IFCs and the US Government: Analysis and Critique

By Richard Horowitz, Principal, Richard Horowitz & Associates, Attorneys at Law, New York

THE US GOVERNMENT HAS FOR MANY YEARS taken a deep interest in IFCs, viewing them with stringent concern and alleging that tax evaders and fraudsters exploit this industry to the government's detriment. Congress held hearings on offshore tax evasion in the early 1960s and has continued to do so in recent years. Members of Congress, both in the Senate and House of Representatives often criticise IFCs, routinely equating them with offshore tax havens and secrecy jurisdictions.

Estimates of lost corporate taxes through offshore loopholes can reach up to US$100 billion per year, with estimates of overall tax evasion through offshore schemes even higher.

Yet, it is commonly known that much of the corporate taxes lost through offshore loopholes are done through legal means. Transfer pricing, which can be described as a corporation creating an entity in an offshore jurisdiction with lower tax rates than that of the US, then transfering its profits to that jurisdiction, thereby lowering its US taxes, is in principle legal. General Electric for example, received much attention for its 2010 profits of US$14.2 billion without owing any US taxes.[1]

In fact, the Internal Revenue Service website has a 'Transfer Pricing' page, which contains a link to its 'Advance Pricing Agreement Program', defined by the IRS as a program "designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional adversarial process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method." And, in December 2008, the US Government Accountability Office published a report entitled 'Large US Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions',[2] clearly listing each corporation with the number of offshore entities they have and their locations. The legality of these offshore arrangements resulting from tax loopholes are not in question.

Moreover, the issue of offshore jurisdiction should be noted in context. Compare the above-mentioned estimates of tax monies lost, perhaps amounting to US$1-2 trillion per decade, with the estimated US$40 trillion of wealth the US economy lost in the recent two-year economic crisis. Of note, the 600 page 'Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States' (January 2011) does not

1 See for example 'G.E.'s Strategies Let It Avoid Taxes Altogether,' New York Times, March 24, 2011.

2 GAO-09-157

contain the words or phrases offshore, secrecy jurisdiction, tax haven, or transfer pricing. Fraud was only mentioned in this report in the context of mortgage and accounting fraud leading to the crisis. The 650 page Senate Permanent Subcommittee on Investigations report, entitled 'Wall Street and the Financial Crisis: Anatomy of a Financial Collapse' (April 2011), contains the word offshore four times and with again no mention of secrecy jurisdiction, tax haven, or transfer pricing.

Further, along with the Tax Reform Act of 1986, Congress published a 1,395 page summary of this Act which made only nine references to offshore tax havens; at the Senate Finance Committee hearing held on March 1, 2011 entitled 'How Did We Get Here? Changes in the Law and Tax Environment Since the Tax Reform Act of 1986' offshore tax havens were not discussed at all.

We see therefore that the issue of the US government's view of IFCs and offshore jurisdictions requires explanation. Based on the statements coming from certain US elected officials, one would not think that the US loses corporate taxes through loopholes which are legal, or even encouraged by US law.

In general, taxes lost through use of offshore tax havens, secrecy jurisdictions, or whatever pejorative term one may think to use, can be divided into two categories: first, legal corporate loopholes and second, taxes lost by individuals or companies through tax evasion. Money laundering is usually included, if only by rote, as another method by which the government loses tax revenue but one must distinguish between money laundering done to evade taxes and money which is laundered as the proceeds of illegal activity. Regarding the latter, money laundering is in effect a tool to assist in fighting other crimes; under US law, the money laundered has to be proceeds of at least one of some 200 unlawful activities specified in the statute prohibiting money laundering. Laundering money to evade taxes, even proceeds of lawful activity, is itself illegal. Therefore, distinguishing between tax evasion and tax revenue lost through money laundering is redundant; the former encompasses the latter. The real question therefore is what is the level of tax evasion through offshore entities.

Why do these corporate loopholes exist, why do some US government officials speak out against tax avoidance using these loopholes if they are legal, and why has the US government not been able to substantially stem tax evasion through offshore entities despite decades of dealing with this problem?

The answer to these questions, indeed, to understanding the entire issue, can be conceptually understood with relative ease. Take the simple case of American Company A using Offshore Entity B to either legally lower or illegally evade taxes. B's offshore jurisdiction can justifiably claim that the establishment of its offshore vehicles is legal under its law, does not or even cannot violate US law, and if the result is good for its jurisdiction but not for the US, such is international business competition and so be it.

An analogous dynamic is found in US law itself. Section 708 of a legal text called the Restatement of Torts (1939) is entitled 'Engaging in Business in Good Faith' and states:

"One who causes loss of business or occupation to another merely by engaging in a business or occupation in good faith is not liable to the other for the loss so caused, though he knows that the loss will result."

We see therefore that a US company under certain circumstances can take action, which it knows will damage a competitor but in doing so does not violate the law. This dynamic is one of the bases of business competition. The analogy is not perfect, however; engaging in a business in good faith is inapposite to establishing a financial vehicle by which citizens of another country can evade taxes. Often, however, it proves to be difficult to distinguish between a legitimate financial instrument or a method of abetting tax evasion. Suffice it to say though, much of the financial vehicles and instruments offered by the offshore industry are legal.

Which brings us to expanding on the principle embodied in Section 708, above, that despite the literary redundancy, something has to be illegal to be illegal. A selection of US court decisions demonstrate this principle.

In deciding whether a taxpayer owed sales tax to his state, the US Supreme Court in 1930 wrote:

"The fact that it is desired to evade the law, as it is called, is immaterial, because the very meaning of a line in the law is that you may intentionally go as close to it is you can if you do not pass it."[3]

A 1994 a US Appeals Court[4] decided that a four-tier trust vehicle was a fraudulent scheme. According to the court: "The trusts were marketed as a device for the purchasers to eliminate income tax liability without losing control of their money and other assets."

The first trust was located in the US and the other three in offshore jurisdictions. The result of a series of complicated transactions through these four trusts, was, according to the court, "the true grantor of these trusts in substance is the purchaser, who is also the trustee, and also the beneficiary." Therefore the court decided that: "It is as if there were no transfers at all; therefore, the purchaser is subject to tax on all of the income of the various trusts" and held that the defendants violated 18 USC 371, or the statute which prohibits a conspiracy to commit an offense against or to defraud United States, in this case, the IRS.

In so concluding, however, the court also noted, citing a 1982 US Supreme Court case, that:

"The government attacked the selling scheme as fraudulent, however, not because of the form of the trusts but because of the way they were operated . . . The income tax consequences under the Internal Revenue Code depend upon the substance of the situation, not the form."

In other words, even though a four-tier trust vehicle may by its form be suspicious, that alone is not sufficient to make it illegal.

Along these lines, another US Appeals Court decided a very significant case in January 1986.[5]

The defendant, an attorney who helped clients launder money in the early 1980s in an offshore jurisdiction, was convicted, among other things of the same statute as in the previous case, 18 USC 371, conspiracy to defraud the United States.

At the time money laundering itself was not a crime, so the prosecution successfully argued at trial that the defendant's not notifying the bank of his intention to launder money amounted to the defendant conspiring to cause the bank to not properly file the appropriate currency transaction reports, thus violating 18 USC 371.

The defendant was found guilty and appealed, arguing that the bank reporting laws and regulations apply to banks and not its customers; therefore this statute does not cover a situation where a customer did not inform the bank of his intentions to launder

3 280 US 390.
4 37 F.3d 1564.
5 780 F.2d 758.

money. Trying to so apply the statute, argued the defendant, would violate his Constitutional right to due process since the defendant could not have known that that was what the statute encompassed.

The appeals court agreed:

"We conclude that the Reporting Act and its regulations did not impose a duty on [defendant] to inform the banks involved of the nature of their currency transaction. We believe that the application of criminal sanctions against [defendant] here would violate due process.

"Even though money laundering furthers the goals of those who may be engaged in criminal activity, it is not our function to rewrite the law or the implementing currency reporting regulations promulgated by the Secretary[of the Treasury]. If Congress or the Secretary wish to impose a reporting duty on financial institution customers, they must do so in clear, unambiguous language. We cannot impose the duty by implication."

In part thanks to this and related cases, in October 1986 Congress criminalised money laundering by enacting the Money Laundering Control Act.

We see therefore that, as stated above, something has to be illegal to be illegal. Questions therefore that stem from this is why are many corporate tax loopholes legal and if they are legal why all the statements over the years from certain elected officials condemning these loopholes?

The answer to the second question is easier. Upon closer review one sees that these statements are targeted either at voters, or, Congressional colleagues – they are in fact requests or pleas to colleagues to change these loopholes. But why then had these loopholes been created? There are differing views regarding this question though they all reflect varying economic outlooks and political compromise. Clearly, however, the IFCs and the offshore industry is an outgrowth of free markets and global competition rather than a systemic, criminal deviation thereof.

The same can be said of illegal tax evasion through offshore entities – it is an exploitation of a natural and legitimate development of the free market and the global financial structure. I have not seen any evidence that proper, offshore financial professionals are more apt to be exploited by financial fraudsters than their US counterparts.

The US Government, as with many other countries, has traditionally used Mutual Legal Assistance Treaties or Tax Information Exchange Agreements with other jurisdiction to fight offshore abuse and has also made changes in its own laws in this attempt. The Foreign Account Tax and Compliance Act, enacted in March 2010 is a very significant development in the fight against offshore abuse. In July 2011, Senator Carl Levin introduced a bill entitled the Stop Tax Abuse Act. If this bill becomes law, it would add significant changes to how Americans use offshore entities.

The effects of these laws, however, can be viewed as remedial, not doctrinal. These provisions make it more difficult for financial fraudsters to succeed; they do not alter the systemic global financial structure which allows for exploitation by fraudsters. Nor do they close legal loopholes that the US Congress allows to remain open for either political or economic-philosophical reasons.

The US view towards IFCs and the offshore industry, therefore, will remain confusing and at times ostensibly paradoxical.