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US and Capital Flight

Reuven S. Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu

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by

Reuven S. Avi-Yonah*

The article explains the development of tax evasion after the USA abolished withholding on interest in 1984. After the financial crisis of 2008, the USA adopted fatca, which was followed by a worldwide adoption of automatic information-exchange mechanisms.

Introduction

The recent leaks of the Panama and Paradise Papers have highlighted the difficulty of taxing the income of residents of developed and developing offshore countries. The basic problem is that such income is subject to neither withholding at source nor information reporting. In the absence of both withholding and reporting, it is easy to use tax havens to hide such income from tax authorities. Estimates of the scope of the problem vary widely, but it is certainly larger than the $200 billion in estimated losses from legal corporate tax avoidance.

This article explains the historic roots of this problem, which dates back to the 1984 unilateral US decision to abolish withholding on portfolio interest. It then suggests a coordinated, refundable withholding tax scheme to be imposed by the USA, EU, and Japan, which are the main destinations of portfolio investments. No cooperation by tax havens is needed for such a scheme. Finally, the article addresses some common counter arguments.

A. The Development of the Problem

* Irwin I. Cohn, Professor of Law and Director, International Tax LLM, the University of Michigan. I would like to thank Shay Moyal (SJD candidate, University of Michigan) for his help in revising this article.

1. 1984-2000

In 1984, the United States terminated its tax treaty with the Netherlands Antilles. The reason was that the Treaty (technically, an extension of the US-Netherlands Treaty) had become a “treaty with the world”: Namely, every US multinational entity could set up a finance subsidiary in the Antilles and use it to borrow funds from investors regardless of their country of residence, secure in knowing that there would be no withholding tax levied on interest payments under Article 11 of the Treaty.[1] The USA became concerned that no country would be interested in negotiating tax treaties with it if its residents could use the Antilles Treaty.

However, the termination of the Treaty also caused concerns: How could the US Government (which was running a large budget deficit) and corporations continue to borrow from overseas investors, if interest is subject to a 30% withholding tax? One answer was that investors from treaty countries already benefitted from a lower tax rate (typically 10%, or even 0%). If the lower rate depended on a treaty, however, foreign investors would potentially be subject to the exchange of information provision (Article 26), which could mean that they would have to declare the US-source interest income in their country of residence.

The solution was to adopt the portfolio interest exemption, under which interest paid by US entities (the US Treasury and US corporations, as well as US banks and other financial institutions) to lenders that do not own 10% of the stock of the payor is unilaterally exempt from withholding tax.[2] This enabled US entities to borrow without paying withholding tax (which is typically shifted to the borrower, since interest rates are set on the global market) without jeopardizing tax evasion by the lender, since the exemption does not depend on the Treaty, so no information needed to be collected by the payors and no information was available for exchange with residence countries.

The result was astonishing: Latin American countries alone invested more than $300 billion in the USA – a sum that exceeded all of the official aid that Latin American countries received during the entire 1980s. As admitted by Charles McLure, then deputy assistant secretary for tax analysis, this was not foreseen by the US Treasury and caused massive damage to developing countries.[3] In addition, tax competition ensured

1 For an example of how this was done see *Northern Indiana Public Service Co. v. Comm'r*, 115 F.3d 506 (7th Cir. 1997), in which the court approved this arrangement.

2 26 CFR Section 871(h).

3 Charles E. McLure, “Remarks at the VIIIth Munich Symposium on International Taxation” (1989), reprinted in Munich Symposium on Int'l Taxation, Influence of Tax

that ever since 1984, no developed country was able to collect withholding tax on interest paid to non-residents because if it tried to do so, the funds would be shifted to the USA. The USA and other OECD members have since benefitted from massive inflows of portfolio investment that is exempt of taxation at source and that is generally not declared at residence, which left trillions of income dollars untaxed.[4]

Nevertheless, the USA was concerned from the beginning that the portfolio interest exemption might be used by US citizens and residents to move funds out of the USA and then reinvest them in US bonds via a tax secrecy jurisdiction. Subsequently, the US Government took several steps to combat potential tax evasion by Americans: It severely restricted "bearer bonds" that are not in registered form, and required that bonds issued by US corporations in Europe bear a legend that states they are not intended for sale to US citizens. In addition, the portfolio interest exemption itself contains a provision that allows the US Treasury to suspend its application to countries that do not participate in information exchange.[5]

These steps proved insufficient. Bearer bonds survived on the Eurobond market, the legend was not enough because it did not apply to secondary bond sales, and the exchange of information limitation was never applied to the portfolio interest exemption.

2. 2000–2010

To improve the policing of withholding, the USA adopted the Qualified Intermediary (QI) Program in the early 2000s. Under the QI Program, banks could qualify as QIs by signing an agreement to validate the identity of their customers. Then, they would give the information to US withholding agents, but only in aggregate form (a given amount

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Differentials on International Competitiveness (1990) P.55: "I must admit that, as Deputy Assistant Secretary of the Treasury at the time this action [the adoption of the **portfolio interest** exemption] was taken, I did not fight early enough, long enough, or hard enough against its enactment", mostly because of the effect on Latin American countries. See also: Charles E. McLure, Jr., "U.S. Tax Laws and Capital Flight from Latin America", 20 *U. Miami Inter-Am. L. Rev.* 321 (1989), pp. 349–350.

4 No one knows precisely how many trillions because the activity is illegal. Global Financial Integrity estimated the total funds in offshore financial centers at $11.5 trillion, including $1 trillion per year from developing countries, $500 billion of which in invested in OECD countries.

5 26 CFR Section 871(h)(6).

subject to 0% withholding, another to 10%, another to 15%, etc.), without revealing the actual identities of the beneficiaries to anyone in the US. The reason for the latter provision, of course, was to make sure that the information was not available to the IRS for exchange under treaties, and thus could not be used by other countries to combat tax evasion by their residents.

The 2009 UBS scandal showed that the QI Program was also insufficient in preventing "round tripping" by US citizens. The UBS sent representatives to visit US locations where the rich congregate and persuade them to set up corporations in tax havens such as the Caymans. These corporations then deposited funds with UBS Zurich, which in turn invested them in the US. UBS claimed that the QI agreement it signed did not require the disclosure of any such information to the IRS as long as the accounts belonged to tax-haven-based corporations, even though it knew that the corporations were owned by US citizens.

3. 2010-2018

The result was the enactment of the Foreign Account Tax Compliance Act of 2010 (FATCA), under which any "foreign financial institution" (FFI) must take affirmative steps to discover who among its depositors is a US citizen or resident and disclose that information directly to the IRS. The penalty for not doing so is a hefty 30% withholding tax on any US source income earned by the FFI. Since most FFIs are exposed to the US market in some way, this Act has real teeth. To lighten the compliance burden, the USA is negotiating Intergovernmental Agreements (IGAs) with several foreign governments with which it has tax treaties under which the foreign government should collect requisite information from its FFIs and share it with the US.[6]

What this saga shows is that the attempt by the USA to aid and abet tax evasion by foreign residents investing in the USA backfired because it enabled US citizens to pretend they were foreigners and benefit from provisions that were meant to attract real foreigners (no collection of information and no withholding). The same problem gave rise to the recent revelations in the Panama and Paradise Papers of the scope of US citizens' investments in the USA through tax havens.

6 Under the Model I IGA, like the one between the US and the UK, information gathering is supposed to be reciprocal, and the USA now requires that US banks collect the information necessary to exchange under IGA. Model II IGAs are non-reciprocal (only the USA obtains information) but no such IGAs have been negotiated.

The same thing happened in Europe. The German Government worried that German residents had deposited money in Luxembourgian banks and then invested it in Germany. The attempt to impose a withholding tax resulted in capital flight to Switzerland. Limitations imposed on the deductibility of interest paid to related foreign parties were struck down by the European Court of Justice, and the German Constitutional Court ruled that imposing withholding on wages but not on interest violates the equal protection principle. The Germans then turned to the EU and managed to get it to adopt a Savings Directive in 2003. Under that Savings Directive, all EU members must either share information or impose a withholding tax on payments to residents of other member states. That directive, however, does not apply to investments by non-EU residents (e.g., Americans), so EU residents can likewise avoid it by pretending to be non-residents.

B. A Modest Proposal

The solution to this problem is simple. Money cannot stay in tax havens because they do not offer sufficient investment opportunities. It has to be invested in OECD-member countries, particularly in the USA, the EU, and Japan. If these three jurisdictions cooperated by imposing either information reporting or a withholding tax on all payments to foreigners, instead of the EU abetting tax evasion by Americans and the US by Europeans, everyone would be better off. That would make it impossible for US residents to evade taxation by pretending to be Europeans, and for Europeans to evade taxation by pretending to be Americans. Everyone would declare their income to their country of residence or be subject to withholding tax (which can be made refundable if subjects prove that their income had been declared in the country of residence).

FATCA offers a preliminary step in this direction. Under the IGAs, foreign governments must collect information on US citizens investing in their FFIs. In exchange, these governments will receive information about their residents' investments in US financial institutions. For the first time ever, US banks will be forced to gather information on payments made free of withholding tax under the portfolio interest exemption.

Now we finally address developing countries. As indicated by the capital flight to Miami after 1984, a large chunk of the funds invested in the USA without the exchange of information come from the wealthy elites of developing countries. If the USA agreed with other OECD countries to implement a global savings directive for their residents by signing IGAs with those countries, it should be possible to extend it to non-OECD countries as well. If the USA and the EU cooperated, the former could simply abolish the portfolio interest exemption (or declare that it does not apply to non-Treaty countries; and it has the power to do so under current laws). If the EU cooperates, the money would not escape to other OECD countries. The USA can then offer developing countries the information they need to tax their own wealthy residents or impose a withholding tax on payments to such residents (which again could be made refundable by intergovernmental agreements). The end result would be a global and automatic exchange of information, which should enable each country to tax its own residents.

The USA has learned the hard way that trying to attract foreign capital by not withholding or gathering information is a recipe for undermining the taxation of Americans. FATCA now offers a forward way to cooperate with other countries that wish to tax their wealthy residents on all income "from whatever source derived." This shows that even in a world with capital mobility, it is possible for countries to tax income from capital if they learn to cooperate with each other. It remains to be seen whether recent revelations (such as the Paradise Papers) will finally result in meaningful EU and US attempts to crack down on tax evasion that everyone concedes is illegal.

C. Conclusion

It has been argued that countries' cooperation on tax matters is unlikely because interest rates vary too much. Still, even though we have witnessed the development of cooperative solutions for tax evasion problems in the CRS and for tax avoidance problem in BEPS, both efforts are flawed. The basic problem is that the cooperation of too many countries is required. CRS is an attempt to enforce a residence-based taxation of passive income, but just one non-cooperating tax haven can ruin the entire system because all income can be routed through it. BEPS is an attempt to enforce source-based taxation of active income, but there are too many source countries outside OECD/G20 to impose such standards universally. In both cases, the USA is not cooperative.

Instead, I would suggest reversing the traditional preference and taxing active income primarily at residence and passive income primarily at source.[7] The G20 are home to most multinationals, and if they could coordinate the current taxation of their residents worldwide, the BEPS problem could be eliminated.

Passive income, as explained above, must not remain in tax havens, but should be invested in large and stable jurisdictions. That is why a cooperative solution involving just the USA, the EU, and Japan is feasible. Given the huge sums involved, it should be possible for these three jurisdictions to cooperate by imposing refundable withholding tax on all outbound payments to countries that do not engage in a meaningful exchange of information (i.e., tax havens).

7 Reuven Avi-Yonah, "Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight", 6 *Harv. Bus. L. Rev.* (2016) 185 (with H. Xu).