The Panama Papers and International Cooperation in Tax Matters

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On April 3, 2016, the International Consortium of Investigative Journalists (ICIJ) disclosed that it was in possession of 11.5 million client documents from Mossack Fonseca, a Panamanian law firm. The documents relate to transactions that took place over the course of nearly 40 years, beginning in the late 1970s. On May 9, 2016, the ICIJ made available to the public a searchable database of information regarding over 200,000 entities created by Mossack Fonseca. The bare bones database does not, however, include any transaction documents, e-mails or bank account statements that would provide context with respect to the entities and owners that appear in the database.

Of course, tax authorities have been salivating over the prospect of gaining access to the documents since their existence was disclosed. The Organization for Economic Cooperation and Development even called an emergency meeting to discuss how governments could cooperate in using the information (OECD 2016a). The ICIJ has stated that it does not intend to provide the transaction documents to government officials. By contrast, the 'source' who provided the documents to the ICIJ has expressed his willingness to cooperate with tax authorities, since one of his stated purposes was to help eliminate the use of tax havens.

While the so-called Panama Papers may prove fascinating reading, those expecting quick revelations of massive tax evasion are likely to be disappointed. If the documents do lead to public prosecutions, those are likely to take years, by which time the international community may have lost interest. There are several different reasons for this. First, the use of the offshore company may not violate any tax laws. Second, the shareholders of a particular company may already have come clean to the tax authorities. Third, the tax crimes may be overshadowed by more sensational crimes.

The Good(ish)

It is hard to read a story about the Panama Papers without finding a reference to tax evasion. The assumption is, if someone has established a company in an offshore jurisdiction, some tax evasion must have occurred. At the same time, the ICIJ states that it does not intend to suggest or imply that any persons, companies or other entities included in the ICIJ Offshore Leaks Database have broken the law or otherwise acted improperly. Clearly, there is a disconnect.

As a starting point, most tax systems respect the existence of a corporation as a taxpayer separate from its shareholder(s). This is true even of the United States, which generally is considered to be a 'substance-over-form' country, and therefore more likely to ignore the form of a transaction than most civil law countries. As a result, income earned by a corporation established in a tax haven generally will be treated as the income of that corporation, not the shareholder. Tax authorities do have various doctrines that would allow them to ignore the corporation and tax income directly to the shareholder if specific criteria are met. In some common-law countries, the corporation may be treated as a 'sham'. In many others, the corporation may be ignored because it is acting as a 'nominee,' an agent, or a 'mere conduit' and therefore is not the 'beneficial owner.' In the United States, benefits may be denied if the interposition of the corporation serves no 'business purpose' or has no economic substance. In some civil law

countries, the whole transaction may be treated as an *abus de droit* (abuse of law). Finally, an increasing number of countries (from both civil law and common law traditions) have enacted 'general anti-abuse (or anti-avoidance) rules,' which might allow them to deny benefits without re-casting the transaction.

The tax authorities' job is made easier in the not uncommon circumstance where the shareholder himself effectively ignores the existence of the company and treats the assets that supposedly have been transferred to the company as if they still belong to the shareholder. On the other hand, tax authorities have lost cases when some amount of cash was left in the company and not immediately paid out to the owners or creditors (Yuan 2012). Developing a case under any of these doctrines is labor intensive as the success or failure turns on the specific facts.

Accordingly, there may be a category of persons included in the Panama Papers database that have established companies in tax haven jurisdictions to engage in various transactions with a view to avoiding the need to report the income themselves, and it is possible that those structures 'work' (i.e., constitute legitimate tax planning). However, it is also possible that the tax authorities of the jurisdiction in which the shareholder is a resident could succeed in ignoring the existence of the corporation under its tax law, but have not (yet) attempted to do so, probably because they do not know the company exists. The release may encourage some tax authorities to try to use one of the doctrines described above in order to ignore the companies and tax the shareholders on the income. This threat is why this category is labelled 'Good(ish),' not 'Good.'

The Clearly Non-Compliant

Non-compliance can take many forms. For example, at least 30 countries have enacted rules, generally described as 'controlled foreign company' (CFC) rules, that tax a shareholder currently on income derived by a foreign company that the shareholder 'controls' (OECD 2015). Thus, even though the company is treated as the beneficial owner of income as described above, the shareholder may still owe taxes on that income. Although the criteria used by countries to define what a CFC is vary considerably, it is safe to say that most CFC regimes would apply to companies that hold primarily passive investments and that are established in the tax haven countries implicated in the Panama Papers. The problem is that not all countries currently have CFC rules, and some of those that do have adopted them quite recently so they may not apply to income derived in earlier years.

Tax authorities will also ask questions about the source of the cash that was used to fund the corporation. In many cases, the primary concern is not about the income that is earned in the corporation, but rather the fact that the shareholder had siphoned off significant amounts of money from legitimate, tax-paying businesses in order to fund the corporation. In some of these cases, people have shifted their assets out of their home countries over the years because of concerns about personal safety. Even if their concerns are justified, it is likely that these people are non-compliant with respect to their local taxes.

In some cases, people may not realize that they have tax filing obligations. For example, the United States is unusual in that it taxes its citizens even if they live abroad. Combined with U.S. 'birthright' citizenship, this means that many people who hold U.S. passports have been non-compliant, and unaware of that fact (DOJ 2016).

For those who have followed international tax compliance developments for the past decade or so, the fact that offshore companies are used by the rich (and not-so-rich) to evade taxes barely counts as news. The release of the Panama Papers is simply the latest episode in this continuing saga of tax evasion and government response.

In the early 2000s, the U.S. government was able to access information regarding hundreds of thousands of credit and debit cards (which allowed easy access to offshore assets) issued to U.S. persons by banks located in offshore jurisdictions (IRS 2002). A few years later, the Senate Permanent Subcommittee on Investigations held hearings on the use of offshore entities in tax evasion (2006). However, these events and other enforcement efforts did not receive much publicity and therefore did not lead to significant changes in the legal environment.

This changed with the UBS case, which came to light in the summer of 2008 and completely changed the political calculus. UBS, a major Swiss financial institution, had entered into a 'qualified intermediary' agreement pursuant to

which it agreed to provide the Internal Revenue Service with information regarding certain income received by U.S. taxpayers. Nevertheless, UBS actively recruited customers in the United States, and helped them to establish offshore companies in order to avoid the required reporting. UBS was charged with conspiring to defraud the United States (Chomentowski 2015). To avoid prosecution, UBS entered into an agreement in February 2009 that deferred prosecution so long as UBS cooperated with the U.S. government, including by turning over to the names of thousands of U.S. accountholders (DOJ 2009).

In May 2009, just a few months after taking office, the Obama Administration proposed a number of budget measures that eventually became the Foreign Account Tax Compliance Act (FATCA). FATCA imposed substantial new reporting requirements on foreign entities (by 'fixing' holes in the qualified intermediary system that UBS had exploited). By that summer, no one in Washington was willing openly to oppose FATCA. The writing was on the wall when even the U.S. Chamber of Commerce, which had been staking out very aggressive positions on any number of Obama Administration proposals, made only modest comments on the pending legislation (Josten 2009). The adoption of FATCA led five European governments (France, Germany, Italy, Spain and the United Kingdom) to insist that the United States enter into 'Intergovernmental Agreements' on automatic exchange of information, which in turn led to the development by the OECD of the 'Common Reporting Standard' for information reporting and exchange of information.

Many governments have recognized that they have an interest in helping taxpayers clear up past deficiencies and to start paying taxes. To encourage them, they have established 'voluntary' disclosure programs that require taxpayers to pay over substantial amounts of their offshore assets in order to avoid criminal prosecution. A recent OECD report describes 47 such programs, adopted by most OECD members and a number of developing countries (OECD 2012).

It is unclear whether the disclosure of the Panama Papers will drive more taxpayers into these programs. It is understood that the flow of new cases into these programs has slowed down in recent years as those who are risk-averse have already taken advantage of the programs. (Early participation is encouraged by the fact that the programs have become harsher over time.) It is likely, therefore, that the shareholders of some of the companies disclosed in the database already have resolved their cases through one of these programs. Those who have not are largely those who believed that they would never be found, perhaps because they had shifted their assets to places, such as Panama, that they thought would continue to stave off international calls for increased cooperation on tax matters (OECD 2016b). The release of the Panama Papers may prompt some of these taxpayers to resolve their past tax deficiencies.

In the past, uncertainty regarding the possibility of disclosure has encouraged participation by taxpayers because these programs may not be available if the tax authorities have already begun an audit of the taxpayer. For example, in February 2009, UBS agreed to provide the U.S. government the names of fewer than 5000 accountholders (NYT 2009), but about 15,000 taxpayers entered the U.S. Offshore Voluntary Disclosure Program between March 2009 and October 2009 (IRS 2014). Governments therefore might have benefited from a longer delay between the disclosure of the existence of the Panama Papers and the release of the database, as some taxpayers who feared disclosure might have come forward voluntarily.

The Truly Slimy

The ICIJ website includes a number of stories about people who are not primarily tax cheats, although they probably also *are* tax cheats. That is, someone who engages in certain types of criminal activity is likely to generate significant income that he is equally unlikely to list on a tax return, even though such income clearly is taxable. The famous historical example is, of course, the bootlegger Al Capone, who served 11 years for tax evasion (IRS 2002).

Some of the more colorful characters that are uncovered as a result of the Panama Papers leak may end up being pursued for criminal activities of various sorts, with tax charges thrown in on top. These cases are the ones most likely to show up on the front pages of newspapers. While fun to read about, they are unlikely to present challenging tax questions.

What Happens Next?

While the international community may be disappointed if there is a lack of courtroom fireworks, the real importance of leaks such as these is the change in the political dynamic that can result. The OECD's Committee on Fiscal Affairs published a comprehensive report on overriding bank secrecy for tax purposes in April 2000, but little progress was made for close to a decade (OECD 2000). It was the political reaction to the UBS case that resulted in the demise of secret bank accounts, the accelerated adoption of systems for the automatic exchange of information for tax purposes and the development of tax amnesty programs to bring taxpayers into compliance going forward.

It is likely that the release of the Panama Papers also will result in significant changes in the legal environment, not because they revealed anything new, but because the public is paying attention. Having learned from the UBS experience, politicians have been much quicker to use the publicity from this leak to push forward desired initiatives (White House 2016). The number of countries that have agreed to adopt the Common Reporting Standard now stands at 101, with such hold-outs as Nauru, Vanuatu and, yes, Panama having capitulated in early May 2016 (OECD 2016c). The new cause of the day is exchanging beneficial ownership information with respect to companies and trusts, an effort that is being led by the United Kingdom (HM Treasury, 2016). Governments no doubt will use the Panama Papers leak to create yet another new 'global standard' on information exchange. In the end, the Panama Papers release is unlikely to change the legal situation very much with respect to those that were named, but it is likely that it will serve the 'source's' goal of making it harder to hide illegal activities and commit tax evasion in the future.

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