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THE USE OF OFFSHORE TAX HAVENS FOR THE PURPOSE OF CRIMINALLY EVADING INCOME TAXES

I. INTRODUCTION*

A complicated set of multinational and intergovernmental problems exist that American law enforcement agencies must overcome to prevent the use of offshore tax havens to shield criminal activity or criminal tax evasion. These agencies encounter a variety of difficulties in analyzing transactions involving offshore tax havens. The problem is not one of substantive law; it is largely informational. The simple prohibition of section 7201 of the Internal Revenue Code, which renders it a felony for anyone willfully to evade a tax imposed by the United States Government, is sufficient and comprehensive statutory authority to deal with any tax evasion problem, including one involving offshore tax havens. By creating a veil of secrecy, however, taxpayers can illegally manipulate transactions involving offshore tax havens to evade United States tax liability. This paper examines offshore tax havens, how taxpayers may manipulate them, how the United States enforcement agencies have attempted to deal with this problem, and proposes some solutions to the offshore tax haven problem.

The extraterritorial effect of United States tax laws defines the conceptual framework of the problem of criminal tax evasion involving the use of offshore tax havens. In enacting section 61 of the Internal Revenue Code, Congress exerted a worldwide taxing jurisdiction. Except as otherwise provided in the Code, gross income is defined as all income from whatever source derived.¹ Unlike many other nations; the United States taxes the income of its residents regardless of where it was

* I would like to thank Messrs. Philmore H. Friedman, David E. Greene and John P. Goodman of Pfizer, Inc.; Mr. Richard A. Gordon, International Tax Counsel for the Joint Committee on Taxation; and Professors Leonard J. Workman and Philip F. Postlewaite who read and commented on this paper at various stages. Of course, all mistakes and omissions are entirely my own.

¹ I.R.C. § 61 (1981). The legislative history to the 1954 Internal Revenue Code reiterates the proposition that statutory gross income is "all inclusive." H.R. REP. NO. 1337, 83d Cong., 2d Sess. A18 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 168 (1954). *See also* Commissioner of Internal Revenue v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955), wherein gross income is defined as "accessions to wealth, clearly realized, over which the taxpayers have complete dominion."

earned.² The Internal Revenue Service is responsible for enforcing the tax laws; it has the power within the United States to issue summonses to compel the production of records.³ Intergovernmental conflicts and multinational business entities make extraterritorial enforcement of the tax laws a more difficult task. Additionally, bank secrecy laws, numbered bank accounts and a host of other barriers to the gathering of information concerning the income that American taxpayers earn or send abroad can effectively impair even the most efficient auditor.

The actual magnitude of illegal use of offshore tax havens is uncertain because estimates of the amount of American money flowing through offshore tax havens and serving illegal purposes, such as the laundering of narcotics money, are unreliable.⁴ Authorities even disagree on whether most illegal money is laundered offshore or within the United States.⁵ Estimates indicate that the amount of illegal money exported to the Caribbean tax havens alone runs in excess of fifty billion dollars annually.⁶

Tax havens are not only 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.⁷ Additionally, courts have consistently recognized the taxpayers' right to minimize their tax liability to the full ex-

² See, e.g., Laws of the Republic of Zambia, Income Tax, Ch. 668 § 14(1) (1972), whereby a person is taxable on income from sources within or deemed to be within the Republic and on interest and dividends from sources outside the Republic.

³ I.R.C. § 7602 (1981).

⁴ *The Use of Offshore Tax Havens for the Purpose of Evading Income Taxes: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means*, 96th Cong., 1st Sess. 1 (1979) [hereinafter cited as *Offshore Tax Haven Hearings*].

⁵ *Illegal Narcotics Profits: Hearings Before the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs*, 96th Cong., 1st Sess. 474 (1979) (Exhibit No. 33, Offshore Banking: Issues With Respect to Criminal Use, Submitted to the Ford Foundation, Nov. 1979, by Richard Blum and John Kaplan) [hereinafter cited as *Illegal Narcotics Profits Hearings*]. Surprisingly, offshore bankers and Internal Revenue Service agents independently offered Professor Blum the same estimate of about \$25 billion transiting the Bahamas annually. *Id.* at n.6.

⁶ *Id.*

⁷ INTERNAL REVENUE SERVICE, U.S. TREASURY DEPT., TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS - AN OVERVIEW, 5 (1981) [hereinafter cited as TAX HAVENS].

Most large commercial banks, for example, maintain branch offices in the Bahamas and the Cayman Islands primarily to participate free of United States control in the Eurodollar market. These branches, which are subject to the general supervisory authority of American regulatory agencies, need not comply with the reserve requirements of the Federal Reserve Board. Thus it may be more profitable to operate offshore, where a bank is unrestricted as to amount of deposit money that it can loan or invest. *Offshore Tax Haven Hearings*, *supra* note 4, at 359.

tent that they are permitted by law, including opportunities afforded by offshore tax havens. As Judge Learned Hand said;

[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 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.⁸

Often the distinction between tax avoidance and tax evasion in the use of foreign tax havens is imprecise because the law governing the transactions is unclear and the requisite data is incomplete. Tax avoidance involves the arranging of a taxpayer's affairs to take advantage of that which the law allows.⁹ In the past, taxpayers have used foreign entities to achieve tax results that were not obtainable in similar transactions with domestic entities.¹⁰ Over the years, Congress has attempted to "plug" certain of these "loopholes."¹¹

Tax evasion, on the other hand, involves acts intended to misrepresent or to conceal facts in an effort to escape lawful tax liability.¹² In a criminal tax evasion case, the government must prove each element of

⁸ *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

⁹ The taxpayer has the burden of proving all items claims on his return in a civil case. T.C. Rule 142. See I.R.C. § 7453 (1981).

¹⁰ *Offshore Tax Haven Hearings*, *supra* note 4, at 175 (testimony of Jerome Kurtz, Commissioner of Internal Revenue).

¹¹ For example, prior to the enactment of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, a taxpayer could take advantage of a foreign situs trust to eliminate or to defer significant amounts of United States taxes. See Kanter, *The Foreign Trust - A 'One World' Concept of Tax Planning*, 22 MAJOR TAX PLANNING 467, 469 (1970). In general, one could structure a trust agreement such that the undistributed income was not taxable to the trust because of the unique tax classifications for foreign trusts. One could avoid the progressive rate structure of the tax system if a grantor created a trust to accumulate income taxed at low rates. The trust in turn would distribute the income at a future date with the beneficiary paying little or no tax. This result occurs because the trust rather than the grantor or the beneficiary is taxed on the accumulated income. The Tax Reform Act's throwback rule prevents this result by taxing beneficiaries on accumulated distributions in the year that they received such distributions. Upon distribution of the trust's accumulated income, the beneficiary would be subject to the throwback provisions of I.R.C. § 666.

Not all tax savings are lost, however, because all distributions made by the trust retain the same character of income in the hands of the beneficiary. Thus long term capital gain characterization would not change and the ensuing tax savings would take the form of a deferral of tax liability. *Id.* at 469, 470.

The Tax Reform Act of 1976 further closed this loophole by the enactment of I.R.C. § 679 which limits the classification of a trust as a foreign situs trust. Under § 679, which draws on the *Clifford* trust rules established in *Helvering v. Clifford*, 309 U.S. 331 (1940), if a United States grantor creates a foreign trust, the grantor becomes taxable on all items of income attributable to the portion of the trust transferred by the grantor to the trust. Zimmerman, *Using foreign trusts in post-1976 period: What possibilities remain?*, 47 J. TAX'N 12 (1977). This is not to say that the Tax Reform Act of 1976 has eliminated the trust instrument as a tax planning device. See Kanter, *Grantor trusts as Sub S shareholders: New vistas for planning opened by TRA of 1976*, 46 J. TAX'N 130 (1977).

¹² I.R.C. § 7201 (1981) renders it a felony punishable by up to a \$10,000 fine or five years

the offense, including intent, some affirmative act to evade tax on the part of the taxpayer and an understatement of tax liability.¹³ Persons intent on evading taxes can use tax havens either to hide income or as part of a complex scheme intended to conceal the true nature of a transaction. In the former instance, the government may be unable to prove either the amount of money or property held in an account. In the latter case, the taxpayer intends to thwart criminal prosecution both by obfuscating the true nature of the transaction and by limiting the government's access to information needed to sustain its burden of proof.¹⁴

II. NATURE AND CHARACTERISTICS OF TAX HAVENS

Commentators have employed both an objective and a subjective approach in determining which nations are tax havens. Under the objective approach, a tax haven is any nation which has no tax or a low rate of tax on all or certain categories of income and which offers a certain level of banking or commercial secrecy.¹⁵ Under the subjective approach, a reputation test is employed. A country is a tax haven if it promotes itself as one, and those who specialize in international tax planning consider it to be one.¹⁶

The most important characteristic of a tax haven is that it imposes little or no tax on all or certain categories of income, or it imposes a rate of tax which is low relative to the taxes imposed by the taxpayer's home country.¹⁷ In some situations, the low or nonexistent tax rates are part of a nation's policy to attract banking, trust or corporate business. In other situations, the havens are small, undeveloped nations whose resi-

in prison or both for any person who willfully attempts to evade or to defeat any taxes imposed.

¹³ *Offshore Tax Haven Hearings*, *supra* note 4, at 176 (testimony of Jerome Kurtz, Commissioner of Internal Revenue).

¹⁴ *Id.*

¹⁵ TAX HAVENS, *supra* note 7, at 14. If this definition is applied literally, it would encompass many nations that are not generally considered tax havens, including the United States. The United States does not tax interest on bank deposits of nonresident aliens if such interest is not effectively connected with the conduct of a trade or business within the United States. I.R.C. § 861(a)(1)(A) (1981). See Rev. Rul. 75-449, 1975-2 C.B. 285 for a definition of deposits.

¹⁶ Most publications identifying jurisdictions as tax havens specify nearly all of the same nations, such as the Bahamas, the Cayman Islands, Singapore, Turkey, Caicos, Hong Kong, the Hebrides, the Jerseys/Guernseys. See Rhoades, *Tax Havens: What They Are; Where They Are; and How You Can Use Them Effectively*, 3 TAX'N FOR LAWS. 68, 71 (1974). See generally *Illegal Narcotics Profits Hearings*, *supra* note 5, at 480-90.

¹⁷ TAX HAVENS, *supra* note 7, at 14, 15. Many nations having tax haven characteristics are also frequently bases for minimizing taxation on various types of perfectly legal income and activities. These same nations have created a veil of secrecy through bank secrecy laws which provide the anonymity sought by persons evading tax laws. One should take care to avoid combining and confusing legitimate uses of tax havens with illegitimate activities, such as laundering money.

dents are poor. A poor population with a minimal tax base makes the imposition of an income tax unfeasible.¹⁸ Instead of an income tax, the country will establish a license or fee system on items such as bank licenses and commercial charters to generate revenues.¹⁹

Tax havens must afford some level of commercial secrecy to banking transactions in order to permit taxpayers to perpetrate tax evasion schemes.²⁰ Banking secrecy has its origins in the common law of Great Britain. Common law secrecy derives from an implied contract between a banker and his client that the banker will treat his customer's affairs as confidential.²¹ Most of the tax haven jurisdictions which were once British colonies have statutorily affirmed and enhanced the common law rules regarding secrecy. A tax haven will frequently strengthen its bank secrecy laws to improve its competitive posture vis-a-vis other tax havens.²²

Most nations, including non-tax havens, afford bank clientele some level of secrecy. At the same time, however, many nations will not protect information from a legitimate inquiry of a foreign government, particularly when the inquiry is made under terms of a treaty.²³ Most major tax havens, on the other hand, will not breach their wall of secrecy even when a major violation of another nation's laws may be involved.²⁴ The crucial distinction is between those nations which enact unreasonably restrictive rules of bank secrecy which tend to facilitate

¹⁸ *Id.* at 15.

¹⁹ *See, e.g.*, Statute Law of the Bahama Islands, Ch. 280 (1965) imposing fees on certain activities.

²⁰ A person also can take advantage of banking secrecy laws for noncriminal purposes, such as hiding money from one's spouse.

²¹ *Tournier v. National Provincial and Union Bank of England*, 1 K.B. 461 (1924).

²² Tax havens also react to other outside factors affecting their ability to function. In *United States v. Field*, 532 F.2d 404 (5th Cir. 1976), *cert. denied*, 429 U.S. 940 (1976), the Fifth Circuit directed a Cayman Islands resident to give testimony concerning bank information before a United States grand jury, even though he would be subject to criminal penalties in the Cayman Islands because his testimony would violate their banking secrecy laws. The Caymans reacted to this decision by enacting the Confidential Relationships (Preservation) Law (Law 16 of 1976). Section 4(b) made it a crime punishable by a \$5,000 fine and a two year prison sentence for an individual to obtain willfully or to attempt to obtain confidential information to which he is not entitled.

²³ Even Switzerland, the world's principal bank secrecy jurisdiction, has agreed to exchange banking information with other nations under appropriate circumstances. Switzerland will exchange information with the United States under a treaty arrangement in order to carry out the provisions of the treaty or to prevent fraud and the like in relation to the taxes which are the subject of the treaty. Convention between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, May 25, 1951, United States - Switzerland, Art. XVI(1), 2 U.S.T. 1751, 1760, T.I.A.S. No. 2316. In practice, Switzerland has been reluctant to give out information. *See infra* text accompanying notes 137-42.

²⁴ Most tax havens will refuse to divulge certain information even upon request and will state that they are not empowered to give out such information under their municipal law.

international tax evasion and other crimes, and those nations which pay homage to the protection of individual privacy but still permit legitimate inquiry under appropriate circumstances.²⁵

Financial institutions frequently assume a dominant role in the tax haven's trade and commerce. One method of testing the importance of banking to an economy is to examine the relationship of foreign assets in the country's banks to that country's foreign trade. Excess foreign assets are the amounts which exceed the ratio of worldwide foreign assets of deposit banks to worldwide foreign trade. Banks in the Bahamas, for example, held \$95.2 billion of foreign assets in 1978. Based on the worldwide average of deposits to world trade, the Bahamas needed only \$1.8 billion to finance its foreign trade. The \$93.4 billion difference represents excess international assets and indicates the attractiveness of the Bahamas as a tax haven.²⁶

One of the reasons that tax havens can attract bank deposits is that they frequently do not impose currency controls or similar restrictions on foreign nationals.²⁷ Nonresidents are, however, subject to currency controls on local currency. Exchange controls will not apply to foreign nationals as long as they are dealing in the currency of other jurisdictions and are not engaging in business in the tax haven.²⁸

Finally, most tax havens promote policies that aggressively seek financial business because banks, trust companies and other financial institutions are a stable source of revenue for the tax haven.²⁹ For example, in 1964 the Cayman Islands had only one or two banks and virtually no offshore or nonresident business. By December 31, 1977, this nation with a population of only 14,000 had 237 banks and trust compa-

See, e.g., An Act to regulate Banking Business and Trust Companies within the Colony and other matters related thereto. (Bahamas, No. 64 of 1965).

²⁵ TAX HAVENS, *supra* note 7, at 16-17. This distinction reflects an American bias. A Swiss national might argue that Swiss law assigns a higher priority to the sanctity of the individual and his personal rights than does United States law. Privacy in Switzerland is a statutorily enforceable right by virtue of Article 28 of the Civil Code and Articles 41 and 49 of the Code of Obligation. *See* Meier, *Banking Secrecy in Swiss and International Taxation*, 7 INT'L LAW. 16, 17 (1973). The Swiss view of privacy can be contrasted with the guarantees of privacy expounded by the United States Supreme Court in *Griswold v. Connecticut*, 381 U.S. 479, 484 (1965). The Court stated that specific guarantees in the Bill of Rights have penumbras, formed by emanations from those guarantees that create zones of privacy.

²⁶ TAX HAVENS, *supra* note 7, at 17. The excess foreign assets for nine tax haven jurisdictions increased sixteenfold for the period from 1970 to 1978 and during this same period, foreign assets grew from 12.5% to 29.1% of all foreign assets held worldwide. *Id.* at 17-18.

²⁷ *Offshore Tax Haven Hearings*, *supra* note 4, at 174.

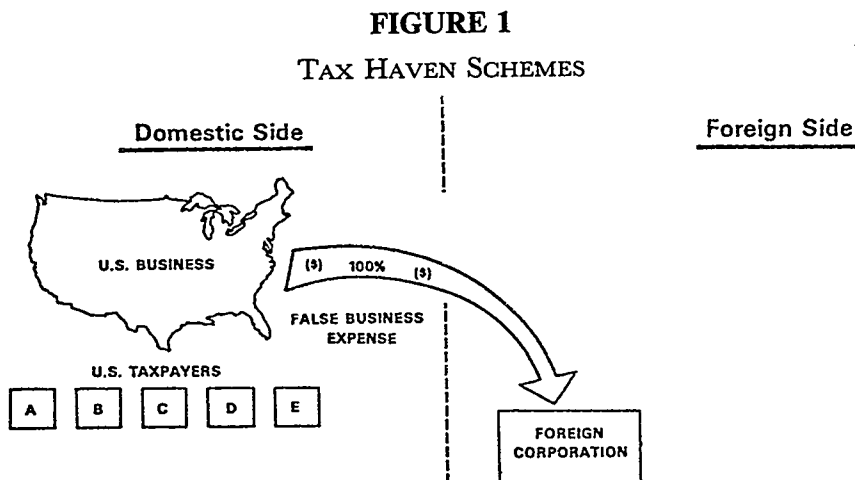
²⁸ TAX HAVENS, *supra* note 7, at 19.

²⁹ *Id.* Modern communications are also necessary to support the banking industry and therefore, most tax havens have excellent communications facilities, particularly telephone and telex services. The Cayman Islands, for example, advertises that it has more telex machines per capita than any place on earth. *Offshore Tax Haven Hearings*, *supra* note 4, at 33.

nies and 8,158 registered companies.³⁰

III. HOW TAX HAVENS ARE MANIPULATED

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.³¹ This section illustrates diagrammatically some of the more common methods in which tax havens are used to perpetrate illegal tax evasion schemes.³² Figure 1 illustrates an American business operation which is owned by American citizens *A* through *E*. The business makes payments to a foreign corporation and deducts these payments as business expenses. For purpose of this illustration, assume that the expenses are completely fraudulent.



An audit might disclose that these business expenses are being paid to a foreign corporation. The American business may bury questionable deductions within the cost of goods sold account and thus these deductions might not be apparent on the face of the return. If questioned on the deductibility of these expenses, the taxpayers would claim that the

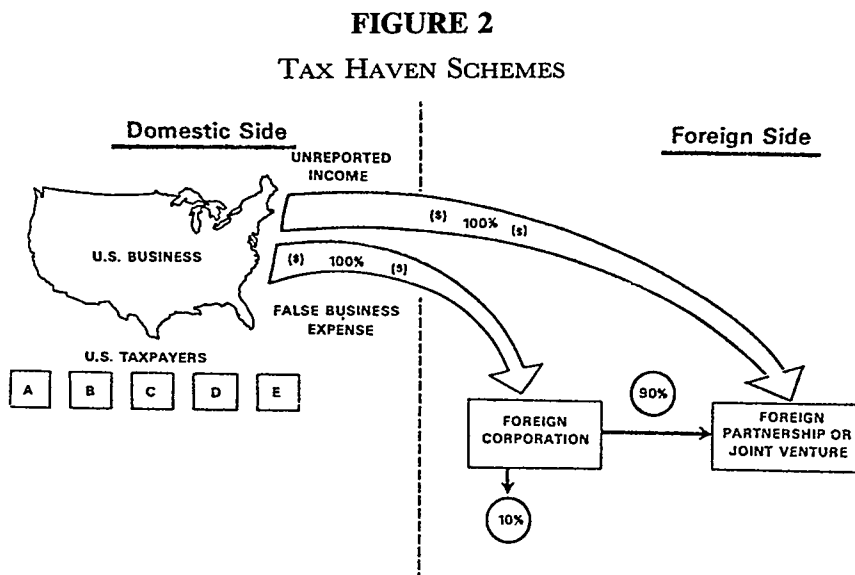
³⁰ *Offshore Tax Haven Hearings*, *supra* note 4, at 15.

³¹ *Legal and Economic Impact of Foreign Banking Procedures on the United States: Hearings before the House Committee on Banking and Currency*, 90th Cong., 2d Sess. 14 (1968) (statement of Robert Morgenthau, United States District Attorney, S.D.N.Y.) [hereinafter cited as *Banking Hearings*].

³² This section, including the diagrams, is largely adapted from the testimony of Ross Macbeth, staff member of the Assistant Attorney General, Tax Division, *Offshore Tax Haven Hearings*, *supra* note 4, at 7-11.

domestic and foreign entities are not related³³ and support the expenses with cancelled checks paid to the foreign enterprise. Other documents such as receipts supporting the payments also might ensure that the expenses are not questioned.

The auditor may also have trouble detecting items on the foreign side of the transaction. In Figure 2, the American business is paying phony business expenses to a foreign corporation which retains approximately ten percent of the funds.



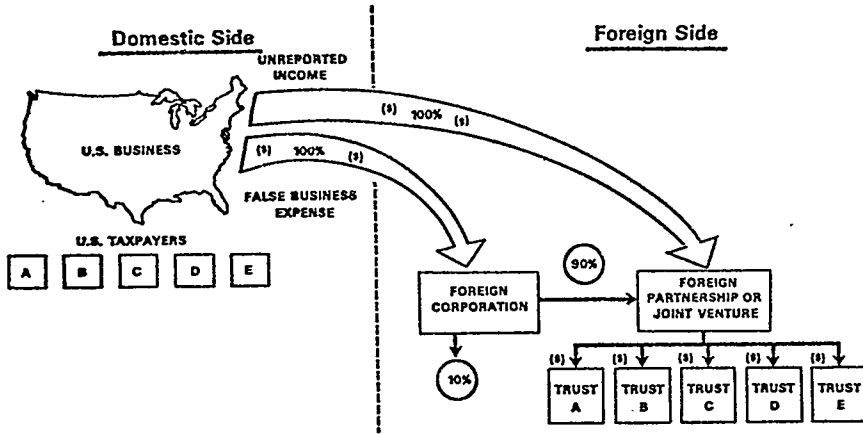
The foreign corporation passes on the balance of the funds to another foreign organization, but the auditor would not find this part of the transaction within the records of the taxpayers. The records supporting this part of the transaction may not even be located in this country.

The auditor also would not discover the channelling of unreported profits to an account in a tax haven on the tax returns or in the books and records of the American business. If the business generates a significant amount of cash, it could send skimmed receipts offshore. Skimming is one of the simplest and most common illegal uses of offshore tax havens.³⁴ The taxpayer could also set up a service contract whereby he claims that the offshore entity is performing services for the taxpayer's

³³ I.R.C. § 482 (1981) empowers the Commissioner in the case of two related organizations to "distribute, apportion, or allocate gross income, deductions, credits, or allowances between . . . such organizations, . . . if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly reflect the income of any such organizations. . . ."

³⁴ *Banking Hearings*, *supra* note 31, at 15.

FIGURE 3
TAX HAVEN SCHEMES



American business. In reality, the United States business performed the services while fraudulently claiming a deduction for the payment to the offshore entity. The auditor would not discover any of these transactions because he does not have access to the records of the offshore entity.

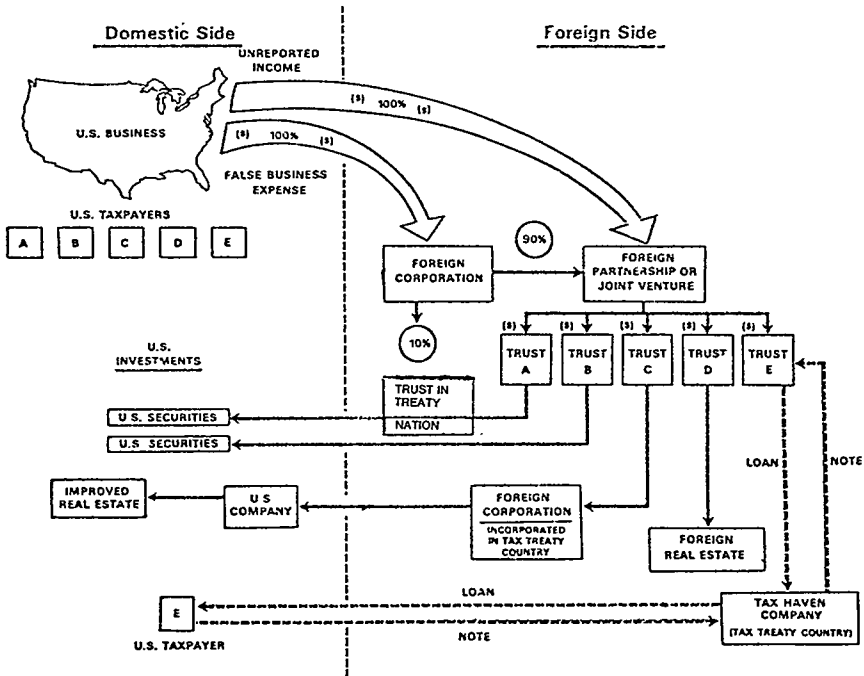
As Figure 3 indicates, the foreign operation is in fact owned by foreign trusts, the beneficiaries of which are taxpayers *A* through *E* or their families. An auditor would not know of the existence of the trusts, and thus he could not connect the taxpayers with the offshore funds.

Even though the money is theoretically offshore, the bank accounts for all these entities may be located in the United States. If the auditors can find these accounts, then a paper trail exists which can connect the taxpayers to the funds. Yet even in cases where the government can successfully identify the relationship between the taxpayers and the offshore transactions, government agents must spend thousands of hours piecing together complex and seemingly unrelated transactions. The government may not even be able to prosecute in situations where it has complete information on the criminal activity because foreign bankers may refuse to furnish witnesses competent to introduce bank documents into evidence.³⁵

In most instances, however, the auditor will never find out what happened to the funds. The money may actually leave the United States and subsequently return through another transaction. If the auditor cannot detect the critical transaction of the flow of funds from the

³⁵ *Id.* at 11-12.

FIGURE 4
TAX HAVEN SCHEMES



offshore entity to the United States, the taxpayer has successfully “laundered” his funds. Figure 4 illustrates some of the more common methods of repatriating funds.

Taxpayer *A* repatriates the funds by instructing his trust to invest in United States securities. The taxpayer would structure the transaction through an intermediary trust so that the investing entity is organized under the laws of a nation with which the United States has a treaty eliminating the withholding tax.³⁶ In this way he would avoid the thirty percent withholding tax on the interest and dividends paid by the securities.³⁷

Taxpayer *B* engages in an annuity transaction in United States securities with his trust whereby he sells appreciated securities to the trust

³⁶ For example, The Netherlands Antilles is a tax haven entity which has a tax treaty exempting interest and dividends from withholding taxes. See Protocol Supplementing the Convention between the United States of America and the Kingdom of The Netherlands with Respect to Taxes on Income and Certain Other Taxes for the Purpose of Facilitating Extension to The Netherlands Antilles, June 15, 1955, United States-The Netherlands, 6 U.S.T. 3696, T.I.A.S. No. 3366.

³⁷ I.R.C. § 871(a)(1) (1981).

in return for an annuity with a carryover basis.³⁸ When the trust sells the appreciated securities, there is no immediate taxable gain because it is realized by an offshore entity that is not subject to tax in the United States.³⁹

Taxpayer *C* has a different approach to repatriation; he invests in improved real estate. If the activity is classified as an investment as opposed to a trade or business, *C* proceeds through a holding company incorporated in a tax haven (treaty) nation, such as The Netherlands Antilles, that has a treaty provision providing for a year-by-year election to net income against expenses as if the investment was a trade or business.⁴⁰ When he sells the real estate, he revokes the election so that he is not subject to tax in the United States in the year of the sale. Therefore, the capital gain would be offshore and untaxed.⁴¹

Taxpayer *D*'s trust invests in foreign real estate, perhaps a condominium on the beach in the Bahamas where *D* takes his vacations. Taxpayer *E* wants to realize his investment in cash while avoiding a repatriation problem. He indirectly obtains a "loan" from the bank in the tax haven which is the trustee of his trust. The bank would loan the

³⁸ I.R.C. § 72(c) (1981).

³⁹ This transaction would merely defer the reported gain. Taxpayer *B* would still have to recognize gain from the annuity transaction as he receives money, subject to the installment sales provisions of I.R.C. § 453 (1981).

⁴⁰ Many of the United States tax treaties permit a foreigner who is not engaged in a United States trade or business to elect to have his real estate income taxed as if it were income derived from a trade or business. Thus taxpayer *C* could annually net his business income from the real estate against his expenses. *C* would then have the option of revoking that election in the year in which the real estate is sold. Thus the gain would not be subject to tax in the United States in the year of the sale. *See, e.g.*, Protocol modifying and supplementing the Extension to The Netherlands Antilles of the Convention between the United States of America and the Kingdom of The Netherlands for the avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income and certain other taxes of April 29, 1948, United States-The Netherlands, 15 U.S.T. 1900, T.I.A.S. No. 5665. For a description of the principal methods of circumventing the adverse consequences of foreign real estate transactions prior to the passage of I.R.C. § 879 (1981), see P. POSTLEWATE, INTERNATIONAL CORPORATE TAXATION § 3.02 (Supp. 1981).

⁴¹ Congress had closed this loophole in response to the growing concern about foreign investment in United States real estate. I.R.C. § 897 (1981). The Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, 94 Stat. 2682, deems gain or loss from the disposition of domestic real property interests to be effectively connected with the conduct of a trade or business in the United States. The legislation achieves parity between foreign and domestic investors in United States real estate. In enacting § 897, Congress chose to override conflicting tax treaties, yet authorized a five year grace period before the new legislation takes effect. See P. POSTLEWATE, *supra* note 40, at §§ 2.28, 4.03.

The Economic Recovery Tax Act of 1981, Pub. L. 97-34, further restricted this loophole. It was never Congress' intent to grant an exemption to foreign investors who rearranged their investments after the enactment of § 897 so as to come under a treaty which exempts the gain from United States tax. With certain technical exceptions, treaties in force still override § 897 until January 1, 1985. H.R. REP. NO. 215, 97th Cong., 1st Sess. 280 (1981). *See* P. POSTLEWATE & M. COLLINS, INTERNATIONAL INDIVIDUAL TAXATION, §§ 3.05, 3.06 (1982).

money effectively secured by the trust account to a dummy company in a tax treaty nation. This allows the taxpayer to "treaty shop" and deal through a nation that has a tax treaty with the United States which provides an exemption from withholding on interest payments.⁴² *E* then borrows the money from the dummy company. Funds in the transaction flow from *E*'s trust to the bank to the dummy company to taxpayer *E* and a series of demand notes go back to the trust.

Transactions involving offshore tax havens are often more complex and sophisticated than those illustrated in this section. Adroit tax planners with knowledge of bank secrecy laws can structure transactions that enforcement agencies could never document. The problem for the enforcement agencies is, thus, informational. The agencies must obtain evidence to connect taxpayers with offshore funds in legally admissible form.

IV. INFORMATIONAL PROBLEMS

Once the problem is defined as informational, the law enforcement agencies must address three related issues. First, the United States cannot effectively deal with tax evasion by closing loopholes in the Internal Revenue Code because the tax evaders in question will continue to ignore the law's substantive prohibitions. Second, the enforcement agencies should focus on obtaining information related to the status of such tax evaders as opposed to recommending statutory revisions. Third, at least in some instances, the investigators must obtain information in a form that courts will admit as evidence in civil or criminal proceedings.⁴³

A. BILATERAL ASSISTANCE: TREATIES

The simplest and most direct solution to this informational problem is to have the tax haven nations assist the United States in obtaining the requisite information. The threshold issue is whether the United States can negotiate treaties permitting the exchange of tax information.

The United States has employed two different types of treaty arrangements to gather more information about United States taxpayers from sources outside the United States. The primary method employed by the United States is exchange of information provisions in double taxation conventions.⁴⁴ As an alternative, the United States has negoti-

⁴² See *supra* note 40.

⁴³ *Offshore Tax Haven Hearings*, *supra* note 4, at 236-237 (statement of Prof. Harvey P. Dale).

⁴⁴ *Id.* at 284 (statement of H. David Rosenbloom, Assistant Secretary of the Treasury for Tax Policy).

ated mutual assistance treaties affecting criminal matters including the coverage of tax problems.⁴⁵

Double taxation conventions are designed to mitigate the effects of two nations claiming the right to tax the same stream of income.⁴⁶ The major substantive thrust of a double taxation convention is to limit taxation by the source country by carving out the respective taxing powers of the treaty partners. The near universal treaty provisions center on the term "permanent establishment" as the basis for taxation.⁴⁷ The treaty provisions emphasize the limits on taxation by the host or source country and therefore, the United States can never expect to be a full scale treaty partner with tax haven nations. These nations do not tax their residents or foreign entities. Thus, they have no incentive to reach an agreement limiting their taxing powers.

It is theoretically possible for the United States and a tax haven to agree on an exchange of information article in isolation from the full blown double taxation convention.⁴⁸ The United States has no such treaties in existence at this time. If the United States were to negotiate such a treaty, its terms would be similar, if not identical, to the exchange of information provisions in double taxation conventions.

Each one of the United States bilateral conventions for the avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income or estates contains a provision requiring an exchange of tax information. The wording of these provisions is generally standardized. The two nations agree to exchange information which "authorities have in proper order at their disposal [and] as is necessary for carrying out provisions of the present Convention or for the prevention of fraud or the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of this present Convention."⁴⁹

⁴⁵ The United States has only four such treaties in force at this time. *See, e.g.*, Treaty with Switzerland on Mutual Assistance in Criminal Matters, May 25, 1973, United States-Switzerland, 27 U.S.T. 2019, T.I.A.S. No. 8302.

⁴⁶ For a general discussion of these conventions and their ramifications, see P. POSTLEWAITE & M. COLLINS, *INTERNATIONAL INDIVIDUAL TAXATION*, chs. 8 and 9 (1982).

⁴⁷ *The Study of Federal Tax Law Transnational Transactions 1981-1982* 191 (V. Kirby, W. Pedrick, R. Hellowell, R. Pugh, M. Dickinson Jr., O'Bryne, W. Oliver, S. Thurmond, & J. Yang eds. 1981). *See, e.g.*, Convention between the United States of America and the Grand Duchy of Luxembourg with Respect to Taxes on Income and Property, Art. III(1), December 18, 1962, United States-Luxembourg 15 U.S.T. 2355, T.I.A.S. No. 5726.

⁴⁸ *See infra* text accompanying notes 132-34 for a discussion of the type of inducements that are necessary to provide incentives for tax haven nations to agree to an exchange of information treaty.

⁴⁹ Convention with The Netherlands with Respect to Taxes on Income and Certain Other Taxes, Art. XXI, April 29, 1948 United States-The Netherlands, 62 Stat. 1757, T.I.A.S. No. 1855. *But see* Convention with Canada for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income, Art. XIX, March 4, 1942, United States-Canada 56 Stat. 1399, T.I.A.S. No. 983 where that particular exchange of information

The official United States policy concerning exchange of information articles is to request the exchange of all tax information necessary to carry out any domestic tax laws of the contracting states.⁵⁰ The point of reference for all United States tax treaty negotiations is the United States Model Tax Treaty,⁵¹ which defines the United States initial nego-

provision has been interpreted by the Second Circuit to have some far-reaching implications. In *United States v. A.L. Burbank & Co., Ltd.*, 525 F.2d 9(2d Cir. 1975) the court held that the I.R.S. could use its I.R.C. § 7602 summons authority to obtain information from American based corporations which had been requested by Canadian tax authorities for purposes of Canadian tax investigations. The court upheld the summonses even though the United States had no interest in the investigation and there was no claim that United States income taxes were potentially due and owing.

On September 26, 1980, the United States and Canada signed a new income tax treaty with a more restrictive exchange of information provision. It is not yet in force. See 1 Tax Treaties (CCH) ¶ 1317K (1980).

⁵⁰ Rosenbloom and Langbein, *United States Tax Treaty Policy: An Overview*, 19 COL. J. TRANSNATIONAL L. 359, 383 (1981).

⁵¹ Treasury Department's Model Income Tax Treaty, reprinted in 1 Tax Treaties (CCH) ¶ 158 (1980). Article XXVI provides,

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1 (General Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation

(a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

(b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

(c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy (order public).

3. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

4. Each of the Contracting States shall endeavor to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by the Convention from taxation imposed by that other State does not enure to the benefit of persons not entitled thereto.

5. Paragraph 4 of this Article shall not impose upon either of the Contracting States the obligation to carry out administrative measures which are of a different nature

tiating position and reflects basic policy objectives. Although the Treasury patterned the model tax convention after the Model Tax Treaty of the Organization for Economic Cooperation and Development, [hereinafter cited as the O.E.C.D.],⁵² the United States model provision on information exchange is much broader than that of the O.E.C.D. The Treasury Model Treaty expressly requires officials of a state from which information is requested to take depositions and to provide authenticated copies of unedited original documents to the extent they can obtain such depositions and documents under the laws and administrative practices of that state.⁵³ The goal of the Treasury Model Treaty is to produce information in a form that the treaty partners can use in civil or criminal cases.⁵⁴

In practice, informational exchange provisions typically include express limitations on the obligations of the parties to gather or exchange information. Ordinarily the states agree to gather only information that is available under the laws of the requested state.⁵⁵ The information exchanges are also normally limited by standard international law restrictions on a state's responsibility to place its public administrative machinery at the service of a sister state.⁵⁶

The second type of agreement providing for an exchange of information is a mutual assistance treaty. Under the terms of such a compact, the contracting parties agree to lend their administrative machinery to each other in connection with specified types of investigations. The treaty sets forth a general obligation to furnish assistance and defines the most important acts included in that concept. This type of

from those used in the collection of its own taxes, or which would be contrary to its sovereignty, security, or public policy.

6. For the purposes of this Article, the Convention shall apply, notwithstanding the provisions of Article 2 (Taxes Covered), to taxes of every kind imposed by a Contracting State.

⁵² Organization for Economic Cooperation and Development Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, *reprinted in* 1 Tax Treaties (CCH) ¶ 151 (1980).

⁵³ Treasury Department's Model Income Tax Treaty, *supra* note 51, at Art. XXVI(3).

⁵⁴ The O.E.C.D., on the other hand, requires the exchange of information only "as is necessary for the carrying out of this Convention." *See supra* note 52, at Art. XIII(1).

⁵⁵ This limitation renders an exchange of information agreement with a tax haven jurisdiction useless because the haven's banking secrecy laws ensure the unavailability of the requested information.

⁵⁶ Under these limitations of a state's responsibility to furnish information, a requested state is normally not required: (1) to carry out administrative measure at variance with its laws and administrative practice or those of the requesting state; (2) to supply information not obtainable under the laws or in the normal course of the administration of either state; (3) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or any information the disclosure of which would be contrary to public policy. *Offshore Tax Haven Hearings*, *supra* note 4, at 285. *See* United States v. A.L. Burbank & Co., Ltd., *supra* note 49, for an expansive use of administrative machinery.

treaty is broadly conceived to overcome the obstacles that preclude access to information obtainable only by official action on foreign soil. Customary international law does not require one state to give aid to another in connection with the first state's administrative or criminal investigations or proceedings.⁵⁷ Municipal law frequently will prohibit measures by a foreign state to collect information because the state views such measures as an infringement of sovereignty if taken in the absence of a treaty or other official sanction.⁵⁸

The United States has only four mutual assistance treaties in force at this time.⁵⁹ Switzerland agreed to the first such compact, largely in response to political pressures exerted by the United States. Switzerland entered into the agreement in part because of its sensitivity to United States public opinion regarding Swiss Bank secrecy.⁶⁰ Many other nations are also sensitive to United States public opinion. The agreements with Columbia,⁶¹ The Netherlands,⁶² and Turkey⁶³ began as agreements to aid American investigations of the activities of Lockheed Aircraft and McDonnell Douglas Corporations. This sensitivity might continue to form the basis for negotiations.

The effectiveness of these treaties, however, to make available tax and fiscal information is uncertain. The United States has had limited experience with mutual assistance treaties. Only the treaty with Switzerland has been in force long enough to enable an analysis of its effectiveness. Interpretive problems have prevented the United States from obtaining tax information under the auspices of this treaty.⁶⁴ The senate advised and consented to the other treaties in December, 1981, and thus, they have not yet been implemented.

Some bank secrecy jurisdictions, however, might benefit from a mutual assistance treaty with the United States. Even if the offshore tax

⁵⁷ *Offshore Tax Haven Hearings, supra* note 4, at 286 (statement of H. David Rosenbloom, Assistant Secretary of the Treasury for Tax Policy).

⁵⁸ *Id.*

⁵⁹ *See, e.g.*, Mutual Assistance in Criminal Matters, Treaty with Switzerland, May 25, 1973, United States-Switzerland 27 U.S.T. 2019, T.I.A.S. No. 8302.

⁶⁰ *Offshore Tax Haven Hearings, supra* note 4, at 291 (statement of H. David Rosenbloom, Assistant Secretary of the Treasury for Tax Policy).

⁶¹ Procedures for Mutual Assistance in the Administration of Justice in Connection with the Lockheed Aircraft Corporation Matter, April 22, 1976, United States-Columbia, 27 U.S.T. 1059, T.I.A.S. No. 8244.

⁶² Agreement on Procedures for Mutual Assistance Between the United States Department of Justice and the Ministry of Justice of the Kingdom of The Netherlands in Connection with Matters Relating to the McDonnell Douglas Corporation, March 21, 1979, United States-Netherlands, 30 U.S.T. 2501, T.I.A.S. No. 9348.

⁶³ Agreement on Procedures for Mutual Assistance in the Administration of Justice in Connection with the Lockheed Aircraft Corporation and the McDonnell Douglas Corporation Matters, July 8, 1976, United States-Turkey, 27 U.S.T. 3419, T.I.A.S. No. 8371.

⁶⁴ *See infra* text accompanying notes 137-42.

haven has little interest in obtaining tax information, it may desire an exchange of information concerning other criminal matters. In certain circumstances, the United States could grant concessions in nontax areas as an inducement to some form of information exchange.⁶⁵ In proceeding with a program to promote mutual assistance treaties, the United States should develop an initial negotiating position which reflects its basic tax and enforcement policy concerns.⁶⁶

Information exchange agreements are probably a better solution to the problem of criminal tax evasion than mutual assistance treaties. Most nations are reluctant to apply mutual assistance treaties to tax matters; historically they have viewed such treaties as adjuncts to extradition treaties which do not cover fiscal or tax violations.⁶⁷ Furthermore, the information exchange agreement is a better means of obtaining sought-after information because the information exchange takes place directly between tax authorities, whereas under mutual assistance treaties the exchange takes place directly between regular law enforcement officials. The information exchange provision in double taxation conventions also creates a familiarity between tax enforcement officials which may constitute a substantial benefit to practical information exchange.⁶⁸

Regardless of which kind of treaty mechanism the United States negotiates with offshore tax havens, bilateral assistance remains the simplest and most efficient solution to the problem of international criminal tax evasion. Bilateral negotiations must focus on the inducements that will encourage tax havens to enter into treaties with the United States. As a practical matter, there might not be any inducements sufficient to promote exchange of information treaties with tax havens.⁶⁹ The United States, therefore, must continue to explore unilateral solutions, including legislation and increased investigation of offshore transactions.

B. SELF-HELP

1. *Bank Secrecy Act*

In the late 1960's, Congress held hearings to explore the possibilities

⁶⁵ *Offshore Tax Haven Hearings*, *supra* note 4, at 292. See *infra* text accompanying notes 132-34.

⁶⁶ The United States had already established a starting negotiation position in the area of double taxation conventions. See *supra* note 51 and accompanying text. The United States is quite familiar with the problems encountered in negotiating double taxation conventions and thus, can better deal with them. Interagency coordination among the State, Justice and Treasury Departments will be necessary to develop the mutual assistance treaty as a functional tool in the solution of the problems of offshore tax havens.

⁶⁷ *Offshore Tax Haven Hearings*, *supra* note 4, at 291-92.

⁶⁸ *Id.*

⁶⁹ See *infra* text accompanying notes 132-34.

of unilateral measures to curb the use of secret foreign bank accounts for illegal purposes.⁷⁰ Congress enacted the Bank Secrecy Act after the hearings disclosed that the use of secret foreign accounts for illegal purposes created grave regulatory and tax enforcement problems.⁷¹ Congress determined that records and reports of domestic transactions of currency and of the export of money "have a high degree of usefulness in criminal, tax, and regulatory investigations and proceedings."⁷²

Title I of the Act deals with financial recordkeeping; it delegates broad authority to the Secretary of the Treasury to "prescribe regulations to carry out the purposes of this section."⁷³ Subpart C of the Regulations requires every financial institution to keep records concerning any advice, request, or instruction received regarding a transaction which results in the transfer of funds, currency, other monetary instruments, checks, investment securities, or credit of greater than \$10,000 to a person, account, or place outside the United States.⁷⁴ In addition, banks must ascertain their account holders' identities and record their taxpayer identification numbers.⁷⁵ Banks must maintain records for a period of five years and must make their records available for inspection at all times.⁷⁶ Violations may subject the recordkeeper to civil or criminal penalties.⁷⁷

Congress enacted Title I because of the trend among large banks to discontinue their practice of photocopying checks and documents of funds transfers. Robert M. Morgenthau, former United States Attorney for the Southern District of New York, testified that in numerous cases, investigations "were frustrated by the premature destruction of bank documents or the failure to make copies of them."⁷⁸

Title II and subpart B of the Regulations specify the reporting requirements. The legislative history indicates that the purpose of Title II is to accumulate information on persons transferring large amounts of currency without the use of legal process. As the House Committee on

⁷⁰ See H.R. REP. NO. 975, 91st Cong., 1st Sess. 1, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4394, for the reports from this hearing.

⁷¹ Bank Secrecy Act, Pub. L. No. 91-508, 84 Stat. 1114 (1970) *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 1301 (codified in scattered sections of 12 U.S.C. §§ 1730(d), 1829(b), 31 U.S.C. §§ 1051-122, 15 U.S.C. § 78(g) (1976)). Title II is referred to as the "Currency and Foreign Transactions Reporting Act."

⁷² Bank Secrecy Act § 101, 31 U.S.C. § 1051 (1976).

⁷³ *Id.*

⁷⁴ 31 C.F.R. § 103.33(b) (1981).

⁷⁵ 31 C.F.R. § 103.34(a)(1) (1981).

⁷⁶ 31 C.F.R. § 103.32 (1981).

⁷⁷ Bank Secrecy Act § 125, 126, 31 C.F.R. §§ 103.47, 103.49 (1981).

⁷⁸ *Hearings on H.R. 15073: Hearings before the House Committee on Banking and Currency*, 91st Cong., 1st and 2d Sess. 92 (1970) (testimony of Robert Morgenthau, United States District Attorney, S.D.N.Y.).

Banking and Currency concluded: "Criminals deal in money—cash or its equivalent. The deposit and withdrawal of large amounts of currency or its equivalent (monetary instruments) under unusual circumstances may betray a criminal activity."⁷⁹

The Secretary of the Treasury is delegated broad powers to promulgate regulations to carry out the purposes of the Act.⁸⁰ These regulations require the filing of three different types of reports:

(1) Every financial institution must "file a report of each deposit, withdrawal, exchange of currency or other payment or transfer, by, through, or to such financial institution, which involves a transaction in currency of more than \$10,000."⁸¹ The regulations provide an exemption for transactions between domestic banks.⁸²

(2) Every person "who physically transports, mails or ships . . . currency or other monetary instruments in an aggregate amount exceeding \$5,000 . . . from the United States to, or into the United States from any place outside the United States" must file a report with Customs.⁸³

(3) Every person who is "subject to the jurisdiction of the United States . . . and who has a financial interest in, or significant authority over, a bank, securities, or other financial account in a foreign country must report such relation for each year in which such relationship exists."⁸⁴

The putative goal of this legislation is to combat the use of secret foreign bank accounts to hide legal or illegal income for tax evasion and other criminal purposes. The Bank Secrecy Act and implementing Treasury Regulations render the failure to report the legal or beneficial ownership of a foreign bank account a crime.⁸⁵

⁷⁹ H.R. REP. NO. 975, 91st Cong., 1st Sess. 3 (1970), *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4394, 4396.

⁸⁰ Bank of Secrecy Act § 204. The constitutionality of the authority conferred upon the Secretary of the Treasury was challenged and upheld in *California Bankers Ass'n v. Shultz*, 416 U.S. 21 (1974). The Court held that the recordkeeping requirements imposed by the Regulations did not deprive the banks of their fifth amendment due process rights. The Court did not directly address the privacy issue. Many student commentators, however, in analyzing this case focused upon the effects of the Bank Secrecy Act on the right of privacy. *See, e.g.*, Note, *Government Access to Bank Records*, 83 YALE L.J. 1439 (1974).

⁸¹ 31 C.F.R. § 103.22(a) (1981). Reported on I.R.S. form 4789.

⁸² 31 C.F.R. § 103.22(b) (1981).

⁸³ 31 C.F.R. § 103.23(a) (1981). Reported on Customs form 4790.

⁸⁴ 31 C.F.R. § 103.24 (1981). Reported on I.R.S. forms 1040, 4683 and Treasury form 90-22.

⁸⁵ Bank Secrecy Act § 126, 31 C.F.R. § 103.49 (1981). Even without this provision, failure to report an ownership interest in a foreign bank account constitutes a crime under 18 U.S.C. § 1001 (1976). This section provides that any person who knowingly and willfully falsifies any document within the jurisdiction of any agency of the United States may be fined up to \$10,000 and imprisoned for up to five years. A taxpayer must answer a question concerning ownership of foreign bank accounts on form 1040 of his tax return.

The efficacy of the Bank Secrecy Act in preventing and combatting tax evasion is uncertain. Many Internal Revenue Service officials contend that the information in the reports generated by the Act do not help them to detect tax evasion.⁸⁶ The General Accounting Office evaluation of the Bank Secrecy Act also criticized the efficacy of the reporting requirements.⁸⁷ The required reports have not been widely used and, therefore, their potential utility as an investigative tool is unknown. The General Accounting Office questioned law enforcement and regulatory officials about their use of these reports. In only one-third of the offices that the General Accounting Office visited were the reports used at all. Even when they were used, these reports served only as secondary investigative tools. Officials used the reports to identify investigative targets, to determine the extent and location of financial assets and to establish secondary criminal violations.⁸⁸

Moreover, since financial institutions must file reports for every transaction in excess of \$10,000,⁸⁹ the amount of data gathering and processing is voluminous. Estimates suggest that financial institutions microfilm over thirty billion photocopies each year at an aggregate cost in the hundreds of millions of dollars.⁹⁰ Both financial institutions and government agencies must file, examine and store reports thus necessitating an elaborate and expensive bureaucracy on the part of both the government and the financial institutions. One commentator has suggested that the "sheer size of the 'haystack' might very well make the discovery of incriminating 'needles' costly beyond proportion to any value they might have."⁹¹

Another reason why the Act is ineffective is because the same persons who are willing to use secret foreign bank accounts to perpetrate tax evasion schemes do not have any qualms about violating the reporting requirements of the Bank Secrecy Act. Those wishing to circumvent the law can easily do so by sending the money both in and out of the United States through the use of phony names. Most tax evasion schemes involve the use of financial intermediaries subject to the recording and reporting requirements of the Bank Secrecy Act. Notwithstand-

⁸⁶ GENERAL ACCOUNTING OFFICE, *Better Use of Currency and Foreign Account Reports by Treasury and IRS Needed for Law Enforcement Purposes* 5 (1979).

⁸⁷ GENERAL ACCOUNTING OFFICE, *Bank Secrecy Act Reporting Requirements Have Not Yet Met Expectations, Suggesting Need for Amendment* 6, 7, 11 (1981).

⁸⁸ *Id.*

⁸⁹ 31 C.F.R. § 103.22(a) (1980).

⁹⁰ *Hearings on H.R. 15073, Hearings Before the House Committee on Banking and Currency*, 91st Cong., 1st and 2d Sess. 320 (1970) (statement of Carl W. Desch, Senior Vice-President, First National City Bank, New York).

⁹¹ Comment, *Swiss Banks and Their American Clients: A Fading Romance*, 3 CAL. W. INT'L L.J. 37, 56-57 (1972).

ing this fact, the veil of secrecy provided by offshore tax havens which prevents enforcement agencies from connecting taxpayers to offshore funds is still effective enough to conceal the true nature of such business transactions.⁹² As Justice Douglas noted in his dissent in *California Bankers Association v. Schultz*, the reporting requirements of the Bank Secrecy Act are a "sledge-hammer approach to a problem that only a delicate scalpel can manage."⁹³

2. *Operation Tradewinds and Project Havens*

The Internal Revenue Service has conducted intelligence operations on the use of offshore banking and investments. From 1965 through 1975, the Intelligence Division of the Jacksonville, Florida district of the I.R.S. conducted two related investigations concerning the use of Caribbean offshore tax havens. The primary information gathering project and the related spin-off project were known as Operation Tradewinds and Project Havens, respectively. The purpose of these projects was to gather intelligence in the Caribbean concerning American investments, particularly those related to organized criminal activity.⁹⁴

In the early 1960's, a number of investigations involving organized crime figures indicated that certain taxpayers conducted financial transactions in the Bahamas in order to evade tax liability. Accordingly, the Intelligence Division made trips to the Bahamas to establish contacts with Bahamian officials and others in order to secure financial information on such individuals.⁹⁵ The Intelligence Division determined that many Americans formed Bahamian corporations and trusts in order to evade tax liabilities. Special agents secured the requisite financial information until the Bahamian government enacted its bank secrecy legislation in October, 1965.⁹⁶ The Act made it a crime "for any person to disclose . . . any information relating to the affairs of a bank or of its customers which [the person] acquired in the performance of his duties or the exercise of his official functions."⁹⁷

The Service's internal machinery then established administrative guidelines which covered the use of paid informants and the receipt of

⁹² Meyer, *Swiss Banking Secrecy and Its Legal Implications in the United States*, 14 N.E. L. REV. 18, 75 (1978).

⁹³ 416 U.S. at 85 (Douglas, J., dissenting).

⁹⁴ *Oversight Hearings into the Operations of the I.R.S. (Operation Tradewinds, Project Haven, and Narcotics Traffickers Tax Program): Hearings before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations*, 94th Cong., 1st Sess. 137 (1975) (testimony of Richard E. Jaffe, Special Agent, I.R.S.) [hereinafter cited as *Tradewinds Hearings*].

⁹⁵ *Id.* at 1301.

⁹⁶ *Id.*; Bank and Trust Co. Regulation Act of 1965 (No. 64 of 1965). See *supra* note 24.

⁹⁷ *Id.* at § 10(2); *Tradewinds Hearings*, *supra* note 94, at 1301.

bank information from Bahamian banks.⁹⁸ These guidelines in effect invited the Intelligence Division to violate the Bahamian bank secrecy law. Additionally, overzealous agents on several occasions failed to follow the guidelines established for securing bank information.⁹⁹ With the information provided by the informants as a starting point, the I.R.S. recommended deficiencies of over \$52,000,000 at a cost to the Service of a little more than \$1,500,000.¹⁰⁰ The Service suspended the investigations in 1975 after it acknowledged that it had obtained the information in violation of federal law.¹⁰¹

Operation Tradewinds and Project Havens did result in some indictments and convictions. The government obtained the critical evidence that was needed to connect many American taxpayers to their offshore funds in a January, 1973 seizure which later became known as the "briefcase caper."¹⁰² An informant of the I.R.S. stole a Bahamian banker's briefcase and photocopied its contents while a woman employee of the informant was "entertaining" the banker.¹⁰³

Among the over 400 documents obtained in the "briefcase caper" was a document indicating that Jack Payner held a bank account with the Castle Bank in the Bahamas. After confirming the Service's suspicion of the Castle Bank's connection with a Florida bank, the I.R.S. subpoenaed the Florida bank and required it to produce all documents related to its dealings with the Castle Bank.¹⁰⁴ The subpoenas resulted in the discovery of a loan agreement which pledged money from a Castle Bank account in the name of Jack Payner, as security for a \$100,000 loan by Castle Bank to Conel Development Inc.¹⁰⁵

Jack Payner was indicted on September 14, 1976, for knowingly and willfully making a false statement in a matter within the jurisdiction of an agency of the United States in violation of 18 U.S.C. § 1001.¹⁰⁶ He was charged with falsely stating on his 1972 tax return

⁹⁸ Service agents could make contacts in the Bahamas subject to the following restrictions: American citizens who were to act as intermediaries could receive the information obtained from bank employees in the Bahamas only in the United States; the I.R.S. could only use the information as a lead; the Service had to designate an agent other than the normal agent used for liaison purposes in the Bahamas as the person to receive such information. *Tradewinds Hearings, supra* note 94, at 1303.

⁹⁹ *Id.* at 1313.

¹⁰⁰ *Id.* at 46, 47, 49.

¹⁰¹ *Id.* at 123 (statement of Donald C. Alexander, Commissioner of Internal Revenue). The suspension of these projects generated allegations that Commissioner Alexander was personally involved with some of the investigatees. It was further alleged that Alexander personally ordered the suspension. *See id.* at 1268.

¹⁰² *Id.* at 57.

¹⁰³ *United States v. Payner*, 434 F. Supp. 113 (N.D. Ohio 1977), *rev'd*, 447 U.S. 727 (1980).

¹⁰⁴ *Id.* at 122.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 117.

that he did not have a foreign bank account when in fact he had an account with the Castle Bank of over \$100,000.¹⁰⁷

Payner waived his right to a jury trial and moved to suppress the evidence relating to the loan guarantee agreement. With the consent of the parties, the district court consolidated the motion to suppress with a trial on the merits.¹⁰⁸ On the basis of all evidence, the court found Payner guilty as charged.¹⁰⁹ The court also found that the United States acting through its agents, knowingly and willfully participated in the unlawful seizure of the briefcase.¹¹⁰ The trial court logically drew the nexus between the loan guarantee agreement and the "briefcase caper" and suppressed the evidence. Although the court held that the search did not impinge on Payner's fourth amendment rights, it did hold that the fifth amendment's due process clause and the inherent supervisory power of the federal courts required it to exclude evidence "which exhibits [the Government's] knowing and purposeful *bad faith hostility* to any person's fundamental constitutional rights."¹¹¹

The Sixth Circuit affirmed in a brief order endorsing the trial courts use of its supervisory power,¹¹² but the Supreme Court reversed in a six to three decision.¹¹³ The Court first held that the district court was correct in finding that Payner lacked standing under the fourth amendment to invoke the exclusionary rule to suppress the documents illegally seized.¹¹⁴ The established rule concerning standing to invoke the exclusionary rule is that evidence may not be excluded unless a court finds that an unlawful search or seizure violated the defendant's own constitutional rights.¹¹⁵ The government violates an individual's fourth amendment rights only when its conduct invades the *individual's* legitimate

¹⁰⁷ *Id.* at 117-18. Payner failed to correctly answer the question on Form 1040 of his tax return relating to foreign bank accounts which reads as follows: "Did you, at any time during the taxable year, have any interest or signature over a bank, securities or other financial account in a foreign country (except in a U.S. military banking facility operated by a U.S. financial institution)?" *Id.* at 118 n.1.

¹⁰⁸ *United States v. Payner*, 447 U.S. at 729.

¹⁰⁹ *Id.*

¹¹⁰ 434 F. Supp. at 120. The woman employee of the I.R.S. informant never testified in the Payner case, even though her testimony would have helped to resolve the factual issue of the propriety of the Government's conduct. The trial court concluded that it was peculiarly within the power of the United States to produce her as a witness because she worked for its agent and was totally unknown to the defendant. The court inferred her from absence that her testimony would be unfavorable to the Government in that it would further delineate the improprieties of the "briefcase caper." *Id.* at 119 n.22.

¹¹¹ *Id.* at 129. (Emphasis in original).

¹¹² 590 F.2d 206 (6th Cir. 1979).

¹¹³ 447 U.S. at 727, 737.

¹¹⁴ *Id.* at 731-32.

¹¹⁵ *Id.* at 731 (citing *Rakas v. Illinois*, 439 U.S. 128, 138 (1978)).

expectation of privacy rather than that of a third party.¹¹⁶ Since the rights infringed upon were those of the Castle Bank and its banker, Payner had no standing to assert the exclusionary rule.

The Supreme Court applied analogous reasoning to the issue of the federal court's supervisory power and included the evidence. The Court held that the district court's approach upset the careful balance of interests embodied in the Supreme Court's fourth amendment decisions.¹¹⁷ In considering the application of the exclusionary rule, the Court balances the government's blatantly illegal actions against the resulting harm from the indiscriminate application of the exclusionary rule. Justice Powell, writing for the majority, weighed these same factors in considering whether to invoke the supervisory power to suppress illegally seized evidence.¹¹⁸ Thus the Court held "that the interest in deterring illegal searches does not justify the exclusion of tainted evidence at the instance of the party who was not the victim of the challenged practices."¹¹⁹

From the perspective of the tax enforcement authorities, Tradewinds and Havens are not functional precedents for future investigations because of the unusual manner in which the evidence was obtained. Simply as a matter of policy, the Service cannot actively participate in illegal activities as a means of enforcing the tax laws, even though the evidence might be admissible in court. The I.R.S. suspended these investigations because it considered Operation Tradewinds and Project Havens an undue allocation of Service resources to organized criminal activity.¹²⁰ As Commissioner Alexander said in his testimony before the Subcommittee on Commerce, Consumer and Monetary Affairs, "such activity fails to serve the ends of tax administration and enforcement."¹²¹

¹¹⁶ *Id.* at 731 (citing 439 U.S. at 143).

¹¹⁷ *Id.* at 733. *See, e.g.*, *Brown v. United States*, 411 U.S. 223 (1973), *Combs v. United States*, 408 U.S. 224 (1972).

¹¹⁸ 447 U.S. at 734-35. Powell emphasized that the Court never held that the supervisory power authorized suppression of illegally obtained evidence. *Id.* at 735 n.7. The supervisory power permits courts to supervise "the administration of criminal justice." *Id.* at 735. (citing *McNabb v. United States*, 318 U.S. 332, 340 (1943)). The Court has applied the supervisory power in a restrained manner. "[A]ny apparent limitation upon the process of discovering truth in a federal trial ought to be imposed only upon the basis of considerations which outweigh the general need for untrammelled disclosure of competent and relevant evidence in a court of justice." *Id.* at 735 (citing *Elkins v. United States*, 364 U.S. 206, 216 (1960)).

¹¹⁹ *Id.* at 735. The Court dismissed the due process issue in a footnote because no protected right of the defendant was involved. *Id.* at 737 n.9. *See Hampton v. United States*, 425 U.S. 484, 490 (1976).

¹²⁰ *See Tradewinds Hearings, supra* note 94, at 121.

¹²¹ *Id.* at 121 (statement of Donald C. Alexander, Commissioner of Internal Revenue).

V. SOLUTIONS TO THE PROBLEM

Substantive legislative revision will not solve or deter international criminal tax evasion. The simple prohibition of section 7201 that renders any willful act or attempt to evade any tax a felony, sufficiently addresses all criminal tax evasion issues. Viable options do exist, however, in the areas of audit investigation and information exchange.

A. INFORMATION EXCHANGES

During the Oversight Subcommittee Hearings on offshore tax havens, Marshall J. Langer, a Miami tax attorney, recognized the importance of information exchange and offered a concrete proposal to deal with illegal tax evasion by Americans in offshore tax centers.¹²² Recognizing that virtually all of the United States' double taxation conventions in force contain an exchange of information provision, Langer suggested inviting all other nations, with which the United States does not already have an existing tax treaty in force, to sign an information exchange agreement with the United States. The United States would then classify each nation in the world according to whether or not it has an information exchange agreement, either in a bilateral tax convention or on its own with the United States. Langer would have the United States impose economic sanctions on every nation refusing to enter into these agreements. He recommends amending the Internal Revenue Code to restrict the benefits that are now freely given to citizens of all foreign nations,¹²³ to foreign citizens of those nations with which the United States has an information exchange agreement. This proposal introduces an extrinsic inducement into the treaty bargaining process. Either a nation would agree to enter into an information exchange treaty or the United States would deny to its residents certain tax benefits.

The United States would tax citizens of countries refusing to enter into such agreements by withholding at the source on all income and gains from United States sources without exception, including interest on bank deposits, treasury bills and capital gains. Furthermore, Langer's proposal would no longer permit tax deferrals by United States shareholders of controlled foreign corporations that are incorporated in nations with which the United States does not have an information exchange accord.¹²⁴

The goal of this proposal is to divide the world into two parts. Foreign nations of countries with information exchange agreements would

¹²² *Offshore Tax Haven Hearings*, *supra* note 4, at 228 (statement of Marshall J. Langer).

¹²³ *See, e.g.*, *supra* note 15.

¹²⁴ *Offshore Tax Haven Hearings*, *supra* note 4, at 228.

continue to enjoy all of the tax benefits they currently possess and foreign persons residing in nations without those treaties would lose their right to enjoy these benefits. Offshore tax havens would have two options—either they could keep their bona fide offshore business or they could keep their illegitimate business. A tax haven could not successfully keep both. With an information exchange agreement in force, offshore tax havens would lose their tax evasion business because bank secrecy laws would no longer protect taxpayers. On the other hand, if the tax haven refuses to enter into such an agreement, then it would probably lose most of its legitimate American financial business because the United States would now deny various American tax benefits to the businesses operating out of the tax haven.¹²⁵

The Service would have to exercise a certain amount of care to prevent persons residing in nations which refuse to agree to an exchange of information treaty from indirectly obtaining unintended benefits.¹²⁶ To mitigate circumvention of the intended effects of Langer's proposal, Congress would have to require full withholding at the statutory thirty percent rate¹²⁷ for all domestic-source income paid to foreign persons notwithstanding the fact that a lower tax-treaty rate exists.¹²⁸ The Service would then monitor claims for refunds of excess withholdings and restrict refunds to intended beneficiaries only.

Langer's proposal would not totally eliminate international criminal tax evasion, but he believes that his plan would reduce evasion substantially for a number of reasons. First, the plan should make tax evasion more costly. With more information exchange agreements in force, a prospective evader would need many tiers of entities in different nations to disguise a transaction.¹²⁹ More complete documentation would enable the Service to piece together virtually any business transaction. Second, the I.R.S. could more easily monitor transactions in the limited number of tax havens that did not sign information exchange agreements than in all of the offshore financial centers that exist today.¹³⁰ This of course assumes that the United States could induce

¹²⁵ *Id.* at 228-29.

¹²⁶ A citizen of a nation without an agreement could circumvent Langer's plan through the use of a three-step transaction instead of a two-step transaction. The transaction would run from the nation without the agreement to a nation with an agreement to the United States.

¹²⁷ I.R.C. §§ 1441 (individuals), 1442 (corporations) (1981).

¹²⁸ Many treaties provide for reduced or zero rates of withholding on certain types of income. *See, e.g.*, Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income, July 22, 1954, United States-Germany, Art. VI (reducing withholding rates on dividends to 15%), Art. VII (exempting interest from withholding), 5 U.S.T. 2768, T.I.A.S. No. 3133.

¹²⁹ *Offshore Tax Haven Hearings*, *supra* note 4, at 229.

¹³⁰ *Id.*

many offshore tax havens to enter into exchange of information agreements through the threat of sanctions that Langer introduces into the bargaining process. Third, the mere fact that such a program exists should deter tax evasion. The prospective tax evader cannot know whether or when the nation in which he is conducting business will enter into an information exchange agreement with the United States. If an offshore tax haven enters into an agreement, transactions which the taxpayer believed to be protected by commercial secrecy laws would become subject to scrutiny by the Service. In this manner, a taxpayer operating in a nation without an information exchange agreement with the United States might eventually become vulnerable to criminal prosecution.¹³¹

The crux of Langer's proposal is the across the board introduction of sanctions involving the domestic tax consequences of overseas transactions into the process of negotiating information exchange agreements. Some general problems with this proposal render it unfeasible to implement. First, it is probably more practicable to offer such inducements on a country-by-country basis, since the best and most appropriate bargains will vary from nation to nation.¹³² There are a great variety of inducements in the tax area and different inducements will attract different nations. The United States needs to offer to offset some of the revenue loss to the offshore tax havens in order to induce them to enter into these information exchange agreements. The United States might, for example, consider granting an exemption from the foreign convention rules¹³³ so that certain offshore centers that sign such an agreement

¹³¹ *Id.*

¹³² *Id.* at 319 (statement of H. David Rosenbloom, Assistant Secretary of the Treasury for Tax Policy).

¹³³ Congress has repeatedly enacted legislation which restricts the deductibility of expenses related to foreign conventions. Congress enacted new section 274(h), added by section 602 of the Tax Reform Act of 1976, PUB. L. NO. 94-455, 90 Stat. 1572 (1976), for the purpose of curtailing tax deductible vacations abroad, disguised as foreign business and professional conventions. See Hefferman and Terr, *Tax Planning for Foreign Conventions After The Tax Reform Act of 1976*, 32 TAX. L. REV. 273 (1977).

Congress further restricted the deductibility of foreign convention expenses with the enactment of Pub. L. No. 96-608, 94 Stat. 3550 (1980). Under the post-1980 rules, no expenses are allowable for any meeting outside the North American area (the United States, its possessions, the Trust Territory of the Pacific Islands, Canada and Mexico) unless the taxpayer can establish that the convention is directly related to the active conduct of his trade or business or to an income-producing activity and that, after considering certain factors, it is "as reasonable" for the meeting to be held outside the North American area as within it. I.R.C. § 274(h) (1981). Inclusion of a nation within the definition of the North American area could generate significant amounts of convention revenue for a tax haven and thus should be considered as a bargaining tool in the information exchange process.

The United States and Jamaica have recently amended their double taxation convention so that convention expenses incurred in Jamaica are now deductible for United States tax purposes. Protocol Amending the Convention for the Avoidance of Double Taxation and the

would have the opportunity to generate additional convention revenue.

Nontax inducements might attract other tax havens. The loss of tax benefits for their residents' United States investments would not affect most tax havens because their residents have only limited investments in the United States.¹³⁴ Promises of American technology and investment might appear more attractive to some offshore tax havens.

Second, Langer's proposal renders the tax treatment of the foreign income of American controlled subsidiaries and the United States income of foreign persons entirely dependent on whether a particular foreign jurisdiction had an information exchange agreement with the United States. This could affect American multinational corporations' ability to compete with foreign entities in foreign markets. The denial of certain tax benefits to American subsidiaries that are incorporated in tax havens increases the cost of doing business for the multinationals and thus, renders them less competitive.

Third, Langer's across the board approach to extrinsic inducements is too inflexible to become a part of the international tax policy of the United States.¹³⁵ In the negotiation of information exchange agreements, the United States must make some policy sacrifices in order to achieve some desired gains. Frequently that determination depends on the particular circumstances. The United States must decide in individual cases as to what sacrifices are appropriate and seek the solution that nets the greatest gain to the United States at the lowest cost in policy terms.¹³⁶ Langer's proposal adds inflexibility to the process of treaty negotiations.

Finally, Langer's proposal is silent on a course of action to pursue when an information exchange agreement does not function properly.¹³⁷ This is a current problem that the United States faces with respect to an information exchange with Switzerland. Article XVI of the tax treaty with Switzerland provides: "The competent authorities of the contracting states shall exchange such information . . . as is necessary . . . for the prevention of fraud or the like in relation to the taxes which are the subject of the present convention."¹³⁸ There is a distinction in Swiss law between *Steuerbetrug*, tax fraud and *Stererhinterziehung*, tax evasion.¹³⁹

Prevention of Fiscal Evasion with Respect to Taxes on Income, May 21, 1980, United States-Jamaica Art. IV.

¹³⁴ *Offshore Tax Haven Hearings*, *supra* note 4, at 319.

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ Convention between the United States of America and the Swiss Confederation 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, 1760; T.I.A.S. No. 2316.

¹³⁹ Meier, *supra* note 25, at 25.

The Swiss definition of tax fraud is more restricted than the American definition; it "encompasses only the falsification . . . of documents . . . intended for proving a fact of legal significance."¹⁴⁰ Tax evasion, on the other hand, encompasses the "willful failure to make a return, willful misstatements on a return, or other deliberate efforts to obstruct proper tax . . . collection."¹⁴¹ The Swiss, unlike the Americans, do not view these latter offenses as fraud.¹⁴² The Swiss interpretation has the effect of greatly restricting the amount of information given to the United States. Furthermore, the Swiss Supreme Court has limited the utility of the information received by American authorities by holding that Switzerland fulfills its treaty obligations by merely furnishing an official report as opposed to providing legal assistance in judicial proceedings.¹⁴³ This renders the information inadmissible as evidence.

Lack of a provision in Langer's proposal for denying tax benefits to such a country renders the proposal ineffective. The presence of such a provision raises a host of other problems that would contravene other policies of the United States. Other policy implications might preclude the denial of tax benefits to a nation when the information exchange provision is not functioning properly. The denial of tax benefits to Switzerland, for example, the nation through which twenty percent of all foreign investment in the United States is routed would have serious economic repercussions.¹⁴⁴ In light of these costs, Langer's proposal would not have a sufficient deterrent effect on international criminal tax evasion to merit its implementation.

Langer's proposal is useful because it forces the United States to focus on initiating discussions with foreign officials and not on obtaining evidence under questionable circumstances. In a manner similar to the Treasury Department's Model Income Tax Treaty,¹⁴⁵ the Assistant Secretary of the Treasury for Tax Policy should define the United States' initial bargaining position with respect to information exchange agree-

¹⁴⁰ *Offshore Tax Haven Hearings*, *supra* note 4, at 287-88.

¹⁴¹ *Id.*

¹⁴² The stated basis for applying this interpretation of fraud to the treaty is a provision in the convention that specifies that "any term not otherwise defined shall, unless the context otherwise requires, have the meaning which such term has under [the nation's] own tax laws." Convention between the United States of American and the Swiss Confederation, *supra* note 138, at Art. II(2), 2 U.S.T. 1756, T.I.A.S. No. 2316. The Federal Supreme Court of Switzerland has confirmed that the Swiss definition of fraud is applicable to this tax convention. *X v. Federal Tax Administration*, BG 96 I, 71-1 U.S. Tax Cas. (CCH) ¶ 9435 (1970) (Unofficial English translation) (The names of the participants in the litigation were not released by the Swiss Supreme Court for privacy reasons).

¹⁴³ *X & Y-Bank v. The Swiss Federal Tax Administration*, BG 101 I 160, 76-1 U.S. Tax Cas. (CCH) ¶ 9452 (1975) (Unofficial English translation).

¹⁴⁴ *Offshore Tax Haven Hearings*, *supra* note 4, at 319.

¹⁴⁵ See *supra* notes 51-54 and accompanying text.

ments, including what the United States is willing to give up in order to promote these agreements. The United States should make concessions and inducements to facilitate the signing of exchange of information agreements whenever the gains derived from the agreement exceed the costs of the concessions made.

B. FURTHER AUDIT INVESTIGATION

The second and less effective method of combatting international criminal tax evasion involves devoting additional resources to auditing transactions in offshore tax havens. Increased audit coverage will not solve the problem, but it is useful because taxpayers will perceive that they will be punished if they evade their tax liabilities.¹⁴⁶ Thus, the Service can more effectively promote voluntary compliance.

Looming forcefully in the background of this problem is the issue of voluntary compliance.¹⁴⁷ The American tax system is based on self-assessment and, consequently, voluntary participation is necessary for its success. Tax paying entities voluntarily submit over ninety-nine percent of the revenues collected.¹⁴⁸ Given its limited enforcement budget, the Service cannot proceed against any significant percentage of tax evaders, either onshore or offshore. The Service's enforcement policy is to prosecute a few well-publicized cases each year in order to deter wrongdoing.¹⁴⁹ In order to promote compliance, the American public must perceive the I.R.S. as a benign, as opposed to an adversary, agency.¹⁵⁰ Congress must place limits on the Service's enforcement budget in order to quell public concern.¹⁵¹ Due to the problems and the resulting high costs of obtaining information on American taxpayers' uses of offshore tax havens for purposes of tax evasion, this area of investigation is not the most cost effective for the Service to pursue. The investigation of international criminal tax evasion is a low priority item because other areas of investigation can generate more revenue.

The Service must employ its limited enforcement budget without violating the law and in such a manner as to derive the maximum benefit per dollar expended while still considering the problems related to public perception. The regular use of evidence obtained under ques-

¹⁴⁶ See generally *Illegal Narcotics Profits Hearings*, *supra* note 5, at 477.

¹⁴⁷ *Id.*

¹⁴⁸ Commissioner of Internal Revenue, Internal Revenue Service, Annual Report of 1977, 15, 20 (1977).

¹⁴⁹ *Illegal Narcotics Profits Hearings*, *supra* note 5, at 477.

¹⁵⁰ *Id.*

¹⁵¹ A government that only seeks to increase revenues (i.e., a rationale profit maximizing government) would spend an unlimited amount of money on taxpayer compliance because each dollar expended generates approximately \$4.5 in revenue. Commissioner of Internal Revenue, *supra* note 147, at 20, 144.

tionable circumstances, such as Operation Tradewinds and Project Havens, would adversely affect the public's perception of the I.R.S. It might even have negative ramifications towards taxpayer compliance.¹⁵² Yet, when the Service investigates fraudulent activity in tax haven nations and remains within the confines of the law, it often does obtain results.¹⁵³

The I.R.S. could minimize its public perception problem if it were to employ only as many resources towards investigating international criminal tax evasion as costs justify it to provide (i.e., revenues derived from the ultimate determination of investigations exceed amounts expended on investigation). Staffing requirements would be based on assessments of expected value determinations wherein the probability of a successful investigation times the estimated amount to be realized equals the enforcement budget related to offshore tax haven investigation. The I.R.S. could minimize its public perception problems if it were to focus its investigation on organized crime figures and high income taxpayers. If Congress were to adopt cost-effective enforcement programs, it could make an inroad on the problem of international criminal tax evasion without any significant drain on the Federal Treasury. Furthermore, such a program would promote deterrence because of the additional resources devoted to criminal investigation.

In addition to increased investigation, sounder administrative efforts might render the fraudulent use of tax havens easier to detect.¹⁵⁴ Initially, the burden of proof to establish the tax consequences of any transaction, including one with an entity in a tax haven jurisdiction, is on the taxpayer.¹⁵⁵ Service agents should deny deductions where a taxpayer has not demonstrated an entitlement to a deduction, or where the agent is not satisfied as to valuations or proper transfer pricing. The I.R.S. took an initial step forward with the issuance of Revenue Ruling 80-324.¹⁵⁶ In that Ruling, a taxpayer, responding to an investment prospectus, invested money in futures contracts in United States Government interest-bearing certificates with a foreign investment firm. When the taxpayer tried to deduct a loss on the transaction, the Service denied the deduction because the investment firm's records were not available to the Service for examination. Despite the taxpayer's offer to substantiate his loss and to present the investment prospectus, cancelled checks,

¹⁵² *Tradewinds Hearings*, *supra* note 94, at 123 (statement of Donald C. Alexander, Commissioner of Internal Revenue).

¹⁵³ See e.g., *United States v. Kelly*, 349 F.2d 720 (2d Cir. 1965), *cert. denied*, 384 U.S. 947 (1966), in which promoters used four "liechtenstein" trusts holding Swiss bank accounts to sell fraudulently priced stock.

¹⁵⁴ *TAX HAVENS*, *supra* note 7, at 128.

¹⁵⁵ See *supra* note 9 and accompanying text.

¹⁵⁶ Rev. Rul. 80-324, 1980-2 C.B. 340.

and a confirmation statement from the investment firm, the Service refused to allow the deduction.¹⁵⁷ Even without increased investigation the Service should continue to assume that aggressive attitude in analyzing all tax haven transactions.

VI. CONCLUSION

The magnitude of the use of offshore tax havens for tax evasion purposes, coupled with the inability of American agencies to deter such use and the international trade implications of the situation, have made the tax haven issue a controversial one. This concern is amplified by the suspicion that much of the funds are not simply sequestered for tax evasion purposes, but rather are the product of corporate and organized crime that are so offensive to the public morals.¹⁵⁸ It is difficult to define an appropriate solution to the problem when commercial secrecy laws prevent a definition of its scope.

The two solutions offered in this comment, exchange of information agreements and cost-effective audit investigations serve to place the problem of international criminal tax evasion in its proper perspective. The focus of the problem is informational, not substantive. Neither of these solutions would put an end to international tax evasion, for it is too widespread. The proposed solutions should, however, make an inroad on the problem. The ultimate importance of this problem remains its effect on voluntary taxpayer compliance. Taxpayers submit ninety-nine percent of all tax revenues voluntarily.¹⁵⁹ As the public perceives widespread evasion going unpunished, it becomes more reluctant to pay compliantly. If a large enough percentage of the public refuses to comply with the tax laws, then the entire tax system falls apart.

DOUGLAS J. WORKMAN

¹⁵⁷ *Id.* at 340-41.

¹⁵⁸ *Illegal Narcotics Profits Hearings*, *supra* note 5, at 476.

¹⁵⁹ *See supra* notes 146-52 and accompanying text.