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STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON COMMERCE, CONSUMER
AND MONETARY AFFAIRS
COMMITTEE ON GOVERNMENT OPERATIONS
HOUSE OF REPRESENTATIVES
ON
FEDERAL EFFORTS TO DEFINE
AND COMBAT THE
TAX HAVEN PROBLEM



Mr. Chairman and Members of the Subcommittee:

We are pleased to be here to assist the Subcommittee in its inquiry into Federal efforts to define and combat the very complex tax haven problem. Our testimony is based on work done during the past 6 months in response to this Subcommittee's request. Our work focused primarily on IRS' efforts to detect and deter tax law abuses relating to tax havens. We also did a

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limited analysis of the Treasury Department's tax treaty negotiation policies and procedures, with particular emphasis on problems surrounding current treaty negotiations with the Netherlands Antilles.

The Federal Government is concerned about tax havens primarily because they afford significant opportunities to abuse the tax system, particularly through tax evasion. While the extent of illegal use of tax havens cannot be readily quantified, IRS estimates that tax evasion through the use of haven countries is costing the Treasury billions of dollars annually.

In carrying out our work, we found that, within the Federal Government, there has been a growing awareness of and willingness to deal with the tax haven problem. We also noted, however, that along with greater awareness of the problem has come a recognition that there are no quick and easy solutions. In particular, we found that:

--Tax havens are a problem for the United States primarily because their banking and commercial secrecy laws limit U.S. access to the information it needs to assure compliance with domestic tax and other laws. There are two kinds of tax havens--nontreaty havens and treaty havens. Among other things, nontreaty havens offer low or no taxes on some categories of income and provide a high level of confidentiality in financial matters. Treaty havens display similar characteristics but also offer special tax benefits not generally available in countries which lack a tax treaty network. The United States must

use different problem solving techniques depending on whether it is dealing with a nontreaty haven or a treaty haven.

--The use of tax havens has been of particular concern to IRS since the mid-1950s. IRS has conducted various special projects and investigations in an effort to identify taxpayers using tax havens to evade U.S. taxes. The most notable of these efforts included the Swiss Mail Watch, the Bahamas Project, Operation Tradewinds, and Project Haven. These activities have, in some cases, proven that tax havens afford individuals and businesses with extensive tax evasion opportunities. More recently, Treasury, Justice, and IRS sponsored a comprehensive study of the tax haven problem. The study report, which was issued in January 1981, identified a variety of potential legislative and administrative actions that could be taken to deal with the tax haven problem. Some actions, both legislative and administrative, have already been taken in response to the report.

--IRS has taken some steps to upgrade its efforts to deal with the tax haven problem. In so doing, IRS has relied primarily on its existing civil tax enforcement mechanisms as the means for identifying potential tax haven abuses. This approach assumes that an accessible "paper trail" exists for tax haven transactions--an assumption which frequently proves erroneous. IRS has recognized this problem and therefore has begun placing

greater emphasis on Criminal Investigation Division efforts to combat tax haven abuses. Still, IRS needs to maintain and enhance its civil tax enforcement efforts in this area.

--Meanwhile, the Treasury Department has embarked on an ambitious program aimed at dealing with part of the tax haven problem through a firm tax treaty negotiation policy. That is, Treasury wants to include strong exchange of information and anti-abuse provisions in all new and renegotiated tax treaties. Treasury's firm approach is both warranted and necessary from a tax policy standpoint. However, in seeking to implement the policy, Treasury has faced a series of difficulties. This is because, along with tax policy concerns, Treasury also has had to take foreign policy and nontax law enforcement concerns into account. Ongoing negotiations with the Netherlands Antilles illustrate these difficulties.

I would now like to discuss each of these points in detail.

THE TAX HAVEN PROBLEM IS
TWOFOLD IN NATURE

Tax havens generally are defined by the tax community as countries which (1) impose a low or zero rate of tax on all or certain categories of income, (2) offer a high level of banking or commercial secrecy, (3) rely on banking as an important segment of their economy, (4) have modern communications facilities, (5) do not impose currency controls on nonresidents, and/or (6) promote themselves as tax havens.

Low tax rates on certain kinds of income offer a strong inducement for individuals and businesses to carry out economic activities through tax haven countries. Moreover, because there generally are no reserve requirements, banks located in tax haven countries frequently can pay higher rates of interest on deposits. Beyond that, such countries also offer investors a very high level of confidentiality in their financial affairs and few or no currency controls. Thus, there are a series of legitimate reasons why businesses and individuals might make use of tax havens.

On the other hand, because tax havens have banking and commercial secrecy laws, they also present significant tax evasion opportunities. Specifically, tax havens can be used as a means for evading taxes on both legally and illegally earned income. They also can be used as a means for concealing the financial transactions associated with illegal activities, such as drug trafficking. And, with respect to illegal use of tax havens, it is important to note that there are two kinds of tax havens--nontreaty havens and treaty havens.

A nontreaty haven, such as the Bahamas and the Cayman Islands, supplies the United States with little or no information on financial transactions which take place in that country. Therefore, a U.S. citizen could deposit funds in a Cayman Islands bank and not report the interest earned to IRS. IRS generally would have no means for detecting this unreported income. This lack of access to information in nontreaty countries serves to facilitate nontax criminal activities, such as the laundering of funds derived from illegal activities.

Ferretting out persons who use nontreaty havens as a means for facilitating illegal activities is a task which requires application of a wide range of criminal law enforcement investigative techniques. Concerning the use of nontreaty havens for tax evasion purposes, IRS faces difficulties in detecting violators through normal civil tax enforcement measures. This is because such measures assume the existence of a "paper trail"--an assumption which frequently proves erroneous with respect to nontreaty havens. Thus, IRS also needs to rely on criminal tax enforcement efforts to detect violators who operate in such countries.

In contrast, tax haven countries with which we have tax treaties may present law enforcement agencies and IRS with a very different kind of problem. These countries display many of the characteristics associated with nontreaty havens and, in addition, provide other opportunities for tax avoidance and evasion by virtue of certain treaty provisions.

Tax treaties are bilateral agreements generally designed to (1) relieve taxpayers of the burden of double taxation on the same income base, (2) create a mechanism for resolving disputes, and (3) provide a framework for exchanging tax information to prevent tax evasion. The United States has tax treaty relationships with over 50 countries. Many of our treaties are with developed countries which are major trading partners, such as Canada, the United Kingdom, and France.

Of these tax treaties, 15 are with countries generally considered, at least to some extent, to be tax havens. Some of

the more significant of these include Switzerland, the Netherlands, and the Netherlands Antilles. These countries offer many of the advantages associated with nontreaty havens. Furthermore, when combined with the domestic laws of tax haven countries, U.S. tax treaties generally have the effect of offering investors (1) low or no U.S. tax on interest, dividends, rents, and royalties earned in the United States, (2) low or no treaty haven country tax on the same income, and (3) free movement of funds out of the treaty haven to third countries.

The Netherlands Antilles is perhaps the best example of a tax haven country which depends heavily, from an economic standpoint, on its tax treaty network particularly the treaty with the United States. In 1955, the United States' tax treaty with the Netherlands was extended to the Netherlands Antilles, a country composed of six islands in the Caribbean. Subsequently, the Netherlands Antilles adjusted its internal law so as to encourage third-country persons to invest money through the Antilles with a view toward taking advantage of the treaty with the United States. Among other things, the Netherlands Antilles reduced its effective tax rate on certain kinds of companies established in the country. As a result, an investor residing in a third country can derive substantial benefits from establishing a company in the Netherlands Antilles and using it as a conduit for investment in the United States.

For example, if a third-country person were to invest \$1 million directly in U.S. corporate bonds paying 10-percent interest, the first year's earnings would total \$100,000. However,

the U.S. would then impose a 30-percent tax on the \$100,000 and the investor's net return would be \$70,000. As an alternative, the investor could establish a Netherlands Antilles company and invest the \$1 million in the same corporate bonds using that company as a conduit for the investment. Because the U.S. tax treaty with the Antilles eliminates the 30-percent tax on interest, the investor would receive \$100,000 in interest the first year--\$30,000 more than what would have been derived through direct investment. The investor would, however, have to pay a small tax to the Antilles on this transaction.

A transaction such as that just described can involve "treaty shopping." That is, an investor "shops around" for the best tax treaty deal available, taking into account such factors as potential financial benefits, bank secrecy, investment goals, etc. The United States is opposed to treaty shopping because treaty benefits are intended to accrue only to bona fide residents of the treaty country. But, in many cases, the United States is hard-pressed to detect or deter treaty shopping. This is because many treaty havens liberally define who qualifies as a "resident" and have bank secrecy laws that prevent IRS from identifying individuals who, in the eyes of the United States, are not bona fide residents of the treaty haven.

Treaty shopping is, of course, but one problem arising from the situation wherein the U.S. has a tax treaty with a tax haven country. This is because the full range of illegal activities

associated with nontreaty havens also can take place in treaty havens. But in terms of dealing with treaty haven countries, the United States has more tools at its disposal. These tools include normal civil tax enforcement activities, based in part on exchange of information agreements, as well as criminal tax and nontax investigative activities. Furthermore, because treaty haven countries frequently have friendly relations with the United States, there may be opportunities to negotiate or renegotiate tax and/or mutual assistance law enforcement treaties.

Nevertheless, dealing with either aspect--treaty or nontreaty--of the tax haven problem is a difficult task. Even more difficult from a tax administration perspective, however, is the task of dealing with an investor's combined use of nontreaty havens and treaty havens to maximize both secrecy and investment benefits. I will provide an example of such a combined transaction later in my testimony. Now, however, I would like to discuss some special Federal efforts directed at the tax haven problem in past years. Then I will discuss current tax administration activities pertaining to tax havens and outline the Treasury Department's tax treaty negotiation policy with respect to tax havens.

SPECIAL EFFORTS TO DETECT
AND DETER TAX HAVEN ABUSES

Over the past two decades, a number of investigations and information gathering projects involving tax havens have been carried out by the Federal Government. Some of these efforts were intended to better understand the problem by developing

institutional knowledge about tax haven activities; others were intended to identify tax evaders.

During 1957 and 1958, special agents in IRS' Manhattan District attempted to and did learn the identity of persons making large deposits of currency in New York banks for possible subsequent transfer to secret Swiss bank accounts. Although it was suspected that some of these transactions involved tax evasion or other violations of U.S. law, no information on the transfers could be secured from Switzerland.

In early 1967, a task force, composed of IRS Examination, Criminal Investigation, and Office of International Operations personnel, was formed to enhance the Service's knowledge about the use of secret foreign bank accounts. As an outgrowth of these efforts, a project known as the "Swiss Mail Watch" was initiated to identify U.S. taxpayers receiving mail from Swiss banks. During early 1968, with the assistance of Postal authorities, IRS monitored mail received in a New York post office and identified Swiss bank mail. A list of 8,500 taxpayers possibly using Swiss bank accounts was developed and 168 individuals were audited by IRS. The audits resulted in the assessment of about \$2 million in taxes and penalties, but less than a third of that amount was attributable in any way to the foreign bank accounts. The audits indicated that about one-fifth of the taxpayers used their Swiss accounts as a depository for unreported income and/or as a means for avoiding the interest equalization tax then in effect.

Subsequently, two more mail watch projects were initiated, one in 1969 and another in 1970. The 1969 mail watch project

identified about 21,500 taxpayers who appeared to have Swiss bank accounts; the 1970-1971 mail watch identified another 20,000 taxpayers who appeared to have such accounts. However, for at least three reasons, IRS initiated no audits as a result of these mail watches. First, because a mutual assistance treaty was being negotiated with Switzerland at that time, IRS believed that use of the mail watch data might jeopardize the treaty negotiations. Second, a Senate Subcommittee was then raising questions about the propriety of developing computerized files on suspected tax violators. Third, some IRS officials believed that this investigative approach would not offer a longterm solution to the foreign bank account problem.

IRS initiated or continued other investigative efforts during the early 1970s. One, sometimes referred to as the "Bahamas Project," involved an investigation of an attorney who allegedly was promoting the use of tax havens by well-to-do clients as a means for evading U.S. taxes. This investigation resulted in hundreds of civil tax cases involving assessments of more than \$100 million in additional taxes and penalties.

In another effort, an IRS special agent established contact with an official of Grand Cayman Island who subsequently furnished some information concerning Cayman Islands bank accounts of U.S. citizens. This effort, called "Project Pirate," was terminated in 1975. IRS records do not indicate that any successful audits or criminal prosecutions resulted from this

information. Nonetheless, in 1976, the Caymans strengthened its bank secrecy laws, making it a crime for any person to reveal information about accounts in the Cayman Islands.

"Operation Tradewinds," an information gathering effort carried out by special agents in IRS' Jacksonville, Florida District Office, was designed to obtain information from Bahamian bank employees about the identity of U.S. taxpayers using Bahamian trust and bank accounts. Information was obtained by IRS from paid informants. Operation Tradewinds resulted in 45 significant audits and several criminal prosecutions before it was suspended in January 1975.

"Project Haven," which was initiated in 1972, involved an investigation of a narcotics trafficker suspected of dealing with a Bahamian bank. A confidential informant was used to obtain Bahamian bank documents regarding this individual. The informant told IRS that Bahamian banks were receiving and disbursing funds on behalf of U.S. citizens whose identities were not revealed to correspondent U.S. banks in Miami, New York, and Chicago. Through surreptitious means, the informant made documents available to IRS. The documents identified over 300 U.S. citizens and firms having accounts with a particular Bahamian bank. However, IRS was criticized by the Congress, the press, and the general public for the tactics it employed during Project Haven and subsequently curtailed its covert operations in the tax haven area for several years.

In late 1979, however, a major study of the tax haven problem was initiated at the request of the Commissioner of Internal Revenue, the Assistant Attorney General (Tax Division), and the Assistant Secretary of the Treasury (Tax Policy). The study resulted in a January 1981 report entitled "Tax Havens and Their Use by United States Taxpayers - An Overview." The report noted that although developed nations were concerned with the use of tax havens to avoid or evade taxes, legal and illegal use of tax havens appeared to be increasing. The report called for a coordinated Federal attack on the use of tax havens, including better coordination and funding of administrative efforts and substantive changes in U.S. laws and U.S. tax treaty policy.

The report has had the effect of focusing greater attention on the tax haven problem, and both Treasury and IRS have initiated efforts which hold promise for the future. I will now turn to a discussion of those efforts, starting with IRS' current civil and criminal tax enforcement efforts.

CURRENT IRS EFFORTS TO DETECT
AND DETER TAX HAVEN ABUSES

The January 1981 tax haven study report prompted IRS to devote greater attention to international transactions. In particular, IRS has sought to upgrade its civil tax enforcement efforts in the tax haven area. Those efforts necessarily rely on three primary sources of information--taxpayers, foreign governments, and withholding agents--as starting points for identification of potential tax haven abuses. And IRS has encountered a series of difficulties in seeking to make effective use of the information it receives from these three sources.

IRS needs to make better use of the various kinds of information it receives with respect to international transactions. However, the Service also needs to supplement its civil tax enforcement efforts with other investigative activities. This is because civil tax enforcement efforts alone cannot hope to solve the tax haven problem. Such efforts often depend on the existence of, and IRS access to, a paper trail. In situations where there is no paper trail or where the paper trail is not accessible, IRS necessarily has to rely more heavily on special investigative techniques. These techniques generally are associated with criminal, rather than civil, tax investigations.

Information IRS receives concerning international transactions has been of limited value

As shown in Chart A, IRS has three primary sources of information concerning taxpayers' international financial transactions. These include (1) tax and information returns which are filed by taxpayers with IRS' 10 service centers, (2) foreign information returns which are sent to IRS' Philadelphia Service Center by U.S. tax treaty partners, and (3) information returns which are filed by U.S. tax withholding agents with IRS' Philadelphia Service Center. From a civil tax enforcement standpoint, IRS must rely heavily on such information as the starting point for identifying potential tax haven abuses.

Taxpayer-provided information

Following issuance of the 1981 tax haven report, IRS began trying to make greater use of various tax and information returns

as a means for identifying tax haven abuses. To this end, IRS designated its International Enforcement Program (IEP) as the focal point for dealing with such abuses. IEP is composed of some 290 revenue agents who have special expertise in international tax matters. The agents are based in 15 key IRS districts throughout the nation. In fiscal year 1982, IEP agents participated in the examination of several thousand tax returns and recommended additional tax assessments of about \$3.7 billion.

Until late 1981, IEP's primary responsibility involved examining the tax returns of multinational corporations. Since then, however, its stated number one priority has been to deal with the use of tax havens--by individuals and corporations. But few individual tax returns containing potential tax haven issues have been identified for IEP review. This is because it is frequently not apparent, from the face of such tax returns, that there are underlying international financial transactions. Also, IRS suspects that there is a serious nonfiling problem with respect to certain information returns.

Chart B identifies some of the various returns filed with IRS service centers which may contain information related to international financial transactions. As you can see, Mr. Chairman, there is a wide variety of such forms, ranging from the much used form 1040 to the little-used form 3520, which pertains to foreign trusts.

When tax returns are received at the 10 IRS service centers, they are manually screened and classified according to established procedures. In attempting to identify individual tax returns

with underlying international transactions, service center personnel look primarily at the forms attached to returns. IRS officials informed us that it is difficult to detect taxpayers' international transactions simply by looking at the face of tax returns. It should be noted that few individual tax returns with potential international transactions were identified at IRS service centers in fiscal year 1982.

As shown in Chart C, IRS service centers processed 95 million individual tax returns during that fiscal year. And, of these 95 million tax returns, only 760 were identified as having underlying international transactions. The 760 returns were set aside for review by IEP representatives but, as indicated on the chart, information on what IEP did with the returns, in terms of actual examinations, was not available. Regardless, the small number of returns identified suggests that service centers face a difficult task in seeking to identify returns containing actual or potential international transactions related to tax havens.

In addition to the identification process followed at the service centers, IRS also relies on revenue agents and tax auditors throughout the country to identify returns containing potential tax haven transactions. In this regard, during the course of an examination, an examiner may discover a transaction involving a foreign entity or might identify a transaction which could be international in nature. In such cases, IRS requires that the tax return be forwarded to IEP for evaluation of its audit potential. As Chart C indicates, however, few individual tax returns were identified by examiners for referral to IEP.

During fiscal year 1982, only 531 individual tax returns were referred to IEP, of which 328 were examined.

Thus, IRS' use of normal tax return processing and examination functions as a means for identifying individual tax returns containing potential tax haven issues has not generated a large inventory of such returns. IRS attributes this to the fact that most tax and related information returns contain little in the way of indications that there are underlying international financial transactions.

In addition to difficulties in identifying individual tax returns containing potential tax haven issues, IRS faces different problems with respect to information returns which, by definition, pertain to international transactions. As Charts A and B depict, these information returns--forms 3520, 3520A, 957, 958, 959, and 5712--are not filed with regular income tax returns but must instead be filed by taxpayers with IRS' Philadelphia Service Center. The forms are filed with that service center because it receives and processes most tax returns filed by U.S. citizens residing abroad and nonresident aliens. Also, the forms are not now filed with regular tax returns because the filing deadlines differ.

We found that IRS received relatively few of these forms during tax year 1982. For example, IRS received a combined total of only 243 forms 3520 and 3520A that year. Similarly, it received only 522 forms 957, 296 forms 958, and 441 forms 5712. IRS officials cannot specify with precision what these filing levels mean in terms of compliance. Nonetheless, the officials

believe that noncompliance with the filing requirements is substantial.

Nonfiling of these forms translates into lost opportunities for IRS. This is because the forms could serve as a starting point for examinations of returns which do in fact contain underlying international financial transactions. Thus, if compliance with the filing requirements were high, the forms would help solve problems stemming from the lack of a paper trail for certain international transactions.

Therefore, IRS needs to determine whether there is in fact a serious nonfiling problem with these information returns. One means through which IRS could do so, which I will discuss in more detail later, involves Criminal Investigation Division information gathering efforts. But such activities will not be of much help, however, until IRS solves a second problem associated with the information returns. That is, IRS does not make very effective use of even the relatively few information returns it now receives. For example, the forms generally are not used as a basis for initiating examinations and frequently are not made available to examiners when a corresponding tax return is selected for examination.

IRS has recognized that information returns filed by taxpayers with the Philadelphia Service Center are not being used very effectively. In July 1982, IRS' Mid-Atlantic Region recommended that certain returns filed at that service center be associated with corresponding tax returns. IRS has recently consolidated several of the international forms, including some of those

filed with the Philadelphia Service Center. IRS will require that taxpayers file the revised form along with their tax returns. IRS, therefore, may soon be in a position to make better use of information returns.

However, to further enhance its civil tax enforcement program, IRS also needs to make more effective use of data supplied the Service by foreign governments.

Foreign government-provided information

Under tax treaties now in effect with certain foreign governments, IRS annually receives thousands of foreign information returns. The returns, which vary in form and content on a country-by-country basis, are designed to provide data on income earned abroad by U.S. taxpayers. For several reasons, however, the forms have proven to be of only limited value to IRS.

In 1975, IRS received 51,000 foreign information returns but did not match them against tax returns. In 1976, this Subcommittee held hearings on IRS' use of foreign information returns and criticized the Service for not making effective use of the information through document matching or examinations. Subsequently, IRS sought to remedy this problem, but its efforts have met with only partial success.

Chart D, now before you, shows that 793,000 foreign information returns, reflecting \$11.6 billion in income earned abroad by U.S. taxpayers, were provided to IRS in 1980 by certain tax treaty countries. Canada accounted for 732,400, or 92 percent, of the 793,000 returns. Only 3 of the 15 tax haven countries with whom the U.S. has a tax treaty (Luxembourg, the Netherlands,

and Switzerland) provided information returns to IRS in 1980. Since not all treaty countries and no nontreaty countries routinely provide information returns to IRS, it seems apparent that the \$11.6 billion does not reflect all of the income earned overseas by U.S. citizens.

Approximately 129,000 of the 793,000 returns, totaling \$10.9 billion, represented payments to businesses. None of these returns could be matched because IRS does not have a document matching program for business tax returns. Developing and operating such a program would, of course, be an expensive undertaking. And the potential benefits of such a program cannot now be predicted because the extent to which this income presently goes unreported is unknown.

Still, IRS has recognized that it needs to begin making use of the documents. To that end, IRS revised its processing procedures for these forms in January 1983 so that selected business information returns soon will be forwarded to IEP examiners. IEP officials, however, have not yet determined how the returns can best be used. Consideration is being given to associating the forms, at least on a test basis, with tax returns undergoing examination. The results of such a test would be used to make decisions on how the returns can and should be used.

With respect to individual taxpayers, IRS was able to use 343,000 foreign information returns, reflecting \$394 million in payments to individual U.S. taxpayers, in its document matching program. However, IRS collected no data on the number of actual

matches, or the amount of additional tax assessments or collections resulting from such matches. As a result, IRS does not know how much of the matched foreign source income went unreported by U.S. taxpayers. IRS needs to develop this type of data in order to assess the utility of these foreign information returns. Making such an assessment should not prove to be a very costly project if random sampling techniques are used. And such an assessment is particularly important because the data would help IRS determine the cost/benefit potential of efforts to perfect unusable foreign information returns.

In this regard, in 1980, IRS received 321,000 foreign information returns, reflecting \$323 million in payments to individual U.S. taxpayers, which it could not match against tax returns. This was because the foreign information returns (1) were incomplete (for example, they contained no taxpayer identification number) or (2) were received too late to be processed by IRS. In the past, IRS made an effort to perfect as many of the unusable returns as possible. IRS decided recently, however, that due to budget constraints, incomplete returns would no longer be perfected. Instead, the unused returns will simply be shipped to a Federal records center for storage.

As previously mentioned, IRS needs to determine the cost/benefit potential of efforts to perfect these returns. And, on a related matter, IRS also needs to begin making more effective use of information provided it by U.S. withholding agents.

Information provided by
withholding agents

Foreign taxpayers are subject to a statutory 30-percent tax on various types of income, such as interest, dividends, rents, and royalties, which is paid to them by U.S. businesses and individuals. On the other hand, certain interest income earned by foreigners on deposits with U.S. banks, savings institutions or insurance companies is not subject to the 30-percent tax and is not reported to IRS.

When the income is subject to tax, it is withheld at source by U.S. withholding agents. The withholding agent can be the actual payor of the income or an agent of the payor, such as a bank or brokerage house. As shown in charts A and B, a basic source of information on these transactions is documents provided IRS by the withholding agents.

Withholding agents are required to identify each treaty benefit recipient for IRS through submission of form 1042S. IRS, in turn, supplies that information to treaty partners, as appropriate, via form 5335. By matching that form against internal records, treaty partners can determine whether the income recipient is complying with their tax laws.

The statutory 30-percent tax on U.S. source income paid to foreign persons can be reduced or eliminated if the recipient is entitled to tax treaty benefits. Recipients can claim treaty benefits with respect to interest, rents, and royalties by providing the withholding agent with a completed IRS form 1001. The form 1001 identifies the recipient of the income, the kind of

income involved, and also contains a statement that the recipient qualifies for the relevant treaty benefits. A different procedure applies for obtaining reduced rates of tax for U.S. source dividends. Under the so-called "address method," the withholding agent may automatically reduce the tax rate if the dividend recipient's address is in a country with which the U.S. has a tax treaty providing for a lower tax rate.

In tax year 1981, IRS' Philadelphia Service Center received approximately 575,000 information returns from U.S. withholding agents. The returns reflected about \$9.6 billion of U.S. source income paid to foreign persons. If tax treaties did not provide for reduction or elimination of the 30-percent tax on U.S. source income, the Federal Government presumably would have collected 30 percent of the \$9.6 billion in taxes, or about \$2.9 billion. In contrast, the agents actually withheld approximately \$727 million in tax on this income, for an effective tax rate of 7.5 percent. Certainly, a portion of the wide gap between the \$2.9 billion and the \$727 million represents legitimate use of treaty benefits by bona fide residents of treaty countries. Unfortunately, however, it is well known that a portion of the gap is attributable to treaty shopping.

In this regard, approximately \$6.5 billion, or 68 percent, of the aforementioned \$9.6 billion was paid to foreign persons claiming residence in five countries--the Netherlands Antilles, the United Kingdom, the Netherlands, Canada, and Switzerland. Three of these countries--the Netherlands Antilles, the Netherlands, and Switzerland--generally are considered by the

international tax community to be tax havens. Significantly, Netherlands Antilles residents received the most income, almost \$1.4 billion; had the least amount of tax withheld, \$26.6 million; and had the lowest effective tax rate on income, 1.9 percent.

Treasury believes that treaty benefits are being claimed by individuals who, in the eyes of the U.S., are not bona fide residents of the treaty havens. This is the case because many treaty havens liberally define who qualifies as a "resident" and because treaty benefits can be claimed based simply on a written statement made to a U.S. withholding agent.

Public and private sector Netherlands Antilles representatives freely acknowledge that only a small percentage of the \$1.4 billion in U.S. source income paid to that country in 1981 went to its citizens. Also, IRS' Internal Audit Division, in an August 1981 report, verified problems in this regard and estimated that Treasury was losing at least \$115 million annually because withholding agents were (1) affording treaty benefits to nonqualifying persons, (2) using incorrect or invalid tax rates, and/or (3) failing to remit taxes withheld.

Recognition that treaty shopping is a serious and growing problem has prompted various actions by Treasury, IRS, and the Congress. For several years now, for example, Treasury's International Tax Counsel--the agency's chief tax treaty negotiator--has sought to incorporate strict anti-treaty shopping provisions in all new and renegotiated tax treaties. This is particularly important with countries which are considered to be tax

havens, such as the British Virgin Islands and the Netherlands Antilles.

Meanwhile, in September 1982, IRS began testing an experimental computer program aimed at detecting mathematical errors on information documents supplied the Service by U.S. withholding agents. As of February 1983, the program reportedly has generated tax and interest assessments of about \$2.5 million. Of this, about \$360,000 has been collected. Furthermore, IRS has recently conducted selective audits of 28 of the more than 14,000 U.S. withholding agents to assess the agents' compliance with withholding requirements. The audits identified various compliance and administrative problems. For example, some agents were granting tax treaty benefits without adequate justification and/or using incorrect tax withholding rates; others were not maintaining or updating required documents.

In 1982, this subcommittee held hearings on the improper use of foreign addresses to evade U.S. taxes. Shortly thereafter, the Tax Equity and Fiscal Responsibility Act of 1982 specified that the Treasury Department was to develop and implement, within 2 years, a means for assuring that treaty benefits accrue only to persons entitled to receive them. In response, Treasury has recently corresponded with 39 U.S. tax treaty partners requesting information on their systems for verifying the appropriateness of treaty benefit claims. In addition, information was requested concerning the type and level of assistance the treaty countries could provide if Treasury and IRS were to change current procedures for certifying entitlements to tax treaty benefits.

As of March 30, 1983, 23 treaty countries had responded and IRS was in the process of evaluating the information.

Thus, IRS' efforts have focused primarily on using information it already receives from taxpayers and other sources concerning international transactions. Further improvements are needed in those efforts, however. And, although continued improvement in methods for using available information are warranted, such methods alone cannot fully address the fundamental problem associated with tax havens. That is, when individuals or businesses use tax havens to perpetrate, facilitate, or conceal illegal activities, including tax evasion, it is highly unlikely that routine civil tax enforcement activities will detect many offenders.

Given this lack of information, IRS must rely on other means to identify taxpayers who are evading taxes through the use of tax havens. IRS' Criminal Investigation Division (CID) would seem to have sufficient authority and expertise to carry out the sensitive investigative operations that may be necessary to identify some of these taxpayers.

IRS' Criminal Investigation Division
is becoming more active in seeking
to combat tax haven abuses

CID has primary responsibility for investigating potential criminal violations of the Internal Revenue Code. CID conducts criminal investigations of U.S. citizens, including citizens residing abroad, and nonresident aliens who are subject to U.S. filing requirements. Some of these investigations begin as a result of referrals from IRS' Examination and Collection Divisions. But CID also generates its own cases through independent information gathering activities and coordination with other law

enforcement agencies. In carrying out self-initiated information gathering activities, CID is authorized to use paid informants, undercover operations, electronic surveillances, and other specialized investigative techniques.

As previously discussed, over the past two decades, CID has conducted various special projects and investigations in an effort to identify taxpayers using tax havens to evade U.S. taxes. Some of those projects generated controversy, however, due to actual and alleged IRS abuses of taxpayers' rights. Consequently, IRS suspended its covert intelligence gathering activities for a period of time in the mid-1970s. And subsequently, for a variety of reasons, CID was hesitant to conduct sensitive information gathering efforts. Among other things, IRS managers wanted to avoid bringing any further negative publicity on the agency. Also, strict legislative and management controls had been put into effect in response to the actual and alleged abuses. In some instances, however, the remedies themselves had unintended effects. A case in point, for example, were the disclosure restrictions set forth in the 1976 Tax Reform Act. Those restrictions essentially isolated CID from other Federal law enforcement agencies. The Congress, however, modified those restrictions through enactment of the Tax Equity and Fiscal Responsibility Act of 1982.

In fact, for several years now, the Congress has indicated to IRS its desire to have the Service get more involved in Federal efforts to combat illegal activities, particularly narcotics trafficking. And, in recent years, CID has exhibited a

growing willingness to once again become active in efforts to detect and deter those who derive income from illegal activities and who, in the process, also violate the tax laws.

For example, CID currently is involved in investigating narcotics and organized crime figures for possible tax violations. Its key project in this area is "Operation Greenback," a coordinated Treasury/IRS/Justice financial investigative task force. The project is directed at investigating possible criminal violations by focusing on individuals who deposit and/or withdraw large amounts of currency from financial institutions in Florida. Since Operation Greenback began in 1980, IRS has reportedly initiated over 180 investigations. Already, 120 individuals and corporations have been recommended for prosecution. Of these, 81 have been indicted and 23 have been convicted. Much of the success of Operation Greenback has been due, in part, to the use of informants and undercover operations.

Through Operation Greenback, CID managers and special agents have regained a measure of confidence in their ability to carry out sensitive investigations. Also, perhaps in part because of successes under Operation Greenback, CID has recently initiated an information gathering project aimed specifically at identifying U.S. taxpayers who are using tax havens and offshore banks to evade U.S. taxes.

Clearly, CID needs to be involved in IRS efforts to detect and deter tax haven abuses. At the same time, however, we would offer a caution. Neither IRS nor any other law enforcement agency should soon forget privacy concerns or concerns over

individuals' rights. IRS can and should carry out sensitive investigative efforts--but these efforts should be carried out in accordance with all applicable laws. And strict managerial controls over sensitive operations are necessary to insure that there is no repetition of the abuses associated with some law enforcement activities in the early 1970s.

IRS thus should continue to supplement its civil tax enforcement efforts with criminal tax investigative efforts. Still, IRS alone cannot solve the tax haven problem. It needs assistance from the Treasury Department in the form of more effective tax treaties.

THE TREASURY DEPARTMENT IS
IMPLEMENTING A FIRM TAX TREATY
RENEGOTIATION POLICY WITH RESPECT
TO TREATY HAVENS

Over the past 5 years, the Treasury Department has become increasingly concerned about tax treaty abuse by both U.S. and foreign investors. In an effort to remedy the problem--which centers primarily on tax haven countries which have treaties with the United States--the Treasury Department has decided to renegotiate all applicable treaties. In so doing, Treasury appears to be taking a hard line approach to renegotiations--an approach which is both warranted and necessary from a tax policy perspective. That is, Treasury is seeking to include strong exchange of information and anti-abuse measures in all new and renegotiated treaties. In carrying out this approach, however, Treasury necessarily has to coordinate with the Departments of State and Justice to assure that appropriate consideration is

given to foreign policy and nontax law enforcement concerns. This presents difficulties for Treasury, as evidenced in its efforts to renegotiate the U.S. tax treaty with the Netherlands Antilles.

Treasury's firm approach to tax treaty renegotiations is warranted from a tax policy perspective

Most U.S. tax treaties with tax haven countries are in effect because previous U.S. treaties with developed nations were extended to present and former colonies of those nations. U.S. tax treaties generally modify domestic law by affording residents of the treaty country low or no U.S. taxes on certain kinds of U.S. source income. For the most part, Treasury wants treaty benefits limited to bona fide residents of the treaty country. That is, Treasury does not want third-country investors to improperly derive treaty benefits. Also of concern to Treasury is improper use of treaties by U.S. citizens.

In several treaty haven countries, such as the Netherlands Antilles, for a relatively small fee, almost anyone can establish a "resident company." This is because, as previously mentioned, many treaty havens liberally define the term "resident." Once residency has been established, the company can take advantage of the U.S. treaty with the tax haven country. And, despite the fact that there are varying anti-abuse measures in most treaties, there is little that the U.S. can do to identify the beneficial owners of such companies-- especially when the element of bank secrecy is taken into account.

Although the actual extent to which treaty shopping takes place is unknown, it is generally considered to be a pervasive problem. In this regard, the January 1981 report on tax havens stated that

"...there is significant use of treaty countries in general, and tax haven treaties in particular for investment in the United States. Much of this use must be by nonresidents of the treaty country, because the volume of investment does not bear any relationship to the indigenous populations of those countries. In 1978, \$3.9 billion out of a total of \$4.5 billion, or 89 percent, of gross income paid to nonresidents of the United States was paid to treaty countries. Of that amount, \$1.8 billion out of the total \$4.5 billion of gross income paid to nonresidents of the United States went to treaty countries which are also tax havens. In that same year, \$309 million or 31 percent of the interest paid to nonresidents went to tax haven treaty countries, and \$1.4 billion or 48 percent of the dividends paid went to tax haven treaty countries."

Moreover, according to IRS statistics, in 1981, \$4 billion, or 44 percent, of the \$9.6 billion in gross income paid to nonresidents of the U.S. was paid to "residents" of treaty haven countries.

In an effort to curb this serious problem, Treasury has decided to begin renegotiating each tax treaty now in effect with tax haven countries. Treasury's policy is to include stronger exchange of information and anti-abuse measures within each renegotiated treaty. Initial results from the application of Treasury's policy are difficult to evaluate. In this regard, effective January 1, 1983, the U.S. terminated its treaty with the British Virgin Islands because that country refused to accept stronger exchange of information and anti-abuse provisions. The British Virgin Islands, however, was a relatively small treaty haven country. In 1981, for example, only \$24 million in U.S. source income was paid out to residents of that country. Moreover, the U.S. had only limited financial and other dealings with the British Virgin Islands. Nevertheless, by terminating the treaty, Treasury sent a meaningful signal to the international tax community. Specifically, Treasury evidenced its intent to deal firmly with treaty haven abuses.

The decision to terminate that tax treaty, however, may have nontax related effects on both the British Virgin Islands and the United States. According to a British Virgin Islands representative, that country derived some 10 percent of its national income from offshore banking activities directed particularly at investments in the U.S. Thus, Treasury's decision to terminate the tax treaty likely will affect the economy of that nation. The representative also noted that the British Virgin Islands might be less receptive to cooperating with U.S. law enforcement

officials in the future. Moreover, he noted that the country might simply seek to become a nontreaty haven in an effort to maintain its offshore banking business.

Recently, another treaty haven country--Antigua--notified Treasury of the intent to terminate its tax treaty with the United States. Antiguan officials publicly expressed the desire to develop international financial and trading operations similar to those which have developed in other nontreaty havens, such as the Bahamas and the Cayman Islands.

The results of the above actions concerning the British Virgin Islands and Antigua are difficult to evaluate. Nonetheless, there remains no doubt that strong action is needed to deal with treaty haven abuses. From a tax policy perspective, Treasury's firm approach to treaty negotiations is warranted. Without strong action, there is little chance of halting treaty haven abuses which result in substantial annual tax revenue losses.

Although Treasury emphasizes tax policy and tax administration concerns during treaty negotiation, other national concerns, such as those relating to foreign policy and law enforcement, also enter into the treaty renegotiation process. This perhaps has best been demonstrated during Treasury's ongoing efforts to renegotiate the U.S. tax treaty with the Netherlands Antilles.

Renegotiating the U.S. tax treaty with the Netherlands Antilles has proven to be a very formidable task

As you know, Mr. Chairman, Treasury is currently renegotiating the U.S. tax treaty with the Netherlands Antilles.

Treasury's primary concern with the existing Antilles treaty centers on its belief that the treaty is being used extensively for treaty shopping purposes. In particular, Treasury is concerned about third-country investors' use of the treaty. It also suspects that U.S. citizens are taking advantage of the anonymity provided by Netherlands Antilles bearer share companies to evade U.S. taxes. For this reason, Treasury is now seeking to incorporate stronger exchange of information and anti-abuse measures in a renegotiated treaty. But the negotiations have been complicated by two major concerns.

First, the economy of the Netherlands Antilles, a pro-American Caribbean country, depends very heavily on offshore banking activities. Second, the U.S. is currently seeking to negotiate a mutual assistance law enforcement treaty with the Netherlands Antilles. I will discuss each of these factors in more detail but, as you requested, I would first like to outline how the current U.S. tax treaty with the Netherlands Antilles can be used by third-country and U.S. investors.

How third-country and U.S. investors can use the tax treaty

In order to make advantageous use of the U.S. tax treaty with the Netherlands Antilles, an investor must first incorporate a company in that country. Doing so is not a difficult task. And once a company has been formed, it can be used as an effective conduit for a variety of investments.

According to banking and trust company officials in the Netherlands Antilles, establishing an offshore company is not a

difficult task. Typically, a foreign investor will contact a U.S. lawyer to seek advice on how best to structure an investment in the United States. The U.S. lawyer evaluates the range of possibilities and sometimes determines that use of a Netherlands Antilles company would be advantageous. When that is the case, the lawyer contacts a Netherlands Antilles trust company on behalf of the foreign investor. In some cases, the name of the beneficial owner of the Antilles' company is made known to officials of the Antilles trust company. In other cases, however, the identity of the beneficial owner is known only to the U.S. lawyer or to another party involved in the transaction.

On the basis of the attorney's instructions, the Netherlands Antilles trust company then prepares the necessary incorporation documents for the new company, obtains the required Minister of Justice approval of the draft articles of association, and arranges for the deed of incorporation to be executed before a civil law notary.

To incorporate in the Netherlands Antilles, a company must have two founders--individuals or entities--and a managing director. The managing director must be a Netherlands Antilles person. Typically, the Netherlands Antilles trust company will supply some or all of the three parties needed to incorporate a company. Thus, the name of the beneficial owner of the new Netherlands Antilles company need not appear within the articles of association. Once appointed, the managing director registers the company with the Netherlands Antilles Chamber of Commerce.

The newly incorporated company often maintains a continuing relationship with the Netherlands Antilles trust company. In this regard, the trust company may

- provide a domicile and mailing address for the new company,
- organize and conduct shareholder and board of director meetings,
- prepare and file Netherlands Antilles tax returns, and
- maintain corporate accounting records and provide other services as needed.

We were unable to ascertain what fees a Netherlands Antilles trust company generally charges for setting up and/or maintaining a new corporation. However, there are some relatively small public fees that are incurred. For example, incorporating a Netherlands Antilles company results in a notary fee of \$600, a Chamber of Commerce registration fee of \$60, a fee for the publication of the articles of association of \$210, and a stamp duty of \$75 for a Minister of Justice "decree of no objection." In addition, a fee is charged for translating the original deed of incorporation into Dutch and an annual registration fee of at least \$17 must be paid. Companies must also have a minimum of \$6,000 in capital at the time of incorporation.

According to records maintained by the Netherlands Antilles Chamber of Commerce, about 25,850 corporations are registered in that country. Chamber of Commerce officials told us that they did not know how many of these corporations are actually

conducting an active business. Information was not available to us on the number of accounts maintained in particular Netherlands Antilles banks.

Once a company has been formed in the Netherlands Antilles, the investor may proceed to take advantage of that country's treaty network, particularly the treaty with the United States. Although there are several different kinds of Netherlands Antilles companies, some of the more important types are finance subsidiaries, real estate companies, and investment companies. Some of these companies must file a form VS-3 or VS-4 with U.S. withholding agents in order to take advantage of the treaty. These forms, which must be certified by the Antilles Minister of Taxation, indicate that the company meets certain criteria. Among the criteria is a residency requirement. Companies experience little difficulty in gaining this certification because Antilles law does in fact afford them "resident" status upon incorporation. In any case, the following are examples of how certain kinds of companies can benefit from the U.S. tax treaty with the Netherlands Antilles.

--A finance subsidiary typically is a wholly-owned subsidiary of a U.S. corporation. These companies are designed to enable the parent corporation to gain access to the Eurodollar market which often provides a more favorable interest rate than is available in the U.S. The parent corporation could float a bond issue overseas without using a Netherlands Antilles finance

subsidiary. But interest paid to foreign purchasers of the bonds would be subject to a 30 percent withholding tax. By structuring the bond issue through an Antilles finance subsidiary, the 30-percent withholding tax can be eliminated.

--A real estate company is used primarily to channel funds into U.S. real property, such as apartment buildings and shopping centers. Foreign investors can invest funds directly in U.S. real estate. But rents and royalties arising from such investments generally are taxed at the 30-percent rate. Also, any capital gains would be subject to tax. By structuring such investments through a Netherlands Antilles company, an investor can avoid the 30-percent withholding tax. Moreover, until recently, investors also were able to avoid U.S. tax on capital gains. But the Foreign Investment in Real Property Tax Act of 1980 has made the use of Antilles real estate companies somewhat less attractive. This is because the act provides that nonresident aliens and foreign corporations will be taxed on capital gains arising from the sale of real property in the United States. However, the more favorable treaty rates will apply through 1984.

--Like a real estate company, an investment company is used primarily to channel funds into the United States. Investment companies, however, generally are used to purchase securities, such as stocks and bonds. Again, foreign investors can invest directly in U.S. security

markets. In so doing, however, the investor typically encounters the 30-percent withholding tax. But, again, by structuring such transactions through a Netherlands Antilles company, an investor can use the tax treaty to reduce or avoid that tax.

These examples demonstrate how Netherlands Antilles companies can benefit from the U.S. tax treaty with that country. And since the Netherlands Antilles' domestic law prohibits its citizens from establishing offshore companies, it seems apparent that most of these companies are owned instead by third-country residents or, perhaps, U.S. citizens. It would be relatively easy for a U.S. citizen to evade U.S. taxes through use of a Netherlands Antilles company. To do so, with virtual assurance of anonymity, the U.S. citizen needs only to start by establishing a shell company in a nontreaty haven. Then the shell company would form a Netherlands Antilles company and proceed to take advantage of the tax treaty through investments in the United States.

In this case, IRS would receive only one tax related information return annually concerning the Netherlands Antilles company--a form 1042S from the U.S. withholding agent--showing the amount of U.S. source income paid to the Netherlands Antilles company. And, if IRS wanted to get further information on the company, it would experience almost insurmountable difficulties. First, it would have to convince the Netherlands Antilles government of the need for the information. The Antilles government, in turn, would have to convince the company's Antilles-based

managing director to reveal the information--something a director is disinclined to do unless there is proof of serious wrongdoing. And, even if this hurdle were overcome, the director could at best inform the Antilles government and IRS that the apparent beneficial owner is the nontreaty haven shell company. Then, IRS would be placed in the position of trying to get further information from the nontreaty haven government--a very difficult if not impossible task.

The Antilles government could take action to remedy some of the problems associated with third-country and possible U.S. citizen use of the treaty. This could be accomplished in part through a tightening of the definition of the term "resident" and effective use of form 5335. As previously discussed, IRS uses the information provided on form 1042S to prepare form 5335. This form is sent to tax treaty countries to inform them that individuals or companies have claimed residence there and have received U.S. source income.

The tax treaty country can use form 5335 to assure compliance with its domestic tax laws. But the forms can prove beneficial to the United States as well. For example, according to IRS' Internal Audit Division, the U.S. derives some \$60 to \$80 million in additional taxes annually from Switzerland's use of form 5335. In this regard, Swiss tax administrators use the form to identify persons not entitled to treaty benefits. Then, in conjunction with their own internal tax administration activities, Swiss tax officials also levy the 30-percent withholding tax that has been avoided and remit the proceeds to the United

States. In contrast, during the period 1978 through 1981, IRS sent 6,710 forms 5335 to Netherlands Antilles tax authorities. According to IRS officials responsible for the program, they could not recall the Netherlands Antilles having returned any of the forms 5335 to the Service since at least 1979.

The Netherlands Antilles has not taken any unilateral actions to remedy treaty-related abuses, nor is it expected to soon do so. This is because, according to Netherlands Antilles officials, such actions would have the effect of essentially closing down the offshore financing business in that country.

Thus, absent strong action, Treasury cannot soon expect to reverse the growth in, much less halt, undesirable use of the U.S. tax treaty with the Netherlands Antilles. In this regard, in tax year 1980, a total of \$684 million in U.S. source income was paid to Netherlands Antilles "residents." In tax year 1981, that figure had grown to \$1.4 billion, making the Antilles the leading worldwide recipient country for U.S. source income which is reported to IRS. The Treasury Department, of course, wants to bring a halt to this growth rate through a renegotiated tax treaty. However, Treasury has faced a series of difficulties in trying to do so.

Other factors affecting
the negotiations

One factor affecting the current negotiations in the status of the Netherlands Antilles' economy. That country's economy is based primarily on four major activities--crude oil refining and transshipment, ship repair and servicing, tourism, and offshore

financial operations. According to public and private sector representatives of the Netherlands Antilles, only one of the four activities--offshore financing--has been a reliable source of economic growth for the Antilles in recent years. That business is based primarily on the island of Curacao.

For a variety of reasons, the other major sectors of the economy have been declining recently. The officials informed us, for example, that the Shell Oil refinery in Curacao needs costly capital improvements, as well as a dependable supply of oil, in order to remain viable.

Concerning ship repair and servicing, we were informed that high union wage scales in Curacao have caused the island to lose its competitive edge over other countries. Meanwhile, tourism in Curacao apparently has declined recently, in part, because Venezuela devalued its currency. In 1980, Venezuelans reportedly represented 50 percent of all tourists who visited the Antilles. Now, any Venezuelans contemplating a visit to the Antilles must take into account the fact that they will incur greater costs.

Furthermore, the economic problems facing the Netherlands Antilles are compounded by the current political situation there. In this regard, Aruba--currently the most prosperous of the six Antilles islands--hopes to soon become an independent nation. If that were to come about, Curacao--the largest of the five remaining islands and the base for the Antilles central government--would have to assume primary financial management responsibility for the nation. And, it would have to do so without support from tax revenues arising from Aruba's tourist and

oil industries. In this regard, Aruba has historically catered more to non-Venezuelan tourists than has Curacao and thus has suffered, and probably will continue to suffer, less from Venezuela's recent currency devaluation. Also, Aruba's oil refinery, as part of an integrated oil company, has a fairly dependable supply of oil and a stable market for its product.

Thus, offshore financing activities are important to the Netherlands Antilles in general and to Curacao in particular. According to information provided us by the Central Bank of the Netherlands Antilles, taxes from offshore financial activities accounted for \$76.5 million, or about 16 percent, of the Antilles total 1981 tax receipts.

Of course, Mr. Chairman, the point of this discussion is to illustrate that in renegotiating the U.S. tax treaty with the Netherlands Antilles, the Treasury Department is also dealing with key aspects of that country's overall economy. This, in turn, becomes a foreign policy concern. The Senate Foreign Relations Committee will most likely inquire into this issue should Treasury be able to present that Committee with a renegotiated treaty proposal. Thus, while it is clear, from a tax policy perspective, that the U.S. can no longer tolerate extensive abuse of the current tax treaty, other concerns come into play. The status of the Netherlands Antilles' economy is one such concern; the United States' desire for ready access to the Eurodollar market is another, related concern.

Netherlands Antilles offshore financial activities, particularly the use of finance subsidiaries, has grown substantially

over the years. As I mentioned previously, finance subsidiaries are wholly-owned subsidiaries of U.S. corporations which are used to gain access to Eurodollar markets.

In the early 1960s, the United States was experiencing a serious balance of payments problem. One remedy for this problem involved encouraging U.S. multinational corporations to borrow funds overseas to finance their foreign operations. Subsequently, however, the corporations exhibited a need for and a desire to use the foreign funds to finance U.S. operations. But the 30-percent withholding tax on interest paid to foreigners acted as a disincentive for foreign investors--at least until the concept of Netherlands Antilles finance subsidiaries evolved.

During the 1960s and early 1970s, IRS consistently issued rulings approving use of the U.S./Netherlands Antilles tax treaty in the manner described. And, although IRS stopped issuing such rulings in 1974, it did not challenge continued and expanded use of such finance subsidiaries by U.S. corporations until 1982. At that time, of course, Treasury was involved in renegotiating the Netherlands Antilles tax treaty.

Thus, Treasury and IRS have played some role in the development of the finance subsidiary business in the Netherlands Antilles. U.S. corporations have borrowed billions through their Antilles-based finance subsidiaries. Those funds have been used to finance both domestic and international corporate activities. Thus, the Eurodollar market has been and is now a source of funds for U.S. corporations. This poses a problem for the Treasury Department. If it were to eliminate use of the finance subsidiaries by U.S. corporations as part of a renegotiated treaty,

those corporations' capital costs would increase--unless other means for accessing the Eurodollar market were devised. In this regard, there have been proposals, from time to time, to eliminate the 30-percent withholding tax on U.S. source income paid to foreigners.

Thus, Treasury faces particular difficulties in deciding how to deal with the finance subsidiary issue. Beyond that, it also has had to take into account the fact that the Justice Department is currently seeking to negotiate a mutual assistance law enforcement treaty with the Netherlands Antilles. Mutual assistance law enforcement treaties are bilateral agreements between countries to cooperate in investigations of criminal activities. In this regard, Justice officials informed us that the Antilles government has provided them with useful information and assistance concerning the flow of drugs through the Caribbean. Netherlands Antilles government representatives told us, however, that their willingness to conclude a mutual assistance law enforcement treaty with the United States would be affected by the outcome of the current tax treaty negotiations.

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Where does all of this leave us, Mr. Chairman? On the one hand, it is clear that the existence of tax treaty havens such as the Netherlands Antilles not only provide opportunities for, but indeed, promote and facilitate tax evasion. On the other hand, the case has been made that some of our national purposes are served, at least in the case of the Netherlands Antilles, by lowering the cost of American businesses' Eurodollar borrowings and promoting capital inflows.

It is a fact that this beneficial access to the Eurodollar market could be just as easily achieved by changing or eliminating the withholding tax requirement applicable to such borrowings--something that Treasury itself has proposed in the past. It is also possible that national purposes would not be adversely affected even if U.S. businesses had to pay higher, in effect unsubsidized, rates of interest for Eurodollar borrowings.

Another benefit that purportedly derives from the Netherlands Antilles and other treaty tax haven arrangements is the promotion of capital flows into this country. Undoubtedly, there is such an effect, but it is also true that by far, the bulk of such flows over the years have come directly from other developed nations without a detour through a tax haven.

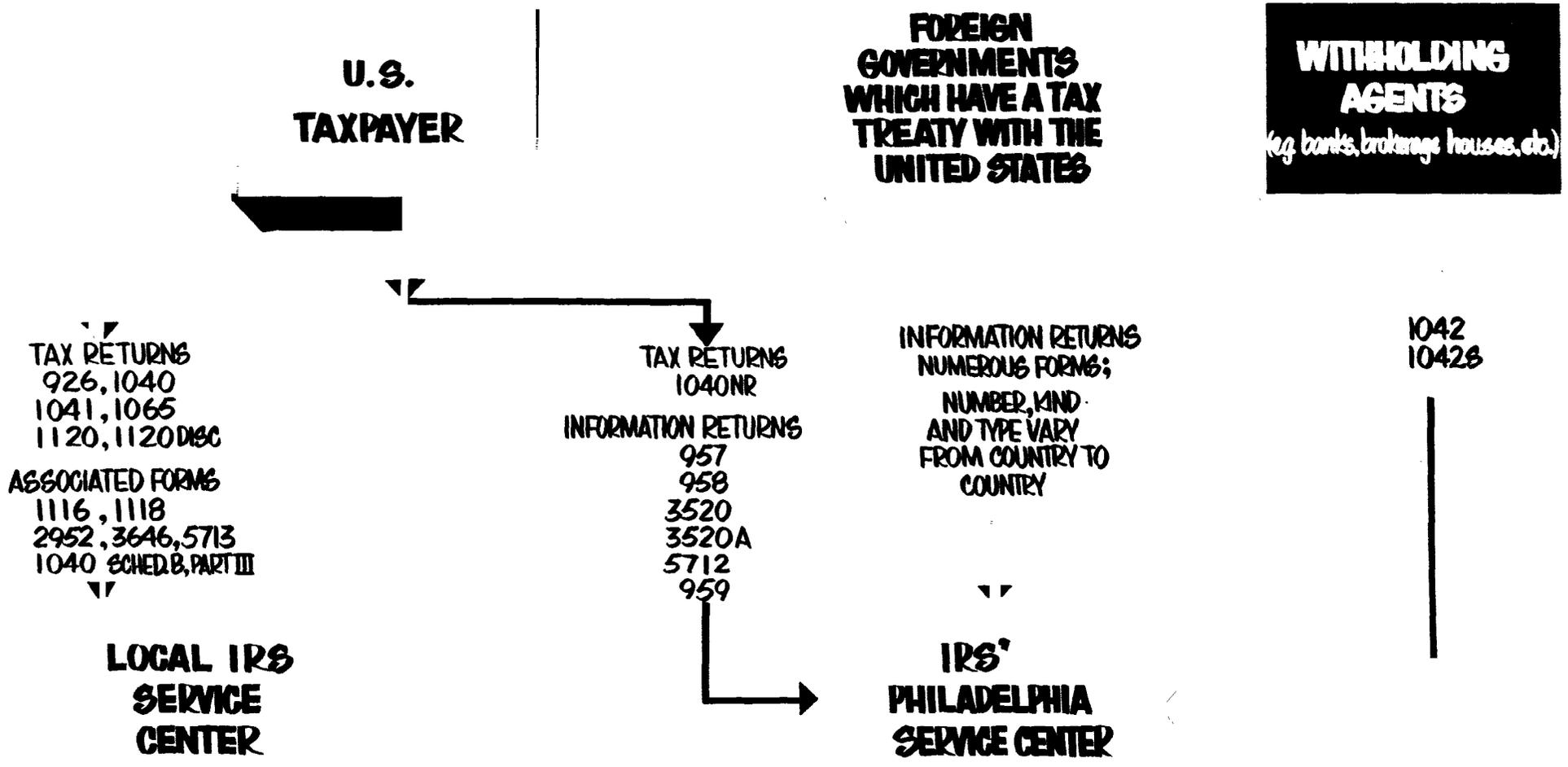
Thus, it would appear that the national benefits obtained as a result of treaties with tax havens are not solely dependent on such arrangements and could in all likelihood continue to be realized in other ways.

Having said that, we can conclude that termination of treaties with tax havens would not affect the credit side of the ledger, but would essentially reduce the debits by removing opportunities for tax evasion. It is clear, therefore, that from a purely tax administration standpoint, this country should only maintain treaties with tax havens when these treaties provide iron clad assurance that their provisions would not be used in an unlawful fashion. If this type of assurance cannot be obtained, then there would seem to be no good reason for entering into or continuing such arrangements.

Having said that, Mr. Chairman, I want to emphasize that I am speaking from a tax administration perspective. As to whether foreign policy or nontax law enforcement considerations should outweigh the tax administration benefits is something that we are not in a position to address authoritatively.

That concludes my statement. We would be pleased to answer any questions the committee may have.

SELECTED INTERNATIONAL TAX INFORMATION SUPPLIED TO IRS



TAX RETURNS

FORM NO.	TITLE
926	RETURN BY A TRANSFEROR OF PROPERTY TO A FOREIGN CORPORATION, FOREIGN TRUST, OR FOREIGN PARTNERSHIP.
1040	INDIVIDUAL INCOME TAX RETURN
1040 NR	NON RESIDENT ALIEN INCOME TAX RETURN
1041	FIDUCIARY INCOME TAX RETURN
1065	PARTNERSHIP INCOME TAX RETURN
1120	CORPORATION INCOME TAX RETURN
1120 DISC	DOMESTIC INTERNATIONAL SALES CORPORATION RETURN.

ASSOCIATED FORMS

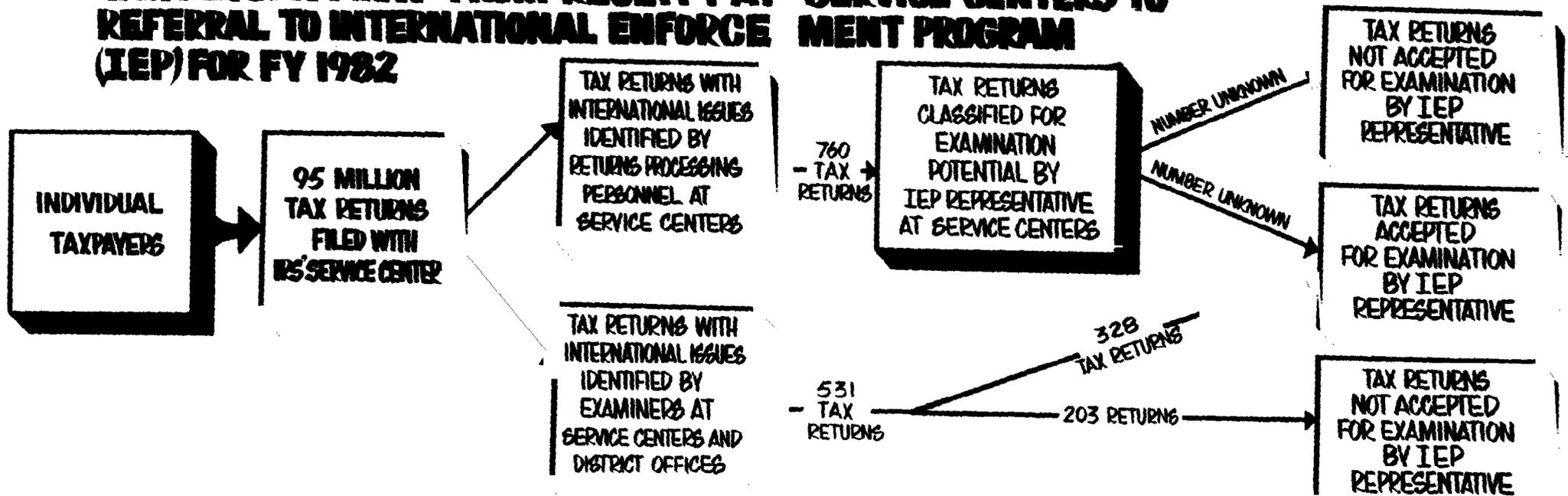
FORM NO.	TITLE
1116	COMPUTATION OF FOREIGN TAX CREDIT-INDIVIDUALS.
1118	COMPUTATION OF FOREIGN TAX CREDIT-CORPORATIONS.
2952	INFORMATION RETURN WITH RESPECT TO CONTROLLED FOREIGN CORPORATION.
3646	INCOME FROM CONTROLLED FOREIGN CORP.
5713	INTERNATIONAL BOYCOTT REPORT
1040, SCHEDULE B, PART III	FOREIGN ACCOUNTS AND FOREIGN TRUSTS

INFORMATION RETURNS

FORM NO.	TITLE
957	FOREIGN PERSONAL HOLDING COMPANY
958	FOREIGN PERSONAL HOLDING COMPANY-ANNUAL REVIEW BY OFFICER OR DIRECTOR.
959	RETURN BY AN OFFICER, DIRECTOR, OR SHAREHOLDER WITH RESPECT TO THE ORGANIZATION OR REORGANIZATION OF A FOREIGN CORPORATION AND ACQUISITION OF ITS STOCK.
3520	CREATION OF OR TRANSFER TO CERTAIN FOREIGN TRUSTS
3520-A	ANNUAL RETURN OF FOREIGN TRUST WITH U.S. BENEFICIARIES.
5712	ELECTION TO BE TREATED AS A POSSESSIONS CORPORATION UNDER SECTION 936.
1042	U.S. ANNUAL RETURN OF INCOME TAX TO BE PAID AT SOURCE.
1042-B	INCOME SUBJECT TO WITHHOLDING UNDER CHAPTER 3, INTERNATIONAL REVENUE CODE.

TAX RETURN FLOW--FROM RECEIPT AT SERVICE CENTERS TO REFERRAL TO INTERNATIONAL ENFORCEMENT PROGRAM (IEP) FOR FY 1982

CHART



FOREIGN INFORMATION RETURNS PROGRAM TAX YEAR 1980

TAX TREATY COUNTRIES

COUNTRY	NUMBER OF DOCUMENTS PROVIDED	AMOUNT (\$ MILLIONS)
CANADA	732,400	6,184.7
WEST GERMANY	9,200	2,350.6
UNITED KINGDOM	8,700	1,108.3
SWITZERLAND	5,100	745.6
JAPAN	3,900	480.1
FRANCE	7,200	436.0
SOUTH AFRICA	700	132.9
TRINIDAD & TOBAGO	7,000	71.1
NEW ZEALAND	1,500	21.8
FINLAND	500	21.7
AUSTRALIA	1,200	17.2
SWEDEN	7,400	16.0
NETHERLANDS	3,700	11.9
NORWAY	4,300	5.9
LUXEMBOURG	*	3.1
DENMARK	200	1.2
BELGIUM	*	0.1
OTHERS	*	0.4

* LESS THAN 20 RETURNS

IRS' PHILADELPHIA SERVICE CENTER

723,000 FOREIGN INFORMATION DOCUMENTS RECEIVED:

- 664,000 PERTAINING TO INDIVIDUALS
- 129,000 PERTAINING TO BUSINESS

REFLECTING \$11.6 BIL. IN INCOME EARNED ABROAD BY U.S. CITIZENS

IRS' DOCUMENT MATCHING PROGRAM

343,000 FOREIGN INFORMATION DOCUMENTS REFLECTING \$394 MIL. IN INCOME-- MATCHED AGAINST TAX RETURNS WITH UNKNOWN FINAL RESULTS

450,000 FOREIGN INFORMATION DOCUMENTS-- REFLECTING \$11.2 BIL. IN INCOME--NOT MATCHED PRIMARILY BECAUSE THE RETURNS:

- (1) WERE INCOMPLETE,
- (2) CONTAINED NO TAXPAYER IDENTIFICATION NUMBER,
- (3) WERE RECEIVED TOO LATE TO BE PROCESSED, OR
- (4) PERTAINED TO BUSINESS TAX RETURNS WHICH ARE NOT SUBJECT TO MATCHING BY IRS.