Here's a Way to Shut Down Panama Papers-Style Tax Havens — If We Wanted To

IT WOULD HAVE been infuriating at any time of the year to learn about the massive tax evasion by the global 0.01 percent revealed by the Panama Papers leak. But it's especially maddening for regular American schlubs to hear about it in April, just as we're doing our own taxes.

According to estimates by Berkeley economist Gabriel Zucman in his book *The Hidden Wealth of Nations*, rich individuals and big corporations use various machinations to pay at least a third of a trillion dollars less than they owe every year. For everyone else, this translates directly into higher taxes, more national debt, and less government spending.

Conservatives like to argue that it's impossible to shut down the dizzyingly complex world of shell corporations and tax havens — a position that supports their argument that there's no point in raising taxes on the wealthy. As George W. Bush proclaimed in 2004, "Real rich people figure out how to dodge taxes."

However, Zucman makes a persuasive case that it wouldn't be *technically* difficult to crush the tax haven industry. The enormous challenge would be mustering the political will — and not just in one country, but on a global level.

Tax havens serve two functions: *tax evasion*, which involves hiding assets and is illegal, and *tax avoidance*, which is done by multinational corporations in the open and is legal (since the same corporations have conveniently made sure the laws work that way). Eliminating them requires different strategies.

Tax Evasion

Let's consider one example: Say you're an American business owner and you want to hide $10 million from the Internal Revenue Service. As Zucman explains it, there are three steps.

First, you set up a shell corporation — say, Definitely Not an Illegal Tax Shelter LLC — in a location like the Cayman Islands with strict privacy laws about disclosure of company owners, so no one knows that DNAITS belongs to you.

Second, you create a bank account for DNAITS in Switzerland.

Third, you have your real, U.S. company buy $10 million in fictitious services — maybe "consulting" — from DNAITS, sending that $10 million to your Swiss bank account.

Now you can take that $10 million and invest it in whatever you want: real estate, stocks, bonds, mutual funds. In theory, you're legally obligated to declare your interest, dividends, and capital gains each year and pay taxes on them. In reality, the IRS may never find out that the money belongs to an American, especially since your Swiss bank may itself not know who owns DNAITS.

Let's say you've invested it all in a Vanguard mutual fund that provides a return this year of 5 percent, or $500,000, in taxable dividends. If you were to follow U.S. law and declare it, you'd have to pay taxes on that $500,000 dividend income at a rate of 20 percent, costing you $100,000. So you don't, and your money continues compounding each year tax-free.

For Americans who aren't super-rich, there's no way to hide your income from the government. Employers and banks automatically report your wages, interest from savings accounts, and any meager dividends and capital gains to the IRS. (In fact, the government knows so much that there's no need for most people to do their own taxes — the IRS could just send you a tax return already filled out for your approval, as is done in Sweden, Denmark, and Spain.)

The main service provided by tax havens is simply that — since they're not bound by other countries' laws — they don't report the income of foreigners to the relevant tax authorities.

Based on the history of previous attempts to crack down on tax evasion, successful and not, Zucman argues that the U.S. and European Union could stop most of it with a two-pronged attack: concrete consequences for tax havens, and an international financial register.

The Foreign Account Tax Compliance Act, passed by Congress in 2010, imposed our national rules on *all* financial institutions worldwide. That is, under FATCA, banks in Switzerland, Luxembourg, the British Virgin Islands, and everywhere else must search their records for accounts held by U.S. citizens, and automatically report their income to the IRS.

While FATCA has flaws, it's been successful in making it more difficult for Americans to evade taxes. What's needed, says Zucman, is even stronger measures to force tax havens to automatically report the income of all foreigners, not just Americans, to the tax authorities in their countries.

The U.S. can force tax havens to comply because we're so big and powerful. But smaller countries could also bring tax havens to heel if they act in coalition, especially since tax havens themselves are generally tiny and dependent on exports. Zucman calculates that if Germany, France, and Italy slapped a tariff of 30 percent on Swiss goods, this would cost Switzerland more than it makes as a tax haven — and such a tariff would be legal under World Trade Organization rules, since it would enable the three countries to recover approximately the amount in tax revenues that Switzerland is costing them.

Of course, as with the hypothetical Definitely Not an Illegal Tax Shelter LLC, bankers may be able to honestly say they don't know who owns many assets. That's where an international financial registry comes in.

Zucman contends that a global registry of who owns which assets is "in no way utopian." Countries have long had national registries of who owns all their land and property. More recently, corporations have set up private, large-scale registries: the Depository Trust Company (which keeps track of the ownership of all stock issued by U.S. companies), Euroclear Belgium and Clearstream (bonds issued by U.S. companies but denominated in European currencies), Euroclear France (French corporate stock), and other national repositories.

Thus it's not hard to imagine the databases being merged under the supervision of a public, international institution with financial expertise — and fortunately we already have one of those, the International Monetary Fund.

Of course, the registry would in many cases record that assets are owned by corporations or trusts whose owners are unknown. Tracing the financial chain through many layers of obfuscation back to the actual human beings who hold the assets would require an enormous, costly, and possibly ineffective IMF bureaucracy.

Zucman proposes a fiendishly clever solution: the global registry should impose a small, refundable wealth tax to make it in the financial interest of anyone with hidden wealth to disclose it.

Here's how it would work:

Imagine that the IMF registry imposed a wealth tax of 3 percent on everything in its records: stocks, bonds, mutual funds, land, property, etc.

Now think again of your $10 million held by Definitely Not an Illegal Tax Shelter LLC, and the $500,000 it's earned this year in dividends from your Vanguard mutual fund. Your Swiss bank records that DNAITS has received this $500,000 in income, but doesn't know you own DNAITS, and so can't report it to the IRS as *your* income.

However, the global financial registry records that $10.5 million in the Vanguard mutual fund is held by DNAITS

— and taxes it at a rate of 3 percent, or $315,000.

You now have two choices. First, you can keep silent about your ownership of DNAITS and let the IMF keep the wealth tax, leaving you with $10,185,000.

Or second, you can prove to the IRS that DNAITS belongs to you. And since there's no wealth tax in the U.S., you'd get all of the $315,000 back. All you'd have to pay is the $100,000 in income taxes you owe on your $500,000 income, leaving you with $10,400,000.

Of course, with such a system in place there would be no point in trying to hide your $10 million in the first place. Instead, you and almost everyone else would simply pay what you lawfully owe — so you don't have to pay more.

None of this is to say that setting up such a system would be politically simple. In particular, conservatives in all countries would suspect that such a global financial registry would make it easier for countries to impose taxes on wealth in addition to taxes on income — and they'd be right. On the other hand, this also makes a global registry an attractive goal for all political parties concerned about wealth inequality. A global financial registry would also be politically difficult to openly oppose, since it would not just hamper tax evasion but would also be a key tool in fighting money laundering and the financing of terrorism.

Tax Avoidance

The U.S. has, by world standards, a peculiar corporate tax system. Multinational companies headquartered in the U.S. must pay an ultimate tax rate of 35 percent on all their profits earned anywhere on earth.

That is, if a corporation makes money in a foreign country with a corporate tax rate of 10 percent, it must pay the IRS an additional 25 percent on its profits booked in that country. But to make things even more complicated, it only has to pay that additional tax when it brings the profits back to the U.S. If it keeps the profits overseas, it can postpone paying the tax bill indefinitely — which is why U.S. corporations are now holding over $2 trillion in profits in other countries.

This creates two obvious incentives for U.S.-based multinationals.

First, they're continually tempted to engage in corporate "inversions," in which they move their formal headquarters to a country with lower tax rates — even as their factories, workers, and customers stay in the same places. This is why Medtronic, founded in Minneapolis in 1949, is now formally Irish, even as its "operational headquarters" remain in Minnesota.

Second, they tend to engage in accounting chicanery to make it appear as if their profits were "earned" by foreign subsidiaries in countries with low corporate rates. This is a particularly attractive strategy for internet companies, whose value is largely non-material. For instance, Google licensed its highly profitable search and advertising technology to a subsidiary in Bermuda, where the corporate tax rate is zero percent. Google "pays" that highly profitable subsidiary billions in royalties each year.

Corporations keep these profits overseas in hopes of striking a deal with the U.S. government allowing them to bring the money home at a reduced tax rate. This already happened once before in 2004, when Congress let corporations pay just 5 percent on repatriated profits. New York Democratic Sen. Chuck Schumer is currently working with Republicans on a similar plan.

All of this is done in the open, and is totally legal. Regular Americans despise it, but the tax system is so complex that it seems impossible that the IRS could ever keep up with armies of highly paid corporate lawyers.

However, there's a feasible solution suggested by Zucman (and many others): Completely throw out our current corporate tax system and begin using something far simpler called "formulary apportionment."

Formulary apportionment starts by discarding the weird fiction that a multinational corporation's subsidiaries are separate companies. Instead, it treats the corporation as what it is, one unitary company, with one unitary amount of profit. Next, a formula based on the location of three concrete factors — the corporation's payroll, physical capital like factories, and sales — is used to apportion percentages of the multinational's profits to the different countries in which it operates. The IRS would get 35 percent of the U.S. apportionment.

This isn't a untested daydream. Individual American states have long used formulary apportionment to determine tax rates for multi-state corporations. The principle would be exactly the same for multinational companies.

There's no "right" formula, though for decades most U.S. states placed an equal weight on each factor. For example, a manufacturing multinational might have 66.6 percent of its payroll, 33.3 percent of its physical capital, and 50 percent of its customers in the U.S. Added together and divided by three, that means that half of its profits should be apportioned to the U.S. and can be taxed here.

Thus a formulary apportionment system would make corporate inversions and the fictitious booking of profits in low-tax countries pointless — neither would change a corporation's U.S. tax liability.

It's true that moving to such a system would be, if anything, more politically difficult than creating a global wealth registry. It would be ferociously opposed by many big U.S. corporations. On the other hand, explained clearly it would be extremely popular with regular Americans. There might also be some unexpected corporate support from CEOs who are tired of terrible PR and spending huge amounts of money on those otherwise-useless armies of tax lawyers.

Moreover, the European Commission (the executive body of the European Union) is pushing for individual EU countries to use a formulary apportionment system. This means that both U.S. states and European countries may soon have analogous approaches to corporate taxes. And as Zucman points out, the proposed Trans-Atlantic Free Trade Area would create one free trade zone covering the U.S. and European Union. Groups fighting tax avoidance could push to make a fusion of the two corporate tax bases part of any TAFTA treaty, which would make it far easier to set up formulary apportionment at the level of the U.S. and EU.

So, as Zucman writes at the end of *The Hidden Wealth of Nations*, this is "above all a battle of citizens against the false inevitability of tax evasion and the impotence of nations." Money launderers, crooked politicians, and huge corporations want the system to be so complicated that only their shady bankers and lawyers can comprehend it. But if regular people worldwide can educate ourselves about the costs the current system imposes on all of us, and mobilize to agitate for possible solutions, there's a path in front of us to a tax system for everyone that's far simpler, fairer, and more transparent.