THE PREVENTION OF TAX HAVENS VIA INCOME TAX TREATIES

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Benjamin Franklin opined that "nothing in this world can be said to be certain, except death and taxes."[1] Yet, legal tax avoidance has been regarded as desirable and respectable. As Judge Learned Hand stated:

> [A] transaction, otherwise within . . . the tax law, does not lose its immunity, because it is actuated by a desire to avoid. . .taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.[2]

Tax havens are used precisely for this end: to reduce tax liabilities. The problem, however, is that not all uses of tax havens are legal. Millions of dollars of income are illegally sheltered in tax havens each year, posing a distinct hardship on the revenue-produc-

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1. C. DOGGART, TAX HAVENS AND THEIR USES 1981 (EIU SPECIAL REPORT NO. 150) 1 (1981).

2. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd* 293 U.S. 465 (1935). Judge Hand also stated:

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor, and do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant.

Quotation in R. KINSMAN, THE ROBERT KINSMAN GUIDE TO TAX HAVENS 1 (1981)

Similar views prevail in the United Kingdom: "No man in this country is under the smallest obligation—moral or other—to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores." Ayshire Motor Pullman Motor Serv. v. Inland Revenue Comm'rs, 14 T.C. 754, 763-64 (1920).

Tax havens are not openly used to further illegal purposes; there are bona fide opportunities for United States taxpayers to invest in offshore tax havens. In many instances, the tax consequences of tax haven transactions reflect clear congressional intent to limit the scope of the United States taxing jurisdiction. Additionally, courts have consistently recognized the taxpayers' right to minimize their tax liability to the full extent that they are permitted by law, including opportunities afforded by offshore tax havens.

Comment, *The Use of Offshore Tax Havens for the Purpose of Criminally Evading Income Taxes*, 73 J. CRIM. L. & CRIMINOLOGY 675, 676-77 (1982).

ing sources of many countries.[3]

In 1981, in the report, *Tax Havens and Their Use by the United States Taxpayers—An Overview Report*,[4] the United States Government directly attacked the evasion of income taxes through tax havens. In examining the legal and illegal uses of tax havens, the Report concluded that the basis for the problem rests in the complexity of tax laws, enforcement difficulties, limited information gathering resources, the secrecy laws in tax haven jurisdictions and the lack of effective tax treaties. Some of the solutions that have attempted to solve the problem of the illegal use of tax havens have included changes in the laws relating to tax havens, improved enforcement efforts, changes in the reporting of taxes, greater compliance cooperation between taxing jurisdictions and changes in tax treaty policies.

Despite these efforts, there still is evidence that the use of tax havens as tax evasion devices is flourishing.[5] In fact, as recently as early 1986, the United States Commissioner of the Internal Revenue Service met with various foreign leaders to discuss the problem.[6]

The Article will atempt to show that the effective use of income tax treaties might be a solution to the problem of tax avoidance and

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3. Tax havens take in $20 billion dollars a year in hidden United States money. *Stark Calls for Action Against Tax Havens*, 28 TAX NOTES 1408 (1985).

4. R. GORDON, TAX HAVENS AND THEIR USE BY THE UNITED STATES TAXPAYERS—AN OVERVIEW, PUB. 1150 (Apr. 1981) [hereinafter REPORT]. For a detailed description of the Report, *see* Zagaris, *The IRS Tax Haven Report Proposes Many Reforms*, 16 TAXES INT'L, Feb. 1981, at 1.

5. A most recent example is the report of "offshore laundries" where tax haven services exist and attempt to lure taxpayers to invest in various schemes, some legal and some illegal. Such services even publish a daily tax haven tabloid. Kurtz, *The Offshore Laundry: IRS Putting Promoters Through Wringer*, Wash. Post, Dec. 9, 1985, at 1, col. 5. Several tax haven guidebooks have been published and are constantly updated. *See* E. CHAMBOST, USING TAX HAVENS SUCCESSFULLY (T. Crowley trans. 1978); W. & D. DIAMOND, TAX HAVENS OF THE WORLD (1981); GRUNDY'S TAX HAVENS: A WORLD SURVEY (J. Walters 4th ed. 1983); R. KINSMAN, *supra* note 2; M. LANGER, HOW TO USE FOREIGN TAX HAVENS (1975); B. SPITZ, TAX HAVENS ENCYCLOPEDIA (1985); A. STARCHILD, TAX HAVENS, WHAT THEY ARE AND WHAT THEY CAN DO FOR THE SHREWD INVESTOR (1979); Deloitte, Haskins and Sells, INT'L TAX NEWS (June 1986).

The United States Internal Revenue Service is constantly attempting to pull the plug on tax havens. *See A Treaty That May Sink Havens*, BUS. WK., Feb. 14, 1983, at 140, 142. *See also* DEPARTMENT OF THE TREASURY, TAX HAVENS IN THE CARIBBEAN BASIN 51 (Jan. 1984) [hereinafter TAX HAVENS IN THE CARIBBEAN BASIN].

6. On January 27, 1986, Roscoe L. Egger, Jr., the United States Commissioner of the Internal Revenue Service, met with tax leaders of France, Germany and the United Kingdom to address the issues of tax havens, tax treaty abuses and exchanges of tax information. This "Group of Four" heads of taxing authorities was formed in 1970 to expand and further the use of tax treaty provisions. *Egger Meets with International Tax Heads in Paris*, 30 TAX NOTES 392 (1986).

evasion through the use of tax havens. Particularly, it will deal with the United States' perceptions of the problem and its uses of treaties as a combative measure. In a sense, this Article will serve as a recent survey of the use of tax havens and tax treaties. Its focus will be a review of current treaties to determine if they have served as an effective solution.

The Article will first set forth the specific proposals for and solutions to the tax haven abuse problem, detailing how the effective use of tax treaties can prevent tax avoidance and evasion through tax havens. Background information on tax avoidance and evasion and tax havens will then be presented. The importance of income tax treaties and current treaty developments relating to tax havens will be examined along with a cursory view of tax evasion through "treaty shopping." This Article will then turn to a few collateral perspectives: a brief survey of the use of the courts as a tax haven prevention mechanism and an explanation of the tax haven problem as it confronts other countries. The substance of this Article will concentrate on the use of recent tax treaties as a prevention mechanism for the tax haven problem focusing on the United States' tax treaty policy.

INTRODUCTION

Tax havens have existed for some time but did not begin to present themselves as a major loss of revenue problem for the United States until 1970.[7] In the early 1970's, attention focused on tax havens, especially with regard to foreign manufacturing corporations which flourished using some of the then-existing tax havens such as Ireland. The long and detailed congressional report completed in 1981 was the first major attempt by the United States to deal with the problem. It was prepared over the course of about one year and contains 235 pages. It evolved as a direct response to congressional inquires and investigations.[8] The goals of the Report

7. "International tax avoidance and evasion, including the use of tax havens to avoid or evade United States taxes, have been of long-standing concern to the Congress and tax administrators." REPORT, *supra* note 4, at 3. In 1921, Congress initially focused on the use of foreign subsidiaries to milk United States parent corporations. In the 1930's, the concern was individuals transferring assets to tax havens. Congressional actions on the abuses of multi-national corporation began in 1962. The Bank Secrecy Act was passed in 1970, the same year the Internal Revenue Service began investigating tax havens. *Id.*

8. *Oversight Hearings into the Operation of the Internal Revenue Service (Operation Tradewinds, Project Haven, and Narcotics Traffickers Tax Program: Before the Subcomm. on Commerce, Consumer and Monetary Affairs of the House Comm. on Government Operations*, 94th Cong., 1st Sess. (1975).

were to find out what was going on in tax havens, quantitatively and qualitatively, to inform decision-makers and to suggest needed administrative, legislative and treaty changes.[9] The Report unequivocally concluded that there existed a wide-spread and growing use of tax havens by United States taxpayers, representing a serious tax compliance problem in the United States.[10]

A series of administrative and legislative changes have occurred since the Report was published.[11] Although not a treaty development per se, a significant change occurred in 1983 with the passage of the Caribbean Basin Initiative which dealt with a series of criminal and tax concerns.[12] This legislation can be regarded as a dis-

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> The purpose of the study was to develop an overview of tax havens and the use of tax havens by United States taxpayers. The study sought to determine the frequency and nature of the tax haven transactions, . . . obtain a description of the United States and foreign legal and regulatory environment in which tax haven transactions are conducted, describe Internal Revenue Service and Justice Department efforts to deal with tax haven related transactions, and to identify interagency coordination problems.

REPORT, *supra* note 4, at 1.

10. *Id.* at 5-10. *See also Growing Use of Tax Havens Is Serious Problem, Says IRS*, 151 J. ACCT. (Mar. 1981), at 22.

Even the Report's opponents admitted:

"There can be no disagreement with the Report's conclusions with regard to the need for the IRS to deal aggressively and effectively with situations of tax evasion." Aland, *The Treasury Report of Tax Havens—A Response*, 59 TAXES 993, 995 (1981).

Obviously, the primary reason for the existence of tax havens is the avoidance of taxes. The Report has outlined some other major factors for the use of tax havens: "(1) confidentiality; (2) freedom from currency controls; (3) freedom from banking controls, particularly the reserve requirements. [sic] (4) receipt of higher interest rates on bank deposits and to borrow at lower interest rates." REPORT, *supra* note 4, at 23. In addition the report noted that another consideration is anonymity. *Id. See also* M. LANGER, *supra* note 5, at 1-10.

11. Gordon, *The United States Government Report on Tax Havens: An Update*, CANADIAN TAX FOUND. 786, 789-95 (Ann. 1982). The legislative changes will be explored in some detail *infra* section H of part II.

12. Caribbean Basin Economic Recovery Act, Pub. L. No. 98-67, 97 Stat. 384 (1983) (codified at 19 U.S.C. 2701-2706 (Supp. III 1985)). *See also* H.R. REP. NO. 266, 98th Cong., 1st Sess. (1983).

> IRS Commissioner Roscoe L. Egger, Jr., told a Senate Subcommittee on March 15 [1983] that Treasury is losing billions of dollars of revenue to tax evaders who launder funds through offshore tax havens—especially in the Caribbean. Testifying before the Senate Governmental Affairs Subcommittee on Investigations, Egger stated that "to a considerable degree the activities in these tax havens involve narcotics traffickers and other elements of organized crime, illegal tax protestors, and promoters of abusive tax shelters."
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> But the offshore tax havens are also attracting "seemingly law-abiding persons of moderate means who are using offshore banking facilities and other offshore entities as a means of tax evasion," said Egger. The Commissioner explained that the tax havens include countries that have little or no tax on certain types of income and that provide "a certain level of banking or commercial secrecy."

Senate Committee Examines Offshore Tax Havens, 18 TAX NOTES 1070 (1983). *See Treasury Reports on Use of Caribbean Tax Havens*, 22 TAX NOTES 165 (1984). *See also* TAX tinct reflection of the United States treaty policies toward tax havens.[13] The changes in United States tax treaty policy, and actual treaty changes, will be explored in detail as the substance of this Article.

I. PROPOSALS

No single action will solve the problem of tax evasion or avoidance via tax havens. The United States' current efforts are a start. More attention, however, must be directed toward the problem. The use of tax treaties can be an excellent preventive mechanism for tax evasion through tax havens.

Although tax treaties are an effective mechanism for curbing tax haven abuses, the United States policy is not strict enough in requiring stringent anti-treaty shopping measures. The concessions in the form of exceptions to the much needed treaty with the Netherlands Antilles are examples.[14] The United States must specifically require strict anti-treaty shopping provisions in all future treaties and must also renegotiate existing treaties to provide for such provisions.

Further, the United States must terminate or renegotiate to its benefit and mutual interests tax treaties that exist with tax havens themselves. This is particularly so with treaties that have resulted from treaty networking.[15] The known abuses of these existing treaties require their immediate termination. The United States must hold strong to its anti-tax haven position through its negotiations with tax havens.[16]

There must also exist a method for examining current treaties for their effectiveness.[17] This is especially true in regard to exchange of

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HAVENS IN THE CARIBBEAN BASIN, *supra* note 5, at 50.

13. *See infra* section H of part II.

14. *See* discussion on Netherlands Antilles *infra* subsection 3b of section B of part V.

15. *See infra* subsection 3 of section B of part V.

16. "The best approach to dealing with treaty problems is to handle them through the negotiation process." REPORT, *supra* note 4, at 175.

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> Despite the obvious abuse of the treaties, a large and growing network of treaties, and an aggressive treaty negotiation program, existing treaties are not reviewed on any systematic regular basis, and the United States has shown little inclination to terminate them. Consequently, treaties which perhaps can be abused or which no longer serve a legitimate economic purpose are still in effect. Further, the United States has been slow to take action to deal with changes in the domestic laws of its treaty partners.

Id. at 151.

information provisions.[18] Use of these provisions is the critical ingredient to obtaining fiscal information which in turn can be used to end tax evasion. Proper enforcement must also be sought if the countries fail to comply with their exchange of information agreements.

Additional legislation in the United States dealing directly with tax havens is needed. The current tax reform legislation, however, is of little value to the tax haven and tax evasion problems. Possibly, tax haven operations could be affected by the proposed tax on United States branches of foreign companies.[19] There are some, however, who believe that the United States' most recent treaties conflict with this proposal.

More use of the courts through litigation might also present a solution to the tax haven problem. However, more attention and emphasis must be directed to this alternative before its viability can be established.

If no single action by one country will solve the problem, it is unreasonable to expect that addressing the problem in one region will deter the use of tax havens in other parts of the world.[20] Tax

18. *See infra* subsection 1 of section A of part V.

19. Under current U.S. tax law, the effectively connected income of a U.S. branch of a foreign corporation is subject to U.S. income tax, but there is no additional tax that would compare to the withholding tax imposed on dividends paid by a U.S. subsidiary of a foreign corporation on the branch's remittances to the home office. Instead, the U.S. imposes a withholding tax ("the second dividend tax") on a proportionate part of the dividends paid by the foreign corporation if more than fifty percent of the corporation's gross income is effectively connected with a U.S. trade or business.

According to the report on details of the Administration tax proposals, the existing second dividend tax "fails to equalize the tax treatment of branches and subsidiaries in many cases." The proposal is that the second dividend tax, and a "second interest tax" analogous to the dividend withholding tax paid by a foreign corporation to foreign persons, both be repealed. They would be replaced by an additional tax on the profits of U.S. branches of foreign corporations and on interest on (1) debt issued by a foreign corporation to an affiliate which is allocable to a U.S. branch of the corporation and (2) extensions of credit by a foreign bank to a foreign corporation which is allocable to a U.S. branch of the corporation. Skilling, *International Parts of Reagan Tax Package Very Similar to Earlier Treasury Proposals*, 12 TAX PLAN. INT'L REV., July 1985, at 3, 4. *See also* Stern, *Tax Plan May Hinder U.S. Firms Abroad*, J. Com., June 3, 1985, at 3A, col. 1

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> The United States alone cannot deal with tax havens. The policy must be an international one by the countries that are not tax havens to isolate the abusive tax havens. The United States should take the lead in encouraging tax havens to provide information to enable other countries to enforce their laws. For example, the United States could terminte tax treaties with abusive tax havens, increase the withholding tax on United States source income paid to tax havens and take other steps to discourage United States business from using tax havens. However, such steps taken unilaterally would place United States business at a competitive disadvantage as against businesses based in other OECD countries. Accordingly, a multilateral approach to deal with tax havens is needed.

haven activities may just be shifted to another geographic area. An international effort, such as a widespread multilateral treaty, might be useful to deal with the tax haven problem. The only current multilateral convention dealing specifically with tax evasion and avoidance is limited to five Nordic countries, only a regional effort. The European Economic Community has made some efforts in this area and surely the OECD Model Convention is an international approach.[21] The United States involvement in and encouragement of an international treaty is needed.

A combination as well as a culmination of these actions are necessary to effectively prevent tax haven abuse and eliminate international tax evasion. The United States' tax haven treaty policy must become firm.[22] The work by the United States has been started; aggressive efforts must continue.

II. TAX HAVENS

The very definition of a tax haven outlines its characteristics and requirements. Tax havens are countries which have a low or zero rate of tax on all or certain categories of income and which offer a high level of banking or commercial secrecy.[23] This definition may even be somewhat philosophical.[24] The history and types of tax havens are important to their current existence as well as their operation as will be examined. However, the role of tax havens in tax avoidance or evasion situations must first be explained.

REPORT, *supra* note 4, at 10.

21. *See infra* subsection 8 of section B of part IV.

22. *See infra* section C of part V.

23. *Egger Discusses Tax Haven Problems Before House Subcommittee*, 3 TAX TREATIES (CCH) ¶ 9947 (Apr. 1983); *Chapoton Explains U.S. Tax Haven Treaty Policy*, *id.* ¶ 9946; REPORT, *supra* note 4, at 14; Browne, *International Tax and Exchange Control Requirements in OECD Countries*, 11 TAX PLAN. INT'L REV., July 1984, at 11, 12. *See also* Irish, *Tax Havens*, 15 VANDERBILT J. TANSNAT'L L. 449, 452 (1982); A. STARCHILD, *supra* note 5, at 21; B. SPITZ, *supra* note 5, at 1.

24. As Internal Revenue Commissioner Egger said, "I'm sure anyone familiar with the subject 'knows one when he sees one,' regardless of the exact definition used." *Egger Discusses Tax Haven Problems Before House Subcommittee*, *supra* note 23, ¶ 9947. For a comprehensive but somewhat outdated bibliography regarding tax havens, *see* F. CHIN, TAX HAVENS: A SELECTED BIBLIOGRAPHY, Public Administration Series: Bibliography P-520, ISSN: 0193-970X, 1 (July 1980).

Following such reasoning, tax havens have been defined as sanctuaries and "[a] sanctuary exists whenever activites elsewhere prohibited, or individuals elsewhere faced with punishment, are provided immunity from harm or loss." R. BLUM, OFFSHORE HAVEN BANKS, TRUSTS, AND COMPANIES: THE BUSINESS OF CRIME IN THE EUROMARKET 1 (1984).

A. Tax Avoidance v. Tax Evasion

The distinction between tax evasion and tax avoidance is important in defining the legal versus illegal uses of tax havens. It is also important in understanding the problem of international tax avoidance which is a catalyst of tax havens.

Tax evasion is a willful and deliberate violation of the law in order to escape payment of a tax imposed on income by the taxing jurisdiction.[25] In the United States, this is a felony punishable by fine or imprisonment.[26] Tax evasion can involve acts intended to misrepresent or conceal facts in an effort to purposely escape lawful tax liabililty.[27]

Tax avoidance is ethical planning utlizing legal methods to avoid unnecessary taxation. Tax avoidance has unfortunate connotations as it usually implies tax evasion.[28] The definitions can cause unclear distinctions or "grey areas" and some believe the terms have never been adequately explained.[29]

The distinction becomes even more complicated with further definitions especially in the international arena. International tax avoidance is the reduction of tax liability through the movement or nonmovement of persons or funds across tax boundaries by legal methods.[30] International tax avoidance is not a recent phenome-

25. *U.N. Group of Experts on Tax Treaties between Developed and Developing Countries*, 3d Rep. at 69, U.N. Doc. ST/ECA/166 (1972).

26. I.R.C. § 7201 (1982).

27. Comment, *supra* note 2, at 677.

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> "The term tax avoidance itself has unfortunate connotations; it is considered as referring to an attitude of unethical and, indeed, unlawful behavior, although it is actually a neutral term. In the pejorative sense the term tax evasion should be used, which indicates an action by which a taxpayer tries to escape his legal obligations by fraudulent means. The confusion arises from the fact that sometimes taxes are avoided—by the use of perfectly legal measures—against the purpose and spirit of the law. Where this is the case, the taxpayer involved is abusing the law and he is blamed for it, although, no penal measures can be taken against him."

REPORT, *supra* note 4, at 60 (quoting van Hoorn, Jr., *The Uses and Abuses of Tax Havens*, TAX HAVENS AND MEASURES AGAINST TAX EVASION AND AVOIDANCE IN THE EEC (1974)).

29. The Report eschews a black and white distinction and establishes four categories of tax conduct ranging from totally legal to fraud. REPORT, *supra* note 4, at 59-61. Identifying the dividing line has occupied the attention of many. *See* TAX AVOIDANCE, TAX EVASION (1982); van Hoorn, Jr., *supra* note 28, at 1.

30. ROTTERDOM INSTITUTE FOR FISCAL STUDIES, INTERNATIONAL TAX AVOIDANCE: A STUDY BY THE ROTTERDOM INSTITUTE FOR FISCAL STUDIES, INTERNATIONAL SERIES OF THE ROTTERDOM INSTITUTE FOR FISCAL STUDIES 29 (1979) [hereinafter INTERNATIONAL TAX AVOIDANCE]. The study analyzes the policies of six Western countries towards international tax avoidance.

> There are as many international tax avoidance practices as there are tax laws and regulations. The extent and variety of those practices are still increasing with the intensification of international economic relationships. There is an equally extensive

non[31] and its origins are deeply rooted.[32] On the international spectrum, the problem is threefold. First, the distinction between tax evasion and avoidance is often unclear because the laws vary from country to country.

> Illegal tax evasion in one jurisdiction may be permissible tax avoidance in another. The characterization of a transaction as tax evasion or tax avoidance is dependent on the local laws applicable to the transaction. There is often considerable debate even within a single jurisdiction as to whether a particular transaction constitutes tax evasion or tax avoidance.[33]

Second, courts will not necessarily enforce foreign tax liabilities.[34] This is the nonrecognition principle subscribed to by many countries. Third, the problem is often in the tax treaties themselves. The collection provisions in the income tax treaties are sometimes ineffective in curbing tax evasion.[35] The treaties may also fail to distinguish between evasion and avoidance in providing for exchanges of

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> and varied body of tax laws designed to prevent international tax avoidance. One major conclusion which can be drawn . . . concerns imperfect, inconsistency, particularity, arbitrariness and even ineffective international tax law. This problem is seriously aggravated by the secrecy surrounding and actual details of international tax practice affecting each individual taxpayer. Most of the details are restricted to tax officials and tax advisors. This limits the scope for a scientific treatment of the subject, which might otherwise make a larger contribution to more rational legislation.

Id. at 63.

31.

> International tax avoidance is not new to the U.S. In 1721, the American colonies shifted their trade to Latin America in order to avoid paying duties imposed by England. The tax morality which developed from this avoidance of English duties has been described as follows: "The fact that the colonists were constantly evading the navigation acts, and made no pretense of paying the duties imposed by England must have had a demoralizing effect, and taught them to evade duties imposed by their own law makers . . . ."
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> The prototype of the modern tax haven is Switzerland, which developed as a "haven" for capital (rather than as a "haven" from tax) for those fleeing political and social upheavals in Russia, Germany, South America, Spain and the Balkans.

REPORT, *supra* note 4, at 21 (footnotes omitted).

32. *See Hearings on Conventions on Double Taxation Before Senate Comm. on Foreign Relations*, 82d Cong., 1st Sess. 3, 71 (1951); Eichel, *Administrative Aspects of the Prevention and Control of International Tax Evasion*, 20 U. MIAMI L. REV. 25, 26 (1965). "This trend will intensify as economic interdependence increases and taxpayers become aware of the ability to evade legally a foreign tax liability by transgressing international boundaries. Adherence to the nonrecognization rule, moreover, encourages such continued tax evasion." Comment, *The Nonrecognition of Foreign Tax Judgments: International Tax Evasion*, 1981 U. ILL. L. R. 241, 267.

33. Irish, *supra* note 23, at 506.

34. "[N]o country ever takes notice of the revenue laws of another." Holman v. Johnson, 98 Eng. Rep. 1120, 1121 (1775). This issue, as well as many international tax issues, requires defining foreign versus domestic taxpayers. For an excellent article on this subject, *see* Tillinghast, *A Matter of Definition: "Foreign" and "Domestic" Taxpayers*, 2 INT'L TAX & BUS. LAW 239 (1984).

35. Comment, *supra* note 32, at 241.

information.[36] The distinction between tax avoidance and evasion is especially important because the particular laws governing the transactions are unclear[37] leading to the exchange of incomplete data.

B. Characteristics and Requirements

The Internal Revenue Service has defined a tax haven to be a country characterized by some of the following:[38]
(1) Tax rates which are lower than the tax rates imposed by countries whose residents use tax havens;
(2) Communication and bank secrecy laws which the jurisdiction refuses to breach, even when faced with serious violations of the laws of another country;
(3) Relative importance of banking in the country;
(4) Availability of modern communication facilities;[39]
(5) Lack of currency controls on nonresidents with respect to foreign currency;
(6) In most cases, aggressive self-promotion as a tax haven; and,
(7) In certain cases, a favorable network of income tax treaties.
The essential characteristic is the existence of a tax rate which can create a variety of tax benefits.[40] This applies to jurisdictions with no relevant direct taxes on the income or capital gains of individuals and/or corporations, to jurisdictions where the taxes in question are generally levied at low rates and to normal tax rate jurisdictions

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36. Note, *Exchange of Information Under the OECD and U.S. Model Tax Treaties*, 5 LOY. L.A. INT'L & COMP. L.J. 129, 134 (1982); REPORT, *supra* note 4, at 59-61.
37. Comment, *supra* note 2, at 677.
38. *See, e.g*, REPORT, *supra* note 4, at 14; Spall, *International Tax Evasion and Tax Fraud: Typical Schemes and the Legal Issues Raised by Their Detection and Prosecution*, 13 LAW. OF THE AM. 325, 328 (1981). *See also* INTERNATIONAL TAX AVOIDANCE, *supra* note 30, at 70; F. CHIN, *supra* note 24, at 2.

Opponents condemn the Report for its definiton:

> The propriety of using the term "tax haven" throughout the Report to describe a country possessing one or more of the above characteristics is questionable, since that term carries a certain opprobrium that may not be deserved in many, if not most, cases. In fact, the author of the Report may have used the term to produce that opprobrium having stated in the Report that "the term 'tax haven' may also be defined by a 'smell' or reputation test: a country is a tax haven if it is considered to be one by those who care."

Aland, *supra* note 10, at 994.
39. Most tax havens offer good travel, telegraph and telephone links to industrial countries, as well as good business facilities and well trained staffs to expedite haven transactions. Irish, *supra* note 23, at 454; W. & D. DIAMOND, *supra* note 5, R. KINSMAN, *supra* note 2; M. LANGER, PRACTICAL INTERNATIONAL TAX PLANNING (2d ed. 1979).
40. All [tax havens] . . . offer low or no taxes on some category of income . . . ." REPORT, *supra* note 4, at 14.

which nevertheless have some particular tax advantages like special exemptions or investment incentives.[41]

These characteristics are inbred with fiscal, political and accessibility requirements, underlying all of which is an ecomonic basis: The taxpayer is usually engaged in business activities and tax havens offer relief from oppressive taxes and other requirements, which in turn promotes the free and efficient flow of capital. If the economic transaction was absent, there would be no need for the use of a tax haven.[42]

C. *Types and Categories*

Students of tax havens have observed various types and categories of tax havens. The lists of countries in each of the following categories vary among sources.[43]

1. Pure Havens: Havens Having No Taxes

Some countries have no direct taxes on income, profits or capital gains, death duties, succession taxes or gift and estate taxes. These countries may impose employment, customs, duty or real property taxes. There might also exist licensing or registration fees particularly for corporations.[44]

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41. INTERNATIONAL TAX AVOIDANCE, *supra* note 30, at 30; Spall, *supra* note 38, at 451; *See* van Hoorn, Jr., *Problems, Possibilities and Limitations with Respect to Measures against International Tax Avoidance and Evasion*, 8 GA. J. INT'L & COMP. L. 763 (1978).

42. Irish, *supra* note 23, at 461-62. Tax havens may act as a catalyst for economic development. *See also* de Jantscher, *Tax Havens Explained*, 13 FIN. & DEV., Mar. 1976, at 31.

43. Tax havens with no taxes include the Bahamas, Bermuda, Cayman Islands, Turks and Caicos Islands, Nauru, Vanuatu, Anorra, Bahrain, Campio, Monoco (with the exception of French citizens) and Tonga. Havens taxing only local income include Anguilla, Antigua, Barbados, British Virgin Islands, Cyprus, Gibraltar, Guernsey, Isle of Man, Israel, Jamaica, Jersey, Lebanon, Liechtenstein, Macao, Mont-Serrat, Philippines, St. Helena, St. Vincent, Sark, Singapore, and Spitsbergen. Jurisdictions with exemption only on foreign income include Costa Rica, Hong Kong, Ireland, Liberia, Malaysia, Panama and Puerto Rico. Havens with tax treaties include the Netherlands Antilles, British Virgin Islands, Barbados, Honduras and Switzerland. These are not exhaustive lists and some jurisdictions may be classified within more than one category.

44.

> In some of these no-tax havens, a corporation is presented with the sharp alternative between being allowed to deal locally and being exposed to the prospect of paying income taxes in some unspecified future in which they may or will be imposed, and being able to deal locally and having a longterm (however specified) guarantee against future taxation (being an "exempt" company). The second kind of situation may seem to be just the thing if one has no real business interest in the haven itself. But one of the relevant considerations for the application of certain important IRS Code provisions is whether or not a company does any local business in its domicile country; that is, does the company have a real "business justicification," or is it just

2. Liberal Havens: Havens Taxing Only Local Income

Several countries tax income from domestic sources but exempt all income from foreign sources. A company incorporated in one of these havens can earn unlimited amounts of foreign source income without paying any local income tax.[45]

3. Havens with Tax Treaties

Several low-tax countries are parties to tax treaties under which they offer access to attractive markets to individuals and corporations who are not residents of the tax havens. The Netherlands Antilles, for example, is a party to several favorable income tax treaties. It also has special low tax rates applicable to several classes of corporate income. This combination of tax treaty and low tax rates is used successfully by many tax haven companies incorporated in the Netherlands Antilles. This creates the problem of "treaty shopping" as will be examined later.

4. Special Tax Havens

These are countries that impose all or most of the usual taxes, but either allow special privileges to special types of companies or allow very special types of corporate organization. One of the classic examples is the flexible corporate arrangement offered by Liechtenstein.[46]

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a tax dodge?

A. STARCHILD, *supra* note 5, at 22.

45.

> The no-tax on foreign income however breaks down into two groups. There are those that allow a corporation to do business both internally and externally, taxing only the income coming from internal sources, and those that require a company to decide at the time incorporation whether it will be one allowed to do local business, with the consequent tax liabilities, or one permitted to do only foreign business and thus be exempt from taxation.

Id. at 22-23.

46. The Lichtenstein "anstalt" was one of the earliest tax havens. Formed in 1926 for the purpose of attracting foreign capital, it has become one of the longest operating. "An anstalt is an institution of public character permanently dedicated to a public purpose, which is usually charitable, medical or education." Glos, *The Analysis of a Tax Haven: The Liechtenstein Anstalt*, 18 INT'L LAW. 929, 930 (1984).

Other types of special tax havens include:

> Luxembourg, the Netherlands, Switzerland and Liechtenstein offer special privileges to qualified holding companies.
>
> Jersey, Guernsey and the Isle of Man, in addition to their low rates . . . also recognize a special category of company generally known as a corporation tax company. Such a company must be managed and controlled from abroad and earn its income from abroad. If it meets both tests it pays a flat annual fee in lieu of income tax. Gibraltar has a similar type of company which need not be managed and con-

D. *List of Tax Havens*

As seen from surveying the various types of categories of tax havens, any list attempting to identify and actually count the number of tax havens is impossible to compose. What one government or investor may consider to be a tax haven for one purpose, another may not for another purpose. Although it has been said that "[m]any publications identify jurisdictions as tax havens, the same jurisdictions generally appear on all the lists."[47] Guide books have been developed which provide lists of tax havens along with essential information including the addresses of promoters and hotels in each tax haven.[48] The comprehensive listing includes some sixty-three tax havens.[49] The Internal Revenue Service officially listed thirty tax havens in 1982.[50]

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trolled abroad.

> Antigua, Barbados, Grenada and St. Vincent each recognizes international business companies. These companies have a maximum tax rate of 2.5 percent and they may even benefit from some tax treaty provisions.

M. LANGER, *supra* note 5, at 14.

47. M. LANGER, *supra* note 39, at 279. *See also* B. SPITZ, *supra* note 5.

48. *See* guide books listed *supra* note 5 and R. KINSMAN, *supra* note 2. Such guide books describe the selection process:

> The correct selection of a tax haven jurisdiction for the purposes of a proposed arrangement requires the careful evaluation of a number of general considerations.
>
> Thereafter a detailed examination of the substantive law of those jurisdictions which are considered suitable, on the basis of the preliminary survey, should be undertaken with particular regard to the law governing legal entities or equitable obligations, the fiscal system and the exchange control regulations.
>
> A comparison of tax and non-tax expenditure in each of the jurisdictions under consideration may also be necessary if cost is a material factor.

B. SPITZ, *supra* note 5, at 3.

49. W. & D. DIAMOND, *supra* note 5, lists in its table of contents the following tax havens: Andorra, Anguilla, Antigua, the Bahamas, Bahrain, Barbados, Bermuda, British Virgin Islands, Campione, Cayman Islands, Channel Islands (Jersey, Guernsey and Sark), Costa Rica, Cyprus, Gibraltar, Greece, Grenada, Hong Kong, Ireland, Isle of Man, Jamaica, Jordan, Lebanon, Liberia, Liechtenstein, Luxembourg, Macao, Malaysia, Monaco, Montserrat, Nauru, Netherlands, the Netherlands Antilles, Panama, Philippines, St. Vincent, San Marino, Seychelles, Singapore, Switzerland, Turks and Caicos, United Arab Emirates, United Kingdom, Vanuatu, Uruguay and Venezuela. Minor tax havens with limited use listed are Brunei, New Caledonia, Pitcairn Island, Svalbard, Tonga, North Korea, Djibouti, Oman, Albania and the Vatican. *See also* GRUNDY'S TAX HAVENS, *supra* note 5.

50. DEPARTMENT OF TREASURY, INTERNAL REVENUE SERVICE, TAX HAVEN INFORMATION BOOK, Doc. 6743 (1982), listed the following tax haven countries: Antigua, Austria, Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Costa Rica, Channel Islands, Jersey, Guetinsey and Saizy Gibraltar, Grenada, Hong Kong, Isle of Man, Liberia, Liechtenstein, Luxembourg, Monaco, Nauru, the Netherlands, the Netherlands Antilles, Panama, Singapore, St. Kitts, St. Vincent, Switzerland, and Turks and Caicos Islands.

E. Legal Versus Illegal Uses of Tax Havens

As has been seen in defining tax avoidance and evasion, there are legal and illegal uses of tax havens. Tax avoidance is the result of the legal use of a tax haven; tax evasion is the result of the illegal use. One of the major findings of the Report was that there is a high level of use of tax havens to evade income tax in the United States.[51] The type of tax haven transactions involved include double trusts, secret bank accounts, false foreign corporate status, various tax shelter devices, use of a foreign entity to step up the basis of United States property and recovery of repatriated funds.[52]

Tax evasion is usually attained through a method of schemes. One observation of these schemes is that:

> Once incorporated behind the shield of commercial secrecy laws, a taxpayer can proceed with his illegal schemes. If he wants to evade taxes, he can buy . . . at inflated prices, reducing his United States income, increasing his basis in U.S. property, and . . . increasing the profits of his foreign subsidiary. If the taxpayer does not wish to evade taxes, but merely wishes to conceal an illegal source of income, the foreign corporation can buy goods from the taxpayer at inflated prices, or it can hire the taxpayer as a "consultant." Either activity can provide a legitimate source for the income that the taxpayer reports to the I.R.S.[53]

Tax evasion is a major and growing problem in the United States and tax havens have served as a catalyst to this problem. A statement of the consequences of participating in tax evasion was acutely espoused by the Assistant Attorney General (Tax Division) in a statement to the Oversight Committee of the House Ways and Means Committee:

> As might be expected, evasion of United States taxes through sham business transaction involving foreign entities is difficult to detect, hard to recognize when found, and, where foreign witnesses and documents are crucial, sometimes impossible to prove in court. Even the most transparent transactions are likely to have sufficient documentation to satisfy a surface inquiry by an auditor and enough complexity to discourage a deeper look. Furthermore, being dependent on form and multiplicity of steps, such transac-

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51. REPORT, *supra* note 4, at 6-7.

52. *Id.* at 118-23. *See also* Spall, *supra* note 38, at 329; Irish, *supra* note 23, at 477-79. The major tax haven transactions involving the avoidance of taxes include offshore banking, international finance subsidiaries and the Eurobond market, captive insurance companies, tax havens as conduits for foreign investment and transfer pricing. *Id.* at 462-74.

53. Spall, *supra* note 38, at 330.

tions will utilize entities in tax haven jurisidictions offering business and banking secrecy to conceal their lack of substance.[54]

There are numerous reports of the illegal uses of tax havens[55] which are often misleading or confusing to taxpayers because there exists both permissible and impermissible uses of tax havens. In fact, legal tax avoidance has become tainted by the gravity of the cases involving tax evasion.[56] Tax evasion through tax havens may have an interesting ramification in that some law-abiding citizens may be hesitant to use tax havens for lawful purposes. There is thus another reason to cure the abusive use of tax havens: to allow their proper use.

F. Secrecy

One of the major characteristics of a tax haven, and a tie to its illegal use, is the haven's commercial and bank secrecy laws.[57] A tax haven jurisdiction must enact secrecy laws in order to protect tax evaders using the haven. Foreign secrecy laws can therefore be regarded as promoters of tax havens.[58]

An explanation of the secrecy laws is simple: Third parties, including banks, are generally not obliged to furnish information to tax authorities. Banking secrecy can properly be invoked against demands by fiscal authorities for production of information. In some circumstances, however, tax claims can lead to the judicial lifting of banking secrecy. These circumstances depend on the na-

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54. *The Use of Offshore Tax Havens for the Purpose of Evading Income Taxes: Hearings Before the House Subcomm. on Oversight of the House Comm. on Ways and Means*, 96th Cong., 1st Sess. 18 (1979).

55. Fictitious tax haven loans were cited in eight criminal indictments charging three corporations, two lawyers and a bank, all located in a tax haven, with promoting fraudulent tax shelters. *An International Tax Shelter Is Indicted for Tax Fraud*, 37 TAXES INT'L, Nov. 1982, at 43.

"The Internal Revenue Service's criminal investigation function has identified 464 cases for the period, January 1978 through August 1983, containing financial transactions allegedly involving Caribbean Basin countries." TAX HAVENS IN THE CARIBBEAN BASIN, *supra* note 5, at 34. See also *Anti-Tax Haven Activities of the U.S.*, 10 INT'L TAX J. 273 (1984); Kurtz, *supra* note 5; *International Tax Evasion: Spawned in the United States and Nurtured by Secrecy Havens*, 16 VAND. J. TANSNAT'L L. 757 (1983); and R. BLUM, *supra* note 24.

56. *See supra* note 28 and accompanying text.

57. Tax evasion schemes utilize foreign haven secrecy laws to escape detection by United States officials. *See Crime and Secrecy: The Use of Offshore Banks and Companies: Hearings Before the Permanent Subcomm. on Investigations of the Senate Comm. on Government Affairs*, 98th Cong., 1st Sess. 16, 255-56 (1983) (testimony and statement of Roscoe L. Egger, Jr., Comm'r Internal Revenue Service).

58. "[S]ecrecy has a legitimate foundation in [the] nation's history and law, and is usually a key factor in the nation's economic condition." *Egger Discusses Tax Haven Problems Before House Subcommittee*, *supra* note 23, ¶ 9947.

ture of the tax offense.[59] Also, the amount of secrecy varies under different laws. For example, in the Cayman Islands, the statutory framework is designed to render 99% of all transactions secret compared to the company secrecy laws of Liechtenstein, Hong Kong and the Bahamas.[60]

The United States does have methods of circumventing the commercial secrecy laws against United States taxpayers, but the use of foreign tax havens makes it difficult.[61] These methods have included federal banking secrecy laws,[62] various customs enforcement laws and certain civil[63] and criminal[64] penalties contained in the Internal Revenue Code. Recently, the courts have served as an excellent means for penetrating tax haven secrecy laws.[65]

Another effective means of piercing the secrecy laws has been exchange of information provisions in tax treaties[66] and special mu-

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59. For an example of bank secrecy laws, *see* Aubert, *The Limits of Swiss Banking Secrecy Under Domestic and International Law*, 2 INT'L TAX & BUS. LAW. 273 (1984).

60. Weisland, *The Use of Offshore Institutions to Facilitate Criminal Activity in the United States*, 16 N.Y.U. J. INT'L L. & POL. 1115, 1118 (1984).

61. Spall, *supra* note 38, at 330. "The ways in which taxpayers can take advantage of the opportunities afforded by tax havens and secret foreign bank accounts to evade income taxes are almost as numerous as the ways of earning money." Comment, *supra* note 2, at 681.

62. U.S.C. titles 26 & 31.

63. I.R.C. § 982 (1982 & Supp. III 1985) gives the Internal Revenue Service examiners the power to get books and records maintained in foreign jurisdictions and I.R.C. § 6038A (1982 & Supp. III 1985) requires the filing of information returns by foreign corporations otherwise not obligated to report.

64. Increased fines are provided for in I.R.C. §§ 7201 (1982), 7203 (Supp. III 1985), 7206 (1982) & 7207 (Supp. III 1985).

65. *See e.g.*, *In re* Grand Jury Proceedings: United States v. Bowe, 694 F.2d 1256 (11th Cir. 1982) (Bahamas lawyer required to testify before a grand jury about tax haven corporations owned by his United States taxpayer clients); *In re* Grand Jury Proceedings: United States v. Bank of Nova Scotia, 691 F.2d 1384 (11th Cir. 1982) (Canadian bank had to give to a grand jury a document held in its Bahamas branch about a United States taxpayer's banking transactions); United States v. First National Bank of Chicago, 699 F.2d 341 (7th Cir. 1983) (United States bank not forced to produce documents held in its Greek branch); *In re* Grand Jury Proceedings: United States v. Field, 532 F.2d 404 (5th Cir. 1976), (Cayman Islands bank official had to testify before a grand jury about bank accounts of United States taxpayers) *cert. denied* 429 U.S. 940 (1076); United States v. Roy R. Carver, Cayman Islands Civil Appeals No. 5 (1982) (Bank officials from the Cayman Islands, Liechtenstein and Switzerland forced to produce banking documents and testify in a United States criminal trial); and United States v. Bache Halsey Stuart, Inc., 563 F. Supp. 898 (S.D.N.Y. 1982) (United States stockbroker ordered to obtain for the Netherlands tax authorities information from its Swiss branch concerning a Dutch taxpayer). *See generally* *Penetrating Tax Haven Secrecy Laws*, 40 TAXES INT'L, Feb. 1983, at 3.

66. For example, the United States—Switzerland Double Taxation Treaty provides that "[n]o information shall be exchanged which would disclose any trade, business, industrial or professional secret. . . ." Convention for the Avoidance of Double Taxation with Respect to Taxes on Income, May 24, 1951, United States-Switzerland, art. XVI, 2 U.S.T. 1751, T.I.A.S. No. 2316, 127 U.N.T.S. 227.

tual assistance aggreements.[67] This international information exchange mechanism will be the key device in eliminating the secrecy element, an essential characteristic of tax havens.[68]

G. *The United States as a Tax Haven*

At this point, it should be noted that the United States itself is often considered a tax haven. The United States is characterized as a tax haven because tax breaks are given to 1) income from foreign investments in United States real estate and 2) interest income earned on deposits with United States banks or foreign branches of United States banks that is paid to foreign persons.[69] While there are other areas of taxation of foreigners, some nevertheless believe that the United States can be analyzed as fitting the major characteristics of a tax haven. This conclusion is reached because

1. The United States applies a zero rate of tax on certain categories of income, including interest received by a nonresident alien individual or a foreign corporation from banks and savings institutions;
2. United States banks offer a high level of banking secrecy to their foreign clients. Unlike domestic clients, foreign clients are excused from obtaining taxpayer identification numbers, their ac-

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67. Treaty on Mutual Assistance in Criminal Matters, May 25, 1973, United States-Switzerland, 27 U.S.T. 2019, T.I.A.S. No. 8302; Treaty on Extradition and Mutual Assistance in Criminal Matters, June 7, 1979, United States-Turkey, 32 U.S.T. 3111, T.I.A.S. No. 9891; Treaty on Extradition and Mutual Assistance in Criminal Matters, June 12, 1981, United States-Netherlands, T.I.A.S. 10734.

68. A proposed treaty between the U.S and the Cayman Islands is an excellent example of how a treaty can provide for the divulging of financial information:

> A new United States-Cayman Islands treaty will provide American law enforcement agencies wide access to the financial records of Cayman banks, aiding in the fight against tax fraud and money laundering. The treaty, which now must be ratified by Britain—Britain handles foreign affairs for its former colony—covers only acts that are criminal offenses in both countries. The United States and the Islands will cooperate in providing bank, business and government records, the taking of testimony and depositions by witnesses, searches and seizures of evidence, and the transfer of individuals in custody for testimony.

TAX NOTES INT'L (July 23, 1986).

"The treaty also permits the Cayman Islands to turn over bank records in cases involving tax fraud and false tax statements. The treaty will not cover simple tax evasion, since the Islands do not have tax laws." Nash, *U.S. and Caymans Sign Crime Pact*, N.Y. Times, July 4, 1986, at D10, col. 2. *See also* Day, *Cayman Island Gives U.S. Access to Bank Records*, Wash. Post, July 4, 1986, at F1, col. 3.

69. Irish, *supra* note 23, at 451. In 1984, Congress repealed the 30% withholding requirement on portfolio interest of foreigners. Tax Reform Act of 1984, Pub. L. No. 98-369, § 127, 98 Stat. 494, 648-53 (1984), *codified in* 26 U.S.C. §§ 1 - 9602 (1982, Supp. II 1984 & Supp. III 1985). This further weakened the view that the United States is a tax haven. *See also* REPORT, *supra* note 4, at 14; *The United States as a Tax Haven*, 24 TAX NOTES 325 (1984).

counts are not reported to the Internal Revenue Service and there is no withholding tax;
3. The United States relies on banking as an important segment of its economy;
4. The United States has extremely modern communication facilities;
5. The United States does not impose currency controls on nonresidents;
6. It is questionable whether the United States is a self-promoter of its tax haven status; and
7. The United States has a favorable income tax treaty network.[70]

Realistically, there is no real impact of this analytical note: The United States cannot be classified as one of the world's tax havens based on its limited areas of tax breaks and its complex and abrasive tax structure.

It is also interesting to note that the Virgin Islands, a United States possession, is also often classified as a tax haven. This is primarily because the transfer of installment obligations to the Virgin Islands may present an opportunity for tax avoidance.[71] However, the Virgin Islands generally employs a system of taxation similar to that of the United States, reducing concerns that it is a tax haven.[72]

H. United States Law

A cursory survey of United States tax laws pertaining to taxing foreign transactions reveals little that applies directly to tax havens. There is no direct provision which deals specifically and exclusively with tax havens. As has been commented,

> [t]he Congress has never sought to eliminate tax haven operations by U.S. taxpayers. Instead, from time to time, the Congress has identified abuses and legislated to eliminate them. The result is a patchwork of anti-avoidance provisions, some intended to deal particularly with tax havens, although of general application, and some intended to deal with more general abuse situations, but which might also be used by the IRS to deal with tax haven

70. *See* Langer, *Antilles Hearings: "Treaty Shopping" Continues to Be a Hot Topic*, 42 TAXES INT'L, Apr. 1983, at 51.

71. *See* Berney, *Transfer of Installment Obligations to the U.S. Virgin Islands*, 7 INT'L TAX J. 229 (1981); D'Avino, *Foreign Investment Incentives in the U.S. Virgin Islands: Part II*, 10 TAX PLAN. INT'L REV., Feb. 1983, at 8.

72. For complete details on the United States Virgin Islands system of taxation, *see* W. & D. DIAMOND, *supra* note 5.

transactions.[73]

Clearly, tax havens in themselves do not provide a tax advantage to taxpayers in the United States. The advantage is a combination of both the United States system deferring taxation of earnings of foreign corporations and the United States system consolidating world-wide foreign tax credits.[74] The United States' best legislative attempt to deal with tax avoidance through tax havens resulted in the Revenue Act of 1962 and Subpart F of the Internal Revenue Code.[75]

Subpart F, which focuses on defined activities conducted abroad generally considered tax haven devices, taxes United States shareholders of a United States controlled foreign corporation on certain categories of income. Additionally, Internal Revenue Code section 482 authorizes the Internal Revenue Commissioner to reallocate income among related entities to properly reflect their incomes.

The Report examined the operations of the current law and presented suggestions for legislative change.[76] Subpart F and section 482 are still the primary bases of the United States legislative policy regarding tax havens. More specific direct legislation is needed in order to offer an alternative to prevent tax haven abuse.

III. Income Tax Treaties

Income tax treaties are useful means for resolving double taxation by two countries. Their history and use is of vast importance in relation to the tax haven problem; tax haven abuses have recently been the major factor in the negotiation and ratification of several income tax treaties. In fact, their use has often been hailed as the solution to today's problem of tax havens.

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73. REPORT, *supra* note 4, at 42.

74.

> Nowhere is this tension more apparent than when it is focused on tax havens. Nowhere is the failure to resolve the policy issues more obvious. Congress over the years, while maintaining deferral of tax on the earnings of foreign corporations controlled by U.S. persons, has at the same time passed numerous anti-avoidance provisions generally intended to solve perceived tax haven-related problems. All have had numerous exceptions, have been complex and difficult to administer, and all have had gaps (many intended, some not).

Id. at 43.

75. I.R.C. §§ 951-964 (1982 & Supp. III 1985).

76. *See* REPORT, *supra* note 4, at 135-46. The Report does not present as an option the expansion of Subpart F to reach all types of income earned by controlled foreign corporations. Aland, *supra* note 10, at 1014. A more recent suggestion has been a federal transfer tax on the movement of assets to tax haven countries. *Stark Calls for Action Against Tax Havens*, *supra* note 3.

A. History, Use and Importance of Income Tax Treaties

Income tax treaties have been most successful in their prevention of double taxation.[77] The only other significant way to offer relief from double taxation is unilateral actions by the individual countries themselves.[78] The other important purposes of income tax treaties include resolution of disputes, prevention of fiscal evasion, avoidance of excessive taxation and advancement of a country's economic and foreign policy.[79] Income tax treaties generally provide for a reduction in the level of tax applicable to payments from sources within either of the contracting countries. They also offer the administrative mechanisms for accomplishing this goal.[80] The treaties and tax havens of today cannot, however, be understood without a view of the history of income tax treaties.

Tax treaties are a result of economics. They originated as a vital role in the commerce between nations.[81] Their beginnings, which date to the middle of the 19th century,[82] were rooted in the desire for mutual assistance between states to suppress international tax

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77. HELLAWELL & PUGH, THE STUDY OF FEDERAL TAX LAW: TRANSNATIONAL TRANSACTIONS ¶ 2110 (1983); Foster, *The Importance of Tax Treaties*, 5 HASTINGS INT'L & COMP. L. REV. 565 (1982); Owens, *United States Income Tax Treaties: Their Role in Relieving Double Taxation*, 17 RUTGERS L. REV. 428 (1963); REPORT, *supra* note 4, at 147. For a detailed background on double taxation, *see* Rosenbloom, *Tax Treaty Abuse: Policies and Issues*, 15 LAW & POL. INT'L BUS. 763 (1983).

Reduction of double taxation is accomplished through exclusion of certain income from taxation, a special rate on certain types of income and provisions for "competent authority" for procedural redress. Note, *Tax Treaties*, 14 INT'L LAW 508 (1980).

"There are five principal purposes for double taxation treaties:

(1) Mutuality of relief;

(2) Equal and equitable treatment of taxpayers;

(3) Accommodation of differing tax systems;

(4) Resolving conflicts; and

(5) Exchange of information." Tomsett, *Tax Treaties Between Developing Countries of Asia and North America, Europe, Japan and Australia*, 12 TAX PLAN. INT'L REV., Mar. 1985, at 9, 10. This is an excellent article on the recent concern of initiating tax treaties with developing countries.

78. Such relief is normally given by crediting foreign taxes against domestic taxes on foreign source of income and gains, by exempting foreign source income and gains from domestic taxes and by allowing foreign taxes as a deduction in computing income and gains for domestic tax purposes. Tomsett, *supra* note 77, at 9. Double taxation is generally mitigated in the United States by permitting a tax credit for income taxes paid in foregin countries. I.R.C. §§ 951-964 (1982 & Supp. III 1985).

79. Rosenbloom, *Current Developments in Regard to Tax Treaties*, INST. ON FED. TAX'N § 31.1, § 31.03 (1982); *Chapoton Explains U.S. Tax Haven Treaty Policy*, *supra* note 23.

80. Freud, *Treaty Shopping and the 1981 United States Draft Model Income Tax Treaty*, 6 HASTINGS INT'L & COMP. L. REV. 627 (1983); HELLAWELL & PUGH, *supra* note 77, ¶ 2101. "This central thrust . . . limiting the taxation of the host or source country . . . explains why the United States has so few treaties with developing countries." *Id.*

81. Foster, *supra* note 77.

82. INTERNATIONAL TAX AVOIDANCE, *supra* note 30, at 21.

evasion through the exchange of information. After the world wars, income tax treaties flourished. Several existing treaties were expanded to multilateral agreements to apply to the colonies of the commerce bearing nations.[83]

The United States' use of income tax treaties, and the efforts in recent years to limit benefits under bilateral income tax treaties, have been well documented.[84] The United States has specifically subscribed to a distinct policy of limiting its economic benefits through its tax treaties.

Along these lines, the United States has pursued one of the major purposes of tax treaties, the prevention of fiscal evasion.[85] Such fiscal evasion usually involves the illegal avoidance of taxes or tax evasion which, unlike the avoidance of double taxation, is not always a subject of shared international concern. The prevention of fiscal evasion is a goal which is pursued principally through the exchange of tax-related information. There are times when the goal of fiscal evasion and double taxation become intermingled and counter-productive.[86] Without bilateral assistance, the ability of the

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83. The first multilateral concerns with international tax evasion can be found in the work of the League of Nations. *Double Taxation and Tax Evasion, Report and Resolutions Submitted by the Technical Experts to the Financial Comm. of the League of Nations*, League of Nations Doc. F 212 (Feb. 7, 1925).

84. *See, e.g., Tax Treaties: Hearings Before the Senate Comm. Foreign Relations*, 97th Cong., 1st Sess. (1981). For a detailed history on the United States use of tax treaties, *see* Rosenbloom, *supra* note 77, at 779-85; Comment, *Income Tax Treaty Shopping: An Overview of Prevention Techniques*, 5 Nw. J. Int'l L. & Bus. 626 (1983).

85.

> Treaty partners have a mutual desire to avoid double taxation, because double taxation may impede international commerce to the detriment of both countries. However, while each country doubtless has a strong interest in preventing evasion of its taxes, there is no such direct interest in regard to evasion of the other country's taxes. On the contrary, no nation ever has a direct interest in ensuring that its taxpayers pay greater taxes to another country.

Rosenbloom, *supra* note 79, § 31.03[3]. As will be seen, this is a second major goal of the Model Income Tax Conventions. *See infra* notes 102-06 and accompanying text.

86.

> If double-tax treaties grant alleviations but impose no new burdens, then they must by definition permit the avoidance of tax by comparison with the previous situation. But it is another question whether this avoidance is undesirable and ought to be hindered by other measures.
>
> The international tax avoidance in question is a consequence of differences between tax systems, whether in rates or structures. If the treaty partners had identical systems, the problem would disappear.

International Tax Avoidance, *supra* note 30, at 153.

> A comparison of the tax treaties of the world would show a wide variety of explicitly stated purposes: no generalizations are possible and each tax treaty must be judged on its own characteristics to assess whether and how far the treaty partners are attempting to combat tax avoidance, "improper" use or even "abuse" of the treaty, or tax fraud or evasion.

Id. at 314.

United States to collect tax-related information is limited.[87]

The United States has interpreted most of its tax treaties as permitting three methods of providing information:

> First, a routine or automatic transmittal of information, consisting generally of lists of names of U.S. resident taxpayers receiving passive income from sources with the treaty partner, and notifications of changes in foreign law.
>
> Second, requests for specific information, which generally are requests of the U.S. competent authority for information. Specific requests for information also result from simultaneous examinations of. . . taxpayers. . . .
>
> Third, spontaneous exchange of information at the discretion of the transmitting country.[88]

The exchange of information goal can also be pursued via a mutual assistance agreement.[89]

An overview of the importance of income tax treaties cannot be made without a brief survey of the treaty process in the United States.[90] Clause 2 of section 2 of article II of the United States Constitution provides that the President "shall have power, by and with the advice and consent of the Senate, to make treaties, provided two-thirds of the Senators present concur . . . ." This clause means that the treaty power can be invoked only by the executive branch. The formal role of Congress is confined to the Senate and is limited to giving, or withholding, its "advice or consent."[91] If advice and consent is given, the President is empowered to make or ratify a treaty. The multiple nature of the process[92] is a treaty pol-

87. Success depends on the Internal Revenue Service being aware that information does or may exist, on gaining access to the information while resolving conflicts between the United States and foreign law, on the willingness of the foreign jurisdictions to cooperate and, in criminal cases, on receiving information in a form admissible in courts. REPORT, *supra* note 4, at 197-98.

88. *Id.* at 207-08.

89. For detailed information on the exchange of information agreements, *see* articles *infra* notes 102-06 and Note, *Information Disclosure and Competent Authority: A Proposal,* 17 CASE W. RES. J. INT'L L. 485 (1985).

90. Tax treaties are defined for this purpose as "generally-worded, bilateral instruments that rest on complex revenue legislation. The treaties modify, restrict and expand the operation of the underlying revenue laws without radically altering them." Osgood, *Interpreting Tax Treaties in Canada, the United States and the United Kingdom,* 17 CORNELL INT'L L.J. 255, 265-57 (1984).

91. "A tax treaty has particular importance in foreign policy terms because of two of its typical features: (1) It truly matters, on a continuing, dollars-and-cents basis, to a variety of persons from both countries; and, (2) Its administration requires ongoing contacts between official representatives of the treaty partners." This is the reason for the Senate's involvement. Rosenbloom, *supra* note 79, § 31.02[3].

92. For articles dealing with the treaty process, *see* Rosenbloom, *supra* note 79; Foster, *supra* note 77; Note, *supra* note 89.

icy problem in itself.[93] Tax treaties inevitably conflict with tax rules and policies within this country as implied in the stated definition and as interpreted by a treaty's authority and precedence.

Clause 2 of article VI of the United States Constitution provides that treaties made under the authority of the United states, like federal laws, are "the supreme law of the land . . . ."[94] The legal authority of the tax treaties is thus equal to that of federal statutes. A treaty "may supersede a prior act of Congress, and an act of Congress may supersede a prior treaty," but there must be clear evidence that it was intended to do so.[95] If a conflict exists between the two, courts will always endeavor, if feasible, to construe them so as to give effect to both.[96] If the legislation and the treaty cannot be interpreted as consistent with each other, accepted cannons of construction favor the more recent provision.[97]

The Internal Revenue Code has recognized the obligation and desirability of honoring international tax agreements and provides to that end that statutory rules taxing income will yield to rules preventing the imposition of United States income tax.[98] Furthermore, section 7852(d) states that "no provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enact-

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93.

> But perhaps the major consideration in treaty policy remains the process for sorting out the relationship of U.S. income tax treaties and the Internal Revenue Code. The persistence of this structural issue is possibly unique to the United States among the developed countries and is largely attributable to the separate delegations of authority not only between the executive and legislative branches, but also the delegation of treaty-making power to the Senate while revenue measures are initiated in the House of Representatives. U.S. tax treaties are negotiated by the executive branch and are submitted solely to the Senate for its advice and consent. In the Senate, the treaties are under the jurisdiction of the Committee on Foreign Relations, while tax legislation is under the jurisdiction of the Finance Committee. On the other hand, the Constitution contemplates that Congressional legislation on revenue measures will originate in the House of Representatives. . . . The potential for tension between treaty rules and statutory rules has increased in the past decade as the United States has been more active in joining other countries in a worldwide network of income tax treaties, while at the same time domestic tax rules have increasingly been brought under the microscope of Congressional examination.

Patrick, *Senate Foreign Relations Committee Hearing on Pending U.S. Income Tax Treaties*, 12 TAX PLAN. INT'L REV., Sept. 1985, at 3.

94. Tax treaties fall within this clause. Samann v. Comm'r, 313 F.2d 461, 463 (4th Cir. 1963); American Trust Co. v. Smyth, 247 F.2d 149, 153 (9th Cir. 1957).

95. The Cherokee Tobacco, 78 U.S. (11 Wall) 616, 621 (1871) (footnotes omitted).

96. Whitney v. Robertson, 124 U.S. 190, 194 (1888). *See also* United States v. Payne, 264 U.S. 446 (1924); Chew Heong v. United States, 112 U.S. 536 (1884).

97. Whitney, 124 U.S. at 194.

98. I.R.C. § 894 (1982).

ment of this title."[99]

Lastly, the importance of interpreting tax treaties on the international level must be considered.[100] As viewed, a tax treaty usually prevails over a nation's laws. Recently, tax treaty partners have come to use the treaty mechanism known as "competent authority" for treaty interpretation. "Competent authority" is a process designed to resolve disputes arising under the provisions of the treaty. Each contracting state delegates a competent authority to serve as its representative for interpreting and implementing the treaty. The delegates may consult with each other, but the treaty does not require the authorities to come to an agreement, nor does it provide any mechanism for binding them to a decision.[101]

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99. I.R.C. § 7852(d) (1982).

As previously examined and from viewing the authority itself, one can see this is becoming a tax treaty policy issue which can become crucial to a treaty's ratification. Senator Robert Dole has commented on this issue:

> However, the displacement of the policies established in the Code by the sometimes conflicting policies established through the tax treaty process give me . . . cause for some concern. Particularly as the United States tax treaty network grows and as tax treaties become more detailed and complex, this concern regarding the possible conflicts between the tax legislative process and the tax treaty process can only increase.
>
> . . .
>
> Equally important [to suggestions of members of the Senate Finance Committee], further initiatives to improve the coordination of the tax legislative process with the tax treaty process will come. . . . Such initiatives should include, at a minimum, consultation with the chairmen of the Foreign Relations Committee and the Finance and Ways and Means Committees at several stages of the treaty negotiation process.
>
> First, before negotiations are commenced, I suggest that the Treasury notify Congress regarding the reasons for seeking a new tax treaty . . . [or] an explanation of the specific provisions of the extant treaty and the U.S. or foreign law, and an explanation of any changed economic conditions, which together may give rise to the need for a revised treaty. Further, the Treasury might provide Congress with a description of the goals hoped to be achieved through the adoption of a new treaty or protocol. For treaties with nations with whom we have no existing treaty such notification should include a description of the problems U.S. taxpayers may experience in commercial and other contacts with the other nation's taxing jurisdiction, the commercial activity that might be fostered by such a treaty, and what interests of the U.S. might be served by promoting trade with or investment between the U.S. and the other nation. . . .
>
> Second, once negotiations have commenced, periodic consultation with Congress regarding progress, problems, and the choices among options in the treaty negotiation process could facilitate the process of later Senate ratification. . . .
>
> Third, the Treasury should find it useful during the tax legislative process itself, to keep the tax-writing committees abreast of the impact of pending legislation on ongoing treaty regulations. . . . Coordination between treaty negotiators and those involved in the tax legislative process could avoid the development of conflicting provisions.

Dole Comments on Pending Tax Treaties, 13 TAX NOTES 1005 (1981).

100. INTERNATIONAL TAX AVOIDANCE, *supra* note 30, at 315.

101. Note, *supra* note 89, at 487 n.12.

In a competent authority proceeding, representatives of the treaty partners negotiate

B. Model Treaties

Two model income tax treaties have been proposed. Both could affect the way tax havens operate, particularly by requiring specific exchanges of information. In 1963, the Organization for Economic Cooperation and Development proposed a model treaty with the object of eliminating tax evasion and providing for the exchange of information.[102] The United States voiced initial opposition to this model treaty, but during the 1960's, the United States signed many protocols and treaties with the purpose of adopting similar provisions, as far as appropriate, to those in the model OECD Convention.[103] In 1981, the Department of the Treasury issued its final Model Income Tax Treaty which was similar to the OECD model, but strenghened and expanded provisions dealing with benefits to third parties. This model is applicable to tax havens.[104]

Both models contain identical limitation provisions on exchanges of information. The contracting parties are not required to go beyond their own internal laws or administrative practices to obtain information for the requesting country. Further, both parties must treat information received as confidential, to be used only in tax proceedings concerning taxes covered by the convention. A party may disseminate information only to those involved in the collection of taxes or enforcement of tax laws.

The United States model is broader in scope than the OECD model in that it requires information to be provided in an authenti-

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> a resolution to a double taxation problem arising under the provision of the applicable treaty. The competent authority negotiations and eventual resolution represent a settlement between the IRS and a treaty partner regarding taxpayer liability on a particular issue and set of facts. This settlement is similar to a private letter ruling in that the taxpayer requests assistance from the IRS. Currently, the only public releases of information on competent authority are two revenue procedures, statistics on the number of cases accepted and resolved, and periodic public statements by treasury officials.

Id. at 487 (foonotes omitted). *See also International Taxation: Competent Authorites Share Their Concerns*, 32 TAX NOTES 573 (1986).

102. OECD COMMITTEE ON FISCAL AFFAIRS, MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL (rev. ed. 1977). For articles on the model treaties, *see* Note, *supra* note 36; Tomsett, *supra* note 77; Rosenbloom, *supra* note 77.

103. Surrey, *Factors Affecting U.S. Treasury in Conducting International Tax Treaties*, 28 J. TAX'N 277 (1968).

104. Article 16 of the United States Model Treaty excludes corporations from benefits when those corporations enjoy special tax benefits in a treaty country, or when those corporations are owned by a substantial number of shareholders who are not residents of either treaty country (designated "third country residents"). Freud, *supra* note 80. The 1981 Draft Model Treaty provision is more specific and applies more broadly than the 1977 Model Treaty provision. Additionally, the 1981 Draft Model Treaty provision is less dependent on the internal law of its treaty partner. *Id.* at 648.

cated form. A country, however, can produce the authenticated information only if permitted by its own laws. The United States model also provides for the collection of taxes, if necessary, to ensure that the tax benefits of the convention do not inure to persons not entitled to them.[105] The United States' provisions indicate the desire to use tax treaties for obtaining information in a form which can withstand scrutiny under United States rules of evidence. Both models are valuable attempts to address the tax haven problem.[106]

C. *Treaty Shopping*

The extensive use of tax treaties has resulted in "treaty shopping" which has a significant impact on tax havens, specifically in their selection by tax evaders.

"Treaty shopping" has been defined as "the ability of residents of countries other than the countries that are parties to the treaty to derive treaty benefits (such as rate reduction on passive income) by channeling investments through entities in organized or resident in a treaty jurisdiction."[107] Treaty shopping must always be consid-

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105. Oliva, *The Treasury's Twenty Year Battle with Treaty Shopping: Article 16 of the 1977 United States Model Treaty*, 14 GA. J. INT'L & COMP. L. 293, 294 (1984). *See also* Rosenbloom, *supra* note 79, § 31.04[2] for details on the United States' adoption of the OECD Model.

106. Critics have added that the model treaties could go further and provide that source countries should forego tax on interest income entirely, rather than imposing a withholding tax at a rate no higher than 10%. Also, the critics believe that the United States treaties should not extend benefits to residents of third countries, and tax treaties should not be used to grant United States tax benefits to United States citizens and residents. Rosenbloom, *supra* note 79, § 31.04[3].

107. *Chapoton Explains U.S. Tax Haven Treaty Policy*, *supra* note 23, ¶ 9946. The Internal Revenue Service explains the practice as follows:

> "Treaty shopping" is the practice of taking advantage of treaty benefits (primarily exemptions and reduced rates of tax) by individuals, corporations or other entities not entitled to these benefits. A major device for treaty shopping is the interposition of an intermediate entity, located in the treaty country, between the ultimate investor and the investment. That entity receives the income from U.S. sources in the form of dividends, interest, royalties, etc. If it qualifies as a resident of the treaty country, the intermediate entity may obtain a reduced rate or exemption from the 30% withholding tax imposed by the U.S. on gross investment income. After receipt of the payment, the intermediate entity may then pay dividends and/or interest to the ultimate investor, a nonqualifying recipient in a third country which does not have a treaty with the United States, with little or no tax being paid to the treaty country. These intermediate entities have been used to claim benefits under several U.S. tax treaties.

Egger Discusses Tax Haven Problems Before House Subcommittee, *supra* note 23, ¶ 9947.

Another definition is "the practice of establishing entities in countries having favorable income tax treaties with the United States, in order to secure a lower U.S. withholding tax rate on 'fixed or determinable annual periodical [sic] gains, profits and income' (I.R.C. § 1441(b)) or some other benefit particular to a given treaty." Freud, *supra* note 80, at 627.

Commentators also see treaty shopping as having a dual purpose: "Some consider treaty ered a factor when dealing with the abuses of tax treaties or tax treaty problems.

The significant use of another countries' treaties through treaty shopping has been a longstanding concern of the United States.[108] Several specific treaties are known for their abuses.[109] With regard to tax havens, treaties are often used by residents of a nontreaty country to achieve a reduction in United States taxation.

> Although most of this use is not fraudulent, some is abusive and inconsistent with present United States tax policy. The low rates of tax coupled with the anonymity afforded by tax havens do, however, give rise to some fraudulent use.
>
> United States taxpayers, particularly multinational corporations, may also use the United States treaty network tax havens to their advantage. The most widely known use is that of Netherlands Antilles finance subsidiaries to achieve zero rates of tax on interest paid on foreign borrowings. Often, the advantages which can be achieved through tax haven treaties can also be achieved through treaties with non-tax havens.[110]

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shopping to serve a permissible policy purpose of attracting foreign capital to the United States, some consider treaty shopping an abuse that exacerbates a perceived inequity under which nonresidents of the United States generally pay less tax on their U.S. portfolio investments than do residents. *Id. See also* Comment, *supra* 84, at 627-28; SENATE COMM. ON FOREIGN RELATIONS, REPORT ON THE TAX CONVENTION WITH THE REPUBLIC OF MALTA, S. EXEC. REP. NO. 30, 97th Cong., 1st Sess. 20 (1981).

108.

> The [IRS] in recent years has been particularly concerned about third-country residents' use of bilateral income treaties to avoid paying tax on United States source income. A "third- country resident" is an individual who is not a resident or citizen of the United States or a country party to a tax treaty with the United States. Treasury Regulation § 1.871-2(b) which defines "residence" for an individual provides: "an alien actually present in the United States who is not a mere transient or sojouner is a resident of the United States for purposes of the income tax." Treas. Reg. § 1.871-2(b) (1957). The term "third-country resident" should not be confused with the term "nonresident alien individual," which includes those individuals who are residents or citizens of other countries party to a tax treaty with the United States. Treas. Reg. § 1.871-2(a) (1957). The rules used to determine the source of income are set forth in I.R.C. §§ 861-864 (1981).

Comment, supra note 84, at 626 & nn.1-2 (citation ommitted).

109. The following three treaties are examples of those widely abused by United States treaty partners: United States—Netherlands Antilles Income Tax Convention, Convention with Respect to Taxes on Income and Certain Other Taxes, Apr. 29, 1948, United States-Netherlands, 62 Stat. 1757, T.I.A.S. No. 1855 (extended to the Netherlands Antilles by Protocol, June 15, 1955, 6 U.S.T. 3696, T.I.A.S. No. 3366; amended by Protocol, Oct. 23, 1963, 15 U.S.T. 1900, T.I.A.S. No. 5665; modified by Convention, Dec. 30, 1965, 17 U.S.T. 896, T.I.A.S. No. 6051); United States—Luxembourg Income Tax Convention, Convention with Respect to Taxes on Income and Property, Dec. 18, 1962, United States-Luxembourg, 15 U.S.T. 2355, T.I.A.S. No. 5726; and Convention for the Avoidance of Double Taxation with Respect to Taxes on Income, *supra* note 66. *See* Granwell, *Treaty Shopping—Recent United States Developments*, 12 TAX PLAN. INT'L REV., Sept. 1985, at 7.

110. REPORT, *supra* note 4, at 147.

> Treaty oriented tax evasion via treaty shopping includes: (a) recycling funds (legally

The third country resident use of tax treaties can take on various forms.[111] "Successful treaty shopping [as the report outlines] generally consists of three elements: (1) a reduction of source country taxation; (2) a low or zero effective rate of tax in the payee treaty country; and (3) a low or zero rate of tax on payments from the payee treaty country to the taxpayer."[112] Many of these elements apply to non-tax haven income tax treaties as well as tax haven treaties.[113]

The United States has taken a hard-line stance on treaty shopping.[114] This has first been attempted by including a provision in article 16 of both model treaties defining third party residents so as to limit the treaty benefits to specific taxpayers.

> It is the policy of this administration not to enter into new treaties which permit . . . benefits to residents of third countries and, as appropriate, to renegotiate, or, if necessary, to terminate existing treaties to accomplish this objective. Limitation of benefits provisions . . . will be employed wherever necessary and in the form appropriate to the circumstances, to ensure that U.S. policy are [sic] met by the extension of benefits in our tax treaties.[115]

Recent tax legislation has focused on limiting treaty shopping in various ways including tightening the definition of nonresident

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> or illegally) in the U.S. or abroad back into the United States through a treaty country after it has first been laundered in a non-treaty tax haven jurisdiction; (b) fraudulent use by United States persons to remove income from the United States at reduced rates of tax by masquerading as foreign taxpayers; and (c) fraudulent use by foreigners to obtain benefits of treaty rates.

Id. at 159.

111. *See id.* at 153-57.

112. *Id.* at 158.

113. It should be noted that the United States model treaty in article 16 directly attempts to prohibit treaty shopping and that both model treaties attempt to limit treaty shopping by providing a definition of "third party residents."

114. The reasons underlying United States policy are:

> (1) A limitation of benefits provision permits the United States to expand its income tax treaty network to countries with which it does not have a treaty and also to renegotiate its existing treaty network;
>
> (2) A limitation of benefits provision assures that tax treaty benefits flow only to intended beneficiaries; and
>
> (3) A limitation of benefits provision assures that important tax policy judgments are made by the United States.

Granwell, *supra* note 109, at 7-8. Some disagree:

> [A]nalyzing the development of anti-treaty shopping provisions in United States bilateral tax treaties . . . demonstrates that the Treasury Department has maneuvered the United States into a very weak position from which to combat treaty shopping, by failing to adopt and implement a consistent policy of including anti-treaty shopping provisions in the United States in tax treaties.

Comment, *supra* note 84, at 632.

115. Comment, *supra* note 84, at 626; *Chapoton Authors Treasury Policy on Treaty Shopping*, 19 TAX NOTES 249 (1983).

aliens.[116] Also, the Internal Revenue Service recently issued two published revenue rulings which have further reinforced the position that the United States has taken against treaty shopping.[117]

IV. Collateral Perspectives

Before analyzing the effectiveness of tax treaties to prevent tax havens, it is useful to examine the tax haven problem from a few different perspectives.

First, a look at other mechanisms to prevent tax havens will be taken. A recent and innovative method of solving the tax haven problem has been the use of the courts which should be pursued as an option. Second, an examination of the tax haven problem as it exists in other countries and those countries' attempts to solve the problem will be made for any useful precedents which could be adopted in the Unites States.

A. The Use of the Courts

A majority of the recent court cases have revolved around the production of documents and fiscal information.[118] These cases have been significant in breaking through the barriers set up by the secrecy laws of the tax haven countries and in providing for the effective exchange of information.[119]

An important and early case in "directly" preventing tax havens was *Aiken Industries, Inc. v. Commissioner.*[120] There, a United States corporation borrowed money from its Bahamian parent and

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116. *See* Report, *supra* note 4; Aland, *supra* note 10; *IRS Faces Treaty Shopping Quandry*, 26 Tax Notes 850 (1985).

117. Rev. Rul. 84-152, 1984-2 C.B. 381, provided that the interest payments by a United States subsidiary of a Swiss parent to that parent's Netherlands Antilles subsidiary which arose from a financial arrangement whereby the Swiss parent loaned funds to its Antilles subsidiary which in turn loaned those funds to the United States subsidiary, were not exempt from United States tax under article VIII(1) of the United States-Netherlands Income Tax Convention as extended to the Netherlands Antilles.

Rev. Rul. 84-153, 1984-2 C.B. 383, held that interest payments that a domestic subsidiary of a United States parent made to that parent's Netherlands Antilles subsidiary, which arose from a financial arrangement whereby the Antilles subsidiary issued bonds to foreign persons and loaned the proceeds to the domestic subsidiary, were not exempt from United States taxes under article VIII(1) of the United States-Netherlands Income Tax Convention as extended to the Netherlands Antilles.

118. *See supra* note 65 and accompanying text.

119. *See* United States v. A.L. Burbank & Co., 525 F.2d 9 (2d Cir. 1975), which held that foreign countries can obtain tax information concerning domestic companies through the Internal Revenue Service exchange of information provision. This case construed the Convention on Double Taxation: Taxes on Income, March 4, 1942, United States-Canada, 56 Stat. 1399, T.S. No. 983.

120. 56 T.C. 925 (1971).

issued it a promissory note. A Honduran company was then formed. The parent company transferred the U.S. corporation's note to the Honduran company in exchange for demand notes bearing the same rate of interest. The U.S. corporation claimed exemption from its withholding obligation under the then-effective United States-Honduras income tax convention which exempted from withholding tax interest received by a Hondurn corporation from a U.S. corporation. Although not stated in the case, interest payments by the Honduran company to its Bahamian parent presumably were not taxed by Honduras.

The United States Tax Court held that the exemption did not apply because the treaty language exempted interest from United States sources "received by" a Honduran corporation. Under the court's interpretation of the facts, the interest was not received by a Honduran corporation. The court interpreted the words "received by" to mean something more than merely obtaining physical possession of the funds coupled with an obligation to pass them on to a third party. Since there was no change in the inflow and outflow of the interest payments and since the three companies were all members of the same corporate family, the interposition of the Honduran company and transfer of the notes to it lacked any valid economic business purpose. The Honduran company was merely a conduit for the passage of interest payments from Aiken to the Bahamian company. It had no actual beneficiary interest in the interest payments and, in substance, Aiken was paying the interest to the Bahamian company. In this way, the case prevented use of the Hounduran tax haven.

Recently, two developments have occurred in tax haven litigation. These developments do not concern the prevention of tax havens, but rather demonstrate the use of the courts for tax haven interpretation problems. In one case, the court dismissed a criminal case against two crude oil dealers and one of their lawyers, thus raising doubts about the constitutionality of a question asked on a federal individual income tax form about the use of foreign tax havens.[121] Also, the government of Guam has filed suit to have declared null and void a revenue ruling and a Treasury decision that would prevent Guam from becoming an international tax haven.[122]

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121. United States v. Eisenberg, Cr. No. H81-09 (S.D. Tex. 1981). *See also Constitutionality of IRS Tax Haven Form Questioned*, Legal Times of Wash., Mar. 30, 1981, at 2, col. 1.

122. The Guam controversy has been building for some time. *See Guam Sues Trea-*

There has also been a move for extra-territorial litigation. The result desired by such actions is to encourage the affected governments to come to the bargaining table to arrange for more organized and predictable information disclosure arrangements.[123]

The courts might play an important role and at some future point become useful in the tax haven problem as demonstrated by these precedents. However, for the time being, the courts are only relied on for the effective production of needed fiscal information about tax evaders.[124]

B. *Other Countries*

The problem of tax havens and evasion of income tax is a problem that confronts not only the United States, but also other nations. The Report suggests that the concerns of foreign countries regarding the problem are deeper than those of the United States.[125] As stated in the Report, "[f]oreign governments have also been concerned with the use of tax havens to avoid or evade their taxes. Some countries have adopted legislative provisions intended to limit the use of tax havens by their nationals. Many of these provisions are based on United States law."[126]

The major method of fighting tax havens by foreign countries has been legislative. It is very important to note that Canada, France, Germany, Japan and the Netherlands have provisions in their tax laws that are more limited than the present United States provisions. Conversely, a vast majority of countries have no provisions at all.[127]

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sury Over Tax Haven Ruling, 21 TAX NOTES 921 (1983); and *Guam, Treasury at Loggerheads Over Tax Rules*, 19 TAX NOTES 244 (1983).

123. Weisland, *supra* note 60, at 1133.

124. *See supra* note 65 and the following articles regarding the use of litigation to curtail tax haven activities: *An Intending Trader*, TAX'N, May 4, 1985, at 85; *Writ Issued in Test of Law on Tax Havens*, N.Y. L.J., Jan. 11, 1985, at 1. *See also* Marc Rich & Co. v. United States, 707 F.2d 663 (2d Cir. 1983), *cert. denied*, 463 U.S. 1215 (1983); and *In re* Grand Jury, 550 F. Supp. 24 (W.D. Mich. 1982) (holding that the grand jury subpoenas served on the United States branch of a foreign bank in New York calling for customer records held by the bank were enforceable).

125. REPORT, *supra* note 4, at 24; Gordon, *supra* note 11. Problems of international evasion are not new. The first tax treaty, signed August 12, 1843, was an agreement concerning administrative assistance between Belgium and France. MANUAL FOR THE NEGOTIATION OF BILATERAL TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, U.N. Doc. St/ESA/94 (1979). The concern about tax havens is illustrated by a German-French memorandum on the International level, *found at* 14 EUR. TAX. 136 (Apr. 1974).

126. REPORT, *supra* note 4, at 3.

127. Aland, *supra* note 10, at 1013-14. There are variations in the details of the foreign legislation, but the basic approach adopted by each country, including the United States, is to impose a charge on certain types of unremitted income of overseas companies

1. United Kingdom

The United Kingdom has been at the forefront in attempting to prevent tax havens. The United Kingdom has always been prone to tax haven abuse by its constant engagement in foreign travel by residents, international emphasis on expansion of the British Empire and convenience of the British flag.

In 1981, the United Kindgom Inland Revenue issued a "Consultative Document," which served as a proposition paper of official policy regarding tax havens, and solicited comments on possible legislation to counter tax haven abuse. This paper stated:

> Section 482 [of the Code of Inland Revenue]. . . has for nearly 30 years been the main provision for countering international tax avoidance in the corporate sector. Until 1979 it was reinforced by exchange control which imposed constraints on international transfers. With the abolition of exchange control it is necessary to consider whether the provisions of section 482 should be retained. The section makes unlawful company migrations, transfers of trade abroad and certain transactions relating to overseas companies in a [U]nited [K]ingdom group without Treasury consent, and the penalties for infringement include imprisonment as well as fines. Arguably these provisions are not appropriate against a background of free exchanges.[128]

The British anti-tax haven proposition paper, which suggested revenue patrols and direct taxes, solicited great debate in the United Kingdom.[129] A majority of commentators preferred modified taxing

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which are controlled by its residents. The resident shareholder is made liable for his proportionate share of the income of the controlled foreign company and is subject to relief for overseas taxes on that income, all normally exempt profits which arise from overseas trading activities and small shareholdings and small amounts of income. *Tax Havens and the Corporate Sector (Great Britain)*, 131 NEW L.J. 135 (1981); Tiley, *UK: Draft Clauses on International Tax Avoidance*, 9 TAX PLAN. INT'L REV., Feb. 1982, at 4. *See* legislative comparisons in chart form of the taxing aspects of foreign corporations in Canada, France, United Kingdom, Germany, the United States and Japan *in* Arnold, *The Taxation of Controlled-Foreign-Corporations*, 66 TAXES INT'L, Apr. 1985, at 3, 10-11.

128. *Tax Havens and the Corporate Sector—A Consultive Document*, 22 TAXES INT'L, Aug. 1981, at 10; *Tax Havens and the Corporate Sector, supra* note 127. The other main measure against international tax avoidance in the United Kingdom was § 478 which was designed to prevent residents from exporting assets and accumulating income overseas.

129. Whiteland-Smith, *An Offshore Association*, 115 TAX'N 414 (1985); Meyers, *Tax Havens*, 133 NEW L.J. 963 (1983); *Tax Havens-Beginning of the End?*, 4 BUS. L. REV., Mar. 1983, at 33; Gammie, *International Tax Avoidance—Progress at Last?*, 110 TAX'N 90 (1982); *Tax Havens and the Corporate Sector: A Response to the Public Comments*, 35 TAXES INT'L, Sept. 1982, at 3; *The Three Escape Clauses, id.* at 9; *The National United Kingdom Tax Computation, id.* at 12; *Other Provisions and General Comments, id.* at 14; *Tax Haven Companies*, BRIT. TAX REV., Jan.-Feb. 1982, at 7; Macquillan & Revill, *Success and Appeal of Tax Havens*, 131 NEW L.J. 537 (1981); *The Disappearing Haven*, 106 TAX'N 583 (1981).

procedures instead of complex income provisions like the United States' Subpart F.[130] The United Kindgom generally desired to adopt general principles with some limited safe harbors with discretion to apply to some taxpayers.

In its usual form, a United Kingdom double taxation treaty provides that the profits of an enterprise of the other contracting party are not taxed unless there exists a permanent establishment in the United Kingdom. The definitions articles of tax treaties usually state that an enterprise is "of" a particular state if its business is carried on by a resident in that state. However, the proposition paper contained definitions which, if enacted in legislation, would have conflicted with those in many treaties. Thus, the anti-tax haven legislation, had it adopted the proposition paper, would have breached many treaties unless the United Kingdom followed its normal practice of giving precedence to its treaties.

The British government's response to the conflicting public sentiment from the Consulative Document was a second document. The second document, entitled "Company Residence," was the logical companion to the first.[131] Its purpose was to solve the problems in the conflicts of the definitions in section 482 and, its proposed amendments and British treaties. It opened with the proposition that "it had become apparent that consideration needs to be given to the concept of company residence for tax purposes." The second document pointed out that there is no statutory definition of "residence," and the meaning of the term derives from case law which "is mostly of some antiquity." The consquences of this legal uncertainty and the conflict between case law and the reality of the commercial world meant that established criteria had become artificial with the passage of time and with technical innovations such as rapid transportation and communications. Companies had been able to arrange a residence for tax purposes which bore little relation to the base of the company's operations. Legislatively, the Inland Revenue of the United Kingdom concluded that any replacement of the prior law, section 482, would necessitate a recasting of the terms on which a company was deemed to be a resident of the United Kingdom for tax purposes.

The courts of the United Kingdom have acted in a manner simi-

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130. *U.K. International Tax Advisors Analyze the Inland Tax Revenue Paper Tax Havens and the Corporate Sector*, 22 TAXES INT'L, Aug. 1981, at 10, 12.

131. The second document is also described in various articles listed *supra* notes 127-30.

lar to U.S. courts by circumventing foreign secrecy laws. For example, a London representative of a Bermuda bank was required to comply with a demand by the Inland Revenue for information about the affairs of the customers of the bank who had consulted the London office.[132]

2. France

The French too have battled with *les parodic fiscals.*[133] Article 70 of the French Finance law of 1980 instituted a system of taxation aimed at French corporate parents on certain profits of their subsidiaries located in a privileged tax country.[134] This encroached on the otherwise strong French principle of taxing company profits on a territorial basis. A French taxpayer is now liable for the corporation's tax in that he is subject to a tax on a pro-rata share of the profits of a foreign subsidiary if he owns, directly or indirectly, at least twenty-five percent of the subsidiary which is established in a jurisdiction providing privileged tax status.[135]

Article 70 applies only to French enterprises subject to the French corporate income tax either by way of law or election. Thus, a French partnership or other French enterprise which is transparent for tax purposes, and which has not elected to be taxed as a corporation, would not be subject to penalties. The same would be true of French individual shareholders controlling a tax haven entity. The French law defines tax havens as "jurisdictions imposing no taxes or taxes at a level much lower than France does." France, as do other countries, directly lists tax havens in its law. The antitax haven provisions are to be applied to these jurisdictions. French law lists jurisdictions not imposing income taxes, such as Andorra,

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132. Clinch v. Inland Revenue Comm'rs, [1973] 1 All E.R. 977.

133. Translated, this means "tax havens." French displeasure with tax havens dates back to 1962 with the enactment of the Swiss-French tax treaty. *See* C. DOGGART, *supra* note 1, at 72.

134. This was later codified as article 209B of the CODE GENERAL DES IMPOTS and supplemented by a decree (No. 91-1173, Dec. 30, 1981). The French Code also contains article 57 which gives tax authorities wide authority to reallocate income and expense when it can be demonstrated that arm's length pricing standards have not been respected in international transactions between related parties. Article 57 applies essentially to French companies under foreign control or themselves in control of businesses conducted outside of French territorial limits. It grants reallocation authority in a situation where there is direct or indirect control between a French-based company and a foreign-based company and profits which should have been taxable in France but which were transferred to the foreign-based company.

135. As could have been expected, French multinational corporations which established subsidiaries in privileged tax countries objected to this new law because of its penalizing aspect and also the lack of information concerning its applicability.

Bermuda and Uruguay, separately from jurisdictions exempting from tax certain types of foreign-source income, such as Lebanon, Panama and Venezuela, and jurisdictions taxing at a level appreciably lower than in France either in all cases or by reason of special tax regimes available to local entities controlled by foreign persons. Included in this last category are several British dependencies and ex-dependencies such as Antigua, Barbados, Gibraltar, Jersey and Luxembourg. Absent from the French list is the important tax haven of the Netherlands Antilles.[136]

3. Germany

The Federal Republic of Germany also legislatively lists *Steverause*[137] countries in the Aussensteuerreformgesetz of 1972 (the German Foreign Tax Act). Although the law does not specifically describe the countries considered as tax havens, the German classifications are very similar to the analysis of the various types of tax havens seen in other nations.

The West German law against tax havens is similar to that of the United States.[138] It is aimed at preventing companies from establishing in countries with lower tax rates than Germany for the sole purpose of avoiding German taxes.[139] Detailed regulations under this act were published in 1974. Germany's Foreign Tax Act also extends German tax liability to German citizens who move out of Germany into a tax haven country. If these citizens retain substantial economic ties with Germany, they remain subject to German taxes on German-source income at progressive rates for ten years after moving out of Germany.[140]

4. Belgium

One of the aims of the 1973 Belgium tax law was to prevent fraud and international tax evasion through anti-avoidance measures. Where payments are made by a Belgian taxpayer to a com-

136. Guillerm-Kirk, *France*, 42 TAXES INT'L, Apr. 1983, at 20. *See also* Kaplan & Ault, *International Developments—Another View*, 8 J. CORP. TAX'N 68 (1981); Guillerm-Kirk, *The Development of the French Anti-Tax Haven Legislation*, 19 TAXES INT'L, May 1981, at 1; Irish, *supra* note 23.

137. Translated, this means "tax haven."

138. For a history of Germany's attempts to deal with tax havens, *see* C. DOGGART, *supra* note 1, at 79.

139. The German Aussensteuerreformgesetz is wider in scope than the United States Subpart F since its coverage extends to individuals and certain foundations.

140. The courts have also played a role in attempting to limit the use of tax havens by Germans. *See* INTERNATIONAL TAX AVOIDANCE, *supra* note 30, at 327-28.

pany established in a country whose tax system is notably more advantageous than that of Belgium, the taxpayer has the burden of proving that the payments were incurred in genuine transactions and that they do not exceed Belgium's normal limits.[141]

5. Japan

Japan currently imposes a tax on the pro-rata share of the undistributed income of specified foreign subsidiaries. This income must be attributable to Japanese resident corporate shareholders owning, directly or indirectly, ten percent of the total shares of the foreign subsidiary.[142] Overall, Japan's prevention of tax havens can be regarded as minimal.

6. Canada

Canadian tax authorities, inspired by those in the United States, have become increasingly critical of income earned through property held by tax privileged "foreign business corporations." Section 48 of the Canadian Income Tax Act now provides that a resident of Canada who departs from Canada is deemed to have disposed of most of his property at its fair market value. As a result of this recently enacted departure tax, a resident leaving Canada finds himself subject to tax on many of his assets as though he had sold them. Even worse, however, this "disposition" may not qualify for foreign tax credit in the United States and some other countries.[143]

7. Australia

Australia's new Labor government promised to launch a campaign against tax havens[144] both by legislation and court action.[145] The attack has been primarily on tax haven islands in close proximity to Australia. Additionally, breaking through secrecy laws is a major goal of the Australian government. Exchange control authority from the Reserve Bank of Australia is required for almost all transactions between residents and non-residents to curtail the improper use of tax havens. To that end, residence for exchange control purposes is defined differently from residence for tax purposes.

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141. *See generally* M. LANGER, *supra* note 5, at 112.
142. REPORT, *supra* note 4, at 25.
143. M. LANGER, *supra* note 5, at 112. *See generally* Ilersic, *Tax Havens and Residence*, 30 CANADIAN TAX. J. 52 (1982).
144. Gorr, *Australia*, 42 TAXES INT'L, Apr. 1983, at 17.
145. C. DOGGART, *supra* note 1, at 75; M. LANGER, *supra* note 5, at 110.

The Reserve Bank of Australia, which administers the exchange control provisions, is not permitted to give exchange authority where one of the parties to the transaction is a resident of or located in a scheduled tax haven unless the Commissioner of Taxation has first granted a Tax Clearance Certificate.[146]

8. Regional Efforts

Groups of countries and various international organizations have made efforts to prevent tax havens. For example,

> OECD member nations, both through international tax avoidance legislation and through exchange control rules, seek to minimize the opportunity for the use of tax haven companies.
>
> This developing attack on tax havens has gathered pace in the last few years. High tax rates in developed nations have undoubtedly led to the increasing use of tax havens and it is perhaps a measure of their success that in retaliation the rules restricting their use have progressively been tightened. Recognition of the tax planning uses of certain aspects of the tax legislation of otherwise normal taxing nations has, in some instances, also led to an attempt to restrict the use of these territories by international companies.[147]

One such attempt was the Convention on Administrative Assistance in Tax Matters concluded by Denmark, Finland, Iceland, Norway and Sweden in 1972, a multilateral convention dealing with international tax evasion and avoidance. The United States, the United Kingdom, France and West Germany presently are considering development of a multilateral auditing program. Various spokesmen in the European Economic Community, the OECD and

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146. Hamilton, *Taxation of Foreign Investors in Australia*, 11 TAX PLAN. INT'L REV., Jan. 1984, at 8, 12.

147. Browne, *International Tax and Exchange Control Regulations in OECD Countries*, 11 TAX PLAN. INT'L REV., July 1984, at 11, 12. *See also* INTERNATIONAL TAX AVOIDANCE, *supra* note 30. The United States' involvement in international efforts is rising:

> The United States, through Treasury Department representatives, has taken a lead role in work-in-process in the Organization for Economic Cooperation and Development (OECD) which bears on the use and abuse of tax havens, in the Caribbean and elsewhere. Working parties . . . of the OECD have been studying tax haven problems generally, and, more specifically, abuse of tax treaties with tax havens. Reports on these subjects are now in preparation with substantial U.S. contributions. The committee has also been doing extensive work on the exchange of information under tax treaties which, while not specifically related to tax havens, clearly bears on efforts to curb their use. Similar work on combatting tax haven abuse has occurred in the Group of Four . . . and the Pacific Association of Tax Administrators (Australia, Canada, Japan, and the United States.)

TAX HAVENS IN THE CARIBBEAN BASIN, *supra* note 5, at 49.

the United Nations constantly consider the problem of international tax evasion and avoidance practices, and they may be of assistance in the future.

The Fiscal Affairs Committee of the OECD recently met in Paris and adopted a draft convention on tax evasion and avoidance. If implemented, the treaty, which is a "joint venture" between the OECD and the Council of Europe, will not affect existing bilateral tax information sharing agreements. The adoption of a draft treaty by the Fiscal Committee of the OECD does not commit any country to adoption of the treaty, but rather simply allows the signature process to begin.[148]

V. Analysis

The use of tax treaties can be an excellent mechanism to prevent tax evasion through tax havens. The recent treaties that the United States has proposed or ratified as well as the United States treaty policy towards tax havens and the history of the treaties are important means for surveying the use of tax treaties to prevent tax havens.

A. *The Use of Income Tax Treaties to Prevent Tax Havens*

Notwithstanding a direct call to tax havens themselves for their cooperation,[149] the history of income tax treaties demonstrates their importance to their present shortcomings in preventing tax haven abuses.[150] The exchange of information between taxing jurisdictions to reduce international tax evasion and measures to avoid and to prevent treaty shopping are paramount factors that must be included in tax treaties to curtail future tax haven abuses.[151]

148. TAX NOTES INT'L (July 23, 1986).

149. "Both United States and foreign persons are evading and avoiding tax laws by using tax haven companies with which the United States has income tax treaties. It is obvious that this activity could not take place at current levels if the tax havens cooperated with the United States." Caribbean Basin Economic Recovery Act, *supra* note 12.

150. REPORT, *supra* note 4; Irish, *supra* note 23, at 501; Gordon, *supra* note 11, at 797.

151. Another result from exchange of information provisions is the development of cooperative audit programs to reduce international tax evasion and avoidance. *See* Irish, *supra* note 23, at 507. For provisions for recognizing foreign tax judgments, *see* Glos, *supra* note 46.

1. Exchange of Information

The Report concluded that "[e]xchange of information provisions in the existing tax treaties with tax havens are simply inadequate because they do not override local bank or commercial secrecy laws. In any event, the United States does not have treaties with most tax havens."[152]

Direct exchanges of information, which have been included in recent treaties, must be provided for in all future income tax treaties. This is the only sure way of circumventing bank or commercial secrecy laws which are essential characteristics of a tax haven operation. However, careful attention is required in drafting the provisions to ensure their utility. There should be no technical difficulties that could prevent the exchange of the information. This would require a clear description of the information that is sought as well as provisions for overcoming any legal obstacles in obtaining the information. Also, the United States' treaty networks must be expanded, particularly to tax haven jurisdictions, to provide exchanges of information.

The United States additionally is confronted with the problem of obtaining information that is admissible in United States courts of law.[153] Provisions addressing this issue can be found in existing treaties, but their interpretation is often difficult and somewhat skeptical.[154]

The exchange of information concept may present itself in bilateral forms other than an income tax treaty. The use of mutual assistance treaties which usually require a criminal violation have been highly successful.[155] The most significant U.S. mutual assis-

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152. REPORT, *supra* note 4, at 9.

153. *See supra* notes 65 & 118 and accompanying text.

154.

> The treaties that exist have several limitations and are of limited usefulness in producing information that is admissible in court. The informaton is often not in a form that is admissible. Even if in admissible form, there is danger. Since U.S. and foreign laws differ, foreign authorities may use methods to produce the evidence which complies with their law, but violates the U.S. Constitution. If so, and if the accused has standing to object to use of the evidence, case law suggests that the evidence would have to be suppressed. Suppression would result because the U.S. government, by requesting foreign assistance, initiated the violation.

Spall, *supra* note 38, at 359.

155.

> The mutual agreement treaty is potentially a more fruitful concept, but it covers much more than tax issues and will usually be administered, in whole or in part, by persons not in the normal path of confidential tax information. This will lead to problems of information exchange not only in the other country but in the United States as well.

tance treaty is its agreement with Switzerland.[156] Similar agreements are also now in existance with the Netherlands,[157] Turkey and Columbia and most recently with Canada.[158] Two major problems confront exchange of information agreements: 1) they are limited in authority; and 2) their enforcement poses a major problem.[159] These obstacles must be overcome.[160]

Recently, there has been pressure to create regional or international mechanisms for exchanges of information among cooperating nations to which tax havens would be persuaded to accede.[161] This would be an excellent means of curbing international tax evasion or avoidance. Also, an emphasis on exchange of information provisions must be stressed in the extensive network of treaties being created with developing countries.[162]

2. Treaty Shopping

As has been seen in its definition and description, there exists an overall heightened administrative and congressional concern with and awareness of treaty shopping. Nonresidents may seek to reduce their United States tax liability via tax havens in various ways. For example, nonresidents may attempt to manipulate transfer prices to shift United States profits to a tax haven subsidiary. They may also try to escape United States taxes by routing transactions through a country with which the United States does not have a tax treaty. This is treaty shopping in its raw form.

Tax treaties are an important device in eliminating the problem

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Rosenbloom, *supra* note 79, § 31.03[3].

156. *See supra* note 67 and accompanying text.

157. *See supra* note 109. It has been suggested that this treaty be revised to include an asset forfeiture provision and extradition provisions. *See* R. BLUM, *supra* note 24, at 271. The Internal Revenue Service has stated that the treaty has been useful, but complains that it is limited to criminal matters. Spall, *supra* note 38, at 347.

158. *See* Comment, *supra* note 2, at 690. The treaty was concluded on February 6, 1985. *See* Zagaris & Kochinke, *Developments in Mutual Assistance: U.S.-Canada Reach New Agreement and Swiss Court Decision Sheds Light on the Operation of the Amended Swiss Act*, INT'L EXCHANGE OF TAX INFORMATION: RECENT DEV. (June 4, 1985).

159. *See* Comment, *supra* note 2, at 691.

160. Congress could empower the President to enter into bilateral executive agreements with foreign jurisdictions for the exchange of tax information; however, it is arguable whether I.R.C. § 6103(k)(4) (1982) would permit this.

161. *See* R. BLUM, *supra* note 24, at 278; Irish, *supra* note 23, at 482. *See European Economic Community, Council Directive of 19 December 1977 Concerning Mutual Assistance by the Competent Authorities of the Member States in the Field of Direct Taxation; German-French Memorandum on Tax Evasion/Avoidance on the International Level*, 14 EUR. TAX'N 136 (1974).

162. *Chapoton Outlines Treasury Policy on Treaty Shopping*, 19 TAX NOTES 249-50 (1983).

of treaty shopping. The Model Income Tax Conventions were designed to limit significantly the third country use of treaties. There is little incentive, however, for tax haven countries such as the Netherlands Antilles to make concessions in a new treaty which the United States would regard as meaningful.[163] Moreover, under certain circumstances, a United States threat of a unilateral termination of a treaty is perceived by some tax haven states as an empty threat. When the United States has a substantial interest in preserving the treaty, there is little likelihood that the threat of a complete termination would be carried through.

The most common way of curtailing treaty shopping in tax treaties is by including an anti-holding company provision which disallows reduced tax rates on dividends, interest and royalties if the recipient corporation is not a resident.[164] Such a provision must be included in all future treaties. Treaty shopping has played a major role in the enactment or reenactment of recent United States treaties. The United States agreement to certain treaty shopping exceptions in the proposed treaty with the Netherlands Antilles[165] is a radical departure from a strong anti-treaty shopping stance and should not become a practice or precedent.

3. Tax Treaty Abuse

A subject of international debate, and of particular concern to the U.S., is tax treaty abuse.[166] The actual abuse of tax treaties varies significantly from treaty to treaty.[167]

> The question of what constitutes abuse of tax treaties is even more difficult to answer than the question of the abuse of the tax law of the various jurisdictions. One reason is that most tax treaties serve several purposes simultaneously, and these purposes may conflict. Another reason is that there is usually little or no official information about any policy the treaty partners may have for preventing tax avoidance or "abuse" through the exploitation

163. *See* Tomsett, *supra* note 77, at 13.

164. *See* Irish, *supra* note 23.

165. *See infra* notes 197-203 and accompanying text.

166. *Egger Discusses Tax Haven Problem Before House Subcommittee*, *supra* note 23, ¶ 99947; Rosenbloom, *supra* note 77. Effective administration of tax treaties and their anti-abuse provisions are limited because (1) full and willing cooperation of the treaty partners' tax administration in the form of resources and expertise is necessary; (2) there must exist meaningful exchanges of information; and (3) there must be a much greater commitment of resources than are available. REPORT, *supra* note 4, at 163-65.

167. *Chapoton Explains U.S. Tax Haven Treaty Policy*, *supra* note 23.

of tax treaties.[168]

Treaty abuse may be in the areas of limitation of benefits, exchange of information provisions, anti-holding company rules or any specified article of the treaty. Treaty interpretation is also an area for great abuse. The summary of treaty abuse by a leading study can best explain the problem:

> a) The question of abuse of tax treaties must be governed primarily by their interpretation with the help of all means of interpretation available in the legal systems of the treaty partners unless these are over-ruled by any special rules of interpretation embodied in or arising from the tax treaty itself.
> b) There is at present no general internationally accepted rule dealing with criteria for tax-treaty abuse (for example similar or analogous to criteria generally to be found in national rules of tax law concerning abuse of tax law or substance over form).
> c) Abuse of tax treaties may be countered, if a tax treaty permits or at least does not expressly forbid, by rules in the national tax law or one or both treaty partners about special techniques of interpretation like abuse of tax law or substance over form. This theoretical possibility does not seem to be of much practical importance because of the serious difficulty of applying these rules.
> d) The intent and purposes of the treaty legislators should be decisive consideration in deciding questions of treaty abuse. An intent to counter a certain kind of abuse should be embodied in specific treaty articles exclusively designed for this purpose. There should at least be clear and unmistakable statements in the official documents explaining the treaty, like exchanges of notes, preambles or other documents such as parliamentary papers. Article 16 of the U.S. Model Treaty is one of the possible examples of this "direct" legislative method.[169]

The United States is always presented with the option of amending the Internal Revenue Code to prevent income treaty abuse for the area involved. Nevertheless, a tax treaty, in order to prevent tax havens, must take into account the possibility of its abuse and contain significant provisions for correcting any such abuse.

B. Recent Treaty Developments

The true factor of the effectiveness of tax treaties as a prevention device for the use of tax havens is actual treaty developments.

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168. INTERNATIONAL TAX AVOIDANCE, *supra* note 30, at 313.
169. *Id.* at 330.

These include the proposal or ratification of new treaties or recognition of old treaties. The United States has a large and growing network of income tax treaties.[170] Some are in various negotiation stages of approval.[171] In light of the growing concern over tax havens, the United States has terminated several tax treaties with

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170.

INCOME TAX TREATIES IN FORCE

Australia	Korea
Austria	Luxembourg
Barbados	Malta
Belgium	Morocco
Canada	Netherlands
Cyprus	Netherlands Antilles
Denmark	New Zealand
Egypt	Norway
Finland	Pakistan
France	Phillipines
Germany	Poland
Greece	Romania
Hungary	South Africa
Iceland	Sweden
Ireland	Switzerland
Italy	Trinidad & Tobago
Jamaica	Union of Soviet Socialist Republic
Japan Republics	United Kingdom

171.

Country.	*Signed Status*
Argentina 1981	Argentina has shown little interest in exchanging Instruments of Ratification since the Senate gave advice and consent subject to certain reservations.
Bangladesh 1981	Bangladesh appears to object to the United States' reservation that the United States be given "most favored nation" treatment with respect to shipping income.
France 1984	Awaiting French ratification. (Protocol)
Israel 1975	Israel questions Senate reservation that certain Congresssional committees and the General Accounting Office have access to information exchanged under the treaty.

TREATIES SIGNED, AWAITING SENATE APPROVAL

Denmark 1980	Question relating to oil and gas tax (Protocol) credit.
People's Republic of China 1984	Sent to the Senate in August 1984.

NEGOTIATIONS COMPLETED, SHOULD BE SIGNED SHORTLY

Finland	At the State Department
Sri Lanka	At the State Department
Sweden	

TAX TREATIES UNDER ACTIVE NEGOTIATION

Austria	Netherlands Antilles
Belguim	Switzerland
Germany	Thailand
Indonesia	Trinidad & Tobago
Ireland	Tunisia
Netherlands	

many tax haven countries, including the treaty with the tax haven of the British Virgin Islands, and renegotiated a new treaty with Barbados.[172] Also, immediately following publication of the Report, the United States Senate began investigating various treaties.[173]

1. Most Recent Treaties

In late 1985, the Senate ratified income tax treaties with Italy,[174] Cyprus[175] and Barbados.[176] The Senate Finance Committee further approved treaties with Denmark and China.[177] In 1986, a treaty with Bermuda was signed[178]and the China treaty was ratified.[179] The most significant development, however, has been the most re-

172.

TAX TREATIES TERMINATED

British Virgin Island	Malawi*
Antigua & Barbuda*	Montserrat*
Anguillia*	Rwanda
Barbados*	St. Christopher-Nevis*
Belize*	St. Lucia*
Burundi*	St. Vincent & the Grenadines*
Dominica*	Seychelles*
Falkland Islands	Sierra Leone
Gambia	Zamabia
Grenada	Zaire

*Denotes tax haven status.

See infra note 176 and accompanying text regarding the United States-Barbados treaty.

173. Within the first year after publication of the Report, the Senate Foreign Relations Committee scheduled at least fourteen pending treaties for consideration. Gordon, *supra* note 11, at 798.

174. Convention between the Government of the United States and the Government of the Republic of Italy for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion, Dec. 30, 1985, United States—Italy, TAX TREATIES P-H ¶ 53,030.

175. Convention between the Government of the United States and the Government of the Republic of Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 30, 1985, United States—Cyprus, TAX TREATIES P-H, ¶ 29,100.

176. Convention between the Government of Barbados and the Government of the United States for the Avoidance of Double Taxation and Fiscal Evasion with Respect to Taxes on Income, Feb. 28, 1986, United States—Barbados, TAX TREATIES P-H, ¶ 20,100.

177. 9 TAX PLAN. INT'L REV., Aug. 1982, at 12.

178. *United States Enters into Treaty with Bermuda on Taxation of Insurance and Mutual Assistance in Tax Enforcement*, TAX NOTES TODAY (TAX ANALYSTS), July 28, 1986.

179. By a vote of 96 to 1, the Senate July 24 [1986] ratified a tax treaty between the U.S. and the People's Republic of China. Sen. Jesse Helms, R-N.C., who has long opposed the treaty, was the only dissenter. Helms had blocked ratification of the treaty last December and was instrumental in the May 10 [1986] signing of a protocol providing rules to prevent treaty shopping. The treaty provides for a 10 percent tax rate on income from dividends, interest and royalties paid to residents of China on income earned in the U.S. The treaty also grants a 10 percent tax rate to U.S. companies doing business in China.

32 TAX NOTES 306 (1986).

cent negotiation and signing of the income tax treaty between the United States and the important tax haven of the Netherlands Antilles.[180] The exact same treaty was also enacted with Aruba.[181]

The Cyprus and Barbados treaties are of particular importance because those countries are known as tax havens. The treaty history of Barbados presents an interesting case example. In 1976, the government of Barbados enacted the Offshore Banking Act of 1979 after declaring its intention to develop as a tax haven. The stated aims of the Act were to encourage the development of Barbados as a responsible off-shore financial center, to provide incentives to investment in Barbados by way of tax reduction, exemptions and benefits for off-shore banking carried on from within Barbados and to enable citizens of Barbados to share in the ownership, management and rewards of any business activities resulting therefrom.[182]

The United Kingdom quickly dealt with the Act by insisting that the United Kingdom-Barbados Income Tax Treaty be revised to exclude international business companies.[183] The United States had difficulties ratifying its previously terminated treaty with Barbados. In their review of the Barbados treaty, the Finance Committee and the Ways and Means Committee warned of a potential loophole in a provision designed to exempt Barbadian resident companies from the United States accumulated earnings tax if the majority of controlling stockholders were residents of Barbados. According to staff documents, the reservation would "make it clear that if a United States citizen holds a majority of the voting power or value of stock in a Barbadian company the United States accumulated earnings tax would apply."[184] The problem was ironed out and the treaty was ratified last year.[185]

A proposed treaty between the United States and Bermuda may also be a significant development in the battle against tax haven abuse. This treaty would exempt Bermuda insurance enterprises from United States income and excise taxes on their United States

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180. *Netherlands Antilles—U.S. Tax Treaty Signed August 8, 1986*, TAX NOTES TODAY (TAX ANALYSTS), Aug. 11, 1986.

181. TAX NOTES TODAY, (TAX ANALYSTS), Aug. 14, 1986.

182. *Government to Develop Island as Tax Haven*, 2 Co. LAW., Jan. 1981, at 42.

183. *See* explanation of art. XXIII United Kingdom—Barbados Income Tax Convention *in Government to Develop Island as Tax Havens, supra* note 182.

184. *Senate Ratifies Three Treaties, SFC Approves Two Others and Ways and Means Sees Problems with Proposed Treaties*, 407 TAX TREATIES, Dec. 27, 1985.

185. On March 13 and 14, 1986, the Central Bank of Barbados held a seminar on the United States—Barbados income tax treaty. For a complete listing of the tax documents that were published as a result of this meeting, *see* 32 TAX NOTES 241 (1986).

premium income if they do not have a permanent establishment in the United States. In addition, the treaty would provide for mutual assistance in tax matters, including the sharing of tax information between the United States and Bermuda.[186] The provision for the exchange of information is arguably an important step ahead; however, some believe that the treaty sets bad precedent by trading tax exemption for mutual assistance in tax compliance matters.[187]

2. Treaties with Tax Havens

Ultimately, the best way of preventing tax haven abuse is the actual negotiation of tax treaties with tax haven countries which would disallow any of the abusive practices. Currently, the United States has treaties with only a few tax haven jurisdictions, yet lists some twenty-nine official havens.[188] The new treaties with Barbados, Bermuda and Cypress are excellent examples of the direction that should be taken. The identification of abuses with some of the United States' tax haven treaty partners are widely noted.[189]

The oldest and probably the most effective income tax treaty with a tax haven is that with Switzerland.[190] This treaty, which specifically prevents abuses of Switzerland's status as a tax haven, can also serve as an excellent model for future treaties.[191]

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186. *United States Enters into Treaty with Burmuda on Taxation of Insurance and Mutual Assistance in Tax Enforcement, supra* note 178.

187. *New U.S.—Bermuda Pact Raises Questions About U.S. Tax Treaty Policy*, 32 TAX NOTES 302 (1986).

188. *See supra* note 50.

189. The Report identified a large number of tax haven treaties, but stated that large sums of money in the form of dividends, interest and royalties are flowing through tax havens with which the United States has treaties. As much as $5 billion in 1979 went to treaty jurisdictions, and more than $1.5 billion of this went to Switzerland, the Netherlands, and the Netherlands Antilles.

Gordon, *supra* note 11, at 797.

The history of this situation is:

> We have, at the present time tax treaties with several jurisdictions that are generally acknowledged to be tax havens. This results largely from historical accident; during the 1950's our tax treaties with several European partners were extended to a number of their overseas dependencies. Some of these have become tax havens and have been exploiting their tax treaties with the United States. The most prominent of these is the Netherlands Antilles.
>
> As I indicated above, it is our firm policy to include limitation of benefits provisions in any new tax treaty, in whatever form is necessary to deal with the potential abuse in that particular bilateral relationship. Since the basic purpose of a tax treaty is to eliminate double taxation, treaties with tax havens cannot be justified on that basis.

Chapoton Authors Treasury Policy on Treaty Shopping, supra note 115, at 250.

190. *See supra* note 66. The United States also has an exchange of information agreement with Switzerland. *See supra* note 67.

191. For example, article III of the Treaty of Mutual Assistance in Criminal Matters,

One of the more recent U.S. tax treaties with a tax haven is the one with Jamaica.[192] Immediately after publication of the Report, the United States government entered protocol negotiations to the then-pending income tax treaty. The United States insisted on strong anti-treaty shopping articles and for provisions calling for exchanges of information. The anti-treaty shopping article finally ratified has been highly praised.[193] Jamaica is also currently providing the United States with the information necessary to enforce the tax laws.

These types of treaties are needed with all countries—especially tax haven jurisdictions. The United States must concern itself with establishing or renegotiating treaties with the problem tax havens.

3. Treaty Networks

One of the primary reasons that the United States is a victim of so much tax haven abuse and treaty shopping is the use of treaty networking.[194] The United States treaties with the United Kingdom and the Netherlands are the main source of the networking. These two countries and the United States extended their treaties to the two important tax havens of the British Virgin Islands and the Netherlands Antilles. These extensions provide a means for surveying treaty networking and its effects.

a. British Virgin Islands. An income tax treaty between the United States and the United Kingdom was signed in 1945 and has been amended by several supplementary protocols. A 1954 supplementary convention extended the treaty to some twenty British col-

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supra note 67, provides that

> [w]here an enterprise of one of the contracting States is engaged in trade or business in the territory of the other contracting State through a permanent establishment situated therein, there shall be attributed to such permanent establishment the industrial or commercial profits which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment.

192. Convention between the Government of the United States and the Government of Jamaica for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 29, 1981, United States—Jamaica, TAX TREATIES P-H, ¶ 55,102.

193. Gordon, *supra* note 11, at 798; Rosenbloom, *supra* note 79, § 31.05; *Dole Comments on Pending Tax Treaties*, *supra* note 99, at 1007. The Jamaica treaty is also praised for its limitations of benefits provision. Comment, *supra* note 84.

194. A treaty network is a situation where "[a] haven can be created when a treaty exists between two powers (or once existed and remains in force only locally) and extends to colonies or dependencies of one of the treaty partners in such a way that third parties may enjoy the advantages of that treaty." R. BLUM, *supra* note 24, at 7. *See also* REPORT, *supra* note 4, at 20.

onies. By its terms, the treaty could only be extended to territories for whose international relations Britain was responsible and which imposed income taxes substantially similar in character to those of the United Kingdom.

The treaty between the United States and the United Kingdom territories is now quite different from the present treaty between the United States and the United Kingdom since the older treaty remains in force in the territories.[195] For this reason, in an attempt to end third country abuses, the United States terminated its treaty with the important tax haven of the British Virgin Islands effective January 1, 1983.[196] Other treaties in the United Kingdom network terminated effective January 1, 1984, include those with Anguilla, Barbados, Belize, Dominica, Grenada, Montserrat, St. Christopher-Nevis, St. Lucia, St. Vincent and the Grenadines. The treaties with Antiqua and Barbuda were also terminated effective August 26, 1983.

b. The Netherlands Antilles. Similarly, a treaty existed with the most abusive tax haven of the Netherlands Antilles through the United States—Netherland Income Tax Treaty. This treaty was also subject to widespread abuse.[197] The Netherlands perhaps has

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195. For examples of some of the situations which apply under the treaty now in force in these territories, *see* M. LANGER, *supra* note 5, at 174-75.

196.

> On 1 July, 1982, the Treasury Department formally announced that the United States had terminated the existing tax treaty with British Virgin Islands . . . . Under the provisions of the treaty the cancellation will take effect on 1 January, 1983. At that time, all income paid to persons in the British Virgin Islands will be subject to the statutory withholding rates of 30 percent on fixed or determinable annual or periodical income from sources in the United States . . . .
>
> . . . The termination resulted after American negotiators had failed to convince the British Virgin Islands officials to accept an anti-abuse clause (Article 16 of the Model U.S. Income Tax Treaty) that Treasury insisted on adding to the existing treaty. Article 16 prevents third party nationals from using holding companies in the British Virgin Islands to avoid paying tax on U.S. earnings.
>
> The existing treaty was an extension of the U.S. treaty with the United Kingdom of 1945. In 1979, the United States and the British Virgin Islands had negotiated an amended treaty which the Senate subsequently declined to ratify. The Senate sent the treaty back to the administration for further changes at the request of the Treasury Department. Tax specialists have indicated that the U.S. action on the treaty is probably a sign that the Treasury intends to take a tough stand in the future in determining tax treaty policy involving nations which they believe to be channels for tax treaty abuse.

9 TAX PLAN. INT'L REV., Aug. 1982, at 12.

197.

> Residents of third countries who are not themselves entitled to U.S. treaty benefits are claiming, by routing their U.S. investments through an Antilles entity, U.S. tax benefits provided under that treaty. Because of a relatively low and flexible tax in the Netherlands Antilles, and because no taxes are levied under Antilles law on income payments to nonresidents of the Antilles, a substantial reduction of U.S. tax

the broadest system of income tax treaties with agreements with most industrial nations and many developing nations.

The first income tax treaty between the United States and the Netherlands was signed and ratified in 1948. It originally applied only to the Netherlands, but article XXVII provided a method by which it could be extended to the Netherlands Antilles. In 1955, a protocol officially extended the treaty to the Netherlands Antilles. The treaty and protocol allowed many abuses and many attempts to change the convention ensued.[198] The latest negotiations began in 1982.[199] The Netherlands Antilles asserted that it wanted a new treaty with the United States that would retain its withholding tax on interest paid through subsidiaries. The recent history of the negotiations was long and complex and some thought that no permanent resolution was in sight.[200]

On August 8, 1986, however, the United States signed an income tax treaty with the Netherlands Antilles[201] which now awaits ratifi-

> liability flows through to the third-country investor. This treaty has often been referred to as "a one-way tax treaty with the world." For this reason, and to obtain better exchanges of the information, we are renegotiating the treaty.

Chapoton Explains U.S. Tax Haven Treaty Policy, *supra* note 23, ¶ 9946.

198. Key provisions of the Netherlands Antilles treaty, *supra* note 109, which affect the tax haven operations include:

> Income of whatever nature derived from U.S. real property is taxable only in the United States [Article V]. The same rule applies to interest from mortgages secured by real property.
>
> Article VII reduces to 15 percent the rate of U.S. tax on dividends from a U.S. corporation by a Netherlands Antilles corporation which is not engaged in U.S. business through a permanent establishment. A further reduction to 5 percent is provided for under some circumstances.
>
> Interest derived from U.S. sources by a Netherlands Antilles corporation not engaged in U.S. business through a permanent establishment is ordinarily exempt from a U.S. tax [Article VIII]. However, the exemption does not apply to interest paid by a U.S. corporation to a parent Netherlands Antilles corporation which controls more than 50 percent of the voting power in the paying U.S. corporation. Nor does it apply to mortgage interest.
>
> Royalties derived from U.S. sources by a Netherlands Antilles corporation not engaged in a U.S. business through a permanent establishment are exempt from U.S. tax [Article IX]. . . . A Netherlands Antilles corporation deriving rentals from U.S. real property may elect for any taxable year to be subject to U.S. tax on such rental income on a net income basis [Article X].
>
> Dividends and interest paid by a Netherlands Antilles corporation are exempt from U.S. tax unless the recipient is a U.S. citizen, U.S. resident or U.S. corporation [Aricle XII].

M. LANGER, *supra* note 5, at 195-96.

199. Comments by spectators flourished. *See, e.g.*, *A Treaty that May Sink Tax Havens*, *supra* note 5, at 140; *Crackdown on Tax Havens*, J. Com., Sept. 7, 1982, at 4A, col. 1.

200. *See* 9 TAX PLAN. INT'L REV., Mar. 1982, at 16 and 9 TAX PLANNING INT'L REV., Aug. 1982, at 12.

201. Convention between the Government of the Kingdom of the Netherlands in Respect of the Netherlands Antilles and the Government of the United States of America for

cation in both countries. The treaty generally subscribes to the United States 1981 Model Draft. It covers the United States federal income tax and certain federal excise taxes. It also covers the Netherlands Antilles income, wages and profit taxes and surtaxes. The treaty provides for maximum tax rates, at source, on dividends of fifteen percent, reduced to five percent for dividends paid to companies owning at least ten percent of the voting stock of the company paying the dividends. Interest and royalties will be generally subject to a maximum rate of tax, at source, of five percent. The treaty also contains provisions concerning the taxation of business profits, personal service income, capital gains and other forms of income, as well as provisions relating to the administration of the treaty and the taxes to which it applies.

Whether this major breakthrough in the treaty with the Netherlands Antilles will gain ratification is questionable. The most controversial and significant factor of this treaty is article 16 which deals with treaty shopping, limiting third country use to specific activities. One exception to article 16 involves international mutual funds. The other exception to the treaty shopping provision applies to qualified real estate companies. Under article 10 of the proposed treaty, qualified real estate companies would receive a waiver for the second withholding tax on dividends. In addition, under article 24, qualified real-estate companies would be eligible to make a subsection (i) election under Internal Revenue Code section 897. An "(i) election" allows a foreign corporation with U.S. real estate holdings to elect to be treated as a domestic corporation and, if under a U.S. treaty obligation, to receive nondiscriminatory treatment with respect to that interest. The treaty also contains an important updated exchange of information provision to assist in tax enforcement.

The major concern on the part of the Netherlands Antilles is the recently enacted tax reform in the United States.[202] If any legislation is enacted that would modify the treaty, negotiations would be reopened to provide for the new United States taxing measures. The United States even admits that the treaty's final negotiation occurred at a bad time when tax reform was pending.[203]

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the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed August 8, 1986, TAX NOTES TODAY (TAX ANALYSTS), Aug. 11, 1986.

202. *Netherlands Antilles—U.S. Tax Treaty Diplomatic Notes of Exchange*, TAX NOTES TODAY (TAX ANALYSTS), Aug. 11, 1986.

203. *Treasury Announces Signing of New Income Tax Treaty with the Netherlands*

Whether the treaty if ratified in its present form will be a major impact on the United States' treatment of treaty shopping and tax havens remains to be seen.

4. Treaty Shopping Stance

Although extremely necessary, some believe that strong anti-treaty shopping provisions have not been a priority in more recent treaty negotiations.[204] The proposed treaties with China and the Netherlands Antilles are foremost examples of the failure to provide a strong anti-treaty shopping clause. In fact, this was probably the reason that the Chinese treaty was not ratified.

The proposed treaty with China contained a limited anti-treaty shopping provision which was of concern to the Ways and Means Committee. Because this provision was less strict than the provision contained in most of the recent treaties enacted by the United States, and less strict than the provision in the Treasury's model income tax treaty, the Committee was concerned that other countries negotiating treaties with the U.S. would demand the inclusion of the less strict provision. Also, abuses could occur since the treaty does not specify whether it will cover Hong Kong when China resumes sovereignty over it in 1997. If Hong Kong is covered, there could be serious potential for treaty shopping. The treaty should state that it will not apply to Hong Kong, or other provisions should be made.[205] The final U.S.-China protocol to the treaty contains a

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Antilles, TAX NOTES TODAY (TAX ANALYSTS), Aug. 11, 1986.

204. In recent treaties, the Senate Foreign Relations Panel disregarded advice offered by the House Panel concerning anti-treaty shopping measures. *Senate Ratifies Three Treaties, SFC Approves Two Others and Ways and Means Sees Problems with Proposed Treaties, supra* note 184, at 1.

205. *Id.* at 3; Patrick, *supra* note 93, at 5. Congressional leaders have expressed their views on this as follows:

> We recognize that the U.S. model provision is only one of several approaches that the Treasury Department considers satisfactory to prevent treaty shopping abuses and that the U.S. negotiators may be able to avoid making other treaty concessions in a particular treaty negotiation by declining to insist on greater anti-treaty shopping protection than appears necessary at the time of the negotiation. . . . [W]e believe that the Treasury Department's agreement to include such a limited anti-treaty shopping provision in this treaty could weaken its ability to negotiate comprehensive anti-treaty shopping provisions in future treaties. Other countries with limited treaty shopping potential at the time of the treaty negotiation will be able to point to the Chinese treaty and, particularly if they are developing countries, demand equal treatment. The danger here is that treaty shopping potential can develop, as it has in some past cases, after treaty ratification.
>
> Apart from the possible percential effect of the Chinese anti-treaty shopping provision, we have some concern about the potential for development of treaty shopping abuses in China itself. Changes in Chinese law and administrative practice with respect to foreign investors have been occurring at a rapid pace in recent years and

strong anti-shopping provision similar to that enacted in the treaty with Denmark in 1984.[206]

The recent income tax treaty protocols with Denmark, France and Italy, as well as the revised protocol to the Chinese treaty, indicate that the United States is changing its traditional policy towards treaty shopping. In signing those protocols, the U.S. has raised the permitted percentage of third country resident ownership of taxable income. This is an example of how the United States is permitting treaty shopping with limitations.[207] Also, recent treaties with Australia and New Zealand contain modified versions of anti-treaty shopping provisions.[208] These clauses are less strict than those used in treaties with tax haven jurisdictions.

The signed treaty with the Netherlands Antilles and its specific exceptions to the treaty shopping provision is a radical departure from current policies and is not in the best interest of the U.S. tax haven policy. However, final comment should be reserved until the protocols are established and the treaty is actually ratified by both countries.

The recent United States attitude to lessening treaty shopping reflected in its treaty with the Netherlands Antilles does not mean it is still not committed to strong policies. The British Virgin Islands treaty negotiation is an example of the United States remaining opposed to treaty shopping.[209] Treaty shopping has also recently

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> could continue to do so. The proposed treaty limits the U.S. withholding tax on dividends paid to any portfolio Chinese investing entities to 10 percent, the lowest rate of a U.S. treaty, matched only by the treaty with Romania.

Rostenkowski and Duncan Express Ways and Means View on Pending Treaties, 29 TAX NOTES 789, 792 (1985).

206. 31 TAX NOTES 817 (1986).

207. Oliva, *supra* note 105, at 322-24.

208. *See New Income Tax Treaty with Australia Ratified by the Senate & New Income Tax Treaty with New Zealand Ratified by the Senate*, INT'L TAX ALERT (RIA), Sept. 1983, at 7.

209. "Our policy of limiting treaty shopping has been supported by the tax-writing committees of Congress and by the Senate Foreign Relations Committee and the charimen of both the the House Ways and Means and Senate Finance Committees." *Chapoton Explains U.S. Tax Haven Treaty Policy, supra* note 23, ¶ 9946.
Commentators agree:

> One area of visible and effective anti-tax haven activity concerns treaty shopping or the unwelcome exploitation by third parties of bilateral conventions for the avoidance of double taxation. Most treaties recently negotiated or renegotiated between high-tax and low-tax countries have contained clauses preventing use of bilateral treaties by third country residents (USA/British Virgin Island, USA/Cypress, USA/Malta, UK/Netherlands, Canada/Barbados). Even under existing treaties, U.S. authorities in particular have disallowed treaty withholding tax reductions where the ultimate beneficiary was not resident in either of the contracting countries. It happened recently in the context of the United States-Netherlands treaty. This attitude, which is likely to be adopted by other high-tax countries, casts further

been approached administratively by the issuance of two revenue rulings which may force jurisdictions such as the Netherland Antilles into serious treaty negotiations.[210] The United States must continue to promote a strong anti-treaty shopping stance.

C. *United States Tax Haven Treaty Policy*

The Report stated that many of the treaty problems regarding tax havens are caused by the failure of the U.S. government to act expeditiously when problems develop.[211] The government has now started to act and is beginning to subscribe to a policy that will combat the problem.[212] The current efforts do not escape criticism.[213] The United States' policy sometimes subscribes to a working hypothesis that the history of the use of treaties establishes boundaries of acceptable tax treaty policy.[214]

1. Policy Options

The Report suggested seven options for the United States tax haven treaty policy,[215] and commentators have also taken notice.[216]

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doubts on the future of artificial holding companies.

C. DOGGERT, *supra* note 1, at 83 (footnote omitted).

210. *See supra* note 117; *Revenue Ruling 84-152: The Beginning of the End for Treaty Shoppers*, 12 SYR. J. INT'L L. & COM. 170 (1985).

211. Gordon, *supra* note 11, at 797.

212. Roscoe L. Egger, Jr., Commissioner of the Internal Revenue Service, and John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy), appeared before Congress to discuss the problems caused by offshore tax havens and tax treaty countries as well as the Internal Revenue Service's effort to deal with these problems. Commerce, Consumer and Monetary Affairs Subcomm. of the House Comm. on Government Operations, Apr. 13, 1983. They also discussed ways in which the U.S. tax treaties with tax haven countries are used to avoid and evade taxes and explained U.S. treaty policy. *See Chapoton Explains U.S. Tax Haven Treaty Policy, supra* note 23; *Chapoton Authors Treasury Policy on Treaty Shopping, supra* note 115; *Egger Discusses Tax Haven Problems Before House Subcommittee, supra* note 23.

213. *See, e.g.*, Comment, *Tax Treaties International*, 14 INT'L LAW. 508 (1980).

214. Rosenbloom, *supra* note 79, § 31.04.

> The hypothesis frequently proves to be incorrect. Views on treaty provisions can change as Administrations and the composition of the Senate change. Moreover, because tax treaties are not a subject that is constantly before the Congress, fresh discoveries of old issues are not uncommon. . . . Generally, a change of view is not known until a newly proposed treaty tests old waters.

Id. at n.144

215.

> Treaty Options
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> 1. To deal directly with United States tax treaties with tax havens, terminate the existing income tax treaties with the Netherlands Antilles and the United Kingdom extension and consider terminating income tax treaties with other tax havens, with possible renegotiation.
>
> 2. To prevent future abuse, be selective in negotiating income tax treaties with countries with which the United States does not have a significant trade or invest-

The official U.S. policy as presented to Congress is not to enter into new treaties which permit, renegotiate or terminate (as appropriate) existing treaties so as to grant unwarranted benefits to residents of third countries.[217] The United States policy indicates that the limitation of benefits in income tax treaties has several objectives.[218] However, it might evolve that the U.S. could enter into a

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ment relationship, and do not enter into full scale income tax treaties with known tax havens. As an alternative, selectively enter into limited treaties with tax havens that would include a nondiscrimination provision and a competent authority mechanism and would contain an exchange of information provision overriding bank secrecy laws and practices.

3. To ensure that information necessary to administer the tax laws is available, and to insure that information necessary to prosecute those who do not comply with those laws is available, insist upon a strong exchange of information provision in United States income tax treaties that would override foreign bank secrecy laws and practices.

4. To deal with changes in local laws and practices of treaty partners, conduct periodic reviews of treaties to determine whether they are being abused and whether they are serving the function for which they were initially negotiated.

5. To provide access to information to be used in criminal prosecutions, vigorously pursue mutual assistance treaties with the more important tax havens.

6. To encourage abusive tax havens to enter into exchange of information agreements with the United States, consideration may have to be given to adopting measures to discouraging United States business from investing through tax havens that do not give information, such as increasing taxes on payments to those tax havens.

7. To limit the potential for abuse of treaties with tax havens, and to limit the incentive for treaty partners to adopt tax haven practices, incorporate strong provisions to limit the use of treaties residents of a treaty country.

REPORT, *supra* note 4, at 12-13. *See also* discussion, *id.* at 170-75; MANUAL FOR THE NEGOTIATION OF BILATERAL TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, U.N. Pub. ST/ESA/94, 66-73 (1979).

216. Rosenbloom, *supra* note 79, § 31.05, suggests three major strands to the United States tax treaty program in general:

(1) Renegotiation of existing treaties;
(2) Expansion of tax treaties to developing countries; and
(3) The evaluation and change of treaties that serve primarily to benefit investments by third country residents in the United States.

Aland, *supra* note 10, at 1021, 1023-24, also states a series of options.

217. *See* articles cited *supra* note 212.

218.

First, curtailment of "treaty shopping" . . . .

Second, expansion and improvement of the U.S. tax treaty network. If residents of these [third] countries can enjoy U.S. treaty benefits by the simple and inexpensive expedient of establishing an entity in an appropriate U.S. treaty partner jurisdiction, their countries of residence have little incentive to enter into [treaties] with the United States. Since such treaties would reduce foreign taxes on U.S. taxpayers, the result is higher taxes abroad for U.S. businesses. The same issue arises with respect to existing treaty partners. . . .

Third, adherence to the letter and spirit of the law. Use of tax treaties by third-country residents violates the coherence of the Internal Revenue Code. . . . If any foreign investor can avoid . . . tax by interposing a treaty-protected entity, then that treaty has, in effect, replaced U.S. internal law. Such a process erodes confidence in the integrity of the U.S. tax system. If Congress wishes unilaterally to repeal or modify the present statutory tax, that should be done explicitly, by both houses of Congress, and not by improper use of a tax treaty.

treaty with a tax haven if, in addition to typical "tax haven" business, substantial real economic relation exist between the U.S. and that country.[219]

The diverging policies regarding treaty shopping have already been explored.[220] Information secrecy problems are also a policy concern regarding the abuse of tax treaties. Accessibility, or the lack thereof, to information is a problem; not so much one of substantive tax law, but of getting the information, as well as using that information effectively. The secrecy provisions of offshore tax havens create a veil which is often difficult to penetrate.[221]

The United States tax policy is decidedly against tax havens. It must, however, be pointed out that other factors come into play as indicated by the economic exception noted above. The Report listed the following as considerations with regard to the United States tax treaty policy objectives:

> (1) Maintaining the competitive position of the United States business investing abroad or exporting;
> (2) Maintaining tax equity as between investments in the United States and investments abroad;
> (3) The need to provide fair rules for taxing foreign investments;
> (4) Administrative efficiency;
> (5) Foreign policy considerations; [and]
> (6) Promotion of investment in the U.S.[222]

The United States must continue to strive to limit benefits, prevent treaty shopping and obtain fiscal information. This will ultimately end tax haven abuses.

2. Caribbean Basin Initiative

One of the most significant developments regarding the current U.S. tax haven policy has been the Caribbean Basin Initiative. Although it is not a treaty process or mechanism, it is nevertheless important. The Caribbean Basin Economic Recovery Act or "Caribbean Basin Initiative," was enacted in 1983 and became effective on January 1, 1984. It requires that the Secretary of the United States Treasury

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Chapoton Explains U.S. Tax Haven Treaty Policy, supra note 23, ¶ 9946.

219. *Id.*

220. *See supra* notes 204-10 and accompanying text.

221. *Egger Discusses Tax Haven Problems before House Subcommittee, supra* note 23, ¶ 9947.

222. REPORT, *supra* note 4, at 42-43.

(1) Indicate the level of use of Caribbean Basin tax havens to evade or avoid Federal taxes, and the effect on Federal revenues of such use;
(2) Provide available information on any relationship between such use and other non-tax criminal use; and,
(3) Describe current anti-tax haven enforcement activities of the Treasury Department.[223]

The legislation provides limited tax concessions and trade benefits to eligible countries which agree to exchange tax information with the United States.

In 1984, the Department of the Treasury released a report entitled "Tax Havens in the Caribbean Basin" in response to the requirement in the Act that it advise the House Ways and Means Committee and Senate Finance Committee on the use of Caribbean tax havens.[224] The report did not suggest solutions to the tax haven problem, but instead attempted to estimate revenue losses and describe criminal enforcement activities. The exchange of information was the basic purpose of the legislation, but early findings were cursory and skeptical in this regard.[225] There were, however, some in-

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223. Caribbean Basin Economic Recovery Act, *supra* note 12, at 97 Stat. 397. For various legislative comments, *see* Sharp & Steele, *The Caribbean Basin Exchange of Information Draft Agreement—A Technical Analysis*, 19 INT'L LAW. 949 (1985); Note, *Anti-Tax Haven Activities of the United States*, 10 INT'L TAX J. 273 (1984); and *Its Tax Havens vs. Tourists in the Caribbean*, BUS. WK., Aug. 22, 1983, at 35, 39.

224. DEPARTMENT OF THE TREASURY, *supra* note 12. The conclusion stated:

> This report is intended primarily to update the material provided in the Gordon report. The data collected and presented in this report show that the use of tax havens, which was already very significant at the time the Gordon report was prepared, has continued to rise sharply. It is very difficult to measure the illegal use of tax havens because of the nature of the transactions and because of the difficulty of obtaining information from most tax havens. Nevertheless, it seems reasonable to assume that a great deal of activity designed to violate the tax and other laws of the United States takes place in the Caribbean Basin tax havens.

Id. at 51-52.

225. For example, "Requirements for exchange of information agreements" findings stated:

> The principal U.S. tax benefit provided to countries of the Caribbean Basin under the CBI legislation is the allowance to U.S. taxpayers of deductions for ordinary and necessary expenses of attending business conventions held in CBI beneficiary countries without a showing that it is as reasonable to hold the convention in that country as in the "North American Area." To qualify for this benefit, in addition to meeting the standards for CBI beneficiary countries generally, a country must enter into an agreement with the United States to exchange tax information. Thus, countries of the region will have to be willing to cooperate with the IRS in tax administration and enforcement in order to benefit from the convention tax deduction provisions of the CBI legislation. This is of particular importance with respect to the tax haven jurisdictions of the Caribbean Basin. In addition to the substantive benefits to U.S. tax compliance efforts which would flow from such agreements, this provision of the statute sends a clear message to other countries of the seriousness with which the United States views the problems of tax avoidance and evasion through transac-

teresting observations regarding the U.S. treaty policy with respect to Caribbean tax havens.[226]

Final reports on the legislation's effect, if any, on the prevention of tax havens are still incomplete.[227] However, the legislation does demonstrate concern in the area and is another beginning for the U.S. anti-tax haven policy.

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tions involving tax havens.

Id. at 48 (footnotes ommitted).

226.

> While the United States would not presently enter into a new treaty relationship with a tax haven, unless the potential for abuse was significantly proscribed and substantial real economic relations exist between the United States and that country, it has or has had tax treaties with several Caribbean jurisdictions that are generally acknowledged to be tax havens. This results largely from historical accident; during the 1950's, U.S. tax treaties with several European partners were extended to a number of overseas dependencies of the European countries. Some of these Caribbean jurisdictions have become tax havens and have been exploiting their tax treaties with the United States.
>
> There are several options available in dealing with existing tax haven treaties. The United States can renegotiate these treaties to eliminate the potential for abuse; it can terminate the treaties and not replace them; or it can terminate the treaties and seek to negotiate a new treaty on satisfactory terms. The Treasury has taken, or is prepared to take, each of these approaches, as appropriate, in individual cases.
>
> In early 1981, a new treaty was signed with the British Virgin Islands (BVI) to replace the extension of the U.S.-U.K. treaty to the BVI, which treaty was becoming increasingly subject to abuse. On reflection, the present Administration determined that the new treaty, while reducing the opportunity for abuse by third-country residents, remained susceptible to a continuing and not insignificant level of potential abuse, and should, therefore, not enter into force without amendment. The ensuing efforts to renegotiate that treaty to insert a sufficiently restrictive limitation on benefits provision were not successful. The negotiations were suspended and the existing treaty which had remained in force, was terminated as of January 1, 1983.
>
> On July 1, 1983, the Treasury announced that notices of termination had been sent to a number of jurisdictions to which the U.K. and Belgian treaties had been extended, including nine U.K. extension treaties in the Caribbean Basin area. These terminations will be effective as of January 1, 1984. . . . In those cases where it is judged appropriate to do so, the United States is prepared to enter into negotiations with these jurisdictions on new treaties which would, at the same time, more adequately reflect those countries economic relationships with the United States, and insure against abuse of the treaty.
>
> Yet another approach has been taken with the Netherlands Antilles. Negotiations have been ongoing for several years on a new treaty which would deal with most forms of third-country use of the treaty. The present treaty has remained in force while the negotiations have proceeded. It is the intention of the Treasury Department that the United States will have no tax treaties in force with Caribbean tax havens that are subject to abuse.
>
> To assure both that the benefits of U.S. tax treaties are received only by persons properly entitled to them, and that the IRS has the information necessary to enforce U.S. tax laws with respect to any transactions which may take place within the jurisdiction of a tax haven treaty partner, any such treaties as may exist will have comprehensive exchange of information provisions.

Id. at 45-47 (footnotes omitted).

227. Commentators have noted that "[t]he trade provisions seem to be working, but the tax provisions are not." M. Langer, *Treasury Issues Draft CBI Exchange-of-Information Agreement*, 58 TAXES INT'L 69 (1984).

CONCLUSION

The use of tax havens is a growing international problem which can result in either illegal tax evasion or legal tax avoidance. There are many forms of tax haven use and abuse. The history of international tax avoidance and tax havens is vast and possible attempts to eliminate the problem of tax evasion have been encompassing.

Income tax treaties also have a long history and have been utilized by nations of the world for various functions including the prevention of fiscal evasion. Income tax treaties can be an extremely effective mechanism or tool in the prevention of tax havens if used properly. Such use includes stringent anti-treaty shopping measures and exchange of information provisions between countries. The primary goal of the U.S. today should be to renegotiate existing treaties to include these mechanisms as well as to provide for them in future treaties as a direct way to curtail tax haven abuse. This is of particular importance in regard to treaties with tax haven jurisdictions.

There are alternative methods to prevent tax haven abuse and tax evasion. Recently, the courts have been a helpful solution, especially in the production of tax evasion information. Broadening legislation has been the major method used by foreign countries in attempting to resolve the tax haven abuse problem and could become a workable method in the United States.

Recent treaties of the United States have revealed an effort to eliminate tax haven abuses. The treaties enacted in the last few years exemplify this. There has been, however, an unfortunate weakening of the U.S. stance toward treaty shopping. The United States with its extensive network of income tax treaties has made some advances with regard to the treaties with tax haven jurisdictions, specifically the negotiation of the treaty with Barbados and termination of the treaty with the British Virgin Islands. Still, the recent proposed treaty with the Netherlands Antilles has been most detrimental to the United State's policy.

The United States has developed a stringent tax treaty policy which includes anti-treaty shopping and exchange of information goals. Future U.S. efforts must include strict compliance with this policy and possible multilateral attempts to deal with tax haven abuse and international tax evasion. As noted in the beginning of this Article, all tax haven use is not undesirable. "The use of tax havens is a part of [tax] planning [but it] should, however, be kept in proportion . . . [as] the promoter of a tax haven company should not forget that it is better to pay tax on profits than to incur losses."[228] In order to reinforce this view, tax evasion and avoidance must be controlled. If comprehensive, income tax treaties can be vital in the prevention of tax evasion and abusive tax avoidance through the use of tax havens.

228. E. CHAMBOST, *supra* note 5, at 192.