The Hypocritical Hegemon

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COUNTERING HARMFUL TAX PRACTICES

Analysts agree on the Clinton administration’s decisive role in putting the issues of tax evasion and avoidance on the agenda of the Group of Seven (G7), and subsequently the Organisation for Economic Co-operation and Development (OECD) (Eccleston 2012; Kudrle 2003; Rixen 2008). Yet disagreement remains as to the reasons for its failure to lead the harmful tax competition (HTC) initiative to success. While some authors refer to timing, arguing that the Clinton administration was simply unable to finish its work on the issue before the end of its term in 2000 (Palan, Murphy, and Chavagneux 2010), others claim that tax havens successfully exploited the regulative norm of nonintervention to defend themselves against OECD requests for more cooperation in tax matters (Sharman 2006a). This chapter shows that the Clinton administration was, indeed, concerned about the impact of tax havens on the perceived fairness of the US tax system, international financial stability, and the US sanctions regime, and thus promoted an international campaign against underregulated financial centers. The OECD, however, made the strategic mistake to tackle tax evasion by individuals and tax avoidance by multinationals in a single project, creating opposition from business associations in the United States and elsewhere. Instead of credibly linking noncompliance with OECD recommendations to economic sanctions, the Clinton administration thus accepted the severe dilution of the HTC initiative’s anti-avoidance elements even before the Bush administration took office in 2001. A nested comparison of two unilateral tax initiatives moreover reveals that the Clinton administration generally failed to pass regulations curbing tax avoidance but succeeded in passing regulations against tax evasion.
The Clinton Administration’s Tax Policy Agenda

William J. Clinton’s election as president of the United States in 1992 ended 12 years of Republican government. Under Presidents Ronald Reagan and George H.W. Bush, income inequality and public debt had dramatically increased because of regressive tax reforms, cuts to public investment in job training and wage subsidies, and a massive surge in military spending (Bartels 2009; Danziger and Gottschalk 1997). Catering to widespread public disenchantment with inequality and an “unfair” tax system perceived as “benefiting the rich,” Clinton had thus promised an income tax cut for the middle class during the electoral campaign (Steinmo 1994, 13). After the election, however, Lloyd Bentsen, secretary of the Treasury, and Robert Rubin, chairman of the National Economic Council, argued that priority should be given to deficit reduction, as this might impress financial market analysts, trigger more private saving and investment, and reduce interest rates. Bentsen and Rubin’s idea of restoring business confidence defeated proposals for Keynesian stimulus in internal debate (Steuerle 2008). Hence, the Clinton administration removed the middle-class tax cut from its first budget proposal for 1994. Instead, it proposed an expansion of earned income tax credits (EITC) for the working poor, financed by higher taxes for upper-income individuals and corporations (Graetz 1993). As President Clinton explained in his first State of the Union speech, the goal of EITC expansion was to “reward the work of millions of working poor Americans by realizing the principle that if you work forty hours a week and you’ve got a child in the house, you will no longer be in poverty” (cited in Hotz 2003, 146).

The measure was indeed retained in the Omnibus Budget Reconciliation Act of 1993, which was supposed to cut the deficit by $500 billion over five years, and also introduced new tax brackets and higher rates for top personal and corporate incomes, as well as slightly higher taxes on motor fuel consumption. Because of large Democratic majorities in both chambers of Congress, the act passed in summer 1993 despite forty-one Democratic representatives and six Democratic senators voting against the bill (Sabo 1993). These members of Congress justified their opposition with concerns over the electoral impact of supporting increased taxes on income and energy consumption (Rosenbaum 1993; Sullivan 1993). On balance, however, “the net effect in 1993 was to give more to low-income families, leave the middle class more or less untouched, and zap the rich” (Steuerle 2008, 166). By passing the Omnibus Budget Reconciliation Act, the Clinton administration thus managed to reconcile deficit reduction with increased tax progressivity, which some even interpreted as a reversal of Reaganomics (Fram 1993). Still, the political cost of increasing taxes was enormous, as 50 percent of survey
Countering Harmful Tax Practices

respondents, even those with low incomes, felt affected (Steuerle 2008). According to Robert Rubin, “the mischaracterization of our deficit reduction as a tax increase on the middle class” was a major reason for Democratic defeat in congressional elections of 1994 (Robert Rubin and Weisberg 2003, 153). As a result, Republicans regained full control of Congress for the first time since 1951, subsequently preventing the Clinton administration from pursuing major legislative initiatives. Its focus therefore shifted to the international level where the Treasury, in particular, aimed to foster projects that could support deficit reduction by creating additional revenue and growth. As Brad DeLong and Barry Eichengreen (2001, 2) explain:

Following the loss of Democratic control of the Congress in 1994, all ambitious domestic initiatives were obviously dead in the water. If this didn’t exactly create a political vacuum and a demand for newspaper headlines that could only be filled by international events, it at least facilitated the efforts of Treasury and other economic agencies to bring these issues to the attention of the president and his core political advisors.

Among the international issues raising concerns within Treasury was the proliferation of tax havens and their increasing use by US investors. This concern was based on a number of economic studies questioning the survival of capital taxation in open economies (cf. Gordon 1992; Frenkel, Razin, and Sadka 1991), which were taken up by international bureaucracies like the OECD, the International Monetary Fund (IMF), and the European Commission, and empirically supported by massive capital flight from Germany to Luxembourg following the introduction of a withholding tax on interest in 1988 (cf. Cassard 1994; Owens 1993; Ruding 1992; Tanzi 1995). At the time, the increasing role of tax havens in financial intermediation had become apparent following the removal of barriers to capital mobility over the course of the 1980s. As a result of the “tax cut cum base-broadening strategy” OECD governments had devised in response to tax competition (Ganghof 2000, 611), however, increased capital mobility had not yet impacted their revenue from the taxation of corporate profits and capital income (Webb 2004; Zucman 2014). Still, proponents of the welfare state bought into economic projections of declining capital taxation, anticipating the near “end of redistribution” (Steinmo 1994, 9). Against this background, the Treasury’s international tax counsel, Joseph Guttentag, as well as his deputy, Philip West, argued for enhanced cooperation in tax matters within the OECD, citing the abuse of transfer pricing, hybrid entities, and lack of information exchange as major areas of concern (Guttentag 1995; West 1996). According to Reuven Avi-Yonah (2005, 314), Guttentag and West were the main players behind a transition
in US international tax policy from the “age of competition” to the “age of cooperation.”

The potentially erosive impact of tax havens on the US tax base was, however, not the only reason for the Clinton administration’s preoccupation with them. From its perspective, the financial opacity they provided to investors also abetted money-laundering and corruption and undermined the stability of the financial system as well as the US sanctions regime (Wechsler 2001). At the time, cases had multiplied involving drug cartels using Caribbean secrecy jurisdictions to launder their proceeds from narcotics sales in the United States. Financial institutions and law firms in the secrecy jurisdictions not only helped to hide the true origin of funds through the provision of bank secrecy or shell corporations; they also invested illicit funds in financial, real estate, and arts markets on behalf of criminal organizations. In parallel, the belief spread among senior law enforcement officials that draining the money supply of criminal organizations was the most effective way to reach their senior figures. Accordingly, legislation enabling tougher prosecution of the placement of illicit funds in US banks was passed throughout the 1980s, leading to an increasing number of cases and convictions. Ultimately, however, this legislation led only to a shift in transfer strategies from simple bank transfers to physical smuggling and the use of nonbank financial institutions. The prevention of money laundering in secrecy jurisdictions after illicit funds had been successfully transferred out of the United States thus required international action. A fortiori this was the case because the laundering of funds that had never been in the United States could still affect US interests. For instance, financial sanctions against particular individuals or governments could easily be circumvented by setting up shell corporations and nominee accounts in secrecy jurisdictions (Sultzer 1995; Williams 1997).

Based on these tax and law enforcement concerns, the Clinton Treasury came to the conclusion that a new strategy against tax havens was needed. Moreover, “any strategy had to be global and multilateral, since unilateral actions would only drive dirty money to the world’s other major financial centers” (Wechsler 2001, 49). However, it was believed that such an anti–tax haven initiative should not be pursued via the United Nations, where countries with underregulated financial markets were a majority. Instead, the Clinton administration preferred working with the G7 and OECD to first establish consensus among large industrialized countries. Once international standards had been developed in these more exclusive formats, noncompliant jurisdictions would be pressured into cooperation through naming and shaming as well as collective sanction threats (Wechsler 2001, 49). In the area of taxation, this strategy led to and was pursued via the OECD’s harmful tax competition initiative, the genesis of which is the subject of the next subsection.
International Politics: Countering Tax Abuse via the OECD

Based on the reasoning described previously, the Clinton administration initiated discussions on an international initiative against tax evasion and avoidance in the G7 in 1995 (Eccleston 2012; Rixen 2008). The idea was welcomed by European G7 members, which were at the time struggling to contain tax evasion and avoidance within the European Union (EU). Following the liberalization of capital flows through the Single European Act and the capital markets directive of 1987, EU member states witnessed an increased volume of cross-border transactions and investments. However, because of the unanimity requirement in matters of direct taxation and fears that tax harmonization within the EU would lead to capital flight from the common market, EU member states were unable to reach consensus on tax cooperation despite several proposals from the European Commission to this effect (Genschel 2002; Radaelli 1999). An initiative binding governments beyond the EU, however, had the potential to alleviate the risk of capital flight to third countries. The interests of France, Germany, Italy, and the United Kingdom were thus largely aligned with those of the United States. As a result, G7 leaders issued a joint call on the OECD to “establish a multilateral approach under which countries could operate individually and collectively to limit the extent of [harmful tax] practices” (G7 Leaders 1996, para. 16).

As requested, the OECD established “Special Sessions on Tax Competition,” which were tasked with elaborating a report on “harmful tax competition,” eventually published in January 1998. In that report, the organization identified tax havens providing financial secrecy, preferential tax regimes (PTRs), or both as potentially harmful—that is, tending to “erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally” (OECD 1998, 8). Tax havens were associated with “no or only nominal taxation” of capital income or corporate profits, a lack of transparency and administrative assistance, and an absent link between tax residency and substantial economic activity. From the OECD’s perspective these factors were indicative of a jurisdiction “attempting to attract investment or transactions that are purely tax driven” (OECD 1998, 22). PTRs essentially referred to tax breaks granted only to foreign corporations, ring-fencing the domestic tax base from their impact. Examples cited by the OECD included the exemption of foreign profits from residence taxation, “deductions for deemed expenses that are not actually incurred,” and the acceptance of transfer-pricing arrangements that do not reflect the arm’s-length principle, thereby overstating a subsidiary’s local profits (OECD 1998, 30–32). The OECD made nineteen recommendations for fighting these practices, focusing on the collective application
by member states of unilateral defense measures and the toughening of administrative assistance clauses in bilateral tax treaties. In addition, the OECD threatened secrecy jurisdictions with blacklisting and sanctions should they not respond to requests for administrative assistance from foreign tax authorities. In contrast, no such threat was issued toward corporate tax havens offering PTRs, most likely because most large OECD members also had such regimes in place (Rixen 2008).

With the exception of Luxembourg and Switzerland, which abstained from the vote, all OECD member states approved the HTC report at the 1998 Ministerial Council. The Clinton administration also expressed its support, pledging to transpose OECD recommendations into national law by 2000. To that effect, the administration announced reporting requirements for all payments going to tax havens identified by the OECD as well as the “termination of credits for taxes paid at source in these countries” (Palan, Murphy, and Chavagneux 2010, 217). Subsequently, Treasury also included these measures in its Green Book of Revenue Proposals for fiscal year 2001 (cf. US Treasury 2000). In contrast, the forty-one jurisdictions identified as tax havens by the OECD for providing secrecy, PTRs, or both tried to attack the HTC project on normative grounds, as a result of their lack of material power resources. Their aim was to convince OECD governments to abandon the campaign by stressing its inconsistency with norms these governments generally promoted. For instance, the jurisdictions argued the project was undermining their fiscal sovereignty and depriving them of an IMF-approved development strategy. Moreover, they claimed that the project’s top-down approach—excluding them from negotiations, while making them subject to its provisions—violated the principle of multilateralism. Last but not least, the jurisdictions also accused the OECD of applying double standards, as it cracked down on non-OECD tax havens but ignored the practices of Luxembourg and Switzerland as well as the PTRs established by larger member states (Sharman 2006a; Webb 2004).

Although these arguments gained traction with the multinational business community and the financial and tax service industries in particular, the OECD still identified forty-one jurisdictions as tax havens in June 2000 and threatened them with the collective application of defense measures. Again, the Clinton administration was supportive of OECD efforts, with Secretary of the Treasury Lawrence Summers declaring the United States “would fully cooperate in preparing sanctions for tax havens that fail to reform” (Associated Press 2000b). In response, six out of the forty-one identified tax havens, including some major players like Bermuda and the Cayman Islands, signed agreements with the OECD in which they pledged to abolish harmful provisions in their tax codes in exchange for being removed from the draft list of uncooperative tax havens that could be hit with countermeasures (cf. Government of Bermuda 2000; Governor of the Cayman Is-
lands 2000). Accordingly, these six jurisdictions were missing from the final tax haven blacklist included in the OECD’s 2000 progress report, whereas the remaining thirty-five jurisdictions were threatened with collective defense measures if they did not sign a memorandum of understanding (MOU) by July 31, 2001, obliging them to abandon their harmful tax practices (cf. OECD 2000). By the end of 2000 the HTC initiative thus seemed to be fostering good progress toward the goal of eliminating the most harmful features of tax haven business models.

Effectively, however, submission to the OECD came at relatively low cost for the targeted jurisdictions, as multinationals organized in the Business Industry Advisory Council (BIAC) had successfully lobbied for a removal of the substantial economic activity criterion from the OECD’s tax haven definition. By removing corporate tax planning from the scope of the HTC project, business gave Bermuda, the Cayman Islands, and other relatively sophisticated countries, acting both as secrecy jurisdictions and corporate tax havens, the opportunity to polish their reputations by renouncing parts of their tax evasion business while at the same time expanding their tax avoidance business with multinationals (Eccleston 2012; Webb 2004). Tax havens were thus provided an opportunity to avoid blacklisting and the risk of sanctions without making fundamental changes to their business models. Still, these jurisdictions failed to halt the HTC initiative altogether by turning dominant norms against their key proponents. Instead, the following subsections will show that differences in material power resources were decisive in this episode of bargaining over international tax cooperation. Rather than tax havens, the domestically defined preferences of the United States, which has traditionally dominated tax policymaking in the OECD, largely shaped the content of the HTC initiative at this stage (Avi-Yonah 2005; Farquet and Leimgruber 2014; Graetz 2000).

Implementing Anti–Tax Evasion and Avoidance Measures Domestically

As demonstrated previously, the Clinton administration was fully supportive of the OECD’s HTC initiative and prepared to deploy sanctions against noncooperative tax havens. The administration’s support was based on economic projections of declining revenue from capital taxation in open economies and a general concern over the relevance of secrecy jurisdictions for organized crime, corruption, and financial instability. Moreover, support was driven by a concern for the publicly perceived fairness of the US income tax system. As Lawrence Summers explained in an interview in 2000, “[the US] tax system is based on voluntary compliance. That compliance depends on people having the sense that others,
particularly those who are more fortunate, pay the taxes they are required to pay” (Associated Press 2000a). However, the Clinton administration faced strong opposition to its international tax agenda whenever it affected the tax-planning practices of US multinationals. Therefore, Treasury accepted the dilution of the substantial economic activity criterion in the OECD’s 2000 progress report, extended check-the-box rules to US multinationals’ foreign subsidiaries despite prior doubts as to potential exploitation of the rules through the setup of hybrid entities, and later backed down from withdrawing corresponding regulations. When neither the interests of US multinationals nor those of US financial institutions were adversely affected, however, Treasury was able to pass regulations—for instance, when creating the qualified intermediary (QI) program.

### Adjusting the HTC Initiative to Business Preferences

With the approval of the United States, the OECD’s Committee on Fiscal Affairs (CFA) had adopted an HTC report aiming both at tax evasion by individuals and tax avoidance by multinationals. Yet dealing with both elements in a single project turned out to be a strategic mistake. One of the elements meant to counter avoidance was the substantial economic activity criterion included in the report’s tax haven definition. From the OECD’s perspective, granting a corporation tax residence in “the absence of a requirement that [its] activity be substantial . . . suggests that a jurisdiction may be attempting to attract investment and transactions that are purely tax driven” (OECD 1998, 24). This practice was considered harmful and thus ought to be ended by governments wishing to comply with OECD recommendations. Yet making a corporation’s tax residence conditional on substantial economic activity in the respective country posed a fundamental threat to corporate tax-planning strategies, which usually hinge on the ability of multinationals to shift profits to low-tax jurisdictions where no production takes place and no value is added (Pinkernell 2014). Accordingly, business lobbyists in the United States and elsewhere staged a campaign against the criterion, trying to convince OECD governments of its incompatibility with basic liberal norms (Webb 2004).

BIAC’s initial response to the HTC report was drafted by Richard Hammer, who also served as chief tax counsel for the United States Council for International Business (USCIB) (Ralph 2000). USCIB, in turn, is the main lobbying group for US multinationals at the OECD, its membership including many corporations reputed for their tax-planning savvy. Following consultations with multinationals and their tax advisers, Hammer criticized the OECD for not having met with representatives of businesses prior to the release of the HTC report (Ralph 1999). Moreover, Hammer framed tax competition as a means to impose fiscal disci-
pline on governments, forcing them “to make more efficient use of tax revenues” (BIAC 1998, cited in Webb 2004, 811), a variant of the traditional liberal interpretation of tax competition as “the taming of Leviathan” (Sinn 1992, 177). Against this background, he went on to argue “that it was legitimate for businesses to consider tax differentials in planning and structuring their investments” (Webb 2004, 811). These two arguments subsequently became the basis for corporate criticism of the HTC project, frequently employed by representatives of multinationals and corporate tax advisers (cf. Couzin 2000; Katsushima 1999).

Yet corporate critics of the OECD did not object to all forms of international tax cooperation. In fact, they were supportive of efforts to combat tax evasion by means of greater financial transparency and in favor of removing regulations ring-fencing tax breaks for foreign-owned corporations from domestic firms. As Webb (2004) suggests, business associations were more conciliatory toward these measures because they either did not directly affect their members or were conducive to expanding targeted expenditures to the entire economy. Regarding information exchange, banks from wealth management hubs such as Florida or Texas were of course opposed to reporting additional client data. Accordingly, the Clinton administration put corresponding proposals on the back burner (Freedberg 2002). Yet the banks were indifferent toward new reporting requirements for foreign financial institutions (FFIs) and corresponding sanction threats against secrecy jurisdictions. Hence, the banks did not back the anti-OECD campaign launched in parallel by the Center for Freedom and Prosperity (CFP) (Sharman 2006a).

At any rate, the OECD Secretariat was swift to accommodate corporate criticism, as it feared opposition from national business associations could cause individual member states to defect from the initiative, thereby endangering the project’s survival. In cooperation with BIAC the OECD thus created a liaison group “to ensure that the views of the business community are heard,” acknowledging “a need for better communication between business and government, and, in particular, a more inclusive attitude on the part of governments toward the views of the business community” (Hammer and Owens 2001, 1305). Moreover, Jeffrey Owens, the OECD’s head of fiscal affairs, explicitly accepted the legitimacy of corporate tax planning, conceding in a joint article with Richard Hammer that “multinational enterprises should be permitted access to certain corporate organizational and structural vehicles, such as co-ordination centres and holding companies” (Hammer and Owens 2001, 1303). Under the chairmanship of Joseph Guttentag, previously international tax counsel in the Clinton Treasury Department, and with the consent of the United States, the CFA therefore adopted some subtle changes to the HTC report’s substantial economic activity criterion during the second half of 2000.
As Kudrle (2008, 7) explains, the CFA first “grafted [ring-fencing] on to insubstantiality as an alternative source of concern” by redrafting the criterion as follows in the 2000 progress report: “the jurisdiction facilitates the establishment of foreign owned entities without the need for a local substantive presence or prohibits these entities from having a commercial impact on the economy” (OECD 2000, 10). On this basis, the CFA then shifted the blame for insubstantiality onto jurisdictions that were denying firms benefiting from preferential tax treatment the opportunity to operate in the domestic market. In the MOU offered to tax havens willing to comply with OECD demands, the requirement for being exonerated from the charge of providing tax residence in the absence of substantial economic activity was thus formulated in a rather twisted way:

For any preferential tax treatment accorded to other service activities, each Party will remove any restrictions that deny the benefits of that preferential tax treatment to resident taxpayers, to entities owned by resident taxpayers, or to income derived from doing the same type of business in the domestic market. (OECD 2000b, 4 cited in Kudrle 2008, 7)

Effectively, this meant that tax havens were allowed to provide tax residence to firms without a substantive presence in these jurisdictions’ territory if they stopped ring-fencing preferential tax treatment of foreign companies from the domestic economy. By November 2000 the CFA had thus neutralized the fundamental threat to corporations’ “legitimate” tax-planning strategies that the original formulation of the substantial economic activity criterion had posed. While Lawrence Summers and Philip West reiterated strong US support for the HTC initiative and urged tax havens to comply with OECD demands, in their capacities as secretary of the Treasury and international tax counsel they had also allowed the CFA to dilute important terms and definitions when they interfered with the interests of US multinationals (Associated Press 2000c; Burgess 2000). As a result, corporate tax havens could enter into MOUs with the OECD to avoid sanctions without risking their stake in tax avoidance schemes. Only those secrecy jurisdictions that refused to make limited adjustments to their administrative assistance practices eventually faced a risk of sanctions from the United States and other OECD members.²

Poking Loopholes into Controlled Foreign Company Rules

The Clinton administration’s inability to implement measures limiting the extent of tax avoidance by US multinationals is even better illustrated in the parallel debate
over check-the-box regulations. These regulations, proposed by the Internal Revenue Service (IRS) in 1995, were meant to simplify entity classification for tax purposes. Until then, taxpayers and the IRS had used the so-called Kintner test to determine whether an entity was a corporation or a partnership, the latter being disregarded for tax purposes because partners—who also assumed full liability for the partnership’s debt—were taxed on its profits at the personal level. With the multiplication of corporate legal forms at the state and international levels, however, determining whether or not a certain company passed the criteria of the Kintner test became increasingly cumbersome for tax authorities. At the same time, well-advised taxpayers were increasingly able to tailor their company’s legal form so as to obtain their desired classification for tax purposes (IRS 1995).

Against this background, some IRS officials as well as business associations began to argue for a simplification of entity classification through an elective approach. That is, taxpayers should be allowed to choose their desired classification by simply checking a box on an IRS form. According to the proponents of this approach, this change would reduce the administrative burden for the IRS, which would no longer have to analyze foreign law to determine entity status, and remove inequities between sophisticated and unsophisticated taxpayers, as the former were de facto already able to choose their desired classification under the Kintner regulations (Mullis 2011).

After public hearings on the issue had yielded almost unanimous support for check-the-box regulations from the business and tax services community, the IRS adopted the regulations in 1996 despite internal warnings as to their potential abuse through the setup of hybrid entities (Dean 2006; IRS and Treasury 1996). Contrary to contemporary wisdom, the proliferation of hybrid entities was not an unintended consequence of check-the-box regulations. In fact, some officials within Treasury and the IRS were fully aware that allowing taxpayers to choose the classification of foreign entities could abet tax avoidance by multinational corporations. Joseph Guttentag (1995, 449), for instance, told tax professionals at a conference in 1996 that “the major concerns with respect to the check-the-box proposal center on the international area, specifically the problems presented by organizations treated as taxable by one jurisdiction and as transparent by another, the so-called hybrids.” Likewise, Robert Culbertson, IRS associate chief counsel (international), told members of the American Bar Association in 1995 he expected an extension of check-the-box regulations to foreign entities to increase the number of hybrids (Mullis 2011). Yet proponents from the tax service community managed to allay these fears, arguing that a move from de facto electivity to formal electivity would lead to merely an incremental increase, if any, in the number of hybrids, which would be more than made up for by the increase in simplicity, efficiency, and fairness provided by check-the-box regulations (cf. NYSBA
In acknowledgment of internal concerns over hybrids, final regulations still indicated that

Treasury and the IRS will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of US tax treaties. (IRS 1997, 216)

In accordance with expectations from internal critics, a large number of US multinationals subsequently began to bring about inconsistencies between the classification of their foreign subsidiaries in the United States and the host country by simply checking the box. This enabled them to circumvent US controlled foreign company (CFC) regulations, as well as taxation at source (IRS 1998b; Office of Tax Policy 2000).

CFC regulations, included in the Internal Revenue Code as subpart F by the Kennedy administration, were intended to curb the ability of US taxpayers to defer tax payments on profits earned by foreign corporations under their control. Until then, such profits were taxed in the United States only once they were redistributed as dividends to US shareholders. Profits retained abroad remained tax-free. The Kennedy administration considered deferral inequitable and distorting, as it disadvantaged taxpayers without foreign income vis-à-vis taxpayers with foreign income, and therefore created an incentive to invest abroad rather than in the United States. In its original CFC proposal the administration therefore suggested that all foreign income of US-controlled foreign corporations be taxed currently. Because of concerns over the competitiveness of US multinationals, however, Congress eventually reduced the scope of subpart F to passive income earned by foreign subsidiaries in low-tax jurisdictions (Office of Tax Policy 2000).

The setup of hybrid entities simplified by check-the-box regulations does, however, enable deferral even for this income category. A US multinational may, for instance, own a CFC in a high-tax jurisdiction (“High Tax Co”). To avoid having High Tax Co’s income taxed at source, the multinational could instruct High Tax Co to create a branch in a low-tax jurisdiction (“Low Tax Br”) and opt for disregarded entity status under check-the-box regulations. Low Tax Br could then offer High Tax Co a loan repayable with interest. As High Tax Co’s host country classifies Low Tax Br as a foreign corporation, High Tax Co can deduct interest payments as business expenses from its local tax bill. As the IRS classifies Low Tax Br as a disregarded entity subsumed under High Tax Co, the loan and interest payments cancel each other out from the US perspective. There is thus no passive income to be taxed currently under subpart F. As a result of this “earnings
stripping with a disregarded loan” strategy, the US multinational may thus significantly reduce its tax bill both in the United States and abroad (Mullis 2011).

Based on their monitoring effort, Treasury and the IRS concluded in 1998 “that the use of certain hybrid arrangements . . . is contrary to the policies and rules of subpart F,” and that “the recent entity classification regulations . . . (the ‘check-the-box’ regulations) have facilitated the creation of the hybrid branches used in these arrangements” (IRS 1998a, 18). Accordingly, the IRS released temporary “regulations to address such arrangements, and [requested] public comments with respect to these subpart F issues” (IRS 1998a, 18). The response from the business and tax service communities was devastating. Tax practitioners argued that temporary regulations were equivalent to an extension of subpart F, for which the IRS lacked the necessary authority (Cooper and Torgersen 1998). Moreover, they claimed “that much of the planning had the effect of reducing foreign taxes, an objective that historically has been viewed as a good business objective from a US perspective” (DeCarlo, Granwell, and Suringa 1998, 21). Accordingly, curbing the abuse of check-the-box rules was interpreted as a blow to the competitiveness of US multinationals (Carson, Cinnamon, and Kronbergs 1998).

US multinationals in response formed several lobbying coalitions with their tax advisers and accountants to convince Congress of their arguments. Eventually, the chairmen of the Senate Finance Committee and the House Ways and Means Committee fell into line, expressing their belief “that Congress, not the Department of the Treasury or the IRS, should determine policy issues relating to the treatment of hybrid transactions under subpart F” (Cooper and Torgersen 1998, 68). Accordingly, they threatened the IRS with a moratorium on its temporary regulations if it did not withdraw them “until a complete analysis of subpart F could be undertaken and laws passed through the proper legislative process” (Cooper and Torgersen 1998, 68). Only six months after the IRS had issued regulations to curb the abuse of check-the-box rules it thus revoked them in June 1998 (IRS 1998b). Hence, the Clinton administration was unable to prevent abuse of its CFC regime under subpart F, while the OECD recommended the collective adoption of CFC legislation as a defensive measure against harmful tax competition (cf. OECD 1998).

Enforcing the Qualified Intermediary Program

The Clinton administration’s attempts to curb international tax avoidance by US multinationals were defeated by business opposition. However, Treasury and the IRS managed to introduce some withholding and reporting requirements for foreign banks to limit tax evasion by US taxpayers with foreign accounts. The QI program and its accompanying regulations were developed from 1997 and finalized
in 2000. They entered into force on January 1, 2001 (IRS 1999, 2000). The program encouraged FFIs to become QIs by signing a contract with the IRS. As QIs they are required to report US-source income received by their clients and withhold the corresponding US taxes. In exchange, FFIs are allowed to report income earned by non-US clients on a pooled basis instead of reporting every client individually. This provision enabled FFIs to shield client data from the IRS and US banks acting as withholding agents, which were potential competitors. Nonetheless, US-source income earned by US taxpayers still had to be reported on an individual basis (Government Accountability Office 2007).

The QI program was supposed to ensure the efficiency of the US withholding regime against the background of increased investment in US securities by non-institutional investors. In 1913, Congress had taken the fundamental decision to withhold tax on income from investments in the United States before this income leaves the country. This included dividends and certain bond yields that were to be taxed at 30 percent. However, other forms of capital income, including interest from bank deposits, Treasury bonds, and corporate debt obligations, were exempt from withholding to attract foreign investment. In addition, the US government offered lower withholding tax rates to foreign countries in bilateral tax treaties. US financial institutions, acting as withholding agents for the IRS, thus had the formal obligation to identify the income source and the beneficial owner’s nationality, withhold accordingly, and transfer resulting tax revenue to the IRS. Exempt income still had to be aggregated by source and destination and then reported to the service (Government Accountability Office 2007). Identification of beneficial owners relied exclusively on so-called “statements of eligibility” provided by nonresident aliens to US withholding agents. There was, however, no system in place that would enable the withholding agent to verify the accuracy of obtained information through documentation provided by FFIs actually servicing the beneficial owner. This lack of verification created uncertainty as to whether US-source income was correctly reported and withheld upon (Shay, Fleming, and Peroni 2002, 123–24).

The growing number of small foreign investors in the United States exacerbated the problem and increased the administrative burden for US withholding agents. Through the QI program, the IRS tried to improve the situation by shifting “the burden of investigating beneficial ownership on foreign financial institutions rather than on US custodians, and . . . providing clear rules requiring withholding in the absence of documentation” (Shay, Fleming, and Peroni 2002, 123–24). Under the new regulations, FFIs had to forward client information obtained through know-your-customer (KYC) due-diligence procedures for every client wishing to be exempt from US withholding tax to the withholding agent managing their correspondent account. By providing this type of data to a US
bank, an FFI basically invited a competitor to lure away its wealthy clients. Therefore, the IRS granted FFIs registering as QIs an exemption from individual reporting of their non-US clients. Instead, they were allowed to report pooled income and obliged to directly withhold and transfer corresponding US tax to the IRS. Income earned by US taxpayers still had to be reported and withheld on an individual basis. But in accordance with general US tax law, IRS regulations did not require FFIs to look through foreign corporations. As a result, US taxpayers could hide behind interposed entities to evade US income tax and, after the QI program had been established, also illegitimately obtain tax exemptions or treaty benefits on their investment in US securities (Government Accountability Office 2007).

The program was very successful with FFIs, as it enabled them to avoid the 30 percent withholding tax on US investments for their clients, while protecting their anonymity from US banks and the IRS. As some tax professionals concluded at the time: “Because of the relative secrecy benefits provided to non-US citizens or residents, the failure of a private bank to qualify as a QI would put that bank in a competitive disadvantage in the marketplace” (O’Donnell, Marcovici, and Michaels 2000, 33). Inside the United States, the program received very little commentary during its elaboration phase because it actually shifted responsibility for the identification of beneficial owners to FFIs, thereby reducing the administrative burden for US withholding agents. In fact, in setting up the QI program, the IRS also responded to “years of requests from US banks and brokers to consolidate, clarify, and reduce documentation rules” (Kentouris 1997, 18). At the same time, those US persons whose interests were most affected—US investors evading tax by operating through foreign banks—could not publicly defend their position and were not considered a legitimate lobbying group by any influential political force. Although the program had many loopholes and was thus easy for US taxpayers to circumvent, it still provided “some level of deterrence against tax fraud and evasion” (Shay, Fleming, and Peroni 2002, 128). Moreover, the IRS had “effectively created the first major operational precedent for the concept of a cross-border anonymous withholding regime” (Grinberg 2012, 17).

Theoretical Implications

The Clinton administration entered office with the goal of restoring the tax system’s progressivity. Because of internal concerns over the budget deficit, however, a promised tax cut for the middle class was replaced by a more targeted EITC for the working poor, financed by higher taxes on high incomes and fuel consumption. Although this package did not have a meaningful impact on the after-tax incomes of the middle class, its regressive element was interpreted as a tax raise
for this income group, leading to Democratic defeat in the congressional elections of 1993. Faced with a Republican Congress, the Clinton administration’s focus subsequently shifted from legislative projects to international initiatives with the potential to increase growth and tax revenue. Within the area of taxation, the administration thus consulted with other developed countries organized in the G7 and OECD to set up an international initiative against harmful tax competition.

A corresponding report elaborated by the OECD Secretariat concluded that tax havens offering financial secrecy and PTRs were abetting tax evasion by individuals and tax avoidance by corporations. The OECD made nineteen recommendations for ending harmful practices and threatened tax havens with blacklisting and sanctions should they not comply with OECD demands. As a result of business opposition, however, the report soon lost much of its corporate dimension, enabling sophisticated tax havens to submit to the OECD while defending their stake in the tax-planning schemes of multinationals. Although the Clinton administration publicly backed the OECD’s sanctions threat, the administration had not leaned against this shift in the HTC project’s underlying focus. At the same time, the administration also failed to defend the US CFC regime against abuse through hybrid entities, the collective adoption of which was one of the defensive measures against harmful tax competition recommended by the OECD. In contrast, some regulatory progress was achieved when multinationals were unaffected and administrative costs could be shifted from domestic to foreign entities. Through the QI program, the Clinton administration introduced new reporting and withholding duties for FFIs, which at least deterred some less sophisticated investors from evading US income taxes on their foreign capital income. This progress happened while the US budget was balanced and in the absence of a financial crisis.

We thus observed a Democratic administration that put tax cooperation on the international agenda as a result of concerns over the perceived fairness of the US tax system, financial stability, and the effectiveness of the US sanctions regime. However, the multilateral HTC initiative soon lost momentum, as it also affected the tax-planning schemes of multinational corporations. From their perspective, the corresponding OECD recommendations created additional costs instead of competitive advantages. Hence, they organized opposition against the initiative’s avoidance-related elements. In reaction, the Clinton administration allowed the dilution of the substantial economic activity criterion, while continuing to strongly support the HTC initiative in public. The administration’s positioning thus fits well into the bottom-left corner of table 2.5, summarizing the expected stance of a government faced with political barriers to regressive tax reform and high adjustment costs for powerful interest groups. At the international level, the Clin-
ton administration made credible sanction threats to force initially reluctant tax havens to the negotiating table. Once important definitions had been diluted, however, tax havens could enter into virtually costless agreements with the OECD to avoid the risk of being sanctioned. Over time, and largely as a result of domestic business opposition, the US strategy thus shifted from coercion to enabling voluntary agreements with tax havens.

The reference to regulative norms played a major role in the communication strategy of tax havens. Yet it did not prevent the OECD or the United States from requesting greater administrative assistance and more financial transparency from these tax havens. In late 2000, six major secrecy jurisdictions even formally committed to respect OECD standards for information exchange in order to be removed from a blacklist. This measure should not have been necessary if normative arguments against foreign interference and extraterritoriality had really turned the decision of tax-haven governments to remain noncooperative into a legitimate policy option. Rather than fending off OECD interference on normative grounds, tax haven governments seized the opportunity to avoid the reputational cost of being included in a blacklist once the OECD had watered down its requests in accordance with demands from domestic business associations in the United States. Likewise, the Clinton administration was not prevented from cracking down on tax avoidance by its electoral defeat. Rather, it bowed to pressure from US multinationals and thus reduced the HTC initiative’s scope even before the Bush administration came into office.