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Closing the international tax gap

by Joseph Guttentag and Reuven Avi-Yonah¹

In July of 1999, the Justice Department entered into a plea bargain with one John M. Mathewson of San Antonio, Texas. Mr. Mathewson was accused of money laundering through the Guardian Bank and Trust Co. Ltd., a Cayman Islands bank. Mr. Mathewson was chairman and controlling shareholder of Guardian, and in that capacity had access to information on its depositors. In return for a reduced sentence, Mr. Mathewson turned over the names of the persons who had accounts at Guardian. The result was an eye-opener: The majority of the accounts were beneficially owned by U.S. citizens, and the reason they used a Caymans bank had nothing to do with laundering funds earned in criminal activities. Instead, the accounts were in the Caymans for the purpose of evading federal income taxes on income earned legally, relying on the Caymans' lack of an income tax and promise of bank secrecy. The IRS ultimately settled 1,165 cases with the individual taxpayers for a total collection of \$3.2 billion—an average of \$1.7 million per taxpayer (Massey 1999 and Blum 2005).

Guardian's U.S. clients relied on four simple realities. First, in today's world, anyone can open a bank account in the Caymans for a minimal fee over the Internet, without leaving the comfort of their home. Second, the account can be opened in the name of a Caymans corporation, which can likewise be set up long-distance for minimal transaction costs (as evident from any perusal of the back pages of *The Economist* magazine, where law firms advertising such services abound). Third, money can be transferred into the account electronically from the United States or from abroad, and in most

cases there would not be any reporting of such transactions to tax authorities. Finally, the funds in the Caymans account can then be used for investments in the United States and in other high tax jurisdictions, and there would generally be no withholding taxes on the resulting investment income, no Caymans taxes, and no information on the true identity of the holder available to the IRS or any other tax authority (Blum 2005). Significantly, other than the use of the Caymans, both the underlying funds that were deposited in the Guardian accounts, and the investment income, were generally purely domestic transactions, and the tax evaded was U.S. income tax on U.S. source income beneficially owned by U.S. residents.

The ability to use the Caymans and other offshore tax havens to evade income taxes is a relatively recent phenomenon. Since about 1980 there has been a dramatic lowering of both legal and technological barriers to the movement of capital, goods, and services. As countries have relaxed their tariffs and capital controls, much of the world economy has shifted from goods to services, and electronic means of delivering services and transferring funds have developed. At the same time, the tools used by tax administrations to combat tax evasion have not changed significantly: Most tax administrations are limited to enforcing taxes within their jurisdiction, and for international transactions, can only rely on outdated mechanisms like exchange of information under tax treaties with other high-tax countries, which are unavailing for income earned through tax haven corporations. Simply put, we have the technology that enables people to conduct their affairs without regard to national borders and without transparency, while restricting tax collectors to geographic borders, that are meaningless in today's world.

This chapter focuses on the problem of closing the "international tax gap," defined as the portion of taxes owed but not collected from U.S. taxpayers when an international connection of some type hinders the IRS. For example, a U.S. business owner selling goods abroad over the Internet can direct her foreign correspondent to deposit the sale proceeds in a Swiss bank account. Or a U.S. resident (like the Guardian depositors) can shift funds to a Caymans corporation and the corporation can lend these funds back to the United States and earn interest income. In neither case will there be withholding or automatic information reporting to the IRS, and as a result, it is unlikely that the IRS will be able to collect the tax due.

The size of the international tax gap

The United States legitimately boasts one of the world's higher compliance rates for tax collections. However, most of the taxes collected by the IRS are from income that is subject either to withholding at the source (e.g., wages) or to automatic information reporting to the IRS by financial institutions (e.g., interest or dividends from U.S. payors). The IRS has recently estimated that in 2001 there was a total "tax gap" (i.e., a difference between the taxes it collected and the taxes it should have collected under existing law) of between \$312 and \$353 billion, or about 16% of total taxes owed (IRS 2005). A large portion of this gap results from income that is subject to neither withholding nor information reporting, such as most income of small businesses and income earned from foreign payors. For these types of income, the compliance rate falls from over 90% to under 70% (Aaron and Slemrod 2004).

No one, including the IRS, has a good estimate of the size of the international tax gap. This is not surprising given that the activities involved are illegal, but one can make an educated guess based on a few publicly available numbers. In 2003, the Boston Consulting Group estimated that the total holdings of cash deposits and listed securities by high net worth individuals in the world were \$38 trillion, and that of these, \$16.2 trillion were held by residents of North America. Out of these \$16.2 trillion, "less than" 10% was held offshore (as compared with, for example, 20-30% offshore for Europe and 50-70% offshore for Latin America and the Middle East) (Dyer, De Juniatic, Holley, and Aerni 2004).

If one translates this estimate into approximately \$1.5 trillion held offshore by U.S. residents, and if one assumes that the amount held offshore earns 10% annually, the international component of the tax gap would be the tax on \$150 billion a year, or about \$50 billion. This figure is in the mid-range of estimates of the international tax gap in 2002 by former IRS Commissioner Charles O. Rossotti (\$40 billion) and by IRS consultant Jack Blum (\$70 billion) (Sullivan 2004). As an order of magnitude, an estimate of \$50 billion for the total international tax gap (for each tax year) appears congruent with the \$3.2 billion actual recovery by the IRS from a single Cayman bank (for multiple tax years).

This estimate suggests that the international tax gap (i.e., *illegal* tax evasion by mostly *individual* U.S. taxpayers through cross-border activities) may be significantly greater than the total *corporate* tax gap, i.e., the underpayment of corporate taxes due to tax shelters, transfer pricing, and other tax avoidance activities, which the IRS has estimated at about \$29.9 billion for 2001 (IRS 2005). And yet, as we will discuss below, the IRS expends far more resources on the corporate tax gap than on the international tax gap.

Why the international tax gap is a problem

Why should we care about the international tax gap? When the Organization for Economic Cooperation and Development (OECD) began its crackdown on tax havens in 1998, Dan Mitchell of the Heritage Foundation criticized it as a group of bloated welfare states ganging up as a cartel to quash the small, defenseless Caribbean islands that depend on offshore banking activities for their livelihood. The tax havens, it was argued, are needed to protect the property of residents of non-democratic countries from confiscation by tyrants. And the availability of low-or no-tax offshore centers serves as a salutary check on the tendency of rich country governments to increase taxes (Center for Freedom and Prosperity 2001).

However, even thoughtful supporters of tax competition like Julie Roin acknowledge that this argument is problematic when it is applied to illegal tax evasion by citizens of democratic countries (Roin 2001). After all, the desirable size of the public sector in those countries, including the United States, is the key political issue of our times, which is fought and re-fought every few years at the ballot box. Once the citizens have determined by their votes what mix of government programs they would like to pay for through their taxes, it seems perverse to argue that some of them can then legitimately opt out of participation in the process by evading the law and stashing their income overseas, away from the reach of the tax collector. After all, those citizens do not actually move to the offshore tax havens, thereby subjecting themselves to a much lower quantity and quality of government services. Instead, they stay at home and continue to enjoy the level of services provided by the rich country government, but refuse to pay their fair share of the cost (for elaboration, see Avi-Yonah 2000).

It is important to distinguish such illegal tax evasion activities by individual residents of high-tax countries from tax competition.² Tax competition is healthy, for example, where it increases government efficiency and the development of sound tax policies that maximize economic development while financing necessary government programs. In this way, tax competition reduces the tax burden.

None of the steps taken by the OECD, nor the ones proposed below, involve forcing the tax havens to collect taxes for OECD member countries. Rather, they involve cooperation in exchange for information, similar to what is already done voluntarily in other contexts that require such cooperation (such as the fight against international terrorism and drug cartels). Otherwise, all the suggested steps can be taken unilaterally by OECD members without discrimination and without harming the sovereignty of the tax havens.

The United States is currently facing significant budget deficits that are likely to increase as costs of entitlement programs go up. These deficits are increasing daily as a result of the ongoing “war on terror” and natural disasters like Hurricanes Katrina and Rita. Closing the tax gap by better enforcing current law is one deficit cutting measure on which Republicans and Democrats may be able to agree (see, e.g., Committee for Economic Development (2005), a bipartisan group). If the United States could collect an additional \$300 billion per year (the total estimated tax gap), this would go a long way to reduce the deficit; and even a significantly lower number (presumably there will always be a tax gap) would be helpful under current conditions.

Closing or reducing the tax gap would have an effect beyond the revenue involved. A large part of the current unpopularity of the income tax has resulted from the perception that “only the little people pay taxes.” If the United States can improve its collections from the rich, everyone will feel better about paying their fair share. This would ease some of the pressure from the income tax and enable a debate about replacing it with another kind of tax in a less acrimonious atmosphere. Taxpayers should not be forced to adopt a different kind of tax system because of the unwillingness (not inability) to enforce existing law, nor should taxpayers decide for themselves how much tax they would like to pay by using the loopholes in existing law to their benefit (Committee for Economic Development 2005).

Solutions to the international tax gap

Following are five steps that can be taken on a bipartisan basis to help close the international tax gap:

1. Increased IRS enforcement

It is well known that the IRS has in recent years faced an increased workload with diminished resources. From 1992 to 2001, the IRS “full-time equivalent” staff decreased by about 20,000 positions. This trend has been reversed more recently, but as former IRS Commissioner Rossotti has written, the increase is not enough to keep up with the increase in complexity of the tax system and the size of the economy (Rossotti 2004). In recent years, Congress has repeatedly increased the complexity of U.S. tax law without adding funding to the IRS. Bipartisan groups like the Committee for Economic Development (CED) have recently called for more resources and political support to be given to the IRS (CED 2005).

Decreased resources have forced the IRS to focus its attention on certain areas and neglect others, and predictably, the areas receiving the most attention have been those in the political limelight, such as the Earned Income Tax Credit (EITC) (under pressure from Republicans) and corporate tax shelters (under pressure from Democrats). However, these are not necessarily the areas likely to generate the most “bang for the buck” in terms of closing the tax gap. EITC fraud involves small amounts, and corporate tax shelters are very difficult to audit and have frequently been upheld by courts upon review. While the United States should continue its effort to combat corporate tax shelters, increased international enforcement could be even more efficient in eliminating the tax gap.

The IRS should dedicate more resources to attempting to close the international tax gap. In particular, the IRS should give more priority, and be given more resources, to audit compliance with existing laws requiring U.S. taxpayers to report ownership of foreign bank accounts and stock in foreign corporations. Moreover, the IRS should focus on auditing businesses relying on e-commerce in overseas transactions, which are particularly susceptible to abuse. If the Mathewson case is any indication, such increased attention may generate many dollars in tax revenue for every dollar spent on enforcement.³

2. *Bilateral information exchange*

The United States currently has bilateral information exchange agreements with several tax haven jurisdictions. However, most of the existing agreements are restricted only to criminal matters. Criminal matters are a very small part of overall tax collections, and pose very difficult evidentiary issues in the international context. Moreover, the agreements sometimes require the subject matter to be criminal in both the United States and the tax haven, which would never be the case for pure tax evasion. In addition, they typically require the United States to make a specific request relating to particular individuals, and they also typically do not override bank secrecy provisions in tax haven laws. These limitations mean that existing tax information exchange agreements, while helpful and important in some cases, are of limited value in closing the overall international tax gap.

The OECD has recently modified Article 26 (Exchange of Information) in its model income tax treaty, and has adopted a model Tax Information Exchange Agreement (TIEA), both of which are intended to address all of these problems. Under the new Article 26 and model TIEA, exchange of information is automatic (rather than just by request), relates to civil as well as criminal tax liabilities, does not require “dual criminality” or suspicion of a crime other than tax evasion, and overrides bank secrecy provisions in domestic laws. The United States should renegotiate its existing tax treaties and exchange of information agreements to incorporate all the changes made by the OECD in its model treaty and TIEA.

Below is a discussion of the steps needed to induce tax haven jurisdictions to negotiate such agreements with the United States. For other jurisdictions that are not tax havens, the inducement is the information they can obtain from the United States on their own residents. To ensure such information is available, the Treasury should finalize regulations proposed by the Clinton Administration that require U.S. banks and financial institutions to collect information on interest payments made to overseas jurisdictions when the interest itself is exempt from withholding under the portfolio interest exemption (Blum 2005). The Treasury has recently proposed to limit such regulations to 16 designated countries, but as Blum writes, there is no legitimate privacy or other reason to impose such limitations. The banks should collect all the information, and the Treasury should

use its existing authority not to exchange it in situations in which it might be misused by non-democratic foreign governments (e.g., when freedom fighters use U.S. bank accounts).

3. Cooperation with the OECD

Current Treasury policy, possibly a reflection of broader foreign policies, is to focus on bilateral agreements to obtain needed information exchange cooperation. However, the OECD has been at the forefront of persuading tax haven jurisdictions to cooperate with information exchange, and is an organization that the United States had traditionally played a leading role in and whose work benefits both governments and the private sector. The United States should cooperate with the OECD and other appropriate international and regional organizations in their efforts to improve information exchange and, in particular, to persuade the tax havens of the world to enter into bilateral information exchange agreements based on the OECD model. The OECD has made significant progress since it began focusing on this issue in 1998, but more needs to be done, both on persuading laggard jurisdictions to cooperate and on increasing the level of information exchange available from cooperating jurisdictions.

4. Incentives to tax havens

The United States should adopt a carrot-and-stick approach to tax havens in order to provide incentives to cooperate with information exchange. In particular, the United States and other donor countries, as well as multilateral and regional organizations, should increase aid of a type that would enable tax havens to shift their economies from reliance on the offshore sector to other sources of income.

The common perception that the benefits of being a tax haven flow primarily to residents of the tax haven is misguided. The financial benefits of tax haven operations, while funding a minimal level of government services, often flow primarily to professionals providing banking and legal services, many of whom (like Mr. Mathewson) live in rich countries, rather than to the often needy residents of the tax havens. Thus, with some transitional support, most tax havens would likely see the welfare of their own residents improve as they wean themselves from dependence on the offshore sector.

5. Sanctions on non-cooperating tax havens

In the case of non-cooperating tax havens, the U.S. Treasury should use its existing authority to prospectively deny the benefits of the portfolio interest exemption to countries that do not provide adequate exchange of information.⁴ This step is necessary to prevent non-cooperating tax havens from aiding U.S. residents to evade U.S. income tax.

A principal problem of dealing with tax havens is that if even a few of them do not cooperate with information exchange, tax evaders are likely to shift their funds there from cooperating jurisdictions, thereby rewarding the non-cooperating ones and deterring others from cooperation. Thus, some jurisdictions have advertised their refusal to cooperate with the OECD efforts.

However, if the political will existed, the tax haven problem could easily be resolved by the rich countries through their own action. The key observation here is that funds cannot remain in tax havens and be productive; they must be reinvested into the rich and stable economies of the world (which is why some laundered funds that need to remain in the havens earn a negative interest rate). If the rich countries could agree, they could eliminate the tax havens' harmful activities overnight by, for example, refusing to allow deductions for payments to designated non-cooperating tax havens or restricting the ability of financial institutions to provide services with respect to tax haven operations.

The financial services industry will no doubt lobby hard against such a step on the grounds that it will induce investors to shift funds to another OECD member country. However, the European Union and Japan have both committed to taxing their residents on foreign-source interest income. The EU Savings Directive, in particular, requires all EU members to cooperate in exchange of information or impose a withholding tax on interest paid to EU residents (EU 2003). Both the EU and Japan would like to extend this treatment to income from the United States. Thus, this would seem an appropriate moment to cooperate with other OECD member countries by imposing a withholding tax on payments to tax havens that cannot be induced to cooperate in exchange of information, without triggering a flow of capital out of the United States.

Conclusion

The international tax gap is a significant component of the overall tax gap and may in fact be larger than some components that have attracted more public and IRS attention, like corporate tax shelters or EITC fraud. In order to maintain any kind of tax system, the U.S. public needs to be confident that current law can be enforced and that tax evasion will be caught and prosecuted. Bipartisan support is needed for taking the steps identified above to close the international tax gap. These steps offer the potential of raising additional revenue without raising taxes, and of leveling the playing field between ordinary Americans who pay their fair share of taxes and others who do not.

Endnotes

1. We would like to thank Henry Aaron, Max Sawicky, Eric Toder, and Philip West for their extremely valuable comments on earlier versions of this chapter. Any remaining errors are our responsibility.
2. Tax competition is the use by governments (localities, states, or nations) of preferential tax treatment—reduced rates or some sort of deduction, credit, or exclusion—to attract taxable activity to their jurisdictions.
3. For example, transfers by U.S. banks to foreign banks, such as occurred in the Mathewson case, generate bank records which can be audited by the IRS. Similar records may not exist for transfers from foreign banks or non-bank networks (e.g., the *hawala* trust-based network). These types of transfers are also used by terrorists and it would be advisable to use the well-developed expertise of the IRS to combat both tax evasion and terrorist financing activities.

Similarly, more use can be made of credit card records and other data mining techniques to establish which U.S. taxpayers have foreign accounts that they have not disclosed (as required by current law) on their tax return.
4. See Internal Revenue Code section 871(h)(6).

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