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Two Bills Target Tax Haven Abuse and Offshore Tax Evasion

Legislation Pending in the 111th Congress

The following proposals to address offshore tax havens have been offered.

The Stop Tax Haven Abuse Act (Levin-Doggett Bill)

On March 2, Sen. Carl Levin (D-MI) and four co-sponsors introduced S. 506, the Stop Tax Haven Abuse Act (the "Tax Haven Act") which would enact important new rules to deter offshore transactions designed to avoid U.S. income tax. Rep. Doggett introduced the same measure in the House the next day, with 59 co-sponsors (H.R. 1265).

"Our bill provides powerful tools to end offshore tax haven and tax shelter abuses [which] contribute nearly $100 billion to the…annual tax gap," Levin said. "With the financial crisis facing our country today and the long list of expenses we're incurring to try to end that crisis, it is past time for taxes owing to the people's Treasury to be collected. And it is long past time for Congress to stop tax cheats from shifting their taxes onto the shoulders of honest Americans."

Sen. Levin has introduced similar legislation before. This bill adds three new provisions addressing businesses that incorporate in tax havens, tax withholding on U.S. stock dividends, and expanded reporting for a passive foreign investment corporation (PFIC).

Requiring Economic Substance

Codify the Economic Substance Doctrine (Sec. 401-403 of the bill)
The most important provision of the Tax Haven Act is actually the very last section of the bill. The Tax Haven Act would put the "economic substance doctrine" in the Internal Revenue Code. The doctrine has been developed over the years by courts to disallow losses or deductions that have no economic substance apart from their tax benefits. Unfortunately, different courts have developed different interpretations of the rule and courts do not apply the doctrine uniformly. The bill would put the economic substance doctrine into the tax law, thereby disallowing losses, deductions, or credits arising from "tax avoidance transactions," for example, where the present value of the tax savings far exceeds the present value of the pre-tax profits.

Tax avoidance transactions rely upon the interaction of highly technical provisions of the Internal Revenue Code to produce a tax result not contemplated by Congress. In developing the tax laws, Congress cannot possibly foresee all the ways the rules might be abused. But tax lawyers figure it out for their wealthy clients—at fees upwards of $500 per hour. If the economic substance doctrine is codified, taxpayers would be required to show that a transaction had a substantial non-tax purpose and had real economic consequences apart from the federal tax benefits.

Of all the provisions in the bill, this one is the most important. It would give the IRS an enforcement tool that would cover any tax avoidance scheme, whether or not the other language in the bill specifically prohibited it. The IRS would be able to challenge the next abusive tax shelters that tax professionals are surely already dreaming up.

Deterring the Use of Tax Havens for Tax Evasion

Create the Initial Tax Haven List and Create Rebuttable Evidentiary Presumptions (Sec. 101 of the bill)

Tax havens, which the bill refers to as "offshore secrecy jurisdictions" are foreign jurisdictions with secrecy laws or practices that unreasonably restrict the ability of the U.S. government to get information necessary to enforce its tax and securities laws. An offshore jurisdiction that has an effective information exchange program with U.S. law enforcement would not be a tax haven under the bill. The bill includes an initial list of tax havens as follows:

Anguilla	Isle of Man
Antigua and Barbuda	Jersey
Aruba	Latvia
Bahamas	Liechtenstein
Barbados	Luxembourg
Belize	Malta
Bermuda	Nauru
British Virgin Islands	Netherlands Antilles
Cayman Islands	Panama
Cook Islands	Samoa
Costa Rica	St. Kitts and Nevis
Cyprus	St. Lucia
Dominica	St. Vincent and the Grenadines
Gibraltar	Singapore
Grenada	Switzerland
Guernsey/Sark/Alderney	Turks and Caicos
Hong Kong	Vanuatu

The bill gives the Secretary of the Treasury the power to add (and delete) jurisdictions from the list if they meet (or fail to meet) the definitions in the law.

In the case of transactions, accounts, or entities in "tax havens," as defined in the bill, the Tax Haven Act would create three presumptions in favor of the IRS in a civil (not criminal) tax enforcement proceeding. When one of the opponents in a legal dispute gets the benefit of a presumption, it means that they do not have to prove that element of the case. It is presumed to be a fact and the other side has to disprove it. This is a big advantage to the side with the presumption. It makes winning the case a lot easier. In his statement introducing the act, Sen. Levin stated that the presumptions are intended to eliminate the unfair advantage provided by offshore secrecy laws.

The first presumption is that a U.S. taxpayer who "formed, transferred assets to, was a beneficiary of, or received money or property" from an offshore entity is in control of that entity. For example, this rule would prevent U.S. taxpayers from claiming that the trustee (usually a foreign person or entity) of their offshore trust is not permitted by the trust document

to send money back to the U.S. to pay creditors (including the IRS). The second presumption is that funds or other property received from offshore are taxable income, and funds or other property transferred offshore have not yet been taxed. The taxpayer will have to prove that the funds aren't taxable income, or else pay the tax. The third presumption is that a financial account in a foreign country controlled by a U.S. taxpayer has a large enough balance ($10,000) that it must be reported to the IRS. If the taxpayer does not report it, the U.S. person would be subject to penalties. The bill also provides two evidentiary presumptions to enforce U.S. securities laws.

Taxpayers could provide evidence that the presumptions were not accurate, for example, that funds received from offshore were a gift. But if the taxpayer wants to introduce evidence from a foreign person (like the trustee), an affidavit would not be enough. The foreign person would have to appear in the U.S. proceeding and be subject to cross examination.

Authorize Special Measures Where U.S. Tax Enforcement is Impeded (Sec. 102)
The Tax Haven Act would add to existing Treasury authority to impose special requirements on U.S. financial institutions. Under the Patriot Act, Treasury can impose a range of requirements on U.S. financial institutions dealing with certain entities—from requiring greater information reporting to prohibiting opening accounts. The Patriot Act's provisions are aimed at combating money laundering. The Levin-Doggett bill would extend that authority to allow Treasury to use those tools against foreign jurisdictions or financial institutions that are "impeding U.S. tax enforcement." It would add an additional tool to the Treasury's arsenal: it would allow Treasury to prohibit U.S. financial institutions from accepting credit card transactions involving a designated foreign jurisdiction or financial institution. This provision would greatly inhibit the ability of U.S. residents to access their hidden offshore funds.

Deny Tax Benefits for Foreign Corporations Managed and Controlled in the U.S. (Sec. 103)
This newly-added provision in the Tax Haven Act would treat foreign corporations as U.S. domestic corporations for tax purposes if 1) the corporation is publicly traded or has aggregate gross assets of $50 million or more, AND 2) its management and control occurs primarily in the U.S. The bill would not override the current-law rules for taxing U.S. multinationals with foreign subsidiaries. This provision is similar to the corporate inversion rules adopted in the American Jobs Creation Act of 2005, but adds entities which are incorporated directly in another country.

This provision of the bill is particularly aimed at hedge funds and investment management businesses that are structured as foreign entities, although their key decision-makers live and work in the U.S. As Sen. Levin put it in his statement, "It is unacceptable that such companies utilize U.S. offices, personnel, laws, and markets to make their money, but then stiff Uncle Sam and offload their tax burden onto competitors [we would say all taxpayers] who play by the rules."

Extend Time for Offshore Audits (Sec. 104)
Generally, after you file a tax return, the IRS has three years to complete an audit and assess any additional tax. Because the bank secrecy laws slow down or completely obstruct efforts to

obtain information, the bill gives the IRS an additional three years on transactions involving a tax haven. The bill does not change the current-law rule that the IRS has unlimited time to audit in cases involving actual fraud.

Increase Disclosure of Offshore Accounts and Entities (Sec. 105)
The success of offshore tax abuses is dependent on secrecy. The bill would create two new disclosure rules that would put the IRS on notice that the taxpayer is using offshore entities.

The first new disclosure rule would expand income reporting responsibilities of financial institutions. Under current anti-money laundering laws, U.S. financial institutions are supposed to know who really owns an account held by an offshore entity. This information is designed to keep the U.S. financial system from being misused by terrorists, money launderers, and other criminals. Also under current law, a financial institution must file Forms 1099 with the IRS reporting income such as dividends and stock sales earned on an account, *unless the account is owned by a foreign entity not subject to U.S. tax law*. The Tax Haven Act would require that U.S. financial institutions file Forms 1099 with the IRS on an account owned by a foreign entity, if the financial institution has knowledge that a U.S. person is the beneficial owner of the foreign entity. This rule would apply to both financial institutions located in the U.S. and foreign financial institutions located outside the U.S. that are voluntary participants in the Qualified Intermediary Program (where they have agreed to provide the IRS information about certain accounts).

The second new disclosure rule would require U.S. financial institutions to report to the IRS a transaction that directly or indirectly opens a foreign account or establishes a foreign entity, such as a trust or corporation, for a U.S. customer. Under existing law, the U.S. customer is already obligated to report that information to the IRS, but many taxpayers do not, relying on the bank secrecy laws to keep their accounts hidden. The third-party obligation to report will make it much more likely that the IRS will have notice of those transactions and be able to investigate them.

Close Foreign Trust Loopholes (Sec. 106)
Many U.S. taxpayers exercise control over a (purportedly independent) foreign trust by using a trust "protector" or "enforcer" to pass instructions to the (purportedly independent) foreign trustee. The bill would provide that, for tax purposes, the person who set up the trust (the grantor) would be deemed to hold any powers held by a trust protector.

Under previous changes to the tax law, foreign trusts are often disregarded and the trust income is taxed to the grantor when it is earned, rather than being allowed to accumulate tax-free. But the current law provision only applies when the foreign trust has a *named* U.S. beneficiary. U.S. taxpayers are avoiding the grantor trust provisions by making sure there is not a *named* U.S. beneficiary, although the trustee has the power to loan trust assets (like jewelry, artwork, or real estate) to U.S. beneficiaries, or the trustee has been informed (outside of the trust document) that the trust's assets will go to U.S. beneficiaries after the grantor's death. The bill would close this loophole by providing that: 1) any U.S. person actually benefiting from a foreign trust is treated as a trust beneficiary, even if they are not named in the trust

document; 2) future or contingent U.S. beneficiaries are treated the same as current beneficiaries; and 3) loans by the foreign trust of *any* trust property are treated as trust distributions for tax purposes.

Deny Legal Opinion Protection from Penalties (Sec. 107)
The Internal Revenue Code provides for a stiff penalty (called the accuracy-related penalty) when a taxpayer engages in a tax-avoidance transaction and the IRS determines that the transaction was not correctly reported on the taxpayer's return. An exception to the penalty applies when the taxpayer has sought legal advice and received an opinion that the transaction is "more likely than not" (at least a 50 percent chance) to survive a challenge by the IRS. Many taxpayers believe, usually correctly, that a legal opinion is all they need to avoid the underpayment penalty.

The Tax Haven Act would require taxpayers to have some other basis, besides the legal opinion, to avoid the penalty on offshore transactions. This provision is designed to "force taxpayers to think twice about entering into an offshore scheme." The Treasury Secretary has the authority to exempt two types of legal opinions from this rule: 1) if the confidence level is substantially higher (70 – 75 percent) than "more likely than not"; and 2) where there is a class of transactions that do not present a potential for abuse.

Close the Dividend Loophole (Sec. 108)
Most income earned by foreigners in the U.S. is not subject to U.S. tax. One exception is dividends on U.S. stocks. Dividends are taxable income and subject to withholding. Two common schemes are used, primarily by offshore hedge funds, to get around this rule. These transactions have no economic purpose other than to avoid U.S. tax, and the bill would close these loopholes.

One technique is to use "equity swaps." A financial institution promises to pay to an offshore hedge fund, for example, an amount equal to: 1) any appreciation in the price of the stock, and 2) any dividends paid on the stock during the swap period. The hedge fund is liable to the financial institution for any decline in the price of the stock during that period. The hedge fund clearly still bears the risks and rewards of ownership of the stock. But this technique allows it to avoid taxes because payments made to a non-U.S. person under an equity swap are treated as foreign-sourced and therefore not subject to U.S. tax withholding. The financial institution has no risk, because it holds the physical shares of stock during the swap period, is paid for any price depreciation, and then "sells" the stock back to the hedge fund. The financial institution earns a fee for handling the transaction, which includes a portion of the tax savings realized by the hedge fund.

The second technique is similar, but involves a "loan" of stock with an upcoming dividend to an offshore corporation controlled by a financial institution. The offshore corporation is obligated by the loan agreement to forward any dividends back to the client. The parties to this transaction claim that these "substitute dividends" are tax-free by relying on a 1997 IRS Ruling which was intended to prevent double withholding when dividends are forwarded from one

foreign entity to another. The IRS testified before a congressional committee that the ruling was never intended to be interpreted the way the parties claim.

The Levin-Doggett bill would treat all payments of dividend-based amounts consistently, making them subject to U.S. tax withholding. The bill would authorize the Treasury Secretary to issue regulations that would also capture dividend equivalent payments when they are netted with other payments under a swap contract or other financial instruments or when they are netted with fees. The Treasury could also issue regulations to reduce possible over-withholding, but only where the taxpayer can establish that U.S. tax was previously withheld. The bill also makes it clear that it does not intend to limit the authority of the IRS to collect taxes on dividend equivalent payments under prior law.

Expand PFIC Reporting Requirements (Sec. 109)
U.S. persons who are direct or indirect shareholders of Passive Foreign Investment Companies (PFICs) are required to report certain information about the PFIC to the IRS. Taxpayers have been able to avoid reporting by using an offshore service provider to hold title to the PFIC stock although the U.S. person has control. The bill would expand the reporting requirement so that a return must be filed by any U.S. person who formed a PFIC, sent assets to it, received assets from it, was a beneficial owner of it, or had beneficial interests in it. It would prevent taxpayers from arguing that no reporting was required because they did not hold a formal ownership interest in the PFIC.

Other Measures to Combat Tax Haven and Tax Shelter Abuses

Increase Penalty for Failure to Make Required Securities Disclosures (Sec. 201)
Companies who are subject to Securities and Exchange Commission (SEC) rules are required to report offshore ownership and offshore transactions in their stock. Tax dodgers have avoided this reporting, claiming that the offshore entities are independent, even though they are effectively controlled by a U.S. company or a majority stockholder. The bill would establish a new penalty of up to $1 million for persons who violate U.S. securities laws by knowingly failing to disclose offshore transactions and stock holdings.

Include Hedge Funds and Company Formation Agents in Money-Laundering Programs (Sec. 202 and 203)
Hedge funds and private equity funds are the only type of financial institutions that are not required by the Bank Secrecy Act to have anti-money laundering programs such as Know Your Customer, due diligence procedures, and requirements to file suspicious activity reports. The Treasury Department proposed, but never finalized, anti-money laundering regulations for these unregistered investment companies, but withdrew them without explanation during the Bush administration. The bill would require Treasury to issue final regulations within 180 days of the bill's enactment.

Company formation agents are also not covered by the anti-money laundering rules. Many taxpayers are aided in their tax avoidance schemes by agents who form companies for them: U.S. company formation agents setting up offshore entities for U.S. clients and forming U.S.

shell companies for foreign clients. The Tax Haven Act would direct Treasury to develop anti-money laundering regulations for company formation agents as well.

Facilitate IRS John Doe Summons (Sec. 204)
The IRS uses a John Doe summons to request information from a third party in cases where the taxpayer's identity is unknown. For example, the IRS might issue a John Doe summons to a bank to get information about an account owned by a foreign entity, although the IRS doesn't know who the foreign entity or its U.S. owner is. When the taxpayer is known, the taxpayer gets a notice of a third-party summons and has 20 days to ask a court to quash the summons. When the IRS doesn't know the name of the taxpayer and where to send the notice, the law provides a procedure for the IRS to get advance permission to serve the summons on the third party. To get the court's permission, the IRS must show that: 1) the summons relates to a particular person or class of persons, 2) there is a reasonable basis for concluding that there is a tax compliance issue involved, and 3) the information is not readily available from other sources. The IRS has successfully used the John Doe summons process to identify offshore hidden funds and collect unpaid taxes. The process, however, is expensive and time consuming. The bill would provide that the court may presume that the case raises tax compliance issues when there is an account or a transaction in a tax haven, relieving the IRS of proving that element in case after case.

In cases where an offshore bank has an account with a U.S. financial institution, the bill would allow the IRS to issue a summons for the U.S. bank accounts records without court approval.

The bill would also streamline the process in large "project" investigations. Where the IRS is planning to issue multiple summonses to definable classes of third parties (such as banks or credit card companies) to get information related to specific taxpayers, the bill would provide a process to have one court approve multiple summonses and retain ongoing oversight of the case. The IRS would be relieved of the burden of proving the same facts before multiple judges in many different jurisdictions.

Authorize IRS to Investigate FBARs and Suspicious Activity Reports (Sec. 205)
Current law requires a taxpayer controlling a foreign financial account over $10,000 to check a box on his or her income tax return (for individuals on Form 1040 Schedule B – Interest and Dividends) and to file a Foreign Bank Account Report (FBAR) with the IRS. Here's the glitch: the IRS authority under Title 26 of the U.S. Code allows the IRS to use tax information only for the administration of the Internal Revenue Code or "related statutes." The FBAR requirement is under Title 31. Although the Treasury Department's Financial Crimes Enforcement Network (FinCEN) has delegated its power to investigate FBAR violations to the IRS, it's not clear that the IRS has the authority under the law. The bill would change the statute to make it clear that the relevant sections of Title 31 are to be considered internal revenue laws.

The penalty for FBAR violations is determined in part by the balance of the foreign bank account at the time of the "violation," which is the date the report is due. The report for the previous calendar year is due on June 30, so the penalty is reduced if taxpayers withdraw funds after

December 31 but before filing the report. The bill would change the statute to impose the penalty on the highest balance in the account during the reporting period (the calendar year).

Financial institutions are required to report suspicious transactions to FinCEN. FinCEN is required to share the information with law enforcement, but not to IRS agents investigating civil tax enforcement cases. IRS civil (as opposed to criminal) agents are issuing an IRS summons to the financial institutions (at substantial time and expense) to get access to the report which Treasury already has. The bill would clarify that "law enforcement" includes civil tax enforcement, giving IRS civil agents access to the information.

Combating Tax Shelter Promoters

Strengthen Tax Shelter Penalties (Sec. 301 and 302)
The IRS can assess penalties for promoting an abusive tax shelter for up to 50 percent of the fees earned by the promoter. Many tax shelters sell for hundreds of thousands, if not millions, of dollars. The bill would raise the penalty to an amount up to 150 percent of the promoters' gross income from the prohibited activity. A similar provision that imposes penalties on persons who aid or abet an understatement of tax, such as accounting, law and investment firms and banks, would raise the penalty from $1,000 (or $10,000 in the case of a corporation) to up to 150 percent of the aider and abettor's gross income from the prohibited activity. Sen. Levin's statement related the case of an international accounting firm's cost-benefit analysis, deciding to participate in an abusive tax shelter because the average deal would bring them $360,000 in fees and the maximum penalty would be only $31,000.

Prohibit Tax Shelter Patents (Sec. 303)
Since 1998, when a federal appeals court ruled that business methods can be patented, various tax professionals have filed applications for a patent of particular tax strategies. Patents are generally thought to promote innovation by giving the patent holder a temporary monopoly. But as Sen. Levin points out, there's ample incentive for innovation in the form of tax savings: "The last thing we need is a further incentive for aggressive tax shelters." In addition, there are policy concerns that a patent would be used by promoters to claim official endorsement of the strategy or to charge a fee for other taxpayers to use the same strategy, when any taxpayer should be able to use the tax law to minimize their taxes. The bill would prohibit the issuing of tax patents.

Prohibit Fees Contingent on Obtaining Tax Benefits (Sec. 304)
The American Institute of Certified Public Accountants, the Securities and Exchange Commission, and the Public Company Accounting Oversight Board have all issued rules that allow contingent fees only in limited circumstances. In many states, accounting firms are prohibited from charging contingent fees on tax work, to reduce the incentive to devise abusive tax shelters. But the content and enforcement of these rules vary widely. And tax professionals are getting around them by making sure that most of the services are performed in a jurisdiction that does not prohibit contingency fees, even if the client is in a jurisdiction that does. The Tax Haven Act would establish a single national rule that would prohibit tax practitioners from charging fees based directly or indirectly on tax savings.

Deter Financial Institution Participation in Abusive Tax Shelter Activities (Sec. 305)
Many abusive tax shelters depend on some sort of financial transaction, for example, using financing or trading securities. The tax code prohibits financial institutions from aiding or abetting tax evasion, but the agencies that oversee the financial institutions, such as the SEC or the Federal Reserve Bank, are not experts in tax law. The bill would require the bank and securities regulators to develop examination techniques with the IRS to detect these abuses. The new examinations would become part of the routine regulatory exams, and potential violations would be reported to the IRS.

End Communication Barriers between Enforcement Agencies (Sec. 306)
The tax code has stringent rules to keep the IRS from disclosing our tax information. Unfortunately, these rules also prohibit the IRS from informing bank regulators, the SEC, or the PCAOB when a tax examination discloses violations of banking, securities, or accounting laws. The bill would authorize the Treasury Secretary, which oversees the IRS, to disclose tax return information related to abusive tax shelters to those agencies, with appropriate privacy safeguards. The information would only be used for law enforcement purposes, such as detecting securities violations or accounting fraud.

Increase Disclosure of Tax Shelter Information to Congress (Sec. 307)
Although they have been subpoenaed by Congress, accounting and law firms have refused to comply with requests for information, such as documents related to the sale of abusive tax shelters. The tax professionals rely on a section of the Internal Revenue code which prohibits tax preparers from disclosing tax information to third parties. There are regulations that state this provision was never intended to create a privilege or override a Congressional subpoena, but tax professionals continue to obstruct the investigations. The Tax Haven Act would codify the regulations and put the necessary language directly into the law.

The bill would also require the IRS to grant Congress access to information about a Treasury decision to deny or revoke an organization's tax exempt status.

Regulate Tax Shelter Opinion Letters (Sec. 308)
The bill would provide express statutory authority for the Treasury Department to issue regulations that establish standards for tax professionals who provide opinion letters on the tax treatment of potential tax shelter transactions. The standards would address issues such as independence, conflicts of interest, appropriate fees, and collaboration among various practitioners.

Foreign Account Tax Compliance Act of 2009

On October 27, House Ways and Means Committee Chairman Charles Rangel (D-NY) and Senate Finance Committee Chairman Max Baucus (D-MT) introduced identical bills (H.R. 3933, S. 1934) aimed at reducing tax haven abuse. The legislation is designed to improve compliance with tax laws that require the reporting of offshore transactions in both information returns and income tax returns and to inhibit the use of foreign financial institutions to evade U.S. tax and hide assets.

The Foreign Account Tax Compliance Act of 2009 (Foreign Account Act) primarily adds additional reporting and withholding requirements and increases the penalties for noncompliance, but it does not address some of the problems that cost the U.S. Treasury an estimated $100 billion annually in tax revenue. The bill would give the IRS some important tools to enforce the offshore provisions and close a couple of loopholes, but is not as comprehensive as the Stop Tax Haven Abuse Act.

Increased Disclosure of Beneficial Owners

Require Offshore Account Reporting or Withholding (Sec. 101 of the bill)
Early each year, brokers are required to report their customers' securities transactions for the prior calendar year to the IRS on a Form 1099-B. The Foreign Account Act would require similar reporting by foreign financial institutions of the value of offshore accounts and transfers of funds to and from offshore accounts. The foreign financial institutions would have to provide a statement to the IRS including: 1) the name, address, and taxpayer identification number of a United States person that is an account holder or a substantial U.S. owner of a foreign entity holding an account, 2) the account number, 3) the account balance or value, and 4) the gross receipts and gross withdrawals or payments from the account (as prescribed by the Secretary).

Foreign financial institutions may elect to be subject to the same reporting requirements as U.S. financial institutions instead of reporting under the new rules.

If a foreign financial institution does not meet the reporting requirements, any transfers to an account with that institution are subject to a 30 percent withholding tax if the transfer is a payment of U.S.-source income such as interest, dividends, rents, compensation, and proceeds from the sale of income-producing property.

This information reporting will give the IRS much-needed information to investigate offshore tax evasion. Perhaps more importantly, it will deter much of the activity if taxpayers know that the transfer information will be reported. The penalty for each failure to file an information report is $50, with a maximum penalty for any year of $250,000.

Repeal Exceptions to Registered Bond Requirements ("Portfolio Interest" Rules) (Sec. 102)
The Foreign Account Act would repeal rules exempting certain bonds from registration and withholding requirements if the bonds are issued under arrangements designed to ensure that the bonds are sold only to non-U.S. persons and interest is payable only outside the U.S. These exemptions for "portfolio interest" allow foreign investors to evade paying income tax on the interest in their home country and allow U.S. taxpayers to evade U.S. taxes on the interest by holding the bonds in the name of a foreign entity (e.g. a shell corporation or a foreign trust).

CTJ has been critical of the portfolio interest rules since before they were adopted.[1] Repealing these exceptions would increase U.S. and foreign country tax revenues and begin to lessen the United States' reputation as a tax haven for citizens of other countries.

Under Reporting With Respect to Foreign Assets

Disclosure of Foreign Financial Assets (Sec. 201 of the bill)
The bill adds reporting requirements in addition to the FBAR rules (which remain unchanged by the bill). Under this provision, individual taxpayers with an interest in a "specified foreign financial asset" would be required to attach a disclosure statement to their income tax return if the aggregate value of all such assets exceeded $50,000. "Specified foreign financial assets" are 1) depository or custodial accounts at foreign financial institutions, 2) stocks or securities issued by foreign persons, 3) a financial instrument or investment contract issued by a non-U.S. person, and 4) any interest in a foreign entity. The taxpayer would be required to report identifying information for each asset and its maximum value during the taxable year. The penalty for failure to make the required disclosure is $10,000 for each taxable year. The penalty increases up to a maximum of $50,000 if the taxpayer is notified by the Secretary of the failure and the failure to disclose continues beyond 90 days.

Penalty for Underpayment Attributable to Undisclosed Foreign Financial Assets (Sec. 202)
The bill would add to the "accuracy-related" penalties a 40 percent (rather than a 20 percent) penalty on any understatement of tax attributable to an undisclosed foreign financial asset.

Lengthen Statue of Limitations Period for IRS Examinations (Sec. 203)
Generally, the IRS has three years to examine a tax return once it has been filed. For assessments of tax on understatements of income attributable to foreign financial assets, the bill provides a new six-year statute of limitations. The statute of limitations is suspended if a taxpayer fails to provide information required with respect to passive foreign investment corporations (PFICs) or under the new rules for foreign financial assets. The limitations period will begin to run only after the Secretary has received the required information.

These new disclosure rules, along with the related penalties and lengthened statute of limitations, would give the IRS information that could help it track down tax cheats. But when

[1] Michael J. McIntyre, Robert S. McIntyre, "Testimony on Banking Secrecy Practices and Wealthy American Taxpayers Before the U.S. House Committee on Ways and Means Subcommittee on Select Revenue Measures," March 31, 2009. http://www.ctj.org/pdf/mcintyresw&mtestimony20090331.pdf

the IRS gets additional time to audit the return, the IRS should not be limited to assessments of tax related to foreign financial assets. A taxpayer who fails to disclose their foreign accounts may be evading taxes in other ways, too, and the IRS should have the additional time to assess tax on *any* understatement of income if the taxpayer is hiding offshore assets.

Other Disclosure Provisions

Require Disclosure of Assistance in Acquiring or Forming a Foreign Entity (Sec. 301)
This provision of the bill requires that each "material advisor" with respect to a foreign entity transaction file an information return disclosing the identity of the foreign entity, the identity of the U.S. citizen or resident acquiring an interest in a foreign entity, and any other information the Secretary may require. A material advisor is a person providing any material aid, assistance, or advice with respect to carrying out one or more foreign entity transactions and directly or indirectly derives gross income in excess of $100,000 for providing such aid.

While we agree with the intent of this provision, the gross income threshold is much too high. Many foreign entity transactions would not be reported under this rule.

Expand Passive Foreign Investment Company (PFIC) Reporting (Sec. 302)
This provision would require each person who is a shareholder of a PFIC to file an annual information return. Currently, returns are only required upon the happening of a "triggering event" such as distribution from the PFIC.

We support an annual filing requirement for PFICs; however, we believe that the taxpayers who are required to file a report should include not just named shareholders, but also any U.S. person who took advantage of a PFIC in some way (see Sec. 109 of the Stop Tax Haven Abuse Act).

Require Electronic Filing for Returns Related to Withholding on Foreign Transfers (Sec. 303)
This provision permits to Secretary to issue regulations to require filing on magnetic media for any return filed by a financial institution with respect to any taxes withheld by the financial institution. The Secretary may require electronic filing without regard to the general rule that electronic filing is required only if the taxpayer files at least 250 returns during a calendar year.

Provisions Related to Foreign Trusts

Foreign Trusts Treated as Having a United States Beneficiary (Sec. 401)
A foreign trust accumulating assets that may eventually make distributions to a U.S. beneficiary will be treated as having a U.S. beneficiary unless the terms of the trust specifically identify a class of persons to whom distributions may be made, and none of those persons is a U.S. person during the taxable year. Consequently, if there is any possibility that trust distributions may be made currently or in the future to a U.S. person, the trust will be treated as having a U.S. beneficiary.

Presumption That Foreign Trust Has United States Beneficiary (Sec. 402)
This rule would create a presumption that a foreign trust has a U.S. beneficiary, for purposes of the grantor trust rules, unless the U.S. person that transfers property to a trust demonstrates that 1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person, and 2) no part of the income or corpus could be paid to or for the benefit of a U.S. person if the trust were terminated during the taxable year.

This provision, along with the one above, would close the loophole that allows taxpayers to avoid reporting the income of foreign trusts under the grantor trust rules simply by avoiding naming a U.S. beneficiary.

Tax Foreign Trust Transfers of Any Property Unless Compensated (Sec. 403)
Under current law, a loan of cash or marketable securities to a grantor or beneficiary (or a person related to a grantor or beneficiary) of a foreign trust is treated as a distribution to that person (which would generally be taxable income). This provision would treat any uncompensated use of trust property as a distribution valued at the fair market value of the use of the property. Grantors and beneficiaries have used offshore trusts to fund their lifestyles, having the trusts "loan" them houses, artwork, and jewelry. Because the transactions were structured as loans, rather than distributions, the grantors and beneficiaries were able to escape taxation on transactions that clearly increased their personal wealth. This provision would close that loophole.

Reporting Requirement of U.S. Owners of Foreign Trusts (Sec. 404)
The bill would require that any U.S. person that is treated as an owner of any portion of a foreign trust (under the grantor trust rules) provide information about the trust as the Secretary may require.

Modify Penalty for Failure to Report Offshore Trust Transactions (Sec. 405)
Current law provides a penalty for failure to report the creation of a foreign trust, transfers to a foreign trust, and the death of a citizen or resident of the U.S. who was treated as an owner or beneficiary of a foreign trust. The penalty is 35 percent of the amount that should have been reported. Often the IRS is unable to compute the penalty because the transaction amount is unknown. The bill modifies the rule to provide a minimum penalty of $10,000.

Dividend Equivalent Payments

Dividend Equivalent Payments Received by Foreign Persons Treated as Dividends (Sec. 501)
This provision of the bill would treat a dividend equivalent the same as a dividend from U.S. sources for certain purposes. This rule is primarily aimed at transactions such as equity swaps that are used to avoid the U.S. withholding rules on payments made to foreign persons.

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Tax Haven Legislation

Comparison of Current Proposals

Proposal	Stop Tax Haven Abuse Act		Foreign Account Tax Compliance Act	
	Included	Bill Section	Included	Bill Section
Codify Economic Substance Rule	√	401-403		
Extend the Statute of Limitations[2]	√	104	√	203
Expand John Doe Summons	√	204		
Create Evidentiary Presumptions	√	101		
IRS Authority to Investigate FBARs	√	205		
Close Foreign Trust Loopholes	√	106	√	401-05
Close Dividend Loopholes	√	108	√	501
End Portfolio Interest Exception			√	102
"Manage & Control" Foreign Corporations	√	103		
Disclosure of Stock Holdings	√	201		
Disclosure of Foreign Financial Assets			√	201

[2] Both bills extend the statute for six years, but the Foreign Account Tax extends the statute only with respect to understatements of income attributable to foreign financial assets.

Proposal	Stop Tax Haven Abuse Act		Foreign Account Tax Compliance Act	
	Included	Bill Section	Included	Bill Section
Report New Account or New Entity[3]	√	**105**	√	**301**
Report Income of Foreign Accounts with U.S. Beneficial Owners[4]	√	**105**	√	**101**
Report Offshore Transfers[5]			√	**101**
Require Electronic Filing			√	**303**
Double Penalties for Underpayments			√	**202**
Expand PFIC Reporting Requirements	√	**109**	√	**302**
Allow Treasury to Restrict Dealings	√	**102**		
Hedge Fund Anti-Money Laundering	√	**202-03**		
Increase Penalties Tax Shelter Promoters	√	**301**		
Increase Penalties on Aiders and Abettors	√	**302**		
Prohibit Contingent Fees	√	**304**		
Prohibit Tax Shelter Patents	√	**303**		
Enhance Cooperation Between Agencies	√	**305-06**		
Disclosure to Congress	√	**307**		
Regulate Tax Shelter Opinion Letters	√	**308**		
Deny Legal Opinion Protection from Penalties	√	**107**		

[3] The Stop Tax Haven Abuse Act requires reporting by financial institutions while the Foreign Account Tax Compliance Act requires reporting by "material advisors."
[4] Under the Foreign Account Tax Compliance Act, financial institutions can elect to collect withholding tax rather than meet the reporting requirements.
[5] Financial institutions can elect not to report the transfers and instead withhold and remit tax.