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Tax Havens

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I. INTRODUCTION

Opinions about tax havens cover a wide spectrum. Some suggest tax havens present an unacceptable face of capitalism and inflict considerable damage on the economies of non-haven countries.[1] Others argue that havens offer relief from oppressive taxes and other regulations which inhibit the free and efficient flow of capital;[2] and still others hold the view that tax haven status may act as a catalyst for economic development.[3] Obviously, the opinions vary according to whether a person is a tax collector in a non-haven country, a taxpayer engaged in international business activities, or a government policymaker in a haven country.

The objective of this Article is to examine the facts from which these opinions developed in order to gain a better understanding of tax havens and the pressures leading to their creation and perpetuation. Special attention will be paid to identifying the interests of the major parties affected by tax haven activities: industrialized countries, non-haven developing countries, foreign investors, and the tax havens themselves.

The remainder of this Article is divided into five parts. Part II identifies the principal attributes of tax havens. Part III deals with transactions using tax havens, and Part IV discusses the various legitimate interests affected by the existence of tax havens. Part V then provides a summary of the responses of non-haven countries to the abuse of tax havens and Part VI offers some concluding comments and observations.

II. Tax Havens Described

A. *Principal Attributes of Tax Havens*

At the outset, it may be useful to recognize that many countries not widely recognized as such can be characterized as tax havens for particular types of income or activities. The United States, for example, a frequent critic of the existence of tax havens, can be characterized as a tax haven with respect to income from investments in United States real estate and interest income paid to

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1. *See generally Hearings before the Subcomm. on Oversight of the House Ways and Means Comm.*, 96th Cong., 1st Sess. (1979) [hereinafter cited as *Oversight Subcomm. Hearings I*]; Symonds, *Tax Havens Under Fire Again*, Accountant, May 19, 1977 at 573; Roscow & Berton, *Tax Havens under Siege*, 143 Fin. World 9 (1975).

2. *See* van Hoorn, Jr., *Problems, Possibilities and Limitations with Respect to Measures Against International Tax Avoidance and Evasion*, 8 Ga. J. of Int'l & Comp. L. 763 (1978).

3. *See* de Jantscher, *Tax Havens Explained*, 1976 Fin. & Dev. 31; *Policy and Economic View of a Caribbean Country v. U.S. Tax Policy* (1980)(Netherlands Antilles Position Paper)[hereinafter cited as Position Paper].

foreign persons[4] that is earned on deposits with United States banks or United States branches of foreign banks. Similarly, South Africa and France, which rely heavily on the territoriality principle of taxation, have tax regimes somewhat similar to those of acknowledged tax havens, such as Panama and Liberia.

Hence, tax haven status is a matter of degree more than anything else. Nevertheless, some countries are widely acknowledged to be tax havens.[5] These traditional tax havens are a varied collection of colonies, principalities, and independent countries[6] geographically dispersed throughout the world and ranging from among the richest countries to the poorest. Notwithstanding their geographic, political, and economic diversity, tax havens share several common features. First, tax havens have low or nil taxes, which are structured to offer foreign persons an opportunity to avoid or evade[7] the taxes of other countries. The tax regimes of haven countries generally fall into one of three categories: pure tax havens, liberal tax havens, and tax treaty havens. Each category is discussed below. A second feature of tax havens generally is an absence or minimum of exchange control restrictions. Bahrain, the Cayman Islands, and Vanuatu, for example, impose no currency restrictions on foreign nationals.[8] The Bahamas, on the other hand, does have exchange controls, but they are imposed only on persons residing or doing business in the Bahamas. A third feature usually found in tax havens is laws insuring the confidentiality of financial and commercial information. Although such laws are not found in all tax havens, many haven countries have bank secrecy and similar internal laws making it a crime to

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4. *See, e.g.,* I.R.C. §§ 861(a)(1)(A), 871(a),(d)(1981).

5. The International Bureau of Fiscal Documentation lists the following as the most important tax havens: Andorra, Antigua, Bahamas, Barbados, Bermuda, British Virgin Islands, Brunei, Cayman Islands, Costa Rica, Cyprus, Eire, Gibraltar, Grenada, Guernsey, Hong Kong, Isle of Man, Jersey, Liberia, Liechtenstein, Luxembourg, Malta, Monaco, Nauru, Netherlands, Netherlands Antilles, Panama, St. Vincent, Seychelles, Singapore, Switzerland, Turks and Caicos, and Vanuatu. 31 BULL. FOR INT'L FISCAL DOC'T. 5 (1977); *see also* Pepper, *From Tax Haven to Fiscal Paradise,* 31 BULL. FOR INT'L FISCAL DOC'T. 31, 37 (1977).

6. Although not all tax havens are independent countries, for convenience in this paper, the havens sometimes are referred to collectively as "countries."

7. Tax evasion is generally defined as an illegal attempt to reduce taxes. Tax avoidance, on the other hand, refers to attempts to minimize taxes which technically are legal, but not within the spirit of the law. *See infra* text accompanying notes 104-15.

8. *See* 80-10 TAX MGMT. INT'L J. 37 (1980).

disclose such information to any person. Though Swiss bank secrecy is renowned,[9] legislation in other tax havens such as Liechtenstein,[10] the Bahamas, and the Cayman Islands is even more stringent. The bank secrecy laws of the Bahamas and the Cayman Islands, for example, make it virtually impossible for foreign government officials to obtain information helpful in tax fraud investigation.[11] The Cayman Islands are considering going even further by creating an enclave where non-residents can transact business without going through passport control and formally entering the territory.[12] Many tax havens, such as the Cayman Islands, Netherlands Antilles, and Vanuatu, permit corporations to issue shares in bearer form so the identities of the true owners of corporations are easily hidden.[13] In addition, the tax havens usually have a well-defined policy against entering into international agreements (such as tax treaties and mutual assistance treaties)

9. Swiss bank secrecy is superseded in a number of important instances under domestic Swiss law. The most important of these is the exemption for criminal investigations. In that situation a banker has no privilege to refuse to testify on grounds that the information is confidential. *Oversight Subcomm. Hearings I, supra* note 1, at 288-89. The mutual assistance treaty between the United States and Switzerland, which entered into force in January 1977, provides that the Swiss Government may make fiscal information available to the United States if such information relates to an investigation of organized crime. *Id.* at 290.

10. Since 1960 Liechtenstein has had its own banking law. Its provisions are even more strict than those of its Swiss model, providing stiff penalties for anyone who trangresses the rules on bank secrecy. Financial Times, July 29, 1980, at 12, col. 5.

11. The Bahamian bank secrecy law is found in section 10 of the Banks and Trust Companies Regulation Act of 1965. The Cayman Islands enacted identical legislation in the Banks and Trust Companies Regulations Law, 1966. In the wake of *In re* Grand Jury Proceedings, United States v. Field, 532 F.2d 404 (5th Cir. 1976), *cert. denied,* 429 U.S. 940 (1976), a case establishing that foreign persons subpoenaed in the United States to give testimony before federal grand juries must testify even though providing the testimony is violative of their residence's laws, the Cayman Islands, on September 8, 1976, enacted the Confidential Relationships (Preservation) Law. The law, designed to cure perceived shortcomings in the bank secrecy law, imposes criminal sanctions not only upon those who divulge or attempt to divulge confidential information, but also upon those willfully obtaining or attempting to obtain such information. *Oversight Subcomm. Hearings I, supra* note 1, at 15-16.

12. *Oversight Subcomm. Hearings I, supra* note 1, at 266.

13. *See, e.g.,* PRICE, WATERHOUSE & CO., 1979 DOING BUSINESS IN THE NETHERLANDS ANTILLES 13; PRICE, WATERHOUSE & CO., 1977 DOING BUSINESS IN THE NEW HEBRIDES 26.

which might override domestic confidentiality laws. A fourth attribute common to the more successful tax havens is a record of political stability and a governmental attitude strongly favorable toward foreign investors.[14] Bermuda, Switzerland, Liechtenstein, Hong Kong, the Cayman Islands, and the British Virgin Islands owe their success as tax havens in part to their political stability and an environment favorable to foreign investors.[15] Continued unsettled conditions in other parts of the world have focused attention on the importance of political stability in particular.[16] Finally, most tax havens offer good travel, telex and telephone links to industrialized countries, good business facilities, and well trained staff to expedite haven transactions.[17] Hong Kong, for example, offers excellent air transportation services, and its communications systems are highly efficient and reliable. The Netherlands Antilles has expended considerable effort recruiting sophisticated personnel to manage its tax haven activities and has spent over $100 million acquiring improved telephone and telecommunications facilities.[18]

B. *Fiscal Structure of Tax Havens*

To gain a better understanding of tax havens, it may be useful to divide them into the following categories according to the structure of their fiscal systems: pure tax havens, liberal tax havens, and tax treaty havens.

1. Pure Tax Havens

Pure tax havens impose no direct taxes on income, profits, or capital gains and do not have death duties, succession taxes, or

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14. In 1979 the Government of Barbados passed legislation permitting offshore banking activities. The government thinks Barbados will be attractive as an offshore financial center because it has the "major requirements for the business—a well-developed infrastructure, political stability, a flexible labour force and first-class communications." Financial Times, Dec. 3, 1980, at 12, col. 7.

15. Long term colonies with no apparent aspirations for independence are often considered ideal tax havens. *See*, Pepper, *supra* note 5, at 33.

16. Financial Times, July 22, 1980, at 30, col. 1.

17. One of the reasons often given for Vanuatu's inability to develop a more substantial tax haven sector has been the inadequacy of its travel and communications systems. *See* D. DIAMOND & W. DIAMOND, TAX HAVENS OF THE WORLD 182 (1978); R. KINSMAN, GUIDE TO TAX HAVENS (1978); M. LANGER, INTERNATIONAL TAX PLANNING (2d ed. 1979).

18. Position Paper, *supra* note 3, at 1, 7-8.

gift and inheritance taxes. They may, however, have employment taxes, customs duties, and real property taxes. In addition, as in other haven countries, the pure tax havens impose license and registration fees on various haven related activities. Thus, in most cases, registration fees are imposed on the formation of holding companies, finance subsidiaries, trusts, and other haven entities; annual license fees are imposed as a condition for continuing to carry on haven transactions and fees are charged for work permits for expatriates working in the tax haven sector.[19]

Generally, pure tax havens are attractive places to accumulate income free of taxes and exchange controls. To take advantage of pure tax havens, however, the transactions giving rise to haven income must be structured to avoid taxes in other jurisdictions. Hence, it would not be especially advantageous for a United States resident to form a Bahamian corporation to make loans at commercial rates to the United States resident and his relatives. In such a case, the interest paid on the loan would not be taxed in the Bahamas, but the United States would treat the interest as having a United States source and impose a thirty percent gross withholding tax on it.[20] The Bahamian corporation also might be characterized as a foreign personal holding company under United States tax law and therefore be subject to additional taxes.[21]

On the other hand, if a United Kingdom corporation is selling goods to an Australian affiliate, it may be advantageous to route the sale through a conduit corporation formed in Vanuatu, Nauru, or another pure tax haven. By having the United Kingdom corporation sell to a related Vanuatu corporation at a low price (just above the seller's cost, for example) and the Vanuatu corporation sell to the Australian affiliate at a high price (e.g., just below the price at which the Australian affiliate resells the goods), the bulk of the profits from the sales will arise in Vanuatu and be attributable to the Vanuatu corporation, thereby escaping taxation in either the United Kingdom or Australia.[22] Because the

19. *See* de Jantscher, *supra* note 3; Pepper, *supra* note 5, at 37.

20. I.R.C. §§ 881, 1442 (1981).

21. *Id.* § 551.

22. The utility of this classic tax haven transaction, and others like it, was eroded greatly by widespread adoption of anti-tax haven legislation and transfer pricing regulations aimed at preventing the tax-free accumulation of income in situations such as that described in the text. *See infra* text accompanying notes 174-213.

chances of escaping taxation are greatly increased if it is not apparent that the Vanuatu corporation is related to the United Kingdom and Australian enterprises, Vanuatu corporate confidentiality laws may be useful to prevent disclosure of the true ownership of the Vanuatu corporation.

Pure tax havens also are used widely as offshore financial centers where funds are borrowed from nonresidents and lent to other nonresidents through the intermediation of banks and other financial institutions. The pure tax havens are attractive sites for these activities because the banking operations can be conducted free of exchange controls and reserve requirements.[23] The secrecy laws and absence of taxes are also attractive to bank customers, although the banks themselves may not benefit greatly from either of these.[24]

The Bahamas, Bermuda, the Cayman Islands, Turks and Caicos, Nauru, and Vanuatu commonly are considered pure tax havens.[25] Other havens come close to being pure tax havens, but impose relatively minor direct taxes on income. The British Virgin Islands, for example, imposes an income tax on both individuals and companies, but the maximum tax rate is fifteen percent.[26]

2. Liberal Tax Havens

Liberal tax havens generally have direct taxes of some sort, but accord traditional haven activities favored tax treatment. Although such tax preferences are fairly common in non-haven countries,[27] the combination of tax preferences, a governmental attitude favoring haven activities, and the size of haven activities relative to the domestic economy distinguish liberal tax havens from other countries offering similar tax preferences.[28]

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23. *Oversight Subcomm. Hearings I, supra* note 1, at 324-25.

24. *Id.*

25. *Oversight Subcomm. Hearings I, supra* note 1, at 14.

26. Pepper, *supra* note 5, at 33.

27. France and Australia, for example, tax on the territoriality principle, as do Hong Kong, Panama, and Costa Rica. PRICE, WATERHOUSE & CO., 1978 DOING BUSINESS IN AUSTRALIA 68; PRICE, WATERHOUSE & CO., 1979 DOING BUSINESS IN FRANCE 83; 1980 PRICE, WATERHOUSE & CO., DOING BUSINESS IN PANAMA 33. The United States exempts interest received by foreign persons on deposits held in United States banks or in United States branches of foreign banks. I.R.C. §§ 861(a)(1)(A), 861(c)(1981).

28. Some liberal tax havens, notably Hong Kong and Singapore, resist being labelled as tax havens and prefer to be characterized as financial centers. They

The tax preferences for haven activities in some liberal tax havens arise as a result of their basic tax structure. Hong Kong, Panama, and Costa Rica, for example, have income taxes, but because they rely on the territoriality principle to determine the scope of their tax jurisdiction, foreign source income generally is not taxed.[29] In other liberal tax havens, the tax preferences exist because of conscious governmental policy encouraging particular activities. For instance, the Republic of Ireland allows an individual who is an established novelist, playwright, composer, artist, sculptor or similar creative worker to establish a residence in Ireland and receive artistic earnings free of tax.[30] Since 1965, Barbados has had legislation permitting registration of "international business companies" that are taxed at a rate of two percent on their global profits (the normal rate being considerably higher—generally forty-five percent) and are allowed to remit dividends to nonresidents free of tax.[31] In 1979, Barbados passed additional legislation allowing offshore banking activities subject to only a modest tax on profits.[32] The Philippines in 1976, and Puerto Rico in 1980, passed similar legislation to stimulate offshore banking activities in their territories.[33]

Some liberal tax havens combine tax systems based on the territoriality principle with special nontax legislation designed to facilitate particular haven activities—notably registration of ships

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certainly are correct in claiming that they are not pure tax havens. They impose direct taxes even on income from some haven activities—notably offshore banking income. On the other hand, in Singapore the rate imposed on offshore banking income is considerably lower than the rates generally applied to corporate income. As of March 1980 the rate of tax on offshore banking income in Singapore was 10 percent while the normal corporate tax rate was 40 percent. Soin, *Singapore: Taxation and the Singapore Asia Dollar Market,* 80-3 TAX MGMT. INT'L J. 7, 8 (1980). In Hong Kong, the tax rate on offshore banking income is the same as the normal corporate tax rate, but that rate is only 17 percent. *Id.* at 9; PRICE, WATERHOUSE & CO., 1979 DOING BUSINESS IN HONG KONG 39.

29. *Oversight Subcomm. Hearings I, supra* note 1, at 14; PRICE, WATERHOUSE & CO., 1980 DOING BUSINESS IN PANAMA 31-32; Financial Times, July 7, 1980, at 46.

30. A. ANDERSON, TAX AND TRADE GUIDE - REPUBLIC OF IRELAND 72 (2d ed. 1979). Other places, such as Malta, the Isle of Man, the Channel Islands, and Sri Lanka, encourage wealthy individuals to become "tax exiles" from high tax industrialized areas. Financial Times, July 8, 1980, at 15.

31. Pepper, *supra* note 5, at 76.

32. Financial Times, Dec. 3, 1980, at 12.

33. Soin, *supra* note 28, at 9; Woods, *Puerto Rico: The New International Banking Center Law,* 80-11 TAX MGMT. INT'L J. 15 (1980).

under "flags of convenience." Liberia, Panama, Singapore,[34] and Malta are examples of countries offering income tax exemption and special registration requirements for shipping activities.[35]

Liberal tax havens are often attractive places to locate activities producing foreign source income. Panama thus has become an important regional financial center for offshore banking operations.[36] Hong Kong and Singapore, although they do impose some taxes on offshore banking income, have become major international centers for offshore banking operations, in part because their tax rates, seventeen percent and ten percent respectively, are far below the rates prevailing in other countries. Of course, the absence of significant exchange control restrictions and banking regulations, and the presence of excellent communications facilities and highly skilled professional services, are probably more important factors than the tax preferences available.[37] Bank customers, in some cases, also may be attracted by relatively rigorous bank secrecy laws.[38]

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34. Singapore generally taxes under a modified territoriality principle under which income is not subject to tax unless it arises in Singapore or is remitted to a person resident in Singapore. PRICE, WATERHOUSE & Co., 1980 DOING BUSINESS IN SINGAPORE 43, 49. Income can be accumulated abroad without paying the Singapore income tax. *Id.* In addition, income from the operation of Singapore registered ships is exempt from tax. *Id.*

35. *See, e.g.*, PRICE, WATERHOUSE & Co., 1980 DOING BUSINESS IN PANAMA 48.

36. Under the territoriality principle used in Panama, interest income from loans made to foreign persons is foreign source income and not taxed in Panama. *Id.* Furthermore, as a result of special legislation, interest paid by offshore banks located in Panama is exempt from Panamanian tax. *Id.*

37. The Philippines had difficulty getting its offshore banking activities to flourish even though the Philippine tax rate on offshore banking income is only five percent, which is lower than either the rate in Hong Kong or Singapore. Soin, *supra* note 28, at 9. Probable reasons for the lack of success are the less favorable monetary controls and regulatory climate in the Philippines as compared to Hong Kong and Singapore. *Id.*

On the other hand, the possible impact of taxes is not completely disregarded in Hong Kong and Singapore, as is apparent from the constant attention each pays to the taxes imposed by the other. Hong Kong at present imposes a 15 percent withholding tax on interest paid to foreign depositors. Although recent transactions (notably U.S. dollar denominated certificates of deposit) have been structured so as to avoid this withholding tax, a recent government report has implied that repeal of the withholding tax might be appropriate given that Singapore no longer has such a withholding tax. Financial Times, July 7, 1980, at 7.

38. *Oversight Subcomm. Hearings I, supra* note 1, at 324. Where the offshore banking operations in either a pure tax haven or a liberal tax haven are carried on by a branch of a bank from an industrialized country, the tax prefer-

Liberal tax havens are also useful for establishing holding companies and trusts provided the income earned by the holding companies and trusts is foreign source and not subject to tax in other countries.[39] Of course, some liberal tax havens are well suited as bases from which to carry on shipping operations or engage in artistic endeavors.

3. Tax Treaty Havens

Tax treaty havens are parties to tax treaties under which they offer access to attractive markets to individuals and corporations, who generally are not residents of the havens, on favorable tax terms. In the typical transaction making use of a tax treaty haven, capital originates in a third country, passes through a company, trust, or similar entity formed in the tax treaty haven and is then lodged in another country. Depending on the nature of the transaction, either the country where the capital originates, or the country where it is lodged, or both, will be parties to the treaties by which the tax treaty haven offers tax preferences.

Tax treaties are used widely to obtain tax advantages not otherwise available in the domestic legislation of the contracting states. In fact, the tax preferences accorded international business and investment transactions are one of the principle reasons countries conclude the treaties.[40] The benefits offered by tax treaty havens are distinguishable from the more generalized benefits available under tax treaties because the former arise from more than just a favorable tax treaty. Countries with favorable tax treaties become havens because they offer a combination of (i) a favorable tax treaty which generally provides relief from source withholding taxes on interest, dividends, and royalties paid to residents of the tax treaty haven (including resident corporations owned by third country residents), (ii) a low or nil tax burden in

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ences available in the haven country generally do not inure to the banks, but to the countries in which the banks are resident through a reduction in the amount of the foreign tax credit the resident countries are obliged to give the banks. *Id.* at 325.

39. Financial Times, Dec. 3, 1980, at 12; Pepper, *supra* note 5, at 76.

40. *See generally Hearings before the Subcomm. on Oversight of the House Ways and Means Comm.*, 96th Cong., 2d Sess. 269 (statement of H. Rosenbloom, Dept. of the Treasury, April 29, 1980)[hereinafter cited as *Oversight Subcomm. Hearings II*]; Surrey, *International Tax Conventions: How They Operate and What They Accomplish,* 23 J. TAX'N 364 (1965).

the tax treaty haven on income covered by the tax treaty, and (iii) freedom from withholding taxes on remittances of interest, dividends, and royalties from the tax treaty haven.[41]

A number of countries offer tax benefits because of the interaction between tax treaties and domestic tax laws. The most prominent tax treaty havens are countries or territories covered by tax treaties offering tax-favored access either into or out of the United States. The Netherlands Antilles is probably the single most important tax treaty haven,[42] but the British Virgin Islands, Barbados, Honduras, and Switzerland also have tax treaties and domestic legislation combining to produce tax preferences not otherwise available.[43]

Tax treaty havens commonly are used as conduits in international financing and investment transactions. For example, a United States company wishing to finance domestic operations on the Eurobond market often forms a Netherlands Antilles finance subsidiary to borrow funds abroad and then lend them to the United States parent. If the parent borrowed the funds directly on the Eurobond market, the interest paid to the foreign creditors might be subject to the United States thirty percent gross withholding tax.[44] By arranging the financing through the Netherlands Antilles, however, the interest paid by the parent to the subsidiary is exempt from the United States withholding tax under Article VIII of the United States/Netherlands Antilles tax treaty.[45] The interest paid by the Antilles subsidiary to foreign creditors is exempt from Netherlands Antilles tax under domestic law and exempt from the United States withholding tax under either United States domestic law or Article XII of the United

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41. *Oversight Subcomm. Hearings II, supra* note 40, at 5 (response of H. Rosenbloom, ITC, Dept. of the Treasury, to questions of Representative Gibbons, July 30, 1980).

42. *Joint Comm. on Tax'n, Description of H.R. 7553 Relating to Exemptions from U.S. Tax for Interest Paid to Foreign Persons,* 96th Cong., 2d Sess. 6 (1980)[hereinafter cited as *Joint Tax'n Comm.*].

43. *Id.* at 6; Langer, *The Need for Reform in the Tax Treaty Area,* in INCOME TAX TREATIES 717, 732-35 (J. Bischel ed. 1978) [hereinafter cited as INCOME TAX TREATIES].

44. I.R.C. §§ 871, 881, 1441-1442 (1981); *Joint Tax'n Comm., supra* note 42, at 9-10.

45. *Oversight Subcomm. Hearings I, supra* note 1, at 293; PRICE, WATERHOUSE & CO., 1979 DOING BUSINESS IN THE NETHERLANDS ANTILLES 32; U.S. DEPARTMENT OF THE TREASURY, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE 42 (1979); Position Paper, *supra* note 3.

States/Netherlands Antilles tax treaty.[46] Further, the net income earned by the Antilles subsidiary (after deduction for the interest paid to the foreign creditors) generally is taxed in the Netherlands Antilles at a rate of twenty-four percent.[47]

III. Tax Haven Transactions

A. *In General*

Generally speaking, tax haven transactions are international trade and investment activities formally structured to legally avoid or illegally evade tax or other laws in non-haven countries. A central characteristic of tax haven transactions is the absence of substantial economic activity in the tax havens involved in the transactions. Tax havens usually serve only as conduits, booking centers, or places of formal ownership, with the real economic activity, including, on many occasions, even the record keeping relating to the tax haven's role in the transaction, taking place in other jurisdictions.[48]

Since World War II, when many countries raised taxes to unprecedented levels, there has been a brisk business in establishing tax havens and making use of their facilities. Aggregate fiscal losses to non-haven countries (or savings to taxpayers—depending on one's point of view) resulting from tax haven activities cannot be estimated accurately, but they undoubtedly amount to billions of dollars annually, with only a small fraction of the losses accruing to tax havens. The fragmented evidence available clearly suggests that tax haven transactions are substantial in amount and growing at a relatively rapid pace. The growth of offshore banking activities in the Bahamas, Bermuda, the Cayman Islands, Panama, Hong Kong, Singapore, and Bahrain, as well as legislative activity in other jurisdictions (the Philippines, Barbados, Puerto Rico, and the United States, for example) aimed at facilitating the establishment of an offshore banking sector is unmistakable evidence of the importance of offshore banking. The substantial growth of revenues derived from internation-

46. Position Paper, *supra* note 3, at 4-5.

47. *Id.*

48. Of course, there is no clear line between tax haven transactions and other international business and investment transactions where the form of the transaction reflects its substance, nor is there a clear distinction between legal avoidance and illegal evasion of the laws of other countries.

al finance subsidiaries of United States corporations by the Netherlands Antilles and the figures on the growth of borrowing on the Eurobond market through these subsidiaries establish the significance of such activities. Transfer pricing, whether it involves avoidance or evasion of the laws of non-haven countries, is generally thought to be a relatively common practice with substantial amounts being shifted from non-haven countries to tax havens. As for the use of tax havens to evade and avoid nontax laws of non-haven countries, recent studies by the United States Congress and the Securities and Exchange Commission demonstrate that such practices are not uncommon.[49] As a consequence, even though an estimate on the aggregate volume of tax haven transactions cannot be made, these transactions are a significant factor in international business and investment.

B. *Description of Tax Haven Transactions*

1. Major Tax Haven Transactions Involving Avoidance of Taxes and Other Laws

a. Offshore banking

Offshore financial centers are locations where funds are borrowed from nonresidents and lent to other nonresidents through the mediation of banks and other financial institutions.[50] The ma-

49. *Oversight Subcomm. Hearings I, supra* note 1, at 15; Pepper, *supra* note 5, at 31.

50. Offshore banking activities have grown considerably in recent years, particularly in areas outside the major financial market of London. There are 305 licensed bank and trust companies, 21 of which were registered in the past year in the Bahamas. Although accurate figures are not available, it appears that the Bahamian share of the Eurocurrency market is close to 10 percent, second only to London. Since 1975, the assets of United States bank branches in the Bahamas have more than doubled from $38.3 billion to $89.7 billion at the end of February, 1980. Financial Times, July 22, 1980, at 30. In Singapore, there has been a spectacular increase in offshore banking from a small base 12 years ago. In the nine months to September 30, 1980, the Asia dollar market has continued to expand at a rate of about 40 percent per annum and now has assets of about $25 billion. Financial Times, Nov. 18, 1980, at IV. The growth of offshore banking activities in Bahrain has been characterized as one of the most successful aspects of the modern development of the Middle East economy. *Id.* at XI. Off shore banking activities were launched in 1975 and total assets now exceed $31 billion. In 1964 the Cayman Islands had only one or two banks and virtually no offshore business. By January 31, 1977, the Cayman Islands had 218 licensed banks and trust companies. *Oversight Subcomm. Hearings I, supra* note 1, at

jor offshore financial centers are London, the Bahamas, the Cayman Islands, Panama, Hong Kong, Singapore, and Bahrain. Some of these centers are fully operational; they conduct actual dealings with customers to obtain funds and negotiate credits. Other centers are merely booking centers where deposits and loans are formally lodged, but no transactions are physically performed.

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15. At the end of 1978, United States bank branches in the Cayman Islands had assets of $18.3 billion. *Id.* at 327.

Although offshore banking today is a natural consequence of the increasing internationalization of business, United States regulations were a significant factor in the growth of offshore banking activities in the 1960s and early 1970s. *Id.* at 324. Beginning in 1963, at a time of fixed exchange rates, the United States adopted several programs that were designed to prevent devaluation of the dollar. Joint Tax'n Comm, *supra* note 42, at 10. These programs attempted to ease the pressure on the United States, which had the effect of closing off United States capital markets to foreign borrowers. Note, *Eurobond Practice: Sources of Law and the Threat of Unilateral National Regulations,* 20 VA. J. INT'L L. 505, 506 (1980). The programs also limited the ability of United States banks to meet their customers' foreign financial needs and to otherwise engage in international banking. *Oversight Subcomm. Hearings I, supra* note 1, at 325. In order to comply with the United States regulations and at the same time to provide a broad range of international financial services, banks began to establish foreign branches principally in the Bahamas and the Cayman Islands. Between 1965 and 1974, the number of branch offices of United States banks in the Bahamas and Cayman Islands increased from 1 to 124. *Id.* at 335-36. Virtually all of these branches were (and are today) merely booking centers for financial transactions negotiated elsewhere, but they gave United States banks access to reserve free Eurocurrency markets. Further, since foreign loans booked and funded through these shell branches did not affect the United States balance of payments, they were exempt from the restrictions on foreign credits that applied to domestic banking operations. *Id.* at 325.

The United States Government program to restrict capital outflow was ended in 1974 and there were many who thought this would bring an end to offshore markets. Note, *Eurobond Practice: Sources of Law and the Threat of Unilateral National Regulations,* 20 VA. J. INT'L L. 505, 506 (1980). By that time, however, offshore banking had become an essential part of international business. Transnational corporations have found that with operations in several countries they need access to a wide variety of credit facilities in different currencies, outlets for idle funds, and the means with which to transfer funds across national boundaries. Transnational corporations also are interested in effecting their international financial transactions free of tax consequences and with a minimum of exchange controls. Banking secrecy and relaxed disclosure requirements also are important to some persons. Banks are eager to accommodate the expanded and diverse needs of their customers for international financial services in locations that impose no reserve requirements and only a minimum of other banking regulations.

London is a good example of an operational center; the Bahamas and the Cayman Islands generally are recognized as examples of booking centers.[51] In offshore financial centers which are principally booking centers, almost all of the bank branches are "shells." Typically, these branches are nothing more than a set of ledgers managed and kept by an agent rather than a physical location where business is transacted. While deposits and loans are formally lodged in these shells, the transactions are physically negotiated elsewhere and the funds may never actually be present in the shell.[52] Other financial centers, such as Hong Kong and Singapore, are a combination of booking and operational centers. In these locations, offshore banking transactions may be physically carried on or they may be simply booked through them.

Offshore financial centers are attractive to banks and their customers for a variety of reasons. First, taxes, or more correctly the absence of taxes, have been an important reason certain locations have become attractive as offshore financial centers. Also very important, however, are factors such as exchange control laws, local reserve requirements, communications and travel facilities, language, the country's time zone, its commercial laws, and its political and social stability.[53] The importance of nontax factors is clearly illustrated by the fact that London, the largest offshore center, is located in a high tax country. Bank secrecy laws may be significant consideration for bank customers, although such laws often do not benefit the banks and on many occasions do not shield the customers.[54]

The highly vaunted tax advantages offered by the offshore booking centers frequently do not benefit the banks. The Bahamas and the Cayman Islands, for example, are by far the most important of the offshore booking centers for United States banks.[55] Operations in such centers generally are carried on

51. *Oversight Subcomm. Hearings I, supra* note 1, at 323-24.

52. *Id.* at 324-25. Of the 307 financial institutions licensed to do business in the Bahamas, only about 55 of them have employees. The July, 1978 issue of TAX HAVEN AND SHELTER REPORT states that on December 31, 1977, there were about 14,000 people living in the Cayman Islands, which by that time had 8,158 registered companies, 237 banks and more telex machines per capita than any other place on earth. Only a few of the banks are authorized to do business with residents of the Cayman Islands, however. *Id.* at 15.

53. *Id.* at 324.

54. *Id.*

55. At the end of 1978, United States banks had 139 branches in the Baha-

through branches, which means the earnings of the branches are immediately subject to United States tax. In these instances, the principal effect of having no taxes in the Bahamas and the Cayman Islands is to reduce the amount of foreign tax credits the banks could claim in the United States and increase the amount of revenues received by the United States Government.[56] Of course, bank customers do benefit from the absence of taxes in the Bahamas and Cayman Islands because that absence permits them to receive their interest payments free of tax. The benefits to bank customers from bank secrecy laws in the offshore booking centers may be even more illusory, at least where United States banks are involved. Generally, the United States Comptroller of the Currency requires United States banks to maintain full records in the United States of transactions booked through offshore branches. In all but three cases, the primary records of United States bank branch operations in the Bahamas and the Cayman Islands are maintained in the United States. Only secondary records, which are duplicates of the records kept in the United States, are maintained in the Bahamas and the Cayman Islands.[57] As a consequence, although the secondary records may be protected by rigorous bank secrecy laws, United States bank examiners and Internal Revenue Service personnel have full access through the primary records to all the names, loans, and deposits booked in the offshore branches of most United States banks.

b. International finance subsidiaries and the Eurobond market

In the early 1960s a market for long-term debt securities de-

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mas and the Cayman Islands. These branches had assets of $90.9 billion. *Id.* at 324, 327.

56. Because of the limitations on the United States foreign tax credit, banks find it more advantageous to operate in a tax-free environment than in a location where the taxes are higher than United States taxes. As between a tax-free environment and one in which the taxes are equal to or less than the United States tax, however, banks generally are fiscally neutral. Political pressures, however, may favor the tax-free environment.

57. *Oversight Subcomm. Hearings I, supra* note 1, at 336-37. In the three cases where primary records are not maintained in the United States, the banks have class A licenses to engage in both international and domestic banking activities in the Bahamas. Because these bank branches are governed by local bank supervisors, only minimal records are maintained in the United States. *Id.* at 337.

nominated in a currency, principally dollars, which was independent of the national markets in which the securities were sold, began to develop. This market has come to be known as the "Eurobond market."[58] Debt securities sold in the Eurobond market normally are free of taxes withheld at source, and the conditions on which the bonds are issued put the risk of any withholding taxes on the issuer by requiring the issuer to pay the interest, premiums and principal net of any tax withheld at source. Usually, if a withholding tax is imposed as a result of a change in law or policy, the issuer may call the bonds. Transnational corporations offer bond issues not subject to the withholding taxes of their home jurisdiction through international finance subsidiaries (as is true with United States and German corporations) or through specific statutory exemptions. Some statutory exemptions apply to interest paid to nonresidents generally (e.g., Norway and Sweden) or, more often, the exemption is contingent on the bond being issued in a foreign currency (e.g., Australia, Canada, and Japan). Because Eurobonds traditionally are not subject to withholding taxes in the source country, an issuer could not compete for funds in the Eurobond market if its interest payments were subject to withholding tax.[59]

Where international finance subsidiaries are used, as in the United States and Germany, the finance subsidiaries usually are established as mere shell corporations, without employees or fixed assets. Their primary purpose is to make offerings in the Eurobond market and then lend the proceeds to the parent or affiliated companies. United States corporations intending to use the funds abroad sometimes form the finance subsidiaries in the United States. As long as eighty percent or more of the subsidiary's gross income is from foreign sources, the interest payments paid on the Eurobond are regarded as foreign source and the entity avoids the United States thirty percent gross withholding tax

58. *Id.* at 294. Eurobonds are distinguishable from Eurocurrency loans and foreign bonds. The former are short and medium term bank loans of eurocurrencies. Note, *Eurobond Practice, supra* note 57, at 505 n.2. The latter are debt obligations issued in a single country other than that of the issuer and denominated in the currency of the country in which they are placed. *Id.* While the Eurobond market is relatively free of regulation, foreign bonds generally are subject to substantial government regulation ranging from the registration requirements imposed by the United States Securities and Exchange Commission to permission from ministeries of finance and central banks. *Id.*

59. *Joint Tax'n Comm., supra* note 42, at 8.

on interest.[60] This gross income requirement generally is met if the United States finance subsidiary invests the Eurobond proceeds in the foreign operations of the corporate group.

A more common way for United States corporations to gain access to the Eurobond market, especially if the bond proceeds are to be used in the United States, is through the formation of a finance subsidiary in a country having a tax treaty with the United States under which United States source interest is exempt from the United States withholding tax. Such a tax treaty also exempts interest paid by the finance subsidiary to the Eurobond holders from the United States withholding tax.[61] Typically, the Netherlands Antilles is used as the place of incorporation of international finance subsidiaries of United States corporations to take advantage of withholding tax exemptions available under the tax treaty between the United States and the Netherlands Antilles.[62] In a standard financing arrangement, the finance subsidiary borrows funds on the Eurobond market and loans them to the United States parent or to other affiliates within the corporate group. The United States parent almost always guarantees the finance subsidiary's Eurobonds, which are usually convertible into equity shares of the parent. Under this arrangement, the United States parent can use the proceeds of the Eurobond issue, but pays interest to the Netherlands Antilles finance subsidiary rather than directly to the foreign bondholders. Article VIII of the treaty between the United States and the Netherlands Antilles exempts the interest payments by the United States parent to the finance subsidiary from the United States withholding

60. I.R.C. § 861(a)(1)(B) (1981). *See generally* Lederman, *The Offshore Finance Subsidiary: An Analysis of the Current Benefits and Problems*, 51 J. TAX'N 86 (1979); 215-2d T.M. PORTFOLIOS, *International Finance Subsidiaries.*

61. Under United States source rules, interest paid by a foreign corporation which derives 50 percent or more of its gross income from United States trade or business may be treated as having a United States source and subject to the United States witholding tax. I.R.C. § 861(a)(1)(D)(1981). Hence, a foreign finance subsidiary which re-lent the Eurobond proceeds to the United States parent for use in the United States would derive the bulk of its gross income from the United States sources and, unless a tax treaty provided otherwise, its interest payments to the Eurobond holders might be subject to the United States gross withholding tax.

62. Approximately 95 percent of all international finance subsidiaries of United States corporations are located in the Netherlands Antilles. *See* 215-2d T.M. PORTFOLIOS, *supra* note 60.

tax.[63] The interest paid by the finance subsidiary to the foreign bondholders is also exempt from the United States withholding tax under either United States domestic law or article XII of the tax treaty, and is exempt from tax in the Antilles under domestic law.[64] The net income of the finance subsidiary, which generally is insubstantial because of the deduction for interest paid to the foreign bondholders, usually is taxed in the Netherlands Antilles at a rate of twenty-four percent.[65]

As with the growth of offshore banking, the United States Government program aimed at curbing capital outflows and preventing devaluation of the dollar was a major catalyst in the emergence of the Eurobond market and the use of foreign finance subsidiaries by United States corporations. The program included several measures intended to encourage borrowing abroad by United States corporations and closing off the United States market to foreign borrowers.[66] The United States Internal Revenue Service officially sanctioned the use of finance subsidiaries to avoid the United States withholding tax and other restrictions in a number of private and public rulings.[67] The program to support the dollar terminated in 1974 and the Internal Revenue Service then revoked its sanction of finance subsidiaries.[68] These developments led to a substantial decline in the issuance of Eurobonds by United States corporations and, in fact, contributed to a major disruption of the Eurobond market as a whole. In 1976 and 1977, however, the market recovered and has grown considerably ever since.[69] Despite the Internal Revenue Service's withdrawal of its sanction of finance subsidiaries in 1974, the Service has not challenged these arrangements, and many bond issues by United States corporations have been floated since 1975.[70] In fact, it is estimated that indebtedness of United States corporations on Eurobonds currently amounts to $3.5 to $4.0 billion.

63. Treaty with Netherlands Antilles, *supra* note 42.

64. *Joint Tax'n Comm.*, *supra* note 42, at 9-10.

65. Lederman, *supra* note 60, at 88; PRICE, WATERHOUSE & CO., 1979 DOING BUSINESS IN THE NETHERLANDS ANTILLES 28.

66. Note, *Eurobond Practice*, *supra* note 57, at 506.

67. *See* Rev. Rul. 110, 1973-1 C.B. 454; Rev. Rul. 416, 1972-2 C.B. 591; Rev. Rul. 645, 1970-2 C.B. 273; Rev. Rul. 501, 1969-2 C.B. 233; Rev. Rul. 377, 1969-2 C.B. 231.

68. Rev. Rul. 464, 1974-2 C.B. 47.

69. Note, *Eurobond Practice*, *supra* note 57, at 506 n.12.

70. Lederman, *supra* note 60, at 88; Position Paper, *supra* note 3, at 17-18.

c. Captive insurance companies

Captive insurance companies are insurance companies set up by large industrial companies and other institutions, ranging from skateboard parks to universities, to insure their own risks. They have existed since the 1920s when companies such as ICI, British Petroleum, Unilever, and British American Tobacco or their precedessors all set up insurance subsidiaries.[71] In the past few years, the use of captive insurance companies has grown from an exotic tax avoidance scheme into a major part of many companies' corporate strategy.[72] About eighty percent of the captive insurance companies are located in Bermuda. In 1978, the Bermuda captives were estimated to have close to $1 billion in assets.[73] Other locations, such as the Cayman Islands, Guernsey, and the Bahamas, compete for the captive business.[74]

Captive insurance companies initially were established to avoid taxes and exchange control restrictions. More recently, non-insurance companies[75] have begun to use captives as a way of combating the steep escalation in insurance rates charged by commercial insurance companies. Therefore, in addition to using captive insurance companies to reduce taxes, investors also are using them to achieve nontax goals such as reducing commercial insurance premiums paid on foreign risks, obtaining access to the reinsurance markets where premiums are lower and coverage often is better, and establishing a funded reserve for losses. In the past, a typical captive insurance situation would have a United States company forming a captive insurance company in Bermuda.[76] The captive could be owned directly by the United States parent or by its affiliates or other subsidiaries. The Bermuda captive

71. *Captives Fight for Their Lives*, THE ECONOMIST, Dec. 2, 1978, at 78 [hereinafter cited as THE ECONOMIST].

72. *Id.*

73. *Id.* at 78.

74. For a description of a newly enacted insurance law intended to encourage establishment of captive insurance companies in the Cayman Islands, see 80-10 TAX MGMT. INT'L J. 36 (1980).

75. In addition to companies, groups of United States doctors, lawyers, accountants, and even soil engineers concerned about the high premiums for liability insurance have formed captive insurance companies. Even funeral directors apparently are considering forming captives to insure themselves against whatever mistakes they might make. THE ECONOMIST, *supra* note 71, at 78.

76. United States citizens and residents have been the leaders in the captive movement, but innovative European companies have not been far behind. *Id.*

then would insure foreign risks of the United States corporate group.[77] To insulate itself from the risk of substantial losses, the Bermuda captive generally reinsured all, or a substantial portion, of the foreign risks. Premiums paid by the United States parent or affiliates in other high tax jurisdictions generally were tax deductible by the payor.[78] Because reinsurance premiums usually are lower then the primary insurance premiums charged by the captive, the captive generally was able to show a profit and, because the profit surfaces in a tax haven, it could escape taxation.

The United States Internal Revenue Service does not always agree that the premiums are deductible by the payor. In Revenue Ruling 77-316,[79] the Service said a United States company paying premiums to a captive insurance company could not deduct the premiums to the extent the insurance risks were retained by the captive because the risks retained by the captive produced no risk-shifting or risk-distributing, which are essential components in insurance.[80] In Revenue Ruling 78-338,[81] the Service ruled that insurance premiums could be deductible so long as they were reasonable in amount and based on sound actuarial principles. Revenue Ruling 78-338 involved a captive owned by thirty-one unrelated corporations, none of which held a controlling interest. Apparently because the captive provided insurance for all of its thirty-one shareholders, the Service characterized payments to the captive as premiums for insurance and hence deductible. Revenue Rulings 77-316 and 78-338 had a significant impact on the structure of captive insurance operations. The captives have scrambled to convert themselves from shell corporations to insurance companies with a diversified insurance base. This has caused captives to move into the reinsurance market as well as the primary insurance market for unrelated parties.[82]

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77. If the Bermuda captive insured United States risks, the premiums paid to it would be characterized as having a United States source and the captive might be deemed to be engaged in a trade or business for United States tax purposes. This could cause the captive to be subject to United States tax. I.R.C. § 861(a)(7)(1981).

78. THE ECONOMIST, *supra* note 71, at 78.

79. 1977-2 C.B. 53.

80. *See* Carnation Co. v. Commissioner, 71 T.C. 400 (1978).

81. 1978-2 C.B. 107.

82. Financial Times, Nov. 24, 1980, at 24.

d. Tax havens as conduits for foreign investment: "treaty shopping"

Tax havens are widely used as conduits through which investments are made. Quite often, residents of one country (the "home country"), desiring to invest in securities or real estate in another country (the "host country"), will form a holding company in a third country (the "tax haven") and then funnel the investment capital through the holding company into the host country. This structure is used because it offers substantial tax avoidance opportunities which result from the interaction of domestic tax legislation in the tax haven and a tax treaty between the host country and tax haven.

The use of a country as an investment conduit to obtain the benefits of a tax treaty is referred to as "treaty shopping." Virtually every treaty in the vast network of bilateral income tax treaties is used to some extent by third party nationals, but some treaties are especially attractive.[83] Tax treaties to which the Netherlands is a party, for example, are attractive to residents of third countries because the Netherlands is a financial center that imposes no withholding taxes on interest paid by Dutch entities to foreign persons, the internal income tax structure is favorable, and the tax treaties provide for favorable treatment of interest income paid to Dutch entities.[84] Tax treaties between the United States and tax havens in the Caribbean are widely used by third country residents to avoid[85] taxes on investments in the United States. It is common for example, for third country residents to use the Netherlands Antilles as a conduit for investments in United States real estate, stocks and other securities, and active business operations. The low domestic tax rates applicable to foreign investors in the Antilles coupled with favorable provisions in the United States/Netherlands Antilles tax treaty make it possible for foreign investors to reduce their aggregate tax liability substantially on a broad range of United States investments.[86] For example, if a foreign person wanted to invest $1 million in

83. Position Paper, *supra* note 3, at 15.

84. *See* United States I.R.S. Private Letter Ruling 7723035 (1977).

85. The tax treaties between the United States and Caribbean tax havens also are used in conjunction with secrecy and confidentiality laws to evade taxes. *See infra* text accompanying notes 107-15.

86. Vogel, Bernstein & Nitsche, *Inward Investments in Securities and Direct Operations Through the Virgin Islands*, 34 TAX L. REV. 321, 324-25.

United States real estate, he could make the investment directly in the United States or he could channel the investment through the Netherlands Antilles. If he chose the direct route and was not a resident in a country having a tax treaty with the United States, the income from the real estate investment would be subject to either a thirty percent gross withholding tax or to full taxation on a net basis in the United States.[87] On a subsequent sale or exchange of the real estate, the gain would be fully taxed in the United States.[88] Further, if the foreign person died owning the United States real estate or made a gift of the real estate, the real estate would be subject to the United States estate or gift tax.[89] On the other hand, if the foreign person chose to channel the investment through the Netherlands Antilles, he might structure it as follows. First, he would form a Netherlands Antilles holding company to which he would advance $250,000 as equity. The Antilles holding company then would use the $250,000 as a down payment to buy the United States real estate and would arrange for a $750,000 mortgage held by the company's sole shareholder either directly or through a financial intermediary.[90] Assuming the Antilles holding company is not too thinly capitalized, the mortgage interest payments will be deductible in computing the holding company's income subject to United States and Netherlands Antilles tax. Further, because of the interaction of the United States/Netherlands Antilles tax treaty and Netherlands Antilles domestic tax law, the interest payments received by the financial intermediary or the sole shareholder will not be subject to tax in either the United States or the Netherlands Antilles. As a consequence, that portion of the foreign investor's total return on his $1 million real estate investment which the mortgage interest represents escapes United States and Netherlands Antilles tax. The balance of the foreign investor's return is taxed in the United States on a net basis, but is exempt from Netherlands An-

87. I.R.C. §§ 871(a)(1)(A), (d), 881(a)(1)(A), 882(d)(1981).

88. Prior to 1980, capital gains earned by foreign persons not engaged in a United States trade or business generally escaped taxation. Beginning in 1980, however, capital gains from the sale or exchange of United States real estate is subject to tax. I.R.C. § 897.

89. I.R.C. §§ 2103, 2511(a).

90. A financial intermediary located in a tax haven (such as the Bahamas) is useful if the sole shareholder would be taxed on the mortgage interest by the country in which the shareholder is resident.

tilles tax.[91] When the foreign person sells the United States real estate, the sale may be structured so the gain is taxed in neither the United States nor the Netherlands Antilles.[92] Finally, because of the interposition of the Antilles holding company between the United States real estate and the foreign person, the foreign person can transfer his interest in the real estate (represented by the shares in the Antilles holding company) during his life or at death free of the United States gift and estate taxes. Because the Netherlands Antilles gift and death taxes usually do not apply to nonresident shareholders of Antilles companies, such transfers also should escape gift or death taxation in the Netherlands Antilles.[93]

The British Virgin Islands and Barbados also have a combination of tax treaties with the United States and favorable domestic tax legislation making them attractive conduits for foreign investment in the United States. If a foreign person wanted to invest $1 million in United States corporate shares, he could acquire the shares directly or have them acquired by a holding company in the British Virgin Islands or Barbados. If the shares were acquired directly by the foreign person and he was not a resident in a country with a tax treaty with the United States, the dividends paid on the corporate shares would be subject to the thirty percent gross withholding tax imposed by the United States.[94] Gains on the sale or exchange of the shares would be exempt from United States tax, but if the person died owning the shares, the shares would be subject to the United States estate tax.[95] On the other hand, if the foreign person formed an "international business company" (IBC) in Barbados and the United States corporate shares were acquired by the IBC, he would avoid any United States estate tax problems, and the dividends paid on the corporate shares would be subject to only a fifteen percent United States withholding tax under the United States/Barbados tax

91. U.S. Department of the Treasury, *supra* note 45, at 43-44.

92. *Id.* Legislation was recently passed in the United States which will tax foreign investors on gains from sales or exchanges of United States real estate. This legislation, however, will not operate to override tax treaty provisions for a period of five years.

93. Kramer, Roeloffs & Walbloom, *Business Operations in the Netherlands Antilles*, 1980 Tax Mgmt. (BNA) Portfolios at A-1, A-4.

94. I.R.C. § 871(a)(1)(A).

95. *Id.* § 2103.

treaty.[96] The dividends also would be subject to Barbadian tax, but the tax rate on IBCs is only two and one-half percent and is not paid until the dividends are distributed to the shareholder of the IBC.[97]

e. Transfer pricing and tax havens

Distortions in the allocation of profits and losses resulting from transfer pricing practices represent one of the most important and vexing problems involving international taxation and transnational corporations.[98] The distortions occur when an enterprise sets artificially high or low intra-firm transfer prices so that profits properly attributable to one jurisdiction are in fact allocated to another jurisdiction. The jurisdiction to which the profits are allocated is frequently a tax haven.

Transfer pricing distortions occur in a countless number of ways. Any intra-firm transfer payment can be used intentionally or unintentionally to shift profits from one jurisdiction to another. Estimates indicate that during particular years in the 1970s around fifty percent of United States exports, thirty percent of United Kingdom exports, twenty-nine percent of Swedish exports, and fifty-nine percent of Canadian exports were intra-firm. This shows that the potential for shifting profits through transfer

96. The 1945 United States/United Kingdom tax treaty was extended to Barbados in 1959 with some modifications. Subsequent protocols and the new United States/United Kingdom tax treaty do not apply to Barbados. *See* TAX TREATIES (CCH) United Kingdom ¶ 8127.

97. International Business Companies (Exemption from Income Tax) Act, 1965 (No. 50 of 1965); *see* INCOME TAX TREATIES, *supra* note 43, at 733-34.

98. Transfer pricing generally refers to the valuation attached to transfers of goods, services, and technology between different affiliates of the same enterprise. Transfer pricing also occurs in instances such as a technology license or a management services agreement in which the transferor and transferee are controlled by a single enterprise, irrespective of actual ownership. Hence, the essence of a transfer price is that it is not set by an independent transferor and transferee in arm's length negotiations, but rather is within the discretion of a single enterprise.

There is no doubt that a significant portion of the distortions produced by transfer pricing occur as a result of intentional disregard of tax laws and exchange controls. Nevertheless, because the establishment of a transfer price usually is a very inexact process, and one on which reasonable people acting objectively can differ widely, it seems appropriate to assume that the distortions are produced more by imperfections in the price setting process than by an explicit intent to evade tax or other laws.

prices is quite substantial.[99] Common examples of transfer pricing distortions involving the use of tax havens are described below.

(i) Imports and exports of goods

By inflating the price of imports ("over-invoicing") and deflating the price of exports ("under-invoicing"), profits can be shifted from the countries of purchase and sale to a third jurisdiction. Profits can be shifted from both the country of the seller and of the purchaser to a tax haven by interposing an affiliate organized in the haven between the true seller and purchaser. Usually, in transactions such as this, the tax haven sales subsidiary will be a mere shell and the sales will be routed through the subsidiary only on the books of the enterprise.[100]

(ii) Licensing of technology

If royalties under technology licensing agreements are set above the prevailing market rate, profits properly allocable to the licensee can be shifted to the licensor, or a sub-licensor located in a tax haven. Similarly, if the royalty rate charged by the licensor to the sub-licensor located in the tax haven is below the market rate, profits can be shifted from the licensor to the sub-licensor. Alternatively, if all the affiliates of an enterprise are charged what appear to be reasonable portions of the costs of developing technology under a cost sharing arrangement, but the rights to exploit the technology are allocated disproportionately to affiliates located in tax havens, profits properly allocable to other jurisdictions are in fact attributed to tax havens.[101]

(iii) Management services

Profits allocable to one affiliate are shifted elsewhere by overcharging the affiliate for services actually performed for it or charging it for services that produce no benefit to it.[102] If the affiliate imposing the charges is located in a tax haven, the profits

99. *See* OECD COMMITTEE ON FISCAL AFFAIRS, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES (1979).

100. *See* C. IRISH, NOTES ON TRANSFER PRICING ABUSES AND DEVELOPING COUNTRIES 3 (1978).

101. U.N. Group of Experts on Tax Treaties Between Developed and Developing Countries, 7th Rep. at 35-41, U.N. Doc. ST/ESA/79 (1978).

102. *Id.* at 41-45.

reflected by such charges may escape taxation and exchange controls.

(iv) Financial services

Overcharging or undercharging for financial services can shift profits into tax havens even where the financial services originate with unrelated third parties. For example, if a Botswana subsidiary of a global mining company borrowed directly on the Eurocurrency market, the interest payments to the commercial banks would be a deduction for the Botswana subsidiary and income to the unrelated commercial banks. If, however, the loan were channelled through a tax haven finance subsidiary and the interest rate charged by the finance subsidiary was greater than that charged by the commercial banks, the interest rate differential would reflect profits shifted from the Botswana subsidiary to the tax haven subsidiary.[103]

2. Tax Haven Transactions Involving Evasion of Taxes and Other Laws

a. Tax evasion and tax havens

Tax evasion is a willful, deliberate violation of law in order to escape payment of a tax imposed on income by the laws of the taxing jurisdiction.[104] Thus, while tax avoidance involves the reduction of taxes by legal means, tax evasion is a conscious failure to comply with existing rules. The distinction between tax evasion and tax avoidance is sometimes unclear because the tax laws vary from one country to another. Illegal tax evasion in one jurisdiction may be permissible tax avoidance in another. Hence, the characterization of a transaction as tax evasion or tax avoidance in the international context depends on the laws applicable to the transaction.[105] Moreover, even within a single jurisdiction there often is considerable debate as to whether a particular transaction

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103. *Id.*

104. U.N. Group of Experts on Tax Treaties Between Developed and Developing Countries, 3d Rep. at 69, U.N. Doc. ST/ECA/166 (1972)[hereinafter cited as 3d Rep.].

105. OECD COMM. ON FISCAL AFFAIRS, TAX EVASION AND AVOIDANCE 13 (1980); *see generally* ROTTERDAM INSTITUTE FOR FISCAL STUDIES, INTERNATIONAL TAX AVOIDANCE—COUNTRY REPORTS (1979).

constitutes evasion or avoidance of the tax laws.[106] As a consequence, some of the relatively simple transactions described below may not involve tax evasion in all jurisdictions.

(i) Non-reporting of income and flight of the income to a tax haven

One of the most direct forms of international tax evasion is the willful failure to report income. Income earned from sources outside a tax haven may be physically or electronically transferred to a tax haven where it resides under the cloak of the tax haven's bank secrecy and corporate confidentiality laws.[107] Items frequently omitted from tax returns are salaries, investment income, business profits, and income from illegal activities. For example, if Y corporation sends employee A to work full time in country P, A frequently will receive some portion of his compensation outside of P. On the tax return A files in P, A may report only the compensation paid to him in P. Similarly, if B is a resident of Q country and derives investment income from X country, B may not report the investment income to Q, especially if his investment is held in bearer form and income is paid into an account maintained in a tax haven with rigorous bank secrecy laws.[108]

(ii) Creation of artificial deductions through the use of tax haven entities

Taxpayers have created tax haven entities and then transferred title to assets in order to generate rents, royalties, interest and other expenses which are tax deductible for the taxpayers but tax exempt for the tax haven entity. Also, in some instances, deductions are attributed to services allegedly performed by the tax ha-

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106. For example, in United States v. Baskes, 442 F. Supp. 322 (N.D. Ill. 1977), a tax attorney was convicted of tax fraud for putting together transactions that produced short-term capital losses in the United States (which taxpayers could use to reduce their United States income tax liability) and equal amounts of short-term capital gains which were paid to Bahamian trusts so as to escape United States taxation. At the trial, another prominent tax attorney testified that in his opinion the transactions did not involve tax evasion. *See Oversight Subcomm. Hearings I, supra* note 1, at 90-150.

107. *See generally* T. Clark & J. Tigue, Dirty Money (1973).

108. 3d Rep., *supra* note 104, at 69.

ven entity, but which in fact are never performed.[109]

(iii) Transfer of income-producing assets to tax haven entities

Taxes also may be evaded by transferring income-producing assets to tax haven entities. The assets transferred may consist of stocks, bonds, rental properties, and intangibles which will generate a continuing stream of passive income, or property transferred to the tax haven entity at an artifically low price so that gain on resale of the property will accrue to the tax haven entity rather than the taxpayer owning and controlling the entity. For example, if X owned a valuable technological right which he wanted to license to a foreign person, X might illegally transfer the technology to a tax haven entity which then would license the technology to the foreign person. The royalties paid under the licensing agreement then could be accumulated in the tax haven and subjected to low or no income taxes. Similarly, if Y planned to sell appreciated property, he could sell the property at a reduced price to a tax haven entity owned entirely by Y and have the tax haven entity sell the property. In this way, the bulk of the gain escapes taxation in the country where Y resides.[110]

(iv) Transfer of income-producing functions to tax haven entities

By forming an entity in a tax haven and arranging to have services performed for unrelated third parties through the entity, the taxpayers performing the services can shift substantial amounts of compensation income to the tax haven entity. In the typical case, the tax haven entity is a shell corporation incapable of performing the services without the assistance of the controlling shareholders.[111]

(v) Use of artificial loans

A fifth method of tax evasion involves the use of artificial loans where the loan proceeds in fact are income being secretly accumulated in a tax haven made to a person in a high tax jurisdiction.

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109. *Oversight Subcomm. Hearings I*, *supra* note 1, at 13-14; 3d Rep., *supra* note 104, at 69-70.

110. For an example of an attempt to shift $700,000 in taxable gain to a foreign situs trust, see United States v. Baskes, 442 F. Supp. 322 (N.D. Ill. 1977).

111. 3d Rep., *supra* note 104, at 71.

This technique enables the borrower to make full use of assets previously concealed abroad while obtaining an interest expense deduction. For example, if A is a United States resident who has unreported income accumulating in a Bahamian bank, he could arrange for a loan from the bank and use his accumulated income on deposit with the bank as collateral. Because there is no tax treaty between the United States and the Bahamas, the interest payments made by A on the loan would be subject to the thirty percent United States withholding tax. As a consequence, to avoid the withholding tax and further disguise the true character of the loan, A would arrange for the Bahamian bank to lend the amount on deposit with the Bahamian bank to a Netherlands Antilles finance company. The Netherlands Antilles finance company then would lend the proceeds to A. Because of the United States/Netherlands Antilles tax treaty, the interest payments received by the finance company would be exempt from United States tax and would be taxed in the Netherlands Antilles only on a net basis (i.e., after deduction of the interest expense paid to the Bahamian bank). As a result, A evades United States taxes on his income, gets the use of that income, and receives a deduction for the interest paid for using the income.[112]

b. Evasion of nontax laws and tax havens

Although the majority of illegal activities involving tax havens probably are tax motivated, tax havens also are used to evade other laws. Exchange controls and host government profit participation requirements, for example, are evaded by transfer pricing abuses that shift profits to tax haven entities. Securities laws, particularly those requiring disclosure of share ownership, are evaded by using corporate confidentiality laws and bearer shares issued by tax haven entities to conceal common ownership and control.[113] Tax havens are used to launder or maintain slush

112. *Oversight Subcomm. Hearings I, supra* note 1, at 19.

113. Tax haven entities also are used to legally avoid such laws. For example, companies sometimes float Eurobonds through finance subsidiaries located in tax havens (principally the Netherlands Antilles) to finance acquisitions in the United States. Because the Eurobonds are beyond the scope of United States securities laws, they can be floated without having to disclose the intended target of the acquisition effort. In 1978, Beatrice Foods, Texas International Airlines, and BASF all issued Eurobonds to pay for takeovers in the United States. Note, *Eurobonds Practice, supra* note 57, at 508 n.22.

funds for illegal political campaign contributions, bribes, kickbacks, and other illegal payments. The extent to which tax haven entities are used in this fashion is unknown, but voluntary disclosures to the United States Securities and Exchange Commission by United States corporations indicate such use is (or at least, was) not uncommon. One large American oil company, for example, created a secret fund used principally for illegal political contributions. False bookkeeping entries facilitated the disbursement of over $2.8 million in corporate funds into two Swiss bearer stock corporations. More than $1.3 million of the fund was returned to the United States in cash and approximately $600,000 was used for illegal political contributions. The funds remaining in the Swiss corporations were distributed overseas in cash.[114] In another case, sham corporations in Switzerland and Liechtenstein concealed the activities of an aircraft company using bribes and other questionable means to sell its product to foreign governments. In connection with the sales of some aircraft to foreign governments, the aircraft were sold to a Swiss or Liechtensteinian corporation which then inflated the final selling price to conceal bribes and other questionable expenses.[115]

IV. The Interests Affected by Tax Haven Activities

Tax haven activities significantly affect industrialized countries, non-haven developing countries, the tax havens themselves, individuals and corporations engaged in international business, and investment activities and persons using tax havens to evade tax and other laws. In this part, the interests of all but those engaged in illegal activities are discussed.

A. *Industrialized Countries*

The governments of most industrialized countries[116] recognize that tax haven activities are neither entirely harmful nor entirely beneficial to their interests. On balance, however, most industrial-

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114. SEC Rep. Questionable and Illegal Corporate Payments and Practices, B-13 (1976)(submitted to the U.S. Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess.).

115. *Oversight Subcomm. Hearings I, supra* note 1, at 170.

116. A few tax havens, such as Switzerland, Liechtenstein, and Bermuda, have per capita incomes high enough to put them in the class of industrialized countries. Obviously, their views on tax havens are markedly different from those of the non-haven industrialized countries.

ized countries are hostile to the perpetuation and expansion of tax haven activities. The industrialized countries are aware that tax havens facilitate the inward flow of foreign investment, provide easy access to the Eurobond market for resident corporations in some industrialized countries, and that haven activities give the tax havens a measure of economic self-sufficiency they might not otherwise attain. The industrialized countries are concerned, however, about the revenue losses caused by tax haven activities and, more importantly, they are concerned about the impact of tax haven activities on both taxpayer equity and the willingness of residents to comply with tax and other regulatory laws.

1. Revenue Losses

The obvious concern of industrialized countries is the revenue lost because of haven activities.[117] Although the revenue losses from tax haven activities cannot be estimated, the indirect evidence available suggests the losses probably are not great, but neither are they so small as to be insignificant.[118] There is no doubt, for example, that the existence of tax havens makes international tax avoidance and evasion easier for the taxpaying public. In addition, the enormous growth in tax haven activities suggests more and more taxpayers take advantage of these tax avoidance and evasion opportunities. On the other hand, anti-tax haven legislation introduced in several industrialized countries in recent years probably has curbed the revenue losses from tax haven activities.[119] Nevertheless, industrialized countries are concerned that tax havens facilitate tax avoidance and evasion and

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117. Some tax haven activities actually generate revenue gains rather than losses for industrialized countries. Offshore banking activities carried on in tax havens by foreign branches of United States banks, for example, generate revenues for the United States which it would not otherwise have received. *Oversight Subcomm. Hearings I, supra* note 1, at 324-25.

118. Accounting for tax revenues lost due to the use of tax havens is virtually impossible. No method presently exists for quantitatively measuring the total loss of revenue from either legal or illegal use of tax havens. *Id.* at 15, 174-75, 224, 256; *see* Pepper, *supra* note 5, at 31. One estimate has put the revenue loss to the United States as a result of funds hidden in tax havens at $2 billion. R. KINSMAN, *supra* note 16, at 36. Any estimate in this area, however, should be viewed with great skepticism. *Id.*

119. *See infra* text accompanying notes 174-213; IFA Seminar Paper, *Recourse to Tax Havens—Use and Abuse: Anti-Tax Haven Legislation* (Sept. 18, 1980).

are responsible for lost revenues. This concern is reflected by anti-tax haven legislation, by the recent government sponsored studies on international tax avoidance and evasion,[120] and by the development of regional, bilateral, and national procedures for exchanging tax information and curbing international tax avoidance and evasion.[121]

2. International Tax Avoidance and the Adverse Effect on Taxpayer Equity

Since many tax haven transactions involve entities which are merely conduits and shells represented by little more than bookeeping entries, giving tax effect to these transactions conflicts with the general proposition that taxes should be assessed on the substance of the transaction rather than its form. It also means that similarly situated taxpayers may have radically different tax consequences due to the transaction's form. For example, foreign investors who channel their investments into the United States through shell corporations or other entities in the Netherlands Antilles, British Virgin Islands, or Barbados receive more favorable income tax treatment than similarly situated foreign persons who make their investments directly in the United States.[122] The foreign investors using tax haven entities also receive more favorable tax treatment than United States residents with direct holdings in similar investments. The disparity in tax treatment resulting from formalistic differences erodes taxpayer confidence in the basic fairness of the tax system and may have an adverse impact on the willingness of taxpayers to comply voluntarily with the tax rules.

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120. The United States Internal Revenue Service, for example, has just concluded a special study on international tax evasion by United States taxpayers. *See* R. GORDON, TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS-AN OVERVIEW (1981); *see also Oversight Subcomm. Hearings I, supra* note 1.

121. *See European Economic Community, Council Directive of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation; German-French Memorandum on Tax Evasion/Avoidance on the International Level,* 14 EUR. TAX'N 136 (1974). *See also European Economic Community, Council Resolution of 10 February 1975 on the measures to be taken by the Community in order to combat international tax evasion and avoidance.*

122. INCOME TAX TREATIES, *supra* note 43, at 733-34.

3. International Tax Evasion and the Adverse Impact on Voluntary Compliance with Tax and Other Laws

Any system or facility encouraging evasion of a government's laws is a source of legitimate concern to that government because the system or facility promotes inappropriate, inequitable, or harmful conduct. Gaps in enforcement procedures in the industrialized countries combined with the rigorous secrecy and confidentiality laws in tax havens undoubtedly makes it relatively easy for residents of the industrialized countries to disguise or conceal their illegal activities from their home governments. The home governments are justifiably concerned about both the gaps in their enforcement procedures and the secrecy and confidentiality laws in tax havens.[123]

The major concern of the governments, however, is the broader impact of international evasion of tax and other laws on the willingness of the citizenry to comply with such laws voluntarily. In Western societies, where individual liberties are highly prized, voluntary compliance with laws is a cornerstone of the society. Voluntary compliance is enhanced if the laws are perceived as fair and evenly enforced. International evasion of tax and other laws erodes public confidence in the fairness and enforceability of the laws. As a consequence, governments of some industrialized countries view international tax evasion as a significant threat to the willingness of taxpayers generally to comply with the tax laws. Further, the other illegal activities concealed within tax havens erode confidence in the legal system.

4. Tax Differentials and Capital Export Neutrality

Tax differentials arise because countries impose tax at different rates and apply varying theories to determine which income is taxable. As a result, effective tax rates vary considerably from one jurisdiction to the next.[124] The opportunity to take advantage of tax differentials arises because many industrialized countries do

123. Of course, the governments should not overlook the possibility that tax evasion and other illegal activities may be a reflection of the citizenry's opinion of the burdens of the governments' tax and regulatory policies. R. KINSMAN, *supra* note 17, at 8; Pepper, *supra* note 5, at 32.

124. Musgrave, *International Tax Differentials for Multinational Corporations: Equity and Efficiency Considerations*, IMPACT OF MULTI-NATIONAL CORPORATIONS AND DEVELOPMENT AND ON INTERNATIONAL RELATIONS: TECHNICAL PAPERS: TAXATION (ST/EAS/11) (1974).

not tax foreign source profits earned by foreign subsidiary corporations until the profits are distributed from the foreign subsidiary to the domestic parent. As a consequence, if a corporation residing in a high tax industrialized country has active foreign operations in a low tax country, it can defer paying the higher taxes in the industrialized country simply by incorporating the active operations in the foreign country and accumulating the income there or shifting it to a tax haven. Organized labor and its government supporters believe this opportunity to defer the higher taxes in the industrialized countries creates an incentive for foreign investment at the expense of domestic investment.[125] As a result, legislation has been proposed to eliminate or reduce the opportunities to defer taxes through the creation of foreign subsidiaries.[126] The major impact of these legislative proposals, if passed, will be in the export processing zones created by many developing countries[127] and in the rapidly growing, low tax economies, such as Taiwan, South Korea, Hong Kong, and Singapore. Because several industrialized countries already have enacted anti-tax haven legislation, the impact of any new proposals to curb tax deferral probably will not be great.

5. The Favorable Impact of Tax Havens on Access to the Eurobond Market and Foreign Investment Flows Into Industrialized Countries

a. The Eurobond market

Tax havens undoubtedly offer enterprises in industrialized countries easy access to the Eurobond market. For example, most United States corporations enter the Eurobond market through international finance subsidiaries formed in the Netherlands Antilles.[128] United States companies would face higher costs for bor-

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125. *See* U.S. DEPARTMENT OF THE TREASURY, THE PRESIDENT'S 1978 TAX PROGRAM 282 (1978). The argument against tax deferral has been asserted most vigorously in the United States. Ironically, critics in the United States ignore very substantial tax incentives, such as the investment tax credit and liberal depreciation allowances that are available only for domestic investment in the United States.

126. *Id.*

127. GLOBAL AND CONCEPTUAL STUDIES SECTION, INTERNATIONAL CENTRE FOR INDUSTRIAL STUDIES, UNIDO, *supra* note 96.

128. Lederman, *supra* note 60, at 86.

rowed funds without access to the Eurobond market. This in turn could reduce the competitiveness of United States enterprises and have an inflationary impact on the United States economy. On the other hand, if the traditional routes to the Eurobond market through tax havens were blocked, it is reasonable to assume that the market and potential borrowers would develop alternative avenues bypassing tax havens. As a consequence, tax havens probably should be viewed as helpful rather than indispensable for gaining access to the Eurobond market.

b. Inward investments into industrialized countries

Unquestionably, the opportunity to channel investments into industrialized countries through tax havens to take advantage of benefits available under tax treaties and tax haven legislation has a major impact on the structure of these investments. In addition, it has been suggested that the favored tax treatment accorded these investments may increase their volume.[129] For this reason, some people urge the United States government to move slowly and carefully before restricting use of tax havens.[130]

6. Tax Havens and Self-Sufficiency

Many tax havens are small, resource poor areas which were or are dependent on an industrialized country. Vanuatu and the Bahamas, for example, are former British colonies. The British Virgin Islands, the Turks and Caicos, and the Cayman Islands are still British colonies with varying degrees of autonomy in internal affairs. Similarly, the Netherlands Antilles still has a formal dependency arrangement with the Netherlands. Being relatively poor, these areas drain the resources of the former or existing colonial power. Consequently, to the extent tax haven status benefits the tax havens, it reduces their dependence on the former or existing colonial power and diminishes the drain on the colonial power's resources. It is unclear whether this fact played a role in the establishment of some areas as tax havens, but it certainly is a reason some industrialized countries may not be disturbed by their continued existence.

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129. *Oversight Subcomm. Hearings II, supra* note 40, at 6-7; *Oversight Subcomm. Hearings I, supra* note 1, at 282.

130. Birger, *Billion-dollar Money Funnel into S. Florida*, Miami Herald, Aug. 4, 1980 (Business Monday Section), at 1.

7. Tax Havens as Allies of the Western Industrialized Countries

Because of low or nonexistent tax rates and the absence of exchange controls or other government regulations, foreign investors consider tax havens paradigms of the capitalist economy. Therefore, the tax havens have strong political and economic ties with the Western industrialized countries. Because, in many cases, the ties stem principally from the haven status of the tax havens, radical measures by the industrialized countries to eliminate or minimize the use of tax havens may have a corrosive effect on these ties and may lead to destabilization of the very governments which are staunch allies of the industrialized countries.[131] As a consequence, the interests of the industrialized countries clearly cannot be defined exclusively in economic terms. There is a significant political dimension that requires careful consideration.

B. *Non-Haven Developing Countries*

Though the governments of non-haven developing countries have many of the same interests as their counterparts in industrialized countries, the interests of the non-haven developing countries center more on the revenues and foreign exchange lost due to tax haven activities. There is little doubt that substantial sums[132] are shifted from non-haven developing countries to tax havens through transfer pricing and other transactions of questionable legality and that the shifting of such sums has an adverse impact on the development programs of the non-haven developing countries. On the other hand, it is not clear that the elimination of tax havens would materially improve the position of the non-haven developing countries. In fact, it is possible that the absence of regulation or taxes in tax havens gives transnational corporations greater flexibility in the allocation of their resources and that this flexibility actually benefits some of the non-haven developing countries.

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131. *See generally* Position Paper, *supra* note 3.

132. In absolute terms, the sums lost by non-haven developing countries due to tax haven activities may not be great; but compared to total resources of the non-haven developing countries, the losses—especially the foreign exchange losses—are often considerable.

1. Revenue Losses

As with the industrialized countries, revenue and foreign exchange losses resulting from tax haven activities are the most obvious concern of the non-haven developing countries. Although empirical evidence on the amounts lost through tax haven activities is sparse, such evidence as there is suggests that the losses probably are sufficiently substantial to have an adverse effect on economic development in the non-haven developing countries. First, it is clear that substantial amounts are shifted out of non-haven developing countries solely as a result of transfer pricing manipulations. In one study in a non-haven developing country, for example, imports above world market prices for comparable products during the period from 1975 to 1976 was found to average sixteen percent for metals and twenty-five percent for chemicals. This overpricing caused a balance of payments loss estimated at $72 million.[133] A parallel study of transfer pricing for three important export products showed that underpricing of exports also was taking place, but in this case it was not possible to arrive at an estimate of the balance of payments loss. In another non-haven developing country, the total foreign exchange loss on all import and export transactions by transnational corporations was estimated to be about $80 million annually.[134] Additional studies involving other non-haven developing countries suggest a pervasive pattern of transfer pricing manipulations throughout the Third World.[135] It also is clear that transfer pricing manipulations are not the only way funds are shifted out of non-haven developing countries. Other devices, such as concealment and flight of assets as well as material understatements of taxable income, which are sometimes facilitated by a misallocation of home office expenses, certainly add to the balance of payments losses of the non-haven developing countries.[136]

It is impossible to quantify the extent to which funds shifted from non-haven developing countries surface in tax havens, but it is known that tax haven entities are widely employed in interna-

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133. UNCTAD SEMINAR PROGRAMME, REPORT SERIES NO. 2, INTRA-FIRM TRANSACTIONS AND THEIR IMPACT ON TRADE AND DEVELOPMENT (1978).

134. *Id.*

135. C. IRISH, *supra* note 100, at 5.

136. *See generally* MAKANI, THE CONTROL OF TRANSFER PRICING AND RELATED MALPRACTICES IN DEVELOPING COUNTRIES: THE TANZANIAN EXPERIENCE 2-3 (1978).

tional evasion and avoidance.[137] Hence, it is reasonable to conclude that a significant portion of the shifting from non-haven developing countries is to tax havens. It does not follow, however, that the existence of tax havens is a major reason funds are shifted out of the non-haven developing countries nor that elimination of tax havens would significantly benefit the non-haven developing countries. The shifting of funds out of industrialized countries into tax havens appears to occur principally for tax reasons.[138] Where non-haven developing countries are involved, however, the shifting of funds occurs for a wide variety of reasons, such as stringent exchange controls, political instability or the threat of political instability, the desire to minimize profits paid to indigenous shareholders, or the desire to understate local profits so as to discourage competition or government scrutiny. In a great many instances it appears that tax factors are of only secondary importance. Hence, if tax havens were eliminated, it is quite possible that a substantial amount of the funds presently shifted out of the non-haven developing countries into the tax havens would simply surface in other jurisdictions such as relatively low tax industrialized countries. Therefore, the elimination of tax havens might not materially benefit the non-haven developing countries. It certainly would not benefit them as much as eliminating the reasons funds currently are shifted out of the non-haven developing countries.

2. Increased Investment Flows into Non-Haven Developing Countries

The possible benefits tax havens offer the non-haven developing countries should not be overlooked. First, the existence of tax havens and the opportunities to shift funds to them through transfer pricing manipulations and related activities may encourage transnational corporations to invest in non-haven developing countries. Tax havens give transnational corporations greater flexibility to cope with negative factors, such as political and economic instability, which are perceived as endemic in many parts of the Third World. Without that flexibility, transnational

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137. *See* 3d Rep., *supra* note 104, at 71; M. Edwardes-Ker, International Tax Strategy (1980).

138. Of course, the establishment of offshore banking facilities and international finance subsidiaries in tax havens is clearly prompted by both tax and non-tax reasons. *See Joint Tax'n Comm.*, *supra* note 105, at 11.

corporations might give greater weight to the negative factors and place their resources in less risky ventures in more established economies. In addition, with their low or nil tax rates and the absence of exchange controls or other regulatory measures, tax havens are the quintessence of an open market. The low or nil tax rates make it possible for private sector capital to accumulate more rapidly in the tax havens than in other countries with even moderate tax rates. The absence of exchange controls and other government regulations enables investors to allocate their capital strictly on the basis of market considerations. As a consequence, investors may have a greater stock of capital available for investment in non-haven developing countries as well as other places and the freedom to take advantage of new investment opportunities.

Of course, not all non-haven developing countries benefit from an investment flow that is more responsive to the marketplace. Countries just entering or reentering the competition for foreign investment, such as Zimbabwe, Chile, Jamaica, the newly independent countries in the Caribbean and Pacific, and the dynamic economies in Asia, may benefit from the rigors of the marketplace. These countries may have less reason to be critical of the existence of tax havens. On the other hand, non-haven developing countries which are concentrating on maintaining their stock of foreign investment and curbing their revenue and foreign exchange losses resulting from tax haven transactions may sense that tax havens have more disadvantages than advantages.

C. *Individuals and Corporations Engaged in International Business and Investment Activities*

The interests of individuals and corporations engaged in legitimate international business and investment activities can be easily stated. The low or nil taxes in tax havens leave greater after tax profits; the absence of exchange controls gives individuals and corporations the opportunity to allocate resources on the basis of economic considerations; and the minimum of government regulations generally insures that business and investment activities channelled into or through tax havens will not have the added administrative costs of complying with burdensome regulations—costs which are substantial and growing in other parts of the world. In addition, the bank secrecy and confidentiality in corporate matters found in many tax havens give individuals and corporations the opportunity to carry on their activities in relative anonymity, out of the view of their competitors and free from the fear of politically and economically motivated sanctions.

D. *Tax Havens*

Policy makers in tax haven countries generally have attempted to use haven status to spur economic development. Although a few wealthy countries are considered to be tax havens,[139] most tax havens are quite poor, lack indigenous resources, and have small domestic markets. Within these countries, the tendency has been to view tax haven status as not just the best mechanism for stimulating foreign investment and economic development, but as the only mechanism available in the present economic climate. Thus, the particularly relevant questions with respect to tax havens are first, what are the benefits and costs to be derived from haven status, and second, whether or not tax haven status will act as a catalyst for broad based economic development.

1. Ostensible Benefits from Tax Haven Status

Tax haven status is thought to generate increased revenues and foreign exchange, greater employment, tourism and construction activities, improved infrastructure, and in some cases more favorable access to financing for local development.[140] The most consistently visible benefit is the increase in government revenues and foreign exchange attributable to haven activities. The impact of tax haven status on employment, tourism, construction, and access to capital is more speculative, but, in the aggregate, is probably favorable to the tax haven economy. The improvements in communications and travel facilities probably are more accurately characterized as a cost of tax haven status rather than a benefit.

a. Government revenues and foreign exchange

The clearest benefit from haven status is the increase in revenues. Tax havens do not offer their services for free, but instead haven entities and activities are subjected to a variety of fees and taxes.[141] For example, in the Netherlands Antilles in 1979, direct

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139. *E.g.*, Bermuda, Liechtenstein, and Switzerland.

140. *See, e.g.*, GOVERNMENT OF BARBADOS, OFFSHORE BANKING IN BARBADOS 6 (1980).

141. *Oversight Subcomm. Hearings I*, *supra* note 1, at 141-64. *See generally*

tax revenues from haven activities were about $44 million, thirty percent of the government's total revenues.[142] In the British Virgin Islands in 1979, the government took in $217,000 in fees from tax haven activities, with revenues rising to $400,000 for the first eight months of 1980. The total government budget in the British Virgin Islands for 1980 was $11.5 million.[143] In the Bahamas, banks and trust companies paid $750,000 for licenses to do business in 1977. Another $2 million was paid for licenses and registration fees on behalf of the clients of the banks and trust companies; and over $800,000 was paid by tax haven entities for work permits for expatriates.[144] The revenues are doubly important because they represent foreign exchange to the haven countries. Because many of the haven countries import almost all their capital and consumer goods, the foreign exchange earned by the haven activities often is critical to the economic health of the haven countries.[145]

b. Employment

Increased employment is another benefit attributed to tax haven status. It appears, however, that there is a tendency to exaggerate the number of jobs created by tax haven activities.[146] Tax haven entities normally are used as conduits or shells so that often no significant business activities are carried out in the haven countries.[147] For example, in 1977 there were 276 financial institutions licensed to do business in the Bahamas (the number has since grown to 306), but only fifty-five of them employed any staff.[148] Nevertheless, the financial sector in the Bahamas does employ about 2,000 people or three percent of the employed work force, and about ninety percent of the employees are Baha-

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A. Anderson, Tax and Trade Guide—Hong Kong 10, 22-23, 46 (1978); A. Anderson, Tax and Trade Guide—Singapore (1977); Price, Waterhouse & Co., 1981 Doing Business in the Bahamas 37-39; Price, Waterhouse & Co., 1978 Doing Business in the Cayman Islands.

142. Position Paper, *supra* note 3, at 8-10.

143. *British Virgin Islands: Mixed Blessings of an Oil Boom,* Financial Times, Sept. 16, 1980.

144. Bahamas Handbook 205 (1979).

145. Position Paper, *supra* note 3, at 8-9.

146. de Jantscher, *supra* note 3, at 33.

147. *Oversight Subcomm. Hearings I, supra* note 1, at 20, 323-24.

148. Financial Times, July 22, 1980, at 30.

mian.[149] This makes the financial sector the third largest employer in the Bahamas after tourism and the government. Similarly, in the Netherlands Antilles, it has been estimated that the offshore sector employs about 1,000 persons, which is about one and three-tenths percent of the employed work force.[150] Norfolk Island, a possession of Australia and a former tax haven, is another illustration. In 1972, more than 1,450 companies were incorporated on the island — nearly one per inhabitant. Nevertheless, the tax haven sector apparently was benefitting only twenty-five residents of the island because much of the business was being done by lawyers and accountants in Australia.[151] It appears there is a similar pattern between the United States and the tax havens in the Caribbean, as a substantial amount of the bookkeeping, accounting, and legal work occasioned by tax haven activities is done in the United States by United States professionals.[152] It has been estimated, for example, that ninety-five percent of the foreign real estate transactions channelled through the Netherlands Antilles are initiated in a lawyer's office in Miami or Fort Lauderdale.[153] Of course, increased employment has a multiplier effect so that the net gain in employment in the haven countries as a result of tax haven activities should be somewhat higher than the figures indicated above. Further, although the level of employment in tax haven activities is not substantial in absolute terms, it is of considerable significance in tax havens such as the Netherlands Antilles and the Bahamas, where unemployment already is approximately nineteen percent and twenty to twenty-five percent, respectively.[154]

c. Tourism

Tax haven activities probably increase tourism in many haven countries, although the effect has not been quantified with any precision. Good climate combined with favorable fiscal and regulatory regimes make many tax havens attractive sites for interna-

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149. *Id.*
150. Position Paper, *supra* note 3, at 11.
151. de Jantscher, *supra* note 3, at 33.
152. Birger, *How Lawyers Set up Tax-Haven Companies*, Miami Herald, Aug. 4, 1980 (Business Monday Section), at 21.
153. *Id.*
154. Financial Times, July 22, 1980, at 29; Position Paper, *supra* note 3, at 11.

tional business and finance conferences. Also, many people setting up or overseeing tax haven transactions may combine a business trip with a holiday in the tax havens.[155] In the Bahamas, for example, it was estimated that in 1977 the tax haven sector attracted over 4,600 clients, potential clients, directors, inspectors, and similar persons for business meetings with executives of banks and trust companies engaged in haven activities.[156] The improved communications and travel facilities that go with being a tax haven and the additional publicity a tax haven receives among wealthy taxpayers also may promote tourism indirectly.[157]

d. Construction

Tax haven status may have a favorable effect on construction activities, although the extent to which the local economy benefits again may be exaggerated. Because tax haven entities generally serve as conduits or shells for transactions, the facilities necessary to accommodate a large volume of haven transactions may be minimal. The presence of many holding companies and other shell trusts and corporations in tax havens often is manifested by little more than a name plate.[158] Nevertheless, the new buildings housing offshore financial activities in the Bahamas, Panama, Bahrain, and elsewhere are evidence that haven status can have a favorable impact on construction activities.[159] It is not clear, however, how much the increased construction benefits the local economy because frequently most of the building materials and a good portion of the labor are imported. For example, sources in one tax haven claimed that in the recent construction of a $10 million offshore banking facility "[e]verything was imported except the sand." Further, even when the local economy participates in increased construction activities, there is the additional question of whether the benefit will be a sustained one which stimulates other sectors of the economy or is likely to be highly cyclical with a depressing effect on the rest of the economy when construction activities slow down. Where the increased construction activities employ persons who would not otherwise be work-

155. GOVERNMENT OF BARBADOS, *supra* note 140, at 6.

156. BAHAMAS HANDBOOK 203-04 (1979).

157. de Jantscher, *supra* note 3, at 34.

158. *Joint Tax'n Comm.*, *supra* note 42, at 9.

159. *See, e.g.*, *Financial Times Survey — Arab Banking*, Financial Times, Sept. 22, 1980, at XI.

ing, even sporadic employment would seem better than none at all. On the other hand, where the increased construction activities discourage people from developing alternative, more stable employment opportunities, the effect of the construction activities on the tax haven economy may be minimal or negative.

e. Communications and travel facilities

Tax haven status generally leads to improvements in communications and travel facilities. Other than the favorable effect such improvements may have on tourism, however, it is difficult to see how the indigenous population benefits much from these improvements. A good portion of the indigenous population in tax havens lives on relatively meager incomes and is many years away from being concerned with the quality of satellite communications or international travel. A more basic issue is whether the improvements in communications and travel facilities should be characterized as a marginal benefit or as a cost to the local economy of the attracting haven activities.

f. Access to international capital markets

The presence of tax haven activities may have a positive impact on the availability of capital for local projects in the haven country. Many of the banks operating in tax havens carry on only offshore business—that is, they are not licensed to do business within the local economy. Tax havens have found, however, that the existence of offshore activities within the country gives the banking community some exposure to their country and makes it easier for them to obtain financing for local governmental and private sector activities. The Bahamian Government, for example, recently had no difficulty placing an $11 million bond issue, a fact which some attributed to the Bahamas' status as a tax haven and an offshore financial center.

2. Ostensible Costs of Tax Haven Status

While it appears that tax havens do benefit from their haven status, the benefits should not be viewed in isolation, but should be balanced against the costs associated with that status. Though these costs often are not readily apparent, they exist and seem to be greatest in countries heavily dependent on tax haven activities. In the least developed tax haven countries, which often depend on their haven status for revenues, foreign exchange, and employment opportunities, it appears that the short term opportunity costs of haven status are nearly zero because the tax haven activities draw on untapped labor and generate foreign exchange and government revenues which would not otherwise be created. In fact, in some of the least developed tax havens, the decision to have neither an income tax nor exchange control restrictions may be due to an absence of cash income or foreign exchange transactions rather than a conscious desire to establish a tax haven. These countries may believe any benefits derived from haven status produce a net gain for the haven country and justify perpetuating haven status. Opportunity costs, however, are rarely zero. Usually the costs will be reflected in the diminished capacity of the haven government to respond to varying political, economic, and social issues, an unhealthy dependence on the highly volatile tax haven sector to the exclusion of other, more stable economic activities, and the diversion of scarce resources away from the critical needs of the indigenous population. There also may be added social unrest as a result of an influx of expatriate personnel to work in the tax haven sector.

a. Diminished flexibility and an unhealthy dependence on tax haven status

The level of tax haven activities in any particular haven country varies widely for four reasons. First, tax haven activities often have only a formal connection with any tax haven. The real economic activity usually takes place elsewhere. As a consequence, formal transactions into or through a particular tax haven can be rapidly routed elsewhere if necessary.[160] Second, the increased competition among countries for the haven business insures that each country's hold on its haven activities is somewhat precarious. For example, the competition between some established offshore financial centers, such as Hong Kong and Singapore,[161] is already intense. In addition, several countries recently have enacted or have considered enacting special legislation designed to attract the offshore banking business. Barbados, Puerto Rico, and the Phillippines all have relatively new offshore banking legislation,[162] and the United States is considering a special interna-

160. de Jantscher, *supra* note 3, at 34; Financial Times, July 22, 1980, at 30.
161. Soin, *supra* note 28, at 9.
162. *See, e.g.*, GOVERNMENT OF BARBADOS, *supra* note 140.

tional banking enclave—probably in New York City.[163] The level of competition contributes to the tenuousness of each haven country's hold on the offshore banking operations conducted within its borders.[164] Third, the attractiveness of a large portion of tax haven transactions depends on the implicit or explicit acquiescence of the industrialized countries. The industrialized countries have the power to greatly curtail tax haven activities and, as a consequence, such activities can continue for only as long as the industrialized countries do not exercise that power. For example, the United States easily could keep its corporations from using international finance subsidiaries organized in tax havens by refusing to recognize their separate existence for tax purposes. The United States already has done this with some captive insurance companies.[165] The accumulation of profits in holding companies organized in tax havens could be curbed if industrialized countries taxed all income earned by or on behalf of their resident individuals and corporations or by abolishing tax deferral for foreign source income.[166] Fourth, tax haven transactions are a reflection of world economic and political conditions. Conflicts and chaos in one part of the world lead to a flight of capital from the troubled area, through tax havens into what is perceived to be a more stable environment.

The volatile nature of tax haven transactions is harmful to the haven countries in at least two ways. First, tax haven status essentially is a statement by the haven government that for foreign investors, the haven country is a free market overseen by a benign, non-interfering government with very conservative fiscal policies. Because of the volatility of tax haven transactions, just a hint that a haven country is planning to alter any of the underpinnings of its haven status can have a significant impact on the level of haven activities in that country. As a consequence, a haven government faced with critical political, economic, or social problems has a limited range of responses available to solve the problems while avoiding damage to its tax haven sector. Many tax havens, for example, are faced with high unemployment and in-

163. *See* Financial Times, Nov. 20, 1980, at 1, col. 3.

164. *Oversight Subcomm. Hearings I, supra* note 1, at 329.

165. Rev. Rul. 316, 1977-2 C.B. 53.

166. At a minimum, such legislation would change what is presently a fairly widespread tax avoidance technique into tax evasion, which presumably fewer people would be willing to attempt.

flation. Traditionally, countries adopt or increase taxes to combat these problems. But, for countries committed to fiscal restraint, as many of the haven countries are, such a response is beyond the realm of political feasibility. The adoption of or increase in direct taxes, or even the suggestion of such changes, probably would adversely alter foreign investors' perceptions of the country as an attractive place in which to carry on haven activities. Second, because the volatility of tax haven activity results from events occuring outside haven countries, they have little or no control over the growth or contraction of the tax haven sector. Where the haven sector is an important component of a country's economy, growth and prosperity or stagnation and depression are determined largely by irrational, widely fluctuating circumstances extrinsic to the country. Though to some extent this is inevitable in small economies with close ties to international business, dependence upon tax haven transactions means the haven country may be subject to an even greater risk of economic upheaval. The Netherlands Antilles, for example, found that just the threat of renegotiation of the United States/Netherlands Antilles tax treaty, which was unilaterally announced by the United States Treasury in July, 1979,[167] had a negative impact on Antilles revenues.[168] Also, in 1973, a small change made by the United States Congress in the taxation of interest payments remitted abroad caused a decline in Netherlands Antilles Government revenues.[169] Similarly, a political or economic scandal, whether rumored or real,[170] or changes in the myriad external factors making a particular tax haven attractive can have a significant effect on tax haven activities in that country.

Where tax haven status has a zero or almost zero opportunity cost, fluctuations in tax haven activities are just an unavoidable consequence of being a tax haven. In some cases, however, the existence of tax haven status and the entrenchment of the interests benefiting from haven status have diverted haven governments' attentions away from the development of more stable and

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167. 44 Fed. Reg. 40,758 (1979).
168. Position Paper, *supra* note 3, at 10.
169. *Oversight Subcomm. Hearings I, supra* note 1, at 297.
170. The Jean Doucet affair in the Cayman Islands and the breach of confidentiality by Michael Wolstencroft of Castle Bank in the Bahamas had significant effects on tax haven activities in those countries. *See* R. KINSMAN, *supra* note 16, at 69-75, 89-94.

possibly more profitable economic activities. Hence, a hidden cost of tax haven status may be the failure of some haven governments to consider alternatives to or changes in tax haven status. In such instances, the haven economies unnecessarily may be kept in the position of heavy, vulnerable dependence on haven activities.

b. Diversion of scarce resources

In the least developed haven countries, an important cost of haven status may be the diversion of resources from social and economic projects in order to produce the infrastructure necessary to be a successful tax haven. The costs of telecommunications equipment, airports, hotels, and related facilities may divert scarce resources from projects such as hospitals and schools. Even where the haven infrastructure is financed in part by concessionary loans or grants to the government, the cost may be a diminished capacity to borrow or a diminished availability of concessionary assistance. By focusing attention on highly visible projects such as airports and hotels, government planners also may be unable or unwilling to spend time on less visible, but more critical projects for the indigenous population.

c. Social pressure

Tax haven activities often are preceded by an influx of expatriate personnel to work in the dominant positions in the tax haven sector. In more than a few tax havens, the inability or unwillingness of these expatriates to integrate themselves into the local community and their relatively favored, lavish lifestyles cause some unrest within the indigenous population.[171]

3. Tax Haven Status as a Catalyst for Development

There appears to be no published data on the issue of whether tax haven status can act as a catalyst for development. Nevertheless, some useful generalizations can be developed from the information available. It seems improbable that haven activities alone can promote sustained, stable economic growth benefiting a large proportion of the indigenous population. Tax haven activities are

171. Lessard, *Profile: A Close Gathering*, NEW YORKER, April 16, 1979, at 43.

volatile, benefit a small enclave of people, and lack the substance necessary to provide an appropriate base for economic development. As a consequence, if tax haven status encourages development, it probably is due to linkages with other sectors of the economy. The stronger the linkages, the more likely it is that tax haven status will stimulate development. Clearly, the volatile nature of tax haven activities will have a negative impact on the substantiality and durability of any linkages. Nevertheless, in the more established tax havens, there usually are linkages between the tax haven sector and tourism, construction, the training of clerical and technical personnel, and the development of local financial and professional expertise. The linkages to tourism may be tenuous, but whatever benefits there are will be increased greatly if tourism in turn develops linkages to the rest of the economy. In other words, if consumer goods and a good portion of the essential services are imported, the linkages and benefits to the local economy will be minimal. On the other hand, if a conscious effort is made to use indigenous resources and personnel, the benefits in terms of employment, government revenues, and foreign exchange will be substantially greater.[172] Similarly, the substantiality of the linkages between tax haven status and the construction industry will depend on the amount of local materials and personnel used. If, as appears to be the case in many tax havens, a good portion of the materials and labor are imported, the effect on the local economy is likely to be insubstantial. If, however, construction techniques are adapted to make maximum use of materials and labor locally available, tax haven status could establish and promote a local construction industry. The training of clerical and technical personnel for work in the tax haven sector and the development of a local financial and professional expertise among indigenous personnel who become more deeply involved in tax haven activities could expand the portion of tax haven services performed in the havens themselves. At present, a large portion of all services related to tax haven activities are performed outside the havens.[173] By developing capacity to perform such services, the haven countries have a good chance of attracting a greater proportion of them. On the other hand, at least in the small, resource poor tax havens, it seems improbable that either the training of clerical and technical personnel or the

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172. Financial Times, July 22, 1980, at 30.

173. *See* Birger, *supra* note 152, at 21.

development of a local financial and professional expertise could serve as a base for establishing a services sector similar to, but not heavily dependent on, the tax haven sector. The opportunities to do this undoubtedly are very limited, as there usually is not a great demand for such services in the poorer tax havens. Further, the probability of creating a demand for such services outside the tax haven sector does not seem very likely as clerical, technical, financial, and professional services generally are performed incident to more substantial economic activities. Of course, if the training received by the indigenous labor force participating in the tax haven sector were broadened to prepare the people for other work, such as self-employment in cottage industries, the training programs could be used to establish and develop other sectors of the economy. In addition, if the training and employment in the tax haven sector anticipated a substantial turnover in the indigenous work force, a fair number of people could be channelled into the training programs, through employment in the tax haven sector, and then into employment in other sectors of the economy.

Hence, it appears that tax haven status can be used to stimulate development in other sectors of the economy. Because of the volatility of tax haven activities, their enclavistic nature and their lack of substance, however, linkages with other sectors of the economy are unlikely to develop naturally. They probably will arise in most cases only as a result of conscious government policies directed at establishing such linkages. Further, it seems self evident that the level of benefit received from tax haven status and the likelihood that haven status will act as a catalyst for development diminishes with each new country entering the tax haven business. As a consequence, as the competition for tax haven business grows, it probably will become more and more difficult for the established havens to sustain the level of benefits and linkages gained from tax haven status. It also probably will become even more difficult for new entrants to establish a level of benefits and linkages making tax haven status worthwhile.

V. Response of Non-Haven Countries to Tax Haven Transactions

Non-haven countries have responded to the growing use of tax havens in a number of ways. They have taken unilateral action in the form of special anti-tax haven legislation, adopted administrative and legislative rules aimed at curbing transfers to tax havens, and judicially attacked tax haven transactions as shams. The non-haven countries have concluded bilateral treaties under which they agree to cooperate in exchanging tax information in order to reduce international tax evasion and avoidance. Several of the bilateral tax treaties also have specific provisions aimed at reducing the opportunities for treaty shopping. On occasion, the bilateral treaties have led to the development of joint audit programs. At the multilateral level, little in the way of concrete action affecting tax havens has been taken. Several multilateral studies, however, have considered the problems raised by international tax evasion and avoidance as well as the options available for bilateral, regional, and multilateral cooperation to deal with the problems.

A. *Unilateral Responses*

1. Anti-Tax Haven Legislation

Legislation dealing with the use of tax havens to avoid or evade taxes is becoming increasingly common in the industrialized countries.[174] The United States, Canada, West Germany, France, and Japan all have specific legislation aimed at tax avoidance techniques which use tax havens. Given the longstanding practices of using tax havens, it is surprising that all the legislation has been enacted within the last twenty years.[175] The anti-tax haven legislation seeks to prevent local taxpayers from sheltering income in tax havens through formalistic structures lacking economic substance. At the same time, no country wants to restrict unduly legitimate international trade and investment activities. Therefore, the legislation generally tries to draw a line between tax haven operations and legitimate international business activi-

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174. *See, e.g.*, IFA Seminar Paper, *supra* note 119; *France: Finance Law 1980*, 20 EUR. TAX, 113 (Apr. 1980); Brockman, *Japan: Taxation of Undistributed Profits of Designated Tax Haven Subsidiaries*, 79-3 TAX MGMT. INT'L J. 3 (1979); Council of Europe, *Joining the struggle against International Tax Evasion*, Apr.-May 1978 EUR. TAX'N 156; *German Federal Republic: The Foreign Base Company in the West German Tax Law*, Nov. 17 & 18 EUR. TAX'N (Nov. - Dec. 1977; Jan. 1978).

175. Subpart F of the United States Internal Revenue Code, enacted in 1962, was apparently the first legislation to deal specifically with the use of foreign entities as a means of tax deferral or avoidance. It was not until 1972 that Canada and the Federal Republic of Germany enacted similar legislation. France enacted anti-tax haven legislation in 1973 and Japan followed suit in 1978.

ties. All the legislation operates in substantially the same way. Domestic shareholders of certain controlled foreign corporations are currently taxed on some or all of the income of the controlled foreign corporations whether the income is distributed to the shareholders or not. These substantial similarities as well as some of the differences in the various approaches can be illustrated by comparing the United States and French legislation.

a. United States

The United States has four separate tax laws dealing with the use of tax havens. Three of the laws deal with foreign personal holding companies,[176] foreign investment companies,[177] and foreign situs trusts,[178] and have only limited application to publicly held corporations. The major United States restriction on tax haven transactions and public corporations is contained in Subpart F of the United States Internal Revenue Code.[179]

While in theory the provisions of Subpart F apply without regard to whether tax havens are involved, the legislation clearly is designed "to impose current tax on income diverted to or lodged in a 'tax haven' while leaving subsidiary operating profits untaxed."[180] In general terms, Subpart F provides that any United States person who owns, directly or indirectly, at least ten percent of a controlled foreign corporation must include in gross income his pro rata share of the foreign corporation's Subpart F income. Therefore, as an initial requirement for the applicability of Subpart F, the United States person must own, or be deemed to own, ten percent or more of the total combined voting power of all classes of voting stock of the corporation.[181] Second, the statute requires that the corporation be a "controlled foreign corporation," which is defined as a foreign corporation in which greater than fifty percent of the total combined voting power of all classes of voting stock is owned, or deemed to be owned, by one or more shareholders who satisfy the ten percent ownership re-

176. I.R.C. §§ 551-558 (1981).
177. *Id.* § 1246.
178. *Id.* § 679.
179. *Id.* §§ 951-64.
180. D. TILLINGHAST, TAX ASPECTS OF INTERNATIONAL TRANSACTIONS 172 (1978).
181. I.R.C. § 951(b).

quirement set forth above.[182] When deciding whether there is fifty percent ownership, the Internal Revenue Service will consider the particular facts and circumstances of each case and will disregard nominal ownership of the voting power if necessary to determine actual control of the voting power.[183] In any event, this requirement will be satisfied if the United States shareholders have the power to control the management of the foreign corporation.[184] The final requirement is that the income earned by the controlled foreign corporation be Subpart F income. In contrast to the French legislation, which focuses on the situs of the foreign corporation, Subpart F defines taxability by reference to the nature of the income received. As it relates to the use of tax havens, Subpart F income includes income derived from the insurance of United States risks[185] and foreign based company income,[186] which can be characterized generally as income attributable to formalistic rather than economically substantial activities. Hence, foreign source income derived by a controlled foreign corporation from the purchase and resale of property would be characterized as Subpart F income if the purchase or resale was to a related party and the property was not manufactured, produced, consumed, or used in the country where the controlled foreign corporation resides.[187] Similarly, in order for foreign source services income to be characterized as Subpart F income, it must be derived in connection with the performance of services for or on behalf of a related person who is outside the country in which the controlled foreign corporation resides.[188]

Clearly, the restrictive definitions of Subpart F income are intended to allow the use of foreign corporations for legitimate reasons without running afoul of Subpart F. There are, in addition, two other provisions serving the same purpose. The first establishes a *de minimis* exception to Subpart F by providing that if less than ten percent of the gross income of a controlled foreign corporation is foreign based company income, no part of the income in that year is to be treated as foreign based company in-

182. *Id.* § 957.
183. Treas. Reg. § 1.957-1 (1963).
184. *Id.*
185. I.R.C. § 952.
186. *Id.*
187. I.R.C. § 954(d)(1).
188. I.R.C. § 954(e).

come.[189] The second provision prevents undue harshness by allowing the Treasury Department to exclude certain income from Subpart F where it appears reduction of taxes was not a significant reason for either creating the foreign corporation or effecting the particular transaction producing the income in question.[190]

b. France

Although France enacted some anti-tax haven legislation in the early 1970s, it was not until 1980 that substantial legislative efforts were made to curtail the use of tax havens by French corporations.[191] Under the 1980 legislation, a French taxpayer liable for the corporation's tax is subject to tax on the pro rata share of the profits of a foreign "société" if the French taxpayer owns, directly or indirectly, at least twenty-five percent of the shares of the société and société is established in a jurisdiction providing privileged tax status for the société.[192] In contrast to the anti-tax haven systems in the United States, the French legislation does not require that the French taxpayer control the foreign société. Instead, a one-quarter French interest in the société is sufficient to establish liability for tax on a pro rata share of the profits, regardless of who holds the other shares.

Unlike the United States law, the French anti-tax haven provisions determine taxability on the basis of the situs of the foreign société rather than on the nature of its income. If the French tax authorities conclude that a jurisdiction either imposes no taxes or taxes at a rate substantially lower than the French tax rate, the no or low tax jurisdiction is deemed to confer a privileged tax status on entities located in the jurisdiction, and French shareholders of such entities are potentially subject to tax on their pro rata share of undistributed profits of the entities. It is presumed that a privileged tax status exists if the overall tax rate is less than two-thirds of the applicable French tax rate.[193]

Because the French legislation is directed to redress the misuse of foreign tax systems, the legislation does not apply if the French taxpayer establishes that the operations of the foreign société do not have as their principal purpose the location of profits in a

189. I.R.C. § 954(b)(3).
190. I.R.C. § 954(b)(4).
191. IFA Seminar Paper, *supra* note 119, at 35-36.
192. *Id; see also France: Finance Law 1980, supra* note 174.
193. IFA Seminar Paper, *supra* note 119, at 41-42.

jurisdiction offering privileged tax status.[194] This is done by showing that the foreign entity carries on effective industrial or commercial activity and that either the foreign entity carries out most of its operations in the local market or there exist "no ties of dependence" between the foreign entity and the other parties to the transaction.[195]

2. Procedures Designed to Curb Transfer Pricing

Most industrialized countries and many non-haven developing countries have rules designed to curb the shifting of profits through artificially high or low transfer prices. These provisions are not limited in scope to tax haven transactions but generally apply to all transactions between related parties.[196]

Almost all the transfer pricing rules rely on the "arm's length standard" which focuses on what unrelated parties would do in similar circumstances.[197] In other words, the arm's length approach involves an attempt to establish the price that would prevail in the marketplace.[198] In large part because of the difficulties of establishing anything other than an arbitrary arm's length price in many cases, alternatives to the arm's length approach have been used in recent years. For example, in some cases countries attack transfer pricing abuses by using the apportionment method. The objective of the apportionment method is not to establish an arm's length price, but instead to determine a fair or proper division of the global profits of an enterprise without regard for how the marketplace would operate.[199] In other cases, countries use posted or national export prices to establish taxable profits with respect to exports of primary commodities. With posted or national export prices, the objective is to establish an

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194. *Id.* at 43 (quoting article 70 of the Law of January 18, 1980).

195. *Id.* Dependence is considered to exist between two concerns whenever:

> —either one holds, directly or through an interposed person, the majority of the corporate capital of the other or in fact exercises in the latter the power of decision;
>
> —or both are likewise controlled by a third concern.

IFA SEMINAR PAPER, *supra* note 119, at 44.

196. *See generally* OECD COMM. ON FISCAL AFFAIRS, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES, *supra* note 99.

197. *See* United States Treas. Reg. § 1.482-1(a)(6).

198. Surrey, *Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions*, 10 LAW & POLICY IN INT'L BUS. 409, 413-14 (1978).

199. C. IRISH, *supra* note 100, at 17.

arbitrary price at which primary commodities are deemed to leave the country. Normally, the price is determined by reference to the market price for the finished product incorporating the primary commodity.[200]

3. Restrictions on Transfer Abroad

Many countries impose restrictions on the transfer of assets abroad. Although these restrictions often are general in scope, they do inhibit transfers to tax havens. For example, exchange controls, widespread in non-haven developing countries and some industrialized countries, limit the outflow of capital to tax havens and elsewhere. Some countries have specialized legislation aimed at preventing the transfer of property abroad for tax avoidance purposes. The United States, for example, imposes a thirty-five percent excise tax on property transferred to foreign corporations, trusts and partnerships unless it is established that the transfer is not part of "a plan having as one of its principal purposes the avoidance of Federal income taxes."[201] Corporate organizations and reorganizations involving transfers to foreign corporations also are denied tax favored treatment unless the avoidance of taxes is not one of the principal objectives of the transfers.[202]

4. Characterization of Tax Haven Transactions as Shams

In addition to specific anti-tax haven legislation, transfer pricing procedures and restrictions on transfers of property abroad, non-haven countries sometimes simply characterize tax haven transactions as shams and recast the transactions on the basis of their substance rather than their form. For example, Ingemar Johannsson, Swedish world heavyweight boxing champion, tried to take advantage of an exemption in the United States/Switzerland tax treaty by claiming that he was a resident of Switzerland and boxing in the United States as an employee of a Swiss corporation. The United States Court of Appeals for the Fifth Circuit said that the transaction lacked substance and was a sham, so Johannsson was taxed in the United States as if the Swiss corporation did not exist.[203]

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200. *Id.* at 18.
201. I.R.C. § 1492(2).
202. I.R.C. § 367(a); *see also* I.R.C. § 679.
203. Johannsson v. United States, 336 F.2d 809 (5th Cir. 1964).

The Netherlands has no specific anti-tax haven legislation such as that in effect in the United States, Japan, Germany, Canada, and France, but transfers of property by Dutch persons to foreign corporations which accumulate portfolio income are regarded as shams. As a consequence, the foreign corporation is treated as a Dutch corporation or as a collection of Dutch individuals.[204]

B. *Bilateral Responses*

The non-haven countries have concluded bilateral tax treaties under which they agree to exchange tax information to curb international tax evasion and avoidance. The exchange of information provisions are broad in scope and cover tax haven transactions as well as other international evasion and avoidance activities.[205] Typically, an exchange of information clause authorizes the taxing authority to request and exchange information relevant to the enforcement of the tax laws. Information such as data on dividends, interests, rents, and royalties generally is exchanged on a routine basis and in some cases in response to specific requests.[206]

Bilateral tax treaties occasionally have led to the development of cooperative audit programs intended to reduce international tax evasion and avoidance. The United States, for example, has established simultaneous auditing programs with Canada, the United Kingdom, France, and West Germany. Similar auditing programs are in effect within the European Economic Community. Under these auditing programs, the treaty partners can agree to audit simultaneously a multinational taxpayer. The simultaneous auditing programs are relatively new, but it is thought that they are more thorough, more effective, and possibly less burdensome than uncoordinated audits by various taxing authorities.[207] Bilateral tax treaties also are used to prevent "treaty shopping" by making the tax preferences in the treaties unavailable to residents of third countries. The most common way of curbing treaty shopping in tax treaties is through the inclusion of an anti-holding company provision disallowing reduced tax rates on dividends, interest and royalties (1) if the recipient corpora-

204. IFA Seminar Paper, *supra* note 119.

205. U.N GROUP OF EXPERTS ON TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, SIXTH REPORT (ST/ESA/42) (1976).

206. Comment, *Taxation: Implementation of Simultaneous Auditing Procedures*, 21 Harv. Int'l L.J. 798, 799 (1980).

207. *Id.* at 801-02.

tion is a resident of the other country and is at least twenty-five percent owned, directly or indirectly, by individual residents of a country other than where the corporation is resident, and (2) if special tax measures apply in the country of the recipient corporation's residence and they reduce taxes on dividends, interest, and royalty income substantially below normal corporate tax rates in that country.[208] Anti-holding company provisions are found in the 1977 Organization of Economic Cooperation and Development (OECD) Model Tax Convention and tax treaties the United States has with Finland, Iceland, Korea, Luxembourg, Norway, Trinidad and Tobago, and the United Kingdom.[209] In a similar fashion, the United Kingdom has curbed the use of international business corporations organized in Barbados through an amendment to the United Kindgom/Barbados tax treaty.[210]

C. *Multilateral Responses*

The only multilateral convention dealing with international tax evasion and avoidance is the Convention on Administrative Assistance in Tax Matters concluded by Denmark, Finland, Iceland, Norway, and Sweden in 1972. The United States, the United Kingdom, France, and West Germany presently are considering development of a multilateral auditing program, but such a program is not yet in existence.[211] Various fora within the European Economic Community, the OECD, and the United Nations have considered the problem of international tax evasion and avoidance practices. The multilateral work done to date, however, has focused on defining international tax evasion and avoidance[212] and on the development of standardized transfer pricing and exchange of information procedures which are to be implemented at the national or bilateral level.[213]

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208. Article 4, 1977 OECD Model Tax Convention; United States Model Tax Convention.

209. Gordon, *supra* note 120, at 149.

210. Article 23 of the 1970 United Kingdom/Barbados tax treaty.

211. *See* comment, *supra* note 206, at 802 n.27.

212. OECD COMM. ON FISCAL AFFAIRS, *supra* note 105; ROTTERDAM INSTITUTE FOR FISCAL STUDIES, INTERNATIONAL TAX AVOIDANCE - VOLUME A, GENERAL AND CONCEPTUAL MATERIAL (1979).

213. OECD Comm. on Fiscal Affairs, *supra* note 99; U.N. GROUP OF EXPERTS ON TAX TREATIES, 7th Rep., *supra* note 101.

D. *Effectiveness of Responses to Tax Haven Transactions*

The various unilateral, bilateral, and multilateral responses of non-haven countries to the problems posed by tax haven transactions undoubtedly have limited the growth of tax haven activities. That haven activities continue to grow, however, is a reflection not only of the increased pressures leading people to engage in international tax evasion and avoidance practices, but also of the ineffectiveness of the measures taken to curb such practices.

It is clear that one of the main stumbling blocks to more effective control of international evasion and avoidance activities is the presence of rigorous bank secrecy and corporate confidentiality laws in the tax havens. As a result of these laws, individuals and companies are able to frame their transactions so that the structure of the transactions, the substance of the transactions, and the identity of the parties to the transactions cannot be discovered by authorities in non-haven countries. The measures taken to curb tax haven activities also are not without their shortcomings. Often information collected in one department of government is not made available to other departments where it could be productively used to curb tax haven abuses.[214] The transfer pricing procedures based on the arm's length approach have been less than satisfactory and often have been so difficult to apply that the parties have reached a negotiated settlement at an arbitrary price. The exchange of information provisions in bilateral tax treaties are still underused and the anti-holding company provisions are difficult to apply due to a lack of information.

As a consequence, there is considerable room for improving the effectiveness of existing measures designed to curb tax haven abuses. A large proportion of the improvements can be done within the non-haven countries without the concurrence of the tax havens. But the most effective measure, lifting the shroud of secrecy surrounding tax haven activities, can be accomplished only with the assistance of the tax havens themselves.

VI. Concluding Comments

Tax haven status would appear to produce some positive benefits for the haven countries and, through careful planning, linkages can be established between the haven sector and other parts of the economy. For the tax haven countries, the major problems

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214. *See Oversight Subcomm. Hearings I, supra* note 1, at 184-91.

arising from their haven status are the loss of flexibility to deal with political, economic, and social issues, and the inherent instability of the tax haven sector. In addition, as competition for tax haven business grows, the level of benefits for the haven countries and the linkages to other parts of their economies are likely to be affected adversely. Countries now entering the tax haven business will probably also find it more and more difficult to benefit from their status and to create linkages with other sectors of their economies. Although the major function of tax havens is to deprive other governments of revenues they would otherwise receive, there is considerable room for accommodating the interests of both the tax havens and the non-haven countries. Many of the tax havens need the revenues and other benefits they derive from their haven status, but these revenues and benefits are but a small portion of the revenues the non-haven countries would collect if international tax evasion and avoidance were more effectively curbed. It would appear, therefore, that the tax havens should consider establishing a dialogue with the non-haven countries to discuss the possibility of exchanging their dependence on tax haven activities for economic assistance in other areas. Of course, given the volatility of tax haven transactions, initiating the dialogue would be a major problem. On the other hand, it should be recognized that many of the more lucrative tax haven transactions, such as offshore banking, captive insurance companies, and international finance subsidiaries, continue to benefit the haven countries in large part because the non-haven countries acquiesce in such activities. Hence, the tax haven countries should consider bargaining with the non-haven countries for assistance in diversifying their economies before the non-haven countries take unilateral action that adversely affects the bargaining power of the tax havens.