“Tax havens and financial markets”

by

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Master Thesis within the double degree master programme with the profiles of Financial Economics and International Business

NORGES HANDELHØYSKOLE AND EGADE BUSINESS SCHOOL

This thesis was written as a part of the master program at NHH and EGADE. Neither the institutions, the supervisor, nor the censors are - through the approval of this thesis - responsible for neither the theories and methods used, nor results and conclusions drawn in this work.
Abstract

This thesis is about some of the effects and implications that tax havens have on our financial markets. It focuses on giving the reader a better understanding of the consequences that tax havens impose to our financial markets using the financial crisis that started in 2007 as an example. The first chapter has a brief introduction that lays the foundation of the thesis. The second chapter defines and explains many different types of tax havens that exist worldwide. The third part considers the corporate structures found in tax havens and their respective use. The fourth chapter discusses the link between the financial markets and tax havens, and also explains the different structured derivatives used in tax havens. The final chapter uses the financial crisis to illustrate some of the effects that are created by tax havens. This chapter also discusses the future of tax havens, provides a conclusion of the thesis and some suggestions for preventing a possible future where tax havens continue to pose as a threat and create uncertainties in our financial systems.
Preface

This work is a part of the double degree master programme at Norwegian School of Economics (NHH) and EGADE Business School in Monterrey, and it is written through the spring of 2011 and 2012.

After making the decision to write about tax havens as my main topic, did I recognized that my own knowledge about tax havens was limited. However, the main drivers for the decision were the personal inner motivation and curiosity of the topic. The whole process has been a very interesting journey that has given me valuable insight in many tax haven matters, and increased my general knowledge about tax havens and financial markets.

Tax havens are being more recognized and mentioned worldwide, especially in relation with different financial crisis. However, is the informative part still very difficult to come around because of the secrecy structures used by the tax havens. The main focus of the thesis is to try to clarify some of the many unknown facts about tax havens. It is an informative and explorative piece that is meant to illustrate the complexity of tax havens and their relation to the financial market. The thesis is written in an easily comprehensive way in order to reach out to as many readers as possible, without ignoring important and complex facts.

I would like to thank my supervisors Guttorm Schjelderup and Roberto Santillán, for contributing with extraordinary advice and feedback that have helped me a lot throughout the process of writing.

Bergen/Monterrey 13 June 2012

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Sigurd Rognmo Solvoll
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Introduction</td>
<td>6</td>
</tr>
<tr>
<td>2</td>
<td>Tax haven – what is it and how does it work?</td>
<td>7</td>
</tr>
<tr>
<td>2.1</td>
<td>Definition</td>
<td>7</td>
</tr>
<tr>
<td>2.2</td>
<td>Other definitions of tax havens</td>
<td>13</td>
</tr>
<tr>
<td>2.3</td>
<td>Criticism against the OECD definition and other tax havens</td>
<td>14</td>
</tr>
<tr>
<td>2.4</td>
<td>Tax havens and their characteristics</td>
<td>16</td>
</tr>
<tr>
<td>2.5</td>
<td>“Which countries become tax havens?”</td>
<td>19</td>
</tr>
<tr>
<td>3</td>
<td>Corporate structures and their use in tax havens</td>
<td>21</td>
</tr>
<tr>
<td>3.1</td>
<td>Tax haven in practice and the financial use</td>
<td>21</td>
</tr>
<tr>
<td>3.2</td>
<td>Corporate structures in tax havens</td>
<td>22</td>
</tr>
<tr>
<td>3.2.1</td>
<td>Derivatives</td>
<td>22</td>
</tr>
<tr>
<td>3.2.2</td>
<td>IBC and PIC</td>
<td>26</td>
</tr>
<tr>
<td>3.2.3</td>
<td>The structure of the PCC and the ICC</td>
<td>27</td>
</tr>
<tr>
<td>3.2.4</td>
<td>The trust structure</td>
<td>36</td>
</tr>
<tr>
<td>3.3</td>
<td>Tax haven in traditional use and in new use</td>
<td>38</td>
</tr>
<tr>
<td>4</td>
<td>Financial markets and the use of tax havens</td>
<td>42</td>
</tr>
<tr>
<td>4.1</td>
<td>Credit rating, asymmetric information and the financial crisis</td>
<td>42</td>
</tr>
<tr>
<td>4.2</td>
<td>Credit derivatives and uncertainty</td>
<td>47</td>
</tr>
<tr>
<td>5</td>
<td>Tax haven influence and its future, conclusion and suggestions</td>
<td>49</td>
</tr>
<tr>
<td>5.1</td>
<td>The link between tax havens and the financial crisis</td>
<td>49</td>
</tr>
<tr>
<td>5.2</td>
<td>Do we need tax havens?</td>
<td>51</td>
</tr>
<tr>
<td>5.3</td>
<td>The future of tax havens</td>
<td>53</td>
</tr>
<tr>
<td>5.4</td>
<td>Conclusion and further research</td>
<td>54</td>
</tr>
<tr>
<td>6</td>
<td>Bibliography</td>
<td>56</td>
</tr>
</tbody>
</table>
List of Figures

Figure 1 Collateralized Debt Obligation ........................................... 25
Figure 2 Protected Cell Company structure .................................... 29
Figure 3 Rent-A-Captive ................................................................. 32
Figure 4 Trust structure ................................................................. 37
Figure 5 Subprime mortgages visual ................................................ 46

List of Tables

Table 1 OECD original list of tax havens ............................................. 17
1 Introduction

Tax havens are located in more and more well-known locations worldwide and are not as hidden as they may seem to be. Tax havens are fast growing and are starting to get more acknowledged for the convenient solutions they provide to financial markets. However, it does exist many different opinions regarding the understanding of the effects the tax havens have on the financial markets.

The thesis will concentrate on the connection between the tax havens and the financial markets. After the financial crisis began in 2007 have the tax havens regained more attention and the hunt for reducing tax evasion was resumed with more authority and determination. This also caused and raised a lot of interesting questions: How was the financial crisis affected by tax havens? What part do the tax havens play in the financial market today? What kind of corporate structures are found in tax havens and are these structures found elsewhere as well? These are some of the challenging questions I am going to focus on and try to answer and discuss in the best possible way.
2 Tax haven – what is it and how does it work?

This chapter will focus on describing some of the different definitions of tax havens and then try to discuss critically these definitions using other approaches. The last part of the chapter will discuss the different characteristics of tax havens and try to explain why some countries become tax havens.

2.1 Definition

Tax haven is not a very precise and accurate term. There are a lot of different definitions, and it seems to be that no specific definition is recognized and accepted worldwide. The problem with narrowing down to one definition can be illustrated by all the names that are attached to the phenomenon: Tax haven, Free Trade zone, Offshore Financial Centre, Tax Relief Zone among many other names. One way to consider it and perhaps solve the name problem would be to say that you can identify a tax haven as a jurisdiction with low tax or no tax. In tax havens is the tax rate equal to zero on capital income like for example dividend (Zimmer, 2009). Many jurisdictions like Ireland and the Netherlands have introduced different laws that reduce the tax on capital income to equal zero for foreign companies, so that these firms decide to move their subsidiaries into these countries (Zimmer, 2009). This is one way of attracting foreign capital (Zimmer, 2009). Another example to illustrate the definition uses the Norwegian tax system to measure: Any income or loss on a share in a company located in a tax haven, usually have an effective tax rate\(^1\) equal to less than two thirds of the effective tax in Norway (KPMG, 2012). However, is it more likely that the tax paid by foreign companies operating in tax havens equals zero (Zimmer, 2009).

This is a start, but the definition may still be too short and vague to be accepted. There is also a specific difference between a tax haven and an OFC according to the OECD that should be mentioned (OECD, 2011b). The OECD defines OFC as: “Countries or jurisdictions with financial centres that contain financial institutions that deal primarily with nonresidents and/or in foreign currency on a scale out of proportion to the size of the host economy” (OECD, 2011b). Enterprises based in the centre may then benefit from the tax advantages that are not available for businesses based outside. This definition does not involve questions related to low tax or the legality of these actions, as the OECD definition of tax havens does. According to the OECD is the OFC a jurisdiction that has more going on financially than it normally would

\(^1\) Effective tax rate is the tax paid (total tax liability) after deductions such as depreciation divided by taxable income.
have, considering the conditions at the specific place. However, would many say that tax havens and OFC are synonyms (NOU, 2009). It could seem like the definition provided by the OECD of the OFC is in line with the functionality of a tax haven. There is somehow a slightly distinction that can be mentioned. The term modern tax havens have existed since the start of the twentieth century, while OFCs are phenomemns that appeared in the mid 1970s (Palan, 2012). London was the first city that acted and operated as an OFC before spreading worldwide (Santillán-Salgado, 2011). The term offshore financial market is commonly used to describe the wholesale international financial market, also known in the past as the Eurodollar market² (Palan, 2012). This type of market takes care of any location trading in the non-resident currencies like the yen, swiss franc, and euro among others. In general are OFCs considered to be the location where such financial transactions take place among the so-called non-residents (Palan, 2012). Examples of such places are the British Virgin Island, Guernsey amongst other. The list of countries that are selected by the OECD as OFCs, are much the same as those that the OECD classifies as tax havens. However, there are other and different views on the classification of OFC. According to another source, the International Monetary Fund (IMF), are strong financial centres like New York, London, Singapore and Tokyo regarded as OFCs (International Monetary Fund, 2000). The international Monetary Fund emphasizes that the greatest differences between the tax havens and the OFC is the amount of value that is added to transactions done by non-residents (International Monetary Fund, 2000). The amount of extra value added is probably more usual in places like Singapore and London than in other OFC that are also categorized as tax havens. There is no general understanding of what functions are necessary for a jurisdiction to act as OFC (NOU, 2009). It is however important to keep in mind the differences between the two terms as explained above. If we were to look quickly on the fundamentals behaviours involved to the existence of tax havens, would it be appropriate to mention three typical behaviours: Tax avoidance, tax planning and tax evasion (Ferreira & Madeira, 2010). It is also necessary to consider the fact that tax havens also offers anonymity that undermines regulation in many different areas from the financial market to provide incentives for illegal unregulated unreported fishing (OECD, 2005).

² Eurodollar market is a wholesale market for the American dollar that emerged in Europe in the 1950s.
Tax avoidance means that an individual or a firm is using methods that are totally legal to minimize their state or federal income tax, estate tax or gift tax. Individuals, organizations or corporations usually manage this by claiming deductions and credits that are allowed. The tax payers are allowed to do tax avoidance in contrast to tax evasion, which is totally illegal.

Tax evasion can be expressed as an illegal action or practice where an individual or a corporation avoids paying their total tax liability. If these individuals or corporations are caught for evading taxes are they normally charged with penalties and other criminal charges. When these persons, firms or legal entities intentionally avoid their tax responsibility and are caught, may the penalties be quite serious. The criminals can be imposed huge fines and even need to serve prison time.

In order to minimize tax, all taxpayers need to arrange and do some sort of tax planning. Tax planning is a way to incorporate efficient elements in a financial plan in the best possible way to minimize tax that is efficiently from the investor’s point of view. These elements can have many different aspects, including the timing advantage of deferring tax payments and legally arrange the financial affairs to reduce tax more efficiently (Harrison, 2010). The main focus is generally to reduce tax liabilities and make more cash available for other investments and purposes.

This brief look on some of the behaviours of tax havens somehow illustrates tax havens to a certain point, however is it necessary to include some key factors to get a better understanding.

In 1998 “the Organization for Economic Cooperation and Development” (OECD), submitted a report named “Harmful tax competition” (OECD, 1998). In the report is the OECD intending to define a tax haven and explain the difference between a tax haven and an OFC. The OECD identifies four key factors in the matter of whether a jurisdiction is a tax haven (OECD, 1998):

1. No or only nominal taxes.
2. Lack of effective exchange of information
3. Lack of transparency
4. No substantial activities

In addition to this does the report also discuss a scenario where only parts of the internationally tax politics for a regime is included.
The key factors for identifying and assessing harmful preferential tax regimes are as follows (OECD, 1998).

1. No or low effective tax rates
2. Ring fencing of regimes
3. Lack of transparency
4. Lack of effective exchange of information

I will include both lists of factors under the same aspect to not complicate things too much, and I am then adding the “no substantial activities” to the second list. I will also add an extra key factor, “no audit and accounting required”. The reason for adding this factor is because it is a strong indication that there may be something illegal activities going on in the respective jurisdiction. I then will end up with six key factors in order to qualify as a tax haven:

1. No or low effective tax rates
2. Lack of effective exchange of information
3. Lack of transparency
4. Ring Fencing of regimes
5. No substantial activities
6. No audit or accounting required

There are many other factors that qualify a jurisdiction as a tax haven. These factors will be mentioned after a more precise and thorough description of these six key factors.

The first key factor “no or low effective tax rates”, is fairly straight forward to explain. The country or state has a financial structure where it allows low taxes or no taxes for foreign investors. They welcome new investors and new capital and this is often the most obvious indication of a jurisdiction acting as a tax haven.

“Lack of effective exchange of information” is often used as part of the protection of foreign investors in tax havens. Generally speaking, the problem lies in the ability or willingness to cooperate with the tax authorities of other countries. Why do some jurisdictions refuse to give out information? The most evident reason could be that they are actually hiding something. An example would be that a jurisdiction could decide that some relations and transactions between an enterprise and its clients are a business secret, and are put under some kind of protected paragraph in some internationally tax law (OECD, 1998, s. 28). This law or policy could indicate that the jurisdiction is applying a harmful tax competition.
The third factor is the lack of transparency. This factor is about how uncomplicated it is for outsiders to get a clear impression and overlook of the tax regime in a jurisdiction. There are two factors that determine whether a jurisdiction is lacking transparency: The jurisdiction must first state clearly the rules and applicability to taxpayers so that these rules may be invoked against the authorities. Second and probably the most important, must the details and information of every taxpayer be available to other tax authorities in the countries concerned (OECD, 1998). Unfortunately are there many examples of failing jurisdictions that treat taxpayers unequal. One example could be that some tax authorities would set up favorable deals for a taxpayer. Another example would be that the jurisdiction is deliberately implementing a weak tax law that gives the taxpayer an incentive to misuse the law (OECD, 1998). This could be due to and encouraged by corruption inside the jurisdiction, which especially seems to be very widespread and common in non-developed countries (NOU, 2009).

The fourth factor is “ring fencing” of regimes and it can be described as a restriction for those that take advantage of the regime. Foreigners would for example not be able to start doing business locally or even do transactions in the domestic currency (OECD, 1998). This constraint may seem a bit odd, since the foreigners are permitted to establish and do business internationally, based from the jurisdiction. It can however, be expressed as a defensive mechanism as the tax havens may be aware of the effects the tax regime may have, and tries to protect its domestic economy (OECD, 1998). This may seem very contradictory, since they in a way “admit” that their tax policy is a harmful one. The regime is in a way hedging themselves against adverse effects and leaves the possible problems for the countries doing “harmful” business in their jurisdiction.

The “no substantial activities” factor discusses the matter whether there are any requirements for those who are active users of the regime. If there is not any obvious requirement or other mandatory demands mentioned in any laws, then it may seem evident that the foreign enterprises are attracted by the tax minimizing opportunities that the country provides (OECD, 1998). Why should there else be any reason to establish a business section in the tiny island of Cayman? Probably not just because of the good weather.

The last factor which contribute to the description of a tax haven is the “no audit and accounting” element. Tax havens do not have any accounting registers for companies. So if the tax authorities or the investors require or demand to look at these accounts, are they usually not able to find them because there is no where to look. Easily accessed accounts are very
important, both for the owners and the employees. It gives a better picture of the operations and the economic status of the company. Tax havens also do not require any audit (NOU, 2009). If there are any requirements of auditing of accounts are these requirements usually loosely worded and easily manipulated.

There are many other factors that contribute to a successful tax haven. Non-tax factors as a solid infrastructure and a good regulated framework would certainly help. Tax havens are one of the major receivers of direct investment from rich countries. Research has shown that if foreign investments make the use of tax havens more appealing and cost-effective, it is natural to assume that the use of tax havens makes the foreign investments more attractive (Desai, Foley, & Hines Jr., 2006a). There are also been discovered that greater economic and financial activity outside tax havens results in a higher demand for tax havens. A one percent higher probability of establishing a tax haven affiliate is estimated to result in a 0.5% to 0.7% greater profit and investment growth outside of tax havens inside the same region (Desai, Foley, & Hines Jr., 2006a).

The majority of the key factors mentioned as indicators of tax havens, are taken from the OECD report from 1998. Since then there have been some slightly changes. In July 2001, the US government and the Bush administration demanded that the “no substantial activities” was removed from the OECD list (Tax Justice Network, 2007). The OECD committee on Fiscal affairs eventually agreed to not include this factor in 2001, and removed it (OECD, 2011c). One could ask how this was possible, how could Bush pull this through and why was this issue an important matter? The Bush followers were generally all the rich and the religious types from the right side, so that can be one of the reasons why the Bush administration did everything they could to remove it. Empirical studies have shown us that the richest are using tax havens the most (Desai, Foley, & Hines Jr., 2006b). Research has provided empirical evidence that indicates that huge American multinational firms began to establish big operations in tax havens as a strategy to avoid tax. The biggest international companies that tend to use intra-firm trade heavily and have high research and development costs, are most likely to have the highest demand for tax havens (Desai, Foley, & Hines Jr., 2006b). The pressure to remove the factor of “no substantial activities” may then not only be put on by the US government, but also by many other countries and companies that had interests and strong attachments in tax havens.
The current American president, Barack Obama, does not have the same voting mass as Bush and exercises a different type of politics. After the financial crisis was the US in need of money and he announced that he would end the tax breaks for American multinational companies (Donmoyer, 2009). “The US has a broken tax system that is full of loopholes that makes it perfectly legal for companies to avoid paying their full share”, Obama stated. This was indeed met by skepticism by the rich democrats in Congress, but a breakthrough for a possible tax revolution.

Obama passed the “The stop Tax Haven abuse act” in 2009, as a part of the growing tax haven problem. However, there are mixed predictions about this act and it is claimed that countries that are vital for it success are unlikely to agree in fully cooperation (Todero, 2010).

The OECD definition from the 1998 report covers many important factors that somehow express how tax havens works and operates. This is also a good place to start and to get a good and a reasonable perspective of the term tax haven. I will now proceed with some other shorter definitions of jurisdictions claimed to be tax havens.

### 2.2 Other definitions of tax havens

The OECD definition of tax havens illustrates that it is difficult to find one sentence to describe tax havens. Tax havens are not the same, and they compete with each other to become the most interesting and attractive place to put your money (Blanco & Rogers, 2008).

A short search on the internet leaves me with a lot of different definitions and explanations. Investopedia, which is a tool for economical terms, defines tax haven as: “A country that offers individuals and businesses little or no tax liability” (Investopedia, 2011). A short and to the point definition, but does it enlighten enough? An alternative definition could be the one from the “Trend report 2008-2009” of Økokrim: “Tax havens is the term used for countries where it is possible to create corporations without anyone gaining access to corporate ownership and control structures, where there is little or no requirement that companies pay taxes, and where it is also not a requirement for audit” (Økokrim, 2009). This definition is similar to the OECD definition, but it is probably more straightforward in determine what elements that makes tax havens problematic for the financial system.

In the report “Tax havens and development; Status, analyses and measures”, by the Norwegian commission on capital flight from poor countries (NOU, 2009), is another perspective of the term tax haven discussed. The commission has not made a precise definition, but it concludes
that tax havens are a combination of secrecy\(^3\) and has a level of close to nothing or very little taxation. The commission emphasizes that the term tax haven is inaccurate, but is heavily and imprecise used in the media to describe jurisdiction that has low taxes for its economy or for foreign companies (NOU, 2009, s. 14).

2.3 Criticism against the OECD definition and other tax havens

I have now focused on different definitions of tax havens and it is now time to challenge these definitions with different approaches. I will also consider other jurisdictions that could be regarded as possible tax havens.

The OECD of today consists of 30 countries, and the majority of them are characterized as jurisdictions with a high level of wealth (Globalis, 2011). The organization is generally seen as little politically controversial, with a counseling function rather than political. However, it may be argued that the organization is underestimated and has more influence. An independent organization that works with science, analysis and knowledge about tax and regulations, named Tax Justice Network (TJN), is very critical to the definition of tax haven by the OECD on many areas. The TJN wrote on its website about the initiative to classify different jurisdictions as tax havens: “This initiative is flawed, partly because it tends to reflect only the interests of rich OECD countries, and it fails to recognize the role that some of the world’s biggest financial centre’s – notably the City of London and New York – are tax havens” (Tax Justice Network, 2011a). The allegation put towards the OECD that they are neglecting and exploiting the poor countries in favor of the rich countries, would probably not surprise anyone. Whether London and New York are considered as tax havens or OFCs, is a difficult matter to discuss.

A journalist in the British paper “The Guardian”, James Meek, wrote an article in 2006 about why so many rich people tend to move to the English capital (Meek, 2006). “One explanation is that in the past few years London has become, even more than in the 1990s, the world’s conduit of choice for private wealth. Its generous tax treatment of the mega-rich, particularly those born abroad, makes it in some ways a virtual tax haven” (Meek, 2006). It can be claimed that we have some sort of “ring fencing” in London, a leading financial city in Europe. This of course is not certain facts, but still something to keep in mind.

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\(^3\)Secrecy is for example rules and systems that prevent transparency into ownership and the activity in the enterprises, and the possibility of registration of tax free shell companies that in reality are running their company in other countries.
In the report “The Netherlands: A tax haven?” (Dijk, Weyzig, & Murphy, 2006), the authors claim that the Netherlands can be regarded as a tax haven. According to authors and the Centre for Research on Multinational Corporations (SOMO), do all their empirical evidence show that the Netherlands deliberately offers tax reductions on interest, dividends, royalties and capital gains from subsidiary companies (Weyzig & Dijk, 2007).

There may be several things that make the Netherlands so attractive. One reason could be the corporate income tax exemption on dividends and capital gains for subsidiary companies based in foreign jurisdictions. Another could be the Double Taxation Treaty (DTT) that reduces the taxes on dividend and interest between the countries inside the treaty and the Netherlands.

The Netherlands have 20000 “mailbox companies” currently that have no substantial activities in the country. As much as 43 % of these companies have a parent in a tax haven like the Cayman or British Virgin Island. This report implicates quite clearly that the Netherlands are a tax haven.

A report by the Spanish observatory on Corporate Social Responsibility in March 2011, revealed that all the companies listed on the Spanish stock exchange are directly or indirectly connected with tax havens by subsidiaries (Observatorio de responsabilidad social corporativa, 2011). The report highlights 28 Spanish enterprises that have 272 subsidiaries in 27 different tax haven jurisdictions.

These recent reports and the research imply that there might be more jurisdictions that resemble tax havens in contrast to the list of tax havens created by the OECD.
2.4 Tax havens and their characteristics

After looking at the different opinions about tax havens and discussing other jurisdictions that may be possible tax havens, is it now appropriate to discuss the characteristics of tax havens. I will focus on the list of characteristic and the criteria’s provided by the OECD.

The OECD has developed their own list of countries that they consider as tax havens according to their preferences and criteria’s. This list of tax havens is updated from time to time, when for example countries improve or aggravate their taxation standard.

In an OECD report from 2000, a list of 41 jurisdictions where characterized as tax havens due to a list of criteria’s (see table 1 on the next page). A huge weakness with the list is that the membership countries in the OECD are held completely outside. Countries like Ireland, Island, Switzerland, the Netherlands and Belgium are all OECD members, and these jurisdictions are countries that could qualify as tax havens according to the Tax Justice Network (Tax Justice Network, 2007).

The OECD has updated the list of tax havens after 2001, and has also changed their approach towards the evaluation of the tax havens countries. The OECD then started to negotiate different agreements with the tax havens, in an attempt to prevent that these countries would act malicious in tax related issues. The OECD now refers to these countries as jurisdictions that are obliged to improve transparency and efficient exchange of information in tax related issues.

The OECD came with an update of the level of implementations of the international taxation standards done by the jurisdictions considered as tax havens during the G20 summit in 2009. According to the update were a total of 30 jurisdictions considered to not have completely substantially implemented the taxation standard, while 10 were considered to have substantially implemented the treaty.
TABLE 1 OECD original list of tax havens

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<td>American Virgin Islands (2)</td>
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<td>Alderney (2)</td>
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<td>Andorra (4)</td>
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<td>Anguilla (2)</td>
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<td>Antigua and Barbuda (2)</td>
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<td>Aruba (2)</td>
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<tr>
<td>Cyprus (3)</td>
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<td>Liberia (2)</td>
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(1) Was later removed from the tax haven list
(2) Is now identified as a cooperative jurisdiction
(3) Was already identified as a cooperative jurisdiction before 2000
(4) Was identified as non-cooperative jurisdiction until April 2009

In 2009, another three jurisdictions where excluded from the list and the number of tax havens went down to 38. A new report was launched by OECD in February 2011 and it stated that only 6 jurisdictions were characterized as tax havens, and three other financial centres had “committed to the internationally agreed tax standard, but have not yet substantially implemented” (OECD, 2011a). There was now not a single tax haven left according to OECD. The campaign to transform the tax havens had taken a positive turn, and it seemed like the OECD eventually was able to cooperate with the tax havens instead of fighting against them.
The OECD consists mainly of wealthy and developed countries as written in the previous part of the chapter. Many of the companies situated in these membership countries have subsidiaries or even parents in tax havens. Recently was it confirmed that 20 of the biggest companies in Britain were operating more than 1000 subsidiaries located in tax havens (Holmes & Hawkes, 2011).

Empirical evidence provided by Peter Schwarz in his article “Tax-Avoidance Strategies of American multinational: An empirical analysis”, claim that American multinational enterprises have huge benefits from using tax havens both for their American parts of the companies and their European subsidiaries (Schwarz, 2009). His research also concludes with that their income is higher due to the profit shifting, for example by retaining more income in the tax havens and using mainly debt for financing the subsidiaries in countries with higher tax (Schwarz, 2009).

In relation to the many subsidiaries found in tax havens owned by multinational companies, may it be assumed that there could be a need for longtime protection and control of these economical interests. One could imagine that this could be done by a collaboration of the rich membership countries in the OECD. However, this is hard to prove since the OECD and its membership countries would not release such information of a common interest in removing countries and cut down the tax havens list.

Since the OECD is currently updating and reducing their list of tax havens is it important to consider other criteria’s and measures to define tax havens. Often can rumors be enough to justify a tax haven. If somebody states that an island or a place is a tax haven, others may be convinced to believe the same. “The rumour criteria” can be explained as if others perceive a jurisdiction as a tax haven or if the jurisdiction presents itself as a tax haven, and then the jurisdiction is a tax haven. The OECD used this rumour criterion in a report from 1987 (OECD, 1998). It is also commonly used by the Tax Justice Network (Tax Justice Network, 2007).

The Tax Justice Network uses a wider and broader definition that also covers regimes with harmful preferential tax regimes (Tax Justice Network, 2007). Their list of jurisdictions classified as tax havens therefore includes more countries than the list of the OECD and examples of these countries are Switzerland, Singapore and South Africa (Tax Justice Network, 2007).
2.5 “Which countries become tax havens?”

Another interesting matter to discuss is the reasons behind the birth of a tax haven. Many smart investors, companies and others are searching for the cheapest and best ways to make a profit. However, are there certainly also other reasons for the taxation differences between countries.

Dharmapala and Hines published an article in 2006 with the title “Which countries become tax havens?” (Hines Jr. & Dharmapala, 2009). In this article the authors investigate tax havens and finds similarities between them (Hines Jr. & Dharmapala, 2009). They also focus on the reasons of the creation of tax havens. In their research they have excluded 9 countries from the OECD list, and included 8 other countries instead. Comparing their preferred list of tax havens with other countries and territories, did they found out that tax havens tended to be small countries with small territories. They also noted that tax havens had higher GDP per capita compared to other jurisdictions (Hines Jr. & Dharmapala, 2009). In addition to this, has their research discovered to a certain level that tax havens had less nature resources, used English as an official language and had a homogeny population.

What has been clearly in the data, but not mention in the literature is that tax havens are achieving high scores in the measures of political stability, government effectiveness, rule of law, corruption control and measures of voice and accountability. In fact are there almost no badly and poorly governed tax havens due to statistics provided by Hines Jr. and Dharmapala in their article (Hines Jr. & Dharmapala, 2009). What can the reasons then be why more well-governed countries become tax havens? One factor could be that the returns may be higher in better-governed countries than in poorly. Foreign direct investment and the economic benefits that are included are more likely to involve tax benefits and reductions in better-governed countries than in worse-governed and poor countries (Hines Jr. & Dharmapala, 2009).

It is also claimed that tax havens are totally unsuccessful without high quality governance. The data also indicates that most tax havens are small countries, often less than one million and that the countries have smaller natural resource endowments than other countries.

In order to reveal the activities of tax havens is it necessary with a competent and functional taxation system (NOU, 2009). Developing countries are often lacking of resources, knowledge and capacity to construct and maintain a functional civil system, so they usually have a less efficient taxation system than in richer countries. This often leads to more tax evasion (NOU, 2009). In addition to this, are many of these countries experiencing difficulties
with corruption. The tax evasion as a crime is then often regarded as a minor offence in these developing countries.

If one challenge people to reflect on the term tax haven, would many probably state that the term reminds and make them think of remote exotic islands perfectly set for a retirement. This could probably also be a description of some of those countries that become tax haven.

This chapter has focused on explaining the basics of tax havens and the different definitions available to describe them. I have also shed light on some of the reasons for the birth of tax havens. The next chapter will focus more on the currently corporate structures used in tax havens.
3 Corporate structures and their use in tax havens

I will now change the focus to the general inner laws of tax havens - how tax havens are run and the advantages they have. I will then continue with the most usual corporate structures used in tax havens, and try to compare these structures with other structures used in jurisdiction regarded as non tax haven countries according to the OECD.

3.1 Tax haven in practice and the financial use

There are a set of secrecy legislation in tax havens that provides security for companies using these jurisdictions. The confidentiality serves the foreign company in a way that the financial or other information exchanged between the company and the tax haven, cannot be sent or shared with a third-part. This is a part of the protection that a tax haven is claiming to provide the client. This secrecy is probably what attracts most investors and their capital to tax havens. It is almost impossible to find and extract information about the company for the stakeholders (NOU, 2009, s. 29). The only way to access information is through a legal request, and this is often just given under very strict conditions. This makes the process of collecting economical information especially difficult. In some cases, where one may encounter something of interest, can it then be very difficult to get any closer to the information hidden in the accounts.

In order to make the right decisions does a decision maker need to have complete information. Transparency in the markets is important, so that decisions makers can operate and work in the best possible way. It is important to know who owns and runs the companies (NOU, 2009, s. 31). For example should all accounts be published and the audit should be done externally.

The tax havens on the other hand have made rules for companies that are not doing business in their jurisdiction (NOU, 2009). Those who are in need of this information are the companies and jurisdictions in other countries. Tax havens do not care about the outside need for information, and have designed systems that make the sharing of information about ownership and the business optional for the owner of it (NOU, 2009, s. 31).

The secrecy part makes it possible to hide the identity of the owners, their assets and their equity. The secrecy legislation also provides the possibility to hide and cut off the connection between a given start and end of a transaction. This feature makes it rather impossible to control how and where the asset originated and if it is legally obtained. It is the same with
securities in the financial market. Securities are favourable tools to for example hide information about transactions and to succeed with money laundry.

The tax havens concentrate a lot in appearing more appealing and try to facilitate the conditions as much as possible for their clients. Reporting is minimal and the statutory obligation is often non-existing. If the audit and accounts need to be presented, are there no clear requirements on the whereabouts of the documents and the period of time they need to be held or available. This makes it even easier to avoid any guilt if a company based in a tax haven is found guilty in any crime, or even be put in front of a court.

3.2 Corporate structures in tax havens

There are offered many different corporate structures in tax havens. Some of them are applied more than others. I will discuss the corporate structures that are most likely to be found mostly in tax havens and try to investigate if there are similar structures used in non-tax haven countries. To be able to understand the functionality of the structures is it necessary to explain some fundamental parts of finance that involves these structures, and I will start with derivates.

3.2.1 Derivatives

Tax havens are an important part of the many transactions done in financial markets. Especially when it comes to securities like derivates have tax havens proved to perform a very convenient role. The secrecy and the other financial advantages offered in tax havens make it easier to exercise and design structures that tricks both rating companies and potential buyers.

Today are derivates commonly used by banks and customers worldwide. A derivate is according to the investorworlds.com: “A financial instrument whose value depends upon the characteristic and value of an underlying, typically a commodity, bond, equity or currency.” (Investorworlds, 2011). There are many different types of derivates that provides different financial benefits. Some of the most popular and adopted ones are swaps, options and futures. Investors use the different types of derivatives if they for example want to: Speculate in the underlying⁴, hedge risk in the underlying, increase leverage or create options. One could describe it as an alternative investment tool that is frequently used by the brokerages, bankers and other investors.

⁴ Underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying can be a price/rate of an asset/liability, but it is not the asset/liability itself (FASB Statement of Financial Accounting Standards No. 133 (FAS 133))
The use of derivatives has been one of the most important financial inventions the last 10-20 years. Since the early 1990s, have brokers and others working in the financial sector developed and designed many new instruments or products, as they are called. With a boost of new products have also new financial institutions emerged every year. Some of these new financial companies introduce new products that promise to secure the customer against potential loss.

A range of different credit derivatives have been heavily used by customers lately and have gained a lot of popularity. Credit derivatives are securities or bonds with a price that is dependent on underlying asset. There are many different credit derivatives to choose from in the marked. Some are called structured savings products and other are called structured investment products. Some examples are Credit Default Swaps (CDS), Structured Investment Vehicles (SIV), Collateralized Debt Obligation (CDO) and Asset Backed Security (ABS). The many names may create some confusion, but the main investment goal for all credit derivatives is to hedge against loss in case the debtor with the mortgage goes bankrupt or breaches the loan.

There have been argued that a credit derivate works in many ways as an insurance paper. There have also been argued the opposite. “Credit derivatives are not insurance” is the title of an article published by M. Todd Henderson (Henderson 2009). He believes that it would be wrong to “...argue that every contract in which a party could be said to reducing its risk and another party was willing to take on some of that risk is or should be called insurance” (Henderson, 2009). The insurance regulators had to regulate all types of swaps, options and many other contracts if this was indeed the matter. Generally it could seem like all sorts of contracts involves a bit of risk. To exemplify how credit derivate works, I will use a CDO and a CDS as examples.

A Collateralized Debt Obligation (CDO) is an instrument backed by an underlying portfolio with one or more securities, bonds or other assets (Rakkestad & Weme, 2006). Usually is a special corporation in charge of the financing of the underlying portfolio by issuing debt securities. These special corporations have many different names. “Special Purpose Vehicle” (SPV) and “Special Purpose Entity” are two names commonly used for these corporations. The SPE and SPV are also often referred to as “shadow banks” or “ghost corporations” throughout the media (The Economist, 2010). The PIMCO Manager Paul McCulley define shadow banks as “...entities that fund illiquid assets with short-term liabilities and yet remain
outside of the banking regulation” (Hsu & Moroz, 2009). The term shadow banks includes hedge funds, private equity groups, CDO structures and other similar entities. It is important to keep in mind that these shadow institutions are usually created by the banks or companies that are using them when they need them. To illustrate visually, can one imagine shadow banks as an institution with no employees or assets until for example a deal is struck between an investor and a corporation. The ghost corporation could then work as a provider and channel the money between the investor and the corporation.

If the bank should be able to remove the claims from the accounts, the SPV or SPE needs to be formally independent. To be able to fulfill this are the entities often created as subsidiaries of a given corporation. As many of the biggest corporations nowadays use the tax havens for financial reasons, they use them for setting up these shadow banks (Tavakoli, 2003). Today, many of these shadow banks are placed in tax havens like Bermuda, Cayman, Ireland and Jersey where it is easier to for example manipulate accounts and use the “benefits” that these financial centres provide. By selling credit derivates of a SPE, the bank is removing risky derivates from their asset inventory and “cleans” their balance (The Economist, 2007).

The CDO often have multiple tranches with different degree of risk and return to meet the demand of the investors. There are usually three different tranches: Senior tranche, Mezzanine tranche and a Junior or Equity tranche. The Senior tranche often has the highest rating, AAA, provided by the rating agencies such as Standard & Poors, while the Mezzanine is often rated BBB (Rakkestad & Weme, 2006). These ratings give the investor an indication of how solid the CDO is. Adding all the tranches together and we have the capital structure of the CDO.

A CDO can be explained as a promise to provide payments based on the cash flow earned from the pool of bonds, securities or assets it owns. However, the instrument has its constraints. If the CDO is unable to pay all of its investors, the ones in the lower tranches suffer losses first. Both the high ratings provided by the ratings agencies and the different tranches separating the CDO were huge contributors to the financial crisis that started in 2007 with the sub-prime mortgages crisis. I will return and elaborate more on this topic in the next chapter.

An illustration of the structure of the CDO can be found on the next page.
Source: (Excel your risk and finance career, 2011) and added extra details.

The banks acquire many advantages by using CDOs. A bank could for example sell its assets or loans to a SPE and it would then be able to remove the assets from the balance sheet. The banks do not need to have coverage for these loans in equity and deposits when the loans are transformed into CDO. All the loans from the banks disappear from the balance, and the banks do not need to put the loans against its own equity on the liabilities side of the balance. This makes it possible for the banks to create unlimited credit.

This transfer of risk is another huge advantage (Excel your risk and finance career, 2011). The risk transfer can be explained like this: The investors buy securities that represent different tranches that are arranged so that the banks are able to hedge and transfer credit risk (default risk) to the investors (Excel your risk and finance career, 2011). In case of a default, investors in the lower tranches may be obliged to take the losses, while the banks are secured.
To summarize one can argue that there are three motives to use CDO for the banks: Transfer risk to the investors, monetizing by receiving cash and shrink down the balance sheet. Then why does the investor invest in CDOs if it has so many benefits for the banks? They might enjoy high yields if they dare to take the risk.

Another commonly known credit derivative is the Credit Default Swap (CDS). This is one of the simplest and most basic credit derivatives on the marked. One way of looking at it is to consider a swap contract agreement where the investor pays a CDS fee or spread for protection to the protection seller (Chander & Costa, 2010). It is a contract where the lender can protect himself against risk of default by paying for premiums to a third party or speculator that agrees to cover the lender in the event of default by the underlying borrower (Henderson, 2009). The borrower may default on the loan and both the speculator and the lender would then receive payment. The lender would always be protected by the CDS, while the speculator can only earn profit if the borrower defaults.

When the loans are transformed into CDS is the original lender insuring himself completely against breaches of the loan and can continue to offer new loans.

I have now explained how some the most commonly credit derivates with relations to tax havens are applied. I will now concentrate more on some of the most used corporate structure used in tax havens.

3.2.2 IBC and PIC

Tax havens offer many different types of corporate structures. Some of the most common companies are those that are not suppose to engage in any form of economical activities in the tax haven. These structures are called different names and some of them are known as International Business Corporations (IBCs), Personal Investment Corporations (PIC) or “mailbox companies”. The main advantages for applying these corporations are because they enjoy low or non-tax liability and often escape the need of audit. The secrecy rules allow them to keep an even lower profile. It is nearly impossible for an outsider to get any inside information. If a banker reveals any information about a customer is this regarded as a criminal offence. The assets of the customer are also protected from any political or economical crisis in the home-country of the settler (Mercantil Commerce Bank, 2011).

The only requirement that tax havens usually put on the foreign companies that wants to use the tax havens, is that they are not allowed to do business in the haven that provide the
mailbox and the shell. It is notable that many of the banks that offer these structures have their headquarters in non-tax haven countries like the US (Mercantil Commerce Bank, 2011).

3.2.3 The structure of the PCC and the ICC

Another structure used in corporate finance is the Protected Cell Company (PCC). The PCC is a flexible structure that provides a cost effective platform of transactions operations. In general, were the cell structures introduced for use in umbrella investment funds⁵ and to support the management of investment pools (OGIER, 2009).

The structure was first introduced in the 1970’s in Bermuda, but it was not before Guernsey in 1997 started to actually use it, that it started to become very popular (Willis, 2008). The incorporation of PCC regulations in the last couple of years in Barbados, Bermuda, Malta, Isle of Man, Gibraltar and in many states in the US, illustrates the huge development that has happened in this market. Today in the US is the PCC used mainly for domestic insurers as a means of accessing other sources for capital and benefit from insurance securitization. There are many states like Illinois, Iowa, Rhode Island, South Carolina, Vermont and Delaware that allows for the PCC structures (National Chengchi University, 2011). Delaware was along with Guernsey the first to introduce the use of PCC structures and they applied the Series LLC legislation (Feetham & Jones, 2010). The series LLC can be explained as a type of a limited liability company that provides liability protection between multiple series (Limited liability company center, 2010). Each series can have different economic structure, management, assets etcetera. Each of these series is protected from liabilities arising from other series. LLC are often formed to protect personal assets from legal claim that can be related to business liabilities (Limited liability company center, 2010). This LLC legislation has been approved in even more states like Texas, Utah, Tennessee and Illinois. This shows that the expansion of the phenonomen has strong links to PCC activities.

The PCC structure is used more widely in the financial sector and in business services. It is especially used in multi-series asset backed securities issues and in structured equity products. PCC owned by the banks are also used as SPV to secure transactions (National Chengchi University, 2011).

The PCC has many different names: “Segregated account company”, “segregated portfolio company” or “segregated cell company”. The PCC also operates almost identical to the

⁵ Umbrella Investment funds can be explained investment with many different sub-funds in a single entity that is traded as an individual investment fund.
insurance structure called “rent-a-captive”, which is gaining more and more popularity after the financial crisis amongst corporations around the world. I will discuss the term rent-a-captive later in this part of the chapter.

In simple terms, the structure of the PCC can be described as a single entity with a core and a number of unlimited parts or cells that are segregated from each other. Each of these parts is legally independent and is held separated from each other and the core of the enterprise.

Each of the parts has its own name, and their financial activities can be seen as totally isolated from each other. If one part experiences any type of financially problems, then the creditors can only claim the assets of that particular cell.

The core itself consists of general assets or also known as “non-cellular” assets. The core can for example be share capital (Corporate options, 2012). While the cellular assets consist of assets attributable to the cells (so-called cell assets), the non-cellular assets are other assets and attributed to the core (so-called core-assets). The cells are in this way created by the core, and each cell is independent and protected from each other. The cells may consist of a property, an aircraft or another business (Corporate options, 2012).

There are many ways to design possible structures, and the structures are tailored to the needs of the company or the person. I will continue by explaining more about the technical and general characteristic aspects of the structure.

As the PCC is separated into two parts, the PCC also operates in that way. The core of the PCC provides each cell with separated services. The new cell owners pay little in establishment costs and they only need to provide risk capital. The core itself transfers the minimum capital requirements to each cell. The PCC as a whole, including both the core and the cells, is regarded as a single entity and this single entity only prepares one account that is audited and shared with the tax authorities. This aspect of audit makes it easier to hide and design an account in line with the preferences of the owners.

The figure found on the next page illustrates the structure of the PCC.
The legal separation makes it possible for each cell to do business as it suits them, without being worried about or affected by the dangers of possible losses due to the financial activities of other cells. Should for example one cell experience insolvency, will the creditors only have access to the cellular assets of that certain part, but in some cases also to the non-cellular assets of the core (Willis, 2008). If the assets of that particular cell are insufficient to cover the liabilities, the creditors may demand something from the non-cellular assets of the company.

The PCC has no limits regarding the number of cells involved in the structure. The number of cells has the potential and opportunity to grow and increase infinite (National Chengchi University, 2011). The structure provides segregation between many subsidiaries and parent companies, and new and additional companies may be incorporated and added without complications. There are also ways to convert a PCC company to a conventional business, or convert ordinary companies to a PCC company (National Chengchi University, 2011). There may be some companies that suddenly want to segregate their operations into different classes of business. This could be to keep the funds for short term investments and for long term investments activities separated from each other.
The core itself has limitations on the changes of core capital, which is different from each cell. Each cell has flexibility in capital. However, this capital has its constraints and it may be considered more as a guarantee fund. So if there are changes in the company, the capital may be changed with the approval of the core (National Chengchi University, 2011).

The main advantages of the structure may be argued to be the protection that each cell has, both financially and legally. Insolvency of one cell cannot affect the performance or business operations of any other cell or the entity as a whole. Another huge benefit of a PCC is the reduced costs of the designing and running the PCC compared to a more traditional company structure (Corporate options, 2012). It can be added that the PCC only submits one account for the whole structure. These characteristics make this structure a popular invention for both huge corporations and private investors. It is however important to keep in mind that the PCC is in general mostly allowed in tax havens. This is due to the fact that the PCC takes risk and isolates valuable assets used to take risk and then limiting their liability beyond what the majority of jurisdictions consider to be reasonable.

In order to uncover anything from behind the core is a court ruling needed. If one should succeed in obtaining the right to open up the core it is still necessary with a court decision for each cell individually. This may be very time consuming and occupy a lot of resources, and in many cases proves to be almost impossible to gain any information from the structure even if a court decision is obtained.

The PCC is applied in many different financial areas, but the main using areas of the PCC can be categorized into three purposes: captive, collective investment schemes and special purpose vehicle (National Chengchi University, 2011).

**The first purpose**, “captive”, is commonly used in tax havens. One type of these captives, called “rent-a-captive”, operates and functions on the same basis as the PCC. I will go through the term “captive” and discuss some different types of captives to be able to clarify the similarities between the rent-a-captive and the PCC.

The financial term captive can be defined “as an insurance subsidiary of a company designed to insure or reinsure possible risks of its parent company” (LLC, 2011). The captive is not an entirely new concept, it has been around in the world of finance since the early 1900s. It all started with many captives that were formed by groups that pooled their risks together, and then obtained better combined terms and deals than the conventional insurance marked. This
was and is still a good solution for corporations that are in need of flexible and stable insurance deals where the ordinary insurance company cannot offer similar terms.

One can evaluate the formation of captives as a reaction to the unfairness felt by many companies and investors. Many felt that the insurance companies were demanding too high premiums and wanted to avoid administration costs (LLC, 2011).

There are several types of captives. A “single parent captive” is a company with one single owner to whom they offer insurance. The risk manager from the parent usually keeps an eye on them and a domiciled captive insurance manager has control of the captive.

Another type of captive is the “industry captive”. These are structures that are controlled by companies in the same line of business that have come together to fix an insurance problem. The stockholders normally create a board of directors that the management of the companies has to report to.

“Association captive” is a captive designed by a trade association of an industry to be able to offer insurance for the members. One example could be medical risks that are often insured this way. The responsibility of this captive usually lies in the hands of a financial expert from the association or with a captive insurance manager. This captive has been successfully operating for many years (Willis, 2008). However, has the structure somehow shown to be difficult to advert and sell. This is mostly due to the reluctance of the customers to share risk and information between corporations or private investors that meet in direct competition with each other (Willis, 2008).

The “rent-a-captive” is the captive that resembles the PCC in the best way (Willis, 2008). The design of the “rent-a-captive” allows the participant to “rent” an infrastructure of a reinsurance business. The user needs to pay a cost for using the captive and is then required to cover with some sort of collateral so that the “rent-a-captive” is secured against any underwriting losses caused by the user. The participant does not need to create his own captive and this enables him to take on own risks with a self-insurance instrument that is flexible and convenient (Zurich Continental Europe Corporate, 2002). The owner of the PCC can provide rent-a-captive services with additional features like the segregation of assets and liabilities between different cells (Willis, 2008). The main difference between a rent-a-captive and a PCC is that the PCC entity allows the users to keep their funds from other renters in the captive as long as the owner of the “rent-a-captive” is solvent.
The figure below shows the general structure of a rent-a-captive.

**Figure 3 Rent-A-Captive**

Using captive structures like the “rent-a-captive” can prove to have many advantages. The cash flow advantage makes the user able to time premium payments to work out with its current cash flow situation. The reinsurance opportunity is easier to obtain at a much lower cost without any additional fees. A more directly access to the reinsurance market can result in more successful underwriting that creates a surplus in the captive (LLC, 2011). The parent company can then manage to lower the need for reinsurance and increase retentions. The concept of the rent-a-captive has been widely and successfully throughout continental Europe and the model is starting to gain more popularity in new developed markets (Willis, 2008).

Source: (Zurich Continental Europe Corporate, 2002) and added extra details.
Different tailored solutions provide flexibility that increases risk management control and this is especially convenient for multinational corporations and their shareholders. For many corporations are the captives the only way to insure goods like hazardous products or waste, environmental pollution, war risk or devaluation. This coverage may be highly priced or totally unavailable in the common market and only offered in tax havens. Using captives also provides a more stable price without fluctuations and risks in the event of market cyclical changes.

The captive produces investment income on capital and premiums during the period when losses are paid out. It is certainly a huge upside to save the investment income and the profit that went away to the insurance companies before. There are some operating costs using captives, but the expenses are nothing compare to using ordinary insurance companies. The tax advantage also adds up to the cost reduction. The level of tax paid depends on the location of captive. Many of the tax havens offer no corporate taxes, premium taxes or income taxes which cut the cost even more (LLC, 2011).

Insurance companies often demand minimum capital and solvency margins, certain ratios of premiums according to net assets and sometimes also restrictions on investments. Corporations using captives may reduce the regulations and restrictions that are imposed by government. Some companies doing international business might experience problems with transfer of dividend payments due to national exchange control restrictions. Using a tax haven to setup a captive insurance can be beneficially for the user and can reduce the regulatory problems.

All in all, is a captive a good solution for companies that are fed up with the traditional insurance market and wants to take advantage of risk transfer and cash flow opportunities. A captive gives a much greater degree of control than the ordinary insurance company can provide.

More corporations start to search for new strategies to handle risk after the global financial crisis started to calm down in 2009. Captives are increasingly taking on a broader and more important role of companies risk management strategy (Captive Review, 2009). This is a structure that has been heavily used in tax havens for a long time. The structure is now being legalized in more and more states in North America, and this is probably a trend that will continue out in Europe (Captive Review, 2009). Could this be a start of integration of tax haven principles? It is striking that the approval of the rent-a-captive may introduce the
approval of the PCC structure in North America and European countries without tax haven semblance, due to the similarity in functionality between the two.

In addition to the similarities of the rent-a-captive, the PCC also provides many other different mechanisms and services. I will now mention a few different uses off the PCC as a captive.

Life insurance is a fast growing business, and the PCC can offer the insurance companies to segregate the pension, the assets and other funds. Insurance companies based in tax havens provide added protection to policyholders (Willis, 2008). Using different cells for individual product or policies ensure a decent segmentation of risk. If a user of insurance decides to include general business and become composite, is the PCC allowed to do this without any separate insurance.

The PCC can also provide insurance trading, where preferably an association with members that have common business interests may be able to access insurance arrangements that provide better prices than in the normal market. This is very similar to the “association captive”. At the same time does the PCC offer full legal protection for the assets of every individual member, by placing these in separate cells.

The restructuring of global insurance programs is also possible with the PCC. This is done through a similar captive operation, where captive capital can be provided by a subsidiary instead of by the whole group. The segregated risk information that is available can be applied to identify needs of risk management (Willis, 2008).

The PCC can also serve as an insurance or reinsurance company where the clients are provided with the services by the insurers or the reinsures (Willis, 2008). The structure can also be designed as a reinsurance company where finite reinsurance deals and contracts of securitization that can be appointed separate cells.

Another used purpose of the PCC is the “collective investment schemes”. **This second purpose** can be defined as financial activities where the investing goal is to spread investment risk and provide shareholders of the company the benefit of the profits arising from the management of its funds (MITCO, 2011).
These collective investments schemes are regulated and are operated through a company or a trust. The structure of a company could be a simple investment group or a PCC structure that provide different cells for individual classes or sub-funds. PCC are operated as investment funds, while these collective investment schemes are suitable for the operation of many funds simultaneously, using each cell as a sub-fund like the umbrella funds. To exemplify, one could imagine a sponsor that designs a multiple series fund by using a PCC, where each cell represent different types of investments and where the distinct series are offered to the investors of the fund.

However, there are certain constraints and rules to follow for the users of these schemes: The users do not have daily control and access to the management of the property. The property itself is managed by the company or by an investment manager and under this condition, the payments made by the users and the profit made are all pooled (MITCO, 2011).

The third purpose of the PCC structure is as a platform for Special Purpose Vehicle (SPV) and that includes those transformer vehicles that support securitization transactions. These transactions can be carried out by the PCC issuing bond or other debt securities where the repayment is covered by the profit from the investment of the PCC.

Using and structuring the SPV as a PCC can provide some huge advantages for the investor (Willis, 2008). It can provide the investor with the possibility of being able to segregate between the different classes of investors. To exemplify, can one imagine an investor that is extremely risk-loving that would want to risk both coupon and capital in exchange of the highest possible return. While other risk-averse investor would just want to risk their coupon and keep their capital secured by paying for capital protection. The legal segregation of cellular assets is more important in the area of the SPV than for the vehicles of the rent-a-captive.

There are many advantages of the PCC function and operating as a transformer for segregated SPV facilities. The main advantage is all the experience that is gathered and put together while the costs for licenses, control and operation of each facility is reduced to a minimum. The expertise and the experience of many different SPV are then providing a more powerful

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6 A trust is a collection of assets where the formal owner has agreed to manage the assets for the benefit of the beneficiaries of the trust (NOU, 2009).

7 Some structure products offer capital protection. The bank would then put an amount a side of the investment and place it to a risk-free rate at the time needed to be able to payout the required sum.
structure than just the experience of one corporate vehicle (Willis, 2008). The PCC is already operational and ensures for example lower cost and exit entry than a single company for a SPV transaction (White Rock, 2007). The use of PCC as a SPV may facilitate the translation of the market transactions of capital into insurance transactions. Or the use of PCC as SPV may serve as risk transfer for securitization of the future income (National Chengchi University, 2011). The tax reduction and general cost reduction due to the location in for example a tax haven, make the PCC a very popular platform for many investors.

There are many other popular corporate structures apart from the PCC structure. Another almost identical structure is the Incorporated Cell Companies (ICC). The difference between the PCC and ICC is that the ICC has a different approach to the cells than the PCC. The ICC incorporates the cells as separate and individual legal entities. However, are all these cells dependent on the cell company which is controlled by common board members (OGIER, 2009). To summarize, one can say that in an ICC is each cell a separate corporate entity, while in the PCC structure is not each cell a single corporate entity and has no separate identity (OGIER, 2009).

The PCC and ICC are structures that provide a lot of advantages for its users. Their services can include trustable ring-fencing of cellular assets and liabilities. There are potential cost savings available due to the opportunity to reduce administrations and statutory fees. It is also easier to treat each cell according to the laws of the company. The two structures also provide the advantage that cells in the company may be able to invest in other cells in the same company (OGIER, 2009).

3.2.4 The trust structure

I have now mentioned and discussed two of the most common structures used in tax havens. I will now go through another very commonly used structure found in tax havens: The trust structure.

According to the The Government Commission on Capital Flight from Poor Countries is a trust “... a collection of assets where the formal and legal owner of the assets (the “trustees” or managers) have agreed to manage the assets for the benefit of those who, according to the basis for establishment (the foundation agreement) are designated as beneficiaries of the trust (owners)” (NOU, 2009). The new trustees have then the obligation to follow the rules set by the owners. The rules are typically about how the asset should be handled and controlled. The
trustees then temporarily acquire the assets and are then legally the owners, but there are many ways to adjust the trust so that the beneficiaries are ending up with acquiring exactly what they demand.

The illustration below shows the connection between the parties involved in a trust.

**Figure 4 Trust structure**

Source: (Morrisey, 2008) and added extra details.

In order to make sure that the trustee is keeping his part of the deal and do not break the agreement, the settlor may hire middle men or so-called “protectors” to instruct the manager of the trust (NOU, 2009). Another way could be to introduce secret agreements that allow the
beneficiary to control the assets. Then the original owner still controls the asset, although the funds are not a part of his personal wealth (NOU, 2009). The original owner is not liable for taxes on the funds, and he cannot be held to account by creditor if the trustee goes bankrupt. For this position, the manager of the trust receives a wage for holding the formal ownership and due to his working hours.

There are many advantages with trust-structures, but the main advantage is the difference between legally and real control over the assets. If the manager of the assets is living in a tax haven, will the assets be taxable in the tax haven, even though the beneficial is living in a country with normal taxes. The creditor may not be able to demand anything from the settlor, since the manager of the assets is the formal owner of them. If the beneficial is to receive anything from the trust, may they be taxed on these assets and the creditors may demand something. However, it may be difficult for the tax authorities to reveal the true beneficiaries that receive the funds. Usually do the beneficiaries have advanced systems to avoid the spread of information to the creditors and other searching for illegal transactions.

3.3 Tax haven in traditional use and in new use

One of the main reasons for using tax havens is the opportunity to turn and remove parts of the taxation from high tax countries to tax havens with low corporate taxes. This is the most obvious reason and there are many techniques and financial designs to reposition the taxation of companies.

One commonly used technique is transfer pricing (NOU, 2009). For a multinational company there are two methods that are applied to be able to transfer gains from a high taxation jurisdiction to a low taxation jurisdiction. The first method used, is to overprice transactions from countries with low taxes to high-tax countries. This strategy will increase the taxable gain in the low tax country and decrease the taxable gain in the high tax country. One type of transfer pricing that is growing and is getting harder to spot and recognize, is the transfer of rights to intangibles (Gravelle, 2009). Considering a patent that is developed in the US and licensed to an affiliate in a country with low taxes, then the income will be transferred or shifted if the payment is lower than the true value of the license. When putting a price on goods are there usually many substitutes or methods that can be utilized to determine if an appropriate price has been set on the goods. These intangibles, like for examples the new patents on drugs, tend to have no similar goods to compare prices with and it is then difficult
to measure an appropriate price. Newly invented intangibles have the potential to cause major transfer pricing problems.

The second method used involves structuring the balance sheet to reduce tax. The company could for example create subsidiaries with debt financing, and then locate them to a high-tax country. At the same time, could the company finance the subsidiaries in low tax countries with equity (NOU, 2009). Initially the banks are financed by equity and then the banks lend money to companies in the same group, but these companies are then located in countries with high tax (NOU, 2009). Many multinational companies prefer this method and it is often applied. The multinational company receives tax deductions on its debt in the high-tax countries when applying this strategy, and it usually does not pay taxes on the profit made internally.

Some multinational companies also create an intermediate firm or a conduit entity in a third country that owns the subsidiary. This entity then functions as an intermediary between the company and the subsidiary in the transactions. This design opens up for more transactions options. The entity could receive equity and transfer these funds as a loan to the subsidiary, or it may receive a loan from the parent and transfer this money as equity (Mintz & Weichenrieder, 2010).

It is clearly that the tax preferences of the different financing arrangements will depend on specific tax rates and system in the three countries involved. One example of tax reduction that has been heavily discussed is the “double dip situation”, where the interest deduction is used in two countries. This could happen if the parent company pulls out a loan and inject this loan as equity into a conduit company, while the conduit company forwards this money as an intra-company loan to the affiliate. Carrying out these transactions and both the parent of the multinational company and the affiliate, may use the tax deduction of the interest on the loans. In addition, the tax on the interest received by the conduit may be low if the conduit is located in jurisdiction with low taxes (Mintz & Weichenrieder, 2010). It seems like a sure thing that tax havens in particular have many advantages as being part of a design like this.

The development of internet and electronic commerce has opened up for new offshore sectors. A business that converted to start handling most of its operations offshore is the online sex business (Palan, 2003). It is known that 1.5 % of all international phone traffic is categorized as telephone sex and it generates approximately 2 billion USD dollars a year (Palan, 2003). The core of this business is the international system which ensures that both the
country that makes the international call and the country in which it terminates, share the profit between themselves. This makes it possible for small developing countries to benefit if it can manage to a lot of incoming traffic of phone calls. One example of this system could be the small islands of Niue and Tuvalu in the pacific. These islands have leased their numbers and codes to big international firms that re-route online sex through these small countries. The origin of the customer that calls is hidden and the system provides the customer with anonymity. In other words, where these phone calls origin is unknown, but for the profit and because of the system itself are these phone calls set to originate in these small islands. Then the island of Niue shares the revenue from these calls with the big companies. This system provides the small countries and preferable tax havens, to earn huge amounts of money.

Another small country in Latin America, Guyana, has also benefited from this phone service setup. In 1991 was the public telecommunication operations (PTO) in Guyana sold to an American company. After this did the volume of incoming calls increase from 23.8 million to 139.7 million in 1995 (Palan, 2003). The revenue also increased to 130 million dollars that was equivalent to approximately 40 % of the total GDP of the country in 1993.

Another offshore industry that is increasing massively is the online gambling. The total value of the online gambling industry grew to an impressive 29.8 billion dollars in 2010, which shows the magnitude of this business (Solomon, 2011). It is a fast growing industry, and it is primarily set up and located in tax havens. Companies simply use the benefits of tax havens and use it as a base and offer their services on the net.

In the US has the US WIRE act managed to convict American gambling companies located in jurisdiction known as tax havens. British companies like sportingbet.com continued to offer their gambling services to American citizens until 2006, when the US passed a bill that denied banks from transferring money from US customers to online gambling sites (Debrebant, 2009). However, are still online companies from countries apart from the US using tax havens as their headquarters, due to their national laws that say that the transactions take place where the web servers, the risk management and payment are located (Palan, 2003).

Canada is a country that is in strong contrast with the US in terms of laws for online gambling businesses. In Canada is online gambling allowed and on top of that is it completely income tax free (Karen, 2010).
Setting up a gambling service may be illegal in many countries, however are international gambling companies very difficult to track down and locate and put in front of a court.

I have now reviewed the most common structures found in tax havens and discussed their use. I have also mentioned some new forms of advantages and operations that the tax havens supply. In the next chapter will I look more on the current use of tax havens in financial markets.
4 Financial markets and the use of tax havens

This part will concentrate more closely on possible effects done by tax havens to financial markets. I will be using the financial crisis as an example throughout the part and I will emphasize on the use of CDO and the negative contribution of the SIVs.

4.1 Credit rating, asymmetric information and the financial crisis

Structured products like the CDO, makes it possible for the original creditor to put high risk and low risk loans in different packages that get high safety grade ratings from big rating companies like Moody’s, Standard & Poor’s and Fitch. In the start of year 2000, a new era of credit derivates began to emerge. Backed by these high ratings obtained by the rating companies did the credit derivates start to gain enormous popularity. Unfortunately were these products a huge contributor to the mortgage crisis in the US and later the international financial crisis that started in 2007.

The use and advantages of credit derivates in the US, tempted many banks to issue loans to persons or institutions with low credit rating and high risk of breaches. The amount of mortgages in the US between 2002 and 2006 increased by 15 % annually. The majority of these loans where so called subprime loans⁸. The customers who were acquiring these subprime loans were by the American bankers called “Ninjas”. This term referred to an individual with “no income, no job and no assets.” In addition to the loans provided to these ninjas, did the banks offer lenders with advantages like low interest rate and free installments in the first few years of the loaning period. This was a profitable strategy designed by bankers as long as the real estate prices where increasing and the interest rates were low. According to the Inside Mortgage Finance, was the total payout of subprime loans in the US of a total of 2500 billion dollars in the period of 2002-2007. That was approximately 18 per cent of GDP in the US in 2007 (Inside Mortgage Finance, 2012).

The reason why the banks were able to grant almost infinite amounts of loan, was because of the credit derivatives instrument available on the market. The banks had started to sell a major part of these loans along with other derivate in securized pools or “packages”. These “packages” of different derivatives were sold to different investors and investment banks worldwide, but mostly banks that were based in the US and Europe.

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⁸ Subprime loans are high risk loans given to person with very low credit rating. The only guaranty of the loan is the asset itself, for example a house.
These “packages” soon proved to involve and include a lot of problems. The main problem was based in the information part. Most of the buyers of these packages did not know what they really consisted of, but they felt comfortable because the payoff of these structured products was very good and it had been through many years. The idea of a great payoff was enough to convince investors to buy huge amounts of these products. To better understand the concept, can one imagine as a hedge fund\(^9\) that took on big bank loans with normal interest rate to be able to buy credit derivatives that gave a much higher payoff. For investments like these could the banks loan up to 15 times their own equity. This resulted in high leverage that gave up to 2 % more payoff than the borrowing rate (The Economist, 2007).

At the same time, did not the majority of the holders of mortgages have a clue that their loans were sold further into a bigger pool. This asymmetric information situation was not only high risk for the people owning just homes, but also for the banks that were taking on huge amounts of risk and were now playing with high stakes.

It seems bad that the subprime mortgage pools were bought by investment banks and other financial institutions. But what was even worse, was that the speculators were even selling insurance over the securized pools of mortgages. They were selling insurance of whether these pools would default or not default (Gilani, 2008). One of these sellers of insurance was the company American International Group Inc (AIG) in the US. When the financial crisis struck did the AIG need to post a lot of collateral and post write downs, but it was not enough. At the end did a single corporate subsidiary crash the largest insurance company in the world (Gilani, 2008)

The information asymmetry may represent a complex problem. On the one hand where the mortgage holders, “the ninjas”, that did not have sufficient liquidity or income to serve the interest, but still obtained a loan. On the other hand were the banks that were selling the mortgages packed to other investors that did not know the content of these packages. An interesting factor and matter is then to review what part the rating agencies that rated these derivatives played in the crisis.

An important reason for the interest of buying these “packages” of derivatives, was the ratings they received by the rating companies. For the rating businesses was this procedure of measuring and weighting these packages extremely lucrative (Lowenstein, 2008). As a

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\(^9\) A hedge fund is a portfolio of investments that can consist of many different investments, such as leveraged, short, long and derivatives positions in all types of markets.
consequence of the ratings, did not the banks need to wait 30 years to get their money back from the borrowers, they just sold their loans into securitized pools and the capital increased tremendously. Not only the banks increased their profit, also rating agencies like Moody’s acquired high returns. Moody’s went public, shares escalated and revenues went sky high and grew by 900 percent (Lowenstein, 2008).

How could then Moody’s and other rating companies justify their ratings of mortgages securities? Did they know that the majority of the mortgage holders were so called Ninjas? Moody’s claimed that they did not have access to the individual loan files. They also stated that because of this, were they unable to communicate with the borrowers and could not verify the information they provided in their applications (Lowenstein, 2008). Moody therefore assigned analysts to evaluate the packages that the investment banks provided.

The analysts did not have enough time to evaluate the information of the mortgages in the hectic climate of 2006. They decided instead to evaluate the bonds issued by the investment vehicle designed to house them (Lowenstein, 2008). This arrangement created very good ratings that especially benefited the rating agencies and the banks. However, did it not benefit the mortgage holders that did not know that their loans were pooled and sold to another party.

Another matter which is necessary to discuss, focuses on the structure of these packages and why these structures did not collapse before the financial crisis. I will break down and analyze the structure of the packages to be able to comprehend this more easily.

The structure of the SIV would usually consist of 12 classes of bonds, from normal AAA to low BA1 (Lowenstein, 2008). The highest rated bonds would be the first to receive the cash from the mortgage loaners, until their loans were fully paid. Then payments would persist with the next level of bonds, and so on until all were fully paid. The designed package provided segregation between the payments that protected the bonds on the top. With this composition of segregation and the lack of information regarding the mortgage part of the package, did Moody’s manage to classify these packages as AAA.

The scenario can be illustrated with a wine bottle pouring wine on an upside-down pyramid with glasses of three levels (Leopold, 2009). The liquid in the bottle is the total amount of interest payments from subprime mortgages, while the bottle itself is the pool of subprime mortgages. The financial securities can be interpreted as the wine glasses and each row of the glasses represent a tranche. Each of the tranches then has different types of securities with
different levels of risk (Leopold, 2009). The interest is then poured as wine from top and downwards to pay all the investors. The top tranche, called the senior, gets the first taste of wine. This tranche is the safest one and then has the lowest return (Leopold, 2009). The second tranche, called the mezzanine, gets the next taste of interest payments. This tranche is a less protected and might be obliged to absorb losses in case of defaults. However, the securities from the mezzanine are safer than investing in the pool as a whole (Leopold, 2009).

The last tranche, called the equity tranche (toxic tranche), gets the last taste of wine. This tranche takes the first hits and falls in case of default. Since this is the riskiest tranche does it also give a higher yield which again attracts investors (Leopold, 2009).

Using the wine example as a visual demonstration, are we able to conclude that in some cases would not the bottles contain sufficient wine for all the glasses. However, would still the top trench always get the serving first.

The next thing that happened was that the banks that were selling the derivates were able to convince the rating agencies that the top tranche was 100 per cent safe. This is the main idea of this illustration: That the senior trench is supposed to always be safe and secure investors against default. The senior trench also got very popular, because it received AAA ratings and had a higher return then other AAA securities (Leopold, 2009). The derivate sellers also managed to convince the raters that the mezzanine tranches were fairly secure and got acceptable investment grade ratings even on this level. The last tranche remained with junk-bond status and was called “nuclear waste”

This design developed AAA ratings for a lot of derivates in the pool and actually succeeded in getting more than 75% rated as AAA (Leopold, 2009). A very important question is then to ask what happened with the risky and toxic tranches at the bottom row. Due to the potential high returns on these equities they also got very popular. In 2007 was it also reported that state pension funds had bought as much as 18% of the most risky CDO tranches and only 4% of the AAA-rated tranches (Leopold, 2009).
The illustration of the concept with the wine and the glasses is illustrated below.

**Figure 5 Subprime mortgages visual**

Source: (Leopold, 2009)

For the original creditor is the spread of loss given by the credit derivates that secure a level of protection against default. It gives at the same time a spread of risk in case of a liquidity crisis and if parts of the credit system should fail. That was what happened during the real estate bubble in 2006/2007. A higher interest rate and a failing real estate marked, unleashed a boom of defaulting. The loss was shared between the investors that had bought derivates with payoff and derivates that consisted of mortgages. The losses were enormous and the last estimate from the IMF in 2009 stated that the global losses for banks and other financial institutions would exceed 4 trillion dollars (IMF, 2009).
When the majority was losing a lot of money, was somebody earning a lot as well. We do not know exactly how much the derivates industry earned during this period. There is no doubt that it has to be a lot of money in it for charging for designing the pools, create and marketing the securities, trade them and collect the massive returns from the equity trenches (Leopold, 2009).

When the derivate industry designed these derivates were they using SPV structures that were based in tax havens. The banks where giving out huge amounts of mortgages to “Ninjas”, and sold those loans mixed in packages rated as AAA derivates to SPV based in tax havens that resold them to a third party. So in a complicated way were tax havens directly linked to the transactions of popular derivates and an important part of the process of raising capital of the balance sheet (Lawler, 2001). As an alternative could the SPE be established in other jurisdictions, but the banking and trust structures in tax havens made it easier to arrange and design them. With a flexible legal and regulatory framework are there more advantages operating in for example the Caymans than in Los Angeles. I will now continue with focusing on the negative effects that affected the relationship between the banks.

4.2 Credit derivatives and uncertainty

It is claimed that credit derivates create a fundamental uncertainty in the financial world (Skarstein, 2009). In many cases is it unclear which banks that owns each derivate, and this may create trust issues between the different banks. The securities were made and designed to reduce risk of the original creditor, but have instead had the opposite effect in many cases and increased the total risk.

In the summer of 2007 were banks with good liquidity not that eager to give credit to banks with low liquidity. The amount of credit transactions went down dramatically. In august the same year did the central bank what it could to prevent a disaster: It had to lend money with very low interest rate. This action only delayed the big financial crisis that struck the world the same year.

Tax havens seem to have had a reinforcing effect on the financial crisis, because the tax havens brought upon different extra costs (NOU, 2009). The common trust between the banks did not become better when they knew the other bank had interest in jurisdictions with low taxation, no transparency and secrecy. As an individual, a bank or a company you may borrow too much and then hide it in a tax haven. They are able to do this because of the secrecy, but they are also then engaging in evasion of regulation and fines that would occur if
you were un-capitalized. In the end gives this the different players a competitive edge and this is applied in the financial marked and also in providing incentives for activities like illegal unreported fishing that was mentioned in the second chapter.

In crisis would many banks terminate counterparty risk with companies that had a lot do with jurisdictions known as tax havens. This can be illustrated with an example of the four week US Treasury bill that was down to zero for parts of 2008. This US Treasury bill was heavily requested because the buyers knew its risk. When the uncertainty was hitting really high levels, were the investors better off with lending money free of charge to the government. They would not believe in a bank that was possibly doing business in a jurisdiction with no transparency, and a government with their own and different style that did not match the modern financial system (NOU, 2009).

A fundamental question that needs to be raised is whether tax havens carried and inflicted too much debt during the finance crisis. Different tax incentives often run through tax havens and according to the Tax Justice Network did these incentives contribute greatly to the build-up of debt throughout the global financial system before the crisis struck (Tax Justice Network, 2011b). Tax havens also assisted different corporations to conceal dramatic losses that also added and increased the number of more problems in the crisis (Tax Justice Network, 2011b). The next chapter will focus more on discussing the financial regulation, the location of the different financial entities and their possible contribution to the global financial crisis.
5 Tax haven influence and its future, conclusion and suggestions

This part will concentrate more on the link between the tax havens and the global financial crisis that started in 2007, and it will also try to clarify any misunderstanding with this connection. I will also discuss the need for tax havens and possible scenarios of the future, come to a conclusion and provide suggestions for further research.

5.1 The link between tax havens and the financial crisis

The financial crisis of 2007-2009 led to the formation of the G-20 consisting of the 20 leading nations worldwide (Santillán-Salgado, 2011). The main reason for this formation was to improve and develop the coordination of different aspects and dimensions of the international economical environment (Santillán-Salgado, 2011).

It was stated that in the G-20 summit in London 2009, that some of the fundamental causes of the financial crisis were “major failures in the financial regulation and supervision” (Maffini & Loomer, 2009). The G-20 leaders also concluded that they needed to “...take action against non-cooperative jurisdictions including tax havens. We stand ready to deploy sanctions to protect our public finances and financial systems.” Another important organ, OECD, also draws a clear link between the financial crisis and tax havens by stating: “Removing practices that facilitate tax evasion is part of a broader drive to clean up one of the more controversial sides of globalized economy.” These statements are important and aim to clarify the link between the recent financial crisis and tax havens. However, do they not explain sufficiently the exact role of the tax havens in the financial crisis (Maffini & Loomer, 2009).

In order to comprehend and have more background information on this matter is it necessary to distinguish between three different concepts: Tax evasion, tax avoidance and financial regulation avoidance (Maffini & Loomer, 2009).

I have highlighted and discussed tax evasion in the second chapter and it can be summarized as a criminal behaviour in general. Individuals or firms are deliberately doing concealment of taxable income. This is a behaviour that is punishable by jail and fines or even in some occasions both. The international taxation standard introduced by the OECD states that the countries should agree to exchange tax information when requested for the administration and enforcement of the requesting country domestic tax laws (OECD, 2011a). Its main focus is to
improve transparency in the process of exchanging information to prevent specific cases of
tax evasion (Maffini & Loomer, 2009). In other words, has it nothing to do with financial
regulation and international tax avoidance or that tax evasion was the main cause of the
financial crisis (Maffini & Loomer, 2009).

Tax avoidance and tax planning are other concepts that were introduced in the first part of the
thesis, and they refer to structuring the affairs to reduce and minimize the tax liabilities to the
minimum according and within the boundaries of the law (Maffini & Loomer, 2009). As
mentioned before can this be accomplished successfully and completely legal. A common and
most usual example of tax avoidance is the multinational companies that locate subsidiaries
and their property in low tax jurisdictions. It is legal, but by many considered highly unethical
and reduces the tax income for the country that should had received and had more available
income for public finances (Maffini & Loomer, 2009).

There is also a specific difference between tax evasion and tax planning to be more accurate.
Tax evasion focuses on the illegal actions such as sham transactions and fabricated expenses,
while tax planning are using the mentioned legal structures and methods to delay or reduce
the tax in the best interest of the tax payer. Since tax planning is referred to as legal are many
claiming in court that they have engaged in this activity. For individuals and companies this
may be the case because they maybe received bad tax advice or that they intentionally made
the choices. However, are many ending up with being convicted for tax evasion (IRS, 2012).

There are different views on whether tax avoidance and tax planning can be considered to be
legit or a criminal offence. When big financial institutions are experiencing losses and these
are met by the domestic taxpayers, the tax avoidance activities carried out in low cost
jurisdictions by these financial institutions are met by a lot of controversy. However, it is
important to remember that the tax avoidance alone cannot be blamed for the collapse in the
financial crisis.

Financial regulation avoidance is on the other hand more linked up to the causes of the
financial crisis. Financial regulation avoidance is many times conducted through tax havens
with the use of SIVs, conduits, and other off-balance sheet and off-budget vehicles. All these
types where in the centre of the events that set of the financial crisis, and most importantly
and mentioned previously was the SIVs particularly influential. The SIVs were funds or
companies investing generally in asset-backed securities, and the SIVs were the first to experience liquidity problems with the sub-prime mortgages crisis in August 2007 (Maffini & Loomer, 2009).

Many of these entities that contributed greatly to the financial collapse and eventually the crisis were located in tax havens, and have of course created some confusion of the role and the part of tax havens in this credit crunch. The “hidden” locations of these off-balance sheets and vehicles are contributing to a system that lacks transparency. However, the main problem with these entities was not their offshore location but their off-balance sheet status (Maffini & Loomer, 2009). This is a very important point to highlight, because it led to asymmetric problems with information failures and low capital ratios. The financial institutions that were using SIVs were cheating with the regulation, but why didn’t they locate them in for example European countries like England? One of the reasons could be that they did not want anybody to find out the exact amount of debt that was being used. Hence, did they use tax havens to hide this sort of information. Tax authorities were and are able to locate the SIVs, but they are not able to judge and measure the exact amount of the debt, because it was located in a tax haven.

The off-balance sheet status along with the business model and design of the SIVs, using short-dated commercial paper for the funding of investment in longer-dated assets, led to a lot of problems at the onset of the crisis (Maffini & Loomer, 2009).

5.2 Do we need tax havens?

The institutions that offer tax reduction services in tax havens often argue strongly for the need of offshore centres (Raftopoulos & Banks, 2009). They argue that the secrecy of banking is not a smokescreen for tax evasion and that the confidentiality is one of the core principles for banks all over the world. (Raftopoulos & Banks, 2009). It is not the issue that corporations and people wish to deliberately hide their financial information, is because they want to keep this information. It has also been argued that tax havens have many beneficial effects (Mitchell, 2009). There are a few arguments that are considered being good influential factors by the tax havens in the global economical perspective. In some cases are tax havens putting pressure on politicians and promoting lower tax rates in high-tax nations (Mitchell, 2009). It is less likely that the politicians will be greedy when they know taxpayers have options to avoid taxes. Even the OECD economists have admitted the facts that tax competition is functioning as a pro-growth force in the world economy (Mitchell, 2009). Lower tax rates
reduce the tax bias against saving and investing of money, and encourage people to save more.

This saving leads us to the next argument that tax havens are generating higher living standards (Mitchell, 2009). The World Bank data shows that 9 out of the 13 richest countries in the world are tax havens, hence leading to big reductions of poverty in developing countries (Mitchell, 2009).

Tax havens also promote better governance and this is a huge problem in developing countries (Hines Jr. & Dharmapala, 2009). It is also argued that tax havens promote more economical activity in the so-called high-tax jurisdictions (Mitchell, 2009). Generally speaking, do the countries with high taxes have better rules for inbound investment than for their own citizens. Politicians have understood that they need to fight for global investors. However, these are all arguments that are justifying the secrecy and many of the illegal actions that tax havens are applying. And many of the financial instruments used before the outbreak of the financial crisis are being justified.

The developed countries in many ways look at and consider the tax havens with their lack of transparency as one of the contributor and accelerator of the financial crisis (McLaren & Passant, 2010). To balance budgets in the future by having tax havens collect income tax for developed countries with large budget deficits, is generally not supported by the developing countries and the solution to budget deficits probably is not found in tax havens (McLaren & Passant, 2010).

In order to confront and solve future challenges and crisis that may occur is action against global tax evasion necessary along with constantly improvement of the global financial regulation. However, these things are totally different. The promotion and improvement of exchange of transparent information for decreasing tax evasion has little to do with the financial crisis. The improvement of international financial regulation has a lot to do with the financial crisis, but is not a big part of the enforcement of tax. However, the only way to really affect international tax avoidance would be substantial improvement and development in the ways international income is taxed (Maffini & Loomer, 2009). This should preferably become the main focus of organizations like the OECD and the Tax Justice Network in their work for more sound and transparent financial markets.
5.3 The future of tax havens

As we are currently struggling with another huge financial crisis in Europe at the moment are there indications that tax havens are contributing to a more insecure and less reliable financial system. There are several reasons why tax havens will continue to provide countries, multinationals companies and individuals with financial services. The whole economic system is dependent on the free flow of capital between different jurisdictions for securing future productivity and development (McLaren & Passant, 2010). The tax havens provide very good mechanism for exactly this to occur. Tax havens will also always be able to provide the service of holding capital for asset protection purposes and so-called high-net-worth individuals who do not have a specific country of residence. An example could be temporary residents and non-domiciled residents of different countries that will keep on using tax havens, because they have no legal obligation by law to pay income in the country were they are residing (McLaren & Passant, 2010). It is also highly possible that multinational companies continue to locate their captive insurance companies in tax havens and tax havens will probably continue to provide crucial functions for the insurance industry. It is evident that without the benefits of low taxes jurisdiction where premium income are invested, will many companies and individuals find it very difficult to purchase insurance cover or even not be able to cover them at all (McLaren & Passant, 2010). It is however ironic that the public that is protected and covered for injury and loss situations, is the ones that benefit from the location of these insurance companies.

Multinational companies will probably continue and diverse their use of tax havens. One example could be the state of Delaware in the US, where big corporation probably will keep on with the incorporation of foreign subsidiary companies (McLaren & Passant, 2010). It is then very easy to draw a general conclusion to the future behavior of tax havens that they probably will continue to survive and flourish, because they provide a lower cost of capital worldwide and different concentrations of investment capital for the ongoing health of the system (McLaren & Passant, 2010).

Different organizations and governments are trying to deal with the financial problems caused by tax havens with different levels of success. The OECD for instance, has tax information sharing agreements as bilateral agreements while the challenges of the tax havens often require multinational cooperation (Gillespie, 2009). However, is it argued that the biggest challenge and problem of the framework and approach applied by the OECD, is that it applies to individuals and not the big multinational companies (Gillespie, 2009). These multinational
companies are in many ways the main responsible for the majority of tax evasion and losses to the government in both northern and southern countries (Gillespie, 2009). It is then preferable that the organizations like the OECD investigate new ways to reveal complex corporate structures, profit laundering and illegal transfer pricing.

Another challenge that has arose after the financial crisis is the lack of trust between the customer and bankers. The collapse of trust may have serious implications for the future of the financial industry (Guiso, 2010). If not moving away from ambiguous securities that are structured with the aid of tax havens to more safer ones, it may affect the availability and the cost of equity financing (Guiso, 2010). Investors may not be willing to bear risk and it may limit the raising of capital to the industry in general.

5.4 Conclusion and further research

Tax havens are affecting our financial markets in many different ways, both positive and negative. The increasing use of captives for instance in risk management strategy for insurance companies, can be positive and beneficially for both the user and the company. There are also argued that tax havens have other positive effects like promoting better governance, more economical activity and that people are saving more with low taxes.

However, tax avoidance and lack of transparency in tax havens are also contributing to huge uncertainties in our financial markets. The increasing use of structured investment vehicles conducted through tax havens and the lack of financial regulation may have a very negative effect on our financial markets. This can lead to asymmetric information failures and low capital ratios, like what happened during the previous global financial crisis with the off-balance sheet status of the financial entities.

It is in our best interest to focus on developing our global financial regulation. The international tax avoidance must be taken seriously and has to be improved in a sustainable way to secure more transparent global financial markets.

There are many research areas to investigate further that could be beneficial for the improvement of a more sound and transparent financial market. Suggested research areas could be to investigate more about the direct effects of the off balance sheet status of SIVs, and for example try to measure the numerical impact done by tax havens in the financial crisis. Other research areas could be to focus on the current developing of new PCC structures.
that are legalized worldwide and investigate the possible effect of the implementation of these structures in our financial markets.

In order to improve our international taxation system, is it crucial to increase our knowledge of the damage that for example tax havens are responsible for. It is then vital that continuing research in the area of international taxation is prioritized, to be able to understand the impact of tax havens in financial markets.
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61


