

SOME CONSIDERATIONS ON TAX HEAVENS AN OFF SHORE COMPANIES

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***Abstract:** The present article introduces the reader in the problem of tax heaven and offshore companies. We tried to present, both positive and negative aspects of this problem. On one hand, this type of companies can help a multinational corporation in its economical and financial global projections, but, on the other hand, these companies can be use as extremely efficient instruments of tax evasion and money laundry.*

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Whilst there is no precise definition of what amounts to an Offshore Financial Center (or OFC), the term is usually meant to refer to low-tax, lightly regulated jurisdictions¹ which specialize in providing the corporate and commercial infrastructure to facilitate the use of those jurisdictions for the formation of offshore companies. Offshore Financial Centers are often (but not always) current or former British Colonies or Crown Dependencies, and often refer to themselves as offshore jurisdictions. The term Offshore Financial Center is a neologism coined in the 1980s.

The IMF² considers the following to be characteristics of an Offshore Financial Center:

- Jurisdictions that have relatively large numbers of financial institutions engaged primarily in business with non-residents;

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¹ "Offshore Financial Centers", Richard Roberts, ISBN 1-85898-155-7. in Tolley's International Initiatives Affecting Financial Heavens (2001), Tim Bennet, ISBN 0-406-94264-1, the author in the glossary of terms defines an "Offshore Financial Center" in forthright terms as "a politically correct term for what used to be called a tax heaven." However, he then qualifies this by adding "The use of this term makes the important point that a jurisdiction may provide specific facilities for offshore financial centers without being in any general sense tax heaven".

² The International Monetary Fund is an international organization that oversees the global financial system by observing exchange rates and balance of payments, as well as offering financial and technical assistance when requested.

- Financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies; and
- Centers which provide some or all of the following services: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity.

Views of OFC's tend to be polarized. Proponents suggest that reputable offshore financial centers play legitimate and integral role in international finance and trade, offering huge advantages in certain situations for both corporations and individuals, allowing legitimate risk management and financial planning. Critics argue that they drain tax from wealthy (and not so wealthy) nations, they are insufficiently regulated, and they facilitate illegal tax evasion, money laundering and to avoid legal risk by improperly employing the corporate veil. Proponents point to the tacit support of offshore centers by the governments of the United States (who promote offshore financial centers by continuing use of the FSC) and United Kingdom (who actively promote offshore finance in Caribbean dependent territories to help them diversify their economies and to facilitate the British Eurobond market). OPIC, a U.S. government agency, when lending into countries with under developed corporate law, often requires the borrower to form an offshore vehicle to facilitate the loan financing.

What is certainly true of offshore financial centers is that recently they have attracted a deal more attention than in the past and international initiatives spearheaded by the OECD³, the FATF⁴ and the IMF have a significant effect on the offshore finance industry⁵. A number of smaller, less regulated jurisdictions literally went to the wall, and closed up shop. Most of the principle offshore centers that remained considerably strengthened their internal regulations relating to money laundering and other key regulated activities.

On 23 February 2007 The Economist published a survey of Offshore Financial Centers; although the magazine had historically been very hostile to OFCs, the report represented a shift towards a very much more benign view of the role of offshore finance, concluding: "...although international initiatives aimed at reducing financial crime are welcome, the broader concern over OFCs overblown. Well-run jurisdictions of all sorts, whether nominally on-or offshore, are good for the global financial system"⁶. Although most Offshore Financial Centers originally rose to prominence by facilitating structures

³ The Organization for Economic Co-operation and Development is an international organization of those developed countries that accept the principles of representative democracy and a free market economy. It originated in 1948 as the Organization for European Economic Co-operation (OEEC), led by Frenchmen Robert Marjolin, to help administer the Marshall Plan for the reconstruction of Europe after World War II. Later its membership was extended to non-European states, and in 1961 it was reformed into the Organization for Economic Co-operation and Development.

⁴ The Financial Action Task Force on Money laundering, also known by the French name Groupe d'action financière sur le blanchiment de capitaux (GAFI), is an inter-governmental body founded in 1989 by the G7. The purpose of the FATF is to develop policies to combat money laundering and terrorist financing.

⁵ In 2000 the FATF began a policy of listing countries perceived to be non-cooperative in the fight against money laundering (both offshore jurisdictions and larger countries), and publishing "recommendations" as to how those countries might improve. The process had a salutary effect, and considerable tightening up of both regulation and implementation was noted by the FATF over subsequent years.

⁶ www.economics.com., Official website of "The Economist", Gary Neil, "Places in the sun", February, 23, 2007.

which helped to minimize tax, the increasing sophistication of onshore tax codes has meant that there usually is little tax benefit to moving a transaction structure offshore.

Most professional practitioners in offshore jurisdictions refer to themselves as “tax neutral”, referring to the fact that, whatever tax burdens the proposed transaction or structure will have in its primary operating jurisdiction or market, having the structure based in an offshore jurisdiction will not create any additional tax burdens. For example, international joint ventures are often structured as companies in an offshore jurisdiction when neither joint venture party wishes to form the company in the other party’s home jurisdiction, but both parties wish to ensure that the company’s jurisdiction of incorporation will not attract unwanted tax consequences.

Many offshore financial centers used to “ring fence” offshore companies formed in those jurisdictions (International Business Companies formed in the British Virgin Islands is a good example). However, recent international pressure has brought an end to ring-fencing in most jurisdictions, and most Offshore Financial centers simply restructured their tax codes so that the activity of the offshore companies, whilst technically subject to tax in the jurisdiction, was never likely to result in tax being assessed. Critics of Offshore financial centers argue that a lack of transparency in Offshore Financial centers means that they are vulnerable to being used in illegal tax evasion schemes.

A number of international organizations also suggest that Offshore Financial centers engage in “unfair tax competition” by having no, or very low tax burdens, and have argue that such jurisdictions should be forced to tax both economic activity and their own citizens at a higher level. Another criticism leveled against Offshore Financial center is that whilst sophisticated jurisdictions have developed tax codes which prevent tax revenues leaking from the use off offshore jurisdictions, less developed nations, who can least afford to lose tax revenue, are unable to keep pace with the rapid development of the use of offshore financial structures.

Most OFC’s now promote themselves on the basis of “light but effective” regulation, and generally only seek to regulate high-risk financial business, such as banking, insurance and mutual funds. Many capital market bond issues are structured through a special purpose vehicle incorporated in an OFC specifically to minimize the amount of regulatory red-tape associated with the issue. Some offshore jurisdictions have sought to replicate this success with equity issues by forming local stock exchanges, but these have not been a notable success to date. A number of internet-based businesses have recently set up business on OFC’s which, whilst lawful in the OFC, would not be lawful in its target market. These businesses often relate to pornography or gambling.

Critics of OFC’s suggest that they are not effectively regulated in all areas, and in particular that they are vulnerable to being used by organized crime for money laundering. However, partly in response to international initiatives and partly in a defensive move to protect their reputations, most OFC’s now apply fairly rigorous anti-money laundering regulations to offshore business. Some even argue that offshore jurisdictions are in many cases better regulated than many onshore financial centers.⁷ For example, in most offshore jurisdictions, a person needs a license to act as a trustee, whereas (for example) in the UK and the USA, there are no restrictions or regulations as

⁷ Legitimate asset protection against future political or economic risk should be distinguished from unlawful attempting to evade creditors.

to who may serve in a fiduciary capacity. Some commentators have expressed concern that the differing levels of sophistication between OFC's will lead to "regulatory arbitrage"⁸, and fuel a race to the bottom, although evidence from the market seems to indicate the investors prefer to utilize better regulated offshore jurisdictions rather than more poorly regulated ones.

Critics of offshore jurisdictions point to excessive secrecy in those jurisdictions, particularly in relation to the beneficial ownership of offshore companies, and in relation to offshore bank accounts. The criticisms are slightly difficult to assess. In most jurisdictions banks will preserve the confidentiality of their customers, and all of the major offshore jurisdictions have appropriate procedures for either law enforcement agencies to obtain information regarding suspicious bank accounts. Most jurisdictions also have remedies which private citizens can avail themselves of, if they can satisfy the court in that jurisdiction that a bank account has been used as part of a legal wrong. Similarly, although most offshore jurisdictions only make a limited amount of information with respect to companies publicly available, this is also true of most states in the USA and the EU, where it is uncommon for share registers or company accounts to be available for public inspection.

In relation to trusts and unlimited liability partnerships, there are very few jurisdictions in the world that require to be registered, let alone publicly file details of the people involved with those structures. However, there are certainly well documented cases of parties using offshore structure to facilitate wrongdoing, and the strong confidentiality laws in offshore jurisdictions have clearly played a part in the selection of an offshore vehicle for those purposes.

The bedrock of most OFC's is the formation of offshore structures. Offshore structures are characteristically involving the formation of an:

- Offshore company;
- Offshore partnership;
- Offshore trust;
- Offshore foundation;

Offshore structures are formed for a variety of reasons.

Legitimate reasons include:

- Asset holding vehicles. Many corporate conglomerates employ a large number of companies, and often high-risk assets are parked in separate companies to prevent legal risk accruing to the main group (where the assets relate to asbestos, see the English case of *Adams v Cape Industries*⁹). Similarly, it is quite common for fleets of ships to be

⁸ In practice, such attempts are rarely effective. A trustee in bankruptcy will usually have access to all of the debtor's financial records, and will usually have little difficulty tracing where the assets were transferred to. Transfers to defraud creditors are prohibited in most jurisdictions (offshore and onshore) and a bankruptcy trustee usually have little difficulty persuading a local court to nullify the transfer. Despite the poor prognosis for success, applications to courts in offshore jurisdictions seem to indicate that insolvent individuals still try this strategy from time to time; notwithstanding that it is usually a serious criminal offence in both jurisdictions.

⁹ See *Adams v Cape Industries plc* (1990) Ch433. The case resolved a number of important issues under English Law. The case is most often cited for the comprehensive of the corporate veil under English company law. However, the case also addressed long-standing issues under the English conflict of laws as

separately owned by separate offshore companies to try to circumvent laws relating to group liability under certain environmental legislation.

- Asset protection. Wealthy individuals who live in politically unstable countries utilize offshore companies to hold family wealth to avoid potential expropriation or exchange control restrictions in the country in which they live. These structures work best when the wealth is foreign-earned, or has been expatriated over a significant period of time.
- Avoidance of forced heir-ship provisions. Many countries from France to Saudi Arabia continue to employ forced heir-ship provisions in their succession law, limiting the testator's freedom to distribute assets upon death. By placing assets into an offshore company, and then having probate for the shares in the offshore determined by the laws of the offshore jurisdiction (usually in accordance with a specific will or codicil sworn for that purpose), the testator can sometimes avoid such strictures.
- Collective Investment vehicles. Mutual funds, Hedge funds and Unit Trusts are formed offshore to facilitate international distribution. By being domiciled in a low tax jurisdiction investors only have to consider the tax implications of their own domicile or residency.
- Derivatives trading. Wealthy individuals often form offshore vehicles to engage in risky investments, such as derivatives trading, which are extremely difficult to engage in directly due to cumbersome financial market regulation.
- Exchange control trading vehicles. In countries where there is either exchange control or is perceived to be increased political risk with the repatriation of funds, major exporters often form trading vehicles in offshore companies so that the sales from exports can be "parked" in the offshore vehicle until need for further investment. Trading vehicles of this nature have been criticized in a number of shareholder lawsuits which allege that by manipulating the ownership of the trading vehicle, majority shareholders can illegally avoid paying minority shareholders their fair share of trading profits.
- Joint venture vehicles. Offshore jurisdictions are frequently used to set-up joint venture companies, either as a compromise neutral jurisdiction and/or because the jurisdiction where the joint venture has its commercial center has insufficiently sophisticated corporate and commercial laws.
- Stock market listing vehicles. Successful companies who are unable to obtain market listing because of the underdevelopment of the corporate law in their home country often transfer shares into an offshore vehicle, and list the offshore vehicle. Offshore vehicles are listed on the NASDAQ, AIM, the Hong Kong Stock Exchange and the Singapore Stock Exchange. It is estimated that over 90% of the companies listed on Hong Kong's Hang Seng are incorporated in offshore jurisdictions.

to when a company would be resident in a foreign jurisdiction such that the English courts would recognize the foreign court's jurisdiction over the company.

- Trade finance vehicles. Large corporate groups often form offshore companies, sometimes under an orphan structure to enable them to obtain financing (either from bond issues or by way of a syndicated loan) and to treat the financing as “off balance sheet” under applicable accounting procedures. In relation to bond issues, offshore special purpose vehicles are often used in relation to asset-backed securities transactions (particularly securitizations).

Illegitimate purposes include:

- Creditor avoidance. Highly indebted persons may seek to escape the effect of bankruptcy by transferring cash assets into an anonymous offshore company.
- Market manipulation. The Enron and Parmalat scandals demonstrated how companies could use offshore vehicles to manipulate financial results¹⁰.
- Money laundering. A number of high profile money laundering investigations have indicated schemes facilitated by offshore structures.
- Tax evasion. Although numbers are difficult to ascertain, it is widely believed that individuals in wealthy nations unlawfully evade tax through not declaring gains made by offshore vehicles that they own.
- Terrorist financing. It is often suggested that offshore vehicles might be used to assist terrorist financing, although exhaustive investigations have yet to obtain any evidence of this. Proponents of offshore jurisdictions argue that because their regulatory structures tend to be designed to focus closely on high risk geo-political areas, and since September 11, 2001 attacks all financial institutions tend to scrutinize United Nations embargoed persons lists with enormous care in international transactions, trying to use an offshore structure for terrorist financing would be like putting a red flag on it.

Although these structures are characteristically set up as companies, they can also be set up as trusts or partnerships, and many offshore jurisdictions offer specialized forms of these entities (for example STAR trusts in Cayman and the VISTA trusts in the British Virgin Islands).

¹⁰ Enron Corporation was an American energy company based in Houston Texas which achieved infamy at the end of 2001, when it was revealed that its reported financial condition was sustained mostly by institutionalized, systematic, and creatively planned accounting fraud. Enron has since become a popular symbol of willful corporate fraud and corruption. The lawsuit against Enron’s directors, following the scandal, was notable in that the directors settled the suit by paying very significant amounts of money personally. Enron still exists as an asset-less shell corporation. It emerged from bankruptcy in November of 2004 after one of the biggest and most complex bankruptcy cases in US history. On September 2006, Enron sold Prisma Energy International Inc., its last remaining business, to Ashmore Energy International Ltd. According to the final restructuring plan submitted to bankruptcy court, Enron will be dissolved at the final conclusion of the restructuring process.

The Parmalat case is similar but the consequences were less important than in Enron’s case. For Enron case see

[http://www.rics.org/Management/Businessmanagement/Communication/A%20new%20identity%20for%20a%20new%20life%20\(Financial%20Times\).html](http://www.rics.org/Management/Businessmanagement/Communication/A%20new%20identity%20for%20a%20new%20life%20(Financial%20Times).html)

For Parmalat see “A new identity for a new life”, 23 October 2003 <http://en.wikipedia.org/wiki/Parmalat>

There are a large number of OFC's (by some measures, there are more countries that are OFC's than not), but the following jurisdictions could be considered to be "market leading" jurisdictions for various reasons:

- Bahamas, which has a considerable number of registered vessels. The Bahamas used to be the dominant force in the offshore financial world, but fell from favor in 1970's after independence¹¹.
- Bermuda, which is market leader for captive insurance, and also has strong presence in offshore funds and aircraft registration.
- British Virgin Islands, which has the largest number of offshore companies.¹²
- Cayman Islands, which has the largest value of AUM in offshore funds, and is also the strongest presence in the US securitization market.
- Gibraltar, which, whilst not dominating the offshore market in any particular specialization, retains a strong presence in most fields.
- Jersey, which is a dominant player in the European securitization market and the European REIT market.
- Luxembourg, which is the market leader in UCITS and is believed to be the largest offshore Eurobond issuer, although no official statistics confirm this.
- Panama, which is a significant international maritime center. Although Panama (with Bermuda) was one of the earliest offshore corporate domiciles, Panama has not been a key market player in numbers of offshore incorporations since the late 1980s and early 1990s¹³.

Although there are many, many other offshore jurisdictions, some of which are relatively sophisticated (for example, Guernsey and the Isle of Man are particularly well developed and well regulated offshore centers, although they tend to be overshadowed by Jersey; and the offshore aircraft registration market, unusually, is not dominated by one jurisdiction but is fragmented amongst Bermuda, Cayman, Aruba, Netherlands Antilles and the Seychelles), those seven jurisdictions are generally considered to be the key market participants, and to possess the most sophisticated offshore infrastructure.

¹¹ At about this time the jurisdiction was also rocked by a number of banking scandals. It is also imposed an ill-advise practice of restricting admission to the Bahamian bar to nationals of the Bahamas, which had a diluting effect on the quality legal talent in the jurisdiction (by preventing the recruitment of expatriates), which is critical to the success of setting up sophisticated offshore structures. Not coincidentally, the rise of Cayman as the dominant force in offshore finance almost precisely mirrors the decline of the Bahamas. See generally Tolley's Tax heavens (2000), ISBN 0754504719.

¹² Over 700.000 offshore companies have been formed in the British Virgin Islands, although only approximately 450.000 remain active. This would account for approximately 42% of the estimated 1.1 million offshore companies incorporated worldwide.

¹³ Retrieved from "http://en.wikipedia.org/wiki/Offshore_Financial_Centre"