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Offshore Financial Centres and the Supranationals: Collision Or Cohabitation?

Richard J. Hay

STIKEMAN ELLIOTT

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Offshore Financial Centres and the Supranationals: Collision Or Cohabitation?

Richard J. Hay

'My tax demand has been twinned with one in France' [1]

Introduction

OVER THE LAST THREE YEARS THE ORGANIZATION FOR ECONOMIC COOPERATION AND Development (OECD), the world's club of rich countries, has demanded sweeping changes in the design and transparency of the world's offshore financial centres. The OECD seeks tax information exchange, and threatens sanctions for offshore centres which refuse to comply with their demands. The Financial Action Task Force (FATF), a G7 chartered agency housed in OECD offices in Paris, has mounted a campaign with complementary objectives to combat money laundering. A number of other bodies including the Financial Stability Forum, the International Monetary Fund, the United Nations and the E.U. have pursued similar initiatives to promote change in the world's financial system.

Offshore centres have voiced concerns that the fora most active in developing standards have elite membership restricted to the world's rich and powerful countries. The initiatives conducted by the OECD and FATF, in particular, have been criticised for adopting an exclusionary and confrontational approach, ill-suited to securing the cooperation necessary to effect meaningful change.

RICHARD J. HAY *is the international tax partner in the London office of Stikeman Elliott, Canadian and International lawyers. He is admitted to practice in Ontario, New York and England. Prior to entering practice Mr. Hay was Law Clerk to the Chief Justice at the Supreme Court of Ontario and an Assistant Professor and Lecturer on the Law Faculties at The National University of Singapore and the University of Ottawa in Canada. Stikeman Elliott is Counsel to the government of The Bahamas, advising on the OECD and other supranational initiatives. Views expressed herein are personal and do not necessarily represent those of The Bahamas government.*

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Offshore centres are troubled by the fact that the standards sought to be imposed on them are not uniformly adopted by Member States of the organizations tabling the demands, fuelling concerns that supranational bodies are proceeding with insufficient regard to fairness or the concerns of non-members.[2] In the absence of a commitment to ensure a level playing field for all participants, the supranational agencies, including particularly the OECD, are perceived to lack the moral high ground claimed by them in the attack on the offshore world.

The OECD project was thrown into disarray by a widely publicised withdrawal of support for elements of the initiative by the new U.S. Republican administration, articulated in a statement tabled by the U.S. Treasury Secretary on 10 May 2001. Secretary O'Neill reiterated support for the core objective of the project – tax information exchange – in testimony before a Senate hearing on 18 July 2001.[3] However, Secretary O'Neill continued to express concerns about the "condemnatory tone" of the OECD Reports leading to "unfair" treatment of non-OECD countries.

The narrowing support from the U.S. Treasury has led to several important developments in the OECD project. First, the deadline for offshore centre agreements with the OECD has been moved from 31 July to 30 November 2001. Second, the prospect of sanctions (termed "co-ordinated defensive measures" by the OECD) being imposed on offshore centres has receded. Any such measures will be delayed in any event to 2003. Third, non-core elements of the initiative have been abandoned as the project has been narrowed to focus on information exchange for the purpose of enforcement of tax laws. Finally, the OECD has been placed under pressure to ensure that OECD Member Countries are held to "standards and timelines at least as rigorous" as those sought to be imposed on offshore centres

This paper considers the current state of play in the complex and overlapping supranational initiatives proposing changes in the regulation of offshore financial centres. The implications of the shift in the U.S. position, in particular, are reviewed. The underlying rationales for change are considered, as are the likely and appropriate responses for the stakeholders in the offshore centres, including governments, financial institutions and clients.

The Appeal of Tax-Free Centres in an Increasingly Transparent World

Offshore financial centres ("OFCs") are jurisdictions that attract a high level of non-resident financial services clients relative to the volume of domestically sourced business. The globalisation of business, enhanced mobility of individuals, increasing sophistication of the offshore world and the higher level of information available on planning opportunities have all increased the attraction of international and offshore financial services. Offshore centres now offer a level of expertise in many areas which exceeds that available in the major onshore money centres.

Offshore centres currently hold assets valued at U.S. $ 6-8 trillion. The rapid expansion of the world economy continues to increase global wealth, further enhancing asset growth in the offshore world.[4] This success is driven by institutions, corporate and individual clients voting with their feet to take advantage of the absence of tax and greater flexibility found offshore.[5]

There is a misguided perception in some quarters that the move to transparency in response to changing standards will lead to the demise of the offshore world. No doubt the appetite of some of the marginal users of the international financial system (tax evaders and money launderers) will be chilled by transparency. However, the main appeal of offshore centres is, and will remain, the ability of clients to transact in an income tax-free environment.

The OECD now accepts the legitimacy of income tax-free systems in the offshore world.[6] Accordingly, the opportunity to conduct business on a tax-neutral platform will continue in offshore centres, and the offshore world will continue to service constantly increasing client demand, despite the extensive changes underway. This is particularly true for those offshore centres which are using their tax neutral platforms to conduct real and substantial activities in areas such as the following:

- establishment and administration of mutual fund companies and trusts
- international tax and estate planning
- structured debt and special purpose vehicles to support capital markets transactions
- structures for management of political and personal risk
- special purpose vehicles for securitisations
- insurance and reinsurance products
- international employee stock option and deferred compensation plans
- shipping and aircraft financing structures

Overview of the Principal Onshore Initiatives

The principal supranational agencies seeking change are:

- the Paris-based OECD, which seeks greater transparency on tax matters, through the Harmful Tax Competition initiative. The main reports published by the OECD on their objectives are *Harmful Tax Competition* (27April 1998), *Towards Global Tax Cooperation* (26 June 2000), *Improving Access to Bank Information for Tax Purposes* (24 March 2000) and the *Report on Misuse of Corporate Vehicles for Illicit Purposes* (29 May 2001)[7];

- the Financial Action Task Force housed in the OECD offices in Paris, charged with countering money laundering. The main reports published by the FATF are the *Review to Identify Non-Cooperative Countries or Territories* (22 June 2000 and 22 June 2001) and the *Report on Money Laundering Typologies* (1 February 2001)[8]; and

- the Basle-based Financial Stability Forum, seeking enhanced standards for international banking regulation to address market integrity and prudential concerns. The relevant report published by the FSF is the *Report of the Working Group on Offshore Centres* (5 April 2000).[9]

Related initiatives include:

- E.U. efforts to impose effective taxation of savings through either a withholding tax or information reporting to support improved taxpayer compliance. This initiative culminated in the Feira Agreement on the taxation of savings reached in Portugal in June 2000.[10] Member States agreed to information exchange as the ultimate objective of E.U. policy, though members imposing withholding tax today can still do so until 2009. Member Countries have committed to promote the adoption of similar information exchange policies in dependent and associated territories (e.g., the British Overseas Territories) and in the U.S. and Switzerland. The E.U. has recently abandoned plans to promote tax harmonisation amongst its members[11]; and

- U.S. program for Qualified Jurisdictions and Qualified Intermediaries, designed to facilitate monitoring of U.S. taxpayers investing back into that country through offshore structures. This initiative has the (incidental?) effect of projecting U.S. domestic regulation of financial intermediaries onto a global basis.

Implications of the Proposed Changes for Personal Financial Privacy

The complete record of an individual's financial transactions – now sought on a global basis – forms a revealing insight into the intimate details of one's personal life. The collection and sharing of such information, and the linkage of databases through the use of electronic tools, poses many concerns for the privacy of individuals.[12]

The OECD report on *Improving Access to Bank Information for Tax Purposes* contains informative insights into the scope of existing financial disclosure in onshore countries. France, for example, requires financial institutions managing stocks, bonds or cash to report to the Government on a monthly basis regarding the opening, modifications and closings of accounts of all kinds. This information is stored in a central computerised database which is used by French authorities for research, control and collection purposes. Four other OECD countries also maintain centralised databases, being Hungary, Korea, Norway and Spain.[13]

Scepticism concerning the ability of governments to resist the temptation to access information for unauthorised purposes is rife, particularly as there is, by definition, no opportunity to monitor unauthorised access. Affluent taxpayers in at least one major OECD country also fear that tax data is routinely sold to criminal gangs seeking targets for kidnapping. Global sharing of information means that criminal access can occur at the weakest point of entry, multiplying the risks associated with unauthorised disclosure.[14]

The risks to personal privacy arising from the collection of financial information are disconcerting, even while apparently sophisticated governments maintain control of the information and apparatus.[15] The prospect of abuse where these vast and globally converged pools of information fall into the wrong hands en masse or through ad hoc unauthorised access is truly frightening. This is particularly so for the many families with direct experience of repressive or corrupt governments.

Compromise of the Rights of OFC States

At the outset, many of the offshore states simply insisted that the OECD had no right or authority to force changes in their domestic laws. This is true, of course, but it ignores the fact that the OECD is not dictating changes as such, but rather requesting changes with the threat of sanctions (including withholding tax and restrictions on access to onshore financial markets) for those centres which do not comply with OECD demands.

An offshore banking centre exists because it is able to:

- service clients from other jurisdictions;
- access international banking networks; and
- invest in onshore securities markets.

Offshore centres rely on such access to foreign markets to conduct a local financial services industry much larger than that which could be supported by domestic demand. Accordingly, it is not practical for an OFC to isolate itself from outside pressure by unplugging from the international grid unless the centre is prepared to restrict the local financial sector to the purely domestic environment, typically tiny markets in most OFCs.

Crucially, the OECD now accepts that OFCs are free to operate income tax-free fiscal regimes.[16] High tax OECD regimes deserve similar tolerance from OFCs. This means, at minimum, that as

long as such mutual respect for different systems of taxation exists, service providers in OFCs ought not to undermine high tax OECD regimes by inviting tax evaders to seek refuge in confidential offshore financial structures.

The opportunity to participate in the markets of other countries also implies some minimum standards of behaviour in order to justify access. Thus, onshore countries can and do take the position that they can prevent or restrict access to banking and securities markets for institutions and their clients in jurisdictions that are perceived to be poorly regulated or overly secretive.

As a general rule there are few effective limits on the right of an onshore country to restrict market access. Possible avenues include resort to the World Trade Organization for a challenge based on denial of market access pursuant to the General Agreement on Trade in Services. An alternative basis may be that such sanctions constitute an improper infringement of Article 8(2) of the International Monetary Fund Agreement, which limits the ability of IMF members to impose restrictions on international fund transfers.[17]

In any event, decisions to deny market access are often discretionary, and as a result are difficult to attack. The banking advisories issued following the June 2000 FATF *Review of Non-Cooperative Countries or Territories,* for example, did not preclude market access but rather simply advised caution in dealing with institutions situated in centres deemed "un-cooperative." Another recent similar example of a decision which is difficult to review is the U.S. program designating "qualified jurisdictions" entitled to access U.S. security markets with reduced withholding tax compliance burdens. Some response and accommodation for the demands of the onshore countries and their agencies is accordingly appropriate and desirable, as a practical matter, if an OFC desires continued market access.

A Level Playing Field for International Financial Services?

The offshore centres are being asked to adhere to rules not universally observed by members of the club (the OECD) seeking changes. This overreaching by the OECD has blunted the force in the Harmful Tax Competition initiative in particular, but the concern applies equally to elements of the other initiatives.

Regrettably, the OECD's high-minded commitment to a level playing field (occasionally trumpeted to garner media support for the project[18]) has not always translated into practical reality. In particular, the OECD has shown inappropriate reluctance to permit the implementation of commitments by OFCs in the context of the Harmful Tax Competition initiative to be conditioned on implementation of equivalent commitments by all OECD Member States, including Switzerland and Luxembourg.

Switzerland and Luxembourg

Switzerland and Luxembourg, both OECD members, dissented from the 1998 Report and continue to resist pressure to exchange information for tax enforcement purposes.[19] Switzerland is a decentralised federal state and, even if the Federal Council were minded to negotiate on this point, there are cumbersome constitutional limitations on its ability to agree on measures to negotiate on bank secrecy.

The OECD appears to take the position that this dissenting view is *de minimus,* as 27 other countries approved the Report. However, this overlooks the fact that the non-cooperating OECD

states are the principal onshore competitors for the offshore world, and account for many of the tax neutral structures run onshore within the OECD. A common standard, universally observed by all OECD states and cooperating OFCs, must be the bedrock principle on which the initiative is based, else the credibility of the project suffers.

Offshore centres are concerned that if Switzerland (and Luxembourg) are not obliged to adhere to the standard sought to be imposed on offshore centres business will migrate from offshore centres to OECD Member Countries. If Switzerland's commitment is delayed so that it remains the "last man standing" for clients seeking financial privacy, client structures may well come to rest there, even if Swiss laws subsequently change.

Financial Centres Outside the OECD Project

Centres such as Hong Kong, Singapore and Dubai do not appear on the OECD tax haven list (see Appendix), nor are they members of the OECD. Accordingly, their international financial services industries are effectively ignored by the project. Clearly, if the OECD's project is to move forward in a coherent fashion, it will be necessary to ensure that all international financial centres are governed by the same rules, else business will simply move to financial centres unaffected by the project.

U.S. State Compliance with the OECD Demands

Some countries within OECD membership have had difficulty in ensuring that local and state governments observe the commitments adopted by the national government. The U.S., for example, perceives constitutional constraints in supervising state governments. Thus, at the same time as the U.S. federal government was threatening sanctions against foreign jurisdictions reluctant to compromise banking privacy, Montana and Colorado passed laws creating "foreign capital depositories," designed as confidential accounts and described as "the first truly Swiss style private banking in the U.S.A." Advertising for the facilities based in Colorado included representations that foreign civil and tax judgements against depositors would not be enforceable in the U.S.[20]

Similar concerns arise from the opportunity to establish U.S. limited liability corporations in Delaware (and most other U.S. states) with no disclosure of beneficial ownership.[21] The OECD is threatening sanctions against offshore centres which do not agree to record and exchange information on beneficial ownership, yet U.S. state governments would plainly be unable to provide similar information in respect of tax-free LLCs established in the U.S.

Clearly, the OECD has a good deal of work to do to establish the level playing field it claims to seek in the attack on the offshore world. Without an effective response to these concerns, the OECD will continue to be seen, even by sympathetic observers, as an economic cartel bent on promoting the agenda of its members - and those it is prepared to accommodate - at the expense of outsiders. As Oxfam notes in a report on tax havens:

> when it comes to offering opportunities for global tax avoidance, St. Kitts and Nevis must be a marginal player compared with Switzerland or Hong Kong.[22]

Offshore Centre Agreements with the OECD

Following publication of the 1998 Report, the OECD identified 47 jurisdictions as putative tax havens. Following representations, six of those were dropped before the 2000 Report was published.

Shortly before publication of the 2000 Report an additional six of the identified havens entered into an advance commitment to make domestic changes in support of the OECD Harmful Tax Initiative. These jurisdictions were Cayman, Bermuda, Cyprus, Malta, Mauritius and San Marino.

The OECD has announced further agreements with four other jurisdictions, being the Isle of Man and the Netherlands Antilles (in December 2000), the Seychelles (in February 2001) and Aruba (in July 2001). Under the original terms of the project the 31 remaining jurisdictions on the list were to be subject to the threat of coordinated "defensive measures" by OECD members if no agreement was reached with the OECD by 31 July 2001. (See list of classified jurisdictions in the Appendix.) Following the U.S. Treasury announcement, it now appears, as discussed below, that the deadline for agreement with the OECD has been pushed back to 30 November 2001, with additional delays in the threatened sanctions.[23]

Narrowed U.S. Support for the OECD Project

The OECD project was thrown into disarray by a 10 May 2001 release by U.S. Treasury Secretary O'Neill. The circumstances of the announcement were confusing, as it initially appeared in an op ed article in the Washington press under the name of a junior Treasury aide, although the text was claimed within hours of publication as the statement of the Treasury Secretary.

Following the 10 May release, control of the Senate shifted to the Democrats when Senator James Jeffords left the Republican Party and became an Independent on 24 May 2001. Senator Carl Levin scheduled a hearing on 18 July to review the U.S. Position on Offshore Tax Havens. Secretary O'Neill appeared at the hearing tabling prepared remarks[24] and provided oral testimony to clarify the position of the U.S. Treasury. Secretary O'Neill expressed continued support for the core objective of the OECD project, which he regards as "the need for countries to be able to obtain specific information from other countries upon request in order to prevent non-compliance with their tax laws." Secretary O'Neill also expressed his concerns with respect to conduct and process for the project. A summary of the current U.S. position in the OECD *Harmful Tax Competition Initiative* follows:

Comments on Tax Harmonisation

In the 10 May statement the Treasury Secretary indicated that:

> The United States does not support efforts to dictate to any country what its own tax rates or tax system should be, and would not participate in any initiative to harmonise world tax systems.

Although the 1998 Report suggested that the OECD favoured tax harmonisation, this objective was abandoned by the OECD at an early stage and this abandonment has been reiterated thereafter.[25] Secretary O'Neill's lack of support for aligning tax rates attracted considerable press comment at the time though it is irrelevant to the project, as it is currently conceived by the OECD.

Comments on Information Exchange

Treasury Secretary O'Neill reiterated robust support for seeking information exchange, on request, including both for "a specific criminal tax investigation or a civil tax examination."[26]

Exchange of information on civil tax matters (undefined by the OECD, and so susceptible to a wide interpretation) has been a particularly contentious point in OECD negotiations. Difficulties have been fuelled by the Swiss refusal to consider exchanging civil tax information. (Switzerland limits cooperation to matters involving "tax fraud," meaning proactive and deliberate deception

under a peculiarly Swiss definition for the term). Secretary O'Neill did not comment on exchange for civil tax purposes in his 10 May statement, so his prepared remarks on this point on his 18 July statement are particularly significant.

Level Playing Field

Secretary O'Neill emphasised the crucial importance of a level playing field, indicating that "in order for the OECD initiative to have the legitimacy it needs to succeed, jurisdictions inside the OECD must be treated no more severely than similarly situated OECD Member Countries." Secretary O'Neill went on to say that "OECD Member Countries should hold themselves to standards and timelines at least as rigorous as those to which they hold jurisdictions that are not part of the OECD."[27]

Sanctions

Following U.S. pressure it has been agreed by the OECD that "co-ordinated defensive measures" would not apply to "uncooperative" tax haven jurisdictions any earlier than they would apply to similarly-situated OECD Member Countries. Thus, such measures would be delayed until the deadline for OECD Member Country compliance with demands (April 2003 at the earliest). Secretary O'Neill indicated that, given that the deadline for offshore centres was earlier than the one set for OECD Countries "it is not surprising there was unanimous support among G7 countries to address this inequity."[28]

Secretary O'Neill also noted that defensive measures are by their nature "highly coercive" and should be reserved only for jurisdictions acting in bad faith. The Secretary indicated that the United States would "strongly prefer working cooperatively with jurisdictions rather than contemplating the imposition of coordinated defensive measures" which he suggested "must be truly measures of last resort."[29]

Ring Fencing

The OECD proposed to treat an offshore jurisdiction as "uncooperative" if it maintained a regime that facilitates the establishment of entities with "no substantial activities." A closely related criterion provided that countries which "ring fenced" aspects of their tax regime to make them available only to non-residents would be similarly treated. Such concessions are commonplace in OECD Member Countries and so, not surprisingly, the U.S. regards these criteria as problematic and difficult to apply. Secretary O'Neill noted that the OECD has now agreed to abandon such criteria for determining whether a jurisdiction is uncooperative.

Deadline for OECD Commitments

Secretary O'Neill noted that the OECD has agreed to extend the deadline for offshore centres providing commitments to the OECD from 31 July to 30 November. The offshore centre discussions with the OECD have been largely discontinued while the OECD has failed to communicate its position in response to U.S. comments, and so this extension is necessary and appropriate.

U.S. Plans for the Future

Secretary O'Neill's remarks showed considerable sensitivity to fairness of process and the need to refocus the project in order to ensure a constructive result. Oral remarks of the Treasury Secretary at the hearing show an ambitious timetable for continuing U.S. efforts on information

exchange, as Secretary O'Neill indicated that the U.S. would seek to conclude tax information exchange agreements with at least half of the tax havens on the OECD list within 12 months. Senator Levin extended an invitation to the Secretary to return to the Senate to review progress at the expiration of that period.

Implications of the Treasury Statement

The drive for transparency has considerable momentum now and is unlikely to disappear. The U.S. and other OECD Member Countries and many offshore centres have articulated broad support for information exchange, on request, for criminal tax matters. Switzerland and Luxembourg excepted, there is also support in principle for information exchange on civil tax matters, though there is no international consensus on what is meant by that term.

Offshore centres may be better positioned to negotiate information exchange agreements through reliance on a universal standard acceptable to all (i.e., including Switzerland) so that any negotiations over information exchange are conducted within broadly agreed parameters. Without some external standard, offshore centres could find themselves under pressure to agree to information exchange with no reference points to restrain the demands of aggressive high tax countries. Accordingly, OFCs may now perceive advantage in participating in the OECD initiative, particularly if the standard to be set for a template information exchange agreement results from truly inclusive dialogue with the OFCs.

OECD Reaction to the Shift in the U.S. Position

Official OECD reaction to the U.S. Treasury Secretary's remarks has been conspicuously muted. Details of an agreement by OECD Member States in response to the shift in the U.S. position were leaked to the press in late June 2001,[30] apparently directly from the OECD press office. A formal response has been delayed by a Spanish threat to veto an agreement on the project unless the United Kingdom agrees to ensure that Gibraltar will respect the agreement.

The current position has been officially stated by the OECD only in a cryptic press release dated 31 July 2001 confirming a delay in the deadline previously set for that day. Curiously, the information gap was filled by the G7 Finance Ministers in the communiqué tabled following their 7 July 2001 meeting in Rome which confirms that the OECD intends to:

- extend the existing 31 July 2001 deadline for offshore centre commitments on transparency and effective information exchange to 30 November 2001;
- delay possible sanctions on offshore centres deemed non-cooperative to mid 2003; and
- eliminate the "no substantial activities" and "ring fencing" criteria.

Agreements are now sought by 30 November 2001 with the putative tax havens with elements as follows:

1. Criminal information exchange: The OECD seeks procedures for efficient administrative exchange of reliable financial data by 2004, achieved through tax information agreements with OECD Member Countries.

   Comment: The "level playing field" principle indicates that the appropriate standard is the one unanimously agreed by OECD Members in paragraph 21[33] of the OECD's April 2000 Report on *Improving Access to Bank Information for Tax Purposes.* Given the parameters

of paragraph 21, this obligation should be limited to exchanging information in circumstances involving the following:

- a specific request
- in respect of deliberate conduct
- which is subject to criminal tax prosecution

2. *Civil tax information exchange:* The OECD seeks procedures in place for efficient administrative exchange of "civil" tax data by 2006. Once again, this would be limited to circumstances where there is a specific request.

   Comment: OECD Member States (i.e., Switzerland and Luxembourg) have refused to provide civil tax information, so the OECD request for this does not observe the "level playing field" principle. Further, Secretary O'Neill notes that:

   > Any jurisdiction that makes a commitment to meet international standards of transparency and effective exchange of information will not be listed as "uncooperative"…[34]

As the international standard for exchange of civil tax information is neither settled nor agreed, any OFC commitment on this point should be limited to indicating a willingness to engage in multilateral discussions with OECD Member Countries and cooperating OFCs to establish the appropriate standard.

3. *Access to ownership and financial data:* The OECD seeks effective government access to locally maintained information regarding beneficial ownership and financial statements for companies and trusts to facilitate the requested exchange of tax data.

   Comment: Local service providers should be required to know beneficial ownership and hold financial statements for structures established in the jurisdiction. (Incongruously, the records of U.S. corporations established in Delaware for foreigners do not contain this information[35] so offshore centres should insist on changes in the U.S. to ensure a level playing field). Such information should be accessible to local authorities, on specific request, when required.

OECD Report on the Misuse of Corporate Vehicles

The OECD has recently tabled a *Report on the Misuse of Corporate Vehicles for Illicit Purposes.*[36] The Report details concerns and criticisms regarding corporate and non-corporate vehicles (including trusts) and is no doubt designed to contribute to the ongoing conversation between the OECD and the offshore centres on the form of information exchange agreements. Once again, the Report shows the skewed perspective which results from preparation by a body like the OECD which represents a narrow interest group. The Report proceeds from the premise that offshore centres are the problem,[37] with only passing mention of the issues posed by vehicles established in OECD Member States and used in the offshore world.

As anyone familiar with the offshore world today knows, the U.S. Limited Liability Corporation (LLC), widely available now under the laws of most U.S. states, is a ubiquitous offshore vehicle. Where established by a non-U.S. person, a U.S. LLC is generally tax-free from a U.S. perspective. LLCs can be formed by fax with no due diligence requirements, and no requirement to track or disclose beneficial ownership.

A report by the U.S. GAO dated 31 October 2000 titled *Suspicious Banking Activities: Possible Money Laundering by U.S. Corporations Formed for Russian Entities*[38] prepared for U.S. Senator

Carl Levin's Committee on correspondent banking details the activities of one service provider which formed approximately 2,000 Delaware companies exclusively for brokers in Moscow, Russia. Many U.S. LLCs opened bank accounts with major U.S. institutions without, apparently, identification of beneficial owners. Senator Levin's Report on Correspondent Banking[39] was silent on the absence of Delaware records on beneficial ownership for structures established in the State despite evident dangers noted in the Report at pages 5-6:

> The records of the registered agents we reviewed generally contain the name of the person or entity requesting the formation of the [Delaware] corporation but do not contain the names of the corporation's principals. Thus, neither state records nor the records of the registered agents contain the names of the principals of the incorporated companies.
>
> Two registered agents informed us that they often form corporations in blocks of 10 to 20 at a time to accommodate single requests from foreign brokers. A registered agent also disclosed that these corporations are sometimes sold by the brokers to others, who may, in turn, sell them again.

Why was the U.S. LLC vehicle, widely used in the offshore world, not properly considered in the OECD Report on Misuse of Corporate Vehicles?

The Financial Action Task Force – Counter Money Laundering

Former IMF Managing Director Michael Camdessus has estimated that the volume of cross-border money laundering is between 2 and 5 percent of the world's gross domestic product.[40] Although money laundering by its nature defies detection, this suggests that U.S. $600 billion is laundered annually through the world's financial system.

The Financial Action Task Force was established by the G7 summit held in Paris in 1989. The FATF examines money laundering techniques and trends and sets and communicates standards for combating such activity. The FATF was established with 16 member countries, and now has 29 members.[41] Like the OECD, the FATF has elite (as opposed to universal) membership and membership is not open to the offshore states. Regional bodies such as the Caribbean Financial Action Task Force support the work of the FATF.

The FATF published a report on 22 June 2000 entitled *Review to Identify Non-Cooperative Countries or Territories.* That report was preceded by a review of 29 jurisdictions over a four-month period to analyse anti-money laundering regimes. This report relates exclusively to the regimes of non-member countries (the FATF does not publish its reviews of the compliance by member states). A number of other jurisdictions have not been reviewed or rated. More than half of the reviewed jurisdictions were identified as non-cooperative. Assessments of additional jurisdictions were considered at the recent FATF plenary which took place on 20-22 June 2001.

The FATF labels the non-member jurisdictions that it sees as requiring improvement as "non-cooperative." This description is inapt in many cases, as it suggests that the jurisdiction is being deliberately obstructive. While there are issues of adequacy in the regimes of a number of offshore centres (as there are in many onshore centres[42]), there is little doubt about the desire of most offshore centres to cooperate to eradicate money laundering.[43]

The FATF did not articulate standards for removal of jurisdictions from the non-cooperative list at the time of their review. However, the FATF took the position that only legislation which is passed and currently in force will be taken into account. The FATF has advised that while technical help is available, such help is provided only after legislation has been adopted. This is curious, of course, since one would expect that the FATF would value consistent, quality legislation to address issues in a comprehensive fashion.

The FATF plenary in June 2001 concluded with a decision to remove four jurisdictions from the non-cooperative list – The Bahamas, the Cayman Islands, Panama and Liechtenstein. Six countries were added at that time, though none of the additions are significant financial centres. The updated list of non-cooperative countries and territories is as follows (new additions are shown in italics)[44]: Cook Islands; Dominica; *Egypt; Guatemala; Hungary; Indonesia;* Israel; Lebanon; Marshall Islands; *Myanmar;* Nauru; *Nigeria;* Niue; Phillipines; Russia; St. Kitts and Nevis; and St. Vincent and the Grenadines.

Striking a reasonable balance between regulation to counter money laundering and the demands of efficient commerce is difficult for all financial centres, offshore and onshore. The U.S. Treasury has, for example, recently indicated plans to review "burdensome" rules to combat money laundering, following pressure from banks to ease reporting requirements seen as "intrusive and costly."[45] By contrast, non-FATF member states proceed in a climate of threats and coercion and are, of course, denied a similar opportunity to take domestic policy considerations into account when designing anti-money laundering regimes.

New developments in the FATF programme appear in the *Report on Money Laundering Typologies 2000-2001* tabled at the FATF plenary in February 2001. That report proposes a major new initiative on trusts and other non-corporate vehicles, even suggesting that standardised documentation for offshore trusts be imposed. The Typologies Report also proposes further pressure on "gatekeepers," including lawyers, accountants and other professionals offering financial advice.

Financial Stability Forum

The Financial Stability Forum was established pursuant to a G7 initiative in early 1999. At its inaugural meeting on 14 April 1999 the Forum established an OFC working group chaired by John Palmer, Superintendent of Financial Institutions, Canada. The purpose of the group was to consider the role of OFC banks in the stability of the world's financial system.

The mandate of the working group was as follows[47]:

- to consider the uses of OFCs and the possible role they have had or could play in posing threats to the stability of the financial system;
- to evaluate the adherence of OFCs to internationally accepted standards and good practices; and
- to make recommendations, including to enhance problematic OFCs' observance of international standards.

In conducting its mandate the FSF was primarily concerned with the activities of the OFC banks in two areas as follows:

- *prudential concerns,* relating to the scope for effective supervision of internationally active financial intermediaries; and
- market integrity, relating to the effectiveness of international enforcement efforts in respect of illicit activity and abusive market behaviour.

A report was tabled by the working group on 5 April 2000. The report contained a number of observations on the role and workings of the offshore world and concluded with an evaluation of the existing calibre of regulation in a number of OFC jurisdictions. (See Appendix.) Not surprisingly, the report concluded that the enhanced acceptance and implementation of international standards by OFCs would address many of the concerns raised about OFC regulation.

The FSF classified OFCs into three groups as follows[48]:

- The first group are jurisdictions generally viewed as cooperative jurisdictions with a high quality of supervision, which largely adhere to international standards.
- The second group of OFCs are jurisdictions generally seen as having procedures for supervision and cooperation in place, though actual performance falls below international standards, and there is substantial room for improvement.
- A third group of OFCs are jurisdictions generally seen as having a low quality of supervision, and/or being non-cooperative with onshore supervisors, and with little or no attempt being made to adhere to international standards.

The majority of OFCs (25 jurisdictions) were placed into category three, with nine and eight, respectively being placed in categories two and one.

FSF work is now being continued by the IMF which will be conducting assessments of a number of OFCs over the next year.

Conclusion

The remarkable success of the world's offshore centres has invited scrutiny from onshore governments and their agencies. A chorus of overlapping demands for change have followed, so much so that the offshore centres now suffer from "initiative fatigue." However, in all of this change, OFCs will retain the great advantage of being able to transact business in a tax neutral fashion while client demand for such services remains unabated, despite supranational pressures.

Offshore centres rely on access to onshore clients, banking and securities markets for their success. Countries which provide such facilities are in a position to restrict access for jurisdictions perceived to be unruly customers. Such decisions are open to challenge, but the prospects for that are cumbersome and uncertain, particularly where the decisions involve discretionary elements determined behind closed doors.

A constructive response to the reasonable concerns of onshore countries is essential for any OFC, unless it is prepared to unplug from the international grid. Responsible OFCs will take steps to ensure that their service providers refrain from disrupting the fiscal systems of high tax countries by inviting tax evaders to alight in the jurisdiction. OFCs must also be prepared to devote resources and provide active assistance in the international fight against money laundering.

Onshore countries and their agencies, in turn, should recognise that they will be judged by the fairness of their demands and process. At minimum, this means that standards should be set by bodies with universal (as opposed to elite) membership. Crucially, there must also be a level playing field for all parties; OFCs need to know that the same rules will be applicable to all. It is not sufficient to say that most members of the club (i.e., the OECD) adhere to the rules demanded. This is particularly so where the dissenting voices emanate from those jurisdictions which compete most effectively with the offshore world.

The recent statements by the United States Treasury Secretary demonstrate long overdue concern for the heavy-handed tactics adopted by the OECD in conducting its project. In the wake of the U.S. shift in position, the OECD and its supranational brethren should pause and reflect on the need to constructively engage the offshore centres in their projects, and show that they are willing to translate the rhetoric regarding level playing fields into a reality. The combative postures adopted by both sides to date may yet yield to cohabitation rather than continuing collision, provided offshore centers are given a genuine and substantial part to play in the design of the changes to come.

Appendix

Supranational Classifications of Offshore Financial Centres[49]

	ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT		FINANCIAL ACTION TASK FORCE		FINANCIAL STABILITY FORUM		
	CLASSIFIED AS TAX HAVENS		ANTI-MONEY LAUNDERING REVIEW		STANDARDS OF FINANCIAL REGULATION		
	COMMITMENT AGREED	NO AGREEMENT WITH OECD	RATED NOT CENSURED	DEEMED NON-COOPERATIVE	I HIGH	II MEDIUM	III LOW
Andorra		X				X	
Anguilla		X					X
Antigua & Barbuda		X	X				X
Aruba	X						X
The Bahamas		X	X				X
Bahrain		X				X	
Barbados		X				X	
Belize		X	X				X
Bermuda	X		X			X	
British Virgin Islands		X	X				X
Cayman Islands	X		X				X
Cook Islands		X		X			X
Costa Rica							X
Cyprus	X		X				X
Dominica		X		X			
Dublin (Ireland)					X		
Gibraltar		X	X			X	
Grenada		X					
Guernsey		X	X		X		
Hong Kong SAR					X		
Isle of Man	X		X		X		
Jersey		X	X		X		
Labuan (Malaysia)						X	
Lebanon				X			X
Liberia		X					
Liechtenstein		X	X				X
Luxembourg					X		
Macau SAR						X	
Maldives		X					
Malta	X		X			X	
Marshall Islands		X		X			X
Mauritius	X		X				X
Monaco		X	X			X	
Montserrat		X					
Nauru		X		X			X
Netherlands Antilles	X						X
Niue		X		X			X
Panama		X	X				X
St Kitts & Nevis		X		X			X
St Lucia		X	X				X
St Vincent & the Grenadines		X		X			X
Samoa		X	X				X
San Marino	X						
Seychelles	X		X				X
Singapore					X		
Switzerland					X		
Tonga		X					
Turks and Caicos		X	X				X
US Virgin Islands		X					
Vanuatu		X	X				X

Additional countries reviewed by the FATF but not classified as offshore centres by the OECD:
Rated but not censured: Czech Republic, Poland, Slovak Republic, Uruguay
Deemed non-cooperative: Egypt, Guatemala, Hungary, Indonesia, Israel, Myanmar, Nigeria, Philippines, Russia

NOTES

1 Reproduced with permission of the Daily Telegraph, 29 May 2001.

2 Article 1 of the OECD Convention requires the OECD to promote the interest of its own members.

3 Statement of Paul O'Neill before the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, OECD Harmful Tax Practices Initiative, July 18 2001 (available at www.senate.gov)

4 The 2000 Merrill Lynch Gemini study, for example, notes that the number of U.S. dollar millionaires in the world economy has increased by 50% over the last three years, to a current total of approximately seven million millionaires.

5 As the FSF *Report of the Working Group on Offshore Centres* notes at page 8, the growth of London as the largest offshore banking centre has been linked directly to regulations imposed on the U.S. banking sector: capital controls implemented through the Interest Equalisation Tax of 1964, the Foreign Credit and Exchange Act of 1965, cash reserve requirements on deposits imposed in 1977 and a ceiling on time deposits in 1979. By establishing foreign branches to which these regulations did not apply, U.S. banks were able to operate in more cost-attractive environments.

6 The OECD report, *Towards Global Tax Cooperation: Progress in Identifying and Eliminating Harmful Tax Practices* (26 June 2000) states at page 5 that their project "is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates."

7 Available on the web at www.oecd.org.

8 Available on the web at www.oecd.org/fatf.

9 Available on the web at www.fsforum.org.

10 Santa Maria da Feira, European Council, *Presidency Conclusions* (19 and 20 June 2000).

11 *Tax Policy in the European Union – Priorities for the Years Ahead* – European Commission, 23 May 2001. The Report states, at paragraph 2.4, as follows:

> It is clear that there is no need for an across the board harmonisation of Member States' tax systems. Provided that they respect Community rules, Member States are free to choose the tax systems that they consider most appropriate and according to their preference.

12 The *UN Declaration of Human Rights 1948* recognises and protects privacy as a basic human right. Article 12 reads:

> No one shall be subjected to arbitrary interference with his privacy, family, home or correspondence, nor to attacks upon his honour and reputation. Everyone has the right to the protection of the law against such interference and attacks.

13 Appendix, Section 3.1.2 of report on *Improving Access to Bank Information for Tax Purposes.*

14 A UN Report published in 1998 notes, alarmingly, that in a part of the former Soviet Union (not an OECD Member), criminal gangs bought banks in order to determine which families had bank accounts large enough to make kidnapping worthwhile. United Nations Office for Drug Control and Crime Prevention (UNODCCP), *Financial Havens, Banking Secrecy and Money-Laundering,* Double issue 34 and 35 of the Crime Prevention and Criminal Justice Newsletter, and Issue 8 of the UNDCP Technical Services, 1998 at page 68.

15 The IRS has recently been admonished by the U.S. GAO for its failure to adequately secure access to its electronic filing systems and the electronically transmitted tax return data those systems contain. In a report dated February 2001 titled *Information Security: IRS Electronic Filing Systems* the GAO states at page 2:

> We demonstrated that unauthorised individuals, both internal and external to IRS, could have gained access to IRS' electronic filing systems and viewed and modified tax payer data contained in those systems during the 2000 tax filing season. We were able to gain such access because the IRS at that time had not (1) effectively restricted external access to computers supporting the e-file program, (2) securely configured the operating systems of its electronic filing systems, (3) implemented adequate password management and user account practices, (4) sufficiently restricted access to computer files and directories containing tax return and other system data, or (5) used encryption to protect tax return on e-file systems. Further, these weaknesses jeopardised the security of sensitive business, financial and taxpayer data on other critical IRS systems that were connected to e-file computers through its servicewide network.

16 2000 Report.

17 *See* Bruce Zagaris, *OECD Harmful Tax Competition Report and Related Initiatives Leave the Caribbean Offshore 'in Irons',* Tax Notes Int'l (21 August 2000) and *Caribbean Tax Havens Seek Refuge in the Arms of the WTO,* Financial Times, Tuesday 3 October 2000.

18 In *Towards World Tax Cooperation,* OECD Observer (27 June 2000) Jeffrey Owens, OECD Head of Fiscal Affairs reviewed the OECD's demands for transparency in the Harmful Tax Competition initiative and stated:

> "And let me emphasise that it is going to be the same standards for all Member Countries and non-Member Countries."

19 Swiss Economics Minister Pascal Couchepin, has reiterated his country's stance on occasions saying that Swiss secrecy laws are "not negotiable." *Swiss Banking Secrecy Rules Hang in the Balance as E.U. Negotiations Loom* 15 May 2001 (available on the web on www.tax-news.com).

20 These statements were modified after complaints by the State Bank Commissioner. *See* "Offshore Bank Rethinks Image" in Rocky Mountain News at www.rockymountainnews.com.

21 See the reference to the U.S. GAO Report on *Suspicious Banking Activities: Possible Money Laundering by U.S. Corporations Formed for Russian Entities* below.

22 Oxfam, *Tax Havens: Releasing the Hidden Billions for Poverty Eradication,* June 2000. The report goes on to say:

> Many developing country havens are highly distrustful of the motivations of rich countries, believing the OECD initiative to be merely another attempt to prevent competition from developing countries undermining their own economic interests.

23 Progress on the initiative has also been slowed by the manner of OECD participation in the Joint Working Group on Harmful Tax Competition which arose out of the meeting in Barbados between OECD and the Caribbean offshore centres. (The offshore side of that organization has now become the International Tax and Investment Organization (ITIO), established in March 2001.) The offshore centre side of the Joint Working Group sought clarification of OECD views on seventeen fundamental points relating to the harmful tax competition initiative at a meeting with the OECD in Paris on 28 February 2001. The OECD provided an oral response at that time and promised a subsequent written response but none has been forthcoming. (*See* "Offshore Jurisdictions Push OECD to Respond to Questions," 7 June 2001 (available on the web on www.tax-news.com)).

24 Statement of Paul O'Neill before the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, OECD Harmful Tax Practices Initiative, July 18 2001 (available at www.senate.gov), hereafter referred to as "O'Neill's Senate Remarks."

25 Donald Johnston, Secretary-General of the OECD, restated the OECD position in his Remarks to the Joint Working Group on Harmful Tax Practices at Salle Marshall, Chateau de la Muette, France (1 March 2001),as follows:

> The [Harmful Tax Practices] project is not about tax harmonisation. All countries should set whatever rates of tax they wish, with whatever they feel appropriate on the taxation of capital, income or consumption. Whether the tax rate of a particular country is zero or whether it is in excess of 50% is of no concern to the OECD in carrying out this exercise.

26 O'Neill's Senate Remarks at page 8.

27 Page 6.

28 Page 6.

29 Page 9.

30 "OECD May Have Deal to Fight Tax Evasion," The Financial Times 28 June 2001

31 The U.K. takes the position, at least formally, that it will not interfere in the domestic affairs of its overseas territories. Spain is reluctant to see this practice extended to Gibraltar, taking the view that independent action taken by Gibraltar in the international field effectively recognises Gibraltar's international status at a time when Spain claims sovereignty over it.

32 Report of G7 Finance Ministers and Central Bank Governors, 7 July 2001, Rome, Italy - *Fighting the Abuses of the Global Financial System.*

33 Paragraph 21 of the OECD Report on *Improving Access to Bank Information for Tax Purposes* reads as follows:

"The Committee on Fiscal Affairs encourages Member Countries to:

(a) undertake the necessary measures to prevent financial institutions from maintaining anonymous accounts and to require the identification of their usual or occasional customers, as well as those persons to whose benefit a bank account is opened or a transaction is carried out. The committee will rely on the work of the Financial Action Task Force in ensuring the implementation of these measures by Member Countries;

(b) re-examine any domestic tax interest requirement that prevents their tax authorities from obtaining and providing to a treaty partner, in the context of a specific request, information they are otherwise able to obtain for domestic tax purposes with a view to ensuring that such information can be exchanged by making changes, if necessary, to their laws, regulations and administrative practices. The Committee suggests that countries take action to implement these measures within three years of the date of approval of this Report;

(c) re-examine policies and practices that do not permit tax authorities to have access to bank information, directly or indirectly, for purposes of exchanging such information in tax cases involving intentional conduct which is subject to criminal tax prosecution, with a view to making changes, if necessary, to their laws, regulations and administrative practices. The Committee acknowledges that implementation of these measures could raise fundamental issues in some countries and suggest that countries initiate a review of their practices with the aim of identifying appropriate measures for implementation. The Committee will initially review progress in this area at the end of 2002 and thereafter periodically.

The Committee notes the international trend to increase access to bank information for tax purposes. In the light of this trend, the Committee encourages countries to take appropriate initiatives to achieve access for the verification of tax liabilities and other tax administration purposes, with a view to making changes, if necessary, to their laws, regulations and administrative practices. The Committee intends to engage in an on-going discussion, within the constraints set out in the preface, to promote this trend."

34 O'Neill's Senate Remarks

35 As noted above. See the reference to the U.S. GAO Report on *Suspicious Banking Activities: Possible Money Laundering by U.S. Corporations Formed for Russian Entities* below.

36 The Report was adopted by the OECD Steering Group on Corporate Governance and declassified on 29 May, 2001. It is available on the OECD website at www.oecd.org.

37 *Report on Misuse of Corporate Vehicles for Illicit Purposes* paragraph 28.

38 www.gao.gov.

39 Minority Staff of the Permanent Subcommittee on Investigations, *Report on Correspondent Banking: A Gateway for Money Laundering,* 5 February 2001

40 *U.S. National Money Laundering Strategy for 2000,* pages 6-7.

41 The 29 FATF Member Countries and governments are: Argentina; Australia; Austria; Belgium; Brazil; Canada; Denmark; Finland; France; Germany; Greece; Hong Kong; China; Ireland; Italy; Japan; Luxembourg; Mexico; the Kingdom of the Netherlands; New Zealand; Norway; Portugal; Singapore; Spain; Sweden; Switzerland; Turkey; the United Kingdom; and the United States.

42 The U.K. Financial Services Authority investigated anti-money laundering controls at 23 banks in the U.K. which maintained accounts linked to General Sani Abacha, the former President of Nigeria. The investigation found that 15 of the banks had significant control weaknesses. Phillip Thorpe, Managing Director of the FSA called the extent of the weaknesses identified "frankly disappointing." Seven banks with significant control weaknesses was ordered to rectify problems within strict deadlines and potential breaches of the Money Laundering Regulations were reported to law enforcement authorities (Financial Services Authority press release dated 8 March 2001).

43 The Intergovernmental Group of Twenty-Four on International Monetary Affairs, meeting at the time of the G7 conference in late April 2001 noted on page 4 of their 28 April 2001 Communiqué as follows:

> Ministers caution against the non-voluntary and non-cooperative manner in which the Financial Action Task Force (FATF) 40 recommendations are currently applied to non-FATF members.

44 FATF *Review to Identify Non-Cooperative Countries and Territories,* 22 June 2001

45 "U.S. Treasury Hopes to Ease Burden of Anti-Laundering Effects on Banks," Wall Street Journal, 7 June 2001

46 For secondary commentary, *see The Gatekeeper's Initiative: An Emerging Challenge for International Financial Advisors,* 22 Tax Notes International 2293-98, May 7, 2001 (Bruce Zagaris).

47 *See* Financial Stability Forum Report at p 6, *supra* at note 1.

48 *See* Financial Stability Forum Report at p 46, *supra* at note 1.

49 Reports:

OECD: *Towards Global Tax Cooperation,* dated 26 June 2000

FATF: Two publications of the *Review to Identify Non-Cooperative Countries or Territories: Increasing The Worldwide Effectiveness of Anti-Money Laundering Measures,* dated 22 June 2000 and 22 June 2001

FSF: *Report on the Working Group on Offshore Centres,* dated 5 April 2000