Offshore financial centres have taken a battering recently, but they have shown remarkable resilience, says Matthew Valencia

Feb 16th 2013 | From the print edition

WHEN THE ECONOMIST INTELLIGENCE UNIT, a sister organisation of this newspaper, published the first bound edition of “Tax Havens and Their Uses” in 1975, a queue several blocks long formed outside The Economist’s bookshop in London. Interest in offshore financial centres (OFCs) kept growing over the following 20 years as dozens of new havens popped up, often with help from lawyers based in Wall Street or the City of London. Tax authorities did little to intervene. Beginning in the mid-1970s, Jerome Schneider, a well-known “tax planner”, hawked various tax-evasion schemes with impunity for more than 20 years, even advertising in airline magazines.
This tolerance ended in the late 1990s, when prosecutors began to catch up with Mr Schneider and his kind and the Organisation for Economic Co-operation and Development (OECD), a rich-country forum, declared war on “harmful tax competition”. Since then tax havens have been under sporadic attack, including two waves of blacklisting. In 2008-09 the G20 took up the cudgels, America put pressure on Swiss banks to reveal more about their customers and various tax authorities started paying for stolen information about offshore accounts.

Pressure on OFCs has since eased a little because they have all accepted, to differing degrees, that they need to exchange more information with their clients’ home countries. But they remain beleaguered as an increasingly confident band of “tax justice” campaigners pushes for more concerted action on tax evasion and avoidance, money-laundering and the proceeds of corruption.

Tax avoidance, the grey area between compliance and evasion, has shot up the political agenda. A recent cover of Private Eye, a British satirical magazine, caught the national mood, showing Santa Claus being booed for living offshore. Governments have been rushing out action plans. Britain has put tax compliance and corporate transparency at the top of its list of priorities for its presidency of the G8 this year. America’s media often suggest that Congress yank money back from tax havens to alleviate the nation’s fiscal woes.

The world has 50-60 active tax havens, mostly clustered in the Caribbean, parts of the United States (such as Delaware), Europe, South-East Asia and the Indian and Pacific oceans. They serve as domicile for more than 2m paper companies, thousands of banks, funds and insurers and at least half of all registered ships above 100 tonnes. The amount of money booked in those havens is unknowable, and so is the proportion that is illicit. The data gaps are “daunting”, says Gian Maria Milesi-Ferretti of the IMF. The Boston Consulting Group reckons that on paper roughly $8 trillion of private financial wealth out of a global total of $123 trillion sits offshore, but this excludes property, yachts and other fixed assets. James Henry, a former chief economist with McKinsey who advises the Tax Justice Network, a pressure group, believes the amount invested virtually tax-free offshore tops $21 trillion. His methodology is reasonably sophisticated but he admits his calculation is still “an exercise in night vision”.

Once commercial transactions are factored in, the likely total for offshore wealth balloons. Over 30% of global foreign direct investment is booked through havens. Mr Milesi-Ferretti studied a group of 32 of them and found that international banks’ claims on these were of the same order as their claims on all emerging markets. Some OFCs are giants in certain kinds of business. The Cayman Islands (population 57,000) is the world’s leading hedge-fund domicile. Bermuda (population 65,000) is number one in reinsurance.
These two are famous but in many ways atypical. Many of their smaller competitors are what Jason Sharman, of Griffith University in Australia, calls “aspirational havens”: islands that turned to finance to reduce their reliance on tourism and agriculture, but have never got beyond selling a few thousand offshore companies a year.

**Evergreens**

Nevertheless offshore finance has shown a “puzzling resilience”, confounding predictions of decline because of its supposed vulnerability to the regulatory clampdown imposed from outside, says Mr Sharman. An academic study last year found that OFCs’ foreign-owned deposits had actually risen slightly in 2007-11. Mr Sharman attributes their staying power to a growing clientele in Asia and other emerging markets which has offset a decline in America and Europe.

Offshore operators put the havens’ endurance down to their legitimate uses, such as their “tax-neutral” role in mediating international financial flows (of which more later) and the protection they offer from unstable or capricious governments—though they believe these uses are poorly understood. Tax libertarians think the havens meet a need created by the complexity and punitive nature of some national tax codes. Their latest hero is Gérard Depardieu, who has taken Russian citizenship in protest against a proposed French supertax on the rich. Besides, they point out, OECD countries also compete on tax. Britain, for example, which has the second-lowest corporate-tax rate among the G8 (after Russia), recently cut it further.

Critics counter that the use of offshore centres involves more sleight of hand than genuine competition. Money is routed through them merely to shelter it from taxes, undermining collection in the client’s home country, where he will continue to benefit from tax-funded public services without paying his way. Ultimately, says Nicholas Shaxson, one of the offshore industry’s most prominent critics, its appeal rests on “providing rich individuals and corporations with financial boltholes, where they can do things with their money that they wouldn’t be allowed to do at home”. He believes that legally enshrined secrecy is just as important to the havens’ success as low tax.

Individuals have a right to financial confidentiality, but only as long as they set about their business lawfully. When it comes to tax crimes, money-laundering and the like, such confidentiality needs to be set aside. Some OFCs still make this difficult, and layering by service providers compounds the problem: try penetrating a Belize bank account fronted by nominees that is owned by a shell company in the British Virgin Islands (BVI) that in turn is owned by a foundation in Panama. Over the past decade the bigger OFCs have co-operated more with foreign law-enforcement agencies, but progress is patchy, and offshore structures still crop up regularly in corruption and money-laundering cases. A recent example is the alleged use of Cayman companies as conduits for bribes to...
Saudis by a subsidiary of EADS, a European aerospace and defence company.

The scale of the offshore industry’s dirty-money problem is hotly disputed. Economists at Global Financial Integrity, a research group founded by Raymond Baker, an authority on financial crime, reckon that developing countries alone suffered illicit financial outflows—defined as money that is illegally earned, transferred or used—of at least $5.9 trillion over the past ten years. Some say this estimate is too high, but the figure is clearly substantial. What is less clear is the proportion that ends up in OFCs rather than in one of the laxer onshore jurisdictions. Estimates of tax-revenue losses onshore are equally imprecise. Some think, for example, that Britain’s “tax gap”—the difference between tax owed and collected—is much bigger than the authorities care to admit: perhaps close to 7% of the total collected in 2010-11. On the other hand tax losses are sometimes overestimated, for instance by assuming that the full rate would have been paid if the money had been kept there.

At a recent conference Malcolm Couch, an official from the Isle of Man, one of the more transparent tax havens, delivered a few home truths to an audience of offshore worthies. OFCs should acknowledge that they, along with some of the big onshore hubs, have “to some extent been hijacked” by illicit money, he said, and should not be surprised when they are attacked for robbing other countries of tax revenues. They need to tread carefully because they face “an inherent existential threat”.

This special report will argue that tax havens are indeed facing serious threats but are also being presented with some enticing opportunities, especially if they have strong links with emerging economies. The best-regulated of them are no longer merely “sunny places for shady people”. They can reasonably feel aggrieved when they are lumped together with the dodgiest havens, or when onshore jurisdictions themselves fail to practise the financial rectitude they preach to their offshore rivals.

All the same, the OFCs will remain under intense pressure as tax compliance receives more political attention. They will have to show not only that they have cleaned up but that they are making a constructive contribution to the world economy.

From the print edition: Special report
Special report: Offshore finance

The OFCs’ economic role

The good, the bad and the Ugland

Havens serve clean as well as dirty money

Feb 16th 2013 | From the print edition

DETRACTORS DESCRIBE THE offshore phenomenon as one of the more noxious features of financial globalisation that is now, mercifully, in retreat. The half-dozen senior lawyers gathered in the wood-panelled boardroom of Ugland House, the head office of Maples and Calder in George Town, the Cayman Islands’ capital, have heard it all before, and they beg to disagree. Offshore centres oil the financial interface between larger economies, insists Alasdair Robertson of Maples. Grant Stein of Walkers, another Cayman firm, thinks of it as “the plumbing that connects the global financial system”. His peers nod vigorously. At times they seem touchy, but then Ugland House, the registered address of more than 18,000 companies, is held up by critics as a symbol of all that is wrong with OFCs.

The lawyers are members of the IFC Forum, a group of “magic circle” law firms from British dependencies that have joined forces to counter those jurisdictions’ bad press. IFC stands for international financial centres. “Offshore” is considered pejorative, “tax havens” unmentionable.

They enjoy support from some fierce ideological warriors, including libertarians at the Cato Institute in Washington, DC. Their opponents can be equally strident. For the moment the critics have the wind in their sails. They include a number of increasingly well-organised NGOs and even the odd government, most notably Norway’s. Who is right is hard to say, because much of the offshore industry lies in the statistical shadows, with little academic work to illuminate it.

The lawyers argue that many offshore transactions are about tax neutrality, not cheating. For example, if a joint venture with partners from Germany, Turkey and Argentina were registered in one of those countries, the government concerned might seek to tax the flows through the vehicle as
well as the investors’ gains. By going offshore they can pool their resources in a jurisdiction that is willing to act as a mere receptacle and refrain from taking a cut other than registration fees. Taxes are still payable by the investors in their home countries. “It’s not about evasion but about avoiding an extra, gratuitous layer of tax,” says John Collis of Conyers Dill & Pearman, a Bermuda law firm.

Such structures offer legal neutrality too. In a joint venture in, say, the BVI, no shareholder has a home advantage; all get a sophisticated, predictable common-law system with a small but well-regarded local commercial court and Britain’s Privy Council as the ultimate arbiter.

Asians are particularly fond of using BVI companies for initial public offerings and international investments. Indeed, on paper the BVI ranks as the second-largest investor in China (see chart 2). Mr Sharman of Australia’s Griffith University believes there is a lot more to it than hiding criminal money or tax-dodging, though these play a part. Indeed, the flows have continued to grow even as tax incentives have been largely withdrawn and as the BVI has become somewhat less friendly to dirty money. The investors now seem to be using it for institutional arbitrage, he says, attracted by the ease of raising funds, cheaper access to capital markets, speed of set-up and access to reliable courts.

Even when the use of an offshore centre means a loss of tax revenue, it may still provide other benefits for the country concerned. Several African countries have signed tax treaties with Mauritius, hoping that this will help them attract investment from Asia routed through the Indian Ocean haven. They would miss out on some tax revenue but may gain from the extra investment. “This whole area is riddled with trade-offs,” says James Hines of the University of Michigan.

One thing about tax havens that governments onshore might quietly welcome, he adds, is that they allow those governments unofficially to tier domestic tax rates. They can let multinationals and other big, mobile investors use havens and thus pay a lower effective rate but require smaller, more domestically oriented companies to pay the full rate. By differentiating tax burdens in this way, countries can maintain sizeable domestic tax bases in the face of growing international competition. A 2006 study identified another way in which tax havens may reduce the costs of entering high-tax countries: the use of offshore affiliates to facilitate debt financing, which had been fuelling investment in Japan. A later study concluded tentatively that firms which had cut their costs by
establishing offshore operations sometimes expanded their activities in poor countries nearby.

Individuals’ use of offshore centres, too, is often misunderstood, say their defenders. Many people believe that only those with something to hide would want a bank account in Jersey. In fact, it offers several legitimate advantages for British nationals working abroad who are not subject to tax at home until funds are repatriated. These include multi-currency services (not available on domestic accounts) and global portability. And for foreign “non-doms” residing in Britain, whose non-British income is not subject to British tax if held offshore, it can make sense to park it in a nearby jurisdiction with broadly similar banking and legal systems.

Some offshore champions consider tax competition a good thing because it discourages countries from trying to tax their way out of trouble. This view occasionally meets with sympathy onshore: the OECD dropped its war on “harmful” tax competition after George W. Bush’s administration objected. It has since focused on promoting tax transparency.

Andrew Morriss, an expert in offshore law at the University of Alabama, thinks that OFCs impose an important discipline on onshore jurisdictions through innovative regulation to lower transaction costs. Such places, the argument goes, can tailor their rules more closely to the needs of particular sectors or subsectors than large countries can.

An example is “captive” insurance, corporate self-insurance of risks that would be difficult to insure in the usual way. The business was first developed in Bermuda, later spreading to other OFCs, including the Cayman Islands, which specialises in medical risks. Today three-quarters of America’s leading 500 firms have active captives in Bermuda alone. The business blossomed offshore rather than onshore because America’s state-by-state regulatory regime could not accommodate it—though a number of states, including Vermont, subsequently rewrote their rules to attract captives.

Even offshore’s fiercest critics acknowledge that captives have some virtues. However, they argue that much commercial investment through havens has no good economic rationale. A much-cited example is “round-tripping”, in which domestic investment is routed offshore to qualify for tax breaks reserved for foreign investors. Some suspect this accounts for a sizeable portion of “foreign” investment in India and China.

A bigger gripe concerns tax and regulatory competition. Mr Shaxson argues that competition between jurisdictions is not like competition between companies. If a firm cannot hold its own, the result is creative destruction; yet a country that cannot compete could become a failed state. In fact, some of the indicators used to measure a country’s competitiveness, such as education or infrastructure, suggest that higher taxes might have a beneficial effect. Mr Hines accepts that tax competition is “unresolved, even as a theoretical matter”. Mr Morriss acknowledges that regulatory competition sometimes backfires. Antigua, for instance, dropped its standards to the point where it became too easy for Allen Stanford to perpetrate a $7 billion fraud through a Ponzi scheme in the Caribbean and America.
Opacity is another problem. On a systemic level it makes the monitoring of financial stability more difficult. Murky vehicles held offshore, and off-balance-sheet, played a part in the financial crisis by concealing risks that banks had built up, though not even the fiercest critics of tax havens claim they were the main cause of the crisis.

Something in reserve

The fog also creates problems for statisticians, and by extension for economic policymakers. Gabriel Zucman of the Paris School of Economics examined anomalies in portfolio-investment data, concluding that official statistics significantly underestimate the net foreign assets of advanced economies because they fail to capture funds stashed away in tax havens. He estimates that 8% of all private financial wealth is held offshore, with three-quarters of it unrecorded. If he is right, the eurozone, officially a big net debtor, becomes a net creditor.

Dodgy funds from poor countries, too, are attracted by the secrecy offered by some jurisdictions. Even the most conservative estimates suggest that the outflow of funds linked to money-laundering, corruption, tax evasion and avoidance and deliberately mispriced commercial transactions exceeds total inflows of aid. Mr Henry calculates that the elites of 139 low-middle-income countries have parked up to $9.3 trillion of unrecorded wealth offshore. As with the eurozone, that turns some of them from big debtors into creditors. “Developing countries as a whole don’t face a debt problem, but a huge offshore tax-evasion and money-laundering problem,” he says.

Offshore moneymen insist that tighter controls have caused inflows of illicit funds to slow down dramatically. The Cayman Islands, for instance, largely complies with global anti-money-laundering standards. Yet questions linger over its implementation of its own rules. A recent American investigation revealed that in 2008, two years after the most recent peer review of its rules, HSBC accounts in Cayman were subject to “massive misuse...by organised crime” from Mexico and elsewhere, as one compliance officer put it. The bank had no information at all about the beneficial owners of 15% of the accounts, suggesting either incompetence or wilful blindness on the part of regulators.

Alex Cobham, an economist with Christian Aid who has studied financial flows to and from tax havens, thinks they attract as much money from poor countries as from rich ones, if not more. This not only deprives the countries concerned of much-needed tax revenue but gives the elites less incentive to build institutions at home.

This, though, is a problem onshore too. Ill-gotten gains often receive a warm welcome in large OECD countries, some of which offer more corporate secrecy than the leading tax havens. This is important for financial crime-fighting because anonymous shell companies and trusts are favourite ways of moving tainted money into the banking system.

From the print edition: Special report
SAM KOIM, THE chairman of Papua New Guinea’s anti-corruption watchdog, raised eyebrows at a meeting of financial crime-fighters in Sydney last October when he described how officials from his country were systematically “using Australia as a Cayman Islands” by laundering a significant portion of corruptly obtained funds through Australian banks and property deals. Papuans were thought to be the largest property investors in Australia’s far north. He vowed to keep up the pressure on Australia until it stopped taking such business.

The traditional image of a tax haven is a palm-fringed Caribbean island, a chillier outcrop in the English Channel or a European microstate such as Monaco or Liechtenstein. But offshore is not so much a geographical concept as a set of activities and offerings. What havens generally peddle is an escape from high taxes and strict regulation, along with easy incorporation and secrecy. Some of the biggest tax havens are in fact OECD economies, including America and Britain, that many would see as firmly onshore. They provide something the offshore islands cannot: a destination for money rather than a mere conduit, with first-world capital markets and banks backstopped by large numbers of taxpayers.

Latin Americans have flocked to banks in Miami for decades, both for legitimate reasons of confidentiality (for instance, fears that details of wealth held at home could be leaked) and to dodge
tax. A congressional investigator, asked where America keeps its dirtiest money, answers without hesitation: “Brickell” (Miami’s financial district).

Can this party go on? Under new IRS rules, from last month America’s banks have had to report interest payments to non-residents. In some circumstances this information could be shared with 80 countries that have information-exchange agreements with America. The regulations were bitterly opposed by Florida’s banks and politicians, who worried that Latin American depositors would flee in droves. They lost, victims of America’s need to offer some form of reciprocation as it presses foreign governments to provide details of Americans who hold money abroad. The scale of the withdrawals from Miami is not yet clear.

America’s other offshore speciality is shell-company registration. States such as Delaware and Nevada offer cheap, easy incorporation, with anonymity guaranteed. Registration agents do not even have to ask for ID, as they do in most tax havens. And what is not collected cannot be passed to the police, which is why criminals and debtors love American shells. Martin Kenney, a fraud-busting lawyer in the BVI, finds them harder to penetrate than vehicles in the Caribbean, where “there will at least be some sort of lead, even if only nominees, to help you start pounding through the layers.” Dodgy operators also like the air of legitimacy around an American company, and the ease with which shells can be used to open corporate bank accounts.

Delaware is America’s incorporation giant, with 945,000 active entities. It makes so much money from company fees that it does not need to levy taxes on sales. Like some of the classic offshore havens, it is a small state with an economy that relies heavily on services for non-residents. Its political class, left and right, is all in favour of crafting local laws to accommodate corporate customers. Registrations grew by an average of 7% a year in the decade to 2011, and anything that interferes with them is fought tooth and nail.

Delaware’s corporate spectrum is broad, with a few thousand public companies at one end, overseen by its world-renowned Chancery Court, and hundreds of thousands of tiny, opaque LLCs (limited-liability corporations) and partnerships at the other. Delaware lawyers say the sleazy reputation of the smaller entities is unjustified, and that many LLCs are created by respectable companies for joint ventures and property transactions. Jeffrey Bullock, Delaware’s secretary of state, insists that it has struck the right balance between curbing criminality and “paying deference to the millions of legitimate businesspeople who benefit” from hassle-free incorporation.

Some of the biggest tax havens are in fact OECD economies, including America and Britain, that many would see as firmly onshore.

But according to a World Bank database, American shells are the most popular corporate vehicles among perpetrators of large-scale corruption. An avid user was Viktor Bout, known as the “Merchant of Death”, a convicted arms smuggler. In a study last year three academics, led by Griffith University’s Mr Sharman, approached shell-company providers around the world posing as
corrupt officials and money-launderers. They found that OECD countries were less compliant than
tax havens with international standards on corporate transparency, that America was among the
least compliant, and that Delaware was one of the worst states (with not a single fully compliant
response). Investigators joke that Delaware stands for “Dollars and Euros Laundered And Washed
At Reasonable Expense”.

A federal bill supported by Barack Obama, which would force states to collect information on
beneficial owners (the human sort rather than “legal persons” such as trusts), has been stalled for
several years. The formidable anti-reform coalition includes the national lawyers’ association and
the United States Chamber of Commerce.

Britain, too, offers lax rules to crafty operators. A report last year by Global Witness, a campaigning
group, highlighted the use of British shells as cover for allegedly corrupt funds originating in Central
Asia. The main shareholder of one of the companies was a Russian who had died years before the
company was registered. Other firms featured nominee shareholders and directors from the BVI
and the Seychelles who were, as the authors put it, “paid to pimp their identities” (perfectly legally)
for their customers to hide behind.

Investigators also point the finger at limited-liability partnerships, introduced in Britain a decade
ago at the urging of accounting firms whose partners were hoping to dilute their long-standing
“joint and several” liability. This corporate form has since been widely misused by people other than
accountants to hide or shift dirty money. Most LLPs do not have to file tax returns, be audited or
have real people as directors.

A 2011 report by Britain’s Financial Services Authority concluded that British banks suffered from
serious flaws in their controls so that, knowingly or unknowingly, many of them were handling the
proceeds of corruption. Most worrying, the regulator found there had been little progress in
compliance since its previous review in 2001. And even as the British government bludgeons rich
nationals who use offshore structures, it continues to offer wealthy resident “non-doms” juicy tax
advantages.

The City of London first dabbled in offshore finance in the 1950s with the creation of the
“euromarkets”—unregulated finance in dollars and other currencies outside their home markets.
This grew rapidly, fuelled by Wall Street firms that used it to escape restrictions at home. The City’s
offshore connections strengthened from the 1970s to the 1990s when British overseas territories in
the Caribbean joined the crown dependencies of Jersey, Guernsey and the Isle of Man in tailoring
their laws to attract deep-pocketed non-residents. Today London is at the centre of a vast
hub-and-spoke system, with the offshore territories acting as feeders. Banks in Jersey, for instance,
who could not possibly find borrowers for all the deposits they take in, pump most of them into the
Square Mile, where they finance a variety of activities at the big banks and securities firms.

Ronen Palan of London’s City University calls this “Britain’s second empire”, noting that one-third
of all international deposits and investments flow through Britain and its offshore satellites. The strength of their relationship shows up in IMF data that make it clear Britain’s and America’s financial links to offshore centres are far closer than the euro area’s and Japan’s.

America has its own (smaller) offshore zone of influence. This includes the Marshall Islands, a former possession, which offers some particularly impenetrable corporate structures and is one of the five most secretive tax havens, according to a ranking by the Tax Justice Network. The islands’ corporate registry is run by a private company in Reston, Virginia, which casts an odd light on America’s relentless bashing of the tax regimes in Switzerland and the Cayman Islands.

Britain aside, the European Union has several other tax havens. Ireland is popular with mutual funds and tax-planning companies. The Netherlands is the world’s largest venue for tax-treaty shopping. Multinationals put foreign investment through Dutch holding companies to avoid withholding taxes on dividends. U2, a stadium-filling rock band, upset fans when it moved part of its business to the Netherlands to cut its tax bill.

Luxembourg has bigger and broader offshore offerings, hosting large numbers of “tax-efficient” corporate transactions and thousands of mutual funds with around $3.2 trillion in assets, though most are managed elsewhere. As in traditional tax havens, finance plays an outsized role in the economy: in a country of 525,000, some 13,000 jobs are linked to the fund industry alone. Luxembourg works hard for new business. The Grand Duchy now presents a bigger competitive threat to the BVI than its Caribbean neighbours do, says a lawyer in Road Town.

FATF chance

Luxembourg has a poor record on tax transparency and combating financial crime. Along with Austria it has held out against full participation in the EU’s savings directive, under which members swap information on bank interest paid to each other’s citizens. Of all OECD countries, it is the furthest from meeting the requirements of the Financial Action Task Force (FATF), the multilateral body that sets standards for anti-money-laundering. And the rest of the OECD, in turn, is mostly less compliant than the leading OFCs (see chart 3).

This highlights a serious flaw in global anti-money-laundering standards. Small OFCs and developing countries have been arm-twisted into adopting a stringent set of rules, which they have done mostly without kicking up a fuss for fear of being blacklisted. Meanwhile the advanced economies that insisted on the standards, and to which they are probably better suited, have been less conscientious in applying them. The majority of OECD countries are only partially compliant with the FATF standard on effective sanctions against failures of anti-money-laundering measures. Richard Hay of Stikeman Elliott, who advises offshore law firms, suggests that these double standards, far from being accidental, are the result of “a policy of commercial hegemony” designed to keep tax havens in their place.
Correction: The original version of this article said that Delaware has no sales tax and no personal income tax. We were right on the first, wrong on the second. This was corrected on February 20th 2013.

From the print edition: Special report
NOT ONE TO mince words, Daniel Mitchell of the right-wing Cato Institute denounces the OECD’s push to co-ordinate global tax enforcement as “the devil’s spawn” and possibly even a step towards the fiscal equivalent of—shudder!—the World Trade Organisation. Tax havens “should not have to enforce the burdensome tax laws of other countries”, he thunders. “Having grown rich with the tax policies of their choosing, the OECD countries are pulling up the ladder and saying, ‘you can’t do the same to attract investment’. It’s fiscal imperialism.”

To tax-freedom advocates like Mr Mitchell, one of the most infuriating aspects of this perceived imperialism is the complete overhaul of cross-border information exchange. It is technical stuff, but the changes are extremely important. They promise to shine a light on some of the darkest corners of banking and investing, not only making tax evasion much harder but also casting a net over a host of other financial sins—and, along the way, testing financial firms’ compliance departments to the limit.

The new era began in 2009 with something of a false start. The G20 decreed that in order to be considered clean, tax havens had to sign bilateral tax-information exchange agreements (TIEAs) with at least 12 other jurisdictions. This led to a surge in TIEAs and tax-treaty amendments (see chart 4 below) and the fairly prompt removal of tax havens from the OECD blacklist. The accords call for exchange “on request”. A country has to share information only if the other signatory asks for it and the request is based on well-founded suspicions.

Ask, and it shall be given?

The OECD touted this as a step towards transparency that would also respect individuals’ right to confidentiality as much as possible. But tax investigators complain that the process for getting information is cumbersome and the bar has been set too high. “You already have to have pretty
much all the information you’re after to get the last piece. It’s a catch-22,” says one. That may explain why the number of requests made has been small.

Offshore officials have complaints of their own. Françoise Hendy, Barbados’s chief tax negotiator, thinks that the real motive for promoting TIEAs was to draw the tax havens’ competitive sting, because TIEAs do not offer the same benefits as the full-blown double-taxation treaties that OFCs such as Barbados generally prefer. And small jurisdictions felt obliged to comply even though they knew that the main target was Switzerland.

Moreover, the TIEAs did not appear to reduce financial flows to tax havens. An academic study of the crackdown by Niels Johannesen of the University of Copenhagen and Gabriel Zucman of the Paris School of Economics looked at data on cross-border bank deposits in 2009-11 and found that, despite modest outflows from less compliant jurisdictions, the overall level of funds in OFCs barely changed.

Tax NGOs say the “on request” model is a dud and that tax transparency can be achieved only through the regular, automatic exchange of information. America gave the world a big push in this direction in 2010 when it passed the Foreign Account Tax Compliance Act (FATCA). This requires foreign
financial firms to identify account-holders and investors who might be American. If the clients do not reply to inquiries, they will have a 30% tax withheld from their income arising in America. The rules will be phased in over four years, starting in 2014.

FATCA’s intrusiveness has caused concern among banks and fund managers. It raises big questions about data privacy. Compliance costs, mostly borne overseas, are likely to be at least double the revenue that the law will generate for America. The necessary overhauls of systems and procedures and the extra digging around to identify American clients could add $100m or more to a large bank’s administrative costs. No wonder bankers have dubbed FATCA the Fear And Total Confusion Act.

An OECD tax official describes the law as “awful, in a way, like a nuclear bomb” but also sees it as “a remarkable leap forward for transparency”. And though it began as a brazenly unilateral move, it has since become more inclusive. America has signed or is negotiating bilateral agreements with 50 countries, each of which would accept some version of FATCA. In return America would offer information on its holdings of their citizens’ money. The resulting patchwork of intergovernmental agreements, each one slightly different, will add further to the compliance burden for international banks and fund managers.

The biggest benefit of automatic exchange is that it deters rather than detects

Inspired by America’s chutzpah, other countries are drawing up similar legislation of their own. Britain is planning to impose a so-called “Son of FATCA” on its dependencies. The Isle of Man has already agreed to this; its chief minister accepts that automatic exchange “is becoming the global standard”. Jersey and others are holding out for now, but will come under increasing pressure to sign up. “It’s the last days of the Roman Empire,” mutters a senior Cayman lawyer.

The automatic-exchange model also enjoys support from some big emerging economies, such as India. And the practice has already been adopted within the European Union (apart from a few holdouts) for cross-border bank deposits, through the EU’s savings directive (EUSD). But the EU’s experience has been mixed, not least because the original directive was riddled with loopholes. Some have been closed through amendments, more of which are proposed, but gaps will remain.

Another problem with automatic exchange is the huge quantities of data it produces. Europe’s tax authorities have struggled to stay on top of the information swapped under the directive. An official from a British dependency taking part in the EUSD reportedly complained that some countries which receive encrypted DVDs with client information do not even get round to asking for the decryption key. And information is not necessarily helpful if the recipient still has to penetrate the web of shell companies, trusts and foundations between the account and the beneficial owner.

A further concern is the risk of misuse of information by corrupt administrations, or rogue government employees, such as the sale of personal financial data to would-be kidnappers. Global
automatic exchange is “a developed-world solution for a global economy unsuited to it”, argues Geoff Cook of Jersey Finance. Some developing countries lack the administration to deal with it, says Gurbachan Singh, a tax lawyer in Singapore. In places like Indonesia “you may have a tax officer but not a proper tax office.”

Tax campaigners argue that appropriate checks and balances can be put in place in most countries. Governments in the developing world already have access to lots of sensitive information about their citizens. And the biggest benefit of automatic exchange is that it deters rather than detects, says John Christensen of the Tax Justice Network (TJN).

Even ultra-secretive Switzerland has made some concessions, such as entertaining other countries’ “group requests” for information on, say, a batch of unidentified clients of a particular bank. But the Swiss remain firmly opposed to automatic exchange and continue to push their own model, dubbed the “rubik” because of its complexity, which involves handing over money but no names. It has signed deals with Britain and Austria under which it will collect and pass on penalties imposed on clients for past evasion, as well as withholding tax on their future investment income. But Germany’s upper house, the Bundesrat, has rejected the Swiss accord with Germany, seriously undermining the rubik project.

Like the EUSD, the rubiks have been criticised for being leaky. The TJN’s analysts believe that the deal with Britain will raise only a small fraction of the £5 billion that the British government hopes to collect. Whatever the type of agreement, implementation is just as important as design. Some of the Caribbean tax havens that received a pat on the back for signing lots of TIEAs have dragged their feet when asked for assistance.

Universal information exchange is still a long way off, if it happens at all. But not so long ago the norm for countries, whether onshore or offshore, was to refuse any co-operation on cross-border tax enforcement, so a lot has been achieved. That cannot—yet—be said of reform efforts in the corporate sphere.

From the print edition: Special report
DURING THE TAX-EVASION trial of Leona Helmsley, a flamboyant hotelier, a former housekeeper testified that she heard her employer say: “We don’t pay taxes. Only the little people pay taxes.” These days, multinational companies stand accused of taking a similarly haughty attitude to their fiscal affairs, shifting profits offshore to cut their tax bills. Many of the tax-avoidance techniques being employed are legal, but many others are ruled to be illegal over time or occupy a grey area between the two. Corporate tax directors have generally worked on the basis that a strategy is legitimate until it is ruled illegal, no matter how aggressively it is structured. Their opponents recall the words of Denis Healey, a former British chancellor, who suggested that the difference between avoidance and evasion was “the thickness of a prison wall”.

The public outcry is forcing tax administrators to rethink their policies. Indignation has been greatest in Europe, with particular venom aimed at Google and Starbucks. In December the coffee chain volunteered to pay around £10m more tax in Britain than it owed, following the news that in 14 years of operation in that country it had paid only £8.6m in corporation tax. Various governments have rushed out anti-avoidance “action plans” and general anti-abuse rules.

The political heat has risen in America, too, fanned by Senate hearings last year on tax-saving manoeuvres by Microsoft and HP that routed profits through Bermuda, Puerto Rico and other havens. Not only do large companies shift profits out of America, where the corporate tax rate is 35%, but they also massage down the rate they pay at home by using all manner of tax breaks and loopholes, to an average of just 17.3% in 2009-10, according to Citizens for Tax Justice and the
Institute on Taxation and Economic Policy.

Profit-shifting has increased even as corporate tax rates have fallen in OECD countries, from an average of 32.6% in 2000 to 25.4% in 2011. In America corporate profits as a share of GDP have been at record levels in recent years, but the corporate tax take as a proportion of federal revenues has been near historic lows. Tax experts see a link between these declining receipts and the growing use of tax havens.

This is a big issue for developing countries, too. In Africa it is not uncommon for a multinational to siphon off the bulk of the taxable profits from its local operations. Global Financial Integrity calculates that mispriced cross-border transactions within companies and the mis invoicing of trade between different parties together account for up to two-thirds of “illicit” (illegal or legally contentious) outflows from poor countries. It believes, startlingly, that transfers within corporate families account for 50-60% of the global trade figures.

Built for another age

The heart of the problem is that tax collection has failed to keep pace with business as it has globalised. The main pillars of the international tax system were built nearly a century ago. It treats multinationals as if they were loose collections of separate entities operating in different jurisdictions, giving companies huge scope to move income around the world to minimise their tax liabilities.

One of the main vehicles of corporate tax avoidance is a practice known as transfer pricing. Under international rules, transactions between company subsidiaries are supposed to be priced as if they were conducted “at arm’s length” between unrelated parties. In practice, though, the price can be adjusted to move profits to the lower-tax jurisdiction and expenses to the higher-tax one. The more complex the transaction, the easier this becomes. Many tax-haven subsidiaries are essentially shell companies that exist only to hold intellectual-property (IP) rights and charge other parts of the group for their use or provide other “services” at above-market rates. Transfer pricing (really mispricing) is sometimes also used to load costs onto countries that offer generous subsidies, especially in extractive industries. It has become a key plank of multinational tax strategies.

Technology companies, with oodles of IP to shift around, are avid practitioners of the art. Google, for instance, avoided a tax bill of around $2 billion in 2011 by moving almost $10 billion into a unit in Bermuda, a jurisdiction that levies no corporate income tax. Bermuda is the legal residence for tax purposes of an Irish subsidiary which collects royalties from another Irish division which in turn had collected revenues from ads sold across Europe (a structure known as the “Double Irish”). To avoid an Irish withholding tax, the company added a “Dutch Sandwich” to its tax-planning menu, routing the payments to Bermuda through a shell in the Netherlands. The end result is that there is little connection between where the economic activity takes place and where the profits are booked.
This can happen in more humdrum industries too. In a 2010 report ActionAid calculated that SABMiller, a giant brewer, had avoided around $30m a year in taxes in Africa and India through a variety of devices, including holding valuable trademarks for African beers in low-tax European countries. SABMiller said the analysis was flawed. Brass-plate Swiss companies have been used to strip profits from Zambian copper ventures.

Such data as are available suggest a big increase in the allocation of profits to havens over the past decade. All but two of the firms in the FTSE 100 have at least one offshore subsidiary. The share of American corporate profits booked in tax havens is six to 14 times those jurisdictions’ share of global GDP, calculates Alex Cobham, an economist with Save the Children. American companies are thought to hold $1.6 trillion offshore, which most are reluctant to repatriate unless offered a tax break. The concern has shifted from companies worrying about double taxation to governments fretting about double non-taxation, says Pascal Saint-Amans, head of the OECD’s tax division.

Not our fault

Some executives argue that tax avoidance is a mere symptom, the real disease being the high corporate tax rates and complex rules imposed by rich countries. Others point out that they are big employers and contribute a lot in payroll taxes. Eric Schmidt, Google’s chairman, has said he is “very proud” of his company’s tax-avoidance structures, which are “based on the incentives that the governments offered us to operate”. Accountancy firms have long supported such strategies, though they are becoming more concerned about reputation risk (see article).

Companies may feel bound to exploit weaknesses in the rules, if only because not doing so would put them at a competitive disadvantage. And there are certainly flaws in the global transfer-pricing guidelines overseen by the OECD. Most tax experts see the arm’s-length principle as unworkable because internal transactions often bear no resemblance to those between unrelated entities. Moreover, many countries have adopted national rules that have created a confusing regulatory thicket.

The system has become so complex that a completely new approach is needed. One intriguing proposal, unitary taxation, would aim to tax activities where they actually occur, not where some tax adviser has shifted them. The company would produce a single set of accounts and its worldwide profits would then be apportioned using a formula that takes in assets, sales and other measures in each jurisdiction. This is already being used in some federal systems, including a majority of American states. Unitary taxation comes with its own challenges, however. Agreeing on where exactly business takes place in a world of services and intangible assets is tricky.

Under intense pressure to do something, the OECD has promised to draw up a plan by the summer. But it is opposed to radical change, arguing that unitary taxation is no better than the current...
arrangements and lacks broad political support. “You’d be swapping one flawed system for another, with the added disadvantage that a new one takes ten years to put in place,” says Mr Saint-Amans. So the most likely outcome is an attempt to simplify the current tangle of rules, perhaps with a push for a global accord on the streamlined version and some specific measures against egregious avoidance schemes. The OECD has already published a guide to help tax authorities spot such ruses, containing details of the 400 most daring.

But this could prove a futile effort to mend a discredited system that is beyond repair. Tax activists accuse the OECD’s tax committee of being cosy with the companies and tax specialists who have an interest in maintaining the status quo. With or without unitary taxation, the activists continue to promote country-by-country reporting. This would require multinationals to disclose the name, location, financial performance and tax liability of each of their subsidiaries and thus reveal the role played by havens. Accounting standard-setters are cool on the idea, but there is some political enthusiasm and a start has been made: both America and the EU now require firms in extractive industries to disclose their payments to governments on a country-by-country basis.

America could do more to reduce companies’ use of havens, over and above cutting its own corporate tax rate. A proposal now on the table that would require American-managed or -controlled firms to be taxed as domestic entities, even if domiciled elsewhere, would reverse the long-term expansion of tax deferral for offshore income, making profit-shifting less attractive. But corporate lobbyists fiercely oppose it.

Developing countries, meanwhile, could do more to increase their leverage in transfer-pricing skirmishes, argues Krishen Mehta, a former partner at PwC. They could, for instance, require that a statutory auditor confirm the legitimacy of offshore transactions, as Mexico does. Galvanised by the SABMiller case, tax authorities in emerging markets are starting to push back against the multinationals, setting up cross-border bodies to share expertise. They are getting help from the OECD, which lends out specialists under its “tax inspectors without borders” initiative, though they will face an uphill struggle because the companies have bottomless legal budgets.

The tax avoiders now find themselves in a bind. The current status quo is bliss for them, and lobbying to maintain it is money well spent. For the largest of them, a tax reduction of a single percentage point means a saving of more than $200m. Yet pressure not to push avoidance too far is mounting, and NGOs are keeping a closer watch. Ultimately the companies may have more to fear from the public than from governments. After all, it was a threatened boycott by consumer groups that drove Starbucks to offer its voluntary contribution to the public coffers.

From the print edition: Special report
Switzerland and its rivals

Rise of the midshores

The offshore industry’s centre of gravity is shifting eastwards

Feb 16th 2013  |  From the print edition

AT THE CENTENNIAL gathering of the Swiss Bankers Association last November, held at a swanky hotel in the hills above Zurich, the celebrations were muted. In his opening address the group’s chairman, Patrick Odier, felt obliged to note that “we have an image problem.” His worry was not that only half a dozen of the audience of more than 100 were women. Instead, he was referring to his industry’s travails since America launched its all-out assault five years ago on banks that served tax evaders.

Switzerland is still the world leader in wealth management, looking after $2.1 trillion in assets. But the attacks from Washington, DC, and, more recently, European capitals have sent its moneymen reeling. In 2009 UBS paid America $780m to end a tax-evasion investigation; when Switzerland’s oldest bank, Wegelin & Co, snapped up many of UBS’s undeclared clients, prosecutors took it to court. The bank pleaded guilty, paid a large fine and has decided to close. Under the UBS settlement thousands of client names were handed to America, knocking chunks out of the once-impregnable wall of Swiss bank secrecy.

The beleaguered Alpine country has since been badgered into agreeing to co-operate in cases of suspected tax evasion as well as fraud—“an earthquake” for a nation that treats evasion as a mere civil offence, says René Matteotti, a tax lawyer in Zurich. With help from leads generated by the UBS settlement, America is going after 11 other Swiss banks, including Credit Suisse and Julius Bär. Switzerland wants a single settlement covering all its banks, but America seems to want to pick them off one by one. Negotiations with European countries are no easier now that Germany has rejected a Swiss proposal to levy and pass on penalties for German tax cheats while preserving their
anonymity. The Swiss banks worry that their government could end up with a dizzyingly complex patchwork of bilateral arrangements.

Less luxe

The industry’s commercial prospects are equally uncertain. Before the crackdown the Swiss found offshore private banking highly profitable. They could earn twice as much as banks in Britain doing the same thing, reckons one official, because they could build some of the tax savings on undeclared funds into their fees. Much of that easy money has gone. This is a challenge for “an industry with no real history of transformation”, says Peter Damisch, head of the global wealth practice at the Boston Consulting Group (BCG).

There is talk of a coming wave of consolidation once the legal clouds lift. Smaller banks could struggle to survive. Some of the independent outfits that help devise offshore holding structures for the banks’ clients have put themselves up for sale. The strongest of the survivors may have grounds for cautious optimism. Mr Damisch expects Swiss assets originating from Europe to decline by up to a third in coming years as undeclared money is “regularised” (American assets are already negligible). But he expects to see offsetting growth in emerging markets.

Still, the next few years will provide a stern test of the Swiss brand in private banking. They will have to show that the selling-points they have long touted—political and economic stability, top-notch service and a holistic investment approach—count for more than the ability to hide money.

They can at least console themselves that they still have some lobbying power. Amid fierce opposition, the Swiss government has dropped a proposal that would have required banks to reject deposits from clients who refused to declare that they were tax-compliant. This was to be part of a national “white-money strategy”, still in the making, to shed Switzerland’s image as a tax haven once and for all. Critics suspect it is a smokescreen.

All in all, the Swiss have played their hand badly since 2008. The banks gambled that other countries would continue to turn a blind eye to tax-dodging. The government underestimated the ferocity of the response and then fought fires as they appeared rather than pushing for an overall solution. “Switzerland always gets it wrong when there’s an external crisis,” says a former adviser to its banks, pointing to an earlier debacle over Holocaust-era accounts. “They think they’ll be forgiven because they’re neutral and play a useful role in global diplomacy.”

By contrast, next-door Liechtenstein, which produced many of the secrecy structures that Swiss banks sold, has won plaudits for reacting promptly to international pressure. Just months after a local tax-evasion scandal erupted in 2008, the tiny principality had launched comprehensive information-exchange agreements in Europe and America. It has made up for some of the lost business by crafting a unique deal with Britain, the Liechtenstein Disclosure Facility. Britons with tainted assets in the principality’s banks can come clean and pay a 10% penalty (which some think
too lenient). Crucially, those who bring in money from other jurisdictions, including Switzerland, are also eligible. Liechtenstein hopes to kill two birds with one stone, winning new business even as it cleans up its own act. Half of the 3,000 people who have taken advantage of the facility so far have brought in their assets from elsewhere. Britain has tripled its forecast for the amount it will raise, to £3 billion.

Singapore zing

The Swiss are keeping an eye on the rise of Asia’s private-banking centres, particularly Singapore. For years the offshore world has swirled with rumours that money from Switzerland, Jersey and other European centres was heading east. They may have been exaggerated: the portion of wealth of European origin managed in Singapore and Hong Kong has gone up by only one percentage point in the past three years, to 8-9% of the total, according to BCG. But the Asian offshore centres do not need help from Europe. Singapore has been sucking in vast sums from South-East Asia, particularly Indonesia, and smaller amounts from India and China. If recent growth continues, Singapore and Hong Kong combined could overtake Switzerland in the next 15 years, reckons BCG.

One question is how they will deal with growing international pressure for greater openness. Singapore, for instance, has strict bank-secrecy laws and a poor record on exchanging information. Four years ago it was branded “out on a limb” by the OECD’s tax chief. Recently it has made concessions, signing dozens of bilateral information accords and making tax evasion a “predicate” offence for money-laundering, which means it can be dealt with more sternly. Local lawyers say secrecy is no longer absolute. In any case, Asians generally choose to bank in Singapore for its economic and political stability, not to hide untaxed income, says Barend Janssens of RBC Wealth Management.

Singapore’s apparent commitment to greater openness has yet to be tested. Meanwhile Hong Kong, which registers 150,000 new companies each year, has taken a step in the opposite direction, making it harder for outsiders to identify the directors of private companies. Asia’s offshore centres are becoming big sellers of corporate and investment vehicles, some of them deliberately opaque. Singapore is big in trusts—unregistered asset-protection vehicles that practitioners argue are “relationships” rather than owned entities. These are increasingly popular with rich Chinese keen to preserve newly acquired wealth.

Offshore centres have to strike a delicate balance when levying fees and taxes on the industry

Private-equity firms have become big investors in the offshore-incorporation business, lured by the strong, stable cashflows from registration and renewal fees. They like “midshore” jurisdictions such as Singapore and Hong Kong that combine offshore traits (low tax, secrecy) and onshore ones (sophisticated, well-staffed financial centres). Martin Crawford, chief executive of OIL, a big offshore service provider, argues that midshores will thrive as regulatory pressure on pure offshore centres grows.
This eastern expansion will present both opportunities and threats to Switzerland. Some of its banking clients are defecting to Asia, but the big Swiss firms, particularly UBS, are wealth-management leaders in that region. Much the same applies to the main Anglo-Saxon tax havens, such as the Cayman and British Virgin Islands and Jersey. Asians are familiar with the products they offer, particularly those from Cayman and the BVI; indeed, some Chinese use “BVI” as a generic term for an offshore firm. But these jurisdictions worry that Asian clients will increasingly shop closer to home, and have responded by stepping up their marketing efforts in Asia, sending high-level delegations and opening representative offices.

According to an industry survey by OIL last year, Hong Kong could overtake the BVI as the leading seller of offshore firms within five years. A senior BVI official expresses regret that his jurisdiction did not see this coming earlier and push harder into areas such as hedge and private-equity funds. To be taken seriously in such higher-end businesses, the BVI would have to smarten itself up: its capital, Road Town, is charming but shabby, as are most corporate offices. The small, dingy meeting room of its sole vaguely international bank is more bedsit than bastion of finance. Richard Peters, the BVI’s pre-eminent corporate lawyer, sees a “slow run-off over time” in the islands’ core business and thinks “it may be too late for all those new products now.”

After the party

Cayman, the most diversified of the Caribbean havens, has its own worries. Its banking assets have declined by 20% from their peak and structured finance is down by considerably more. Overall deal flow fell by 40% during the crisis and is now in “a very shallow climb,” says Kevin Butler of Conyers Dill & Pearman, a law firm. Cayman has maintained its spot as the main hedge-fund domicile, though numbers have dipped by 9%. A lot of fund administration work has gone back onshore, enticed by Canadian provinces, American states and Asian countries dangling tax breaks. The recent ousting for alleged corruption of the Caymanian premier, McKeeva Bush, has not helped.

Cayman’s public sector expanded hugely in the go-go years before the crisis, but it became a fiscal albatross as fees from offshore firms shrank. In response, the government tried to introduce a direct tax on expatriate workers but scrapped it amid fierce opposition from the foreign residents, who make up 40% of the population. Cayman bankers expect their annual licence fees to rise by up to 50% as officials try to plug holes.

Jersey has suffered a similar decline in bank and fund assets. The island has tried to turn regulation to its advantage, marketing itself as being at the “high-value”, respectable end of the tax-haven spectrum. But its time-consuming rules for everything from corporate registration to verifying the provenance of bank deposits are scaring off clean as well as dirty
business, claim offshore bankers and corporate service providers. Mr Crawford says Asian law firms have been asking OIL to help move their clients from Channel Islands trusts to Singaporean ones. Jersey has hired McKinsey to help it navigate its challenges. Keeping tax for most companies at zero is “sacrosanct”, says an official, so the island responded to the squeeze by bringing in a 3% goods-and-services tax (a kind of VAT), subsequently raised to 5%. “When they need more they’ll just turn the spigot, and it’s the locals who’ll pay,” complains John Heys, a tour guide and activist.

Orlando Smith, the BVI’s premier, accepts that offshore centres have to strike a “delicate balance” when levying fees and taxes. If the industry feels squeezed too hard by the OECD’s rulemakers on one side and the local politicians on the other, it might move elsewhere. In jurisdictions where finance typically accounts for around half of GDP, that is no small concern.

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