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United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510–6250

October 5, 2012

Senator Max Baucus
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Senator Orrin Hatch
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Representative Dave Camp
Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Representative Sander Levin
Ranking Member
House Committee on Ways and Means
1106 Longworth House Office Building
Washington, DC 20515

Dear Colleagues:

When Congress returns after the election, we will hopefully reach agreement on a balanced, comprehensive deficit reduction package. "Balanced" means a combination of additional revenues and additional cuts in spending.

Relative to the need for additional revenues, one area where bipartisan agreement should be possible is closing abusive offshore tax loopholes. Closing these loopholes would not only produce significant revenue to help reduce the deficit and prevent sequestration, it would strengthen tax fairness and remove tax incentives to move U.S. businesses, jobs, and profits offshore.

Attached is a list of ten offshore tax abuses examined over the last decade by the Permanent Subcommittee on Investigations, which I chair. The list calls for closing tax loopholes that:

(1) allow U.S. multinational corporations to shift profits offshore through abusive transfer pricing arrangements;

(2) allow U.S. multinationals to pretend to keep profits offshore, while actually returning offshore cash tax-free to the United States through serial loans;

(3) allow U.S. multinationals to pretend to keep profits offshore while using offshore subsidiaries to place the offshore cash in U.S. banks and investments;

(4) allow U.S. entities operated and managed out of the United States to incorporate offshore, claim foreign status, and dodge substantial U.S. taxes;

(5) allow U.S. financial firms to treat swap payments received from the United States as nontaxable foreign source income;

(6) allow U.S. multinationals to make an offshore subsidiary invisible for tax purposes and avoid taxation of passive offshore income under the so-called "check-the-box" and "CFC look-through" rules;

(7) allow U.S. multinationals to deduct the costs of moving jobs and operations offshore;

(8) allow mutual funds to dodge limits and taxes on commodity speculation by routing their commodity activities through offshore shell corporations;

(9) hamstring U.S. tax enforcement with inadequate tools to combat taxpayers hiding assets in secret tax haven bank accounts; and

(10) allow U.S. taxpayers to hide assets in U.S. bank accounts opened in the name of offshore entities.

Today, U.S. multinational corporations hold as much as $1.7 trillion offshore, and numerous U.S. taxpayers continue to hide assets in offshore bank accounts. Legislation to close abusive offshore tax loopholes is readily available and would raise hundreds of billions of dollars in additional tax revenues over ten years.

If you or your staff have any questions, please contact me or have your staff contact Ty Gellasch at 4-9123.

Sincerely,

Carl

Carl Levin, Chairman
Permanent Subcommittee on Investigations

Enclosure

CC: Senator Harry Reid
Senator Mitch McConnell
Senator Dick Durbin
Senator Jon Kyl
Senator Kent Conrad
Senator Saxby Chambliss
Senator Mark Warner
Senator Mike Crapo
Senator Tom Coburn
Senator Michael Bennet
Senator Mike Johanns
Senator John McCain
Senator Jeanne Shaheen
Senator Lindsey Graham
Senator Sheldon Whitehouse
Senator Kelly Ayotte
Honorable Timothy Geithner, Secretary of the Treasury
Mr. Gene Sperling, Director, National Economic Council

Prepared by Senator Carl Levin
October 5, 2012

CLOSING TEN OFFSHORE TAX LOOPHOLES

For more than 10 years, the U.S. Senate Permanent Subcommittee on Investigations, which I chair, has been investigating how corporations and individuals have used, misused, and abused tax loopholes and tax gimmicks to shift profits or hide assets offshore.

Every tax dollar lost to loophole users either deepens the deficit or forces taxpayers who don't use tax loopholes to pay more. At this time of large deficits and difficult budget choices, when American families are facing tax increases or cuts in critical programs from education to health care to food inspections to national security, offshore tax abuses are particularly unacceptable and unaffordable.

If the ten offshore tax loopholes and abuses listed below were ended, the resulting tax revenues could total in the hundreds of billions of dollars over ten years.

1. Offshore Profit Shifting by Multinationals

In September 2012, a Subcommittee hearing illustrated how U.S. multinational corporations use profit shifting to dodge U.S. taxes. It featured Microsoft as a case study. The hearing showed how Microsoft developed computer software products in the United States using U.S. research and development tax credits, transferred intellectual property rights in those products to offshore subsidiaries that it established in low-tax jurisdictions, and then used dubious transactions to shift a large amount of the profits from product sales around the world to those tax havens, avoiding billions of dollars in U.S. taxes.

The starting point in U.S. corporate taxation is that U.S. corporations pay taxes on all the income they earn, whether here or abroad. The tax code then allows corporations to defer paying taxes on their non-U.S. income until it is returned or "repatriated" to the United States. Some corporations have taken advantage of this deferral rule by creating elaborate networks of offshore subsidiaries aimed at keeping offshore income from returning to the United States and sometimes even turning U.S. income into non-U.S. income.

In 2011, two controlled foreign corporations established by Microsoft paid the U.S. parent corporation $4 billion for certain intellectual property rights to reproduce and distribute Microsoft products abroad. Microsoft Singapore paid $1.2 billion for rights to Asia; Microsoft Ireland paid $2.8 billion for rights in Europe. That same year, Microsoft Singapore reported revenue of $3 billion from relicensing those same rights in Asia, while Microsoft Ireland reported $9 billion from Europe. In short, Microsoft USA "sold" rights to its intellectual property to those subsidiaries for $4 billion, and its offshore subsidiaries then turned around and sold those same exact rights for $12 billion, in effect enabling Microsoft to shift $8 billion in taxable income offshore in a single year. Microsoft didn't have to pay any U.S. taxes on that income, even though over 85% of Microsoft's research and development is conducted in the

United States and, without the transfers to its subsidiaries, that income would have been attributable to the U.S. parent.

That's not all. Microsoft USA also "sold" some of its intellectual property rights to a foreign corporation it controlled in Puerto Rico. Microsoft USA then immediately bought back the distribution rights in the United States. Why? Because under the distribution agreement, Microsoft USA paid Microsoft Puerto Rico a certain percentage of the sales revenues it received from selling Microsoft products in the United States. In 2011, this corporate sleight of hand enabled Microsoft USA to shift 47 cents of every dollar in U.S. sales, totaling $6 billion, to its Puerto Rican subsidiary, dodging payment of U.S. taxes on nearly half of its U.S. sales income.

Microsoft's software products are developed here. A large percentage is sold here, to customers here. Microsoft uses U.S. infrastructure in its business and U.S. courts to defend its patents. And yet Microsoft pays no U.S. taxes on nearly half of its U.S. income. During the three years examined by the Subcommittee, by routing its sales activity through Puerto Rico, Microsoft saved over $4.5 billion in taxes on goods sold right here in the United States.

The remedy for these gimmicks is to close the loopholes that allow these so-called "transfer pricing" arrangements to shift U.S. intellectual property and profits offshore while dodging U.S. taxes.

2. Returning Corporate Offshore Money through Serial Loans

A second offshore tax scheme recently uncovered by my Subcommittee involves the use of so-called "short-term" loans by U.S. multinational corporations to bring a continuous stream of offshore funds into the United States without paying taxes. Focusing on Hewlett Packard (HP) as a case study, our hearing showed how HP directed two of its offshore subsidiaries to provide billions of dollars in offshore cash to its U.S. operations through serial, alternating loans. HP characterized the ongoing lending as short-term loans which are exempt from U.S. taxes.

Currently, under the U.S. tax code, a U.S. parent is supposed to pay taxes on offshore funds sent to it by an offshore subsidiary, including any funds sent in the form of a loan. But the tax code also includes a number of exclusions and limitations. Short term loans are excluded, for example, if they meet certain time restrictions, such as if they are repaid within 30 days or are initiated and concluded before the end of the foreign subsidiary's fiscal quarter.

Some U.S. multinationals attempt to exploit those exclusions by orchestrating a continuous stream of offshore loans from their offshore entities to their U.S. operations. In the case of HP, its offshore loan program has been sending funds to the United States since at least 2008, and has supplied as much as $9 billion at a time to fund HP's general U.S. operations, including payroll expenses and HP stock repurchases. The funds came primarily from two HP offshore subsidiaries located in the Cayman Islands and Belgium, which have acted as cash pools. HP documents indicate that the lending from these two entities was essential to its U.S. operations, because HP did not otherwise have adequate cash in the United States to run those operations. HP records also show that, during one period, the U.S. parent orchestrated serial loans on an alternating basis from the two offshore subsidiaries, so that they would take place without interruption for thirty straight months. This scheme to bring offshore funds to the United States without paying taxes was so blatant that internal HP documents openly referred to it as part of HP's "repatriation history" and "repatriation strategy."

Structuring loans from offshore subsidiaries to provide an ongoing stream of funds to the United States mocks the notion that U.S. multinational profits are "locked up" or "trapped" offshore. Rather, it shows how some multinationals have systematically used loan schemes to bring billions of dollars in offshore profits to the United States for years without paying taxes. The short-term loan loophole should be closed to ensure funds effectively repatriated are taxed.

3. Corporate Offshore Deposits in U.S. Banks

In 2011, a staff report issued by my Subcommittee showed how some U.S. multinational corporations have used another U.S. tax loophole to place $250 billion in "offshore" funds in U.S. banks, U.S. Treasury bonds, and other U.S. stocks and bonds without triggering any tax.

A basic principle of U.S. tax law is that when a U.S. corporation makes money abroad and brings its profits back to the United States, it is supposed to pay U.S. taxes on the repatriated amount. But some corporations have found another way around that rule. Instead of bringing the funds back directly, those corporations have directed their offshore subsidiaries to place the offshore funds in U.S. dollars in a U.S. account.

Suppose, for example, a U.S. corporation directs a foreign subsidiary to open an account at a Cayman Island bank, deposit its foreign earnings into that account, and ask the Cayman bank to convert the foreign earnings into U.S. dollars. The Cayman bank typically complies by opening a U.S. dollar account at a U.S. bank. When one bank opens an account at another bank, the account is generally referred to as a correspondent account.

The end result is that the U.S. corporation's offshore funds often aren't really offshore at all. Instead, they are sitting in a foreign bank's correspondent account at a U.S. bank. The deposits are kept in U.S. dollars and typically placed in U.S. dollar investments to earn interest. The U.S. corporation or its foreign subsidiary can even direct the Cayman bank to invest some or all of their U.S. funds in U.S. treasuries, securities, or bonds. The bottom line is that the corporation's offshore profits sit in a U.S. account in the United States. The U.S. corporation gets the benefit of using U.S. dollars, the safest currency in the world. It also gets the benefit of using U.S. financial institutions and investing in U.S. financial markets, whose safety, soundness, and security are overseen by the U.S. government, all without paying any income taxes to support the U.S. financial system.

A Subcommittee survey of 27 U.S. multinational corporations found that, as a whole, those 27 corporations held a total of about $538 billion in tax-deferred foreign earnings at the end of FY2010. The survey also found that 46% of those foreign earnings – almost $250 billion – was maintained in U.S. accounts or invested in U.S. assets such as U.S. Treasuries, U.S. stocks (other than the corporation's own stock), U.S. bonds, or U.S. mutual funds. The survey also found that the corporations varied widely in the extent to which they placed their foreign earnings in U.S. assets. Nine of the 27 companies, or one-third, including Apple, Cisco, Google, and Microsoft, held between 75% and 100% of their tax-deferred foreign earnings in U.S. assets. Eleven corporations invested 25% or less of their tax-deferred foreign earnings in U.S. assets.

Corporations are able to invest their foreign earnings in U.S. assets without treating them as “repatriated” and subject to taxation, because the tax code, specifically Section 956(c)(2), currently allows U.S. corporations to use foreign funds to make U.S. bank deposits and a wide array of U.S. investments without incurring tax liability. If those U.S. investments then produce income, the additional income may be subject to taxation. The tax loophole allowing U.S. corporations to invest foreign earnings in U.S. assets and make U.S. dollar deposits in U.S. accounts, without triggering the tax on repatriated funds, should be closed.

4. Phony Offshore Incorporations

Another offshore tax loophole involves corporations which are located in and controlled from the United States, but claim to be “foreign” corporations in order to avoid payment of U.S. taxes on their non-U.S. income. These so-called foreign corporations operate right here in the United States in direct competition with domestic corporations that are paying taxes.

Under the tax code, U.S. corporations have to pay taxes on all of their worldwide income, while foreign corporations are generally exempt from paying U.S. taxes on their foreign income. That’s why a corporation’s status as a U.S. corporation instead of a foreign corporation has a significant impact on its tax liability. In the United States, a corporation’s status typically depends upon where its incorporation documents were filed. For example, if a company filed incorporation papers in Bermuda, it would be treated as a Bermuda corporation, even if the company did not have any offices, employees, or operations there. In other countries, other factors, such as where a corporation’s management is located, or where its directors meet, are considered more important.

Over the years, Subcommittee investigations have identified numerous examples of so-called foreign corporations that appear to be operating solely in the United States and to be exploiting U.S. corporate formation laws to dodge U.S. taxes. In an October 2008 Subcommittee hearing, for example, three sizeable hedge funds, Highbridge Capital which is associated with JPMorgan Chase, Angelo Gordon, and Maverick Capital, each admitted that, although incorporated in the Cayman Islands, none had an office or a single full time employee in that jurisdiction. Instead, their offices and key decisionmakers were located right here in the United States, in Connecticut, New York, Texas, or California. Yet all three claimed foreign status and were taxed as if they were foreign corporations.

Many other U.S. corporations engage in similar gamesmanship. In 2008, the Government Accountability Office (GAO) traveled to the Cayman Islands to inspect the famous Ugland House, a five-story building that is the official address for over 18,800 registered companies. GAO found that about half of the companies registered at the Ugland House — around 9,000 entities — had a billing address in the United States and were not actual occupants of that building. In fact, GAO determined that not a single one of the companies registered at the Ugland House was an actual occupant.

In too many cases, corporations claiming foreign status through tax-haven incorporations appear to be engaged in a deliberate effort to take advantage of U.S. benefits, while dodging U.S. taxation and undercutting U.S. competitors who pay their fair share. The tax loophole that enables corporations to use foreign incorporation papers to claim foreign status, despite locating the corporation's management and control right here in the United States, should be closed.

5. Source Rule Loophole for Offshore Swap Payments

Still another offshore tax loophole involves billions of dollars in complex corporate transactions known as derivative swap transactions or "swaps." Under the tax code, if a swap payment is sent from the United States to an offshore recipient, it currently escapes U.S. taxes. That loophole has created a powerful tax incentive for U.S. businesses, as well as U.S. banks, hedge funds, and derivative dealers, to send otherwise taxable swap payments outside the United States.

Swaps are contracts in which the parties agree to exchange cash payments on or before a specified future date based upon specified assets or events, such as a change in the value of currencies, interest rates, commodities, or stocks. One common type of swap is a credit default swap (CDS), which is essentially a financial bet about whether a company, loan, bond, mortgage backed security, or other financial instrument or arrangement will default or experience a specified "credit event" during a specified period of time. Swap parties typically make a series of payments to each other over the relevant time period based upon indicators of the relative value of the underlying assets; in the case of a credit default swap, the CDS buyer typically sends a stream of payments to the CDS provider – similar to insurance premiums – but can become the recipient of a larger payment if a default or other credit event takes place. The worldwide swaps market today involves a notional value of about $600 trillion, while the CDS market alone involves over $28 trillion. Most, if not virtually all, U.S. financial players now engage in swap transactions.

Over the years, Subcommittee investigations into the financial crisis, stock dividends, and other matters have examined numerous swap transactions. The Subcommittee learned that even if both parties to a swap transaction are located in the United States and make payments using U.S. dollars sent from U.S. accounts, the income generated by those payments – if sent to an offshore recipient – is not taxed.

The cause is a 1991 U.S. tax regulation which categorizes what types of income should be treated as coming from a U.S. versus foreign source. U.S. source income is more likely to be subject to U.S. taxes. The so-called "source rule" currently deems swap payments sent from the United States to an offshore recipient as non-U.S. source income, which means it is probably not taxable. But this approach twists the common definition of the word "source." It says that the "source" of a swap payment is determined, not by where the money comes from, but by where it ends up. In other words, the payment's source is the country where the payment recipient resides. Instead of looking to the origin of the payment to determine its "source," the IRS swap rule looks to its end point – who receives it. That "source" is not really a "source" by any known definition of the word.

This tax loophole encourages U.S. financial institutions to establish entities in tax havens or other non-U.S. locations, direct swap payments to those offshore recipients, and thereby extinguish U.S. tax liability associated with the income from those payments. Some argue that it has encouraged U.S. financial institutions to open offices abroad as well, so that they are moving not only funds, but also U.S. jobs offshore. Closing this source rule loophole would stop U.S. businesses from sheltering billions of dollars in swap income from taxation by sending it offshore.

6. Check-the-Box Rule for Disregarded Offshore Entities

Another top corporate offshore tax loophole involves an IRS regulation usually referred to as the "check-the-box" rule. A Subcommittee hearing in September showed how some multinational corporations rely on that regulation -- which undercuts current U.S. tax law -- to check a box on an IRS form to make related corporations disappear for U.S. tax purposes and thereby shield billions of dollars in offshore income from U.S. taxes.

Under U.S. tax law, corporations with income offshore normally do not have to pay U.S. taxes until they bring that money home to the United States. But, if the income consists of royalties, licensing fees, or other funds that don't require the active involvement of the business, that so-called "passive" income is supposed to be taxed immediately even while offshore.

The Subcommittee investigation showed how some corporations, using the check-the-box rule, can literally check a box on an IRS tax form and make offshore subsidiaries, and their taxable offshore income, invisible for tax purposes. The Subcommittee has learned, for example, that in a three-year period from 2009 to 2011, Apple has been able to use this loophole to defer U.S. taxes on offshore passive income totaling over $35.4 billion. Google has deferred over $24.2 billion in the same period. For Microsoft, the number is $21 billion.

The Treasury Department issued the check-the-box rule fifteen years ago in 1997. Its purpose was to simplify tax analysis by allowing a business enterprise to declare what type of legal entity it wanted to be considered for federal tax purposes by just checking a box. As soon as it was issued, however, U.S. multinational corporations began restructuring their offshore operations under the new rule to get around the taxation of passive offshore income. Many multinationals established, for example, a tax haven subsidiary which received passive income such as royalty payments or dividends from the parent' corporation's other offshore subsidiaries, and then checked the box to make those subsidiaries and their passive income payments disappear for U.S. tax purposes.

Due to the immediate and rampant abuse, a year after it issued the check-the-box rule, the Treasury Department issued a 1998 proposal to rescind it. That proposal was met with such opposition from industry groups and Congress, however, that it was never adopted. In 2006, in response to pressure from multinationals to prevent the IRS from restricting or rescinding the check-the-box loophole, Congress enacted the so-called "Look through Rule for Related Controlled Foreign Corporations," which effectively excludes certain offshore corporate passive income, including interest, rents and royalties, from taxation. That provision has since been extended on a year-to-year basis and is currently up for renewal once more.

The check-the-box and look-through rules create offshore tax loopholes that currently prevent the taxation of billions of dollars in offshore corporate income. Both should be closed.

7. Taking Deductions for Offshoring Jobs

Another corporate tax loophole, which is especially troubling in tough times, creates a tax incentive that rewards U.S. multinational corporations for moving operations and jobs offshore.

Under current tax law, U.S. corporations are generally able to lower their tax liability by deducting business expenses. That same principle, when applied offshore, allows U.S. corporations to deduct the expenses incurred when moving operations to another country, even when paying no U.S. tax on their new foreign income.

For example, a U.S. multinational corporation can take an immediate deduction from its U.S. taxes for expenses associated with closing a U.S. manufacturing plant and opening a new plant abroad. That includes deducting the costs of boxing up equipment, breaking a lease, firing U.S. employees, and shipping materials overseas. It can also deduct the costs of building the new foreign plant, including deducting interest charges for borrowing funds. And it can deduct some costs of its overseas operations. The multinational can deduct these costs from its U.S. taxes, even while deferring payment of U.S. taxes – perhaps indefinitely – on income arising from the new foreign facility. The multinational can then attempt to use other tax loopholes to bring those offshore funds back to the United States without paying any tax.

By allowing corporations to deduct expenses associated with foreign operations from their U.S. taxes before – and often without ever – repatriating the income produced by those foreign operations, this loophole creates a tax incentive for U.S. multinationals to move operations, jobs, and profits offshore. This tax loophole should be closed.

8. Offshore Commodity Firms with Mutual Fund Backing

Still another corporate tax loophole that shields billions of dollars from taxation involves offshore shell corporations established by mutual funds to engage in commodity speculation.

Under the tax code, so long as mutual funds derive 90% of their income from securities, interest, or foreign currency investments, and no more than 10% from alternatives such as commodities, mutual funds do not have to pay any corporate income taxes on their income. Instead, mutual funds pass on their profits to their investors who are then responsible for paying any taxes due. This preferential tax treatment is worth billions of dollars per year to the $11 trillion mutual fund industry.

About six years ago, despite the decades-old restriction on its investing in commodities, the mutual fund industry began petitioning the IRS to approve various gimmicks that would allow it to make increased investments in commodities without losing its preferential tax status. In response, beginning in 2006, in a series of 72 private rulings, the IRS approved two methods that allowed mutual funds to make heavy investments in commodity markets while continuing to escape corporate taxation of the resulting profits.

One of those methods allowed a mutual fund to set up an offshore corporation, use it to invest in commodities, and then treat the resulting income – not as income from commodities subject to the 10% limitation – but as income from securities, specifically from investing in the stock of the very offshore corporation that the mutual fund itself set up. The IRS action opened the floodgates to mutual funds using offshore corporations to invest in commodities.

A January 2012 Subcommittee hearing showed how many mutual funds had established offshore corporations in tax havens and typically operated them with no physical offices, no employees, and no business purpose other than to further the mutual fund's commodity investments. The commodity portfolios of those offshore shells were typically selected and managed by U.S. employees working for the sponsoring mutual fund in the United States. The hearing identified 40 commodity-related offshore shell corporations backed by U.S. mutual funds with an accumulated total of $50 billion in assets, all of which claimed exemption from U.S. corporate taxes despite the longstanding 10% limit on commodity speculation.

The mutual fund offshore subsidiaries are corporate fictions whose sole purpose is to make an end-run around the legal restrictions on commodity investments by mutual funds. By treating the income of their offshore shell subsidiaries as derived from securities rather than commodities, the IRS has elevated form over substance and enabled mutual funds to use financial engineering to do indirectly what the tax law does not let them do directly. The result has not only created a new tax loophole for offshore commodity firms with mutual fund backing, it has also opened the door to increased commodity speculation. This tax loophole should be closed.

9. Secret Tax Haven Bank Accounts

Corporations are not the only U.S. taxpayers engaged in offshore tax abuses. In July 2008, a Subcommittee hearing exposed how two offshore tax haven banks helped U.S. clients hide billions of dollars in assets from the IRS. Case histories involving UBS AG of Switzerland and LGT Bank of Liechtenstein showed how each bank used an array of secrecy tricks to help U.S. clients hide assets and dodge U.S. taxes.

The hearing showed, for example, that UBS had opened bank accounts in Switzerland for an estimated 52,000 U.S. clients with over $18 billion in assets, without disclosing the accounts to the IRS. A UBS private banker based in Switzerland pled guilty to conspiring to helping a U.S. billionaire hide $200 million and evade over $7 million in tax, and provided sworn testimony to the Subcommittee about how UBS Swiss bankers sought and serviced clients right here in the United States. He explained how those bankers sometimes falsely claimed to be in the United States on vacation, used client codes and computers to keep client data secure, and received training on what to do if spotted by a U.S. official. UBS later admitted conspiring with U.S. clients to defraud the United States, paid a fine of $780 million, and promised not to open any new Swiss accounts for U.S. clients without disclosing them to the IRS.

The hearing also presented multiple instances of U.S. taxpayers who had secretly stashed millions of dollars in accounts at LGT Bank in Liechtenstein. Internal documents showed how officials from LGT Bank and its affiliate LGT Trust acted as willing partners to move funds into LGT accounts and other offshore institutions, while obscuring the ownership and origin of those funds from tax authorities, creditors, and courts. LGT used a range of secrecy gimmicks to help clients hide their identities and assets, including using client code names, directing LGT employees to use pay phones to call clients, opening client accounts in the names of shell corporations, and using LGT controlled shell entities called "transfer corporations" to disguise the trail of client funds moved into and out of LGT accounts.

Afterward, the IRS announced a series of voluntary offshore disclosure initiatives which have resulted in over 30,000 U.S. taxpayers disclosing hidden offshore bank accounts and paying back taxes, interest, and penalties in excess of $5 billion. Congress also enacted the Foreign Account Tax Compliance Act (FATCA) to require foreign financial institutions to disclose all accounts opened by U.S. persons to the IRS. Tax experts have indicated many more offshore accounts remain hidden and will require intensive IRS efforts to uncover.

Weak tax laws and regulations, however, make it expensive and time consuming for the IRS to uncover offshore accounts and link them to U.S. taxpayers. Those tax enforcement loopholes should be closed, including by eliminating red tape complicating use of John Doe subpoenas, ending curbs on IRS access to key foreign account information, strengthening penalties on tax shelter promoters, and creating rebuttable presumptions in tax proceedings to establish the ownership of offshore entities. In addition, the U.S. Treasury should be empowered to take special measures against any foreign financial institution or jurisdiction that impedes U.S. tax enforcement, including by prohibiting U.S. banks from doing business with non-cooperative foreign financial institutions or jurisdictions.

10. U.S. Bank Accounts Held by Offshore Entities with U.S. Owners

While many U.S. taxpayers have opened offshore accounts to hide assets from the IRS, other individuals have formed offshore entities and used those entities to open accounts right here in the United States. Current law allows U.S. financial institutions to treat those accounts as foreign-owned and avoid making the normal account disclosures to the IRS expected for accounts held by U.S. persons.

In 2006, a Subcommittee hearing presented multiple examples of U.S. individuals using offshore entities to open accounts at U.S. banks and securities firms to evade U.S. taxes. In one case, two brothers from Texas, Sam and Charles Wyly, established 58 offshore trusts and corporations, and operated them for more than 13 years without alerting U.S. authorities. To move funds abroad, the brothers transferred over $190 million in stock option compensation they had received from U.S. publicly traded companies to the offshore corporations. The brothers then directed the offshore corporations to cash in the stock options and start investing the money.

The Wylys also directed a number of their offshore entities to open accounts at U.S. securities firms, including Credit Suisse First Boston, Lehman Brothers, and Bank of America, and tell those firms to treat the entities as foreign accountholders. IRS regulations require U.S. financial institutions that make payments into accounts, such as for interest, dividends, or capital gains, to file disclosure forms with the IRS. The rules require a 1099 form to be filed for accounts held by U.S. persons, and a 1042 form for accounts held by non-U.S. persons. To determine an accountholder's status, U.S. financial institutions are allowed to rely on information provided by the accountholder, unless they have "actual knowledge" or "reason to know" the information is false or unreliable. Accountholders are supposed to provide the information on a W-9 form for U.S. persons or W-8 form for non-U.S. persons.

In the Wyly matter, the Wyly-controlled offshore trusts and corporations claimed status as foreign entities and filed W-8 forms. The securities firms knew they were associated with the Wyly family, but accepted the W-8 forms anyway and did not disclose either the accounts or their Wyly connection to the IRS. Current IRS practice is to allow U.S. financial institutions to take that course of action, so long as the accountholder can produce documentation showing it was formed in a foreign jurisdiction, even if the entity is also associated with a U.S. person. The end result is that the Wylys hid millions of dollars in "offshore" funds at U.S. financial institutions.

The tax loophole that allows U.S. owners of offshore entities and the U.S. financial institutions that service them to treat those offshore entities as foreign accountholders, omitting any mention of the U.S. owners to the IRS, should be closed.

Today, U.S. multinationals hold over $1.5 trillion offshore, while numerous individuals continue to hide assets in offshore bank accounts. We can't afford the revenue loss from offshore tax abuses. Reducing the deficit, including avoiding the draconian cuts mandated by sequestration, require a balanced approach that includes raising revenues. Closing abusive offshore tax loopholes offers a rational course of action that would not only raise revenues to help stave off sequestration and reduce the deficit, but also strengthen tax fairness, redress the imbalance between corporate and individual taxation, and remove tax incentives to shift U.S. jobs, businesses, and profits offshore.

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