TESTIMONY

STATEMENT OF PAUL H. O'NEILL BEFORE THE SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OECD HARMFUL TAX PRACTICES INITIATIVE JULY 18, 2001

Mr. Chairman, Senator Collins, and members of the Subcommittee, I appreciate this opportunity to discuss the position of the United States with respect to the OECD harmful tax practices initiative. This detailed statement will cover all the specific issues regarding the OECD initiative that Chairman Levin asked me to address in his June 29th letter.

As I have stated previously, when I took my oath of office as Secretary in January, I pledged faithfully to execute the laws of the United States. We have an obligation to enforce our tax laws because failing to do so undermines the confidence of honest taxpaying Americans in the fairness of our tax system. At the same time, we should not presume to interfere with the internal tax policy decisions of sovereign nations. Based on these two fundamental principles, I have concluded that the United States should attempt to refocus the OECD project on its core element: the need for countries to be able to obtain specific information from other countries upon request in order to prevent noncompliance with their tax laws.

Extent of tax evasion through use of offshore accounts or entities

It is impossible to quantify precisely the extent to which U.S. taxpayers are using offshore entities or secret bank accounts – the facilities of tax haven jurisdictions – to evade their U.S. tax obligations. Such taxpayers obviously do not report the extent of their noncompliance with U.S. tax laws, and it is difficult to obtain anything other than anecdotal information with respect to such activity.

However, based on this anecdotal information, I believe that the potential for such evasion is significant. For example, the cases involving a bank in the Cayman Islands run by John Mathewson highlight the opportunities available to U.S.

taxpayers to evade their U.S. tax obligations through the use of offshore bank accounts. According to Mr. Mathewson, over 95 percent of the more than 1,000 depositors in his bank were U.S. citizens, and the bank had over $150 million in its accounts when it was shut down in 1995. The IRS has to-date obtained tax evasion convictions on, and collected substantial back taxes from, over 20 of Mr. Mathewson's clients. The IRS was able to demonstrate this evasion only because of Mr. Mathewson's extraordinary cooperation. Without it – and because we do not have an information exchange agreement with the Cayman Islands – this large-scale tax evasion would have gone unpunished.

I should note that the United States and the Cayman Islands have been discussing new legal mechanisms to provide for effective exchange of information, and that the Cayman Islands is one of the jurisdictions that has made a commitment to implement effective information exchange procedures in connection with the OECD harmful tax practices initiative.

The use of offshore entities or accounts by U.S. taxpayers to evade their tax obligations is likely to increase because of trends that are unlikely to be reversed, including the increasing solicitation of U.S. taxpayers by offshore banks through the Internet and the ease of access to offshore funds through electronic banking and account-linked credit cards, which may allow significant fund transfers that do not create a paper trail. The primary obstacle to enforcement of our tax laws in these cases remains the unwillingness of jurisdictions to enter into effective information exchange agreements with the United States that would provide us with access to critically important information in cases involving suspected tax cheats.

For example, in connection with a recent tax investigation, IRS examiners suspected that an offshore International Business Corporation (IBC) and its offshore bank account were being used by a U.S. taxpayer to evade the taxpayer's U.S. tax obligations. The IRS could not obtain the shareholder and bank account information needed to prove this because there was no treaty or agreement in place that allowed the exchange of taxpayer information with the jurisdiction in which the IBC was established. Put simply, jurisdictions with strict bank secrecy rules and a resistance to cooperate in tax matters facilitate the evasion of U.S. tax.

U.S. efforts to address tax evasion

The United States employs a multi-prong strategy to enforce our tax laws. First and foremost, we undertake significant unilateral efforts to combat tax evasion. For example, we presently are engaged in a multifaceted effort to address the problem of fraudulent tax schemes, many of which employ offshore entities or secret bank accounts. The IRS estimates that there are thousands of Internet sites with information relating to methods for evading U.S. tax obligations. Our approach is to educate the general public to avoid these scams and to take civil and criminal enforcement action against those who use them and those who promote them.

While we do everything we can ourselves to address tax evasion, we can be more effective with the cooperation of other countries. When the United States suspects that a particular taxpayer is evading U.S. tax laws through the use of offshore entities or secret bank accounts, we sometimes need information from another country to address that situation. The United States has been more successful than any other country in negotiating and implementing tax information exchange agreements. Our tax information exchange agreement program was initiated in 1983 to encourage the entry into these agreements by jurisdictions with which we would not conclude comprehensive income tax treaties – typically low or no tax jurisdictions for which the provisions in a comprehensive treaty addressing issues of double taxation are not necessary. The United States has tax information exchange agreements with five of the jurisdictions identified as tax havens by the OECD in June 2000, as well as with another jurisdiction that made a commitment with respect to the OECD initiative and was not included in the June 2000 list. Most other OECD countries do not have information exchange relationships with any of the identified jurisdictions.

At present, the United States has over 60 bilateral tax treaties and agreements that provide for information exchange. The information exchange provisions in these agreements are consistent with, and have served as a significant resource in the development of, international standards with respect to information exchange. The United States frequently is able to prosecute taxpayers for tax evasion because of information obtained from other countries. Further, the fact that the United States may be able to obtain information from a foreign

country when we have reason to suspect noncompliance helps to deter taxpayers from attempting to evade tax through entities or accounts in that country.

The United States, however, has been unable to develop information exchange relationships with some jurisdictions that are significant financial centers. Some jurisdictions simply are not interested in cooperating in this regard. Other jurisdictions are wary of agreeing to effective tax information exchange with the United States unless competing offshore financial centers enter into similar agreements. Working with the OECD and other OECD member countries on the development of a framework for reaching information exchange agreements with these jurisdictions may indeed prove fruitful.

In order to effectively enforce our own tax laws, it is critical that we are able to obtain the cooperation we need from other countries. The OECD initiative has the potential to advance the interests of the United States in this regard. This objective is too important to allow the OECD project to stray into other areas that could distract from or hinder success in this objective. In my view, the OECD initiative has the greatest chance of enhancing the ability of the United States to enforce our tax laws if it is focused on its core element: the need for countries to be able to obtain specific information from other countries upon request in order to prevent noncompliance with their tax laws.

History of the OECD project

The OECD harmful tax practices initiative began in 1998 with the publication by the OECD of a report that set out criteria to attempt to iden tify so-called "harmful tax practices" and provided a framework for future work to address such practices. Part of that framework was the establishment of a subsidiary OECD body called the Forum on Harmful Tax Practices, which was co-chaired by the United States from October 1998 until October 2000. The United States also has been one of four members of the Forum’s steering group, called the Bureau to the Forum, from October 1998 up to and including the present.

The 1998 OECD Report, and a follow-up report issued in June 2000, contained rhetoric that implicated fundamental internal tax policy decisions of countries within and outside the OECD, including decisions regarding tax rates. The Reports

enumerated the harms potentially caused by "tax havens or harmful preferential regimes that drive the effective tax rate levied on income from the mobile activities significantly below rates in other countries." Tax systems that "redirect capital and financial flows and the corresponding revenue from" other countries were condemned as "poaching" the rightful tax base of the other countries, even though such systems may simply provide a more attractive investment climate without facilitating noncompliance with the tax laws of any other country.

The two OECD reports take a notably condemnatory tone with respect to the issues addressed, and the advocacy of internationally coordinated action against targeted countries represents an approach that is more aggressive than is typical for the OECD.

The OECD's technical work on harmful tax practices has proceeded on three tracks since 1998:

· The identification and elimination of harmful tax practices within OECD member countries;

· The elimination of such practices in identified tax haven jurisdictions; and

· Outreach to other non-OECD jurisdictions, with the goal that such jurisdictions eventually eliminate their own harmful tax practices.

The 2000 OECD Report identified 35 so-called "tax haven" jurisdictions. Under the criteria established in the 1998 OECD Report, a tax haven is a jurisdiction that imposes no or nominal direct taxes on financial or other mobile services income *and* also meets one of three other criteria: (1) its regimes lack transparency; (2) it does not engage in effective information exchange; or (3) its regimes facilitate the establishment of entities with no substantial activities. The 2000 Report also identified 47 "potentially" harmful preferential tax regimes in OECD member countries. A harmful preferential regime is a regime that provides for low or no taxation of financial or other mobile services income *and* also meets one of three other criteria: (1) the regime lacks transparency; (2) the country does not engage in effective information exchange with respect to taxpayers utilizing the regime; or (3) the regime is "ring fenced" (as described below).

The 2000 Report provided a one-year period for the identified tax havens to enter into commitments to eliminate (by the end of 2005) their harmful tax practices. The 2000 Report also provided that jurisdictions that do not make such commitments will be included on a list of "uncooperative" tax haven jurisdictions to be published in July 2001. The report anticipated that the OECD would recommend that OECD member countries implement a coordinated framework of "defensive measures" against the jurisdictions that are listed as "uncooperative."

Concerns about the OECD project

On February 17th, following a meeting of G7 Finance Ministers in Palermo, I indicated that certain aspects of the OECD project were under review by the Administration. I was troubled by the notion that any country, or group of countries, should interfere in any other country's decisions about how to structure its own tax system. I felt that it was not in the interest of the United States to stifle tax competition that forces governments – like businesses – to create efficiencies. I also was concerned about the potentially unfair treatment of some non-OECD countries, with regard to both the deadlines to which they were being subjected and the uncertainty created by the lack of clarity with respect to the application of the "no substantial activities" criterion. This perceived unfairness seemed to be contributing to the difficulty in obtaining commitments from most of the identified jurisdictions. I was particularly troubled because these aspects of the project did not relate to what appeared to be a critical – and attainable – objective of the OECD' s work: the establishment of a framework for reaching information exchange agreements with countries that have shown little interest in cooperating with other countries on tax matters in the past. Indeed, these aspects distracted from and interfered with the achievement of that objective.

Our review of the OECD project has been guided by two fundamental principles. First, we must do everything that we can to enforce our own tax laws, including working to obtain needed information that is in the hands of other countries. Second, we will not interfere in the internal tax policy decisions of other countries. These principles led me to conclude that the United States should attempt to refocus the OECD initiative on its core element: the need for countries to

be able to obtain specific information from other countries upon request in order to prevent noncompliance with their tax laws.

Recent developments with respect to the OECD tax haven work

I am happy to report that, together with other OECD member countries, we have made substantial progress in focusing the initiative on its core element of effective information exchange and in addressing aspects of the initiative that seemed unfair to non-OECD countries.

Treasury representatives have worked with their counterparts from other OECD countries through the OECD process and have been able to obtain agreement to significant modifications to the work with respect to tax haven jurisdictions. The recent discussions regarding the OECD project focused on the portion of the work relating to tax haven jurisdictions because that work was facing immediate decision points and deadlines. The modifications recently agreed to at the OECD were noted in the July 7th report by the G7 Finance Ministers on Fighting the Abuses of the Global Financial System.

I would like to summarize three significant modifications to the OECD tax haven work, each of which I will describe in greater detail below.

· First, coordinated defensive measures would not apply to "uncooperative" tax haven jurisdictions any earlier than they would apply to similarly-situated OECD member countries.

· Second, the "no substantial activities" criterion will no longer be applied to determine whether or not a jurisdiction is considered to be an "uncooperative" jurisdiction.

· Third, the time for tax haven jurisdictions to make a commitment to transparency and information exchange has been extended from July 31st to November 30th.

The United States argued for each of these modifications within the OECD, and strongly supports them. It is important to note that the United States was not alone within the OECD in advocating these modifications, and that agreement within the OECD would not have been possible without the support of other countries. In my view, these modifications constructively

focus and clarify the OECD tax haven work, and therefore increase the likelihood that it can achieve its critical objective.

Parity of timeline for application of defensive measures. In order for the OECD initiative to have the legitimacy it needs to succeed, jurisdictions outside the OECD must be treated no more severely than similarly-situated OECD member countries. The 2000 OECD Report anticipated the coordination and application of defensive measures by OECD member countries against "uncooperative" tax haven jurisdictions as of July 31, 2001. Such measures, however, would not be applicable to similarly-situated OECD member countries – including OECD member countries with substandard transparency or information exchange practices which they have not yet made commitments to improve – until April 2003 at the earliest. That disparity in treatment would not have been fair. It is not surprising that there was unanimous support among G7 countries to address this inequity.

Accordingly, the OECD has now agreed that defensive measures would not be applicable to non-OECD jurisdictions any earlier than they would be applicable to similarly-situated OECD member countries. Each OECD member country, of course, reserves the right to take or refrain from taking any measure as appropriate, whether within the coordinated framework established by the OECD or outside of that framework. Tax haven jurisdictions will be able to observe whether OECD member countries with significant financial centers make the changes necessary to meet the standards that the jurisdictions are being asked to meet. OECD member countries should hold themselves to standards and timelines at least as rigorous as those to which they hold jurisdictions that are not part of the OECD.

Removal of the no substantial activities criterion. Under the provisions of the 1998 and 2000 OECD Reports, a jurisdiction that meets international standards of transparency and information exchange could nevertheless be considered an "uncooperative" tax haven jurisdiction potentially subject to defensive measures if it has regimes that facilitate the establishment of entities with "no substantial activities." Application of the "no substantial activities" criterion proved difficult, and the OECD sought to apply a ring-fencing criterion to the tax haven jurisdictions as a proxy. Under the 1998 OECD Report, which addresses ring fencing in the context of identifying harmful preferential regimes within OECD member

countries, a tax regime is ring fenced if it available only to non-resident investors or if the activities of entities formed under the regime are limited to international transactions.

The ring-fencing criterion is problematic because it does not provide an adequate basis to distinguish regimes that facilitate tax evasion from regimes that are designed to encourage foreign investment but that have nothing to do with evasion of any other country's tax law. Countries may have good reason to provide different levels of taxation to income earned by nonresidents or to income earned by residents from foreign activities, such as to provide investment incentives or to improve access to capital markets. If such policies are not coupled with a lack of transparency or a refusal to exchange information and otherwise do not interfere with the enforcement by other countries of their tax laws, they should not be targeted by the OECD initiative.

As a practical matter, the OECD has struggled to articulate the application of the "no substantial activities" criterion, or the ring-fencing criterion as its proxy, to the tax haven jurisdictions. Moreover, this criterion necessarily would have uneven application to the tax haven jurisdictions as it would have potential application only to those jurisdictions that have an income tax system and would have no application whatsoever to those jurisdictions that have no income tax system. This lack of clarity in definition and uneven application are particularly troubling because the criterion potentially implicates fundamental tax and economic policy decisions of the jurisdictions.

Accordingly, the OECD has now agreed that neither the "ring-fencing" criterion nor the "no substantial activities" criterion will be used to determine whether a jurisdiction would be listed as "uncooperative" and would be subject to potential defensive measures.

Extending the time for commitment. In light of the recent modifications to the OECD initiative and the number of jurisdictions that have yet to complete discussions with the OECD with respect to commitments to improve their practices, it made good sense to reconsider the anticipated July 31st date for listing "uncooperative" tax haven jurisdictions. The OECD is in active discussions with many of these jurisdictions, and these discussions have proved to be quite time-consuming. Maintaining the July 31st deadline almost certainly would have

caused many jurisdictions that are engaged in ongoing, good-faith discussions with the OECD regarding the commitment process to be included in the list of "uncooperative" tax haven jurisdictions. It would have been counterproductive to so label jurisdictions merely because the OECD and the jurisdiction were unable to conclude their discussions by July 31st. In order to avoid this inappropriate result, the time for jurisdictions to make commitments to improve transparency and information exchange practices, and therefore avoid being considered an "uncooperative" tax haven, is being extended from July 31st to November 30th.

Any jurisdiction that makes a commitment to meet international standards of transparency and effective exchange of information will not be listed as "uncooperative" and will not be subject to potential application of coordinated defensive measures. The United States fully supports efforts to improve the information exchange and transparency practices of countries within and outside the OECD which are necessary to enable other countries effectively to enforce their own tax laws.

Information exchange standards. International standards with respect to exchange of tax information have been developed through the work on the relevant provisions of the OECD Model income tax treaty and other instruments. These standards have been strongly influenced by developments regarding the U.S. Model income tax treaty and the standards set out in the Internal Revenue Code with respect to tax information exchange agreements. The ten jurisdictions that have committed to the OECD initiative thus far have been participating with OECD member countries, including the United States, in developing an exchange of tax information instrument based on these U.S. and international standards. It is anticipated that this instrument could be used in meeting the jurisdictions' commitments to engage in effective tax information exchange.

In the context of the OECD initiative, effective information exchange means that governmental authorities will provide information upon specific request if necessary for the conduct of a specific criminal tax investigation or civil tax examination. In general, information exchange can be effective only if bank secrecy, bearer shares, and other practices do not impede such exchange. Requests for information that are in the nature of a "fishing expedition" are not within the scope of standard information exchange relationships.

United States tax authorities may directly exchange tax information with authorities of foreign countries only pursuant to bilateral tax treaties or tax information exchange agreements, and the United States currently has over 60 such treaties and agreements. These treaties and agreements provide that the information cannot be used for non-tax purposes or disclosed without authorization, thus protecting the confidentiality of such information. The OECD project contemplates that confidentiality standards will be included in the model exchange of information agreement being developed by the joint group of OECD and non-OECD countries, and the United States will continue to insist on these important protections in any agreement to which it is a party.

Transparency standards. International standards with respect to transparency have been developed at the OECD as part of the harmful tax practices initiative. In this context, transparency means two things: (1) the absence of non-public tax practices, such as the secret negotiation, or waiver, of public tax laws and tax administration rules; and (2) the absence of obstacles, such as strict bank secrecy or the use of bearer shares, to obtaining financial or beneficial ownership information within a jurisdiction. The United States supports efforts to improve transparency as critical to establishing and maintaining an effective information exchange relationship; a jurisdiction that could not obtain basic financial or beneficial ownership information from residents or financial institutions within its jurisdiction could not satisfy its information exchange obligations in a meaningful way. Efforts to improve transparency should prevent the establishment of barriers to effective information exchange.

Possible application of defensive measures. The OECD initiative can reach its core objective of improving the ability of countries to enforce their own tax laws only if the significant financial centers within and outside the OECD are persuaded to meet international standards for transparency and effective information exchange. Drafting lists and devising defensive measures ultimately will not help countries curb noncompliance with their tax laws. Accordingly, it is the hope of the United States and other OECD member countries that we will never have to consider the implementation of coordinated defensive measures with respect to uncooperative jurisdictions.

It is important to note two things with respect to defensive measures in connection with the OECD harmful tax practices

project. First, the threat of such measures by a group of 30 large, developed countries is by its nature highly coercive and accordingly should be reserved only for jurisdictions acting in bad faith whose practices demonstrably facilitate the noncompliance by taxpayers with the tax laws of other countries. In this context, such measures must truly be measures of last resort.

Second, while the work in the OECD project to refine the identification of appropriate potential defensive measures is still in an early stage, it is important to recognize that several of the defensive measures that have been identified thus far by the OECD have been part of the international tax policy of the United States and other OECD member countries for many years. For example, the Internal Revenue Service has a practice of enhanced audit and enforcement activities with respect to transactions and activities in jurisdictions which, in its experience, are used by U.S. taxpayers to evade their U.S. tax obligations. These jurisdictions invariably do not have effective information exchange agreements with us or other countries, and in fact most were identified as tax havens by the OECD. In addition, since the mid-1980s, the United States has had a policy of not entering into comprehensive tax treaties with no-tax jurisdictions because such treaties would not serve a principal purpose of our bilateral tax treaties – the elimination of double taxation on cross-border activities and investment flows – and because such jurisdictions traditionally have not had effective information exchange practices. Consistent with that policy, the United States has termi nated several tax treaties in the last 20 years with no or low-tax jurisdictions, many of which were identified as tax havens by the OECD.

More generally, however, the aspects of our international tax laws designed to prevent noncompliance do not target lists of countries because, as the experience with the OECD initiative shows, such lists are difficult to draw up and maintain and can become the subject of controversy. Thus, most aspects of our international tax laws apply without regard to the particular foreign jurisdiction in which the activity or taxpayer is located. For example, our tax law includes a comprehensive controlled foreign corporation regime, as well as other complementary anti-deferral regimes, that provides for the immediate taxation of certain categories of foreign income earned by foreign corporations controlled by U.S. taxpayers. These rules are not limited to corporations located in particular jurisdictions.

The United States, like other OECD member countries, would strongly prefer working cooperatively with jurisdictions rather than contemplating the imposition of coordinated defensive measures. It would be premature for me to speculate as to what measures, if any, the United States or other countries might consider applying in two years if it were to come to that. I will note at this time, however, that many of the defensive measures identified by the OECD would require legislation and therefore would require action by Congress.

Concluding thoughts on the OECD project

I am heartened by the significant progress we have made with our OECD counterparts in focusing the OECD's work with respect to tax haven jurisdictions on its core element: the need for countries to be able to obtain specific information from other countries upon request in order to enforce their own tax laws. It is clear from the recent developments with respect to the OECD initiative that this important objective can be achieved without stifling tax competition. These developments also reflect a fairer and more constructive approach to the dialogue with non-OECD countries, whose cooperation ultimately is necessary to the success of the OECD initiative. We look forward to ongoing discussion with countries both within and outside the OECD aimed at establishing effective transparency and other mechanisms for the provision of tax information upon specific request while protecting against unauthorized use and disclosure of such information.

Additional comments on money laundering work

I would also like to make a few points about our work to combat money laundering, something that I know has been of interest to this Subcommittee. First of all, this Administration is committed to aggressive enforcement of the money laundering and asset forfeiture laws. To that end, the President has nominated, with my full support, Jimmy Gurulé, a former Federal prosecutor and expert on money laundering enforcement, to be the Under Secretary for Enforcement at Treasury. President Bush has also tapped Judge Robert Bonner, a former U.S. Attorney and Administrator of the Drug Enforcement Administration, to head the Customs Service, which plays a crucial role in our efforts to root out international money laundering. Professor Gurulé, with my full support, has announced his intention to make enforcement of the money

laundering laws his top priority during his tenure at the Treasury. Assistant Attorney General Chertoff has told us that money laundering enforcement is also one of his top priorities for the Justice Department's Criminal Division. Though neither Professor Gurulé nor Judge Bonner is yet confirmed, they have both been advising me on this issue. With their expert assistance, and with the support of our colleagues at the Department of Justice, I am comfortable that our internal review of our money laundering programs will put us in a position to ensure that the American people are getting the best possible return on their investment in this area.

The previous Administration published a spread sheet that indicated that we spent about a billion dollars each year combating money laundering. Since becoming Secretary I have learned that that number was significantly in error, and I have asked the Treasury staff a series of tough questions about the nature of our actual expenditures and what exactly we get in return for our efforts. I'm still not satisfied that we have good answers to all of these questions, but I assure you that, as we move forward, I will continue to push the staff to answer them. I believe this approach is the best way to ensure effective public policy, regardless of the subject area. It is clear to me that money laundering control is an important component of our overall effort to combat crime and to protect the integrity of our financial institutions and markets. But it is also clear to me that we can do a much better job in making ourselves accountable to the American people.

We will circulate shortly for interagency review a draft of the 2001 National Money Laundering Strategy. I expect we will be in a position to publish a final strategy in the coming weeks. That strategy will articulate a number of specific steps across a range of different activities, all designed to ensure effective law enforcement. The three main pillars of the strategy will be, first, to focus our limited federal resources to investigate and prosecute money laundering on high impact major cases; second, to protect the integrity of the U.S. financial system; and third, to significantly improve the Government's capacity to measure the results of its efforts, so that we can be fully accountable to the American taxpayers.

Thank you.

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