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The Evolving Offshore Landscape
—A Review of Recent Developments—

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Outline

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ABSTRACT

In this article we review recent policy and regulatory developments undertaken by supranational institutions relevant to taxation of transactions attributable to, and/or entities domiciled in, Offshore Financial Centres ("OFC"). We examine the legal and economic basis for such actions, the success of the initiatives taken to date, as well as assess the likelihood that these policy actions will remedy the perceived harmful effects of tax competition.

1.0 Introduction

The importance of suprantional initiatives should not be underestimated by the global financial community. The effect of these initiatives on the offshore landscape is undeniable. Offshore tax havens that have historically relied on revenues generated by hosting offshore entities and investments, as a means of minimizing domicilary tax burdens for entities and individuals, are finding it more difficult to attract the business. These jurisdictions are being pressured into entering into information exchange agreements which may eliminate one source of revenue and ultimately eliminate tax competition.

The question of whether tax competition is harmful is a controversial one. To what extent can jurisdictional tax schemes be harmonised and still provide beneficial competition among jurisdictions?

2.0 Supranational Initiatives

There is a strong case for supranational initiatives. Supranational initiatives can identify global issues where consensus among their member states can be reached and provide certainty in legal enforcement of interstate business transactions. Alternatively, such initiatives could be seen as eliminating governmental accountability. If such initiatives eliminate competition among governments and thus their resident companies, can the global economy operate efficiently and will the consumer benefit from the long-term implementation of a particular initiative. Competition promotes efficiency and encourages lawmakers to rationalise public finance. Tax competition might be seen as imposing on politicians a necessity to exercise fiscal discipline in order to attract companies, jobs, capital and entrepreneurship. Notwithstanding this economic controversy, member states have embraced the creation of supranational initiatives and often seek to integrate the legal orientation posed by such initiatives.

As an example, the Organisation for Economic Co-operation and Development ("OECD") has addressed creation of global guidelines for the exploitation of the Internet which create a climate of soundly based user trust, essential to the adoption of this form of commerce. These guidelines, called the Guidelines for Electronic Commerce, address such issues as maximization of security and protection of individual privacy and consumer protection. Although the primary focus is on these important issues the Guidelines incorporate its members consensus regarding harmful tax competition, recognizing that the somewhat intangible nature of web-presence offers new opportunities for companies to locate in tax havens in order to maximize their online profits. This is particularly attractive to companies who can complete entire business transactions including, delivery of products or services over the Internet.

2.1 OECD Harmful Tax Competition Project

The OECD has focused on a project to address "harmful tax competition" since 1996, based on an OECD Ministerial Communiqué directing the OECD "…to develop measures to counter the effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases.…"[2].

A large component of this project has been to identify "tax havens" and commence a dialogue with them to address the deficiencies in their tax and regulatory environments in relation to the OECD's criteria, which were set forth in its report entitled "Harmful Tax Competition: An Emerging Global Issue"[3] (the "1998 Report") in part, as follows:

[2] Organisation for Economic Co-operation and Development. "Harmful Tax Competition: An Emerging Global Issue". Paris: OECD Publications, 1998, page 3.
[3] Organisation for Economic Co-operation and Development. "Harmful Tax Competition: An Emerging Global Issue". Paris: OECD Publications, 1998.

- No or only nominal taxes (generally or in special circumstances) and offers itself, or is perceived to offer itself, as a place to be used by non-residents to escape tax in their country of residence, <u>and</u>
    - Laws or administrative practices which prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdiction, <u>or</u>
    - Lack of transparency in the operation of legislative, legal or administrative provisions, <u>or</u>
    - The absence of a requirement that the activity be substantial[4]

The 1998 Report, issued under the joint chairmanship of France and Japan, discussed these criteria and set out a series of recommendations to counteract these practices, both by its member countries maintaining "harmful preferential tax regimes" and by non-member countries identified as "tax havens". The 1998 Report noted the potential of preferential tax regimes and tax havens to divert capital away from other countries within the context of an increasingly global marketplace, with the negative consequence of creating "free riders" enjoying the benefits of a relatively advanced level of public services in one jurisdiction while keeping their investment capital domiciled in another jurisdiction(s). It also noted that such distortions commonly exist even within countries as a conscious government policy designed to reduce regional disparities. There were two notable dissenters from within the OECD's membership: Luxembourg and Switzerland--countries with significant offshore financial sectors--which objected to the language in the 1998 Report linking the concept of financial privacy with illegal activities such as tax evasion.[5]

In the spirit of cooperation, the OECD proposed to compile and publish a list of jurisdictions it considered as meeting its "tax haven" criteria, as an impetus to "…encourage these jurisdictions to re-examine their policies."[6]

In order to discourage harmful tax competition by "tax havens", the 1998 Report also made a series of recommendations on potential coordinated defensive measures which could be implemented by OECD member countries, including:

- Restriction of deduction for payment to tax haven entities
- Imposition of withholding taxes on certain payments to residents of countries that engage in harmful tax competition
- Residence rules
- Application of transfer pricing rules and guidelines
- Thin capitalisation
- Financial innovation
- Non-tax measures[7]

With this Damoclean sword as a backdrop, the OECD began engaging the "tax haven" jurisdictions in direct discussions.

A follow-up report was issued by the OECD in 2000[8] (the "2000 Report") wherein the OECD named 35 non-member jurisdictions as practicing "harmful tax competition" [see table xx]. An updated list of non-member jurisdictions practicing "harmful tax competition was published by the OECD in April 2002.[9] The 2000 Report also identified [61] separate instances of "harmful tax

[4] ibid., pp. 22-23 [1998 Report].
[5] Both Luxembourg and Switzerland have subsequently expressed support for the OECD project.
[6] 1998 Report, page 57.
[7] 1998 Report, page 39.
[8] Organisation for Economic Co-operation and Development. "Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices". Paris: OECD Publications, 2000.
[9] The following jurisdictions, which have not yet made commitments to transparency and effective exchange of information, have been identified by the OECD's Committee on Fiscal Affairs as unco-operative tax havens: Andorra, The Principality of Liechtenstein, Liberia, The Principality of Monaco, The Republic of the Marshall Islands, The Republic of Nauru, The Republic of Vanuatu

competition" in the form of "preferential tax regimes" being practiced by countries within its membership.

As expected, the 2000 Report's identification of specific "tax haven" jurisdictions provoked a great deal of discussion concerning the OECD's criteria and characterisation of tax-related practices as "harmful". The 2000 Report also provided further specifics on the nature of defensive measures being contemplated:[10]

- To disallow deductions, exemptions, credits, or other allowances related to transactions with Uncooperative Tax Havens[11] or to transactions taking advantage of their harmful tax practices.
- To require comprehensive information reporting rules for transactions involving unco-operative Tax Havens or taking advantage of their harmful tax practices, supported by substantial penalties for inaccurate reporting or non-reporting of such transactions.
- For countries that do not have controlled foreign corporation or equivalent (CFC) rules, to consider adopting such rules, and for countries that have such rules, to ensure that they apply in a fashion consistent with the desirability of curbing harmful tax practices (Recommendation 1 of the 1998 Report).
- To deny any exceptions (e.g. reasonable cause) that may otherwise apply to the application of regular penalties in the case of transactions involving entities organised in unco-operative Tax Havens*)* or taking advantage of their harmful tax practices.
- To deny the availability of the foreign tax credit or the participation exemption with regard to distributions that are sourced from Uncooperative Tax Havens or to transactions taking advantage of their harmful tax practices.
- To impose withholding taxes on certain payments to residents of Uncooperative Tax Havens.
- To enhance audit and enforcement activities with respect to Uncooperative Tax Havens and transactions taking advantage of their harmful tax practices.
- To ensure that any existing and new domestic defensive measures against harmful tax practices are also applicable to transactions with Uncooperative Tax Havens and to transactions taking advantage of their harmful tax practices.
- Not to enter into any comprehensive income tax conventions with Uncooperative Tax Havens, and to consider terminating any such existing conventions unless certain conditions are met (Recommendation12 of the 1998 Report).
- To deny deductions and cost recovery, to the extent otherwise allowable, for fees and expenses incurred in establishing or acquiring entities incorporated in Uncooperative Tax Havens.
- To impose "transactional" charges or levies on certain transactions involving Uncooperative Tax Havens.

Resistance to the OECD's recommendations has appeared both within and outside the OECD member countries. In March 2001, several of the tax havens named in the 2000 Report formed a coalition called the International Tax and Investment Organisation ("ITIO"), based in Barbados and is comprised of 13 jurisdictions,[12] drawn from both from within the "committed jurisdiction"*)* list as well as the "uncooperative" list. Their principal objection to the OECD project has been the

[10] 2000 Report, page 25.
[11] Under the terms of the 1998 report, a "tax haven" is a jurisdiction that: (i) imposes no or only nominal taxes (generally or in special circumstances) and (ii) offers itself, or is perceived to offer itself, as a place to be used by non-residents to escape taxation in their country of residence and (iii) possesses one or more of three confirming criteria for engaging in harmful tax practices. Those confirming criteria are: 1) lack of effective exchange of information; 2) lack of transparency; and (3) attracting business with no substantial activities. These criteria are consistent with the nature of the tax poaching schemes that are the object of the OECD's work: schemes that impede the ability of home countries to enforce their own tax laws. The confirming criteria for identifying a harmful preferential tax regime are similar to these. The commitments made by the six jurisdictions would ensure that effective exchange of information and transparency are achieved in those jurisdictions, and that their regimes are not designed so as to attract business with no substantial activities.

[12] ITIO's current membership includes: Anguilla, Antigua and Barbuda, Bahamas, Barbados, Belize, British Virgin Islands, Cayman Islands, Cook Islands, Malaysia, St Kitts and Nevis, St Lucia, Turks and Caicos Islands, Vanuatu

lack of consistency in imposing defensive measures against uncooperative jurisdictions outside the OECD membership, versus those "preferential tax regimes" within the OECD's own membership. The ITIO construes this bifurcated treatment as fundamentally discriminatory and thus anti-competitive. The ITIO has also voiced a general concern about not having a role in shaping the OECD's concepts of "exchange of information" and "transparency". Further, there is a perceived undercurrent in the OECD's work of 'rich vs. poor' nations, since jurisdictions such as Hong Kong and Singapore possess many of the elements considered indicative of a tax haven, yet are not on the OECD's list.

Perhaps most importantly, the change of administrations in the United States considerably blunted support for the OECD's notion of "harmful tax competition," as well as the broad scope of the OECD's original recommendations for coordinated defensive measures and their "encouragement" of non-members to effect changes in their tax and regulatory structures. Former U.S. Treasury Secretary Paul O'Neill has stated:

> "Our review of the OECD project has been guided by two fundamental principles. First, we must do everything that we can to enforce our own tax laws, including working to obtain needed information that is in the hands of other countries. Second, we will not interfere in the internal tax policy decisions of other countries. These principles led me to conclude that the United States should attempt to refocus the OECD initiative on its core element: the need for countries to be able to obtain specific information from other countries upon request in order to prevent noncompliance with their tax laws."[13]

In a May 2001 statement published in the Washington Times,[14] former Secretary O'Neill went on to convey that "the United States…will not participate in any attempt to harmonise world tax systems." and that "In its current form the [OECD] project is too broad and it is not in line with this administration's tax and economic policies."

On January 15, 2002, The Center for Freedom and Prosperity Foundation, a U.S. nonprofit organisation created to defend the principles of tax competition, economic sovereignty and financial privacy, released a study—based on government data—claiming that there is no link between so-called tax havens and money laundering. Andrew Quinlan, President of the Center, remarked, "This new study uses State Department, CIA, IRS and FATF findings to show conclusively that countries with low tax burdens and financial privacy are not any more likely to be money laundering centers than high-tax countries. In fact, it shows the opposite. Dirty money is more likely to be laundered in high-tax countries because that is where the illegal activity is most likely to occur." Thus, one conclusion might be that the initiative has done no more than drive taxpayers underground, whereas, a low-tax burden would reduce incentives to implement complex tax reduction/minimization schemes and underreport.

Against this backdrop, the OECD's most recent report[15] on harmful tax competition issued in November 2001, conceded on one of the three principal attributes originally identified as an indicator of a tax haven; namely, the 'lack of substantial activities'. The OECD also extended the time for developing an actual implementation plan to 12 months from the commitment (up from 6 months). Finally, the 2001 Report also committed not to impose "defensive measures" against uncooperative non-OECD member jurisdictions before it implemented them against its own member countries.

The key commitments being sought by the OECD in its discussions with uncooperative tax havens has been narrowed to:

[13] Paul H. O'Neill, Statement of Paul H. O'Neill Before the Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations—OECD Harmful Tax Practices Initiative, July 18, 2001.
[14] Washington Times, May 11, 2001, "Confronting OECD's 'harmful' tax approach" Paul O'Neill, page A17.
[15] Organisation for Economic Co-operation and Development. "The OECD's Project on Harmful Tax Practices: The 2001 Progress Report". Paris: OECD Publications, November 2001.

(i) transparency in the setting of tax rates and policies, and
(ii) exchange of information on criminal tax matters

In the realm of exchange of information, the OECD is not seeking an automatic exchange of information, but rather a case-by-case arrangement whereby the requesting jurisdiction must justify its request for information based on specific violations of its domestic tax laws. By extension, the OECD is seeking to dismantle the long-held position within OFC circles that criminal tax matters must be "reciprocal" violations (i.e. that the alleged breach would constitute a violation under the local laws as well as the foreign laws) in order to constitute a basis for co-operation with foreign jurisdictions. This change is particularly significant since in countries where there is no income tax regime, tax evasion will not be a crime, thus, exchange of information would follow only if another crime has been alleged. To further the goals embodied in the Guidelines, the OECD created the Global Forum Working Group on Effective Exchange of Information which included representatives from several OECD countries and Aruba, Bermuda, Bahrain, Cayman Islands, Cyprus, the Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino. The result was a Model Agreement of Exchange of Information in Tax Matters.[16] The Working Group members are encouraging adoption of this model agreement as the global standard.

As has been the OECD's position all along, the fact that a jurisdiction is a no- or low-tax environment is not in itself a sufficient indicator that it is a tax haven. The 2001 Report also reiterates the OECD's principals for developing a framework of defensive measures against non-compliant jurisdictions. The OECD recognises that to be meaningful, such action must be coordinated. However, it also acknowledges the rights of individual member countries to determine what measures, if any, they wish to implement against a specific jurisdiction.

Indeed, as a policy-making body, the OECD lacks authority to implement its recommendations. Moreover, several observers[17] have expressed reservations about the legality of the majority of the OECD's proposed defensive measures in relation to World Trade Organisation ("WTO") member countries' obligations under the General Agreement on Trade in Services ("GATS"). For example, should an OECD member country impose withholding taxes on banking and other financial services transactions with an uncooperative jurisdiction, such action may be challengable under the general market access provisions of the GATS, if the individual WTO member country has not specifically carved out taxation under the Most Favoured Nation rules. Notwithstanding this situation, it remains to be seen whether a legal challenge to the actions contemplated under the OECD's recommendations would be successful in a specific instance, as it is likely that specific measures only would give rise to an uncooperative jurisdiction's challenge under the WTO rules.

How successful has the OECD project been? Most of the largest "tax havens" had already conceded to the pressures brought about by merely the drafting of the OECD recommendations to reform their regulatory environments within a specific timetable (e.g. prior to December 31, 2005) prior to publication of the OECD's 2000 Report. The final 2000 Report named 35 jurisdictions as "tax havens", yet publishing the names of the 'sinning' jurisdictions had little effect on encouraging them to adopt the OECD's recommendations. Only 6 of those 35 jurisdictions made a commitment to the OECD between the 2000 Report and the OECD's narrowing of its demands in November 2001.

The broad scope of the OECD's original position, even within its member countries, has clearly been diluted since the publication of the 1998 Report. The principal issue on the table is

[16] March 2002.
[17] See: "WTO Compatibility of the OECD 'Defensive Measures' Against 'Harmful Tax Competition'", by Dr. Roman Grynberg & Ms. Bridget Chilala, Journal of World Investment, September 2001.
"Offshore Financial Centres and the Supranationals—Collision or Cohabitation?", The Chase Journal, by Richard J. Hay, Volume V, Issue II, 2001.
"Potential WTO Claims in Response to Countermeasures under the OECD's Recommendations Applicable to Alleged Tax Havens", by Stephen J. Orava, WTO Practice Group, Baker & McKenzie, October 2001 [unpublished paper].

information exchange, which is objectionable to the remaining uncommitted jurisdictions (as well as the committed ones) based on the principals of financial privacy and fiscal sovereignty. However, as information exchange will be implemented on a case-by-case basis, there will be considerable scope for differing interpretations of whether a particular case would meet the qualifying criteria.

Indeed, as testament to the OECD's more palatable criteria post November 2001, 21 out of the remaining 29 tax havens have subsequently made reform commitments to the OECD[18], and the OECD itself has unilaterally removed another three,[19] having determined that they no longer qualify under the revised criteria. There are only six remaining tax haven jurisdictions: Andorra, Liberia, Liechtenstein, Marshall Islands, Monaco, and Nauru..

2.2 Other Supranational Initiatives

The United Nations ("UN") has also taken pen in hand and formulated initiatives to eliminate harmful tax competition. In an August 2001 report, a UN panel[20] chaired by Ernesto Zedillo, put forth initiatives that support the creation of an international tax organization, recommend the imposition of global taxes and call for tax harmonization. The resulting changes would eliminate the right of member states to formulate their own tax policies.

The initiatives go much further than those guidelines proposed by the OECD, and have been met with more resistance. The resistance is based not only in the limitations it levies on sovereignty but the potential effects on the fiscal accountability and maneuverability of governments. In addition, the panel acknowledges that implementation would be extremely problematic and could result in new schemes designed to avoid tax and creation of derivative instruments that would be more difficult to tax. The UN report suggests an alternative scheme of global tax harmonization, a tax on fossil fuel consumption. This tax would be punitive in nature and assessed on contribution to greenhouse gases.

In its quasi-supranational role, the G8[21] meets annually to deal with the major economic and political issues facing their domestic economies and the international community as a whole. The G8 works closely, both during the annual summits and throughout the year, with the OECD. This relationship has developed to provide the G8 with access to the ongoing research and development of its own various initiatives. At this year's Summit, the G8 resolved to support the standards established in the OECD Guidelines for multinational enterprises and Improving Access to Bank Information for Tax Purposes. Two other OECD initiatives were supported by the G8, the Corporate Governance Principles and Anti-Bribery Convention which serve two purposes: a) promoting fiscal and financial transparency and integrity; and b) eliminating harmful tax competition through financial transparency.

Another supranational organization whose initiatives can be viewed as aimed at moderating the effect of competitive tax schemes, is Asia-Pacific Economic Cooperation ("APEC").[22] Although the initiatives developed by APEC do not appear aimed primarily at harmful tax competition, the measures recommended would have the effect of limiting the ability of companies and individuals to make business decisions based on tax minimization strategies. For example, APEC promotes its initiatives in the form of "goals". The goals are generally for the promotion of free trade and investment in Asia-Pacific. Three identified goals include: liberalisation of trade and investment through elimination of tariffs and other barriers to trade; business facilitation by reducing

[18] Vanuatu was the most recent tax haven jurisdiction to agree to improve the transparency of its tax and regulatory systems and establish effective exchange of information for tax matters with OECD countries by 31 December 2005 and has been subsequently taken off the list of unco-operative tax havens in May 2003.

[19] Tonga made a commitment to reform in August 2001, but has also been subsequently excused by the OECD after re-examination.
[20] The High-level Panel on Financing for Development.
[21] France, the United States, Britain, Germany, Japan, Italy, Canada and Russia.

[22] APEC was established in 1989 to take advantage of the growing interdepence among Asia-Pacific economies by facilitating economic growth.

transaction costs; and economic and technical cooperation. In order to achieve these goals the member states will have to agree to some tax harmonisation and broader exchange of information agreements.

2.3 Tolerance for Supranational Initiatives

The prevalent theme among supranational initiatives appears to be reduction of competition among sovereign nations, whether regionally or globally. More specifically, competition that might shift significant economic benefits from one country to another or from one region to another. Tolerance for supranational initiatives will be apparent in wide-spread implementation of recommendations contained therein.

When compared to the UN initiatives, the OECD initiatives appear to be more balanced and implementation more practical. The fact that only six tax havens remain on the OECD list of unco-operative tax jurisdictions is illustrative of the success and acceptance of its initiatives. Although controversy remains, these initiatives have been extremely influential in minimizing harmful tax competition.

3.0 The Case of the Cayman Islands

We examine the case of the Cayman Islands because it is one of the leading offshore financial centres and is also at the forefront of compliance with the recommendations of the OECD and other supranational bodies. As such, the Cayman example will be illustrative for the economic changes which may be expected for the OFC community as a whole, if more jurisdictions choose to so comply. By some measures the Cayman Islands is 5th largest financial centre in the world, and by far the largest OFC thanks to its longstanding traditions of stability, privacy, and low tax.

Table 3a
International Financial Centres
ranked by banks' external assets: end-2000

	US$BN
United Kingdom	$2,095
Japan	1,199
Germany	975
United States	951
Cayman Islands	***782***
Switzerland	740
France	640
Luxembourg	510
Hong Kong	450
Singapore	424
Netherlands	290
Belgium	285
Bahamas	276

(Source: Bank for International Settlements)

3.1 U.S.—Cayman Islands Relationship

Contrary to the perception of impenetrable secrecy, the Cayman Islands has a long tradition of cooperation with external governments, especially the United States. Examples of such legislation on the Cayman Islands books include:

- The Narcotics Drugs (Evidence) (United States of America) Law, 1984 ("Narcotics Law")
- Mutual Legal Assistance (United States of America) Law, 1986 ("MLAT")
- Misuse of Drugs (International Co-operation) Law, 1997
- Evidence (Proceedings in other Jurisdictions) (Cayman Islands) Order, 1978

The MLAT entered into effect in 1990 and covers serious criminal matters. The MLAT governs procedures for and disclosure by banks and other financial institutions of otherwise confidential client information, as a result of foreign proceedings in the U.S. The MLAT superseded the more restrictively-scoped Narcotics Law, and as of November 2001 had been used over 180 times since its enactment.[23] Although based on the principal of reciprocity, it does cover U.S. crimes such as racketeering which are not also Cayman crimes. Significantly, the MLAT does not entertain enquiries from the U.S. with respect to purely tax offences. The U.S. Internal Revenue Service has the ability to circumvent this restriction by compelling the U.S. branches of financial institutions maintaining a presence in the Cayman Islands to disclose confidential information existing within the U.S. In essence, the greatest confidentiality protection was reserved for clients of purely offshore banks, i.e. those which refrained from establishing branches in jurisdictions other than the Cayman Islands.

The most recent U.S.—Cayman agreement was signed on November 27, 2001. In it, the governments of the United States and United Kingdom (including the Territory of the Cayman Islands) agreed on rules governing the exchange of information relating to taxes[24] ("Tax Information Agreement"). The highlights of the Tax Information Agreement are:

- only federal income taxes are covered by the agreement (excludes, for instance, estate, gift and state- level taxes);
- effective from January 1, 2004 for criminal tax evasion, and January 1, 2006 for civil and administrative tax matters;
- information exchange is implemented on a case-by-case basis, not across the board;
- any information disclosed under the agreement may not be disclosed to any third party.

The Tax Information Agreement marks an important break with tradition in that it recognizes criminal tax evasion under U.S. law, which is not considered a crime under Caymanian law, as justification for access to information on the taxpayer which may be held in the Cayman Islands. While on its face a stunning development, it actually represents a pragmatic act on the part of the Cayman Islands. Faced with the prospects of sanctions spearheaded by the OECD, as well as, the Cayman Islands' high profile amongst OFCs, the Cayman Islands apparently decided that agreeing to the Tax Information Agreement was the best way forward. It is also noteworthy that the Cayman Islands Bankers Association supports the Tax Information Agreement. Eric Crutchley, president of the Cayman Islands Bankers Association, is on record stating that the banking sector "had no problem" with the criminal tax aspect of the agreement with the U.S.[25]

Although not readily quantifiable, it is generally acknowledged that about 80% of the assets domiciled in the Cayman Islands are attributable to U.S. economic interests. Manhattan District Attorney Robert Morgenthau cited a 2000 study by the Federal Reserve Bank of New York that found more than $800 billion in U.S. currency in the Cayman Islands.[26] By these measures, the U.S. tax legislative and regulatory environment is extremely relevant in assessing the impact of the information exchange agreement on the Cayman Islands' asset base.

3.2 Economic Impact on the Cayman Islands

According to the most recent report of the Cayman Islands Monetary Authority, estimated assets and principal categories within the financial services sector are comprised of:

- $748 billion in bank and trust company deposits
- $215 billion in mutual fund assets
- $14 billion in captive insurance company assets

[23] Governor Smith comments at signing ceremony.
[24] Full Name of Agreement: "Agreement Between the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland, Including the Government of the Cayman Islands, for the Exchange of Information Relating to Taxes."
[25] "Caymans deal gives US access to tax records" Financial Times; Nov 29, 2001, By Canute James.
[26] "Tax havens an evasive issue—Critics contend Bush backing off on crackdown", Chicago Tribune; Chicago, Ill.; Jul 22, 2001; Frank James, Washington Bureau.

To what extent will these assets, which to a large extent underpin the Cayman Islands' relatively advanced economy, be placed in danger of flight as a result of the Tax Information Agreement? As the first major OFC to sign such an agreement with the U.S., it certainly places the Cayman Islands at a disadvantage in the short term. However, to properly gauge the expected impact, one must understand the principal reasons for the Cayman Islands' popularity as an OFC for financial assets attributable to U.S.-based investors. The factors most commonly advanced include:

- liberal regulatory environment for hedge funds (permissible investments, indebtedness, etc.)
- a "zero-tax" jurisdiction
- well-developed and sophisticated legal system based on English law
- availability of supporting professional services (legal, accounting, administrative)
- geographic location and time zone
- modern communications infrastructure

Trusts

A large portion of Caymanian bank assets is composed of deposits placed via various offshore trust structures, generally domiciled in the Cayman Islands. Under pressure from the U.S. tax authorities, Cayman Islands financial institutions have not dealt directly with "U.S. persons" for many years. U.S. persons interested in placing assets in the Cayman Islands have generally circumvented this restriction by establishing offshore-domiciled investment trusts or corporations with local nominee directors. However, under U.S. tax rules, any foreign trust having a U.S. person as a beneficiary (for any portion of the trust) is considered a "grantor trust". As such, the trust's income and assets are attributable back to the settlor, who is responsible for all U.S. tax liabilities arising from the trust. Under U.S. income tax law, U.S. citizens are liable for U.S. income tax on their worldwide income, without regard to the concept of residence. Although this is the generally-regarded U.S. federal income tax status of an offshore trust, in reality the grantor has been able to conceal non-reporting of the foreign trust income and assets because such information is not reportable to the U.S. tax authorities under the confidentiality protection afforded by the MLAT. It is these types of situations, which are clearly unlawful under U.S. tax law, which are potentially at risk as a result of the Tax Information Agreement. However, these situations constitute a small minority of the assets domiciled in Caymanian banks, and an even smaller proportion of the overall financial sector.

Within the U.S. context, a far more important reason for establishing an offshore trust has been to shelter the assets from potential loss due to adverse litigation consequences in the U.S. (i.e. an "Asset Protection Trust"). Professional legal and financial advisors in the U.S., who are more likely to be engaged by wealthier clients with larger asset bases, have stressed this advantage of the offshore trust, and have consistently maintained that its status for U.S. income tax purposes is neutral.

Mutual Funds

The Cayman Islands has become an extremely popular location for the offshore mutual fund industry, which has been attracted by the accommodating regulatory structure, simplified tax system, professional services and support, and reliable legal system afforded by the Cayman Islands. Specific initiatives such as the Mutual Funds Law (1993) and the establishment of the Cayman Islands Stock Exchange in 1997 to facilitate secondary market trading in offshore mutual funds, were large catalysts for the growth in Cayman mutual funds. To the extent taxation has factored into locational decisions, the key taxation element has been withholding, rather than income, tax. In a typical fund structure, the unitholders are based in various foreign jurisdictions and are responsible for income tax compliance in their own jurisdiction(s). The fund itself is not subject to income taxation in the Cayman Islands. The fund does, however, end up paying withholding tax to various foreign jurisdictions as a final tax of its interest and/or dividend income. In the case of foreign investors in the U.S., the non-treaty rate of withholding is 30%. For U.S.-based unitholders of offshore mutual funds (typically institutional investors or high-net-worth individuals) it is uncertain whether this represents any reduction of U.S. income tax otherwise payable, should their investments have been held directly.

Captive Insurance Companies
Similarly, in the case of U.S.-parent captive insurance companies, typically all income of the captive is subject to U.S. taxation, either through federal income or excise taxes. This is the case even though the income may not have been distributed back to the parent company. Companies generally choose to base their captive insurance operations in the Cayman Islands for regulatory and commercial reasons, not especialy for income tax savings. The Insurance Law (1979) sets out basic licensing, capital, supervisory, and reporting requirements. The more recent Segregated Portfolio Companies Act (1988) offers additional protection for assets segregated under arrangements with third-party service providers (termed "Rent-a-Captive") or deferred variable annuity programs.

Special-Purpose Financing Vehicles
The Cayman Islands has become an extremely popular domicile for special-purpose vehicles ("SPVs"), especially structured finance securities which are subsequently listed on the Cayman Islands Stock Exchange. The Cayman Islands has distinguished itself as the domicile of choice for such transactions because it has the professional infrastructure of lawyers, bankers, and accountants necessary to efficiently execute such transactions. Similar to the benefits of mutual funds, being a Cayman entity simplifies the SPV's tax withholding obligations. Moreover, to the extent the SPV retains income, it would not be subject to income tax in Cayman.

U.S. Foreign Sales Corporations
Indeed, acceding to the U.S. request for an information sharing agreement has made the Cayman Islands a more attractive domicile for Foreign Sales Corporations as defined under U.S. tax law, as the existence of such an agreement is one of the requirements for beneficial treatment of foreign-incorporated companies under the Internal Revenue Service's FSC regulations[27]. While there are undoubtedly numerous existing Cayman-domiciled vehicles ultimately attributable to U.S. economic interests, the new information sharing agreement should have the effect of simplifying the legal structures and reducing the potential risks for U.S. corporations in establishing such structures.

E-commerce
The Cayman Islands continues to introduce legislation to keep pace with global business developments. The Electronic Transactions Law (2000) provides the authority for legal recognition of electronic contracts and transactions, as well as extending privacy protection to the electronic , intermediaries and protection of data. In concert with upgrading its telecommunications infrastructure, the Cayman Islands is aiming to capture a large share of the emerging trade in offshore e-commerce services. Unsurprisingly, the OECD has another project underway suggesting modifications to its Model Tax Treaty to account for the unique aspects of e-commerce transactions[28].

3.3 Overall Assessment

In light of the above analysis, the impact of the Tax Information Agreement on the Cayman Islands' economic base is expected to be limited. Government revenues from fees and licences related to the financial services sector represented less than 5% of the government's total revenues in 1999, so the health of the domestic economy is of far more immediate interest. Still, it is difficult to understand why the Cayman Islands has conceded on the very important principle of financial privacy, an area where OECD member country OFCs such as Switzerland and Luxembourg continue to stress as an indelible aspect of their banking sectors. Moreover, given that the Tax Information Agreement takes force from 2004, the U.S. appears to gain little more

[27] See Internal Revenue Code, s.922(a) for additional FSC requirements.
[28] Reference in GEB's research paper on this topic (from e-logistics and fulfillment book)

than publicity, as there is ample time for those who fear being caught under the new rules to take appropriate action by transferring their assets and records elsewhere.

Examples of Uses of Offshore Financial Centres[29]

Offshore banking licenses. A multinational corporation sets up an offshore bank to handle its foreign exchange operations or to facilitate financing of an international joint venture. An onshore bank establishes a wholly owned subsidiary in an OFC to provide offshore fund administration services (e.g., fully integrated global custody, fund accounting, fund administration, and transfer agent services). The owner of a regulated onshore bank establishes a sister "parallel" bank in an OFC. The attractions of the OFC may include no capital tax, no withholding tax on dividends or interest, no tax on transfers, no corporation tax, no capital gains tax, no exchange controls, light regulation and supervision, less stringent reporting requirements, and less stringent trading restrictions.

Offshore corporations or international business corporations (IBCs). IBCs are limited liability vehicles registered in an OFC. They may be used to own and operate businesses, issue shares, bonds, or raise capital in other ways. They can be used to create complex financial structures. IBCs may be set up with one director only. In some cases, residents of the OFC host country may act as nominee directors to conceal the identity of the true company directors. In some OFCs, bearer share certificates may be used. In other OFCs, registered share certificates are used, but no public registry of shareholders is maintained. In many OFCs, the costs of setting up IBCs are minimal and they are generally exempt from all taxes. IBCs are a popular vehicle for managing investment funds.

Insurance companies. A commercial corporation establishes a captive insurance company in an OFC to manage risk and minimize taxes. An onshore insurance company establishes a subsidiary in an OFC to reinsure certain risks underwritten by the parent and reduce overall reserve and capital requirements. An onshore reinsurance company incorporates a subsidiary in an OFC to reinsure catastrophic risks. The attractions of an OFC in these circumstances include favorable income/withholding/capital tax regime and low or weakly enforced actuarial reserve requirements and capital standards.

Special purpose vehicles. One of the most rapidly growing uses of OFCs is the use of special purpose vehicles (SPV) to engage in financial activities in a more favorable tax environment. An onshore corporation establishes an IBC in an offshore center to engage in a specific activity. The issuance of asset-backed securities is the most frequently cited activity of SPVs. The onshore corporation may assign a set of assets to the offshore SPV (e.g., a portfolio of mortgages, loans credit card receivables). The SPV then offers a variety of securities to investors based on the underlying assets. The SPV, and hence the onshore parent, benefit from the favorable tax treatment in the OFC. Financial institutions also make use of SPVs to take advantage of less restrictive regulations on their activities. Banks, in particular, use them to raise Tier I capital in the lower tax environments of OFCs. SPVs are also set up by non-bank financial institutions to take advantage of more liberal netting rules than faced in home countries, reducing their capital requirements.

Tax planning. Wealthy individuals make use of favorable tax environments in, and tax treaties with, OFCs, often involving offshore companies, trusts, and foundations. There is also a range of schemes that, while legally defensible, rely on complexity and ambiguity, often involving types of trusts not available in the client's country of residence. Multinational companies route activities through low tax OFCs to minimize their total tax bill through transfer pricing, i.e., goods may be made onshore but invoices are issues offshore by an IBC owned by the multinational, moving onshore profits to low tax regimes.

Tax evasion and money laundering. There are also individuals and enterprises who rely on banking secrecy to avoid declaring assets and income to the relevant tax authorities. Those moving money gained from illegal transaction also seek maximum secrecy from tax and criminal investigation.

Asset management and protection. Wealthy individuals and enterprises in countries with weak economies and fragile banking systems may want to keep assets overseas to protect them against the collapse of their domestic currencies and domestic banks, and outside the reach of existing or potential exchange controls. If these individuals also seek confidentiality, then an account in an OFC is often the vehicle of choice. In some cases, fear of wholesale seizures of legitimately acquired assets is also a motive for going offshore. In this case, confidentiality is very important. Also, many individuals facing unlimited liability in their home jurisdictions seek to restructure ownership of their assets through offshore trusts to protect those assets from onshore lawsuits. Some offshore jurisdictions have legislation in place that protects those who transfer property to a personal trust from forced inheritance provisions in the home countries.

[29] Source: Financial Stability Forum's Working Group on Offshore Financial Centers Report (April 2000). – International Monetary Fund.

Progress on OECD-named Tax Havens?

		External Deposits[30] (US$MM)	Date of OECD Commitment	ITIO Member
1.	Cayman Islands	$722,431	Pre-2000	◆
2.	Bermuda	$43,503	Pre-2000	
3.	Cyprus	$10,669	Pre-2000	
4.	Malta	$3,945	Pre-2000	
5.	Mauritius	$3,260	Pre-2000	
6.	San Marino	na	Pre-2000	
7.	Netherlands Antilles	$88,750	Nov-2000	
8.	Bahrain	$20,080	Sep-2001	
9.	Aruba	$917	Jul-2001	
10.	Seychelles	$356	Feb-2001	
11.	Tonga	$5	Aug-2001	
12.	Isle of Man	$36,316	Dec-2000	
13.	Commonwealth of the Bahamas	$220,389	Mar-2002	◆
14.	Panama	$40,626	Apr-2002	
15.	Barbados	$8,136		◆
16.	Gibraltar—Overseas Territory of the United Kingdom	$7,711	Feb-2002	
17.	Liberia	$7,865		
18.	The Republic of Vanuatu	$1,298	May 2003	◆
19.	Belize	$1,979	Mar-2002	◆
20.	Turks & Caicos—Overseas Territory of the United Kingdom	$1,087	Mar-2002	◆
21.	St. Vincent and the Grenadines	$931	Feb-2002	
22.	Samoa	$917	Apr-2002	
23.	The Commonwealth of Dominica	$151	Mar-2002	
24.	Grenada	$93	Feb-2002	
25.	The Republic of the Maldives	$85		
26.	The Republic of Nauru	$35		
27.	St. Lucia	$75	Feb-2002	◆
28.	Anguilla—Overseas Territory of the United Kingdom[31]	(note 31)	Mar-2002	◆
29.	Antigua and Barbuda[31]	(note 31)	Feb-2002	◆
30.	British Virgin Islands—Overseas Territory of the United Kingdom[31]	(note 31)	Feb-2002	◆
31.	Montserrat[32]—Overseas Territory of the United Kingdom[31]	(note 31)	Feb-2002	
32.	The Federation of St. Christopher & Nevis[31]	(note 31)	Mar-2002	◆
33.	Andorra	$6,031		
34.	Cook Islands—New Zealand	na	Mar-2002	◆
35.	Guernsey/Sark/Alderney—Dependency of the British Crown	$72,784	Feb-2002	
36.	Jersey—Dependency of the British Crown	$233,939	Feb-2002	
37.	The Principality of Liechtenstein	$20,195		
38.	The Principality of Monaco	na		
39.	The Republic of the Marshall Islands	$409		
40.	Niue—New Zealand	na	Apr-2002	
41.	US Virgin Islands—External Territory of the United States	na	Mar-2002	

[30] "Table 7A: External loans and deposits of banks in individual reporting countries", *BIS Quarterly Review.* Basle: Bank for International Settlements, June 2003 Figures are for December 2002.
[31] Total figure for West Indies (UK) = $70,407. West Indies (UK) is comprised of: Anguilla, Antigua and Barbuda, British Virgin Islands, St. Kitts and Nevis, and Montserrat.
[32] Overseas Territory of the United Kingdom