OFFSHORE TAX EVASION

The role of Exchange of Information

by

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MILAN
Chairman Baucus, Senator Grassley, members of the Committee, it is an honor for the Organization for Economic Co-operation and Development\(^1\) to be invited to testify before you today on the subject of offshore tax evasion. Improving compliance, both on and offshore, is a major objective of our member countries and for many other countries.

By way of background, I am the Director of the OECD’s Centre for Tax Policy and Administration ("CTPA"). The CTPA’s tax experts support the work of the Committee on Fiscal Affairs, which leads the OECD’s work on taxation issues. The Committee brings together senior tax policy and tax administration officials from the United States and 29 other member countries. The OECD is widely recognized as the main international standard setting body in the tax area and provides a valuable forum at which governments can exchange views on tax policy issues and develop best practices in the tax administration area.

The Committee on Fiscal Affairs has a long history of helping governments to design international rules to minimize frictions between national tax systems and to avoid double taxation or double non-taxation of cross-border activities. The OECD Model Tax Convention, which incorporates many of these rules, forms the basis for over 2700 bilateral tax treaties around the world. The Committee also provides comparative information and analysis on the operation of tax systems to help governments make informed choices on how best to design their tax systems. Recent examples of the scope of our work include a report on tax reform trends, the tax treatment of foreign direct investment, the taxation of pensions, encouraging savings through tax preferred accounts, taxing wages, and the political economy of environmental taxes. The OECD has also been at the forefront of encouraging countries to deny the tax deductibility of bribes paid to foreign public officials. Over the last four years we have intensified our work on improving the efficiency of tax administrations resulting in the publication of 26 comparative studies and best practice guidelines on topics ranging from taxpayers’ rights to audit selection techniques. One of the unique outputs from this work is a comparative analysis of the structure and performance of revenue bodies in more than forty countries. Throughout this work, the OECD involves non-OECD economies and particularly the BRICS (Brazil, Russia, India, China and South Africa) in a variety of ways and we now have twenty-five non-OECD countries that have set out their positions on the OECD Model Tax Convention.

All of this work is intended to help governments design tax systems that encourage economic growth, produce a fair distribution of the tax burden, minimize tax compliance costs for taxpayers and at the same time ensure that taxpayers pay the right amount of tax, at the right time and in the right place. We at the OECD support tax reforms which lower rates and broaden the tax base. We support tax competition that is based on the service provided but not on the basis of secrecy. The OECD has consistently pursued a pro-competition agenda, including in the tax area. Our work on trade and investment liberalization and export credits are just a few examples. Our project on harmful tax practices is aimed at anti-competitive practices. It is focused on promoting international co-operation through exchange of information and providing a transparent, non-discriminatory fiscal environment within which real tax competition can flourish and where competition on the basis of excessive secrecy is eliminated.

\(^1\)The OECD is made up of 30 market-based democracies: All NAFTA members, four Asian-Pacific countries (Australia, Japan, Korea and New Zealand) and 23 European countries. In the tax area, the OECD has regular dialogue with over 70 non-OECD economies.
Offshore tax evasion is a multifaceted problem which requires a variety of responses at both the national and international levels. There is no silver bullet. A long term strategic approach is required to ensure that the right legislative framework is in place, that tax administrations have the necessary information, tools and resources to address the problem and that bilateral and multilateral co-operation is intensified.

I am pleased to be here today to share with you the OECD’s work on these issues and some of the solutions adopted in individual OECD countries.

I. OFFSHORE TAX EVASION: A GROWING PROBLEM

Offshore tax evasion is not about small islands that do not impose income taxes: it is about all countries that lack transparency and that are not prepared to cooperate to counter tax abuse. These practices make it difficult for other countries to enforce their own tax laws. With globally integrated financial markets and modern communication techniques the creation of offshore financial accounts, shell companies and the like are just the click of a mouse away. In this context, countries can no longer rely exclusively on their own sources of information to ensure compliance with their domestic tax laws. This is true for all countries, whether OECD or non-OECD, developed and developing, large or small, that rely on income taxes to fund the necessary governmental expenditures voted for by their national legislatures.

In this new era of “banking without borders”, wealthy individuals can easily evade capital income taxes in their country of residence by transferring capital abroad and channeling passive investments through offshore jurisdictions. This type of tax evasion is facilitated by the existence of jurisdictions with strict bank secrecy rules which prevent information exchange with the residence country, the increased recourse to foreign institutional investors and shell companies with opaque structures based in offshore financial centers can make it very difficult for domestic tax authorities to track capital income. With the growth of cross-border capital flows, the potential for abuse created by the lack of access to bank information for tax purposes and the resulting adverse consequences have increased exponentially. At the same time, tax authorities find it more and more difficult to monitor foreign portfolio investments of their residents because of the removal of traditional sources of information on these transactions (e.g. exchange controls). Thus, a decision by one country to prevent or restrict access to bank information for tax purposes is now more likely than ever before to adversely affect tax administrations of other countries.

Furthermore, the progressive elimination of withholding taxes at source on non-residents’ portfolio investment income allows more and more taxpayers to escape all forms of capital income taxes. Quite often, even when investing in their own countries, resident investors use foreign financial intermediaries and corporate or trust vehicles based in secrecy jurisdictions or offshore financial centers to disguise themselves as non-residents to evade domestic taxes. Thus, for example, an increasing proportion of investment into Asia is channeled through structures established in the British Virgin Islands. Even more significant is the possible use of bank secrecy jurisdictions to escape domestic taxes on income and wealth originating domestically (business income, substantial gains on the sale of assets, inherited wealth, etc.) that represent the “principal” of the foreign investment.

We know the offshore evasion problem is big but we do not have a precise estimate of the amount of tax at risk. Given that the main reason that tax evaders go offshore is the secrecy provided to enable them to hide their assets and income from their tax authorities, this is not surprising. We can approach the issue by looking at the size of the offshore sector and its tremendous growth over the last decade:

- Using data from the BIS, IMF and OECD, we estimate that a total of $5-7 trillion is held offshore.
- Brazil reports a commercial deficit of 4 billion dollars with the Caribbean islands.
- Singapore has now joined Luxemburg and Switzerland as the top private wealth centers of the world.
• The Bahamas is now ranked among the top five locations in the world for offshore mutual funds and trust funds and has also developed a significant inter-bank market.
• The Cayman Islands are the world’s fifth largest banking center, and the first among offshore jurisdictions, with a prominent position both in the inter-bank business and in private banking.
• The British Virgin Islands has developed into one of the most successful centers for International Business Companies. Conservative estimates put the number of shell companies at over 300,000.

In recent years, the demand for offshore facilities has considerably expanded, owing to the high growth rates of cross-border investment and to the increased number of wealthy and not so wealthy individuals who are prepared to use the new technological and communication infrastructures to go offshore. There is also a growing use of multiple layers of transactions to structure offshore operations through vehicles located in different countries. The gradual relaxation of reserve requirements, interest rate controls and capital controls in the main “onshore” markets and the creation of offshore banking facilities in some of the main industrial countries (the US and Japan) have reduced the regulatory advantages of offshore financial centers, making them less attractive for conventional banking. In some respects, every country has an offshore element. On the other hand, the tax avoidance facilities of offshore financial centers have become more and more important, particularly for foreign direct investment and asset management. The limited initial investments needed to enter the offshore industry have induced new countries, especially the smaller ones, to implement the “offshore package” of financial services and asset protection products to compete for internationally mobile capital. As a result, the number of offshore financial centers has grown significantly.

Of course, many of these offshore holdings and arrangements are undertaken for sound commercial and legitimate tax planning reasons, without any intent to conceal income or assets from the home country tax authorities. The experiences of tax authorities, however, lead them to believe that much of this money is there to evade or avoid tax.

Some recent initiatives in OECD member countries bear this out:

• Ireland collected almost 840 million euros ($1.14 billion) from about 15,000 Irish residents hiding undeclared income in offshore bank accounts. This may not seem like a big number in the US context but it amounts to about 8% of total 2006 income tax collected and almost 30% of 2006 income tax collected from self-employed taxpayers. Ireland is currently negotiating tax information exchange agreements with some of these jurisdictions.

• In Italy, a recent tax amnesty resulted in the disclosure of 75 billion euros ($102 billion) in assets held offshore.

• The United Kingdom has just launched an offshore compliance initiative which the accounting firm, Grant Thornton, estimates could bring in 5 billion pounds ($10 billion) in back taxes, interest and penalties, which is almost 4% of income tax receipts.

• South Africa has estimated that it is losing 64 billion rand ($9.1 billion) to tax havens.

• The Australian government recently approved more than $250 million for a multi-agency operation to address the promotion of and involvement in offshore tax evasion schemes. The potential loss of tax revenue from the schemes involving one promoter alone was estimated as exceeding $208 million.

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2 With reference to this latter market, the possibility of reducing inheritance and other capital taxes for individual investors acts as a prime incentive and has led to a large expansion in offshore fund management activity, in particular by the use of investment vehicles such as trusts and private companies.
The debate over improving offshore compliance is part of the broader debate on how to narrow the overall tax gap. Our research reveals that only four OECD countries (Mexico, Sweden, the United Kingdom and the United States) regularly publish estimates of the tax gap. Discussions in the OECD’s Forum on Tax Administration suggest that tax administrations will never be able to collect every dollar of tax due. In fact, it can be argued that this should not be the goal since the measures required to do this would be so intrusive as to lead taxpayers to revolt.

On the basis of the limited amount of information available, the US tax gap (approximately 14% of the estimated tax base) is consistent with the VAT gap calculated in the United Kingdom, above the overall tax gap estimates in Sweden (6-9%) and significantly below the gap estimates in Mexico (35%).

II. THE BROADER POLICY IMPLICATIONS OF OFFSHORE EVASION

Offshore tax evasion has effects that go beyond the lost revenue of the tax evaded. Offshore tax evasion undermines the fairness and integrity of national tax systems and adversely affects the willingness of the vast majority of law abiding taxpayers to voluntarily comply with their tax obligations. Public attitudes to tax compliance are heavily influenced by perception and the “voluntary” element of compliance can be badly eroded if a minority of taxpayers, usually those with significant incomes, can evade or are perceived to be evading their taxes by hiding assets offshore.

Furthermore, tax evasion by some restricts the ability of governments to lower tax rates for all. As Treasury Secretary Paulson put it recently in testimony before this Committee, “when people fail to pay their taxes, it serves as a de facto tax increase on everyone else.”

Competition on the basis of secrecy and lack of tax co-operation reduces global welfare since decisions on where to locate funds are driven by the ease of evasion and not by the true economic return on capital. This is especially true once the gross returns have been adjusted to reflect the often substantial fees of scheme promoters, arrangers, advisors, offshore trustees, nominees etc.

Excessive bank secrecy and a lack of bilateral tax co-operation is particularly serious for developing countries where offshore tax evasion may erode already weak tax bases, which can seriously undermine their ability to make the vital investments in social services and economic infrastructure upon which sustainable economic development depends. Excessive bank secrecy and an unwillingness of countries to cooperate to counter tax abuse undermine the national fiscal sovereignty of other countries. In a global environment, individual governments can maintain sovereignty over the design of their respective tax systems only insofar as they can count on the cooperation of other governments to share information needed to enforce their tax policy choices: choices which reflect their economic, social and political preferences. This is true even for countries that have a territorial system of taxation because income derived in such countries can still be hidden offshore.

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3 One reason why countries are reluctant to calculate any possible tax gap is that there is no agreed methodology to measure the gap. OECD is currently undertaking work in this area.

4 VAT accounts for 20% of tax revenue in the UK.

5 Testimony of Treasury Secretary Henry M. Paulson, Jr. before the Senate Finance Committee on Ways to Reduce the Tax Gap, April 18, 2007.
III. COUNTERING OFFSHORE NON-COMPLIANCE

A. OECD Tax Haven Initiative

The removal of barriers to cross-border trade, the liberalization of financial markets and new communications technologies have had very positive effects on global growth but have also opened up opportunities for money laundering, misuse of corporate vehicles, tax abuses and increased the threat to the stability of the financial system. All of these activities thrive in a climate of secrecy, non-transparency, and lack of bilateral and multilateral co-operation. Not surprisingly, the various initiatives launched by the international community to respond to these threats – the Financial Action Task Force, the Financial Stability Forum and the OECD’s tax haven initiative -- have focused on improving transparency, exchange of information and other forms of international co-operation.

The OECD has consistently advocated exchange of information between countries as part of tax treaty policy. However, its efforts to promote exchange of information vis-à-vis offshore jurisdictions were stepped up in the context of its harmful tax practices initiative launched in 1998. The initiative looked at both potentially harmful preferential tax regimes in member countries and at tax havens. In 2000, the OECD reinforced this initiative by publishing a new standard of access to bank information for tax authorities, which included a set of measures that needed to be taken by the small minority of OECD countries that did not meet that standard. Given the time constraints, I will not go into the details of all of our work on harmful tax practices or on improving access to bank information for tax purposes. A number of reports on these topics have been prepared over the years and they are available on our website www.oecd.org/ctp. I would also be pleased to provide more detailed information that may be useful to the Committee after today’s hearing.

The term “tax haven” is widely used but means different things to different people. For some, it simply means a low or no tax jurisdiction. For others, it means a secrecy jurisdiction. At the OECD, we decided to establish objective criteria to identify tax havens and these can be summarized as follows:

i. No or nominal taxation on the relevant income. Why? Tax cheats generally don’t try to hide money in places where it will be subject to significant taxation. No or nominal taxation is the starting point of the analysis but is never sufficient by itself to identify a tax haven.

ii. Lack of effective exchange of information for tax purposes.

iii. Lack of transparency of the tax or regulatory regime (e.g. excessive banking secrecy; inadequate access to beneficial ownership information, etc.) which may limit the availability of, or the access to, information when it is needed for tax examinations or investigations.

iv. Lack of a requirement that activities be substantial (e.g. shell companies).

Lack of transparency and lack of effective exchange of information are the key attractions for tax cheats because they can place their assets in a jurisdiction with these features in the knowledge that information

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7 Since 2000, the OECD has referred to offshore financial centers that have committed to improve transparency and to establish effective exchange of information as “Participating Partners”.

on their activities will not be disclosed to the tax authorities back home. They are also the key factors in identifying tax havens.\(^9\)

Using the criteria referred to above, in 2000 the OECD issued a list of 35 jurisdictions which met the criteria (see Box I). A decision was taken not to include Bermuda, Cyprus, Cayman Islands, Malta, Mauritius and San Marino because prior to the issuing of the list, these jurisdiction made high level political commitments to implement the principles of transparency and effective exchange of information.

### Box I

**OECD 2000 Tax Haven List**

<table>
<thead>
<tr>
<th>Andorra</th>
<th>Liberia</th>
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<tbody>
<tr>
<td>Anguilla – Overseas Territory of the United Kingdom</td>
<td>The Principality of Liechtenstein</td>
</tr>
<tr>
<td>Antigua and Barbuda</td>
<td>The Republic of the Marshall Islands</td>
</tr>
<tr>
<td>Aruba - Kingdom of the Netherlands(^1)</td>
<td>The Principality of Monaco</td>
</tr>
<tr>
<td>Commonwealth of the Bahamas</td>
<td>Montserrat – Overseas Territory of the United Kingdom</td>
</tr>
<tr>
<td>Bahrain</td>
<td>The Republic of Nauru</td>
</tr>
<tr>
<td>Barbados</td>
<td>Netherlands Antilles – Kingdom of the Netherlands(^1)</td>
</tr>
<tr>
<td>Belize</td>
<td>Niue – New Zealand(^2)</td>
</tr>
<tr>
<td>British Virgin Islands – Overseas Territory of the United Kingdom</td>
<td>Panama</td>
</tr>
<tr>
<td>Cook Islands – New Zealand(^2)</td>
<td>Samoa</td>
</tr>
<tr>
<td>The Commonwealth of Dominica</td>
<td>The Republic of the Seychelles</td>
</tr>
<tr>
<td>Gibraltar – Overseas Territory of the United Kingdom</td>
<td>St Lucia</td>
</tr>
<tr>
<td>Grenada</td>
<td>The Federation of St. Christopher &amp; Nevis</td>
</tr>
<tr>
<td>Guernsey/Sark/Alderney – Dependency of the British Crown</td>
<td>St. Vincent and the Grenadines</td>
</tr>
<tr>
<td>Isle of Man – Dependency of the British Crown</td>
<td>Tonga</td>
</tr>
<tr>
<td>Jersey – Dependency of the British Crown</td>
<td>Turks &amp; Caicos – Overseas Territory of the United Kingdom</td>
</tr>
<tr>
<td>US Virgin Islands – External Territory of the United States</td>
<td>The Republic of Vanuatu</td>
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</tbody>
</table>

\(^1\) The Netherlands, the Netherlands Antilles, and Aruba are the three countries of the Kingdom of the Netherlands.

\(^2\) Fully self-governing country in free association with New Zealand.

The 2000 Report made it clear that the listing was intended to reflect the technical conclusions of the Committee only and was not intended to be condemnatory. Rather, a further list was to be developed for that purpose (the “list of uncooperative tax havens”). Jurisdictions that made a commitment to implement the principles of transparency and effective exchange of information were not to be included on that list. A total of 33 jurisdictions (including Bermuda, Cyprus, Cayman Islands, Malta, Mauritius and San Marino)

\(^9\) Because the lack of substantial activities criterion proved difficult to apply objectively, it was not used as a basis for determining whether a jurisdiction was unco-operative. See (OECD 2001), *The OECD’s Project on Harmful Tax Practices: The 2001 Progress Report.*
made such commitments, leaving only five jurisdictions currently on the OECD’s list of unco-operative tax havens (Box II).

<table>
<thead>
<tr>
<th>Box II</th>
<th>OECD LIST OF UNCO-OPERATIVE TAX HAVENS</th>
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<tbody>
<tr>
<td>Andorra</td>
<td>Monaco</td>
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<tr>
<td>Liberia</td>
<td>Marshall Islands</td>
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<tr>
<td>Liechtenstein</td>
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Since the publication of the 2000 list, all the jurisdictions that have made commitments have been invited to participate in the OECD’s “Global Forum on Taxation.” The discussions in the Global Forum have lead to the development of high standards in the areas of transparency and exchange of information. These standards are embodied in the “2002 Model Agreement on Exchange of Information in Tax Matters” and in the 2006 report, “Tax Co-operation: Towards a Level Playing Field.”

The publication of that report, which was the result of collaboration by 82 countries and jurisdictions, represents a major milestone in the international discussions between offshore and onshore financial centers. For the first time, we have available a comprehensive compilation of the transparency and exchange of information practices of these centers. OECD governments’ policies towards offshore jurisdictions can now be based upon facts rather than perception of how far each jurisdiction meets the internationally agreed standards for transparency and information exchange in the tax area. Some of the conclusions that emerge from the Report are:

- There are only 5 countries (Cyprus, Hong Kong, Malaysia, the Philippines and Singapore) that require a domestic tax interest in order to obtain and respond to a request from a treaty partner for information.
- Of the countries that are able to exchange information for both civil and criminal tax purposes, the vast majority of the countries reviewed are able to obtain and provide banking information in response to a request for information related to a criminal tax matter in some or all cases. Only three countries (Guatemala, Nauru and Panama) are unable to obtain bank information for any tax information exchange purposes and a small minority of countries limit their exchanges to serious tax fraud (e.g. Andorra, Liechtenstein, Luxembourg and Switzerland).
- 74 of the countries reviewed reported that ownership information is available for companies and 45 countries reported it was available with respect to partnerships. In most cases, legal ownership information is available. Beneficial ownership information is available in an increasing number of countries.
- All countries reviewed treated as confidential any information received pursuant to tax treaties and tax information exchange agreements (TIEAs).

What is clear from the review undertaken is that considerable progress has been made since 2000. For example, Jersey and Guernsey have implemented high standards of transparency and 12 TIEAs have been signed. There is no longer any OECD country where a domestic tax interest, of itself, is an impediment to exchange of information. Many countries have improved transparency by implementing the FATF

10 The text of every commitment is available on the OECD website. See www.oecd.org/taxation.
11 Barbados was not included in the list of unco-operative tax havens because it had transparency, was already engaged in effective exchange of information with OECD countries, and because it is willing to enter into tax information exchange arrangements with the OECD countries with which it currently does not have such arrangements. The Committee also subsequently determined that the Maldives and Tonga should not be considered tax havens.
customer due diligence requirements and several countries have recently required bearer shares to be immobilized or held by an approved custodian. Nevertheless, progress is still needed, particularly in the following areas:

(i) Further progress is required in some jurisdictions and countries to address the constraints placed on international co-operation to counter criminal tax abuses. In today’s global environment it is essential for all countries to co-operate with other countries in the fight against all financial crimes, including tax crimes, and this requires the implementation of transparency and the establishment of effective exchange of information mechanisms.

(ii) Further progress is required to address those instances where offshore financial centers require a domestic tax interest to obtain and provide information in response to a specific request for information related to a tax matter. A domestic tax interest requirement, particularly in countries with a territorial tax system such as Hong Kong and Singapore, can seriously limit the information that can be exchanged because it is unlikely that the requesting and requested countries will both have an interest in the same information, taxpayer, tax year, etc.

(iii) Although most countries reported being able to obtain bank information for criminal tax matters, four OECD and several non-OECD countries continue to have strict limits on access to bank information which excessively constrain their ability to respond to specific requests for information in civil and criminal tax cases.

(iv) Further progress is required in some countries to ensure that competent authorities have appropriate powers to obtain information for civil and criminal tax purposes. Although the majority of countries have such powers, some non-OECD countries reported limitations on the use of their information-gathering powers to the onshore sector or otherwise lack the power to obtain information for exchange of information purposes.

(v) Most countries have access to legal ownership information of companies, trusts, partnerships, foundations and other organizational structures. Beneficial ownership information is available in a far fewer, but an increasing, number of countries. Further improvement is necessary. A large number of countries still allow bearer shares. In some countries the availability of ownership information is further complicated by the fact that responsibility for corporate law is in the hands of political sub-divisions. Progress in this area is expected to be assisted by countries’ implementation of Recommendations 5, 33 and 34 of the FATF Recommendations and other international initiatives (e.g. EU Second and Third Money Laundering Directives12).

As a result of the OECD initiative we now have in place globally endorsed standards, a framework for constructive dialogue with offshore centers, a fact-based evaluation of how countries measure up to the standards and countries have the means (i.e. primarily TIEAs) to implement those standards.

Status of TIEA Negotiations

All of the jurisdictions that made a commitment to the OECD agreed to establish effective exchange of information on a bilateral basis with interested OECD member countries. The United States in particular has a long history of trying to improve exchange of information for tax purposes through the use of TIEAs going back to the Caribbean Basin Initiative launched in 1984 by the Reagan administration.

12 The EU Second Money Laundering Directive has been transposed into the domestic law of all EU Member States. The EU Third Money Laundering Directive has been adopted by the Council of Economic and Finance Ministers and must be transposed into the domestic law of the Member States by December 15, 2007.
TIEAs are not just important because they permit the IRS to obtain, upon request, ownership, accounting, banking and other relevant information, but also because they send an important signal to those considering cheating on their taxes: you can no longer hide behind the veil of secrecy and lack of cooperation. TIEAs have, therefore, an important deterrent effect.

Since 2000, a total of 12 TIEAs have been signed between OECD countries and offshore jurisdictions: the United States has signed nine, Australia three, the Netherlands and New Zealand one each. More than 40 bilateral negotiations are currently ongoing.

Despite this progress, there are a small number of jurisdictions that have systematically refused requests by OECD countries to negotiate TIEAs, even though they committed to doing so. There have also been some jurisdictions that are prolonging the negotiations in the hope of obtaining full tax treaties, even where the jurisdiction does not impose income taxes and there are some countries that still refuse to endorse the standards (e.g. Andorra, Liberia, Liechtenstein, Marshall Islands, Monaco and Singapore). It is now critical to ensure that all negotiations come to a successful conclusion within a reasonable time period. It is also important to recognize those jurisdictions that have implemented transparency and signed TIEAs with effective exchange of information provisions.

The negotiation of TIEAs is a bilateral process that permits the contracting parties to take account of the totality of their bilateral relations, their respective legal systems and practices and their mutual economic interests. In the vast majority of cases where bilateral arrangements exist for effective exchange of information for both civil and criminal tax matters, the parties derive mutual benefits from the arrangement either as a result of a likely balance in the exchange of information or through other benefits. The nature of such benefits would necessarily depend on the legal systems and particular circumstances of the two parties to the arrangement. One of the obvious benefits for a jurisdiction in signing TIEAs is enhancement of its reputation as a legitimate financial center. Some countries, such as Australia and New Zealand, have agreed to include as part of their TIEA arrangements provisions for the allocation of taxing rights with respect to certain types of income earned by individuals (e.g. pensions, government services, students or business apprentices) and have also provided a mutual agreement procedure to deal with transfer pricing adjustments. Canada, as discussed further below, is proposing to extend an exemption from Canadian tax on active foreign source income to income earned in a country that has signed a TIEA. Other countries may consider providing non-tax benefits such as access to universities. What is clear, however, is that OECD countries are generally unwilling to enter into comprehensive tax treaties with tax havens.

Some of the smaller offshore jurisdictions will require assistance in replacing their “concealment center” activities by other real economic activities which can ensure the long term viability of these economies. This will require a “whole of government” approach from OECD countries that takes into account a number of different dimensions. Since the immediate beneficiaries of the implementation of the new tax standards will be the treasuries of OECD countries whereas the providers of assistance will be the state or foreign affairs departments of OECD countries, these policies must be coordinated both between OECD countries and between international organizations, particularly the IMF, World Bank and OECD. In addition, it is also important for OECD governments to consider the importance of establishing effective exchange of information mechanisms when expanding trade relations with offshore jurisdictions (e.g."

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13 Prior to 2001, the U.S. also signed TIEAs with Antigua and Barbuda, The Bahamas, Barbados, Bermuda, Colombia, Costa Rica, Dominica, Dominican Republic, Grenada, Guyana, Honduras, Jamaica, Marshall Islands, Mexico, Peru, St. Lucia, Trinidad and Tobago, and the U.S. Virgin Islands.

14 See Annex.
through free trade agreements or other similar agreements) so that the further removal of trade barriers does not also result in expanded opportunities for offshore evasion.15

Also relevant in this context is the way that the EU has linked the good governance agenda, tax compliance and development by including in their partnership agreements with developing countries in Africa, the Caribbean and the Pacific goals on transparency and effective exchange of information. These agreements have almost €3 billion in the 10th European Development Fund allocated to incentives for implementing good governance:

\[
\text{When preparing new cooperation strategies with the ACP [African, Caribbean and Pacific] countries, the Commission will propose granting additional financial support to countries adopting or ready to commit themselves to a plan that contains ambitious, credible measures and reforms.}
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\text{For the Caribbean and the Pacific regions, the Community’s priority will be to promote good financial, fiscal and judicial governance. These regions need to rapidly implement OECD standards on transparency and the effective exchange of information for tax purposes and to eliminate harmful tax practices. Special attention will be paid to such problems as money laundering, organised crime and terrorist financing.}
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The next year will be crucial in assessing the willingness of jurisdictions to conclude and implement TIEAs. A failure to effectively implement transparency and exchange of information standards will force OECD countries to examine alternative strategies vis-à-vis these countries.

**B. OECD Initiative to Strengthen the Article on Exchange of Information in Income Tax Conventions**

The OECD’s Committee on Fiscal Affairs continues to work on improving both the legal framework and practical aspects of exchange of information. In 2004, the Committee approved revisions to the exchange of information provisions of the OECD’s Model Tax Convention. The key changes were to set out explicitly the requirement to exchange information held by banks, financial institutions, nominees or persons acting in an agency or fiduciary capacity and to require the exchange of information notwithstanding that the country requested to provide the information does not have an interest in obtaining the information to administer its own tax laws. The vast majority of OECD countries already can and do exchange banking information --only Austria, Belgium, Luxemburg and Switzerland cannot. OECD is very pleased to see that the new treaty signed between the United States and Belgium on November 27, 2006 does require exchange of bank information when such information is requested for a criminal or civil tax matter. It is the first tax treaty in which Belgium has agreed to such a provision.

The vast majority of OECD countries believed it was important to revise the Model Tax Convention to send a clear signal to all countries including jurisdictions outside the OECD such as Hong Kong and

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15 For example, the US Treasury announced the commencement of TIEA negotiations with Panama in January 2002 and in December 2006 the United States Trade Representative announced the completion of the Free Trade Agreement negotiations with Panama. The U.S.-Singapore Free Trade Agreement entered into force on May 6, 2003 but the United States still has no tax treaty or TIEA with Singapore.
Singapore, that effective exchange of information requires the ability to exchange bank information, whether or not the requested jurisdiction needs the information for its own purposes.

Countries are choosing to reinforce this signal at the national level as well. Canada has just announced in its 2007 Budget Proposal, “To enhance Canada’s network for the sharing of tax information, the International Fairness Initiative proposes that Canada require that all new tax treaties and revisions to existing treaties (including treaties currently under negotiation) include the new OECD standards in relation to exchange of tax information.”  http://www.budget.gc.ca/2007/bp/bpc5ee.html

C. OECD Initiatives on Tax Shelters and Aggressive Tax Planning

When 35 tax commissioners met at the OECD’s Forum on Tax Administration in Seoul in September 2006, the main focus was on how to improve international tax compliance. The final communiqué stated that

*Our discussions in Seoul confirmed that international non-compliance is a significant and growing problem. Cross-border non-compliance can take many forms, up to and including outright tax fraud. Individuals have, for example, used offshore accounts, offshore trusts or shell companies in offshore financial centers or other countries to conceal taxable assets or income, as well as credit cards held in offshore jurisdictions to provide access to concealed assets; businesses of all sizes have created shell companies offshore to shift profits abroad often taking recourse to over or undervaluation of traded goods and services for related party transactions and some multinational enterprises (including financial institutions) have use more sophisticated cross-border schemes and/or investment structures involving misuse of tax treaties, the manipulation of transfer pricing to artificially shift income into low tax jurisdictions and expenses into high tax jurisdictions which go beyond legitimate tax minimization arrangements.*

The Forum on Tax Administration, which is chaired by IRS Commissioner Everson, agreed to pursue this work and to also examine the role of tax intermediaries (accountants, lawyers, investment bankers, etc) in promoting unacceptable tax minimization schemes. This work now encompasses the role that intermediaries play – both positive and negative – in the operation of national tax systems. The outcome of this initiative will be presented to the January 2008 meeting of the Forum, which will be hosted by South Africa.

IV. MEASURES USED BY COUNTRIES TO ADDRESS OFFSHORE TAX EVASION

A. Legislative Initiatives

Beyond the international dimension, countries are also acting at the national level by enacting legislation to address the offshore problem. Several countries (both OECD and non-OECD) have enacted measures to deal with their inability to obtain relevant information from offshore jurisdictions. Some of these types of legislative measures were discussed in the 2004 Progress Report on the OECD’s Project on Harmful Tax Practices16 and include:

- The use of provisions having the effect of disallowing any deduction, exemption, credit or other allowance in relation to all substantial payments made to persons located in tax havens except

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where the taxpayer is able to establish satisfactorily that such payments do not exceed an arm's length amount and correspond to bona fide transactions.

- The use of thin capitalization provisions restricting the deduction of interest payments to persons located in tax havens.
- The use of legislative or administrative provisions having the effect of requiring any resident who makes a substantial payment to a person located in a tax haven, enters into a transaction with such a person, or owns any interest in such a person to report that payment, transaction or ownership to the tax authorities, such requirement being supported by substantial penalties for inaccurate reporting or non-reporting of such payments.
- The use of legislative provisions allowing the taxation of residents on amounts corresponding to income earned by entities established in tax havens in which these residents have an interest and that would otherwise be subject to substantially lower or deferred taxes.
- The use of legislative provisions ensuring that withholding taxes at a minimum rate apply to all payments of dividends, interest and royalties made to beneficial owners receiving such payments from entities established in tax havens.

An example of legislative measures targeted at offshore tax evasion can be found in the 2007 Canadian government budget proposal, which includes an “International Tax Fairness Initiative” consisting of the following key elements:

- Enhancing Canada’s ability to collect tax information from other jurisdictions, through revised tax treaties and TIEAs with non-treaty countries.
- Modifying the exemption from Canadian tax for foreign-source active business income which is currently limited to income earned in countries with which Canada has a tax treaty, to also include income earned in a non-treaty jurisdiction which has signed a tax information exchange agreement with Canada. This will give non-treaty countries an incentive to enter into TIEAs with Canada, as Canadian companies will then enjoy exempt surplus treatment in respect of active business income earned in that jurisdiction.
- To increase the incentive for countries to enter into TIEAs with Canada, income earned by foreign affiliates in non-TIEA, non-treaty countries will be taxed in Canada as it is earned. In the case of TIEA negotiations that begin after March 19 2007, this treatment will apply if those negotiations are not successfully completed after the passage of five years from the earlier of the commencement of TIEA negotiations and the date on which Canada proposed the negotiations. In the case of a country that is already in the process of negotiating a TIEA with Canada, this treatment will apply if the negotiations are not successfully completed before 2014. Canada will give public notice of its invitations for TIEA negotiations.
- Providing additional funding for auditing and enforcement by the Canada Revenue Agency (CRA).


Spain also offers an interesting example of a country that has designed a legislative framework to deal with offshore tax evasion. Spain has established a list of tax havens that currently identifies more than 45 jurisdictions. Spain will automatically remove a jurisdiction from the list when a TIEA with that jurisdiction or a treaty including a provision following Article 26 of the OECD Model Convention on Income and on Capital enters into force.

The Spanish list is used for a range of different tax purposes. For instance, certain rebuttable presumptions are created under Spanish controlled foreign corporation (CFC) rules for entities located in a listed jurisdiction. In such a situation all of the income is presumed to be passive and the tax rate is presumed to
be lower than the threshold rate that triggers the application of the CFC rules. The presumption does not apply if the CFC consolidates its accounts with a Spanish resident company.

Spain’s list is also used for other purposes:

- The exemption method that applies to dividends received by Spanish resident corporations does not apply to dividends received from entities in listed jurisdictions.
- The thin capitalization rules prohibit resident corporations from applying a debt-equity ratio other than 3 in cases where the shareholders who directly or indirectly provide debt finance to the corporation are residents of a listed jurisdiction.
- The list is used to deny the exemption from withholding tax applicable to interest paid on public debt, including Spanish government bonds.
- Certain specific reporting rules also apply to Spanish resident taxpayers that have operations in, make payments to, or collect payments from properties or shares in listed jurisdictions.
- Dividends from a Spanish holding company that are derived from exempt income are not exempt from withholding tax if paid to a resident in a listed country. The tax exemption that may apply to capital gains derived from the sale of shares in a Spanish holding company is not available to a person resident in a listed country.
- A Spanish resident investor with an interest in a collective investment undertaking resident in a listed jurisdiction is subject to tax on a deemed gain equal to 15% of the acquisition value of the interest unless the taxpayer can demonstrate that that amount is not correct, in which case the investor is taxed on a mark-to-market basis.
- The exemption of income derived by an individual resident in Spain from dependent personal services exercised abroad for a non-resident entity or permanent establishment is not applicable if the entity or permanent establishment is situated in a listed jurisdiction.
- The deduction for investment in non-resident companies is not allowed for a non-resident company that is resident in a listed jurisdiction.
- Payments made to a transparent partnership (entidad en regimen de atribución de rentas) in a listed jurisdiction but without a taxable presence in Spain are subject to withholding taxes at the general rate, regardless of the residency of its partners.

**B. Offshore Compliance Initiatives**

Countries are establishing wide-ranging offshore compliance initiatives to better detect and deter offshore evasion. Several tax administrations have had recent successes with such initiatives. As mentioned above, in its most recent investigation alone Ireland collected € 840 million from more than 15,000 taxpayers that came forward to make voluntary disclosures. The success was largely based on four factors:

(i) the availability of necessary powers under its domestic legislation,

(ii) a voluntary disclosure system,

(iii) persuading the banks to write to their customers with offshore accounts concerning the proposed government actions and

(iv) an extensive media strategy.
Before commencing the investigation the Irish tax administration approached certain large domestic banks with offshore operations. The banks were advised that their offshore operations would be investigated and were given a date at which investigations would commence. The banks agreed to co-operate and wrote to their customers informing them that an investigation would soon begin. At the same time the tax administration engaged in an extensive media strategy to ensure that all non-compliant taxpayers would be aware of the benefits of the voluntary disclosure regime.

The United Kingdom also has had some notable successes in its offshore investigations. Following two favorable court decisions that permitted the United Kingdom tax administration to obtain records on UK residents with undeclared offshore accounts, the UK on April 17, 2007 launched an “Offshore Disclosure Facility” (see https://disclosures.hmrc.gov.uk/oaics/). The initiative follows a pattern very similar to that used by the Irish tax administration.

Australia is employing a whole of government approach. In 2004, Australia established a multi-agency taskforce known as Operation Wickenby to counter offshore tax arrangements involving tax avoidance or evasion, and in some cases large-scale money-laundering. It combines the investigative powers of the Australian Taxation Office, the Australian Crime Commission (ACC), the Australian Federal Police, the Australian Securities and Investments Commission and the Commonwealth Director of Public Prosecutions, supported by AUSTRAC (Australian Transaction Reports and Analysis Centre), the Attorney-General’s Department and the Australian Government Solicitor, to deal with large scale international tax avoidance and evasion. This approach recognizes the similarities in the means used to commit tax crimes and money-laundering. By combining the expertise of the different law enforcement agencies involved in combating these crimes, Australia hopes to more effectively address international tax evasion and money laundering. Some examples of the progress made include:

- **Arrests/charges:**
  - Three company directors were arrested and charged in Southport, Queensland on 20 July 2006 with two counts each of conspiracy to defraud the Commonwealth of some $6.6 million.
  - In another investigation, one person of interest has been charged with a breach of the ACC Act for allegedly refusing to take the oath and take part in an ACC examination.
  - An individual faced court on 1 February 2007 in relation to serious tax offences. While not yet charged, the individual has advised the Court he will plead guilty to tax related offences and is scheduled to face a pre-sentencing hearing in the Victorian County Court on 2 July 2007.

- **Legal challenges:**
  - Since the establishment of the ACC, 20 challenges have been finalized in the Federal and High Courts in relation to ACC’s Operation Wickenby, and the ACC has succeeded in all of those challenges. The ACC is currently defending a number of matters in the Federal Court in favor of the Commissioner of Taxation that disallowed claims for legal professional privilege.
  - There is also an appeal by a taxpayer against a Federal Court decision in favor of the Commissioner of Taxation on legal professional privilege.

- **Audits:**
  - More than 100 audits have commenced. Assessments totaling $26.95 million have issued with $24.9 million either collected or under payment arrangements.
V. CONCLUDING REMARKS

Without vigorous and coordinated action by governments to ensure that the right legislative framework is in place, that tax administrations have the necessary information, tools and resources to address the problem, and without greater bilateral and multilateral co-operation, offshore tax evasion will continue to grow and undermine the integrity of national tax systems.

No one country by itself can meet this challenge. The next year will be crucial to see how far offshore centers are prepared to move away from financial services based on concealment to legitimate financial services. For those jurisdictions that have already made this move, the international community and individual countries should provide political recognition of this progress and should ensure the further integration of these jurisdictions in the international financial system.

The U.S. has led the way in the signing of TIEAs and must continue to do so because closing one avenue for tax evasion simply redirects evasion to other offshore centers. A very clear example of this is the way Singapore has used the fact that it is not on the OECD list of tax havens and has restrictive exchange of information provisions in its tax treaties to market itself as the ultimate secrecy jurisdiction.

Jurisdictions like Singapore are rightly proud of their international co-operation in combating money laundering but if we are to succeed in the eradication of offshore tax evasion, we must work together to change the perception of such secrecy jurisdictions that it is acceptable in today’s global economy to facilitate tax evasion by the residents of other countries. High level political commitment and action is needed to bring about such a change. Countries around the world stand ready to work with the United States to achieve this goal.
## ANNEX

### TIEAS SIGNED BY CO-OPERATIVE JURISDICTIONS AND UNCO-OPERATIVE TAX HAVENS

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Agreements signed with the US</th>
<th>Agreements signed with other OECD countries</th>
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<tbody>
<tr>
<td>Anguilla</td>
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<tr>
<td>Antigua and Barbuda</td>
<td>Dec. 2000</td>
<td>Australia, Jan. 2007</td>
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<tr>
<td>Aruba</td>
<td>Nov. 2003</td>
<td></td>
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<tr>
<td>The Bahamas</td>
<td>Jan. 2000</td>
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<tr>
<td>Bahrain, Kingdom of</td>
<td></td>
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<tr>
<td>Barbados(^{17})</td>
<td>Nov. 1984</td>
<td></td>
</tr>
<tr>
<td>Belize</td>
<td></td>
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<tr>
<td>British Virgin Islands</td>
<td>Apr. 2002</td>
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<tr>
<td>Cayman Islands</td>
<td>Nov. 2001</td>
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<tr>
<td>Cook Islands</td>
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<tr>
<td>Cyprus</td>
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<tr>
<td>Dominica</td>
<td>May 1988</td>
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<td>Gibraltar</td>
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<tr>
<td>Grenada</td>
<td>Dec. 1986</td>
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<td>Guernsey</td>
<td>Sept. 2002</td>
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<tr>
<td>Jersey</td>
<td>Nov. 2002</td>
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<td>Malta</td>
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<td>Mauritius</td>
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<td>Montserrat</td>
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<td>Nauru</td>
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<tr>
<td>Netherlands Antilles</td>
<td>Apr. 2002</td>
<td>Australia &amp; New Zealand, March 2007</td>
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<td>Niue</td>
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<tr>
<td>Panama</td>
<td></td>
<td>Commencement of TIEA discussions in January 2002 but negotiations appear to be stalled.</td>
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<tr>
<td>Samoa</td>
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<td>San Marino</td>
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<td>Seychelles</td>
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<td>Saint Kitts and Nevis</td>
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<td>Saint Lucia</td>
<td>Jan. 1987</td>
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<tr>
<td>Saint Vincent and The Grenadines</td>
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<tr>
<td>Turks and Caicos Islands</td>
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<tr>
<td>U. S. Virgin Islands</td>
<td>Tax Implementation Agreement, 1987</td>
<td>Exchange of information carried out through US tax treaty network</td>
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<tr>
<td>Vanuatu</td>
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\(^{17}\) See footnote 11 supra.
Unco-operative Tax Havens

<table>
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<th>Jurisdiction</th>
<th>Agreements signed with the US</th>
<th>Agreements signed with other OECD countries</th>
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<td>Liechtenstein</td>
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<tr>
<td>Marshall Islands</td>
<td>Mar. 1991</td>
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<tr>
<td>Monaco</td>
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<td>Tax Treaty with France, May 1963</td>
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The Role Of Tax Havens in a Changing Environment

by

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Director OECD’s Centre for Tax Policy & Administration
And Alessandra Sanelli*, Italian Central Bank

Presentation

Tax Havens and Tax Competition
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*The views expressed in this article are those of the authors and do not in any way commit the OECD and its Member countries nor the Banca d’Italia

18 This paper is part of a wider research on “Tax Systems and Tax Reforms in Latin America”, carried out at the Department of Public Economics of the University of Pavia, under the direction of L. Bernardi, A. Barreix, A. Marenzi and P. Profeta, and the supervision of V. Tanzi. Tax havens have played an increasingly important role in world financial markets, particularly in the Caribbean and Latin American regions.
1. Introduction

Tax havens play an increasingly important role in world financial markets, particularly in the Caribbean and Latin American regions. Tax havens thrive in a climate characterized by excessively strict bank secrecy, a lack of transparency and where countries are not prepared to cooperate to counter abuse. Over the last 30 years, we have seen many Caribbean islands move into offshore financial activities. This has had profound implications for the structure of their economies. It has also had profound implications for both developed and developing countries. This paper examines the role of Caribbean tax havens, the response of the international community and sets out what is the current position of these jurisdictions in the light of the international initiatives aimed at curbing harmful tax practices.

The paper is organized as follows. Section 2 identifies the growing concerns about tax havens, particularly those of national tax administrations, and reviews the theoretical and empirical literature on tax havens and information exchange. Section 3 tracks the origins of the Caribbean tax havens, while Section 4 examines their present weight in the international financial and economic landscape. Section 5 reviews the international initiative undertaken at the OECD level to counter fiscal abuse through tax havens and the response of Caribbean jurisdictions. Finally, Section 6 examines the possible future prospects for these economies.

2. Tax havens: a growing concern for the international community

In recent years, improved communications and liberalization of financial markets have fostered an impressive growth of both cross-border financial transactions and foreign direct investment (FDI). The rising volume of international transactions has brought new risks, among which the wider potential adverse effects of financial crises and financial instability and the larger possibilities to hide abroad the proceeds of illicit activities.

A fundamental concern of national governments, both in developed and developing and transitional economies, relates to the possible erosion of national tax bases arising from the transfer of their residents’ capital to offshore financial centers. In fact, while there may be legitimate reasons to use offshore financial centers, including tax reasons, they are often used for tax evasion and avoidance purposes. This is due to the fact that offshore financial centers are often referred to as "tax havens", because these are often countries or territories which attract foreign
capital by promoting themselves through a combination of low or no taxation, advanced
communication facilities, reliable legal systems and a high degree of confidentiality for financial
data, such as those on beneficial ownership, companies, trusts and bank accounts.\textsuperscript{19} Tax havens
are used both by individuals and companies. In the new era of “banking without borders” wealthy
individuals can easily evade capital income taxes in their country of residence by transferring
capital abroad and channeling passive investments through tax havens. This type of tax evasion is
facilitated by the existence of jurisdictions with strict bank secrecy rules which prevent
information exchange with the residence country, and by the increased recourse to foreign
institutional investors and shell companies with opaque structures based in offshore financial
centers, which can make it very difficult for domestic tax authorities to track the capital income.
With the growth of cross-border capital flows, the potential for abuse created by the lack of access
to bank information for tax purposes and the resulting adverse consequences have increased
exponentially. At the same time, tax authorities find it more and more difficult to monitor foreign
portfolio investments of their residents because of the removal of traditional sources of
information on these transactions (e.g. exchange controls). The decision by one country to prevent
or restrict access to bank information for tax purposes now is therefore much more likely than
ever before to adversely affect tax administrations of other countries.

Furthermore, the progressive elimination of withholding taxes at source on non-residents’
portfolio investment income allows more and more taxpayers to escape all form of capital income
taxes. Quite often, even when investing in their own countries, resident investors use foreign
financial intermediaries and corporate or trust vehicles based in bank secrecy jurisdictions or
offshore financial centers to disguise themselves as non-residents and evade domestic taxes. Thus,
for example, a significant part of the investment into China via Hong Kong is made by Chinese
residents; Cyprus plays a similar role for Russia. An increasing proportion of investment into
Asia is channeled through structures established in the British Virgin Island. Even more
significant is the possible use of bank secrecy jurisdictions to escape domestic taxes on income
and wealth of a different origin (business income, inherited wealth, etc.) that represent the
“principal” of the foreign investment.

Companies make use of tax havens mostly for tax minimization purposes. They shift

\textsuperscript{19} These different factors may have a different weight for each tax haven. This also means that there may be different
groupings of tax havens, depending on the combination of relevant factors chosen to identify them.
income to tax havens through their foreign affiliates in order to reduce or defer residence-country taxes. In this respect, the most attractive features of tax havens are the low level of taxation and the availability of flexible and tax-advantaged vehicles to channel international business, such as shell or holding companies. Investments in high-tax countries, for example, may be financed with loans from affiliates in tax havens; the resulting interest payments reduce taxable incomes in high-tax locations while producing taxable income in the havens. Another method is the use of transfer pricing. Even if most high-tax countries require firms to use transfer prices that would be paid by unrelated parties, following the OECD’s 1995 Transfer Pricing Guidelines, difficulties in enforcement makes it possible for firms to reduce the overall tax burden. Tax havens can be also used to avoid repatriating foreign income in the firm’s home country and thereby producing a home country tax obligation. The resulting tax savings can be substantial, contributing to the value of tax haven operations (Dharmapala and Hines, 2006). Bank and financial confidentiality may nonetheless play a role, both for closely held or passive investment companies and, more generally, because it makes it more difficult for home-country tax administration to track tax haven activity aimed at tax avoidance and evasion.

The effects of tax havens have recently been the object of a theoretical and empirical literature (see box 1).

**Box 1 - Tax havens: theoretical analysis and empirical findings**

The nature of tax havens and the effects of tax haven activity on the economies of high-tax countries have been examined in the context of the tax competition literature.

A first question addressed by the theoretical studies concerns the factors that influence the desirability of becoming a tax haven (see Dharmapala and Hines, 2006, and Slemrod and Wilson, 2006, for a review). A common result is that small open economies have an incentive to undercut large countries in order to attract mobile capital: whilst they are not able to influence the interest rates prevailing on international markets through their mainstream economic policies, they can quite easily attract international capital flows by reducing their tax rates, either directly and/or by offering a “favorable” tax climate for non-resident investors. The budgetary cost of these tax reductions need not be very high, since the tax reduction is accompanied by a larger tax base due both to greater investment by non residents and to greater taxable income of residents.

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20 The explanation lies in the classic argument of Diamond and Mirrlees (1971) that governments unnecessarily distort production when they tax intermediate production, from which it follows that in small open economies governments with a sufficient number of available tax instruments can make all domestic residents better off by not taxing internationally mobile capital. In fact, since small open economies are price-takers in world markets, they are unable to shift any of their tax burdens on foreign investors: any attempt to do so would simply distort their
This result seems confirmed by the patterns observed in tax havens economies. Tax havens tend to be small countries with extremely open economies and substantially smaller natural resource endowments that non-havens. Also the experience of tax haven economies over the last two decades is consistent with the predictions of the theory. The period of globalization has been very favorable for tax havens, which grew at an average annual real per capita rate of 3.3 per cent between 1982 and 1999, compared to the 1.4 per cent growth rate of the world as a whole (Hines, 2004). This result is consistent with the growth of FDI in the same period21 and with the empirical evidence showing that both the volume and location of FDI are sensitive to tax differentials22.

The effects of tax haven activity on the economies of non-haven countries is a highly controversial point. A common fear of non-haven countries is that tax havens may help diverting economic activity away from them, eroding tax bases that might otherwise be used to raise government revenue. This fear is more acute in the case of nearby tax havens, which might divert activity from other countries within the same region or economic federation. In this respect, the empirical evidence seem to suggest a complementary rather than substitute relationship between investment in tax havens and investment in nearby countries: the availability of tax havens seem to stimulate, rather than divert, economic activity in nearby non-haven countries (Hines, 2004; Desai, Fritz Foley and Hines, 2004). However, as suggested by Sullivan (2006), it is possible that the complementary relationship holds for certain types of foreign investments in low-tax countries (for instance, those aimed at establishing “export platforms” that provide market access for goods and services from the home country), while a substitute link holds for other types of FDI (those aimed at establishing production facilities for goods and services). Thus, the overall impact of tax havens on the welfare of high-tax countries is still ambiguous. Tax haven operations may stimulate activity in nearby countries by facilitating the avoidance of taxes in that country, the avoidance of taxes elsewhere, or by reducing the cost of goods and services that are inputs to production or sales in high-tax countries. At the economies by putting additional costs on domestic factors in the form of lower wages and land prices. It follows that domestic residents would be made better off by removing any taxes on foreign investors and instead directly taxing the returns to local factors of production. In addition to the price-taker position of small economies and to the availability of a sufficient set of tax instruments for the governments of the same economies, another basic assumption on which the Diamond and Mirrlees argument relies is that foreign investors do not earn economic rents from their investments in the small economies.

21 Between 1982 and 1999 total world foreign direct investment grew from around 0.5 per cent to around 3.5 per cent of world GDP. See Hines (2004), that reports data from the World Bank database World Development Indicators.

22 Empirical studies have shown other relevant features of tax havens. For instance, better-governed countries seem more likely to become tax havens (Dharmapala and Hines, 2006). A possible interpretation of this is that only better-governed countries can credibly commit not to expropriate foreign investors. It is not clear, however, whether it is the decision to become a tax haven that affects the quality of local governance or the quality of governance itself is influenced by economic and political conditions that also determine whether or not a country becomes a tax haven. Another relevant finding (from studies referring to American multinational firms) is that the highest share of tax haven operations seem to come from large firms with high volumes of international activity, high R&D intensity and significant volumes of intrafirm trade (Desai, Fritz Foley and Hines, 2006b). For these firms tax haven affiliates appear to facilitate the relocation of taxable income from high to low tax locations and to reduce the cost of deferring home country taxation of income earned in low tax foreign locations. Of course, the issue at stake here is not the tax haven characteristics of the jurisdiction, but the existence of a low rate of tax.
same time, tax haven activity could provide governments of high-tax countries with a device to move toward a less-distorting tax regime, that could not otherwise be implemented, mainly for political constraints. The use of tax havens could in fact allow high-tax countries to apply a lower effective tax rate on mobile firms compared to the one applied on immobile firms. On the other hand, tax avoidance and evasion will erode the tax base and therefore tax revenues of high-tax countries. In a recent study, Slemrod and Wilson (2006) demonstrate that the full or partial elimination of tax havens would improve welfare in non-haven countries, reduce compliance costs and lead to a more balanced tax structure.

Even if the conclusions of the theoretical and empirical analysis are somewhat still controversial, policy makers in non-haven countries are increasingly concerned about the potential adverse effects of tax haven activity on their national tax systems and, more generally, on their economies. These concerns have prompted many governments to consider international cooperative efforts designed to preserve their economies from the negative externalities due to tax havens. Following an endorsement by the G-7 at the Lyon Summit in June 1996, the OECD launched in 1998 the Harmful Tax Practices initiative23 to discourage OECD Member countries and certain tax havens outside the OECD from pursuing policies that were thought to harm other countries by unfairly eroding tax bases.

The OECD initiative has evolved considerably since its launch in 1998, offering a forum for constructive dialogue between on and offshore financial centres. Overtime, an increasing emphasis has been put on access to bank and financial information and on exchange of taxpayer-specific information between national tax authorities, which are increasingly viewed as necessary pre-conditions for the effective functioning of national tax systems in a context where the ever-increasing levels of foreign direct investment and of portfolio cross-border capital flows implies the risk of a growing demand for tax haven operations. In the OECD’s view, an effective information exchange should allow all countries to protect the integrity of their tax system from the effects of international tax evasion, while preserving the right to tailor their tax systems to their own needs24. Put it another way, effective cooperation to counter abuse is an essential requirement to get the full benefits of a more competitive environment.

Conversely, the existence of obstacles hampering the access to financial information by domestic and foreign tax authorities leads to adverse consequences. First, it distorts international

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capital flows, since funds can be attracted by or routed through countries whose strict secrecy provisions offer a favorable environment to tax evaders. Second, it has adverse consequences on the structure of national tax systems, since the tax burden is shifted from capital to less mobile factors (such as labor) or consumption, in an attempt to limit the erosion of the tax base. Preventing the full taxation of income arising from portfolio investments, the lack of access to bank information jeopardizes the overall equity of the tax system, both between compliant and non-compliant taxpayers and among different income sources. Strict bank secrecy rules may represent a significant constraint for governments wishing to raise a given amount of tax revenues in order to be able to deliver the desired amount of public goods. This latter effect is particularly serious for developing countries where capital flight towards bank secrecy jurisdictions may give rise to an erosion of their already potentially weak tax base, which can seriously undermine the ability of governments to make the vital investments in social services and economic infrastructure upon which sustainable economic development depends. Finally, strict bank secrecy regimes may have adverse effects in domains other than taxation, attracting money laundering and other types of criminal activities, ranging from terrorism to financial fraud.

The issues of bank secrecy and information exchange and, in more general terms, the need for an increased level of transparency - have become a priority also on the political agenda of other international organizations, particularly those dealing with the different forms of financial abuse or taking care of the stability of the international financial system: both the Financial Stability Forum (FSF) and the Financial Action Task Force on Money Laundering (FATF) have undertaken efforts to convince offshore financial centers to comply with international standards by requiring, among other things, enhanced transparency.\(^{25}\)

The lifting of bank secrecy and the need for information exchange have received considerable attention in the economic literature (see Box 2), which has also tried to answer the question of whether information exchange agreements can arise spontaneously.

\(^{25}\) In April 2000 the Financial Stability Forum (FSF) launched an assessment of the compliance of supervisory and regulatory systems of the OFCs’ financial sector with international standards with the prospect of enhancing financial stability and fighting financial fraud and the financing of terrorism. The assessment led to the identification of several OFCs, especially in the smaller and poorer jurisdictions, having critical deficiencies. In the same year the Financial Action Task Force on Money Laundering (FATF) undertook an initiative to identify non-cooperative countries and territories in the fight against money laundering. Between 2000 and 2001 the FATF identified a list of 21 non-cooperative countries and territories, among which several Caribbean OFCs. Thanks to the significant and rapid progress in addressing deficiencies, all countries have been gradually removed from the list.
In the theoretical literature, the lifting of bank secrecy and the need for information exchange between national tax authorities have received consideration within the analysis of the impact of tax policy on mobile financial capital in a context of open economies (Giovannini 1990; Bacchetta and Espinoza 1995; Huizinga and Nielsen 2000; Makris 2003; Sørensen 2001; Keen and Ligthart 2003). Information exchange between tax authorities and the prerequisite of access to relevant information have been recognized as essential for the taxation of capital income according to the residence principle. The residence principle is recommended by several authors as a second-best measure to the full coordination of tax policies (interpreted as a system of uniform tax rates and uniform tax bases: see, for instance, Giovannini, 1990, and Sørensen, 2001), since it allows national governments to choose their own preferred tax rates without violating international production efficiency, i.e. without distorting the location of international investment (the Diamond and Mirrlees theorem, 1971)\(^\text{26}\). Other reasons in favor of the residence principle are interpersonal equity, as it allows for the progressive taxation of worldwide capital income, and a fair distribution of tax revenues among countries (since each country is able to tax its own residents).

An effective implementation of the residence principle is only possible when national tax authorities have full information on foreign source income earned by domestic taxpayers. This condition is met when information exchange covers all types of foreign source income and when foreign tax authorities have access to all relevant information. In practice, however, information exchange is far from perfect, mainly for two reasons: transaction costs and differences in country incentives. The last factor is probably the most important: the level of information sharing with foreign governments is considered a strategic variable and is taken into account by national governments when designing the optimal international tax system in the same way as the tax rate on domestic and foreign source income (Bacchetta and Espinoza, 1995). Since countries face a diverse set of incentives to exchange taxpayers' information, it is far from clear that information exchange agreements can be self-enforcing\(^\text{27}\). This question has been addressed by several

\(^{26}\) The residence principle is consistent with the Capital Export Neutrality (CEN) condition, since it implies that the taxpayer faces the same tax burden on domestic and foreign source income. In the presence of different marginal tax rates across countries, the CEN condition implies that the international allocation of investments is neutral because the cost of capital (the required pre-tax rate of return) is equated across countries. For this reason the residence principle is considered superior to the source principle of taxation, which implies taxation of capital income at different rates depending on the country of the investment. The source principle allows for neutrality in the international allocation of savings and is thus consistent with the condition of Capital Import Neutrality (CIN), since it assures that capital income is taxed in the source country (usually through withholding taxes) at the same rate for residents and non residents and that foreign source capital income is exempted from tax in the investors’ home countries. However, it distorts the investment decisions because it allows the pre-tax rates of return to differ among countries.

\(^{27}\) Some countries may choose to not release bank information to foreign jurisdictions in the attempt to enhance their attractiveness for foreign investors, thereby increasing the size of their financial industry, employment and national welfare. Other countries, particularly those which have substantial capital outflows, may be interested in obtaining information on portfolio investments made abroad by their residents, in order to limit the erosion of their tax base due to underreporting of foreign source income. In general, the discrepancy in the values placed by any two countries on each other’s taxpayer information depends on a number of factors (Tanzi and Zee, 2001). The most relevant are:
studies. Assuming perfect capital market integration, Eggert and Kolmar (2002) show that there exist equilibriums where information exchange arises spontaneously. However, this happens in a paradoxical context, where the high elasticity of capital makes governments unable to apply any tax that could potentially benefit from the exchange of information (typically, taxes on capital income). In other words, if capital is perfectly mobile, information exchange arises spontaneously but is useless, since all the taxes that are potential candidates for information-induced tax-base effects simply disappear. In the authors’ opinion, this model can help explain why in recent years the growing integration of capital markets is being accompanied by some progress in measures of tax information exchange.

Apart from the paradoxical case of perfect capital mobility described by Eggert and Kolmar, three sets of circumstances have been identified in which countries may find in their interest to provide information (Keen and Ligthart, 2003). The first can be modeled as a two-stage game where countries first decide the level of information exchange and then set the tax rates. Assuming that the institutional features of the tax system are given from the outset to tax authorities, Bacchetta and Espinosa (1995) find that a country may choose to provide at least some information to foreign tax authorities if this enables the information-receiving country to increase its own income tax rate. These conclusions are confirmed by Sørensen (2001). On the other hand, using the same two-stage game framework, but with the different assumption that all the institutional features of the tax system (i.e. the degree of information exchange and the level of tax rates) are chosen by the tax authorities instead of being given from the outset28, Makris (2003) finds not only that the non-cooperative equilibrium is characterized by zero information transmission, but also that there is no scope for cooperation in information sharing policies, irrespective of the transactions cost function and of the double taxation schemes. In fact, he shows that a coordinated increase in information exchange not only will make no difference, but in the case where information exchange is an equilibrium outcome, it will even leave countries worse off.

The second possibility, explored in a later paper by Bacchetta and Espinoza (2000) and by Huizinga and Nielsen (2002), is one where countries view the choice of tax rates and information provision as an infinitely repeated game and continuously adapt their decisions to those of other countries. In this setting, information exchange arises spontaneously if the possible advantages that each country can have by defecting from (or not entering) the agreement are balanced by some form of punishment29. The result of this balance – and hence the long-term sustainability of cooperative information exchange agreements – depends on several variables. The attractions of defection will be greater the higher are policy-makers’ asymmetries in the economies’ size (as GDP level, taxpayers’ number, capital flows, etc.); differences in the capital account balances (taxpayer information provided by the tax authorities of a capital-importing country to a capital-exporting country is more valuable to the latter than similar information to the former provided to it by the latter); differences in the completeness and reliability of information gathered by national tax administrations.

28 Unlike Bacchetta and Espinoza, Makris assumes that all distortionary tax rates can be different and endogenously determined.

29 Since in this context it is likely that uncooperative behaviour by any country would lead to other countries behaving also non-cooperatively, each country must balance the long-term gains from continued cooperation with the temporary gain from failing to provide information and with the permanent cost of non-cooperative behaviour by the other countries.
discount rates (information exchange is more likely to be chosen if governments have little discounting of
the future, i.e. if they are long-term oriented), the more imbalanced are capital flows and the more sensitive
are capital flows to their effective tax treatment. One clear implication of this approach is that small capital-
importing countries are likely to have least to gain from information exchange: for these countries, the
advantages arising from the choice of lower tax rates in order to attract inward investment - an increase in
the size of the banking and financial industry, a resulting increase of the wage tax base and of welfare in
general - largely compensate the losses of any revenue from the small domestic capital tax base.

The third possibility consists in introducing some kind of compensation rather than punishment in
order to induce countries to exchange information, as proposed by Keen and Ligthart (2003, 2004).
Countries may redistribute to the information providing jurisdictions a certain proportion of the additional
revenue they are able to collect thanks to the exchange of information, in order to compensate them for the
adverse economic effects of voluntarily engaging to exchange information. Keen and Ligthart (2004) show
that while large countries always prefer information exchange with any level of revenue sharing (since they
always gain more from taxing their residents thanks to the information they receive compared to what they
lose from the transfer of a certain amount of revenues to the information providing countries) small
countries only have attractions to information exchange if the difference in size with the information
receiving country is not very pronounced and if the share of revenue they receive from the residence
country is sufficiently large.\(^{30}\)

An issue connected with the implementation of information exchange is the “third country problem”,
i.e. whether a group of countries (i.e., the OECD or the EU) as a whole can gain from reaching an
agreement on information exchange if the rest of the world does not join into the agreement. Unless all
countries take part in the information exchange, the gains to any subset from agreeing to exchange
information are likely to be reduced to the extent that third countries continue to provide an opportunity to
invest without declaring the proceeds. These latter countries could even become more aggressive in tax
competition because of their enhanced monopoly power in the provision of strictly confidential saving
schemes and in consideration of their potentially higher gains. Since small countries have probably more to
gain from remaining outside information exchange agreements, and since the number of small jurisdictions
is quite high, the difficulties of implementing a truly comprehensive information exchange agreement are
obvious. However, it is also possible that the small dimension of these countries represents a factor of
vulnerability on which bigger countries can rely to persuade the small ones to agree to exchange
information.

To sum up, it turns out from the theoretical literature that it is unlikely that full information exchange
will spontaneously emerge, particularly because offshore financial centers have little interest to agree to
any international agreement that will curb their ability to attract capital, unless some form of positive

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\(^{30}\) When the difference in size with the information receiving country is very pronounced, small countries may resist
moving to exchange information, whatever the share of revenue sharing. If, however, the size of the two countries is
sufficiently close, the small country will prefer information exchange even if all the additional revenue it generates is
retained by the information receiving country (the residence country).
incentives is given. This solution requires a coordinated effort on a multilateral basis and needs to be extended to as many tax havens and bank secrecy jurisdictions as possible in order to reduce the risk of defections.

The empirical literature on the implications of bank secrecy is more limited. A few studies (Grilli, 1989; Alworth and Andresen, 1992; Huizinga and Nicodème, 2004) have found a certain degree of sensitivity of international bank deposits to bank secrecy and other tax variables, from which it could be argued that cross-border financial flows are, at least to a certain extent, “tax-driven”, i.e. affected by tax cheating purposes.

3. Origins and evolution of the Caribbean tax havens

Most tax havens are small, very open economies, and this is particularly true in the Caribbean region where the majority of islands have, over the last thirty years, moved into the offshore financial business. At least three reasons can explain this development.

a) The agricultural sector in the Caribbean area was increasingly unviable as preferential trading schemes were removed and more efficient producers entered their traditional markets;

b) Few of the islands have any natural resource endowments;

c) Tourism, which was highly successful in certain of the islands, was volatile and, in some cases, it could not be further exploited.

Financial services have been seen as an area in which, for a modest initial investment, Caribbean islands could upgrade the skills of the population, generate employment and revenues for their governments and, more generally, boost their GDP by taking advantage of the high growth rate of the industry.

For some of these dependencies the move towards the offshore financial center and tax haven status was quite successful and led to significant rates of economic growth. Their colonial heritage gave them important competitive advantages, among which a modern-style legal system (usually based on the Anglo-Saxon model), English language (for most of them), a currency tied to that of the mother country, and in many cases the benefit of tax treaties which had been extended to them. These advantages were strengthened through the introduction of attractive rules for the incorporation of international business companies (IBCs) and for the establishment of trusts, the adoption of zero or very low taxes on incomes, profits and wealth tax (particularly for foreign-source and non-resident income), the absence of exchange controls and the introduction of
strict bank secrecy and confidentiality of information rules. Further advantages were the political stability, a pleasant physical environment and, more importantly, the proximity to or links with major on-shore financial centers (such as the US and the UK).

In the Caribbean region these factors allowed the Bahamas first and the Cayman Islands soon later to become leading offshore financial centres, moving from poor subsidized economies in the beginning of the 1960s to net providers of resources to the Commonwealth since the 1980s. The Bahamas is nowadays ranked among the top five locations in the world for offshore mutual funds and trust funds and has also developed a significant inter-bank market. The Cayman Islands are nowadays the world’s fifth largest banking centre, and the first among offshore jurisdictions, with a prominent position both in the inter-bank business and in private banking. The Cayman also host half of the world’s hedge funds, hundreds of major non-financial subsidiaries of US corporations and the World’s second-largest captive insurance market. The British Virgin Island has developed into one of the most successful centres for IBCs and Trust arrangements.

The Netherlands Antilles developed as a typical “treaty tax haven”, being used in the 1960s through the mid-1980s to allow non-resident investors to receive portfolio income from the United States tax free. Once the US abolished its withholding tax, there was no longer any motive for taking this route. Nowadays, the country is not anymore among the most prominent offshore jurisdictions, and is trying to develop other sectors of the offshore industry, namely incentives aimed at international business companies.

In more recent years, the demand for tax haven facilities has considerably expanded, owing to the high growth rates of cross-border investment and to the increased number of potential customers arising from the new possibilities offered by the new technological and communication infrastructures and the growing use of multiple layers of transactions to structure offshore operations through vehicles located in different countries. The gradual relaxation of reserve requirements, interest rate controls and capital controls in the main “onshore” markets and

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31 For instance, the rules for the legal protection of bank secrecy were introduced in 1966 in the Cayman Islands and in 1980 in the Bahamas.

32 Sullivan (2004) reports that, according to the Cayman Islands Monetary Authority 2002 Annual Report, about 70% of the international assets and liabilities booked through the Cayman Islands originate from the US.

33 Until 1984, interest income received by non-residents from US sources was subject to withholding tax, either at 30% or at a lower rate as provided in a tax treaty. Since the treaty between the US and the Netherlands Antilles reduced the withholding tax rate to zero, and the Netherlands Antilles did not charge any withholding tax, the country was used to route interest payments from the US to third-country recipients free of taxes at source.
the creation of offshore banking facilities in some of the main industrial countries (the US and Japan) have reduced the regulatory advantages of offshore financial centres, making them less attractive for conventional banking. On the other hand, the tax avoidance facilities of OFCs have become more and more important, particularly for FDI and asset management\textsuperscript{34}. The limited initial investments needed to enter the offshore industry have induced new countries, especially the smaller ones, to implement the “offshore package” of financial services and asset protection products in order to join in the competition for attracting internationally mobile capital\textsuperscript{35}: hence, the number of tax havens has grown remarkably. This process have involved also some new entrants in the Caribbean area: Antigua and Barbuda, St. Kitts and Nevis, Grenada, Dominica, St. Lucia.

In this more competitive environment, the choice of a tax haven is increasingly determined by their ‘specialization’ and by their proximity to target investment markets, although in some cases the geographical proximity to taxpayers still acts as a driver\textsuperscript{36}. Some Caribbean tax havens have been able to succeed or to retain their market share thanks to product diversification and specialization in specific market niches. For instance, Bermuda is nowadays one of the world’s biggest insurance and reinsurance markets; the British Virgin Islands have become one of the world’s favorite locations for international business corporations (which are used exclusively as offshore vehicles); the Bahamas have developed a significant inter-bank market. Furthermore, in order to enhance their reputation, some of the most significant Caribbean offshore centres have taken the political decision to commit to tax information exchange by entering into \textit{Tax Information Exchange Agreements} (TIEAs)\textsuperscript{37}.

Some of the late arrivals in the Caribbean region and elsewhere, however, have had little success, because they have not been able to offer any advantage over the more established

\textsuperscript{34} With reference to this latter market, it is especially the possibility to reduce inheritance and other capital taxes for individual investors that acts as a prime incentive and has led to a large expansion in offshore fund management activity, in particular by the use of investment vehicles such as trusts and private companies.

\textsuperscript{35} For example, Malta launched its international financial centre facilities in 1994.

\textsuperscript{36} Thus in the last few years, we have witnessed the growth of some new OFC and tax haven practices in the East-Asia region, where some jurisdictions (Labuan in Malaysia, and Samoa) are emerging thanks to their ability to intermediate in a “tax-efficient” way the growing capital flows which circulate in the area. Given the significant economic growth rates currently reached by some of the biggest countries in the region, such as China and India, the global weight of Asian OFCs - both of well established ones, such as Singapore and Hong Kong, and of those which seem to be emerging more recently - is likely to increase.

\textsuperscript{37} The Cayman Island, for example, has a TIEA with the United States and Bermuda; Antigua has one with Australia; the Netherlands Antilles have signed a TIEA with Australia and New Zealand.
centers. Overall, it is fair to say that with the exception of the Bahamas, Bermuda, British Virgin Island, the Cayman Islands and Panama, the other Caribbean offshore financial centres are struggling to make their financial activities a sustainable part of their economies.

4. The position of the Caribbean tax havens in the global financial markets

The relative importance of Caribbean tax havens can be measured through several indexes. However, a difficulty often encountered when trying this kind of estimates is the limited availability of reliable and internationally comparable data for many sectors of the OFC industry.

Suss, Williams and Mendis (2002) collect some relevant indicators with reference to 2001 or previous years. Overall, these indicators show that the size of the Caribbean tax havens and offshore financial centers varies significantly from one country or territory to another, and that there is a wide range of specialization across the region. So, for instance, while the British Virgin Islands is the largest register of international business companies (estimated to account for 48 per cent of global IBC incorporations), the Cayman Islands, estimated to be the fifth largest offshore financial center in the world, has fewer registered IBCs, but significantly more banks, insurance companies and trusts. Among recent entrants into the OFC sector, St. Kitts and Nevis has the largest number of registered IBCs, while Antigua and Barbuda has the most diversified OFC industry, including not only IBCs, but also banks and trusts.

The study also examines the contribution of the OFC sector to specific economic indicators. So, for example, it emerges that in many Caribbean jurisdictions employment opportunities arising from the OFC industry are significant. In 2000 the estimated employment in the OFC sector represented 15 per cent of the labor force in the British Virgin Islands, 8 per cent in Antigua and Barbuda, 1 per cent in the Bahamas and 0,5 per cent in Dominica. The wide range of variation depends both on the relative size of the economy and on the type of OFC business prevailing in each jurisdiction (for instance, offshore banks and shell companies do not require physical presence and as such, do not require a significant number of people).

Another significant indicator used in the study is the amount of the fees collected by the central government from OFCs service providers. As of end-2000, Antigua and Barbuda derived over 7 percent of central government revenues from offshore sector fees, followed by Grenada at

This was the case, for instance, of Dominica, Grenada, St. Lucia and, to a lesser extent, St. Kitts and Nevis.
4.5 per cent and Anguilla at 3.6 per cent. Among the more established OFCs, the British Virgin Islands, which is the world market leader in incorporation of international business companies, collected fees representing 55 per cent of government revenues, equal to 13 per cent of GDP. The Cayman Islands also rely heavily on fees collected from offshore banks, which accounted for 14.5 per cent of government revenues by end-2000. In contrast, the governments of Bahamas and Barbados were less dependent on offshore sector fees (respectively: about 1 per cent of government revenues and between 0.2 per cent and 0.4 per cent of GDP).

Further information on the weight of the financial industry and offshore business for tax havens can be obtained looking at the contribution of these sectors to GDP. According to the limited information publicly available, it can be estimated that the contribution of all offshore services to GDP ranges from around 15% in the Bahamas to 25% in the Cayman Islands and 45% in the British Virgin Islands. For other tax havens, the only available information is the GDP share of the whole area of services; quite often, the financial sector and tourism represent the main components of this share. According to available information, at end 2001 the GDP share of all services was 89% for Bermuda, 84% for the Netherlands Antilles, 81% for Montserrat, 77% for Antigua and Barbuda.

With reference to the offshore banking sector, a more detailed set of comparable statistical data can be taken from the Bank for International Settlements *Locational Statistics* as complemented, in some cases, by national sources.

Table 1 reports (at the first column) the size of foreign bank liabilities as a multiple of GDP for a set of offshore financial centers that have historically relied heavily on bank secrecy and for other representative offshore and mainstream financial centers; the second column of the table reports each country’s share of global foreign bank liabilities. Countries in each group are ranked according to the amount of their foreign liabilities vis-à-vis all sectors, banks and non-banks.

The Caribbean tax havens amount to just under 8.5 per cent of the world foreign bank liabilities. As can be expected, the foreign liability/GDP ratio is much higher in small havens compared to other financial centers, however, even within small countries, the ratio shows a wide diversity, ranging from the highest value of 617.87 in the Cayman Islands to less than 0.11 for

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39 Data from IMF and national sources.

40 Data on GDP are from the *World Development Indicator* of the World Bank.
Aruba. Apart from the Cayman Islands and, to a lesser extent, the Bahamas, the Netherlands Antilles and Bermuda, for the remaining tax havens the banking business with non-residents seems to be far less important, confirming the specialization of the different Caribbean jurisdictions.

Table 2 reports similar indicators with reference to the amount of bank deposits of non-bank non-residents for a subset of countries for which relevant data are available. These indicators can be useful to assess more specifically the value of private banking in each tax haven. Once again, the Cayman Islands show a very high ratio (bank deposits vis-à-vis non-bank non-residents being equal to 230.87 times the country GDP), followed at a distance by the Bahamas (21.52). Also the share of total bank deposits of non-resident non-banks which is held by the most prominent offshore financial centers appears to be significant: as can be seen from the last column in the table, the Cayman Islands hold more than 10 per cent of the global stock of these deposits, a share comparable to that of Switzerland and higher than the United States.
Table 1 Weight of foreign banking activity in selected OFCs (2001)

<table>
<thead>
<tr>
<th></th>
<th>Bank liabilities vis-à-vis non-residents as multiple of GDP</th>
<th>Country share of total bank liabilities vis-à-vis nonresidents</th>
</tr>
</thead>
<tbody>
<tr>
<td>CARIBBEAN OFCs IDENTIFIED AS TAX HAVENS BY THE OECD</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The Cayman Islands</td>
<td>617.87</td>
<td>6.97%</td>
</tr>
<tr>
<td>The Bahamas</td>
<td>20.86</td>
<td>0.94%</td>
</tr>
<tr>
<td>Netherlands Antilles</td>
<td>13.33</td>
<td>0.28%</td>
</tr>
<tr>
<td>Bermuda</td>
<td>3.91</td>
<td>0.13%</td>
</tr>
<tr>
<td>Panama</td>
<td>0.73</td>
<td>0.11%</td>
</tr>
<tr>
<td>Aruba</td>
<td>0.11</td>
<td>0.0020%</td>
</tr>
<tr>
<td>Antigua and Barbuda</td>
<td>0.20</td>
<td>0.0013%</td>
</tr>
<tr>
<td>St. Kitts &amp; Nevis</td>
<td>0.26</td>
<td>0.0012%</td>
</tr>
<tr>
<td>The Commonwealth of Dominica</td>
<td>0.31</td>
<td>0.0011%</td>
</tr>
<tr>
<td>St Lucia</td>
<td>0.13</td>
<td>0.0010%</td>
</tr>
<tr>
<td>Grenada</td>
<td>0.24</td>
<td>0.0009%</td>
</tr>
<tr>
<td>St. Vincent and the Grenadines</td>
<td>0.12</td>
<td>0.0006%</td>
</tr>
<tr>
<td>Anguilla</td>
<td>0.65</td>
<td>0.0006%</td>
</tr>
<tr>
<td>OTHER NON-OECD OFCs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Singapore</td>
<td>4.36</td>
<td>3.63%</td>
</tr>
<tr>
<td>Hong Kong SAR</td>
<td>1.58</td>
<td>2.35%</td>
</tr>
<tr>
<td>OECD OFCs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Switzerland</td>
<td>3.16</td>
<td>5.70%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>16.93</td>
<td>3.57%</td>
</tr>
<tr>
<td>Belgium</td>
<td>1.16</td>
<td>2.71%</td>
</tr>
<tr>
<td>Austria</td>
<td>0.46</td>
<td>0.90%</td>
</tr>
<tr>
<td>OTHER SELECTED FINANCIAL CENTRES</td>
<td></td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1.65</td>
<td>20.77%</td>
</tr>
<tr>
<td>United States</td>
<td>0.13</td>
<td>11.42%</td>
</tr>
<tr>
<td>Germany</td>
<td>0.47</td>
<td>8.77%</td>
</tr>
<tr>
<td>France</td>
<td>0.49</td>
<td>6.76%</td>
</tr>
<tr>
<td>Japan</td>
<td>0.15</td>
<td>4.64%</td>
</tr>
</tbody>
</table>

Sources: data on foreign liabilities are taken from BIS Locational Statistics and from national sources; data on GDP are from World Bank (World Development Indicators database), from national sources or from other international organizations estimates.

Notes: data on foreign liabilities and GDP are for 2001 when available, otherwise latest available.
Table 2 Weight of foreign private banking in selected OFCs (2001)

<table>
<thead>
<tr>
<th>OFCs</th>
<th>Bank deposits of nonresident non-banks as multiple of GDP</th>
<th>Country share of total bank deposits of non-resident non-banks*</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Cayman Islands</td>
<td>230.87</td>
<td>10.83%</td>
</tr>
<tr>
<td>The Bahamas</td>
<td>21.52</td>
<td>4.04%</td>
</tr>
<tr>
<td>Bahrain</td>
<td>2.02</td>
<td>0.89%</td>
</tr>
<tr>
<td>Netherlands Antilles</td>
<td>3.21</td>
<td>0.28%</td>
</tr>
<tr>
<td>Singapore</td>
<td>1.31</td>
<td>4.52%</td>
</tr>
<tr>
<td>Hong Kong SAR</td>
<td>0.44</td>
<td>2.71%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1.43</td>
<td>10.72%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>5.37</td>
<td>4.70%</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.36</td>
<td>3.44%</td>
</tr>
<tr>
<td>Austria</td>
<td>0.04</td>
<td>0.35%</td>
</tr>
</tbody>
</table>

OTHER SELECTED FINANCIAL CENTRES

<table>
<thead>
<tr>
<th>Country</th>
<th>Bank deposits of nonresident non-banks as multiple of GDP</th>
<th>Country share of total bank deposits of non-resident non-banks*</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>0.33</td>
<td>17.46%</td>
</tr>
<tr>
<td>United States</td>
<td>0.02</td>
<td>7.01%</td>
</tr>
<tr>
<td>Germany</td>
<td>0.15</td>
<td>11.33%</td>
</tr>
<tr>
<td>France</td>
<td>0.04</td>
<td>2.34%</td>
</tr>
<tr>
<td>Japan</td>
<td>0.01</td>
<td>1.13%</td>
</tr>
</tbody>
</table>

Sources: data on non-residents bank deposits are from BIS Locational Statistics; data on GDP are from World Bank (World Development Indicators database), from national sources or from other international organizations estimates.

Notes: data at end 2001 when available, otherwise latest available; *total stock for BIS reporting countries.

5. The OECD initiative on Harmful Tax Practices and the position of Caribbean jurisdictions

5.1 The OECD Harmful Tax Practices initiative

In 1998, the OECD Ministerial Council established a forum which identified the following four key criteria for identifying harmful tax practices:

a) No or nominal taxes, in the case of tax havens, and no or low taxation, in the case of Member country preferential tax regimes;

b) Lack of transparency.
c) Lack of effective exchange of information.

d) No substantial activities, in the case of tax havens, and ring-fencing, in the case of Member country preferential regimes.

The no/nominal/low taxes criterion was intended merely as a gateway to determine those situations in which an analysis of the other criteria is necessary. The adoption of low or zero tax rates is never by itself sufficient to identify a jurisdiction as a tax haven. The OECD does not prescribe appropriate levels of taxation or dictate the design of any country’s tax system. This work has received considerable political support\(^{41}\).

In 2000, the OECD identified 35 jurisdictions that were found to meet the tax haven criteria\(^{42}\). A process was also established whereby the identified tax havens could commit to improve transparency and establish effective exchange of information for tax purposes. Those jurisdictions that were not willing to make such commitments would be included in a list of uncooperative tax havens. Thus, the key distinction for OECD countries became whether a tax haven was cooperative or uncooperative. The 2001 Progress Report made certain modifications to the tax haven work. There were two principal modifications. First, a tax haven that committed to eliminating lack of transparency and lack of effective exchange of information would be considered cooperative and therefore would not be included on the OECD’s list of uncooperative tax havens. A second modification was that a potential framework of coordinated defensive measures would not apply to uncooperative tax havens any earlier than it would apply to OECD countries with harmful preferential tax regimes. In April 2002, the OECD published the list of uncooperative tax havens, containing 7 jurisdictions that still were at that time unwilling to commit to transparency and exchange of information for tax purposes; two jurisdictions - Nauru and Vanuatu - made commitments in 2003 and the list now contains only 5 jurisdictions: Andorra, Liberia, Liechtenstein, the Marshall Islands and Monaco.

\(^{41}\) The G7/8 Finance Ministers have consistently provided political support for the project and the G-8 Heads of Government confirmed their support at the Gleneagles Summit in July 2005. Also, at the November 2004 meeting of the G-20 Finance Ministers a strong statement in support of this work was issued and further endorsement of this work was provided in the most recent G-20 Communiqué issued in November 2006 and in a Communiqué from the Caribbean-Uk Forum on 28 April 2006.

\(^{42}\) Andorra; Anguilla; Antigua and Barbuda; Aruba; The Bahamas; Bahrain; Barbados; Belize; British Virgin Islands; Cook Islands; Dominica; Gibraltar; Grenada; Guernsey; Isle of man; Jersey; Liberia; Liechtenstein; the Maldives; Marshall Islands; Monaco; Montserrat; Nauru; Netherlands Antilles; Niue; Panama; Samoa; Seychelles; St. Lucia; St. Kitts and Nevis; St. Vincent and the Grenadines; Tonga; Turks and Caicos; US Virgin Islands; Vanuatu. Six other jurisdictions - Bermuda, Cayman Islands, Cyprus, Malta, Mauritius and San Marino - were not included in the 2000 report because they committed to eliminate their harmful tax practices prior to the release of that report.
The 33 jurisdictions that made commitments to transparency and effective exchange of information are referred to as Participating Partners. The OECD and non-OECD Participating Partners have worked together in the Global Forum on Taxation to develop the international standards for transparency and effective exchange of information in tax matters. The Caribbean offshore financial centers have played a particularly active role in the Forum. They took part in the specially created working group which developed the 2002 Model Agreement on Exchange of Information on Tax Matters\textsuperscript{43}.

In order to determine exactly where countries stand in relation to transparency and information exchange, the Global Forum decided at its June 2004 meeting in Berlin that it was important to carry out a review of countries’ legal and administrative frameworks in these areas so as to assess progress towards a level playing field. In addition to Global Forum Participating Partners (Table 3a), other significant financial centers (Table 3b) where invited to participate in the review\textsuperscript{44}. Overall, the factual assessment covered 82 countries.

\textsuperscript{43} Available on the OECD website at http://www.oecd.org/ctp. The Model Agreement, released in March 2002, was developed by the Global Forum Working Group on Effective Exchange of Information which consisted of representatives from OECD countries and delegates from Aruba, Bermuda, Bahrain, Cayman Islands, Cyprus, Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino. The work of that group has been complemented by the work of the Global Forum’s Joint Ad Hoc Group on Accounts which has developed guidance on accounting and recordkeeping requirements for corporations, partnerships, trusts and other entities or arrangements.

\textsuperscript{44} All Global Forum Participating Partners except Antigua and Barbuda and Grenada responded to the questionnaire which forms the basis of the factual assessment. The information of the factual assessment about Antigua and Barbuda and Grenada is based on publicly available information or information previously provided by Antigua and Barbuda and Grenada. Among the invitees, all but two – Brunei and Liberia – responded to the questionnaire used as the basis for the factual assessment. Liberia was unable to do so due to its current political situation.
Table 3 COUNTRIES COVERED BY FACTUAL ASSESSMENT

a) Global Forum Participating Partners

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<th>Country</th>
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<td>Anguilla</td>
<td>Dominica</td>
<td>Korea</td>
<td>San Marino</td>
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<tr>
<td>Antigua and Barbuda</td>
<td>Finland</td>
<td>Malta</td>
<td>Seychelles</td>
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<td>Aruba</td>
<td>France</td>
<td>Mauritius</td>
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<td>Australia</td>
<td>Germany</td>
<td>Mexico</td>
<td>Spain</td>
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<td>The Bahamas</td>
<td>Gibraltar</td>
<td>Montserrat</td>
<td>Saint Kitts and Nevis</td>
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<tr>
<td>Bahrain, Kingdom of</td>
<td>Greece</td>
<td>Nauru</td>
<td>Saint Lucia</td>
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<tr>
<td>Belize</td>
<td>Grenada</td>
<td>Netherlands</td>
<td>Saint Vincent and the Grenadines</td>
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<tr>
<td>Bermuda</td>
<td>Guernsey</td>
<td>Netherlands Antilles</td>
<td>Sweden</td>
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<tr>
<td>British Virgin Islands</td>
<td>Hungary</td>
<td>New Zealand</td>
<td>Turkey</td>
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<tr>
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<td>Iceland</td>
<td>Niue</td>
<td>Turks and Caicos Islands</td>
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<tr>
<td>Cayman Islands</td>
<td>Ireland</td>
<td>Norway</td>
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<td>Cook Islands</td>
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<td>Italy</td>
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<td>Japan</td>
<td>Portugal</td>
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<td>Denmark</td>
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b) Invitees

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<th>Country</th>
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<tr>
<td>Andorra</td>
<td>Guatemala</td>
<td>Monaco</td>
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<td>Argentina</td>
<td>Hong Kong, China</td>
<td>Philippines</td>
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<td>Austria</td>
<td>Liberia</td>
<td>Russian Federation</td>
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<td>Barbados</td>
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<td>Belgium</td>
<td>Luxembourg</td>
<td>South Africa</td>
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<td>Brunei</td>
<td>Macao, China</td>
<td>Switzerland</td>
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<tr>
<td>China</td>
<td>Malaysia (Labuan)</td>
<td>United Arab Emirates</td>
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<td>Costa Rica</td>
<td>Marshall Islands</td>
<td>Uruguay</td>
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The Report “Tax Co-operation: Towards a Level Playing Field - 2006 Assessment by the Global Forum on Taxation” issued in May 2006 reflects the outcome of the factual review carried out by the Global Forum. All the OECD and non-OECD Participating Partners in the Global Forum on Taxation have endorsed the principles of transparency and exchange of information for tax purposes that are reflected in the Report. They have also agreed to their legal and administrative frameworks being reviewed in the light of these principles. For the first time, other significant non-OECD economies such as Hong Kong, China and Singapore have participated in the work of the Global Forum in these areas. Six of these non-OECD economies have also endorsed the principles of transparency and exchange of information and agreed to work with the Global Forum towards a level playing field: Argentina; China; Hong Kong, China; Macao, China; the Russian Federation and South Africa.
5.2 How do the Caribbean and other financial centers measure up to these criteria?

The results of the Global Forum assessment of legal and administrative practices concerning transparency and information exchange is a valuable mean to examine the current standpoint of the Caribbean tax havens towards the OECD *Harmful Tax Practices Initiative*. Their position regarding the different aspects of the assessment is as follows:

**A. Exchanging Information**

Many of the Caribbean jurisdictions have (or are in the process of negotiating) exchange of information arrangements that permit them to exchange information for both civil and criminal tax purposes in the form of double tax conventions or TIEAs (some exceptions are Anguilla, Panama and Turks and Caicos). In addition, as a practical matter, Panama is rarely, if ever, able to exchange information in criminal tax matters. None of the Caribbean jurisdictions reported having a *domestic tax interest*, i.e. being unable to respond to a request for information where they have no interest in obtaining the information for their own tax purposes. Also, none of the Caribbean jurisdictions reported applying the principle of dual incrimination to all their information exchange relationships concerning the administration or enforcement of domestic tax law. However, Saint Lucia and Saint Vincent and the Grenadines apply this principle in connection with exchange of bank information (see Section B below).

**B. Access to Bank Information**

While in 77 countries covered by the factual assessment governmental authorities have access to bank information and/or information from other financial institutions for at least some tax information exchange purposes, among the Caribbean jurisdictions Panama have indicated an inability to access bank information for any exchange of information purposes. In 17 countries, access to bank information is granted only for the purpose of responding to a request for exchange of information in criminal tax matters. Of these the Caribbean jurisdictions of Saint Lucia, Saint Vincent and the Grenadines (in addition to Andorra, Austria, Cook Islands, Luxembourg, Samoa, San Marino, and Switzerland) apply the principle of dual criminality in connection with access to bank information for exchange of information purposes.
C. Access to Ownership, Identity and Accounting Information

Of the 82 countries reviewed, 78 - including all the OECD countries - generally have powers to obtain information that is kept by a person subject to record keeping obligations which may be invoked to respond to a request for exchange of information in tax matters. In addition, 71 countries reported that they also generally have powers to obtain information from persons not required to keep such information which may be invoked to respond to a request for information. Anguilla, Montserrat, Panama and Turks and Caicos Islands have very limited powers to obtain this kind of information for criminal tax matters.

D. Availability of Ownership, Identity and Accounting Information

Companies

Of the 82 countries reviewed, 77 require companies to report legal ownership information to governmental authorities or to hold such information at the company level. Three countries (Montserrat, Saint Kitts and Nevis and the U.S. Virgin Islands) each have one form of company where this is not the case. More stringent ownership reporting requirements exist in the financial sector in certain countries. All but 5 countries (Aruba; Guatemala; Hong Kong, China; Macao, China and Singapore) indicated that applicable anti-money laundering legislation would normally require corporate service providers or other service providers to identify the beneficial owners of their client companies.

In 75 countries, all domestic companies are required to keep accounting records. No such requirements exist for international business companies in Belize, Brunei and Samoa or for limited liability companies in Anguilla, Montserrat and Saint Kitts and Nevis. In the Bahamas, only public companies and regulated companies in the banking, securities and insurance sectors are required to keep accounting records. Mandatory accounting records retention periods of five years or more exist in 63 countries.

Bearer shares may be issued in 48 countries. Of these, 39 have adopted mechanisms to identify the legal owners of bearer shares in some or all cases. Furthermore, 10 of these 39 countries (Antigua and Barbuda, Belize, British Virgin Islands, Cayman Islands, the Cook Islands, Dominica, Grenada, Montserrat, Saint Kitts and Nevis and Saint Vincent and the

45 With respect to Grenada there was not sufficient information to reach a conclusion.
46 In these cases only records that the directors of such consider necessary or desirable need to be kept
Grenadines) also require bearer shares to be immobilized or held by an approved custodian. The remaining 29 rely mainly on anti-money laundering rules, investigative mechanisms or a requirement for the holders of shares to notify the company of their interest in the shares. Anguilla is one of the 9 countries that reported not having any mechanism to identify the owners of bearer shares, although it indicated to plan to adopt such mechanisms in the near future.

Bearer debt instruments may be issued in 52 countries and 40 of these have adopted mechanisms to identify the owners of such instruments. In general, these mechanisms rely on anti-money laundering rules, on investigative powers or, in the case of EU Member States and their associated or dependent territories, on procedures set out in the EU Savings Tax Directive and savings tax agreements.

Trusts
Of the 82 countries reviewed, 54 have trust law. Of these, Macao, China and the Seychelles have no trust law applicable to residents, but have trust law applicable to non-residents. Information on the settlers and beneficiaries of domestic trusts is required to be held under the laws of 47 countries. In 36 of the countries with trust law, a domestic trustee of a foreign trust would also be required to have information on the identity of settlers and beneficiaries, in some or all cases. Of the 28 countries that do not have trust law, 18 indicated that their residents may act as trustees of a foreign trust. In all of these, except for Luxembourg, there is a requirement on resident trustees to identify settlers and beneficiaries of foreign trusts. Of the 54 countries which have trust law, 45 countries reported requiring all trusts formed under their law to keep accounting records. Dominica, Saint Lucia and Turks and Caicos are among the 7 countries that have not reported a requirement to keep records under their trust law.

6. The way forward for Caribbean Offshore Financial Centres

The future for Caribbean offshore financial centres depends, to a large extent, on their willingness to meet the new international standards that have been developed by such bodies as the FATF, the FSF and the OECD. Meeting these standards will enhance their reputation and make them more attractive as financial centres in which to carry out legitimate transactions.
For the more established centers, such as the Bahamas, the Cayman Islands and the British Virgin Islands, which have already developed relatively strong and extensive legislative and regulatory frameworks, the cost of introducing the additional measures necessary to comply with international standards need not be substantial. At the same time, the international community is committed to helping these countries and territories to implement effectively these standards. The main mechanism for this implementation in the tax area is *Tax Information Exchange Agreements* (TIEAs). These agreements provide an effective mechanism that minimizes the risk that these centres are misused by residents of other countries to evade their tax responsibilities. Over the last few years, all the major Caribbean offshore financial centres, other than Panama, have entered into one or more TIEAs. We can expect that this trend will accelerate and that these OFCs will extend their network of TIEAs, not just with OECD countries, but also with major non-OECD countries (China, India, Brazil and South Africa have already begun negotiations).

In the case of some of the smaller Caribbean OFCs, they may decide that the burden of meeting these new standards means that the cost of having an offshore sector outweighs the benefits. In these cases, the international community needs to stand ready to provide assistance so that other economic activities are open up for these islands.
References


