Super Power or Super Haven – Part I

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It is widely accepted that the United States of America is one of the most litigious countries on earth. As of 2010, US residents spent about 2.2% of their GDP (approximately 310 Billion Dollars) annually on litigation costs[1]. There are more lawyers per capita in the United States that any other country in the world. These are some of the reasons why Asset Protection Trusts (APTs) are a rage in the United States. APTs provide secrecy, security and stability to assets from creditors, lawsuits and settlements. Once an irrevocable trust is created and assets are transferred, risks of losing the same in any future legal entanglement are reduced to a minimum.

A particularly exclusive variant of APTs are self-settled domestic APT. A self-settled DAPT is often, an irrevocable trust, which allows the grantor/settlor (the person creating the trust) to fund the trust (transfer his or her own assets) and also remain one of the beneficiaries of the trust. On paper, you do not own the asset since you have transferred the asset to a trust. However, you design the trust deed by incorporating yourself as a beneficiary to receive a pre-determined sum of money at pre-determined intervals. A properly-structured DAPT shields those trust assets from the claims of most future creditors of the grantor: an estranged wife, an illegitimate son, a cheated customer, an accident victim, all included.

Almost 19 states of the United States have DAPT law. The widespread adoption of DAPT law by several states in the US is often believed to be a response to the billions of dollars that flow out of USA yearly into offshore APTs, located in tax havens which are mostly common law countries with lax tax and regulatory oversight. Current estimates suggest that a staggering amount of $1 trillion of foreign trust funds are held in asset protection trusts[2].

Recently, New Hampshire and Wyoming have taken the search for secrecy and asset protection one notch higher. The New Hampshire Foundation Act, enacted in 2017, created, for the first time in the United States, a hybrid composite of trusts and companies, the private foundation. Foundations, unlike trusts, hold assets in their own name and are perpetual in nature as against the time restrictions applicable to trusts. In addition to these technical niceties, the one glaring new weapon of foundations, from the point of view of Base Erosion and Profit Shifting (BEPS) is the absence of beneficial ownership. Foundations have no beneficial owners and are therefore 'ownerless' structures (even where the foundation property is held for the benefit of beneficiaries). In the absence of beneficial owners, there is no information about Beneficial Owners to be passed on to either the Internal Revenue Service or to tax administrations of other sovereign nations. This development is radical. As an outcome of the enactment of this law, the United States is now ranked second (or second worst) on the 2020 Financial Secrecy Index of the Tax Justice Network[3].

This development in the United States is not a singular or uncommon phenomenon. The US has been providing a wide selection of secrecy and tax-free facilities for non-residents, both at a Federal level and at the level of individual states. A brief look at the historical developments in this light merits attention at this juncture.

Heralding Harmfulness

The Revenue Act of 1921 excluded interest income earned by non-residents from within the United States from Income Tax. In the wake of the First World War, one of the first features of harmful regimes crept into the domestic taxation law of the United States. It exempted from income tax, the interest earned by non-residents from deposits situated in the United States. Clearly a territorial system of taxation offering preferential treatment given to interest income, this measure was ring-fenced from residents and there were, quite obviously, no stringent reporting requirements in place for exchange of information, a century back. It is a measure that checks all the boxes that are required to be categorized as a preferential regime. To illustrate, we may juxtapose this against Section 42(1) of the Indian Income Tax Act, 1922 of similar vintage. It said,

> *[Income deemed to accrue or arise within [the taxable territories].]—(1) [All income, profits or gains accruing or arising], whether directly or indirectly, through or from any business connection in [the taxable territories], or through or from any property in [the taxable territories], or through or from any asset or source of income in [the taxable territories], or through or from any money lent at interest and brought into [the taxable territories] in cash or in kind] [or through or from the sale, exchange or transfer of a capital asset in [the taxable territories],] shall be deemed to be income accruing or arising within [the taxable territories], and [where the person entitled to the income, profits or gains is not resident in [the taxable territories], shall be chargeable to income-tax either in his name or in the name of his agent, and in the latter case] such agent shall be deemed to be, for all the purposes of this Act, the assesse in respect of such income-tax. [emphasis added]*

In comparison, in India, we incorporated a global system of taxation at source (which is as non-harmful as it gets), with no features of ring fencing or preferential rate for non-resident income. In the 1920s, while the United States was slowly climbing the rungs to becoming a global super power, India was still an underdeveloped colony, with a severely depleted industrial and manufacturing sector serving purely as a supplier of raw material to Britain. The irony is conspicuous. If there was a country between the two that required capital, it was India and this deduction applies to most colonies during the 1920s. However, USA was attracting deposits from across the world. For businesses and individuals that were not resident in USA, the choice was evident. Income earned in a high tax jurisdiction could be deposited in an American bank and tax free interest from the corpus could be enjoyed at ease. With exchange of information still many decades away, sovereign governments had no clue how much cash was held by its residents in the USA. A single stroke of the pen in USA attracted, without any legitimate economic purpose, billions of dollars of foreign exchange into USA and out of the rest of the world.

This arrangement hasn't changed much in the last 100 years. At the close of the first decade of the 21st century, the United States held approximately 17 Trillion Dollars of deposits in its banks[4],[5], the largest for any country by a long distance, close to ten times the deposits in Indian banks. This arrangement continued for 4 decades during which period, all interest on deposits in banks in the United States paid to persons not conducting trade or business in the United States was treated as foreign source income and was not subject to US income tax notwithstanding the treatment of the income in the country of residence.

An attempt at course-correction

In 1965, the Foreign Investors Tax Bill was introduced in the US legislature, one of the proposals of which was to tax the interest earned by aliens in banks in the United States. 1965 was the year when USA was facing a balance of payments crisis in the background of the Vietnam war. The Balance steadily declined, breaching the negative boundary for the first time in 1971[6]. During the discussion on the bill, it was unambiguously stated,

> *The US balance-of-payments problem would be made more acute if this interest were taxed since it seems reasonable to believe that a substantial part of the under-lying deposits would be transferred to foreign banks. If this were to happen, there would be an increased likelihood of these dollars shifting from private to public hands and then becoming a claim on our gold……. the shifting of these deposits to foreign banks not subject to US taxation would reduce taxable income otherwise generated by US banks on these deposits**[7]**.*

The understanding was clearly evident. It was admitted:

1. that the scheme was unfairly attracting deposits from other countries,
2. that these deposits formed a substantial portion of the total deposits in USA,
3. that profits have been unscrupulously shifted to the United States due to this structure and,
4. that these profits would be shifted back to their rightful jurisdictions if amendments were introduced.

Quite understandably, the amendments failed to get through and the abusive arrangements continued.

While we end Part I of this two-part article here, we shall be taking a dive into the move from Harmful to Abusive through the use of Offshore Onshore banks, a radical new mutation in the Exchange of Information paradigm and Delaware, all tested against the parameters of the OECD's Forum on Harmful Tax Practices in Part II of this article.

The views expressed in this blog are personal to the author.

[1] https://www.nytimes.com/roomfordebate/2010/11/15/investing-in-someone-elses-lawsuit/more-money-into-bad-suits (Accessed 01st March 2020)

[2] Elena Marty-Nelson, Offshore Asset Protection Trusts: Having Your Cake and Eating It Too, 47 Rutgers L. Rev. 11 (1994) Provided by: NSU Shepard Broad College of Law Panza Maurer Law Library

[3] https://fsi.taxjustice.net/en/introduction/fsi-results (Accessed 01st March 2020)

[4] https://www.theglobaleconomy.com/rankings/financial_system_deposits_GDP/ (Accessed 03rd March 2020)

[5] "World Economic Outlook Database, October 2019". IMF.org. International Monetary Fund. 15 October 2019. Retrieved 3 September 2019. (Accessed 03rd March 2020)

[6] https://www.census.gov/foreign-trade/statistics/historical/gands.pdf (Accessed 03rd March 2020)

[7] Legislative History of H.R. 13103, 89th Congress, Foreign Investors Tax Act of 1966, Public Law 89-809: Ninetieth Congress, First Session