate, or otherwise, in any important activity of such a group;"[132] (2) the evidence available to United States authorities is inadequate to prosecute the organized crime figure;[133] and (3) the assistance requested "will substantially facilitate the successful prosecution of such person and should result in his imprisonment for a sufficient period of time so as to have a

126. Treaty on Mutual Assistance in Criminal Matters, May 25, 1973, United States-Switz., 27 U.S.T. 2019, T.I.A.S. No. 8302.

127. *Id.*, art. 1(1), (4), sched. 1, 27 U.S.T. at 2025-26, 2064-67. In recognition of the focus of the Mutual Assistance Treaty on traditional criminal conduct, the central authority designated for the exchange of information is the Attorney General of the United States, rather than the Secretary of the Treasury. *Id.*, art. 28(1), 27 U.S.T. at 2050.

128. *Id.*, art. 2(1)(c)(5), 27 U.S.T. at 2027.

129. *See id.*, art. 2(1)(c)(5), sched. 1(26), 27 U.S.T. at 2027, 2066.

130. *See id.*, art. 2(1)(c)(5), sched. 1(26)(a)-(c), 27 U.S.T. at 2027, 2066.

131. *Id.*, art. 6(1), 27 U.S.T. at 2031.

132. *Id.*, art. 7(2)(a), 27 U.S.T. at 2033.

133. *Id.*, art. 7(2)(b), 27 U.S.T. at 2033.

significant adverse affect on the organized criminal group."[134] The term "organized criminal group" is elaborately defined, but lacks precision or clarity.[135]

Moreover, the Mutual Assistance Treaty contains additional restrictions on the production of evidence that would disclose information which is otherwise protected by the bank secrecy laws or which constitutes a manufacturing or business secret. The disclosure of this type of evidence is limited to an investigation or prosecution of a "serious offense."[136] Thus, when income tax violations are incident to narcotics, poisonous chemicals, and firearms violations, the Swiss Government has the right to examine each case on an ad hoc basis to evaluate whether the offense is sufficiently serious to warrant disclosure.[137] When the income tax violation relates to a top echelon figure in organized crime, the Swiss have the right to consider "the acts of violence or other serious offenses committed by the organized criminal group" in deciding whether there is justification for disclosing information protected by Swiss secrecy laws.[138] Finally, even if the balancing tests weigh in favor of disclosing bank and commercial secrets, the Swiss Government retains the discretion to withhold the information if disclosure would "prejudice [the Government's] sovereignty, security, or similar essential interests."[139]

The paucity of the concessions that the United States obtained in the Swiss Mutual Assistance Treaty prompted one Treasury official to observe:

> Perhaps the most salient characteristic of these provisions [of the Swiss Mutual Assistance Treaty] is the illustration they make of Swiss sensitivity about the disclosure of tax information. The provisions contain an elaborate series of conditions, most of which are framed in terms which have no precise meaning under any country's law. . . . The net effect of the subjectivity of the conditions imposed and the discretionary powers conferred . . . is to make compliance with the treaty provisions almost completely discre-

134. *Id.*, art. 7(2)(c), 27 U.S.T. at 2033.

135. *See id.*, art. 6(3), 27 U.S.T. at 2031-32.

136. *See id.*, art. 10(2)(a), 27 U.S.T. at 2036.

137. The term "serious offense" is not defined in the Treaty, but an understanding of its meaning has been achieved through an exchange of letters between the ambassadors of the United States and Switzerland. *See id.*, app., 27 U.S.T. at 2120-78.

138. *Id.*

139. *Id.*

tionary. . . .[140]

3. *Swiss Act for International Mutual Assistance in Criminal Matters*

A further development, the impact of which is yet to be evaluated, occurred when Switzerland adopted a domestic Law on International Mutual Assistance in Criminal Matters (IMAC),[141] effective January 1, 1983. IMAC sets forth the Swiss procedures for international cooperation in criminal matters. Significantly, IMAC enlarges the category of matters for which tax information may be made available. Although definitional problems remain, and "tax evasion" under United States standards is still not a crime under Swiss standards, IMAC does provide judicial assistance for the production of information "if the subject of the proceeding is a tax fraud."[142] Thus, information relating to allegations of tax fraud may be released even though the suspect is not a figure involved in organized crime.[143] Despite this broadened scope, the present restrictions on the flow of tax information from Switzerland will remain unremedied if the Swiss adhere to their narrow definition of fraud when implementing IMAC.

4. *Convention on Diligence*

After a 1977 banking scandal, the Swiss government, through the Swiss National Bank and the Swiss Bankers Association, executed an agreement known as the Convention on Diligence, which requires Swiss bankers to identify all new depositors to ensure that the source of new funds is not criminal.[144] The value of the

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140. *See Offshore Tax Haven Hearings, supra* note 91, at 290 (statement of H. David Rosenbloom).

141. Law on International Mutual Assistance in Criminal Matters, Mar. 20, 1980 (Switzerland), *reprinted in* 20 I.L.M. 1339 (1982).

142. *Id.*, art. 3(3), *reprinted* at 1340. IMAC specifically states that "[a] request shall not be granted if the subject of the proceeding is an offense which appears to be aimed at minimizing taxes . . . ." *Id.* IMAC also specifically reasserts the right of privacy of persons not involved in the criminal proceedings and provides that "[d]isclosure of manufacturing or business secrets in the sense of Art. 273 of the Penal Code, or of facts which a bank must usually keep secret, shall not be made if there is reason to believe that such disclosure would cause serious prejudice to the Swiss economy and it does not appear justified in relation to the seriousness of the offense." *Id.*, art. 10(2), *reprinted* at 1341.

143. SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 86-87.

144. Article 3, paragraph 1 of the Convention requires Swiss bankers "not to

Convention, however, is hampered by the Swiss definition of "criminal." Monies from tax evasion are considered criminal only "when associated with fraudulent documentation."[145]

The Convention on Diligence also contains a serious structural loophole. Banks may receive funds from Swiss attorneys or auditors[146] serving as nominees for their clients and may rely upon the representations of these nominees that the deposited funds are not criminally tainted. The nominees are not required to identify their clients when establishing "current" accounts (checking accounts) and "deposit" accounts (savings or investment accounts), or opening safe deposit boxes, if the nominees vouch that the money does not arise from a criminal source.[147] In the Swiss practice, a nominee is commonly engaged to open up banking accounts, trust accounts, and brokerage accounts, and to form corporations in which shares are issued in bearer form, rather than registered in the names of their owners. Swiss bankers, consequently, may not know the beneficial owners of a nominee account or the true owners of a corporate enterprise, and thus may be unable to comply with the standards of the Convention on Diligence.[148]

5. *Swiss Philosophical Bent*

Despite the government's adoption of a "moral" national policy[149] raising the potential for state-to-state cooperation in exchanging information to detect tax-evading monies, the attitude of the Swiss Bar[150] and banking community on this subject is not

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open bank accounts or securities deposits nor to effect fiduciary investments unless they have ascertained with such care as can reasonably be expected in the circumstances the identity of the persons entitled to the funds to be credited or to be invested." Convention on Diligence, art. 3(1), *reprinted in* SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 232. The Convention was amended in 1982 to extend the diligence requirement to depositors involved in over-the-counter currency transactions for amounts in excess of 500,000 Swiss francs. *Id.*, art. 3(9).

145. SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 87.

146. In Switzerland, auditors are the equivalent of certified public accountants.

147. SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 88.

148. *See* TREASURY TAX HAVEN GUIDE, *supra* note 124, at 102.

149. *See* SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 91.

150. *Id.* at 89. The study described the ease with which Swiss attorneys purchase, through the mail, companies registered in secrecy haven countries, such as Liechtenstein, Panama, the Channel Islands, the Cayman Islands, and Liberia. By "layering" these haven nominee companies and haven nominee ac-

monolithic. Some bankers oppose relaxation of secrecy rules in tax fraud cases because of a philosophical objection to the basic premises underlying the United States tax system. They view the United States as a country that deprives its productive citizens of the fruits of their industry and describe its progressive income tax system as an inequitable transfer of wealth operating on the wrong incentives and encouraging citizens to "enjoy the fruits of welfare rather than their own labor."[151]

A more pragmatic concern underlies the observation by other bankers: "if we don't do it, they will."[152] These bankers presume that if the confidentiality laws are relaxed, the secrecy-seeking capital and the concomitant profits will shift to other havens where secrecy standards are tightly maintained: "unless all regulate, the competitive benefit is to those who do not."[153] The validity of this observation is borne out by a senior Bahamian bank official's comment that "changes in Switzerland were driving the careful money to the Bahamas, a situation which . . . was very pleasing . . . ."[154]

D. Anonymity in the Netherlands—A Treaty Partner

Even without enacting bank secrecy laws per se, anonymity is obtainable in many countries that are United States treaty partners. For example, the Netherlands offers nonresidents and nominees the opportunity to use its vast network of income tax treaties as a conduit for investment in other countries.[155] In addition,

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counts, Swiss attorneys are able to conceal the identity of the beneficial owners. The Swiss interviewees estimated that of the 50,000 haven nominees operating through Liechtenstein, not more than 10% are being used to conceal "criminal" monies. It is conceded that 5,000 of such nominees are being used for clearly criminal purposes by Swiss definitions. The other 90% of the Liechtenstein nominee accounts could, even according to the Swiss, contain the tax evading monies which they do not deem criminal. *See id.* at 89-90.

151. *Id.* at 90.

152. *Id.*

153. *Id.* at 90-91. This is not a unique Swiss response. The Senate Staff found the same view expressed in London "as an excuse for doing nothing by way of enforcement collaboration against offshore crime." *Id.* at 90.

154. *Id.* at 90 n.80.

155. *See* GORDON REPORT, *supra* note 6, at 20. The Netherlands currently has income tax treaties with Austria, Belgium, Canada, Czechoslavakia, Denmark, Finland, France, West Germany, Hungary, Indonesia, Ireland, Israel, Italy, Japan, Luxembourg, the Netherlands Antilles, Norway, Singapore, South Africa, Spain, Surinam, Sweden, Switzerland, Thailand, the United Kingdom,

the normal operation of the Dutch internal corporate laws enables a person to conceal his identity as the owner of a Dutch company.

Foreign investors can operate in the Netherlands as a *Naamloze Venootschap* or N.V., which is a publicly-held company resembling the typical United States public entity, or in the form of a *Besloten Venootschap* or B.V., which resembles a privately-held United States corporation.[156] Although an N.V. or B.V. must be established by two or more incorporators, the shares of either of these entities may be transferred into the hands of one stockholder. Certain generic information on an N.V. or B.V., such as the amounts of authorized and paid-up capital, the location of the registered office, powers of officers and directors, and articles of incorporation and by-laws, must be made public. The critical information as to the identity of the beneficial shareholders, however, need not be stated publicly: nominees can be shareholders for both types of companies.[157] In addition, shares in an N.V. may be registered in the names of nominees or issued in bearer form represented by bearer share certificates.[158] A bearer share issuance provides anonymity for beneficial ownership of N.V. corporations. As a result of this anonymity, the company's bankers, the corporate management, and the Dutch government itself may not know who in fact holds and owns the bearer shares.[159]

Although the United States is discussing the renegotiation of its basic treaty with the Netherlands, it has not made an issue of the well established and regular use of nominees and bearer shares by the Netherlands. During the renegotiation discussions, the United States has objected instead to the bank secrecy laws of the Netherlands Antilles, a country which functions under the jurisdiction of the Netherlands. The Criminal Code of the Netherlands Antilles imposes a fine or imprisonment on anyone who "intentionally discloses any secret that he is obliged to keep" or who "intentionally discloses particulars where secrecy was imposed upon him concerning a commercial or industrial

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and the United States. *See generally* Starchild, *Holland and the Tax Haven Company*, 10 INT'L BUS. LAW. 352 (1982).

156. The B.V. designation comes from "Besloten Venootschap met beperkte aansprakelijkheid." TREASURY TAX HAVEN GUIDE, *supra* note 124, at 79.

157. *Id.* at 80.

158. *Id.* at 81.

159. *See House Subcomm. Hearings on Foreign Addresses*, *supra* note 7, at 42.

enterprise."[160]

According to the latest statistics, Switzerland, the Netherlands, and the Netherlands Antilles (all of which offer a cloak of anonymity to investors) together received almost fifty percent of the total United States corporate dividend income paid to foreign addressees and one-third of the total section 1441 interest income paid to foreign addressees.[161] This latter figure is exclusive of section 861(c) interest for which no reporting requirements exist.

E. Secrecy in the Bahamas—A Nontreaty Country

Although no one agrees on the same list of tax havens,[162] the United States Treasury Department has so labeled twenty-eight countries,[163] the majority of which do not have tax treaties with the United States. In addition, all of these countries have varying degrees of secrecy rules backed by varying degrees of sanctions. This Article will examine the Bahamas and Panama as prototypes of nontreaty tax havens publicly promoting their secrecy legislation as an inducement to attract foreign investment.

The Bahamas, lying only fifty miles from Florida, is characterized by social instability, an unemployment rate of twenty-seven percent, a lack of natural resources, a work force labeled as "unreliable and unmotivated" but with high expectations, a large underground economy based primarily upon supplying the United

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160. J. DARILEK, BANK SECRECY IN THE NETHERLANDS ANTILLES (English translation of Articles 285 and 286 of the Netherlands Antilles Criminal Code), *reprinted in* SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 222.

161. *House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 12 (statement of Dean T. Scott).

162. *Cf.* von Thulen Rhoades, *Tax Havens: What They Are; Where They Are; and How You Can Use Them Effectively*, 3 TAX. FOR LAWYERS 68, 71 (1974) (list of 28 tax havens).

163. The Treasury Department, in 1982, named the following as tax havens: Antigua, Austria, Bahamas, Bahrain, Barbados, Belize, Bermuda, the British Virgin Islands, the Cayman Islands, Costa Rica, the Channel Islands (Jersey, Guernsey, Alderney and Sark), Gibraltar, Grenada, Hong Kong, the Isle of Man, Liberia, Liechtenstein, Luxembourg, Monaco, Nauru, the Netherlands, the Netherlands Antilles, Panama, Singapore, St. Kitts, St. Vincent, Switzerland, and the Turks and Caicos Islands. *See generally* TREASURY TAX HAVEN GUIDE, *supra* note 124. On the other hand, the International Bureau of Fiscal Documentation omits the following countries from its list of tax havens: Austria, Bahrain, Belize, Alderney and Sark, and St. Kitts, but adds the countries of Andorra, Brunei, Cyprus, Eire, Malta, and the Seychelles. *See* 31 BULL. FOR INT'L FISCAL DOCUMENTATION 5, 5 (1977).

States market with narcotics, and a sharp increase in violent crime and piracy.[164] Congressional investigators refer to the Bahamas as a "time bomb" and caution that unless socioeconomic remedies are found, the country could be transformed into "a radical-left nation hostile to the U.S." by the mid-1990s.[165]

The Bahamas constitute a major Eurobanking center.[166] The is-

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164. *See* SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 54.

165. *Id.*

166. The Euromarket, particularly the Eurobond market, refers to a network of underwriters and financial institutions that market bonds for purchase by individuals, banks (who often acquire the Eurobonds for nominee accounts managed by the banks), investment companies, insurance companies, and pension funds. *See 1980 Joint Committee Description, supra* note 16, at 8. Most of the bonds sold in the Eurobond market are issued in United States dollars, but some are also issued in other currencies. *Id.*

The impetus to the creation of the offshore banking industry and the Euromarket arose from restrictions imposed by the United States Government during the 1960s, a time when exchange rates were fixed. The United States adopted several measures such as the Interest Equalization Act, the Foreign Direct Investment Program, and the Voluntary Foreign Credit Restraint Program to encourage United States corporations to borrow abroad and thereby prevent devaluation of the dollar. *Id.* at 10. In an effort to comply with these governmental restrictions, but also to raise sufficient capital in foreign markets and satisfy the demands of their customers, United States banks began establishing foreign branches in the Caribbean, initially in the Bahamas and the Cayman Islands. *See Offshore Tax Haven Hearings, supra* note 91, at 335-36. *See generally* Note, *Eurobond Practices: Sources of Law and the Threat of Unilateral National Legislation,* 20 VA. J. INT'L L. 505 (1980). The branches operate as "shells" through which foreign loans are booked outside of the United States. Debt securities sold in the Euromarket are not subject to withholding taxes at the source. The cost of a withholding tax is placed on the issuing institution because the issuer is required to pay the purchaser both interest and principal, together with any premium net of any source withholding tax that might be imposed. *See 1980 Joint Committee Description, supra* note 16, at 8.

United States corporations establish "finance subsidiaries," which usually are shell corporations created to borrow money in the Eurobond market and reloan the proceeds to United States parent corporations or affiliates. If the finance subsidiaries are established in a country such as the Netherlands Antilles, they can take advantage of the Netherlands treaty that was extended to include the Netherlands Antilles. Under this treaty, no United States withholding taxes will be imposed on interest paid to foreign owners of the Eurobonds. *Id.* at 9.

Various United States governmental agencies have encouraged the use of finance subsidiaries located in tax havens. The Securities and Exchange Commission has relaxed its no-action letter policy regarding United States corporations' offerings made through their offshore finance subsidiaries to foreign investors. In addition, the IRS has issued Private Letter Rulings which, if certain conditions were met, would exempt issues sold to foreign investors by offshore lands house Eurodollar assets of more than $100 billion located in a total of 330 licensed banks, which employ nearly 2,000 Bahamians and account for up to fifteen percent of the country's gross national product.[167] Although interbank Euromarket transactions represent legitimate business activities, a darker aspect of Bahamian banking practice is emerging with respect to transactions involving individuals. The opportunity for criminal activities may travel in tandem with the opportunity for commercial profits when such opportunities arise, as they do in the Bahamian banking system, from the acknowledged factors of no taxation, no bank regulation, common use of bearer bonds, and secrecy legislation.[168] Existing evidence conflicts on the degree of penetration by the criminal element into the Bahamian off-shore banking industry.[169] At the request of the banking community,[170] however, the Bahamas adopted an extremely rigid form of secrecy legislation in 1979.[171] Moreover, the identities of stockholders in Bahamian cor-

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finance subsidiaries from United States withholding taxes. *Id.* at 10. The IRS also has published several Revenue Rulings granting favorable tax treatment to foreign borrowing by offshore subsidiary finance companies. Rev. Rul. 73-110, 1973-1 C.B. 454; Rev. Rul. 72-416, 1972-2 C.B. 591; Rev. Rul. 70-645, 1970-2 C.B. 273; Rev. Rul. 69-401, 1969-2 C.B. 233; Rev. Rul. 69-377, 1969-2 C.B. 231.

Although the United States government terminated its program of supporting the United States dollar in 1974, and the Internal Revenue Service revoked its approval of tax benefits for offshore finance subsidiaries, Rev. Rul. 464, 1974-2 C.B. 47, the offshore finance companies have continued to flourish for several reasons. First, the Euromarket is free from the control of the Federal Reserve; thus, it is more profitable than the United States market. *See* GORDON REPORT, *supra* note 6, at 23. If a deposit-loan transaction occurs in the United States, the Federal Reserve Board requires a member bank to maintain a portion of the deposit as a reserve against future contingencies, and the bank may lend only the balance. The reserved portion produces little or no income. If a foreign branch of a United States bank books the same transaction in a foreign jurisdiction such as the Bahamas, however, the foreign branch can loan out as much or all of the deposit as it deems advisable, free from current Federal Reserve restrictions. *Id.*

167. SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 55. The Bahamian share of the Eurocurrency market is said to be second only to the share captured by London. FINANCIAL TIMES, July 22, 1980, at 30.

168. *See* SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 30-33.

169. United States bankers, foreign bankers, and government officials in Nassau believe little evidence exists to support the United States concern that criminal elements are using Bahamian Eurobanks. *Id.* at 56. The United States, however, finds "ample grounds for suspicion." *Id.* at 60.

170. *Id.* at 57.

171. *See* TREASURY TAX HAVEN GUIDE, *supra* note 124, at 12.

porations remain completely anonymous because of the common practice of using nominees as shareholders.[172]

Approximately 25,000 registered trading companies are operating in the Bahamas, 15,000 of which are active.[173] Bahamian attorneys charge a standard $1000 fee to create these corporations and, in contrast to Swiss standards, have no attendant duty to evaluate the character of the client or the nature of the funds financing the new corporation.[174] In practice, the Bahamian government does not require any initial screening or subsequent reporting of corporate assets.[175] If a Bahamian company desires to be free from local tax, it must file the names of its beneficial owners with the Bahamian Central Bank. These names, however, remain secret under the Bank Secrecy Laws. Apparently, to avoid even such minimum disclosure, at least two layers of ownership by entities or nominees in two different foreign secrecy havens are used. To illustrate, if a Panamanian attorney is the stockholder of record of a Bahamian company as nominee for a United States taxpayer, the identity of the true beneficial holder may be concealed for all practical purposes.[176]

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172. *See id.* at 11. The Bahamian secrecy law extends even to information concerning liquidated corporations. Thus, Treasury officials note:

> Obtaining information on companies which have been liquidated is extremely difficult since their record retention consists of a somewhat haphazard system of storage in a basement storeroom. The records seem to be stored in unmarked boxes and OIO (Office of International Operations) has had no luck in obtaining these company files in past requests.

Id. at 12.

173. SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 58.

174. *Id.*

175. *Id.*

176. Although Bahamian law does provide that the Supreme Court may lift bank secrecy rules and require disclosure of confidential data if an attorney petitions for a court order, a petition for such disclosure must show "that a crime has been committed, the proof of which bears on the requested documents, or that a crime is suspected, the proof of which rests on the documents, to be successful." *Id.* This is a difficult standard to meet. One witness testified that Panama, the Caymans, the Netherlands Antilles, and

> to some extent the Bahamas . . . are all havens which we believe are utilized with quite some regularity by those who wish to make use of the tax havens for illegal purposes.
>
> . . .
>
> I think that the bank secrecy requirements or bank secrecy laws, which operate in these countries . . . remain the principal obstacle to our being able to get the kinds of information that we need.

If a Bahamian bank forms a Bahamian company, an exemption from filing even the minimal information on the beneficial owners' names is granted. The filing requirement is eliminated if the local bank forming the Bahamian entity represents to the Central Bank that the beneficial stockholders are nonresidents.[177] This opportunity for concealment of beneficial ownership is publicized in Bahamian banking efforts to court foreign investors.[178]

F. Secrecy in Panama—A Nontreaty Country

Secrecy is prized in Panama as the cornerstone of its prosperity. Panama's status as a major tax haven is supported by three factors: (1) its geographical position is accessible to political flight capital, particularly from Latin America; (2) its political stability is expected to be maintained by the United States to ensure continued access to the Canal; and (3) its regime of secrecy is tripartite.[179]

"Discreet monies" are held in Panama through registered offshore companies.[180] These offshore companies are organized under Panamanian law but are domiciled outside of Panama. The companies are not required to pay Panamanian income tax, file any financial reports or income tax returns with the government, or obtain a commercial license. In addition, their records and account books may be kept anywhere in the world.[181] An offshore

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Senate Crime and Secrecy Hearings, *supra* note 1, at 42 (testimony of J. Walker, Jr., Assistant Secretary, Enforcement, Department of Treasury).

177. SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 59.

178. Numerous opportunities are claimed for Bahamian holding companies created by Bahamian banks. The holding companies can:

> transfer the legal title in securities, options, commodities, real estate into an Investment Holding Company . . . managed by a Bahamian Trust Company. In such a shelter income and gains accumulate, tax-free in many instances. Such a company can be incorporated with a minimum of formalities. . . . The names of the beneficial owners do not have to be disclosed, since nominee holdings . . . are permitted. Thus, a comparison can be made to the concept of companies using bearer shares in other jurisdictions.

Id. at 59 (quoting Bahamas Handbook and Businessman's Annual 161 (Etienne, 1981)).

179. During his political exile even the Shah of Iran selected Panamanian banks to safeguard his funds. *See* SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 79.

180. *Id.* at 80.

181. *See* TREASURY TAX HAVEN GUIDE, *supra* note 124, at 89.

company may be owned by a sole stockholder, individual or corporate, Panamanian or foreign; and stock can be issued in bearer form to allow the transfer of ownership by the exchange of possession.[182]

Panama requires an offshore company to appoint a Panamanian, usually a local law firm, as a resident agent. The agent, however, is not responsible for any information regarding the offshore company. The government, therefore, possesses no information on the ownership of the company. The structure of this system does not even provide the government with the number of Panamanian offshore companies in existence.[183]

A foreign investor may also hold funds in Panama without being identified by using the technique of interbank deposits. It is a common practice for registered companies in other havens such as the Bahamas to place their funds with a Bahamian bank which then establishes an interbank account with a Panamanian bank. The true owner of the account is assured his confidentiality by this two-step process—secrecy is enforced in both jurisdictions and beneficial ownership is unknown in each jurisdiction.[184] In the unlikely event that a bank employee[185] is aware of a customer's financial transactions, his disclosure of information, unless pursuant to a Panamanian court order, will subject him to fine and imprisonment.[186]

The bank and commercial secrecy rules of Panama are reinforced by a territorial concept embodied in Panamanian criminal law. Panama does not recognize a crime committed abroad as a

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182. *Id.*

183. *See* SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 80-82. Panamanian practice permits an investor to obtain a registered company for a low initial legal fee, usually under $1,000, plus a small annual maintenance charge of approximately $250. According to Senate investigators, Panamanian law firms sell old "shelf" companies "to back date transactions documented abroad. Attorneys form and hold these 'vintage' shells. As with good wine, one pays for the age." *Id.* at 80. As an indication of the magnitude of the business created by offshore companies, one Panamanian law firm maintaining offices in Greece and Switzerland for the convenience of its European clients claimed that in 1981 it received approximately $30 million in gross receipts for acting as a registered agent in the sale and maintenance of such entities. *Id.* at 81.

184. *Id.* at 79.

185. The criminal sanction applies to Panamanian and foreign bank employees.

186. SEN. CRIME AND SECRECY STUDY, *supra* note 82, at 83.

basis for any action within Panama.[187] Consequently, if the United States government requests information relating to any United States crime, Panama will not disclose any data on jurisdictional grounds if the crime was not committed within Panama.[188]

The prevailing Panamanian attitude does not suggest a spirit of cooperation or any willingness to modify local law to assist the United States in enforcing its tax laws. Leading local Panamanian attorneys, even those sympathetic to the United States, assert that the

> bar would fight to the death to keep [company registration law] as it is. . . . If the United States were to seek to pressure the government of Panama . . . to change the present system, it would create an uproar. It would threaten our livelihood. . . . Any effort to influence our legislation in regard to Panamanian corporations and banking numbered accounts will not only be futile but will create a tremendous burden for the U.S. . . . in Panama.[189]

Influential Panamanians view the Caribbean Basin Initiative, in which the United States has offered tax deductions for conventions only with those Caribbean countries exchanging tax information with the United States, as "inconsequential."[190] They shrug off United States criticisms and threats as "bombast."[191] It is with purposeful intent that the combination of its corporate, banking, and criminal laws have made Panama what many consider "the best haven in the world."[192]

Under current conditions, it is predicted that as the United States is successful in exerting pressures to force more pliable tax havens to exclude criminal funds, ". . . [the funds] will fly to Panama. It is not unreasonable to predict that given reasonable efforts elsewhere, in 10 years, much of the European and Western world criminal money will reside in Panama."[193]

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187. *Id.* at 82.

188. *Id.* at 82-83. The only known exception in which Panama honored a request for banking information involving a crime committed outside of Panama related to the Jonestown, Guyana massacre.

189. *Id.* at 83.

190. *Id.* at 84.

191. *Id.*

192. *Id.*

193. *Id.* at 85.

V. TEFRA Provisions to Increase United States Powers to Gather Tax Information on Foreign Transactions

A. United States Powers to Gather Tax Information on Domestic Transactions

A brief review of the weapons the United States routinely utilizes in collecting taxes in the domestic context is helpful in comprehending the extraordinary obstacles that foreign secrecy laws create by blocking the collection of revenue rightfully due the United States from foreign transactions. The weapons enable the Service to inspect books and records, to gather information about financial assets and transactions of taxpayers within the United States, and to compel payment of full liability.

The Code requires all persons liable for tax to maintain adequate books and records[194] and to keep records at a convenient location accessible to IRS personnel.[195] The taxpayer is subjected to penalties for failing to maintain adequate books and records.[196] If a taxpayer is uncooperative, the IRS has sweeping powers to compel the production of relevant books and records,[197] including those in the hands of a third party.[198] The Service, therefore, has the right to examine and obtain information from bankers, brokers, customers, suppliers, investment houses, and any other relevant persons who deal with the taxpayer.[199] Basically, the only

194. *See* I.R.C. § 6001 (Supp. V 1981).

195. *See* Treas. Reg. § 31.6001-1(e)(1955).

196. The Code imposes a penalty of 5% of any underpayment due to "negligence or intentional disregard of rules or regulations." I.R.C. § 6653(a) (Supp. V 1981). This penalty was applied for failure to maintain adequate books and records in Estate of Simkins, 47 T.C.M. ¶ 78,338 (1978).

197. I.R.C. § 7602(a) (1976).

198. *Id.* The IRS also has the power to issue a summons, which may be enforced by a United States district court, compelling the production of records. *Id.* § 7604(a). If the taxpayer fails to comply, he is subject to citation for contempt of court. *Id.* §7604(b) (Supp. V 1981).

199. The Right to Financial Privacy Act of 1978, Pub. L. No. 95-630, § 223(c), 92 Stat. 3697, 3706, restricts voluntary disclosure of financial records held by banks, savings and loan associations, finance companies, loan companies, credit unions, and similar institutions. These institutions are forbidden to disclose their customers' records to the Service voluntarily, but disclosure of bank data may be compelled through the use of an administrative summons, a judicial subpoena, or by service of a properly obtained search warrant. Thus, by following due process procedures, the Service can obtain bank data from United States institutions.

defense the taxpayer may invoke against the sweeping powers of the IRS in a tax audit lies in the fourth amendment[200] (protection against unreasonable search and seizure) and in the fifth amendment[201] (protection against self-incrimination) of the Constitution. Both of these defenses are available only to individual taxpayers and not to corporations. These defenses, moreover, cannot be used to prevent the Service from gaining access to evidence consisting of third party testimony or records.[202] Professor Owens has commented: "The *in terrorem* effect of the Service's audit powers, combined with the civil and criminal sanctions . . . [in the Code] tend to guarantee a substantial degree of honesty in tax returns."[203]

With the enactment of TEFRA[204] in 1982, Congress magnified the "*in terrorem*" effect for those over whom United States courts have jurisdiction by broadening the categories of conduct subject to sanction and by dramatically increasing the amount of civil and criminal fines and penalties. TEFRA enlarged the number of information returns to be filed; raised the penalty for failure to file and created a new penalty for intentional failure to file informational returns;[205] increased the civil penalty for failure to supply the Taxpayer Identification Number (TIN) on a return or to furnish a TIN to a third party; increased the penalty for omission of the TIN on third party returns;[206] provided new civil penalties specifically directed against promoters of abusive tax shelters,[207] including the power to enjoin such promoters;[208] created a new penalty for any substantial understatement of income tax, even though not the result of negligence or fraud, attributable to a filing position not disclosed on the taxpayer's return or for which

200. U.S. CONST. amend. IV.

201. *Id.*, amend. V.

202. The taxpayer does have the right under § 7609 to intervene in a proceeding brought by the IRS for the issuance of a summons compelling the production of books and records in the hands of a third party, but his defenses are limited. Typical defenses would include the raising of certain privileges, such as the attorney-client privilege, to defeat production.

203. 3 E. OWENS, INTERNATIONAL ASPECTS OF U.S. INCOME TAXATION: CASES AND MATERIALS 246 (1980).

204. Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324 (codified in scattered sections of 26 U.S.C.).

205. *See* TEFRA § 315 (codified at I.R.C. § 6652).

206. *See* TEFRA § 316 (codified at I.R.C. § 6676).

207. *See* TEFRA § 320 (codified at I.R.C. § 6700).

208. *See* TEFRA § 321 (codified at I.R.C. § 7408).

the taxpayer did not have "substantial authority";[209] imposed a new civil penalty aimed at tax advisors for aiding or assisting in the preparation or presentation of false or fraudulent documents resulting in an understatement of tax liability;[210] increased the civil fraud penalty;[211] and substantially increased the maximum amount of fines for major criminal tax offenses.[212]

B. Limitations on Gathering Information Abroad Prior to TEFRA

The Code does not require specifically that books and records relevant to the determination of the tax liability of a United States taxpayer be maintained within the United States.[213] Re-

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209. *See* TEFRA § 323 (codified at I.R.C. § 6662). Congress intended this new penalty to improve compliance by deterring taxpayers from playing the "audit lottery." The "audit lottery" occurs when taxpayers take questionable positions on their returns, not amounting to fraud or negligence (for which there are penalties), hoping they will not be audited. If the return was audited and the questionable items spotted, the taxpayers had little downside risk because their maximum exposure was to pay the additional tax, which was the amount originally due with interest. The taxpayers viewed this payment as the cost of borrowing the monies from the IRS. According to the legislative history, a taxpayer could avoid the danger of a fraud or negligence penalty by relying upon an opinion of a tax advisor, even though the opinion may have been significantly qualified. The new penalty is intended to make it more expensive for the taxpayer to play the audit lottery if there is no "substantial authority" for his position, a phrase Congress intentionally left undefined and ambiguous.

210. *See* TEFRA § 324 (codified at I.R.C. § 6701).

211. *See* TEFRA § 325 (codified at I.R.C. § 6653).

212. Any person convicted of a willful attempt to evade or defeat any tax is guilty of a felony and subject to imprisonment of not more than five years, or a fine increased from $10,000 to $100,000 ($500,000 for corporations), or both. TEFRA § 329(a) (codified at I.R.C. § 7201). Any person who willfully fails to file a return or pay any tax or estimated tax is guilty of a misdemeanor and subject to imprisonment for not more than one year, or a fine increased from $10,000 to $25,000 ($100,000 for corporations), or both. TEFRA § 329(b) (codified at I.R.C. § 7203). Any person convicted of willfully filing a false declaration under penalty of perjury or assisting in preparing false or fraudulent documents for the purpose of evading or defeating any tax is guilty of a felony and is subject to imprisonment for not more than three years, or to a fine increased from $5,000 to $100,000 ($500,000 for corporations), or both. TEFRA § 329(c) (codified at I.R.C. § 7206). Any person who willfully delivers false or fraudulent documents to the Secretary is guilty of a misdemeanor and is subject to imprisonment for not more than one year, or to a fine increased from $1,000 to $10,000 ($50,000 for corporations), or both. TEFRA § 329(d) (codified at I.R.C. § 7207).

213. A United States shareholder of a controlled foreign corporation is re-

quiring such record maintenance from third parties who are not United States taxpayers, citizens, or residents is outside United States jurisdictional power; consequently, the Service must seek such information abroad. If it desires to make an on-site examination of the taxpayer's books and records in a tax haven jurisdiction, the Service must obtain both the consent of the taxpayer and the permission of the local government prior to conducting any interviews with third parties located on foreign soil.[214] Secrecy havens, by definition, do not grant this permission and, therefore, the likelihood of an effective on-site foreign examination by IRS representatives is greatly diminished. When the United States taxpayer is not cooperative, the Service must resort to compulsory process in one of three forms: (1) an administrative summons; (2) a judicial subpoena; or (3) letters rogatory.[215]

The administrative summons has been successful in gaining access to books and records located in foreign jurisdictions, provided these materials are subject to the custody or control of a United States person or of an entity or a person controlled by a United States person (for example, a foreign branch of a United States bank).[216] A third party located in a secrecy haven, however, can raise the defense that production of these documents would subject him to a penalty under the local jurisdiction's civil or criminal law and that, consequently, the disclosure is prohibited.[217]

As a general proposition, United States courts do not require a person to perform an act that would violate a foreign law.[218] When faced with the issue of the bank secrecy laws in tax haven jurisdictions, certain courts have adopted a balancing of interest test on an ad hoc basis to evaluate whether the interest of the Service in obtaining the requested information outweighs the interest of the foreign jurisdiction in maintaining the confidentiality of the documents.[219]

The Service will not be able to obtain access to bank or corpo-

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quired to maintain United States records. *See* I.R.C. § 964(c) (1976).

214. *See* GORDON REPORT, *supra* note 6, at 200.

215. *Id.* at 201. Letters rogatory are necessary if the foreign government is requested to exercise its compulsory process on behalf of a United States court.

216. *Id.*

217. *Id.*

218. *See, e.g.*, United States v. First Nat'l Bank, 699 F.2d 341 (7th Cir. 1983).

219. *See id.* at 345-46.

rate records in the secrecy haven if no person or entity subject to the personal jurisdiction of the United States courts can be compelled to produce the information. Unless the IRS can obtain evidence from an independent source, such as an informer or by means of undercover operations, the case cannot be prosecuted.[220]

There are other limitations on the use of the administrative summons by the IRS. A summons directed to a United States citizen outside the country may not be enforceable for lack of venue. Prior to TEFRA, venue existed only when a United States person resided or could be found within the United States.[221] An administrative summons, of course, cannot be served on a foreign person not present in the United States.

The use of a judicial subpoena to secure the production of books and records located in a foreign jurisdiction is similarly limited. Its range encompasses only those subject to the personal jurisdiction of United States courts.[222] Letters rogatory requesting a foreign tribunal to assist a United States court in obtaining evidence have not been commonly used in tax cases.[223]

C. Provisions of TEFRA that Strengthen IRS Capability to Gather Tax Information on Foreign Transactions

TEFRA directly addresses and solves the procedural defects inherent in the administrative summons process, particularly the situation in which a summons validly issued against a United States person residing outside of the country was unenforceable because venue existed only in the district court for the judicial district in which the person resided or was found. This procedural oversight is remedied by according the United States citizen a resident status in the District of Columbia.[224] Although the venue and jurisdiction rules have been modified, the provisions for the proper service of a summons remain unchanged. To be effective, the summons must be "delivered in hand to the person to whom it is directed or left at his last and usual place of abode."[225] A United States citizen who has no usual place of abode within the

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220. *See* GORDON REPORT, *supra* note 6, at 203-04.
221. *See* I.R.C. § 7402(b), 7604(a) (1976). *See also* United States v. Harkins, 581 F.2d 431, 438 n.11 (5th Cir. 1978).
222. *See* GORDON REPORT, *supra* note 6, at 205.
223. *Id.*
224. I.R.C. § 7701(a)(39).
225. *Id.* § 7603.

country and remains abroad, consequently, can still avoid service of process. TEFRA does not ameliorate the problem of obtaining jurisdiction over a foreign person who remains outside the United States and maintains the needed documentation in a secrecy jurisdiction.

Section 982 of the Code, a TEFRA provision, appears narrow and procedural on its face. A closer examination, however, reveals that this section reflects Congress' new policy of not recognizing the validity of foreign secrecy laws, even if these laws provide for the imposition of civil or criminal penalties on those who disclose confidential information. The operation of section 982 prohibits a United States taxpayer from introducing any "foreign-based documentation," in any civil judicial proceeding involving his tax liability, that was not produced for the IRS in response to the IRS formal document request.[226] The term "foreign-based documentation" is defined as "any documentation which is outside the United States and which may be relevant or material to the tax treatment of the examined item."[227] A formal document request issued by the Service must contain the following four elements: (1) notice of the time and place the taxpayer is to produce the documents; (2) a statement of the reasons (if any) why the documents previously produced are insufficient; (3) a description of the documentation sought; and (4) the consequences of failing to produce the described documentation.[228]

The penalty for substantial noncompliance[229] with a formal

226. *Id.* § 982(a).

227. *Id.* § 982(d)(1). Two components are evident in this definition. Documents are not necessarily "foreign-based documentation" solely because they are geographically located outside the United States. They become foreign-based documentation only if they are located in foreign countries and "may be relevant or material" to the tax treatment of an item under examination. For an observation that this definition involves a "considerable measure of circular reasoning" and for a good critique of § 982 in general, see Feinschreiber, *Tax Procedure: Analysis of the New International Provisions,* 9 INT'L TAX J. 5,8 (1982). The definitional provisions of § 982 also cover the term "foreign-connected" with respect to an item that is "directly or indirectly from a source outside the United States" or "purports to arise outside the United States" or "is otherwise dependent on transactions occurring outside the United States." This ambiguous definition fortunately appears to be inoperative and a leftover provision in § 982 from prior legislative options.

228. I.R.C. § 982(c)(1).

229. If the taxpayer substantially complies with a formal document request, he can avoid the sanctions of nonadmissability. Neither the Code nor the legisla-

document request, the nonadmissibility of the documentation in subsequent civil litigation, is subject to a major exception. If the taxpayer's failure to comply is due to "reasonable cause," no procedural penalty will be imposed.[230] The statute, however, flatly states: "For purposes of paragraph one, the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation is no reasonable cause."[231]

The legislative history of this section is equally unambiguous. The Conference Report on TEFRA states:

> The sanction of non-admissibility does not arise if the taxpayer establishes that the failure to provide the documentation as requested by the Secretary is due to reasonable cause . . . .
>
> The fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the

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tive history, however, define the term "substantial compliance." The Conference Report states that whether a taxpayer has substantially complied "depend[s] on all the facts and circumstances." H.R. CONF. REP. No. 760, 97th Cong., 2d Sess. 591 (1982) [hereinafter cited as H.R. CONF. REP. No. 760], *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 1190, 1363. The following example is set forth in the report:

> For instance, if the Internal Revenue Service presents a taxpayer with a formal document request for ten items and the taxpayer produces nine of them but fails (without reasonable cause) to produce the one requested document that appears to report the most significant item, a court may decide that there has not been substantial compliance and exclude all of the items. However, when the Service issues multiple requests in the course of an audit, and when, for example, the taxpayer fails to comply with one particular request for only one document, the taxpayer's timely satisfaction of other requests is one factor (but not the only factor) to be considered in determining whether his overall compliance has been substantial.

Id. This example illustrates an unexpected procedural dichotomy. If the taxpayer fails to produce individual documents I and J in response to a single request by the Service for multiple documents A through J, the court may have the right to exclude documents A through H. In contrast, if the Service had requested those ten documents in ten multiple separate requests, one each, and the taxpayer had failed to comply with two of the ten separate requests, his failure would not automatically disqualify the remaining eight documents from admissibility, but would merely be "one factor" in determining substantial compliance.

230. I.R.C. § 982(b)(1). *See also* Connors & Krauthamer, *Reporting of International Transactions: A View of the Current Enforcement System*, TAX'N INT'L TRADE 42, 45 (1983).

231. I.R.C. § 982(b)(2).

> requested documentation is not reasonable cause. Frequently, taxpayers choose to operate through a particular country because of its restrictive non-disclosure laws.[232]

An evaluation of section 982 is presented below.[233]

Finally, in enacting TEFRA, Congress expressed specific concern with the tax evasion occurring through the false foreign address device and recognized that "substantial amounts of passive income, which would be tax-free in the hands of foreigners, finds its way into the hands of U.S. persons and residents of non-treaty countries who should be paying tax on it."[234] Current procedures were deemed inadequate to curb this conduct.[235] Congress recognized the acuteness of this problem, but did not know how to remedy the situation. Instead of formulating new substantive law addressing this device, Congress enacted the following directive for the Secretary of the Treasury to solve the problem with respect to section 1441 income:

> Not later than 2 years after the enactment of this Act, the Secretary of the Treasury or his delegate shall prescribe regulations establishing certification procedures, refund procedures, or other procedures which insure that any benefit of any treaty relating to withholding of tax under sections 1441 and 1442 of the Internal Revenue Code of 1954 is available only to persons entitled to such benefit.[236]

VI. ANALYSIS

The United States encounters serious obstacles in its efforts to obtain evidence concerning suspected tax offenses from jurisdictions with strict secrecy laws. To meet the inescapable challenge, the government has pressed a partially successful attack on secrecy havens by utilizing the administrative, judicial, and legislative arenas.

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232. H.R. CONF. REP. No. 760, *supra* note 229, at 592, *reprinted* at 1364.

233. *See infra* notes 280-89 and accompanying text.

234. H.R. CONF. REP. No. 760, *supra* note 229, at 593, *reprinted* at 1365.

235. *Id.* at 594, *reprinted* at 1366.

236. TEFRA, Pub. L. No. 97-24, § 324, 96 Stat. 324, 635 (codified at I.R.C. § 6701).

A. Administrative Remedies to Curb Evasion Under Sections 1441 and 1442

1. *Withholding-Refund System*

Even prior to TEFRA, the Treasury Department considered alternative administrative solutions to eliminate tax evasion by United States residents and foreign recipients of portfolio income using false foreign addresses, but found no solution wholly satisfactory. The introduction of a refund system of withholding tax on United States portfolio income (other than section 861(c) interest) is one alternative considered by the Treasury. Under this method, United States payors withhold tax at the flat thirty percent statutory rate on section 1441 portfolio income paid to all foreign recipients, regardless of the potential availability of a treaty reducing or eliminating the statutory rate on the items involved.[237] The foreign recipient of section 1441 income could obtain reduced treaty rates in the withholding system only if he filed an annual tax return with the Internal Revenue Service and claimed a refund. The foreign recipient would be obligated to submit sufficient documentation establishing his residence in the claimed treaty country. Under one proposal, the documentation would be in the form of a "Certificate of Residence" issued by the government of his home country. The Certificate of Residence would verify that the foreign investor had filed a tax return as a resident with the country under which he claimed treaty benefits.[238]

The advantages of a system of withholding coupled with a refund are obvious. The United States automatically receives a full thirty percent tax on all portfolio income. In addition, the Service assumes the primary responsibility of deciding whether a particular recipient is eligible for treaty benefits. The foreign investor has the burden of proving to the Service the bona fides of his foreign residence because the Service reviews the documentation in the context of a refund process.

The subtle collateral problems attendant upon the introduction of a withholding-refund system, however, could adversely affect foreign investors and treaty partners. The system could have a negative impact on the flow of foreign monies into United States

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237. *See House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 47 (statement of A. Granwell).

238. *Id.*

portfolio investments because the system would generate temporary but real increased tax costs for foreign investors. The extra expense results from the investor's loss of funds between the date on which the statutory thirty percent is withheld and the date on which the United States ultimately pays the refund to the bona fide treaty-benefitted investor. This delay becomes especially costly to a foreign investor in view of the present limited interest rates the United States pays on refunds.[239]

The unilateral introduction of a withholding-refund system has little to offer to United States treaty partners except extra burden and expense. Each treaty partner would be required to expend time and effort preparing the necessary Certificates of Residence solely to assist the United States collection of its own taxes. A Treasury official testified: "The reaction of each treaty partner obviously would be gauged to some extent by whether our proposed refund system would be a more or less onerous system of tax collection than that presently employed by each treaty partner."[240] This refund system clearly would be more onerous to our treaty allies than the current *laissez-faire* approach under which there is no responsibility to furnish documentation to the United States. Recognizing that treaty partners may react negatively to a refund procedure, Treasury officials have concluded that "implementation of a refund system would be premature" at this time.[241]

As an alternative, the system could make the refund of withheld taxes contingent upon the foreign investor's furnishing sufficient documentation of his bona fide residence in a treaty country. How extensive this documentation should be and whether the Service could verify the accuracy of the foreign data for the enormous number of refund applications claiming treaty country residency are issues of administrative feasibility and cost-effectiveness. The absence of the standard Tax Identification Number used to collate data by computer would hamper the Service's processing of a foreign investor's refund application. The Service would be forced to establish categories of acceptable foreign documentation. Would affidavits from registered attorneys, auditors,

239. *Id.*

240. *Id.* at 48.

241. *Id. See also id.* at 24 (comment of the Commissioner of the Internal Revenue Service that the operational and economic impacts of a refund-certification system have not yet been fully explored).

or bankers, accompanied by an English translation, be sufficiently reliable? The new burden of documentation and the loss of the "float"—the extra interest on the money withheld prior to refund—would dampen the foreign investment community's enthusiasm for this type of system.

If the United States unilaterally adopts any form of refund system, officials have predicted that "several of our treaty partners would not be very happy because any unilateral activity relating to a treaty, either substantive or procedural, is upsetting."[242] Other countries could express their unhappiness by reacting negatively to the United States investor's assets within their own jurisdiction and adopting a mirror or reciprocal refund system, thereby penalizing United States investors with a comparable documentation burden and the loss of the "float" on income from foreign investments.[243]

2. *Certification System*

A second approach to solving evasion problems is the introduction of a certification system under which the foreign government certifies that the investor has filed a resident tax return with that country[244] and is, therefore, entitled to preferential treaty rates. Once the taxpayer files this certification with the Treasury Department, he is exempt from the thirty percent statutory withholding rate, is immediately entitled to the appropriate lower treaty rate, keeps the "float" privileges, and avoids the refund process.

The certification system favors the foreign investor and reimposes the burden on the foreign government. The scope of a certification system remains an issue under this plan. For example, must the foreign government certify that it has verified the resident's return as true, complete, and inclusive of all United States source income? Suppose an investor with an address in treaty country X claims reduced rates on $10,000 of United States dividends under the United States-X treaty, files a resident return in treaty country X, but on that return reports only $100 of United States dividends. Although this omission raises the specter of possible evasion of X country tax on the remaining $9,900, is this

242. *Id.* at 35.
243. *Id.*
244. *Id.* at 47.

omission theoretically irrelevant in the determination of the investor's bona fide residence in country X? If so, can the objective of certification—bona fide foreign residence—be circumvented by a United States resident's filing of a "resident" tax return, which uses a false foreign address and reports only a nominal amount of income, in a treaty country that does not police returns of small taxpayers? These questions arise because the Treasury has proposed, for administrative convenience, that certification of the act of filing a foreign resident tax return will be prima facie evidence of foreign residency, even though there is no necessary correlation between the act of filing and legal residency.

A more difficult question concerns the proper treatment of nominee accounts under a certification system. Nominee accounts are used extensively in many countries for legitimate purposes, such as holding investment securities. The nominee's country of residence, however, should not determine the treaty withholding rates available to the beneficial owners who reside in a different country. If nominees do not disclose the true owners, the United States treaty partner cannot certify true residency. The Treasury, however, has not suggested specifically that different standards be applied to nominee accounts under a certification system.

Corporations that issue bearer shares, rather than registered shares, are commonly found in major treaty partner countries.[245] Foreign corporations with bearer shares may be sham entities used to conceal the identities of their stockholders.[246] If, for example, the stockholders are United States persons the transactions are subject to scrutiny and, depending on the facts, are vulnerable to an attack based on the doctrine of substance over form. These stockholders of foreign corporations also are susceptible to a variety of sanctions for tax liability on otherwise con-

245. *See* TAX MGMT. FOREIGN INCOME PORTFOLIOS (BNA), No. 39-6th, § 3(D)(1)(c), at A-40 (France); *id.*, No. 82-54th, § 3(B)(1)(h), at A-8 (Switzerland); *id.*, No. 93-5th, § 2(A)(1)(a)(5), at A-11 (Belgium); *id.*, No. 174-4th, § 1(F)(7)(c) (West Germany).

246. In the United States, stock certificates must be registered to disclose ownership. Municipal bonds and other interest-bearing obligations, however, have long been issued in bearer form. In 1982 Congress became concerned that the existence of unregistered bearer bonds impeded the fair and efficient gathering of tax information. Congress, therefore, restricted the subsequent issuance of many categories of long-term obligations in bearer form. *See* TEFRA § 310 (codified at I.R.C. § 103, 163, 312).

cealed income.[247] No treaty partner, however, can certify the true identity of the bearer share owners because they have no way of ascertaining this information. One Treasury official stated the dilemma bluntly: "If you have a refund system . . . let us say you have a Dutch company which has bearer shares. We ask them [the Dutch Government] for certification and what are they going to do?"[248] The current certification system proposed by the Treasury contains no special treatment for corporations issuing bearer shares.

3. *Two Track Certification and Withholding System*

A third option for an administrative remedy consists of a "fast track" certification system offered only to *individual* foreign investors claiming residence in treaty countries. The "fast track" certification system would exclude all nominees, corporations, and other nonindividual entities even though they are organized in treaty countries. If these individual investors claiming residence in a treaty country file satisfactory documentation with the Service, they will be granted a preclearance. The preclearance will establish that the named individual investors are bona fide residents of a named treaty country and specify the correct withholding rate for the various items of section 1441 income under treaty coverage.

Once an individual resident of a treaty country obtained and filed the fast track IRS residence certification, it would remain effective for a period of time and entitle him to treaty-reduced rates on all section 1441 portfolio income. If the IRS finds any error or failure to comply with requirements during the effective period, the foreign investor would forfeit his continued eligibility for the fast track certification and return to the standard track

247. For example, although a foreign corporation may qualify for the reduced treaty withholding rates, it could constitute a foreign personal holding company if sufficient numbers of its stockholders are United States persons. The undistributed income of foreign personal holding companies is to be reported and included in the gross income of United States stockholders. *See* I.R.C. § 551-558, 6035 (information returns required of officers, directors, and stockholders of foreign personal holding companies). The use of foreign corporations with bearer shares obviously makes it very difficult to determine whether a corporation is a foreign personal holding company and to identify the particular United States persons who may be evading tax.

248. *House Subcomm. Hearings on Foreign Addresses, supra* note 7, at 42 (statement of A. Granwell).

category.

The standard track consists of the initial imposition of the statutory thirty percent withholding rate, followed by application, where appropriate, for a refund. The standard track would apply to all nominee accounts, corporations, and other nonindividual entities claiming residency in a treaty country. Nonindividual investors from treaty countries placed in the standard track category would be obligated to establish the identity of their true owners for the refund claim.

The advantage of the third option is that it would require prompt preclearance and identification of a bona fide residence only for named individuals whose proof of foreign residence may be most readily obtainable. This proof is available, as an administrative matter, through the submission of passports, voting records, evidence of military service, and other documentation unique for natural persons. Nominees and corporations will object to this proposal on the ground that they are singled out unfairly. They carry a heavier burden of proof and receive lower financial relief through the refund process, even though they may be legitimate commercial enterprises not involved in tax evasion. The proposal may be defended against the objections because the beneficial owners determine their own fate. If the beneficial owners desire fast track clearance and immediate availability of treaty rates, they can invest in their own name. If they wish the anonymity of a nominee, however, they must pay a higher price for the tax evasion potential of this anonymity through the thirty percent withholding rate.[249]

The third proposal retains the financial advantage for individual investors residing in treaty countries, as distinguished from nontreaty countries. By doing so, the proposal retains the value of treaty status and serves as an incentive for foreign governments to enter into treaties with the United States and obtain preferential tax benefits for their residents.[250] To the extent that countries

249. The concept of imposing a higher tax on a nominee than on an individual is not without analogy. France has a 45% withholding tax (*prélèvement liberatoire*) on interest paid to nonresidents, other than interest paid on state loans and other negotiable bonds, but "where the recipient does not identify himself, the 45% rate is raised to 50%." UNITED KINGDOM BOARD OF INLAND REVENUE OVERSEAS TAX DEVELOPMENT, No. 1/83, at 16.

250. This is consistent with the current United States policy of limiting treaty status to genuine allies. Thus, the United States is actively canceling treaties with tax havens and countries with which it has limited economic contact.

are induced to execute treaties with the United States, investors will enjoy reciprocal benefits by investing in treaty partner states. As an additional spinoff, new treaties should contain more effective exchange of information provisions.[251] Finally, the presence of such a system should deter tax evasion by United States residents using mail drop addresses in treaty countries because of the burdens encountered in producing stricter documentation of bona fide residency and the real prospect of IRS scrutiny of the certification application or the refund claim.

B. Administrative Remedies to Curb Abuse of Section 861(c) Interest Paid to Foreigners

TEFRA's mandate to the the Treasury Secretary for tighter withholding procedures in order to curtail tax evasion applies only to section 1441 portfolio income. Neither Congress nor the Treasury have proposed any realistic solution to the tax evasion made possible under sections 861(A)(1)(a) and 861(c) which exclude from tax the interest paid to foreign recipients on banking accounts, savings and loan accounts, and amounts held by insurance companies. The exclusion is available whether or not the recipients reside in a treaty country, and whether or not the recipients are individuals, corporations, or nominees. This blanket exclusion, coupled with the existence of secrecy havens, is an open invitation for United States residents to evade taxes.

Cognizant of the vulnerability in this area, Treasury officials have proposed that payors of section 861(c) interest be required to report the amount of interest remitted to foreign investors. The Government, therefore, would have some record of the dollar volume involved in the 861(c) payments. Officials have suggested that a self-certification procedure be instituted, one similar to the Form 1001 procedure currently used for nondividend United States portfolio income.[252] The avowed purpose for reporting of

In 1982, it terminated its treaty with the British Virgin Islands. On July 1, 1983, the United States delivered notices terminating, effective January 1, 1984, its income tax treaties with Anguilla, Barbados, Belize, Burundi, Dominica, the Falkland Islands, Gambia, Grenada, Malawi, Montserrat, Rwanda, St. Christopher-Nevis, St. Lucia, St. Vincent, the Grenadines, Seychelles, Sierra Leone, Zambia, and Zaire. *See* Treas. News Release No. 2222, *reported in* 11 FED. TAXES (P-H) ¶ 55,116 (1983).

251. *See* GORDON REPORT, *supra* note 6, at 170.

252. *See House Subcomm. Hearings on Foreign Addresses*, *supra* note 7, at

section 861(c) interest is "to at least put on notice those who are evading U.S. taxes in this manner that I.R.S. will have a record of the recipient of such payment."[253]

This is a paltry solution to the gaping hole in the current revenue collection system. The introduction of a Form 1001 with a reporting system, alone will be no more effective in curtailing section 861(c) interest tax abuse than it has been in controlling abuses with respect to section 1441 income paid to foreign recipients.

C. Mixed Treasury Success in Piercing Foreign Secrecy Laws by Resort to the Judicial System

Under limited conditions and after much persistence and expense, the United States has succeeded on occasion in extracting needed tax information from secrecy havens. An analysis of a few representative cases illustrates the narrow area within which certain courts have balanced the United States interest in equitably administering its tax laws against the foreign jurisdiction's interest in preserving financial secrecy. In *United States v. Field*,[254] a federal grand jury investigated possible criminal tax violations in the use of a foreign bank account to evade United States tax enforcement. Field was a Canadian citizen, a resident of the Cayman Islands, and the managing director of a bank in the Cayman Islands. While in Miami, Field was subpoenaed to testify in a federal grand jury investigation. During his testimony, he refused to answer questions about the Cayman Bank and its customers' accounts on the grounds that his testimony would violate the Cayman Bank Secrecy Laws and subject him to criminal prosecution and possible imprisonment of up to six months.

Field argued that as a matter of international comity the United States should not require the performance of an act another nation had determined was illegal.[255] The Fifth Circuit recognized that when the laws of nations conflict, various factors must be balanced in the determination as to which law shall pre-

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253. *Id.* at 20.

254. United States v. Field, 532 F.2d 404 (5th Cir.), *cert. denied*, 429 U.S. 940 (1976).

255. *See* United States v. First National City Bank, 396 F.2d 897 (2d Cir. 1968).

vail.[256] The *Field* court emphasized the significance of the grand jury's function within the United States system of jurisprudence as well as the subject matter of the investigation. The court rejected Field's position that such a tax investigation constituted "mere economic regulation"[257] and instead, asserted that the collection of tax revenue "is crucial to the financial integrity of the republic."[258] The *Field* court found that the United States interest in tax collection outweighed the interest of the Cayman Islands in preserving financial confidentiality. The court concluded:

> We regret that our decision requires Mr. Field to violate the legal commands of the Cayman Islands, his country of residence. In a world where commercial transactions are international in scope, conflicts are inevitable. Courts and legislatures should take every reasonable precaution to avoid placing individuals in the situation Mr. Field finds himself. Yet, this Court simply cannot acquiesce in the proposition that United States criminal investigations must be thwarted whenever there is conflict with the interest of other states.[259]

The *Field* case marked the opening salvo against those foreign bank personnel who can be served a subpoena to testify in grand jury proceedings while on United States soil.[260] The *Field* princi-

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256. The balancing of interest test is derived from the RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES, § 40 (1965), which reads as follows: *Limitations on Exercise of Enforcement Jurisdiction*

> Where two states have jurisdiction to prescribe and enforce rules of law and the rules they may prescribe require inconsistent conduct upon the part of a person, each state is required by international law to consider, in good faith, moderating the exercise of its enforcement jurisdiction, in the light of such factors as
>
> (a) vital national interest of each of the states,
>
> (b) the extent and the nature of the hardship that inconsistent enforcement actions would impose upon the person,
>
> (c) the extent to which the required conduct is to take place in the territory of the other state,
>
> (d) the nationality of the person, and
>
> (e) the extent to which enforcement by action of either state can reasonably be expected to achieve compliance with the rule prescribed by that state.

257. *Id. Fields,* 532 F.2d at 408.

258. *Id.* at 407-08.

259. *Id.* at 410.

260. It is well-established that the federal courts have jurisdiction over a nonresident alien actually present in the United States. *See* United States v. Germann, 370 F.2d 1019 (2d Cir. 1967), where it was stated, "Of course there is

ples were reaffirmed in *United States v. Bank of Nova Scotia*.[261] The Eleventh Circuit required the Bank of Nova Scotia, a Canadian bank, to comply with a subpoena served on its Florida office and to produce certain banking statements relating to depositors for a grand jury investigation. The requested statements were physically located at the Bank's branch in the Bahamas. The Bank resisted the subpoena, asserting that disclosure would expose it to criminal prosecution under Bahamian bank secrecy laws and that, under the doctrine of comity[262] between nations, the Bank should not be forced to commit a criminal act. Applying the balancing test enunciated in *Field* and the *Restatement*,[263] the Eleventh Circuit upheld the right of the United States to order production on the grounds that the Bahamian Privacy Act "does not present a Bahamian interest sufficient to outweigh United States interest in collecting revenues and insuring an unimpeded and efficacious grand jury process."[264]

Given a suspected violation warranting a grand jury investigation and the ability to obtain jurisdiction over a party, the judiciary has been willing to issue orders overriding foreign secrecy legislation. Such cases are relatively rare, however, and cannot form the basis for a routine, orderly, cost-efficient enforcement procedure of the United States tax system with the enormous volume of financial transactions occurring in secrecy havens.

A remarkable United States victory recently occurred in the case of *United States v. Carver*, in which the Supreme Court of Jamaica, sitting as the Court of Appeals for the Cayman Islands, reversed the Cayman lower court and directed it to honor a request for "letters rogatory" made by the United States District

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no power to compel such a witness to come from abroad. But anyone within the jurisdiction of the court may be subpoenaed . . . . It makes no difference where he is resident or of what country he is a citizen." *Id.* at 1022-23. Claiming jurisdiction over foreigners with respect to acts performed outside the United States has been criticized. *See, e.g.*, Rio Tinto Zinc Corp. v. Westinghouse Elec. Corp. 1978 A.C. 547, 616, 629-31, 639-40, 650 (H.L.).

261. 691 F.2d 1384 (11th Cir. 1982), *cert. denied*, 103 S. Ct. 3086 (1983).

262. Comity is defined as "a nation's expression of understanding which demonstrates due regard both to international duty and convenience and to the rights of persons protected by its own laws." Somportex Ltd. v. Philadelphia Chewing Gum Corp., 453 F.2d 435, 440 (3d Cir. 1971), *cert. denied*, 405 U.S. 1017 (1972).

263. *See supra* note 256.

264. 691 F.2d at 1391.

Court for the District of Columbia. The letters rogatory were sought in a pending United States criminal case involving charges of commercial fraud and diversion of funds to secret bank accounts in Liechtenstein, Switzerland, and the Cayman Islands. To trace the money to the defendants, United States prosecutors needed access to financial records in the Caymans. The lower courts had denied the request on the grounds that the information was protected by the Cayman confidentiality laws. The Jamaican Appeals Court, however, reversed the prior decision, directing the information to be transmitted.

Although the United States prevailed in the *Carver* case, which attracted enthusiastic responses in the press,[265] the letters rogatory process is too cumbersome, time consuming, and expensive to use in any but the most notorious circumstances. Its utility as a deterrent for tax evasion on a day-to-day basis is negligible.

It must be noted that United States courts applying the balancing of interest test are not unanimously attributing greater importance to the United States interest in collecting tax data than to the foreign interest in secrecy legislation. In *United States v. First National Bank of Chicago*,[266] the Seventh Circuit reversed the enforcement of an IRS administrative summons which had directed the First National Bank of Chicago to produce certain customers' bank statements kept in its Athens, Greece branch. First Chicago refused to comply on the grounds that under the Greek Bank Secrecy Act[267] all bank employees, whether in or out

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265. *See* Taylor, *Cayman Isles' Secrecy Lid Pried Loose by Precedent-Setting U.S. Fraud Case*, Wall St. J., Jan. 11, 1983, at 12, col. 1; *Caymans Case Shows How Courts in U.S. Are Cracking the Secrecy of Foreign Banks*, Wall St. J., Oct. 14, 1982, at 33, col. 1.

266. 699 F.2d 341 (1983).

267. The Library of Congress translation of the Greek Bank Secrecy Act reads as follows:

> Article 1: Deposits in Greek banks are regarded as secret.
>
> Article 2:
>
> 1). Governors, members of the board, [members of] other collective bodies, or employees of the bank who, in the course of their duties, acquire knowledge of deposits, and convey any information in any manner are punished with a minimum of 6 months imprisonment.
>
> The consent or approval of the depositor who has the right to secrecy does not change the punishable nature of the act.
>
> 2). Upon conviction for the offense mentioned in the above paragraph, the court cannot order suspension of the penalty nor can it change a conviction to a fine.

of Greece, who disclose exact account information about Greek branch depositors may be subject to criminal penalties, including a six-month prison term. The Seventh Circuit found that disclosure of the requested information would subject the Bank employees to jeopardy of imprisonment. The Greek Bank Secrecy Act does not allow the prison sentence to be commuted into a fine and "even the consent of the depositor cannot alter the punishable nature of the disclosure."[268] The issue was, therefore, whether under these circumstances "a sensitive balancing of the competing interests at stake"[269] should nevertheless compel production of the documents.

Following the *Restatement* balancing of interest test,[270] the Seventh Circuit held that the lower court's issuance of an unqualified order, without opinion, compelling First Chicago to produce the documents was an abuse of discretion. The court stressed the unique language of the Greek Bank Secrecy Act and noted the exposure of Greek bank employees, as well as First Chicago itself, to criminal penalties even though they were "involved only as neutral sources of information and not as taxpayers or adverse parties in litigation."[271]

The Seventh Circuit distinguished the Eleventh Circuit's *Bank of Nova Scotia* decision on several grounds: (1) the Bank of Nova Scotia had not made a good faith effort to comply with the subpoena whereas First Chicago had made some type of effort; (2) in *Bank of Nova Scotia*, the interest of the United States involved the protection of the grand jury process and the enforcement of United States criminal laws, as well as the collection of taxes; and (3) the Bahamian criminal sanctions in the *Bank of Nova Scotia* case were less severe than the Greek Bank Secrecy Act (under

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3). The persons mentioned in paragraph 1, called upon as witnesses at a civil or criminal trial, cannot be questioned on the secret deposits, even though the depositor consents.

Article 3:

As an exception, information is allowed on secret bank deposits only by virtue of a specially justified decision of a domestic court, to the extent that the information is regarded as absolutely necessary for searching and punishing offenses which are regarded as felonies committed in Greece.

Id. at 344 n.2.

268. *Id.* at 345.

269. *Id.*

270. *See supra* note 256.

271. 699 F.2d at 346.

Bahamian law, consent of the bank customer would decriminalize the disclosure, while under the Greek Act, bank disclosure remained a punishable crime even with customer consent).[272]

In addition, the Seventh Circuit noted that the *Restatement of Foreign Relations Law* was being revised with respect to court ordered production of documents located outside the United States when such production violates the law of the jurisdiction in which the documentation is situated.[273] In accordance with the tenor of these tentative draft revisions, the Seventh Circuit remanded the case to the district court to consider ordering First Chicago to "make a good faith effort to receive permission from the Greek authorities to produce the information specified in the summons."[274]

The *First Chicago* decision corroborates the observation that the judicial system, when confronted with foreign secrecy laws, will not provide the certainty, swiftness, and consistency needed to administer and enforce the United States tax system fairly and efficiently. Certain other overtones of the court's opinion are ominous. First, Greece is not customarily listed as a tax haven. This case, however, demonstrates that Greece clearly is a secrecy haven *par excellence.* If the critical factor influencing the court's refusal to compel production of the bank data was the clear and unambiguous statutory language of the Greek Bank Secrecy Act, then it is likely the statutes in many other foreign jurisdictions that

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272. *Id.* at 346-47.

273. The Seventh Circuit stated that the substance of § 40 of the *Restatement (Second) of Foreign Relations Law of the United States* was being revised, and that the material in § 40 concerning the factors involved in the balancing test is now contained, with certain modifications, in § 403 of the Tentative Draft No. 2 and §§ 419 and 420 of the Tentative Draft No. 3. The court quoted the following portions of the revised *Restatement* as pertinent:

> Section 419(1) provides that "[a] person may not ordinarily be required by authority of the United States . . . to do an act outside the United States prohibited by the law of the state where the act is to be done." Section 420 deals specifically with court ordered production of information located outside the United States. Section 420(2) provides that "[i]f disclosure of information located outside the United States is prohibited by a law or regulation of the state in which the information or prospective witness is located . . . the person to whom the order is directed may be required by the court to make a good faith effort to secure permission from the foreign authorities to make the information available."

699 F.2d at 346.

274. *Id.*

profit from their reputation for bank secrecy will soon be redrafted along the lines of the Greek Act to incorporate the same severe criminal provisions and to prohibit decriminalization of disclosure, notwithstanding customer consent.

The second troubling development noted in the *First Chicago* opinion is the thrust of the revised tentative drafts of the *Restatement* on court ordered disclosure of foreign-based information. The solution implied in the *Restatement*—good faith efforts to obtain foreign permission to disclose—is unrealistic because the *raison d'être* of secrecy legislation is to prohibit disclosure. The tenor of the revised draft does not bode well for the Treasury in its continued use of the judicial system to pierce the veil of foreign secrecy havens.

The cases discussed above concern secrecy havens with which the United States has no tax treaty. But even with a treaty partner such as Switzerland, delay and uncertainty continue to plague United States judicial efforts to obtain Swiss-based tax data. The pressure to secure information on suspected tax offenses, in addition, leads to negative diplomatic repercussions. In the pending case of *United States v. Marc Rich*, a federal grand jury investigated charges of alleged tax evasion, through certain manipulations with a United States subsidiary, by the Swiss firm of Marc Rich. The federal courts, in a manner open to debate,[275] stretched the subpoena power and upheld service on the Swiss company, previously considered beyond United States jurisdiction. After service was upheld and after eighteen months of court maneuvering, the prosecutors succeeded in forcing Marc Rich to agree to turn over the requested documents located in Switzerland. This agreement was obtained only after the court imposed fines in the amount of $50,000 a day on Marc Rich for contempt, froze certain United States assets, and threatened additional sanctions to terminate the profitable operations of the United States subsidiary.[276] The prosecutors rejected official Swiss requests that the United States government use the treaty procedures for bilateral cooperation to obtain the desired exchange of information.[277] Af-

275. *See Court Decisions in Marc Rich Case to Help U.S. Pursue Foreign Firms*, Wall St. J., Aug. 22, 1983, at 17, col. 4.

276. *See Marc Rich & Co. to Turn Over Subpoenaed Files*, *id.*, Aug. 8, 1983, at col. 2; *Court to Close U.S. Operations of Marc Rich*, Wall St. J., Aug. 2, 1983, at 2, col. 1.

277. On June 28, 1983, the legal advisor to the Swiss Embassy in Washing-

ter these rebuffs, the Swiss government itself actually intervened and seized the disputed documents in its territory before Marc Rich could surrender them to the United States. The Swiss believed a surrender would have violated the Swiss Penal Code prohibition against the disclosure of economic and trade secrets by Swiss entities.[278]

Whatever the ultimate outcome of the case,[279] the *Marc Rich* battle illustrates that the pursuit of foreign-based tax information through aggressive litigation, with each nation engaging in extrajudicial power plays, can cause international friction as a by-product. The negative impact on diplomatic relationships may be, on balance, more significant than the amount of tax revenue involved in the dispute. Although United States frustration with secrecy havens is understandable, resort to this type of litigation is not an appropriate long-range solution.

D. Evaluation of Unilateral Congressional Attempts to Curb Powers of Secrecy Havens

The new Code section 982, which prevents a taxpayer from introducing into litigation foreign-based documentation not previously disclosed to the Treasury, was fashioned with ingenuity. The section is not a violation of the principles of international comity or the *Restatement of Foreign Relations Law* because it does not compel the performance of an act that would be illegal in a foreign jurisdiction. Although it clearly is a valuable bargain-

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ton, D.C., requested the district court to delay imposing a contempt of court penalty on Marc Rich while United States attorneys applied for cooperation from the Swiss Government. The court refused the request and instead imposed a $50,000 a day fine on Marc Rich for contempt of court in not producing the documents. On July 5, 1983, the Swiss ambassador to the United States met with officials from the Departments of State and Justice to urge the United States to follow procedures for bilateral cooperation. On July 22, 1983, the Swiss Government, having failed to receive a positive response from the United States, sent a diplomatic note stating its concern about the *Marc Rich* case and the methods employed by the United States Government to pursue Swiss companies and documentation. *See Switzerland Enters Marc Rich Case to Halt U.S. From Obtaining Subpoenaed Papers,* Wall St. J., Aug. 15, 1983, at 3, col. 2.

278. *Id.*

279. These enforcement procedures can be effective only to the extent a foreign corporation has operations within the United States. On the day after the court found the Swiss company guilty of contempt for not complying with the subpoena, the United States subsidiary was sold to stockholders and certain former executives. *See* Wall St. J., Dec. 2, 1983, at 7, col. 1.

ing tool for inducing taxpayers to produce foreign-sited information, section 982 is subject to serious limitations.

First, the section's primary sanction of nonadmissability of documents operates only with respect to a taxpayer and not to third parties.[280] Section 982 would have no relevance in a suit against neutral stakeholders, such as financial institutions, when the government is seeking an order to compel the production of financial documents concerning depositors. Because of its procedural mechanics, the section's language attacking the validity of foreign secrecy laws, although indicative of Congressional outrage, does little[281] to facilitate actions against third parties. To illustrate, the sanction of nonadmissibility is not leveled against the taxpayer if there is reasonable cause for his refusal to submit the documents to the IRS.[282] The statute provides that the existence of foreign laws imposing penalties for disclosure does not constitute reasonable cause.[283] Foreign bank secrecy legislation, however, uniformly imposes penalties for disclosure upon the third party entrusted with confidential information[284] but does not penalize the depositor for revealing information belonging to him. Third parties, such as financial institutions, raising foreign bank secrecy laws as a defense to justify nondisclosure, therefore, are not affected by the proscriptions of section 982.

A second limitation on the efficacy of section 982 is that it applies only to civil proceedings.[285] The taxpayer can still use the double standard tactic in criminal proceedings—refuse to produce documents requested by the Service but introduce them on his behalf in a criminal trial. If the offense is most egregious and criminal prosecution is contemplated, section 982 would have no relevance.

Third, section 982 is of the most utility under circumstances in which the Service already has sufficient initial information on the suspect transactions to accurately describe the documents sought,[286] and the taxpayer desires to produce the foreign data. If the taxpayer intends to suppress all information, both on an audit

280. The Code reads: "If the taxpayer fails to substantially comply with any formal document request . . . ." I.R.C. § 982(a).

281. *Id.* § 982(b)(2).

282. *Id.* § 982(b)(1).

283. *Id.* § 982(b)(2).

284. *See supra* pt. IV.

285. I.R.C. § 982(a).

286. *Id.* § 982(b)(1)(C).

and at a trial, and depends on the Service's total lack of admissible evidence to prevent proof of the transaction, he has no incentive to produce any documents at the trial, and the sanction of section 982 becomes meaningless.

In addition to the enactment of TEFRA and section 982, Congress legislated a direct inducement to Caribbean nations for exchange of tax data with the United States. The Caribbean Basin Initiative[287] confers certain economic benefits in the form of deductions for United States taxpayers attending business conventions held in those countries that have entered into satisfactory agreements with the United States on the exchange of tax information.[288] Whether the Intitative will be successful depends upon how each Carribean country perceives and values the financial benefits accruing from the potential increase in its tourist revenue and the potential loss of revenues experienced by foregoing its tax and secrecy haven status.[289]

VII. CONCLUSION

The solutions discussed above, as well as those suggested by others, which would curtail tax evasion schemes made possible by foreign secrecy havens,[290] have been predicated on increased en-

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287. Caribbean Basin Economic Recovery Act of 1983, Pub. L. No. 98-6, 97 Stat. 369, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 369.

288. *Id.* § 222(a)(6)(C) (codified at I.R.C. § 274).

289. Indications are that the Bahamas will reject the offer of the Caribbean Basin Initiative, even though the country desires the convention tax deduction, because of the conditions attached and the "U.S. demands" for cooperation in investigating "American citizens secret Bahamian bank accounts." *Bahamas Shut Out from the Carib Basin Project*, Nassau Guardian, Mar. 24, 1982, *reprinted in Senate Crime and Secrecy Hearings*, *supra* note 1, at 45.

290. To solve the problems, Gordon recommended new legislation imposing harsh sanctions on countries designated as abusive tax havens for failing to disclose tax data requested by the United States. The sanctions would include: (1) increasing the withholding tax rate to as high as 50% on all portfolio income, including section 861(c) interest paid to addressees in abusive tax havens; (2) presuming that loans from designated tax havens to United States persons constitute ordinary income unless the taxpayer produces sufficient satisfactory evidence to the contrary; (3) disallowing United States persons deductions for expenses and losses incurred in transactions with entities in tax haven countries; (4) canceling direct United States airline flights to tax havens; and (5) prohibiting United States banks from conducting business in these countries. *See Gordon Report*, *supra* note 6, at 213-14.

The Tax Compliance Bill of 1982 from which TEFRA originated, contained forcement powers within the United States and increased pressure on foreign jurisdictions to subordinate their laws to the United States need for data essential to its tax collection. The question must be asked whether it is feasible for the United States to stamp out secrecy legislation in every nation. As long as one haven is in existence, capital seeking secrecy will migrate to it with the speed of electronic transfer, and the present enforcement dilemma will remain substantially unresolved. The current preoccupation with bank secrecy legislation, moreover, obscures a more fundamental economic fact: almost all countries offer anonymity to those investors who take advantage of the nominee structure to use banks or brokerage houses to hold portfolio investments or who establish unsupervised corporations to issue bearer shares. Each of these legal structures, which are ubiquitous as well as respectable in developed countries, can conceal effectively the identity of an investment's true owner. It is unrealistic to expect and egocentric to believe that the United States could, or should, compel all other countries to alter their internal tax, corporate, banking, and commercial laws, at the expense of their nationalistic self-interests, in order to facilitate United States tax collections.

Responsibility for the burgeoning tax evasion by United States residents does not lie solely on the doorsteps of the many nations accused of being tax or secrecy havens. The fault also lies in the historical United States insistence on a treaty policy which fosters international tax evasion by favoring residency basis taxation over source basis taxation of portfolio income.[291] Although the Code establishes source country taxation by imposing a hefty thirty percent on passive income earned (sourced) in the United States, the United States treaty policy, which is also followed by the OECD, is predicated on the primacy of taxation by the country of residence. Thus, when a United States resident receives portfolio income earned in a foreign jurisdiction with a treaty, the

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some of Gordon's proposals in the version introduced on May 6, 1982. House Resolution 6300, however, was not enacted, and these provisions did not survive in TEFRA.

291. "Over the years, U.S. tax treaty negotiators have been very strongly oriented towards residency basis taxation . . . particularly with respect to periodic income . . . ." *See Hearings on Income Tax Treaties Before the Subcomm. on Oversight of the House Committee on Ways and Means*, 96th Cong., 2d Sess. 28 (1980) (statement of D. Brockway) [hereinafter cited as *Hearings on Income Tax Treaties*].

treaty partner (the source country), is asked under the Treasury Model Treaty[292] and other extant treaties to forego taxing this portfolio income, or to tax it at low rates, and give the United States (the country of residence) the tax right. In exchange, the United States will reduce or eliminate its thirty percent source tax on portfolio income earned in the United States by residents of the treaty partner and accord the treaty partner (the country of residence) the primary right to tax.

The tilt in treaty policy from sourced-based to residency-based taxation of portfolio income has widened the opening for tax evasion. It is most difficult for a residence country, such as the United States, to detect all portfolio income earned abroad by United States residents and all United States-sourced portfolio income and bank interest received abroad by United States residents masquerading as foreigners with false foreign addresses. The successful detection of this income hinges upon the transmission of massive amounts of information to the residency country. Secrecy laws and the anonymity resulting from nominee accounts and bearer shares intervene and block the flow of this vital information. Thus, when source country taxation on portfolio income is reduced or eliminated, and residence countries are unable to

292. *See* Model Income Tax Treaty, *supra* note 97. For example, article 10(2)(b) reduces United States source taxation on United States-sourced "portfolio dividends" to 15%. Article 11(1) completely eliminates all United States source taxation on United States interest, in each case conceding the taxation right to the recipient's country of residence.

Even with business profits, the United States treaty negotiating stance is more restrictive of source country taxation than is the Code. The Code imposes statutory rates of taxation on the net profits of a foreign business if its income is "effectively connected" with a trade or business engaged in within the United States. I.R.C. § 882(a). Foreign business income is considered "effectively connected" and taxable by the United States if the foreign enterprise has an "office or other fixed place of business within the U.S. to which some income is attributable . . . ." *Id.* § 864(c)(4)(B). Under the Treasury Model Treaty, however, source taxation is imposed on a foreign business entity only if the business income is both "effectively connected" with the source country and is also carried on "through a permanent establishment" situated within the source country. Model Income Tax Treaty, *supra* note 97, art. 7(1). The definition of "permanent establishment" in article 5 of the Treasury Model Treaty operates to reduce source taxation by providing that certain enumerated business activities, although generating "effectively connected" income and therefore otherwise taxable by the source country, will not be deemed to arise from a permanent establishment and, therefore, will not be taxable by the source jurisdiction under bilateral treaty policy. *See* GORDON REPORT, *supra* note 6, at 171.

ascertain the amount of foreign income earned or received abroad, the unscrupulous person can escape tax in both the source country and the residency country.[293]

The treaty policy orientation toward residency country taxation of portfolio income should be reappraised, and a return to source country taxation should be reconsidered. There is precedent for moving in this direction. The enactment of FIRPTA[294] reflects

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293. *See Hearings on Income Tax Treaties, supra* note 291, at 29, in which it is stated:

> Residency basis taxation . . . facilitates tax avoidance and evasion. The only truly effective means of controlling tax avoidance and evasion is through withholding at source. To the extent that source basis taxation is restricted, it serves to increase the flow of movable capital to tax havens and tax secrecy jurisdictions with the result that little or no tax is paid on the income to any country . . . .
>
> Consequently, the residence basis taxation policy of the treaty places the United States in the position of relying on our treaty partners to prevent abuse of our tax system—a particularly risky proposition in the case of treaties with tax havens.

Id.

294. *See* Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, § 1121-25, 94 Stat. 2599, 2682 (codified at I.R.C. §§ 861(a)(5), 897, 6039C, 6652(g)). Normally, foreign persons are not taxed on capital gains from the disposition of assets if the gain is not "effectively connected" with the conduct of a United States trade or business. I.R.C. § 871(b), 882. FIRPTA, however, strengthened United States source taxation of capital gains on disposition by foreign investors of certain real property interests. FIRPTA established a legal fiction that treats gains realized by foreign persons from the disposition of United States real property interests as if the gains were effectively connected with the conduct of a United States trade or business during the year of disposition. *See* I.R.C. § 897(a)(1). For a good discussion of this point, see Recent Development, *Withholding from Recipients of FIRPTA Gain,* 35 VAND. L. REV. 439, 445, 449 (1982). For a sharp criticism of the shift to source country taxation embodied in FIRPTA, see Kingson, *The Coherence of International Taxation,* 81 COLUM. L. REV. 1151, 1275 (1981) ("In furtherance of what represents at best a peripheral source tax interest, the United States betrayed residence interests").

The Treasury itself has shown recent signs that it may be leaning more favorably toward source basis taxation. The proposed new income tax treaty with the British Virgin Islands (which was not executed on other grounds), for example, provided that interest sourced in the United States and paid to residents of the British Virgin Islands was subject to a United States source tax. *See* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, United States-British Virgin Islands, Feb. 20, 1980, art. 6, *reprinted in* 1 TAX TREATY (CCH) ¶ 1004, at 1011-12 (Mar. 1981). For a discussion of this issue, see Note, *Renegotiation of the U.S.-British Virgin Is-*

the Congressional conviction that the gains realized by foreign investors on the disposition of United States real property interests, previously untaxed, should be taxed by the United States as the source country. FIRPTA overrides the treaty policy under which the United States had ceded the right of taxing these gains to residence countries.

In the past, the concept of source country taxation has been opposed because it would negatively affect United States revenue. United States residents have more foreign-sourced income (on which the United States would lose the tax to the host country) than foreign investors have United States-sourced income (on which the United States would gain the tax). Although this observation remains valid in terms of actual total dollars, the percentage growth in the foreign ownership of United States assets has been meteoric.[295] This trend undercuts the loss of revenue argument. In addition, the evaluation of the revenue impact resulting from the adoption of source country taxation of portfolio income must involve the present revenue loss from the tax evasion inherent in residency basis taxation and the increasing administrative costs of allocating more resources to international enforcement and compliance procedures.[296] The merit of source country taxa-

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lands Tax Convention: Prelude to the End of Treaty Shopping?, 22 VA. J. INT'L L. 381, 402 (1982).

295. According to Commerce Department statistics, direct foreign investment in United States companies in 1981 increased 32%, and in 1982 increased another 13% to $101.84 billion, while United States direct investments in foreign operations rose only 5.1% in 1981 and fell 2.2% in 1982 to $221.34 billion. This is the first drop since the end of World War II.

Based upon a comparison of all known United States-owned assets abroad with all known foreign-owned assets in the United States, the Commerce Department figures disclose that the 1982 net investment position of the United States in foreign assets rose by the smallest amount since 1978. During 1982, overall United States investment abroad rose 16% to $834.15 billion while foreign assets in the United States increased during 1982 by almost 19% to $665.52 billion. *See generally Net Investment of U.S. in World Rose in '82 by Smallest Amount Since '78*, Wall St. J., Aug. 26, 1983, at 4.

296. *See* Statement of Roscoe L. Egger, Jr., Commissioner of Internal Revenue, Before the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Government Operations Committee (Apr. 13, 1983), *reported in* NEWS DEVELOPMENT (P-H) ¶ 9947 (1983). Among other things, the IRS has tripled its undercover operations in the past few years as "the only effective means of obtaining evidence to convict persons hiding money in secret accounts in offshore tax havens." Taylor, *Paths of Danger: Federal Agents Encountering New Hazards as the Number of Undercover Operations Grow*, Wall St. J., June 1,

tion lies in its simplicity of administration and certainty of tax collection. It is cost efficient. If all portfolio income paid to foreign investors incurred a uniform and inescapable tax at the source, less profit would be gained from operating secretly. Tax would be withheld at the source regardless of the identity of the recipient. United States tax enforcement officials, nevertheless, would have to institute administrative procedures to distinguish bona fide foreign investors from United States residents posing as foreigners because the maximum marginal rate for United States taxpayers probably would be higher than the uniform withholding rate for foreign investors. Under this proposal, however, officials could concentrate their efforts more effectively on a single problem rather than dissipating their efforts, as they must under alternative proposals, in attempts to identify the true residence of each foreign investor and apply the appropriate withholding rate.

Shifting the United States treaty policy could occur only after negotiating with our treaty partners and reaching an agreement on reciprocal source taxation. In view of the sizeable amount of United States-owned, foreign-sourced portfolio income, this shift might enhance rapport with developing countries, long advocates of source taxation.[297] Problems such as the rate of source taxation on portfolio income remain to be resolved. Because an estimated ninety percent[298] of all portfolio investment income in the United States is funneled through treaty countries and taxed at reduced rates, the present effective rate on United States-sourced portfolio income paid to foreigners is much lower than the statutory thirty percent. It is likely, therefore, that a new rate could be established substantially below thirty percent without negatively affecting revenue. If a multinational reevaluation of treaty policy should occur, the agenda should include the proposal that all countries include bank interest as an item of portfolio income

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1983, at 48, col. 1.

297. For a general analysis of the developing nations' position and their preference for source country taxation on the grounds that they tend to be "capital importing" countries, see U.N. Department of International Economic and Social Affairs, Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries, U.N. Doc. ST/ESA/94 (1979). Source taxation does not produce problems of double taxation of the same income as long as the residence country allows, either by statute, *see* I.R.C. §§ 901-08, or by treaty, appropriate foreign tax credit for taxes paid to source countries by its residents.

298. *See House Subcomm. Hearings on Foreign Addresses*, *supra* note 7, at 12.

taxable at the source.[299] No logical basis exists for the present exclusion. Governments have feared initiating the unilateral taxation of bank interest because bank deposits may be lost to other jurisdictions where interest remains tax-free. Tax "price wars" and competition among nations for banking funds can be avoided, however, if countries act in concert to impose a tax on bank interest at a reciprocal uniform rate. Furthermore, such a tax is appealing in the name of equity as it strikes hardest at the foreign and domestic investor who has manipulated the present system, with the interposition of secrecy havens, to earn bank interest free of tax at the source while evading the tax due to his country of residence.[300]

299. Congress has frequently viewed the tax-free status of bank interest paid to foreign investors as a candidate for taxation. Congress was persuaded in 1976 to leave such interest tax-free because of the long list of countries that similarly did not tax bank account interest paid to foreign countries. The list included the United Kingdom, Germany, the Netherlands, Luxembourg, all of Scandinavia, Belgium, Singapore, Panama, the Bahamas, the Cayman Islands, the Netherlands Antilles, Japan, and Canada. Congress posited that, given the mobility of funds, it was in the best interest of the United States to retain the tax-exempt treatment of bank interest paid to foreigners in order not to jeopardize the billions of dollars of foreign bank deposits in United States banks. *See House Subcomm. Hearings on Foreign Addresses*, *supra* note 7, at 330. This rationale would evaporate if all source countries agreed to tax bank interest paid to foreignêrs at the same rate.

300. Other countries relying on residence taxation have criticized the United States for paying § 861(c) bank interest tax-free to foreigners and not requiring any information returns to identify the recipient, either for United States purposes or for the country of residence. Ironically, such countries have complained that "this anonymity encourages [their] nationals to invest in the United States because of tax evasion possibilities." Kingson, *supra* note 294, at 1286 n.718.