TAX HAVENS: DO THEY HAVE A FUTURE PROVIDING BANKING AND FINANCIAL SERVICES?

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I INTRODUCTION

This paper will attempt to provide an answer to the question: will tax havens continue to provide financial and banking services to non-resident investors in the face of sustained pressure from the Organisation for Economic Cooperation and Development (OECD)[1] and the developed nations, in particular the G20? The question encompasses more than just the issue of whether or not tax havens and Offshore Financial Centres (OFCs) will continue to operate as financial centres attracting mobile capital from individuals and Multi-National Enterprises (MNEs) because they have low or no taxes. Two other important considerations which are fundamental to the future of tax havens are: first, whether these nations will amend their bank secrecy laws; and second whether tax havens and OFCs will enter into Tax Information Exchange Agreements (TIEAs) so that non-resident taxpayers and MNEs will be deterred from locating capital in those tax havens to minimise the impact of taxation in their home country.

The rapid fire agreement by tax havens to adopt TIEAs after the G20 railed against them at the height of the Global Financial Crisis (GFC) indicates that no or low tax countries may have difficulties in the future resisting the OECD pressure to amend their bank secrecy laws and enter into TIEAs.[2] However, it is argued that the important role tax havens play in facilitating global capital transfers at low cost may be one of the main reasons why tax havens will continue irrespective of the impact of the campaign against them.

Virtually all OECD member countries impose income tax on their residents' worldwide income.[3] This includes income derived in tax havens. Arguably if tax havens ceased to exist then the problem of hiding income and assets in tax havens would be solved. If tax havens

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[1] The OECD pressure included tax havens in its original campaign beginning in 1996 against harmful tax competition. See *Harmful Tax Competition: An Emerging Global Issue* (OECD, 1998).

[2] *The Global Plan for Recovery and Reform*, G20 Declaration, 2 April 2009 [15].

[3] This is the situation in Australia: *Income Tax Assessment Act 1997* (Cth) s 6-5(2). All OECD member states have a similar system. Hong Kong is the only place that imposes income tax on a territorial basis.

introduced measures whereby non-residents were likely to have their financial details reported to their home country then those non-residents may be deterred from investing capital in those states. Alternatively if they did so invest, they would be more likely to report the income earned and assets held there.

As a result of the GFC most developed countries incurred large government debts to stimulate their economies. The debts incurred by these countries have to be repaid and tax revenue is one major source of funds to be used to repay them. In the developed countries tax havens and OFCs are seen by Governments as being part of the problem and part of the solution, especially if lost tax revenue can be recovered and the future use of tax havens curtailed.[4]

Tax havens and OFCs have been viewed by the G20 and the OECD as being part of the reason for the global financial crisis. They hid risk and contributed to the spread of financial products across the world blind to the real level of risks involved. The Tax Justice Network for example says havens 'did not "cause" the crisis but contributed powerfully to it.'[5] If they didn't cause it, how did they contribute to it? Anna Gibson from the international financial reform group, Re-Define puts it this way:

> ...the operation of tax havens and other entities complicit with tax flight is predicated on an environment of secrecy, which has a detrimental impact on the stability of the financial system as a whole. The financial crisis has demonstrated that many financial institutions carried off-balance sheet liabilities, often registered in low tax secrecy jurisdictions, which foment distrust between corporations and enhances information asymmetry. As a result, this opacity undermines the international financial market, contributes to higher risk of collapse, and boosts borrowing costs for both rich and poor countries.[6]

It was the G20 Summit in April 2009 that made it clear that the OECD member countries are committed and ready to use countermeasures against tax havens.[7] It was agreed that tax havens not complying with internationally recognised standards would be placed on a

[4] G20 Declaration, above n 2.
[5] Tax Justice Network, *Economic Crisis + Offshore* <http://www.taxjustice.net/cms/front_content.php?idcat=136>.
[6] Anna Gibson,Re-Define, *Tackling Tax Havens – Addressing Fiscal Deficits, Finance Development and Stabilizing Finance* <http://www.re-define.org/blog/2010/02/05/tackling-tax-havens-adressing-fiscal-deficits-financing-development-and-stabilizing->.
[7] G20 Declaration, above n 1.

'blacklist' of uncooperative tax havens.[8] Tax transparency and TIEAs became the focus for eliminating tax evasion facilitated through tax havens. As the G20 leaders stated in London:

> We agree to take action against non-cooperative jurisdictions, including tax havens. We stand ready to deploy sanctions to protect our public finances and financial systems. The era of banking secrecy is over. We note that the OECD has today published a list of countries assessed by the Global Forum against the international standard for exchange of tax information.[9]

Not everyone agrees with this analysis. For example, Geoffrey Loomer and Giorgia Maffini from the Oxford University Centre for Business Taxation reject this view. They argue that improving financial regulation of banks and investment institutions has little to do with the enforcement of tax.[10]

There is no dispute that tax havens and OFCs have prevented developed countries from collecting tax revenue that should have been paid by taxpayers in their country of residence. The fact that large amounts of tax revenue have been lost as a result of the involvement of tax havens and OFCs has been documented by a number of countries and organisations over many years.[11] In the US for the 2008 year Addison estimates that tax havens have cost the tax revenue USD 100 billion, and for the past decade the cost has been USD 1.027 trillion.[12] Addison discusses the outcome of a report released in August 2006, prepared by the US Senate Committee on Homeland Security and Governmental Affairs in which the Senate found that tax havens and OFCs held more than USD 11 trillion of high-net-worth individuals' assets worldwide.[13] Addison provides the following quote from US Senator Carl Levin to illustrate the problem the US has with tax havens:

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[8] Ibid.
9 *Global plan for recovery and reform: the Communiqué from the London Summit*, G20 2 April 2009, <http://www.londonsummit.gov.uk/en/summit-aims/summit-communique/>.
[10] Geoffrey Loomer and Giorgia Maffini, 'Tax Havens and the Financial Crisis', (Policy Article 09/03 Oxford University Centre for Business Taxation April 2009) <http://www.sbs.ox.ac.uk/centres/tax/Pages/Policyarticles.aspx>.
[11] The OECD and Oxfam, to name just two, have reported the perceived loss of revenue for many countries as a direct result of tax havens hiding assets.
[12] Timothy Addison, 'Shooting Blanks: The War on Tax Havens' (2009) 16(2) *Indiana Journal of Global Legal Studies* 703, 704.
[13] Ibid, 707. The report is titled: *Tax Haven Abuses: The Enablers, the Tools and Secrecy*.

> With a $345 billion annual tax gap and a $248 billion deficit, we cannot tolerate a $100 billion drain on our Treasury each year from offshore tax abuses.[14]

According to the US Senate Permanent Subcommittee on Investigations 'the United States loses an estimated USD100 billion in tax revenues due to offshore tax abuses.'[15] Global Financial Integrity estimates that privately held non-resident deposits in tax havens (what it calls secrecy jurisdictions) are just under USD10 trillion.[16] The United States, the UK and the Cayman Islands topped the list, with over USD1.5 trillion each.[17] The Tax Justice Network estimates the figure at USD11.5 trillion by high wealth individuals alone.[18] According to a Norwegian Government Report '[w]hen President Obama submitted proposals on new tax regulations and measures against tax havens on 4 May 2009, the press release noted that almost a third of all profit earned abroad by US companies came from "three small low-tax countries: Bermuda, the Netherlands and Ireland".'[19]

However, let us stress that most activity within and through tax havens is legitimate. Tax havens attract not just criminals – those evading tax and other responsibilities in one jurisdiction, or laundering money, for example. They attract business, mobile finance and investment capital in the main, including established services like reinsurance. As the Australian Taxation Office notes:

> Most [Australian] dealings with tax havens are within the law. Some tax havens, including those that have large value dealings with Australian taxpayers, have developed particular niche markets. Others are highly regarded as offshore financial centres. Tax havens are particularly attractive to international businesses involved in portfolio management, such as insurance companies, self-insurers, hedge and mutual funds and offshore investment funds,

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[14] Ibid, 706. The quote from Senator Levin can be obtained from the following website: <http://www.senate.gov/levin/newsroom/release.cfm?id=269479>.
[15] Permanent Subcommittee on Investigations, United States Senate, *Tax Haven Banks and U.S. Tax Compliance*, 17 July 2008 <http://hsgac.senate.gov/public/_files/071708PSIReport.pdf>.
[16] Ann Hollingshead, *Privately held, non-resident deposits in secrecy jurisdictions* (Global Financial Integrity, March 2010) 1. A link to the pdf can be found at <http://www.gfip.org/index.php?option=content&task=view&id=296>.
[17] Ibid.
[18] Tax Justice Network, *Magnitudes: dirty money, lost taxes and offshore* <http://www.taxjustice.net/cms/front_content.php?idcat=103>. The US Senate Permanent Subcommittee on Investigations Report *Tax Haven Banks and U.S. Tax Compliance* at n 14 above also refers to the USD11.5 trillion figure.
[19] Norwegian Government Commission on Capital Flight from Poor Countries, *Tax Havens and Development: Status, Analyses and Measurement* (Official Norwegian Reports, 19, 2009) 17 n 2. A link can be found at <http://www.cmi.no/publications/publication/?3470=tax-havens-and-development>.

> because they have low or no taxes. These international businesses require access to the huge international foreign exchange markets and 24-hour-a-day management. [20]

It is this legitimate aspect of tax havens and the importance of these functions to global and national business which ensure in our opinion that tax havens will continue to perform their clearing house aggregation and focussing role despite the close attention of the developed countries and their ongoing demands for transparency and an end to bank secrecy.

Addison argues that information exchange agreements between the US and tax havens will be of no effect unless the Internal Revenue Service (IRS) undertakes more audits of high net worth individuals in the US.[21] This is because if the home country doesn't know about the taxpayers' activities in the tax haven they will not be able to obtain information about that taxpayer. The material will not be foreseeably relevant under the terms of the model and subsequently agreed TIEAs and so cannot be provided.

Addison says that 'the Permanent Subcommittee on Investigations' found that high net worth individuals - those with USD1 million or more in assets - currently hold USD11 trillion in offshore accounts.'[22] In 2007, 9.25 percent of those taxpayers had their returns audited whereas the IRS only audited 2.26 percent of taxpayers with income between USD200,000 and USD1 million.[23] There were an estimated 9.3 million individuals with a net worth of $1 million living in the United States as at the middle of 2007.[24]

In Australia, the Australian Taxation Office (ATO) undertook a similar exercise in trying to ensure compliance with the taxation law by Australia's wealthiest people.[25] The Commissioner of Taxation explained in his Wealthy and Wise guide that the ATO had identified about 1,200 wealthy Australian with net worth of more than AUD30 million and that they wanted to ensure compliance by that group.[26] The guide says that since the 'High Wealth Individuals Taskforce' had been established in 1996, the ATO had collected an additional AUD1.766 billion and had disallowed AUD934 million in revenue losses and

[20] Australian Taxation Office *Tax Havens and Tax Administration* (Australian Taxation Office, December 2009) 11.
[21] Addison, above n 11, 707.
[22] Ibid, 725.
[23] Ibid, 726.
[24] Ibid.
[25] Australian Taxation Office, *Wealthy and Wise: A tax guide for Australia's wealthiest people* (Australian Taxation Office, March 2008).
[26] Ibid, 3.

AUD777 million in capital losses.[27] The ATO has also recently begun a Wealthy Australian Initiative, looking at those with net wealth between AUD5 million and AUD30 million. In addition, Project Wickenby – a multi-agency criminal, corporate and tax crackdown targeting the abusive use of tax havens – has been running since 2005. It has recouped over $200 million in previously unpaid tax and penalties and seen those under investigation pay $300 million in later years, what the ATO calls a compliance dividend.[28] There are currently over 500 Wickenby audits under way and a further $700 million in liabilities raised.

The problem of lost tax revenue is not just confined to the US or Australia. It is a global phenomenon. Addison provides evidence that worldwide, tax havens account for a loss of tax revenue of over USD 255 billion each year.[29] To add to the situation, it is estimated that 15 percent of the world's states are tax havens and half of world trade passes through them although they only account for 3 per cent of the world's GDP.[30] Tax havens attract mobile capital through the use of their banking system and financial services combined with no or low tax rates. However, the capital is then invested in the major financial centres such as the US or the United Kingdom. Australia is a beneficiary of capital flowing from tax havens. More money flows into Australia from tax havens than flows out from it to tax havens. Avi-Yonah notes that funds cannot remain in tax havens and be productive; they must be reinvested in the prosperous and stable economies of the world.[31]

There is also the issue of what will happen to tax havens and OFCs if they are not used by non-resident investors and MNEs? If tax havens cease to provide these services what happens to the economies of the tax havens, for example to the people employed in the banks and providing professional financial advice? Does this means that the wealthy nations then have to start providing foreign aid to those states? The seeming lack of action on the part of the industrialised world in helping tax havens adjust to the new reality of scrutiny and exchange indicates that the real target of the harmful tax competition project is in fact tax havens per se with their low or no tax rates, rather than anything else.

[27] Ibid, 7.
[28] Australian Taxation Office Project Wickenby – is it worth the risk? <http://www.ato.gov.au/corporate/content.asp?doc=/content/00220075.htm&page=7&H7>
[29] Addison, above n 11, 708.
[30] Ibid, 711.
[31] Reuven Avi-Yonah , 'The OECD Harmful Tax Competition Report: A Retrospective After A Decade' (2008 – 2009) 34 *Brooklyn Journal of International Law* 783, 793.

A *The Approach to Tax Havens by Australia*

The Australian Government has a contradictory approach to tax havens, in part because of the benefits they provide to the Australian economy even if sometimes at the expense of the Australian revenue. That contradictory approach finds expression in Australia's enthusiastic and ongoing support for the OECD's harmful tax competition project,[32] undertaking domestic activity like Project Wickenby and establishing a strong negotiating program for TIEAs while at the same time, as a capital importing nation dependent on foreign capital for its economic success, actively encouraging investment into the country[33] from a multitude of sources, including tax havens. As Australian business and investment expand offshore that expansion will, to remain competitive, also follow global patterns and often occur through tax havens. Indeed the Australian Government's Future fund has done exactly that.

The Australian economy and government receive certain benefits because of the existence of tax havens and OFCs. For example, historically more money flows from tax havens into Australia than flows out to tax havens. The ATO states that the flow of Australian dollars out to tax havens amounted to AUD 5.3 billion in the period 2005 – 2006. However, the flow of money from tax havens to Australia was AUD 8.4 billion in the same period.[34] According to a report in 'The Age', which referred to figures from the ATO, for the 2007-2008 period AUD 16 billion flowed to tax havens but AUD 29 billion flowed back to Australia from tax havens. If tax havens cease to exist then Australia would not necessarily attract a similar level of foreign investment from mobile capital looking for a safe haven for investment.[35]

Australia offers a tax concession to 'temporary residents'. They do not pay income tax on income derived outside Australia.[36] This is an attempt to attract foreign investment and is clearly based on enticing capital flows into the country from tax havens and OFCs.[37] This was the policy intention of the Australian government when it introduced these tax laws in

[32] This has now formalised and expanded as the Global Forum on Transparency and Exchange of Information for Tax Purposes.
[33] Including tax inducements such as the non-taxation of many capital gains of foreign residents and the establishment of a temporary residents' category.
[34] Australian Taxation Office, above n 19, 8.
[35] Ruth Williams, 'ATO ups attack on tax cheats', *The Age Newspaper* (Melbourne), 21 November 2009, 4 business day.
[36] *Income Tax Assessment Act 1997* (Cth) Sub-division 768 - 900,
[37] For a full discussion on 'temporary residents' see: John McLaren, 'Should the International Income of an Australian Resident be Taxed on a Worldwide or Territorial Basis?' (2009) 4(1) *Journal of the Australasian Tax Teachers Association* 71

order to attract foreign investment by wealthy individuals who may wish to live in Australia.[38] The fact that the temporary resident may have their wealth invested in a tax haven free of income tax is of no consequence to the Australian government. This is similar to the situation of the 'non-domiciliary' living in the UK where they are only subject to a 'territorial' system of taxation, or the returning New Zealand citizen or new migrant to New Zealand, who also only pays income tax on income derived within the territory. However, this means that Australian residents for tax purposes are 'ring fenced'[39] from being able to take advantage of similar tax benefits.

A further example of the ring fencing of resident taxpayers is found in the tax law relating to the non-resident investor and the non-payment of income tax on capital gains generated on a range of assets, including shares and other financial products. Only some business assets held within a permanent establishment and real property such as land and fixtures or an interest in a land rich company attracts income tax on a capital gain by a foreign investor.[40] The policy reasoning behind this tax law is to make it attractive for foreign investors to invest in Australian business, equities and collective investment products.[41]

The Australian Future Fund, a sovereign wealth fund belonging to the Australian Government with AUD 64 billion, invests those funds through asset managers located in the Cayman Islands.[42] The former Minister for Finance and Deregulation, The Honourable Lindsay Tanner, justified this practice on the basis that the Cayman Islands was changing and that it was negotiating a TIEA with Australia and 'given the structure of the industry and complexity of international law, this is common practice'.[43]

There can be a fine line between 'appropriate' investment into and out of Australia, often through tax havens for legitimate commercial reasons, and the abusive use of tax havens to avoid or evade Australian tax. Certainly the two seemingly contradictory purposes can meld

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38 Explanatory Memorandum, Tax Laws Amendments (2006 Measures No. 1) Bill 2006, Chapter 1.

39 The term 'ring fencing' refers to the concept of providing tax concessions to foreign investors that are not available to resident investors. The resident taxpayer is precluded from being able to take advantage of those tax benefits.

40 See Division 855,

41 As sub-section 855-5 *Income Tax Assessment Act 1997* (Cth) says 'the object … is to make Australia an attractive place for business and investment.'

42 Peter Martin, 'Fund to maintain tax-haven investments', *The Age Newspaper* (Melbourne), 26 November 2009, 9.

43 Lindsay Tanner, 'The Future Fund: Delivering for Australia', (Speech delivered at the National Press Club of Australia, Canberra, 25 November 2009) <www.financeminister.gov.au/speeches/2009/>.

into a complex mix of intent and outcome. The Australian government has been walking a tightrope between trying to attack the abuse and encourage the legitimate. The problem is that walking a tightrope can lead to a fall and the fear is that in cracking down on tax havens governments overstep and adversely impact global flows of capital, increasing the cost of capital unnecessarily and slowing global economic growth. If Australia runs too far ahead of the pack it risks becoming a less favourable place to invest and imposes restrictions on capital outflows that reduce the competitiveness of Australian business. Australia will hasten slowly, within the limits of the OECD and wider developed countries' response to tax havens for fear of frightening the foreigner investors. It is too early to tell yet whether Australia's response to tax havens, and indeed the OECD and developed countries' campaign against them, will have that effect.

B *The United States Approach to Tax Havens*

Marshall Langer contends that Manhattan and London are the location of two of the most important tax havens in the world by aggressively and openly attracting wealth from all corners of the world.[44] The reasons given for this statement are the tax concessions that are available to foreign investors. US banks are not required to withhold tax before crediting interest payments to non-US residents on their investments.[45] Langer reports that in 1975 the Joint Committee on Taxation estimated that over USD 3.1 billion in interest had been paid to foreign persons on over USD 36 billion of bank deposits: today this figure would be much higher.[46] This has been the situation for over 80 years and the banks have no obligation to report these transactions to the IRS unless the account holder is a resident of the US or a Canadian resident taxpayer.[47] Interest on government bonds, notes and treasury bills is free of withholding tax but may be subject to reporting to the IRS.[48]

The State of Delaware has been one of the most popular places for the incorporation of a company. For example, over 40 per cent of New York Stock-Exchange listed companies and over 50 per cent of Fortune 500 companies are incorporated in Delaware.[49] The reason for the

[44] Marshall Langer, 'Harmful Tax Competition: Who Are the Real Tax Havens?' (December 2000) 18 *Tax Notes International* 3.
[45] Ibid, 1.
[46] Ibid, 3.
[47] Ibid.
[48] Ibid, 4.
[49] Catherine Barnard, 'Social Dumping and the Race to the bottom: Some Lessons for the European Union from Delaware', (2000) 25(1) *European Law Review* 57, 59.

popularity of Delaware as a place of incorporation of a company is found in the fact that it has very favourable tax, trust and corporations laws.[50] A single director limited liability company can be incorporated and provided it has no US sourced income it is not subject to US income tax and it does not need to file a tax return.[51] Many will believe that it pays tax in the US[52] when in fact it is taxed on a territorial basis. In other words, tax administrators in other countries could assume that income tax had been imposed on the company in the US, irrespective of the source of the income. In Australia, for instance, the law requires a company that has been incorporated in Australia to pay income tax on its worldwide income, even if the source of the income is outside Australia.

Companies incorporated in the State of Delaware have similar tax advantages to any company incorporated in a tax haven or OFC, and yet the US government has not indicated any intention to remove the attractive benefits associated with a Delaware company. Similarly, the US tax system 'ring fences' its own taxpayers from the benefits of no income tax on bank deposits and bonds, while attracting mobile capital from outside the US.

C *The Case of New Zealand as a 'Tax Haven'*

New Zealand does not have taxation law requiring resident and non-resident taxpayers to pay income tax on capital gains, unlike Australia, its nearest neighbour. New Zealand also facilitates a flow through structure for foreign investors through the use of 'offshore trusts'.[53] Trusts that are established in New Zealand with non-resident beneficiaries and a non-resident settlor are not liable to be taxed in New Zealand on income earned anywhere else in the world. In fact the Inland Revenue Department of New Zealand (IRD) does not obtain any information about these trusts because they do not need to pay tax. Sawyer states that when in 2006 the Australian Government exerted pressure on New Zealand to reveal whether any Australian citizens were settlors of these trusts, the response by the IRD was that these types of trusts are not reviewed by the department.[54] Sawyer contends that New Zealand shows no signs of moving away from maintaining an absence of tax on capital gains and removing the

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[50] Ibid, 61.
[51] Langer, above, n 40, 5.
[52] Ibid.
[53] Adrian Sawyer, 'Tax Havens "Coming in from the Cold": A Sign of Changing Times?' (Paper presented at the Australasian Tax Teachers Conference, Sydney, 21 January 2010), 6.
[54] Ibid, 7.

tax benefits of its offshore trust regime.[55] It is for these reasons that New Zealand could be considered to have some of the characteristics of a tax haven, namely lack of transparency.

II Why Tax Havens will Survive

There are a number of reasons why tax havens and OFCs will continue to operate as financial centres with low or no tax on income and gains. Some of the reasons have been discussed above but the following discussion provides additional evidence that tax havens have a place in the global financial environment and provide important benefits to governments, MNEs and individuals.

A *Lawful Use of Tax Havens*

The Australian Commissioner of Taxation has stated that not all financial transactions involving a tax haven will amount to unlawful activity. Indeed, according to the ATO, most transactions with tax havens are legitimate. The ATO publication on 'tax havens and tax administration' lists acceptable activities such as portfolio management, insurance companies, self-insurers, hedge and mutual funds and offshore investment funds, because they have low or no taxes. The ATO give the example of the Cayman Islands as a major financial and captive insurance centre with significant flow–through transactions for equity and hedge funds. Similarly, Jersey and Guernsey have major regulated financial services industries, and many international banks are represented in these jurisdictions.[56]

The ATO also confirmed that it is not illegal to deal with a tax haven, provided taxpayers comply with the relevant tax laws of both jurisdictions. For example, an individual may accumulate savings in a bank account in a tax haven while working overseas as a non-resident. When the individual becomes an Australian resident, they need to declare the interest on their account each year to meet their Australian tax obligations.[57]

There are other valid reasons why tax havens are important and should be preserved. Mitchell strongly contends that tax havens offer a safe haven for people subject to persecution on the basis of religious belief, political leanings, ethnic origin, and sexual preferences to be able to

[55] Ibid.
[56] Australian Taxation Office, above n 19, 10.
[57] Ibid, 11.

place some of their wealth beyond the control of the government or government agencies in their home state.[58] Mitchell provides examples of a Middle Eastern Jew who is wealthy and likely to face persecution and Christians living in some 13 countries likely to be oppressed or persecuted in 31 nations.[59] He provides an example of a family living in Zimbabwe who places money in a tax haven in order to protect the wealth of the family because of the persecution and the economic problems devaluing the currency. Similarly, ethnic Chinese are persecuted in Indonesia and the Philippines and place money in banks in Singapore. Mitchell also uses the example of homosexuals living in Saudi Arabia who are constantly facing prosecution and need to use a tax haven to protect their wealth. He states that there are 84 nations that have laws that target homosexuals.[60] The key to maintaining tax havens in order to protect wealth is the expectation that their financial information will be kept private. Privacy and confidentiality of personal financial information is of paramount importance for individuals facing issues discussed above and bank secrecy laws are vital in order to achieve this objective.

B *Insurance Companies and Captive Insurance Companies*

The Commissioner of Taxation has stated above that one of the main lawful uses of tax havens such as the Cayman Islands is for the location of captive insurance companies.[61] The deductibility of insurance premiums paid to 'captive' insurance companies in Australia is examined by the ATO in their practice statement law administration, PS LA 2007/8. The following description of a captive insurance company is taken from the practice statement:

> A captive insurance entity is an insurance entity where the parent company is not primarily engaged in the business of insurance. It is usually formed to insure the risks of its parent and affiliates, but it can also be used to insure third party risks. A captive insurance entity can retain the risks or it can pass on the whole or a part of the risks. A captive insurance entity would normally operate in a similar way to other general insurance or reinsurance companies.[62]

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[58] Daniel Mitchell,, 'The Moral Case for Tax Havens' (2006) Occasional Paper 24 *The Liberal Institute of the Friedrich Naumann Foundation* 19.
[59] Ibid, 22.
[60] Ibid, 22 – 23.
[61] Ibid. Captive insurance companies are insurance companies wholly owned by a large corporation to insure risks associated with the business. The captive insurance company then obtains reinsurance from a large insurer for large losses but maintains the risk itself for small losses. Many large Australian corporations and banks have their own captive insurance company usually located in the Caribbean or Singapore.
[62] Australian Taxation Office, *Treatment of non-resident captive insurance arrangements*, PS LA 2007/8, 2.

The practice statement sets out the basis on which premiums are deductible based on an assessment of the risk being insured; the cost of the premium; the existence of reinsurance and the ability to meet any claim made by the insured. The case of *W D & H O Wills (Australia) v Federal Commissioner of Taxation* (1996) 32 ATR 168 established the precedent that insurance premiums paid to a captive insurance company that was an associate of the taxpayer, were still deductible. It also reinforced the fact that many large companies are unable to purchase insurance to cover many of their risks and their only option is to use a captive insurance company and locate it in established tax haven or OFC that specialises in captive insurance business.

Many insurance and reinsurance companies are located in tax havens such as Bermuda. The reason for this is that they are able to invest their premium income without the cost of paying income tax on the earnings. This means that there is more money to be used to pay claims, including those that arise as a result of a catastrophe happening in the world such as 'hurricane Katrina' in the USA in August 2005. Without this tax benefit, many businesses would not be able to operate because they would not be in a position to acquire the required insurance cover for their particular business activity. This was the situation in the US in the mid-1980s when US businesses were unable to obtain liability insurance cover.[63] McDonald discusses the future of insurance companies domiciled in Bermuda that are facing the prospect of tax changes to be made by the US. She notes that at this stage all companies have stayed but are able to quickly move to Ireland or Switzerland if the US imposes taxes on the business.[64]

Bermuda is a dominant player in the insurance business in that it has 35 per cent of the insurance industry worldwide and 65 per cent of the reinsurance industry worldwide.[65] Half of all risks insured are of US origin and one third of all risks are European.[66] About 60 per cent of all policies sold in Bermuda are for property insurance and reinsurance.[67] Reinsurers take some of the risk from the original insurers and by doing this, insurance companies can

[63] Yelena Tsvaygenbaum, 'A tax treaty that doesn't tax? The unique history of the United States-Bermuda tax treaty and the subsequent problems facing the United States insurance industry' (2008-2009) 15 *Connecticut Insurance Law Journal* 267, 281.
[64] Caroline McDonald, 'Bermuda Carriers Not Expected To Rush Off The Island Despite U.S. Tax Concerns' (2009) 19 October *National Underwriter* 22.
[65] Tsvaygenbaum, above n 38, 279.
[66] Ibid.
[67] Ibid.

take on more risk or less desirable risk, thus helping more customers.[68] If premium income was not given favourable tax treatment by tax havens and OFCs then many risks facing businesses throughout the world would not be insured. The business would not be permitted to operate. The continued existence of tax havens in the insurance and reinsurance industry is of global importance.

C *The Role of Tax Intermediaries in the Survival of Tax Havens*

Tax havens would not operate as financial centres unless they had the resources of accounting, legal and banking services to provide financial and investment advice and the ability and competence to manage the mobile capital inflows.

The OECD conducted a study into the role that tax intermediaries have in aggressive tax planning for their clients.[69] The OECD describes tax intermediaries as law and accounting firms, other tax advisors and financial institutions.[70] The focus of the report is on the role that tax intermediaries have in the promotion of 'unacceptable tax minimisation arrangements' which are classified as 'aggressive tax planning'.[71] There are two types of arrangements that qualify as being unacceptable and they are as follows:

- Planning involving a tax position that is tenable but has unintended and unexpected tax revenue consequences. This involves misusing legislation to achieve results not foreseen by legislators.
- Taking a position that is favourable to the taxpayer without openly disclosing that there is uncertainty whether significant matters in the tax return accord with the law. This involves taxpayers not disclosing their view on grey areas of the law when completing their tax return.[72]

The report identified two main markets for aggressive tax planning by tax intermediaries: large corporations, - MNEs - and high-net-worth individuals.[73] The report also identified the role played by some banks in developing and implementing aggressive tax planning and

[68] Ibid, 280
[69] OECD, *Study into the Role of Tax Intermediaries* (2008).
[70] Ibid, 7.
[71] Ibid, 10.
[72] Ibid, 11.
[73] Ibid, 6.

discussed a number of examples of structures used to help wealthy clients and MNEs.[74] The OECD acknowledged that the study team was unable to deepen its understanding of aggressive tax planning by banks.[75] The report made a number of recommendations as to how revenue bodies such as the ATO should use risk management tools to prioritise compliance risk.[76] However, the revenue bodies need to improve their capability to understand the work of tax intermediaries based on greater commercial awareness.[77]

The recommendations contained in the report would suggest that many revenue bodies are incapable of detecting the existence of tax schemes at an early stage in their product life due to an inability to comprehend the commercial attributes of the arrangement and more importantly, lack an understanding of structured finance tax schemes developed by some banks. The study on the role of accountancy firms in tax avoidance by Sikka and Hampton has highlighted the fact that major accounting firms have expanded globally due to the ability to provide tax avoidance schemes.[78] The accounting firms would prefer to describe their activities as 'tax planning' or tax minimisation within the law.[79] In fact many large accounting and legal firms have an office in various tax havens and OFCs to service their clients involved in tax minimisation arrangements. Sikka and Hampton believe that more research needs to be undertaken on the role of tax intermediaries and provide the following comment on the future of tax avoidance and the involvement of professional advisers:

> The possibilities of curbing the tax avoidance industry are further complicated because of 'globalisation and technological change has made it easier to avoid paying taxes so you have to introduce more anti-avoidance measures just to stand still [and] government's attempts to raise revenues by tackling tax avoidance will inevitably be countered by the tax planning industry' (Financial Times, 9 March 2005). Indeed, anarchy of the markets only recognises financial rewards and a partner of a major accountancy firm has stated that 'No matter what legislation is in place, the accountants and lawyers will find a way around it. Rules are rules, but rules are meant to be broken' (The Guardian, 18 march 2004).[80]

[74] Ibid, 47.
[75] Ibid, 54.
[76] Ibid.
[77] Ibid, 55.
[78] Prem Sikka, and Mark Hampton, 'The role of accountancy firms in tax avoidance: Some evidence and issues' (2005) 29 *Accounting Forum* 325, 330.
[79] Ibid, 329.
[80] Ibid, 341.

The OECD has acknowledged the role of tax intermediaries and private banks in providing trustee services where the beneficial ownership of assets is obscured.[81] They also provide structures involving companies and trusts to ensure that the identity of the client remains anonymous.[82] Their services are an integral part of the tax minimisation industry being conducted in tax havens and OFCs. Until such time as there is evidence of major accounting firms, law firms and banks moving from tax havens and OFCs, it can be stated with some degree of confidence that tax intermediaries still believe that their services will be in demand despite action to curb the influence of tax havens by the OECD, the G20, the EU and individual countries, including Australia.

D *Difficulties in Identifying the Beneficial Ownership of Offshore Assets – Corporate Vehicles, Trusts and Bearer Shares*

Tax administrators have a great deal of difficulty in identifying offshore investments held by their own residents in a tax haven or an OFC when the assets are held in a company with nominee or corporate directors, or in a trust. All common law jurisdictions have well developed laws relating to trusts and many tax havens and OFCs adopt the common law system. The situation is further complicated if the shares in a company used in the taxation scheme are bearer shares. The OECD has recognised the difficulty of identifying the beneficial owners and controllers in their report prepared by Witherell in March 2007.[83] Witherell provides the following summary of the problem facing taxation and anti-money laundering authorities when it is very difficult to identify the beneficial owner of assets held in tax havens and OFCs:

> The task of identifying ultimate ownership and control of cross-border transactions has become more challenging with the emergence of a large variety of international and corporate vehicles, some of which are designed specifically to obscure the identity of the beneficial owners and controllers.[84]

This report draws on earlier work undertaken by the Financial Action Task Force (FATF) on the misuse of corporate vehicles.[85] The report is based on the responses from 32 countries

[81] William Witherell, *Identification of ultimate beneficiary ownership and control of a cross-border investor* (OECD, 2007, 5.

[82] Ibid.

[83] Ibid.

[84] Ibid, 10.

[85] Financial Action Task Force, *The misuse of corporate vehicles, including trust and company service providers*, October 2006 <www.fatf.org>,

that completed a questionnaire relating to the types of corporate vehicles that were available; the types of beneficial ownership relationships; the source of beneficial ownership information that was available and methods used to obtain the information; and examples of misuse of corporate vehicles in the jurisdiction.[86] The report highlights the situation where a company has another company acting as the director instead of a natural person which adds a further layer of complication to the task of determining the beneficial owner.[87] This situation is permitted in nineteen of the 32 jurisdictions that responded to the survey.[88]

The use of offshore trusts to hide assets in a tax havens assists in maintaining the anonymity of the non-resident taxpayer and investor. This problem has been highlighted by Maria Tihin when examining the difficulty the IRS is experiencing in trying to combat abusive tax shelter arrangements in tax havens. The following statement by Tihin illustrates the problem facing taxation administrators:

> Often the degree of secrecy is so great that United States law enforcement is not able to detect the existence of an offshore account or entity. Even if the existence of the offshore entity has been brought to the attention of the United States officials, other problems still remain. Many offshore jurisdictions that host tax shelters impose a long and cumbersome process for gaining any relevant information, such as a trust's grantor and beneficiary. These secrecy laws make it extremely difficult to determine who holds effective control of an offshore trust, as well as the details of its functioning and who should be held accountable for its actions. … A taxpayer can create a trust that cannot be directly tied to him without further information. [89]

It is not only very difficult to identify a foreign trust having any connection with the country of residence; it is then almost impossible to find out who has effective control over the assets within the trust. This situation is even worse when the company that acts as trustee has bearer shares. The OECD provides a definition of what are bearer shares and a bearer debt.[90]

> Many countries permit the issuance of bearer instruments either in the form of bearer shares or bearer debt. Very generally, a bearer security is one in which the legal rights attaching to the instrument belong to the person in physical possession of the instrument itself. This is

[86] Ibid, 10. The list of countries that participated in the survey is found on page 29, Annex 3.
[87] Ibid, 11.
[88] Ibid, 12.
[89] Maria Thin,, 'The Trouble with Tax Havens: The Need for New Legislation in Combating the Use of Offshore Trusts in Abusive Tax Shelters' (2007-2008) 41 *Columbia Journal of Law and Social Problems* 417, 423.
[90] OECD, *Tax Co-operation: Towards a level playing field* (2009).

> distinct from a "registered" security, which requires that legal ownership is based not on physical possession of the instrument but on entry in a ledger or other record of ownership.[91]

This means that a non-resident taxpayer can have their assets held by a company where the control of the company is in the hands of a shareholder that physically holds the shares and is not shown as the registered shareholder. This makes it virtually impossible for the tax administrators to determine who is the real owner of the shares. The OECD recommends that countries that allow for bearer shares to be issued to have mechanisms in place to identify the true owner of the shares or to not allow for a custodian to hold the shares on behalf of the true owner.[92] The OECD has reported that there are 46 countries that still allow bearer shares to be issues but of those, 41 countries have mechanisms in place to identify the owners of the shares. Similarly, 56 countries permit bearer debt instruments to be issued, but 47 of those countries have mechanisms in pace to identify the holder of the debt.[93]

The challenge facing taxation authorities in trying to identify their own taxpayers involved in offshore trusts and companies is an almost impossible challenge to win. The situation discussed above highlights some of the difficulties facing regulators with the issue of identifying beneficial ownership and unless all countries introduce laws that require the beneficial owners of assets to be identified then the problems will persist. If this is the case then tax havens and OFCs will continue to provide financial services to individuals and MNEs.

E *The Future of Bank Secrecy Laws*

Any amendments to the secrecy provisions of the domestic banking laws in tax havens and OFCs require their national parliament to pass new laws. The simple act of signing a tax information exchange agreement (TIEA) does not ensure that the national parliament of that country will either incorporate the agreement into domestic law or transform the agreement into domestic law. The process whereby international agreements become part of the domestic law can be complicated depending upon the legal system in the particular country. Some international agreements automatically become part of the domestic law through the

[91] Ibid, 24.
[92] Ibid, 26.
[93] Ibid.

doctrine of incorporation or through the doctrine of transformation.[94] There is no certainty that all countries that have entered into TIEAs will be able to amend their bank secrecy laws unless their own parliaments agree to do so.

For example, because Switzerland requires international law to be transformed into its domestic law, the Swiss Parliament must agree with the reform of its banking laws otherwise it needs a referendum of the nation if 50,000 signatures are collected.[95] The Swiss government will not permit other countries to undermine the confidentiality of its financial institutions by allowing unspecified 'trawling' for names by foreign tax administrations.[96] The historical basis for the Swiss bank secrecy laws are based on saving lives rather than facilitating tax evasion. The Swiss Federal Banking Act was enacted in 1934 to protect foreign customers by ensuring that their bank details were kept confidential. The law was established to counter the Nazi government in Germany which at that time imposed a death penalty on German citizens who did not report assets held in a foreign bank. In order to protect German customers no information could be provided to a foreign agency by a Swiss bank.[97]

Panama is now appearing as the 'New Switzerland' and has, according to Arce, arguably the strictest bank secrecy laws in the world.[98] Panama does not impose any income tax and does not regard tax avoidance or tax evasion as a crime and upholds the 'dual criminality' principle.[99] Therefore any request by the US for information on purely tax related matters will generally not be honoured.[100] However, Panama does treat criminal activity seriously and it has strong anti-money laundering laws.[101]

It will be interesting to see if in the future all countries that have committed to enter into TIEAs do in fact pass the requisite domestic laws to put this aspect of international law into

[94] John McLaren, 'The OECD's "harmful tax competition" project: Is it international tax law?' (2009) 24(3) *Australian Tax Forum* 421, 436.
[95] Stephen Fidler, and Michael Phillips,, 'Swiss vow to help US battle tax scams', *The Australian*, (Sydney), 22 June 2009, 22.
[96] Ibid, 22.
[97] Greg Brabec, 'The Fight For Transparency: International Pressure To Make Swiss Banking Procedures Less Restrictive' (2007) 21 *Temple International & Comparative Law Journal* 231, 233.
[98] Bryan Arce,, 'Taken To The Cleaners: Panama's Financial Secrecy Laws Facilitate The Laundering of Evaded U.S. Taxes' (2008-2009) 34 *Brooking Journal of International Law* 465, 467.
[99] Ibid, 468.
[100] Ibid.
[101] Ibid.

effect. It can be argued that the OECD has been successful in making soft international law addressing tax havens – TIEAs - and for that law to be complied with by tax havens and OFCs.[102] There are some commentators who believe that this commitment by tax havens will ultimately fail to translate into hard law. For example, it may be, as argued in The Australian, that TIEAs will not be a strong deterrent in practice. The report said:

> The fact that Switzerland 'led a rush of offers to exchange information with other governments' before the G 20 meeting March 2009, does not mean that Switzerland will not be a major repository of finance from tax avoidance. According to Murphy, the 'agreements to exchange information are useless; the secrecy will be completely intact'.[103]

F *The Role of Tax Havens in Facilitating Global Business Activity*

Half of all cross border transactions flow through tax havens. This is because havens have no or low tax regimes and allow the concentration of capital to occur from and between developed countries. To remove tax havens and hence destroy their facilitating role is to increase the global cost of capital. The OECD may argue that its attacks on tax havens are not about destroying them but about reining in bank secrecy and lack of transparency. But these elements are vital to the ability of tax havens to offer no or low tax rates. Even if the OECD is right, the reluctance to use tax havens engendered by their anti-haven campaign will result in an increase in the overall cost of capital, with outcomes that may include a lessening in cross border lending and investment for productive purposes. These potential adverse results arguably mean that tax havens' importance to the system of global trade and finance will have to continue. Coupled with gaps in the adequacy of TIEAs and changes to bank secrecy laws, tax havens will continue to provide banking and financial services into the foreseeable future.

III CONCLUSION

This paper has looked at some of the factors which indicate that tax havens will continue to provide banking and financial services into the foreseeable future. There are a number of legitimate reasons why different nations, MNEs and individuals will continue to avail themselves of the financial services being offered in those jurisdictions.

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[102] McLaren, above, n 89, 453.

[103] Peter Wilson, 'Pirates of the Caribbean' *The Australian*, (Sydney) 14 April 2009, 24. The 'Murphy' referred to in the article is Richard Murphy, a British accountant who runs the 'Tax Justice Network' dedicated to eliminating tax evasion through tax havens. More information is available at www.taxjustice.net

The global economic system depends for its existence on the free flow of capital between nations to enable ongoing productive activity to continue. Tax havens provide the main mechanism for that to occur, and to occur at rates that do not deter that investment. There are other reasons why tax havens will continue to exist. For example, individuals will always need to hold capital in a foreign jurisdiction for asset protection purposes and high-net-worth individuals who do not have a specific country of residence will invest mobile capital in tax havens. Temporary residents in Australia and non-domiciled residents of the UK and other countries will use tax havens because there is no tax consequence as they have no legal obligation to pay income tax in the country where they live.

Multi-national enterprises will locate their captive insurance companies in certain tax havens and purchase other insurance policies from a company in Bermuda. Tax havens and OFCs perform a crucial function in providing the headquarters for the insurance industry. Without the benefits of low or no tax jurisdictions in which to invest premium income, many individuals or businesses would be unable to purchase insurance cover or would find the premiums beyond their financial reach. The beneficiaries are the public who are covered for loss or injury by insurance companies that exist in tax havens.

MNEs will take advantage of special economic regions or countries that offer tax advantages such as Ireland. Until the US takes action to amend the laws in the State of Delaware, MNEs will continue to incorporate foreign subsidiary companies in that jurisdiction. MNEs will continue to present problems for the country of residence in trying to tax them on their worldwide income. The Australian model, which is widely used in many other nations, to exempt from income tax active business income generated in a comparable state, is arguably the best solution in encouraging Australian MNEs to be global entities. Similarly, many countries including Australia will continue to use tax havens and OFCs for the investment of their sovereign wealth funds for a variety of reasons, as discussed above.

While there is arguably no evidence to support the argument that the Global Financial Crisis was caused by the existence of tax havens, the developed countries certainly view tax havens and the lack of transparency as one contributor to and/or accelerator of the crisis. Further, the argument that the solution to balancing national budgets in the future lies in having tax havens collect income tax for the developed nations with large budget deficits, is simplistic at best and not supported by the tax situation in the developed countries' today. It is interesting to note that, according to Avi-Yonah, the total tax revenue as a percentage of GDP of OECD member countries, during the period 1975 to 2006, had increased even though tax havens and OFCs were actively competing for capital by offering low or no taxes on income.[104] For instance, total tax revenue as a percentage of GDP increased from 29.4% in 1975 to 35.9% in 2006.[105] Both individual and company income tax had also increased by 1.8% and 1.7% respectively.[106]It may be then that budget deficits could be rectified within the next few years without taking drastic action against tax havens and OFCs. In any event the amount likely to be raised, even on best estimates, is unlikely to be anywhere near large enough to address the chronically large budget deficits of some European countries and the US. The solution to budget deficits does not lie in the sunny sands of tax havens.

Under pressure from the ATO, Australian individuals will reduce their use of tax havens and OFCs for tax minimisation purposes and this will be the situation in other countries such as the US and the UK. As a result of Project Wickenby, the ATO strongly contends that many hundreds of millions of dollars will now be collected in income tax as a direct result of action that has been taken to detect Australian taxpayers who held or hold investments in tax havens and did not or do not declare foreign income. The US and other OECD member nations are actively taking action to detect and deter their own taxpayers from using the financial services in tax havens and OFCs. On the other hand, Pinto contends that tax havens and OFCs, once the domain of the rich, will soon be within reach of the average taxpayer due to the internet.[107] It will be up to the ATO to meet this challenge and Pinto urges the ATO to work closely with the private sector to keep up-to-date with technology in the area of E-commerce in order to combat tax evasion through the internet.[108]

In terms of the effectiveness of the OECD and its drive to have all tax havens enter into TIEAs, the action may not result in the demise of tax havens and OFCs as financial centres. Rawlings conducted research by way of interviews with participants involved in offshore financial services in Andorra, Australia, Guernsey, France, Samoa and Singapore in order to asses the effects of the OECD's harmful tax competition project was having on their future

[104] Reuven Avi-Yonah, 'The OECD Harmful Tax Competition Report: A Retrospective After A Decade' (2008 – 2009) 34 *Brooklyn Journal of International Law* 783, 791.
[105] Ibid.
[106] Ibid.
[107] Dale Pinto, 'The Challenges of Dealing with Tax Havens – Can Innovative Uses of Technology be Part of the Solution?' (2008) 10 Innovative Technologies 23, 28.
[108] Ibid, 35.

prospects.[109] Rawlings contends that the push by the OECD to amend bank secrecy laws and enter into exchange information agreements can be accommodated without unduly damaging the leading OFCs.[110] He uses Singapore as an example of an OFC that has not only expanded its banking system to 115 commercial banks but has become a leading centre for private wealth management involving private banks and trust firms. The interviewees expressed confidence in the future of their operations especially in light of the wealth being created in China.[111]

Avi-Yonah contends that there are two ways in which the influence of tax havens may be reduced: first, by eliminating the ability of Controlled Foreign Corporations[112] to defer tax and second, for all OECD member states to impose a refundable withholding tax on payments to non-treaty countries while requiring real exchange of information by treaty countries.[113] By way of contrast, Arce, in his study of Panama as a tax haven, reaches the conclusion that until such time as Panama signs a TIEA with the US, Panama's bank secrecy laws will continue to facilitate the laundering of evaded US taxes.[114] However, since many tax havens and OFCs may not enter into TIEAs with the US or other major developed countries, the domestic bank secrecy laws may not be repealed. This undermines the value of a TIEA since it means that bank secrecy will continue and may only be overridden in the possibly limited situations where a country has a TIEA with the tax haven. . While some countries will not agree to exchange information, it is difficult to see all tax havens complying with the OECD.

Tax havens will survive and flourish, providing as they do a lower cost of capital globally and concentrations of investment capital for the ongoing health of the system.

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[109] Gregory Rawlings, 'Mobile people, mobile capital and tax neutrality: Sustaining a market for Offshore Finance Centres' (2005) 29 *Accounting Forum* 289, 291.
[110] Ibid, 307.
[111] Ibid.
[112] These are companies in foreign countries, often tax havens, owned or controlled by entities in, for example, Australia and other developed countries.
[113] Avi-Yonah, above, n 99, 795.
[114] Arce, above, n 93, 490.