9-1-2001

The Future of Offshore Tax Havens

Taylor Morgan Hoffman

Recommended Citation
Available at: http://chicagounbound.uchicago.edu/cjil/vol2/iss2/22

This Article is brought to you for free and open access by Chicago Unbound. It has been accepted for inclusion in Chicago Journal of International Law by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.
Recently, the Organization for Economic Cooperation and Development ("OECD") issued a report targeting "harmful tax regimes"—preferential, low tax regimes that are primarily tailored to tap into the tax bases of other countries. The report, *Towards Global Tax Cooperation: Progress in Identifying and Eliminating Harmful Tax Practices* ("Towards Global Tax Cooperation"),\(^1\) identified a list of tax practices the OECD deemed harmful, such as "ring-fencing" (where foreign customers are subject to rules different than those applied to citizens which encourages the establishment of foreign entities with no substantial activities), a lack of transparency, and the absence of information exchange regarding tax practices. The OECD then released a second report, *Framework for a Collective Memorandum of Understanding on Eliminating Harmful Tax Practices* ("Framework").\(^2\) This report listed the OECD's objections to the policies of harmful tax regimes and provided a host of scheduled remedies, which presumably would be backed by the threat of sanctions detailed in *Towards Global Tax Cooperation*.

Not surprisingly, the Commonwealth countries were among those identified as having harmful tax practices. In January 2001, the OECD met with the Commonwealth countries and other tax haven regimes to negotiate a "mutually acceptable" tax policy. What took place both during and after these negotiations is the subject of this Development.

After highlighting the issues at stake and addressing the January negotiations, this Development will consider how two Caribbean countries, the Bahamas and Bermuda, have reacted to the OECD's proposals. These countries provide a good illustration of contrasting positions: while the OECD deemed the Bahamas "non-cooperating," Bermuda gave advance commitment to the OECD proposals. Yet both

\(^*\) BA, Lawrence University, 1999; JD candidate, University of Chicago, 2002.


have essentially adopted the core principles of the OECD proposals that eventually emerged from the January 2001 negotiations. Next, the essay will discuss the role of the Bush administration in shaping the accepted OECD proposals. Finally, in considering the future of tax havens, this Development will conclude that the compromised position advanced by the Bush administration was merely an affirmation of the course of reform already begun by the offshore tax haven regimes themselves.

I. THE NEGOTIATIONS

Towards Global Tax Cooperation and Framework provide the foundation for solving what the OECD considers to be the problems caused by harmful tax practices. As a result, they also serve as the foundation for ongoing negotiations between the OECD and the countries identified as engaging in such practices. However, the road to the negotiation table has been obstructed by a number of issues, including traditional North-South tensions, the unilateral approach taken by the OECD, and attendant sovereignty concerns (namely, the right to determine internal policies of taxation).

As a result, the January 2001 tax policy negotiations between the OECD and tax havens were less than amiable. However, the OECD agreed to forego its rigid implementation schedule by withdrawing its Framework in exchange for proceeding with the reform initiative on the basic principles set forth by the OECD—transparency, non-discrimination, and effective exchange of information. A task force was set up to find a mutually acceptable political process that would transform the OECD principles into commitments and to continue the dialogue begun at the January meeting. The OECD gave the “offending” nations until July 31, 2001 to cooperate with its program or face economic repercussions.

Under pressure from the new Bush administration, modifications were made to the original plan at the meeting of G-7 Finance Ministers in July. Specifically, the Finance Ministers agreed that coordinated sanctions or “defensive measures” would become effective for uncooperative tax haven jurisdictions no earlier than they would for similarly situated OECD member countries; the July compliance deadline would be pushed back to November 30, 2001; and the “no substantial activities” criterion would no longer be applied to identify a jurisdiction as “uncooperative.” A spokesperson for the OECD said that OECD member countries would not implement sanctions until April 2003 at the earliest.

II. THE STAKES

With British encouragement, many Caribbean countries developed financial industries when they gained their independence in the 1960s. These financial industries provided a means of economic diversification in times of falling commodities prices and a highly competitive tourist market. These countries employed tax regimes with no or only nominal rates and strict secrecy rules. As a
result, their financial markets flourished. Indeed, in terms of the size of its capital market, the Cayman Islands is the fifth largest in the world, behind New York, London, Tokyo, and Hong Kong. From 1985 to 1994 the value of investments put into the low tax jurisdictions of the Caribbean and South Pacific islands grew fivefold, to over $200 billion. Some estimates put the figure in the trillions.

The Caribbean nations fear that the OECD plan will devastate their economies. Indeed, some might see their Gross Domestic Product ("GDP") drop as much as 25 percent because their economies are so heavily dependent on the financial industry. Financial services provides about one third of Barbados' government revenues. Some Caribbean financiers also fear a domino effect: that troubled economies brought on by these new regulations will invite corruption and high crime rates, which would in turn ruin the tourist industry and force Caribbean nations to rely on foreign aid.

The OECD countries see their vital interests at stake as well. Tax haven privacy laws make it tough for countries to tax the worldwide income and assets of their citizens. As a result, OECD member countries, especially the high-tax regimes of Europe, are losing a considerable amount of revenue to tax evasion. The US estimates that it loses $70 billion annually in taxes from Americans using offshore accounts. In addition, OECD countries worry about the over-reporting of income as international criminals launder money in these tax havens with impunity. The Caribbean nations, however, are quick to point out that billions of dollars in laundered money sits in New York and London financial institutions. Regardless of location, money laundering is a serious issue. International Monetary Fund Managing Director Michel Camdessus estimates that money laundering constitutes between $800 billion and $2 trillion per year. In addition to financial concerns, former Special Advisor to the Secretary of the Treasury, William F. Wechsler, argues that US security is at stake as rogue banking has helped Saddam Hussein stay in power and has fueled Slobodan Milosevic's war machine.

But the core issue for OECD countries in launching their campaign may have been what they perceive as the predatory policies of tax regimes. Rather than attracting true foreign investment, the purpose of predatory tax regimes is to siphon off part of another country's tax base. For instance, policies in the Cayman Islands enabled Fruit of the Loom to save almost $100 million in taxes every year by moving its headquarters there. With a population of 35,000, the Cayman Islands has

7. Id at 48.
banking assets which exceed $670 billion and is home to 570 banks and trust companies, 2,240 mutual funds, and 45,000 offshore businesses. In addition, it is estimated that more than $800 billion in US currency is held in the Cayman Islands. Combined, the so-called tax havens account for 1.2 percent of the world population and 3 percent of the world GDP, but 26 percent of the assets and 31 percent of the net profits of American multinationals (though only 4.3 percent of their workers).

The advancing technology of the Internet has made these activities considerably easier. For example, one Internet site advertising offshore brokerage accounts in Dominica boasts, "US stocks, bonds, options, currencies and mutual funds are frequently bought through offshore companies because they are not liable to US capital gains taxes." Another brags that Dominica is "one of the best tax havens, unbeatable for offshore company formations, offshore accounts, online banking and asset protection in total secrecy." The site also advertises that there is no requirement to file accounting information with any authority and that there is a complete exemption from all local taxes, death duties, and other similar charges.

III. BERMUDA

On May 15, 2000 Bermuda contacted the OECD, pledging its advance commitment to the OECD guidelines. Bermuda, once legendary for offshore corruption, now possesses an established independent regulator and has been open to new regulations. Its Premier, Jennifer Smith, has noted that "[w]e negotiate and seek solutions that provide the maximum mutual benefits. Bermuda will continue to stand apart as the jurisdiction for high-quality legitimate business."

Currently, Bermuda does not tax profits, dividends, or income (corporate or personal). Moreover, there are no capital gains taxes, withholding taxes, or gift taxes. International companies registered in Bermuda may apply for exemption from any taxes on profits or income until the year 2016, should such taxes ever be assessed. Revenues are raised from customs duties, employment taxes, hospital levies, land taxes, and various other minor levies such as stamp duties.

With one of the highest per capita incomes in the world, and as a British dependency, Bermuda has less to lose than the Bahamas by complying with the OECD's proposals. In addition, many Bermudan financiers are concerned that an unfavorable label from the OECD would do more to harm the financial industry than

9. Wechsler, 80 Foreign Aff at 42 (cited in note 6).
would the new reforms. Therefore, Bermuda amiably signed on to the OECD's proposals.

Despite fears of initial changes and irritation over the OECD's high-handed tactics, there is a great deal of optimism in the Bermudan business community about the reforms required by the OECD. Ray Medeiros, chairman of the Bermuda International Business Association, said, "Ultimately, as we look to the future of the global economy, it will be those jurisdictions that adopt and maintain international standards that will be most highly regarded. These jurisdictions will by extension inspire confidence and continue to attract quality business, as we have experienced in Bermuda."

IV. BAHAMAS

The Bahamas, in contrast to Bermuda, has been vocal in its complaints about the OECD's actions. The Bahamas has become especially and increasingly dependent on the offshore sector as an engine of growth. In fact, offshore finances account for 15 percent of GDP and 20 percent of government revenue. The Bahamas has 580 mutual funds, 60 insurance companies, and 100,000 international business companies ("IBCs")—roughly one for every three Bahaman. It has $350 billion worth of assets under management and is home to 418 banks from 36 countries.

Nonetheless, the Bahamas is moving away from its previous hard-line stance against the OECD's proposals. In February 2001, the OECD singled out the Bahamas, along with the Cayman Islands, as having adopted a pro-active approach toward the implementation of new measures addressing the OECD's concerns. OECD recognized the Bahamas' significant additional progress. Progress that the OECD noted with particular satisfaction includes laws addressing banking supervision, customer identification, information about the ownership of IBCs, and channels for providing international cooperation at judicial and administrative levels. However, the OECD is still not satisfied since the Bahamas has not "enacted [or] implemented all necessary reforms."

In response to continued concerns regarding Bahaman practice, major reforms have been implemented, such as the ban of anonymous ownership of its 100,000 IBCs.

References:
2. Christopher Vogt, Commonwealth countries and OECD team up to fight fiscal corruption, Agence France Presse (Jan 10, 2001).
3. All Havens in a Storm, Economist 70 (July 1, 2000).
banking requirements. The government has indicated that it will close any bank that it deems to be threatening "the integrity of the international financial system." Government regulators also froze $9 million in assets in an offshore account held by a man wanted in France for money laundering.

In terms of substantive legal change, the Bahamas enacted the Central Bank of The Bahamas Act ("Act") in 2000. The Act provides for improved bank supervision, full cooperation on cross-border supervision of banks, enhanced cooperation between the Central Bank and overseas regulatory authorities, as well as extensive information gathering powers for the Central Bank. In addition, the Bahamas passed the Financial Transactions Reporting Act, which addresses money laundering issues by imposing restrictions on financial institutions, including the verification of the identity of persons with whom the banks transact business. While a number of banks may end their business relationship with the Bahamas as a result of these two acts, it is estimated that approximately half of the managed banks will remain in the Bahamas and comply with the new reforms, establish a physical presence, and expand operations. The reforms taken have led to widespread speculation that the Bahamas will soon join other tax havens and pledge compliance with the OECD programs.

In a sense, the emergence of globalization that helped foster the environment in which the Bahamas could become a successful tax haven is now forcing it to adopt international standards for banking and tax regulation. As the Executive Director of Bahamas Financial Services Board, Barry J. Malcolm, noted, "[A]s a people of reason, we also know that if globalization is to bear positive fruit, it will dictate widespread changes in the domestic and international arenas, especially in the area of trade." Neither this statement, nor those of the Bahaman Premier in regard to the various reforms mentioned the OECD as a driving force. This is not merely due to diplomatic maneuvers and pride. Instead, it is indicative of other forces at work—most notably, the wishes of international investors. So while it stands to lose a number of international investors with the new regulations, the Bahamas will almost certainly attract others through the use of internationally accepted banking and accounting procedures. Prime Minister Ingraham's administration has focused on economic development and job creation, through which the government seeks to improve the country's image in the eyes of foreign investors who have demanded more

19. Id.
21. The Bahamas Charts A New Course In International Finance, Mondaq Bus Briefing (Dec 8, 2000).
than anonymity and exceedingly low taxes. In sum, the reforms are a part of an evolving process independent of the OECD's campaign against harmful tax practices.

V. "AFTER DIRTY AIR, DIRTY MONEY": THE ROLE OF THE US

With a Republican in the White House, critics of the OECD's proposals have found a more receptive ear. Most notably, Andrew Quinlan of the Center for Freedom and Prosperity has been active in slowing, if not stopping, the OECD's efforts. The core arguments against the Framework are that it hampers global tax competition and limits sovereignty by arrogantly dictating countries' tax policies. While the campaign against the OECD proposals has been highly successful, the worries are actually largely unfounded.

The task force set up by the OECD and the Commonwealth is limited to issues of transparency, non-discrimination, and effective exchange of information. However, tax rates will be addressed through the non-discrimination principle. As noted in the Framework, the OECD seeks to eliminate the preferential tax treatment accorded entities without substantial business presence as compared to their resident counterparts. In no way does this non-discrimination principle eliminate tax competition among nations. Rather, it fosters true tax competition by requiring all countries to utilize tax revenues efficiently in order to provide the services that the businesses and investors require. The current regime essentially provides the option to escape tax liability by allowing the creation of faux headquarters while the entity continues to enjoy the benefits of a higher tax regime residence—benefits such as a skilled workforce, transportation, stability, and proximity to its markets. Without some limitation on tax discrimination, corporations and investors would continue to enjoy the benefits of a high tax regime gratis.

Concerns over limiting sovereignty are, ironically, focused on the wrong side of the equation. While the OECD has often acted arrogantly in dictating tax reforms, its main goal is to influence domestic legislation that directly affects OECD member country interests via consensual trade agreements. It is because the policies of the named tax havens greatly affect the sovereign right of OECD member countries to tax their citizens that the OECD has pushed these reforms. Thus it is within the OECD member nations' sovereign rights to respond to the tax havens' lure by declining to extend various deductions, exemptions, credits, or other allowances related to transactions with uncooperative tax havens and imposing transactional charges or levies on certain transactions involving uncooperative tax havens.

The Clinton administration took a supportive, though not pro-active, role in advancing the OECD's initiatives. As then Treasury Secretary Lawrence Summers said, "In today's global economy, it is vital that we put an end to international tax practices that encourage tax evasion and improper tax avoidance and that distort
capital flows." Shifting gears, Bush's Treasury Secretary Paul O'Neill surprised senators by suggesting that he could get better and faster results through bilateral talks rather than by working through the OECD. More to the point, O'Neill laid out two fundamental principles: enforcing US tax laws and not interfering with the internal tax policy decisions of sovereign nations. Essentially, O'Neill focused on the need for countries to be able to obtain upon request specific information from other countries in order to prevent noncompliance with their tax laws. Free market principles played an important role in his objectives, as O'Neill made clear when he added that "it was not in the interest of the United States to stifle tax competition that forces governments—like businesses—to create efficiencies."

VI. THE FUTURE OF TAX HAVENS

Since the Framework, ten countries have signed letters of commitment; others, like Tonga, have been removed on the basis that they have made significant progress. However, with the encouragement of the US, tax havens have been more confident in finding their own way. At the August 2001 Pacific Islands Forum, leaders of sixteen Pacific countries strongly denounced the OECD's efforts, issuing a communiqué questioning the OECD's right to action, and reaffirming the "sovereign right of nations to establish domestic tax regimes of their own design and choosing." The communiqué nonetheless encourages "the development of a cooperative framework within which countries can work together to address transparency, capacity building and appropriate information exchange in relation to tax matters." Indeed, the leaders officially welcomed the technical assistance in improving transparency and information exchange from OECD member Australia.

At the forum, host President Rene Harris of Nauru noted that weaknesses in its financial system invited danger by essentially granting opportunities to international criminals. But he would not fully accept the OECD's proposals: "]the issue has been given the title of 'harmful tax competition' by the OECD, but I strongly refute this and ask the question of who is being harmed?" Answering his own question, he

23. Mark Battersby, Offshore Tax Havens to Come in From Cold, Investment News 38 (June 26, 2000).
25. What is the U.S. Position On Offshore Tax Havens?, Hearings before the Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations, 107th Cong, 1st Sess (July 18, 2001) (statement of Paul H. O'Neill, Secretary of the Treasury).
27. Id.
28. Id.
stated, "I put it to you that the fact that many small island countries choose not to levy taxes on their people does not harm the people of that [sic] country."\textsuperscript{29}

The existence of offshore financial centers will not end with compromises stemming from promulgation of the original OECD Framework. Indeed, the very opposite is likely to happen. Investors will retain many of the legitimate financial advantages of offshore investing and will gain greater confidence in these investments as the offshore centers develop greater rules of law. For instance, the president of Nauru charged that because it was the "victim" of bad publicity, business had worsened. Hence, he argued that before reforms could be implemented, Nauru required $10 million compensation for its losses. This reinforces the Bahaman notion that investors are looking for more than mere anonymity and low taxes. If anonymity and low taxes were all that investors were seeking, the OECD's publicity would have only helped Nauru's business. In addition, the day that the Financial Action Task Force on Money Laundering ("FATF") met, Standard & Poor's downgraded its rating for a top Liechtenstein bank.\textsuperscript{30}

\textbf{VII. CONCLUSION}

Developed nations, as represented under the umbrella of the OECD, have legitimate complaints about secrecy and discriminatory tax policies that need to be addressed. The predatory practices of many Caribbean nations amount to nothing more than classical, inefficient rent-seeking activities that allow taxpayers to free ride off their true residences. By addressing the lack of transparency, the developed nations will be in a better position to tax the worldwide income of their citizens. The compromised position that resulted from O'Neill's core objectives addresses these issues yet avoids the appearance of dictating tax rates.

Many of these reforms were set in motion prior to OECD action, driven in part by the demands of what Thomas Friedman calls the "electronic herd," or a global market made up of millions of investors.\textsuperscript{31} The emergence of financial globalization initially encouraged international investment in tax havens and is now the force imposing changes on those regimes. The majority of the electronic herd places a higher importance on standard accounting and banking regulations than secrecy and nominal taxes. Bermuda and the Bahamas have been implementing changes consistent with these demands.

The compliant tax haven nations understand that legitimate investments from the electronic herd will be more beneficial to their economies in the long run than

\textsuperscript{29} Nauru: Excerpts from President's Address in Opening Pacific Summit, BBC Worldwide Monitoring (Aug 18, 2001).
\textsuperscript{30} Wechsler, 80 Foreign Aff at 55 (cited in note 6).
\textsuperscript{31} Thomas Friedman, \textit{The Lexus and the Olive Tree} 94 (Farrar Straus Giroux 1999).
those of the limited pool of investors seeking high degrees of secrecy and nominal tax rates. Therefore, regardless of OECD action, it is in these nations' best interest to adopt internationally accepted accounting and banking principles. As highly affected nations, the move by the Bahamas and Bermuda toward these standards is a good indicator that others will follow suit. The carrot of the international investors and the stick of the developed nations continue to create too powerful a force to ignore.