The wide publicity given to tax havens has led many developing countries to contemplate the adoption of similar status in order to speed up their development. This article defines both the dividends and drawbacks of such a status.

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What do the Bahamas, Bermuda, Hong Kong, Liberia, the Netherlands, the New Hebrides, Panama, and Switzerland have in common? They are all “tax havens.” As such they are apt to excite either passionate praise or passionate denunciation, depending on the point of view of the commentator. Those who recommend the use of tax havens may cite with approval the remark of Lord Tomlin that “every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be.” Speaking of those who deplore their use, one writer observed that “many of the pronouncements on the subject were sufficiently vehement to convince one that nothing short of the destruction of the tax haven and a virtual embargo on [exports of] . . . capital would save the Republic.”

What is a tax haven?

Essentially, a tax haven is a place where foreigners may receive income or own assets without paying high rates of tax upon them. Although strictly speaking not all tax havens are countries, we can refer to them as such here for the sake of convenience. In some havens the tax relief that foreigners enjoy stems from the absence of the chief forms of direct taxation—income, estate, and gift taxes; but in most countries the relief stems from special features of the tax system that result in a very low effective tax rate on certain forms of foreign investment. Some countries that enjoy a reputation as tax havens have cultivated it. In others the features that make them a tax haven are merely a consequence of their having followed certain principles of taxation, such as that of strict territoriality in applying income taxation, but without the intention of establishing a tax haven. Such countries are likely to consider the tax haven label derogatory.

In the absence of reliable data on the use made of tax havens, exaggerations flourish. The advantages that these countries offer to taxpayers are well described in guides written by professionals who specialize in carrying out operations in tax havens for their clients. But hard statistical information on the extent of the revenue losses suffered by high-tax countries and the benefits which tax haven countries derive from their status is woefully meager. There is general agreement on only a few facts, principally that the amount of business activity carried out in tax havens is considerable, even though exact figures are not available. Moreover, it appears that the use of tax havens by enterprises in high-tax countries—particularly by multinational enterprises—is growing.

Even though the list of tax havens includes several developed countries, most are developing countries. It is precisely their example that other developing countries are tempted to follow, in the hope that becoming a tax haven will help them solve some of their economic problems. While the tax haven status does bring some benefits to the tax haven country, it is one of the objects of this article to dispel the myth that the tax haven status is a panacea for a country’s economic problems.

The modus operandi

Tax havens are used for a great variety of operations. The main purpose of those who patronize them is to minimize the taxpayer’s total tax burden by subjecting at least a part of his income or wealth to a lower effective rate than would otherwise be applicable. But care should be taken to distinguish between operations whose main purpose is that of diminishing a taxpayer’s total burden and those that have a bona fide business purpose. The latter are generally not considered tax haven operations, even if they take place in a tax haven. Some industries located in tax havens are engaged in producing goods for the domestic or international market. Some royalties are paid from tax havens for patents or know-how actually being used in the country. Some foreign citizens work in tax haven countries. Even though these individuals or corporations benefit from the country’s low tax rates, they do “real” business within its borders.

In contrast, much “tax haven” business is fictitious, in the sense that little or none of it is effectively carried out in the tax haven proper. Goods that are bought and sold by tax haven subsidiaries often do not pass through the tax haven’s territory; they move directly from the country of origin to the country of destination. The assets of trusts that are established in tax havens are usually kept thousands of miles away; and neither the grantor nor the beneficiary is normally resident in the tax haven country.

Tax haven operations consist fundamentally in establishing within a tax haven country one or more legal entities, such as trusts, personal holding companies, or corporate subsidiaries, and attributing to them income earned elsewhere in order that it should be taxed at the country’s low rates—or perhaps not taxed at all. This objective is usually accomplished by either (1) accumulating income in the tax haven country at low rates of tax, to be withdrawn later and invested elsewhere according to the investor’s wishes; or (2) artificially shifting business profits from high-tax countries to a tax haven country.

In the case of passive investment, from which dividends, interest, or royalties are derived, trusts and personal holding companies are used as buffers or screens between the real investor and his assets. For many years the creation of these

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legal entities for the purpose of obtaining a tax advantage was among the most popular uses of tax havens. As a result of countermeasures enacted during the past few years in certain capital exporting countries, the use of tax havens to shelter passive investment income has apparently not increased as fast as other tax haven activities.

At present, the most rapidly growing type of tax haven operation is that of shifting business profits from high-tax countries to tax haven countries. These profit shifting transactions are usually carried out by large corporations through tax haven subsidiaries, using sophisticated methods that are designed to diminish the tax base artificially in high-tax jurisdictions while increasing it in the tax haven country.

The most important of these methods involves transfer pricing: the setting of prices on goods and services that are bought and sold between a parent company and its foreign subsidiary. No “arm’s length” bargaining takes place between these parties, so the prices that are set can be manipulated to minimize the enterprise’s total taxes. The “arm’s length” relationship implies dealings between two independent and unrelated parties, where prices are determined according to market forces. For example, instead of a company selling goods directly to a foreign buyer and realizing a profit that is fully taxable in its home country, it may sell the goods at an artificially low price to its subsidiary in a tax haven country. Thus, it shows only a small profit on which it has to pay a low tax, or perhaps even a loss! Its subsidiary then resells the goods to the ultimate buyer at the normal price, earning a large profit, all of which however is taxed at a low rate, or not taxed at all, because the subsidiary is located in a tax haven.

Another type of activity is carried out in tax haven countries by the financial sector. In most of these countries there exists a financial sector whose size and importance are out of proportion to the size and resources of the country itself. This sector usually comprises a large number of banks and trust companies, most of which are branches or subsidiaries of foreign-owned institutions. The reasons for their presence in tax haven countries are quite varied. These institutions manage trusts and holding companies that have been established to shelter foreign passive investment income; they hold deposits for foreign investors; they provide administrative facilities for a variety of corporate subsidiaries.

Foreign banks also use “shell” banks or branches located in tax haven countries to do Euro-currency business.

The activities of the financial sector are largely of an ancillary or dependent nature. The main object of many of these banks or trust companies is to provide services to other tax haven activities, such as administering tax haven trusts and corporate subsidiaries and holding deposits for foreign investors. Much of the business of this sector is “real” business in the tax haven. Banks and trust companies that administer trusts or holding companies do a large amount of the technical, audit, and legal work of administration in the tax haven country. In other cases, however, such as the Euro-currency branches of foreign banks, the “real” activity is carried out elsewhere, except perhaps for a nominal presence in the tax haven.

Tax havens also attract foreigners who come to work for foreign banks or other companies, and retirees, who decide to establish their residence where the advantage of a temperate climate is joined to that of a low-tax environment. In these cases there is “real” activity in the country—whether working or merely residing in it—and the tax factor is only one of several considerations that induce these individuals to settle in a tax haven country.

Tax and other advantages

Low tax rates are perhaps the principal attraction offered by tax havens. Usually these low rates are associated with income taxation; in fact, what springs to mind immediately upon hearing the words “tax haven” is the absence of income taxation, or the existence of a form of income taxation that exempts foreign investment. Though it is true that many of the advantages offered by tax haven countries are income tax advantages, these are by no means the only benefit that these countries offer to foreign investors.

Within the tax field, the absence of other taxes such as estate, inheritance, and gift taxes may be as important to certain investors as the absence of an income tax. Bilateral tax treaties between a tax haven country and some of the major developed countries are another feature that may attract investors. The existence of a tax treaty allows third-country investors to base their holding companies in tax havens and obtain a reduction in withholding taxes applied to the dividends and interest they receive from developed countries with which the tax haven country has the tax treaty.

Strict and well-enforced rules of banking secrecy and, in general, the possibility of doing business without close supervision by government agencies are additional attractions usually offered by tax haven countries. Other factors, such as the low cost of doing business, the existence of liberal banking regulations, and the absence of exchange controls are also important. These advantages were the chief reasons why foreign banks established Euro-currency branches in the Bahamas; the country’s attractive tax climate was apparently of only secondary importance. Finally, a good communications service, a well developed legal system with an abundance of legal and accounting expertise, and, above all, a high degree of political and financial stability also help to make a country successful as a tax haven.

Countering tax loopholes

Are these all the elements necessary to enable taxpayers from high-tax jurisdictions to minimize their tax burdens? In fact, there is one other element without which they could not do so and that is the existence of features in the tax systems of developed countries that allow taxpayers to take advantage of the benefits offered by tax haven countries. Among these features are, for example, the more favorable tax treatment granted to trusts located abroad than to domestic trusts, and the mechanism of tax deferral that allows taxpayers of high-tax countries to defer income tax payments on income from foreign sources until it is repatriated. These and other mechanisms may be likened to escape valves left in their tax systems by high-tax countries, in order to grant taxpayers relief from the pressures of taxation. As long as these
provisions remain in effect, high-tax countries cannot place all the blame on tax havens for the losses of revenue they suffer. During the past two decades some countries have moved to eliminate these safety valves. The United States has pioneered the way, with other countries, such as Australia, Belgium, Canada, the Federal Republic of Germany, and the United Kingdom following that example. The enactment of measures against the use of tax havens has not been easy and in each of these countries has produced an uproar among interested taxpayers in high-income brackets.

In general, legislation on this subject is aimed at one or both of the following objectives: (1) preventing the tax-free accumulation by tax haven countries of certain forms of income, such as passive investment income and income derived from the assignment of service contracts to a foreign subsidiary; and (2) attacking the problem of transfer pricing, by attempting to tax a parent company on the profits it would have obtained if the transaction with its subsidiary had taken place at arm’s length.

The tax systems of a number of industrialized countries, such as Canada, the Federal Republic of Germany, the United Kingdom, and the United States, permit domestic companies to postpone the payment of taxes on profits earned by foreign subsidiaries until those profits are repatriated. This has made attractive the establishment of foreign personal holding companies in tax haven countries that can accumulate income either free of tax or subject to a very low effective rate. The rules recently enacted in some developed countries to prevent this accumulation generally require the income of these foreign holding companies to be taxed on an accrual basis, thereby eliminating the tax deferral privilege that the owners previously enjoyed.

There are several reasons why these rules are complex. Perhaps the main one is the wish of the developed countries to soften their impact upon companies that are accumulating income in low-tax jurisdictions for normal business reasons, without intending to avoid taxes. In order to achieve this purpose, anti-accumulation rules rely heavily on percentage criteria, which have the merit of being objective but which at the same time leave a wide margin for maneuvering by taxpayers. Thus the anti-accumulation rules usually apply only when the subsidiary established in a low-tax country is “controlled” by taxpayers in the high-tax country. “Control” is defined as ownership of more than 50 per cent of the stock of the foreign subsidiary. The United States and Canada, however, only count corporations or individuals, each of whom owns more than 10 per cent of the foreign corporation, toward the 51 per cent “controlling” share of the company. This latter rule attempts to exclude portfolio investment from the anti-accumulation provisions. The Federal Republic of Germany does not employ this provision. Obviously, these percentage criteria can be easily circumvented. A case in point is the recent increase in the number of subsidiaries in low-tax countries whose parent company legally owns only 50 per cent of the stock, but in practice exercises full control without being subject to the anti-accumulation provisions.

Apart from those loopholes due to the percentage criteria, there are other important exceptions to these rules that have usually been enacted in response to special interest groups. This is the case, for example, of the exceptions to these rules that until recently favored shipping interests in the United States.

Transfer pricing
In spite of the shortcomings of the rules that attempt to prevent the accumulation of tax-free income in tax havens through holding companies, these rules appear to have been more successful than the provisions designed to curb the use of transfer pricing to shift income from high-tax to low-tax jurisdictions. The tax laws of several developed countries contain provisions to ensure that sales and other operations carried out between domestic corporations and their foreign subsidiaries are transacted at arm’s length prices. These provisions are difficult to administer, since the actual determination of the arm’s length price is fraught with complexity.

As a result, the provisions against the use of tax havens that developed countries have lately introduced have mainly affected the accumulation of passive investment income in tax haven countries, not by banning accumulations outright, but by making them more costly and complex. Therefore, the accumulation of income by holding companies and trusts is still possible, but only for very wealthy investors or the large corporations. As the latter are also the corporations that use transfer pricing to shift income to tax havens, and as transfer pricing practices have not been much affected by the provisions against the use of tax havens, it is probable that the “clients” of tax havens are increasingly being drawn from higher-income and greater-wealth brackets. In fact, some of the movement against tax havens in developed countries has stemmed from medium or small corporations that claim that tax havens afford tax relief mainly to large corporations, making competition more difficult for other enterprises.

Benefits to the tax haven
But what are the benefits that tax havens may obtain from their status and what is the price they must pay for those benefits? For developing economies one of the main apparent advantages of being a tax haven is the possibility of achieving a higher employment level. This is particularly attractive to countries with a narrow resource base, which tend to have chronic unemployment problems. However, there is a tendency to exaggerate the number of jobs created by tax haven activities. The establishment of hundreds and even thousands of corporations and trusts and the large number of transactions that technically take place in tax haven countries are generally accomplished by using little manpower within the tax haven country. The case of Norfolk Island, a possession of Australia and a former tax haven, illustrates this point. According to a survey quoted in a manual on tax havens, in 1972 more than 1,450 companies were incorporated in Norfolk Island—nearly one per inhabitant. Nevertheless, it appears that the tax haven sector was directly benefiting only 25 residents of the Island, as much of the business was being carried out by lawyers and accountants in Australia.

It should be remembered that the main purpose of tax haven activity is to avoid taxation and that no business or trade is actually carried out in the country. The main exceptions are the institutions in...
the financial sector, which are the principal generators of employment opportunities and additional demand for services within the tax haven sector of the economy. However, these institutions usually prefer to staff their organizations with expatriates—particularly in the higher positions—so not all the jobs created by this activity will be available for nationals of the host country.

Other economic activities are also stimulated by tax haven operations. Construction is boosted, principally of commercial buildings. As in the case of employment, the number of new buildings required is much smaller than the size of the tax haven sector might indicate, as hundreds of holding companies or other subsidiaries may require only enough office space on which to hang a nameplate. Only those enterprises that actually do something—again mainly enterprises in the financial sector—require sizable office space to carry out their activities. Another activity that may be stimulated is tourism, particularly if the country enjoys an agreeable climate and meetings of directors in the country are a requirement for incorporation. A tax haven country may also attract retired persons as residents, and their presence provides employment opportunities and helps bring in foreign exchange.

The existence of a large financial sector has other important effects too. It may help a country maintain a free and open foreign exchange and payments system. In addition, the advantage of having a readily accessible financial market is considerable. Government bond issues may be underwritten or subscribed to by foreign banks, thereby making funds available for public investment and economic development.

Finally, the tax haven sector is a source of revenue to the government. However liberal the tax system of a country may be, there will always be some form of tax or fee for which the foreign investor will be liable. These contributions range from a simple annual fee payable by all corporations established in the country to income tax on profits considered to be of domestic origin. For example, in the case of banks that do both domestic and foreign business, profits from domestic sources may be taxable while income from foreign sources is exempt. Moreover, in most tax haven countries indirect taxes such as customs duties, sales taxes, and others are fully applicable.

The drawbacks

Is there a price to be paid for all these advantages? Yes, and it is generally not fully apparent when countries set out to become tax havens but may become burdensome later.

The problems created and constraints imposed by the tax haven status vary according to the degree of development of the country, the size and composition of its tax haven sector, and the kind of benefits granted to this sector. In general terms, the most troublesome problems arise in developing countries where the tax haven sector contributes a relatively important share to the country's gross national product (GNP).

At first glance this may appear paradoxical. The fact that the tax haven sector is contributing substantially to GNP should mean that new economic activity is taking place, which is desirable. This is true, but the problem lies in the nature of tax haven activity. As its main purpose is that of tax avoidance, tax haven activity generates very little investment in tangible assets; therefore, tax haven business is extremely volatile and lacking in stability.

The one sector that does engage in real economic activity—the financial sector—is heavily dependent on what occurs in the rest of the tax haven sector. If this foreign business disappears, the domestic activity will not be sufficient to retain the large number of banks, insurance companies, and other organizations that form the financial sector of a tax haven country.

Tax haven activity is highly sensitive to national and international developments. Within a tax haven country itself, the slightest whiff of financial scandal—such as a prominent bank defaulting on its obligations—is enough to send investors in search of another tax haven that offers more security. Situations such as these are difficult to prevent, as one of the things investors look for in tax havens is absolute secrecy and as little prying as possible by government officials into their affairs. Secrecy and supervision do not go well together, and generally the latter suffers in tax haven countries; accordingly, it is not surprising when bank failures or other financial problems do occur.

Another circumstance that may frighten away investors is the suspicion that a country's leaders are considering important changes that may include nationalization or other radical measures. Even the smallest indication of this may precipitate a flight of depositors and other investors. A tax haven government must also be cautious about hinting that it may change its tax policies to meet revenue demands, for such hints may destabilize the tax haven sector. This situation seriously constrains the formulation of a coherent domestic tax policy, as there is a natural reluctance among authorities to jeopardize the tax haven sector by any changes, however necessary, in the tax system.

International factors

Internationally, one of the factors that can influence tax haven investment is the attitude of developed countries toward this activity. The measures against the use of tax havens already taken by them have all had some impact. Future measures are already being studied by some developed countries that will make the use of tax havens more costly and complex than it is at present.

Fluctuations in the world economy and disturbances in international financial markets also affect tax haven activities. Competition among tax havens trying to outdo one another by offering more stability, lower taxes, and better commercial facilities accentuates the volatility of tax haven investment.

Tax haven countries tend to be more vulnerable to external factors than developing countries that are not tax havens.