The George Washington University
WASHINGTON DC

IBI - INSTITUTE OF BRAZILIAN BUSINESS AND PUBLIC MANAGEMENT ISSUES

Theory and Operation of a Modern National Economy

Tax Havens

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Minerva Program, Fall 1999

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CONTENTS

1. INTRODUCTION

The increasing movements across national frontiers of goods and services, of financial capital, of factors of production, as well as of technology, are a clear evidence of a process of growing integration of world's economies. Facilitated by the gradual reduction or even elimination of tariffs and trade barriers, as well as by improvements in the transportation sector, trade among countries has grown considerably. Restriction on the exportation and importation of financial capital have also been progressively removed, stimulating a phenomenal growth in the world capital market. Many countries' legal systems allow financial capital to flow freely, with little or no control.

New communication technology has been especially important for the development of financial activities. Computers, Internet, switching devices and telecommunications satellites have slashed the cost of transmitting information internationally, of confirming transactions, and of paying for transactions. Moreover, thanks to these technological innovations, information is easily and quickly available and can be accessed and sent around the world in seconds. Capital transfers can thus be made instantaneously and with low costs.

In addition, companies and enterprises can cross frontiers much more easily than in the past, leading to the growth of truly multinational enterprises. Multinational enterprises operate their production branches in several countries, trying to exploit comparative advantages of particular locations. As a result, integrated international production trade among branches or subsidiaries of the same multinational corporation has been growing very fast and represent a large share of total world trade. As the trade among branches of the same multinational enterprises grows, it becomes more difficult to allocate the profits of theses corporations among the countries where they operate and consequently to tax those profits.

Within this process of increasing globalization of economic activities and of growing integration of the world's economies, private economic operators have become more sensitive to differences in effective tax rates and react to these differences whenever a decision related to business or investment is made.

Given that each country bears different shares of national income or gross domestic product (GDP) in tax revenue, tax systems of different countries develop arbitrage pressures created by different tax rates, by differences in the bases that are taxed, leading taxpayers to use the process of internationalization of economic activities to reduce their tax liabilities through tax planning, tax avoidance or tax evasion, so as to maximize the return of their operations. Thus, differences in tax systems of foreign countries have become an important variable that influences the economic decisions of the taxpayers.

Owing to these differences, the mobility of capital, brought about by the deepening of economic integration, may lead capital to flow from high to low tax countries, in search of shelters against high tax rates to which the income produced by the capital would have been subjected if it had not moved from one country to another.

The purpose of this paper is to study the origin and the consequences of the use of these “shelters”, better known as “tax havens”, as well as the measures that have been adopted to minimize the damages caused by them. The increasing volume of operations involving tax havens countries, which leads to enormous losses in terms of tax revenues, reveals the relevance of this subject. However, notwithstanding the concerns of Brazilian authorities regarding tax havens, it is a quite recent issue in Brazil and very few books and publications in Portuguese about this subject can be found.

2. CLASSICAL TAX HAVENS

2.1. HISTORICAL ANTECEDENTS AND DEFINITION

Tax havens are so intrinsically related to taxation that their existence, however irregular, has proved to be as inevitable as taxes and their origins are buried deep in the past, although the expression “tax haven” itself has only been used from the current century on. In ancient Greek, the merchants stored their merchandises in islands near Athena, in order to avoid the 2% tax imposed on imported goods. During the middle ages, cities of the Hanseatic League owed much of their prosperity to favorable tax treatment given to commerce. Almost as ancient as the Catholic Church, the Vatican City has served as a private tax haven for the Pope and the papal staff.

The oldest established of modern tax havens is Switzerland. Long before the Second World War, dating back to Roman times, it developed as a haven for capital rather than as a haven from tax, as its numbered bank accounts allowed capital to flee political and social turmoil in Russia, Germany, South America, Spain and the Balkans. The war brought an even greater flood of cash, from all sides. When peace returned, taxes inevitably rose in North America and Europe, except in Switzerland, to meet the need of funds for reconstruction and social demands. It was during this period that the modern tax haven emerged as a refuge primarily from taxation.

From the 1930s on, wealthy Canadians and US citizens started to use The Bahamas as a shelter for their assets, in where the US Mafia would later hide their large flows of illegally earned cash and use refined money laundering techniques to recycle cash flows back into US economy. By the late 1960s to early 1970s, many US banks had set up branches in Caribbean tax havens as Eurocurrency booking offices. Many other tax havens have popped up in many different locations and new ones are likely to be created.

Despite the increasing internationalization of capital, and although certain manufacturing and extractive industries have gradually gained transnational character, in general there has not been a corresponding growth of transnational legislation to regulate this increasing business activity. Thus, there is no internationally accepted definition of exactly what a tax haven is, or even internationally standardized accounting or fiscal laws.

In this manner, the existence of different tax systems with their particularities makes the attempt to provide a single definition of “tax haven” a hard task, if not controversial. According to Sol Piccioto, tax haven could be broadly defined as any country whose tax laws interact with those of another so as to make it possible to produce a reduction of tax liability in that other country. With this definition, virtually any country might be regarded as a "haven" in relation to another, so that this definition turns out to be too vague and imprecise. Aiming to restrict the broadness of this idea, the same author presents a narrower definition of tax havens as countries that offer themselves or are generally recognized as havens.

In the same vein, OECD report on tax havens referred to the "classical havens" as "jurisdictions which make themselves available for avoidance of tax which would otherwise be payable in relatively high tax countries, usually by attracting income from activities carried on outside the tax haven" (OECD 1987a-I, Paragraph 10). The aim of the legislator of a classical tax haven is usually to attract income from activities that are to be carried on outside the territory of the tax haven.

Most tax havens, in the classical sense referred by OECD, are very small countries not suitable as industrial centers and offer themselves as instruments for reducing the tax burden of individual and companies to generate demand for domestic services and products, such as banking, legal and accountancy assistance, transport and communications, office equipment, printing, construction, hotels and all sort of infrastructure. Many tax havens have this service framework as the principal economic activity, which represents an important, if not major, source of employment, and significant revenue comes from issuing bank licenses, registration fees, stamp duties and others. Furthermore, tax havens that attract large amounts of capital and tax it at low rates can increase their tax revenue without imposing higher burdens on their own citizens.

2.2. TAX HAVENS IN NATIONAL TAX LEGISLATION

In practice, most of OECD Member countries have not set in their legislation or administrative procedures any definition of tax havens nor any criteria to identify them. However, a number of countries that have passed counteracting measures have established criteria, in terms of level of taxation for identifying "tax havens" and prepared lists of countries which fit in these criteria. For instance, the Belgian law made reference to countries where taxation is "substantially more favorable" than that in Belgium and to countries where companies benefit from a special tax treatment. In France, the legislation refers to the concept of a foreign country or territory with a "privileged" tax regime where no tax is imposed on profits or taxation is substantially lower than that in France. The same criterion is followed by Japan. Under the German provision, tax havens are defined as jurisdictions with less than 30 per cent taxation on intermediate income. Reference is made by the United Kingdom legislation to "a lower level of taxation", which is defined as meaning a tax charge which is less than one-half of that of the United Kingdom tax which would be payable by a non resident company if it were resident in the United Kingdom.

Concerning the Brazilian experience, operations involving tax haven had never been considered by our legislators until the enactment of the "Lei nº 9430/96", which brought some changes to the federal taxes' legislation. Instead of *tax havens*, this law adopted the expression *countries with favored taxation* ("paises com tributacao favorecida"), defined as countries that have no income tax or which maximum income tax rate is inferior to twenty per cent. Later, the Brazilian Revenue Office edited the "Ato Declaratorio SRF nº 32/98" and the "Ato Declaratorio SRF nº 110/98", which listed the places that fit in the definition mentioned above. Similarly, the "Instrucao Normativa SRF nº 116/98", which regulated some customs procedures, brought a list of places regarded as tax havens. They were explicitly mentioned as follow:

I- Countries: Barbados, Bahrain, Chipre, Costa Rica, Liechtenstein, Panama and Trinidad-Tobago;
II- Autonomous areas: Netherlands Antilles and Madeira Island;
III- United Kingdom's dependencies: Bermuda, Gibraltar, Cayman Islands, Channel Islands (Jersey and Guernsey), the Turks and Caicos and British Virgin Islands.

The purposes of these lists and of defining "countries with favored taxation will be analyzed further in this paper.

2.3. MAIN CHARACTERISTICS OF CLASSICAL TAX HAVENS

In the years since the Second War, many places have acquired reputation as tax havens, in the classical sense of OECD report. From these experiences emerges a number of factors which are generally accepted as characteristic of successful tax havens.

a) *No or low taxes on all or certain types of income and capital*. The main purpose of an operation involving tax haven is to obtain benefits in taxation, taking advantage of its no or lower taxation. Thus, there may be extremely low or no capital gains or transfer tax, gift, death or estate duties. The difference in the level of taxation between jurisdictions is determinant to decide whether a tax haven should be used and, if so, which one.

b) *Bank and commercial secrecy*. Tax havens generally allow secrecy or confidentiality to operations in or through them. Many jurisdictions offer protection to banking affairs and other financial transactions from divulgence to foreign tax authorities, and some of them have also enacted secrecy or confidentiality provisions. Generally, classical tax havens do not require the production of companies' annual accounts.

c) *Lack of exchange controls*. Many tax havens developed a dual currency control system, under which residents are subjected to both local and foreign currency controls and non-residents, only to the local currency controls. Companies set up in a tax haven are treated as non-residents for exchange control purposes and their operations conducted outside the tax haven, in foreign currency, are not subjected to exchange controls. These rules are purposely designed to facilitate the use of tax havens.

d) *Relative importance of banking*. In classical tax havens, the banking sector gives different treatment to residents and non-residents, suppressing or smoothing controls and imposing lighter or no taxation on the latter. The existence of a modern and efficient banking system is essential for the success of a tax haven and, for this reason, greatly stimulated. Thus invariably, the volume of banking business is totally unrelated to the size and needs of the domestic market. Financial activity generates revenue for the tax haven, which also benefits from the generation of employment and the rental of local facilities, and creates an infrastructure which can be used both by fraudulent and legitimate business.

e) *Communications*. Tax havens must be accessible physically and have facilities to deal with information. Thus, it is necessary an infrastructure that provides good means of transportation (such as air or sea connections) and networks such as post, telephone, cable and satellite communication, which are especially important to financial and banking activities in tax havens.

f) *Other aspects*. A tax haven must have political and economic stability. Lack of political or economic confidence has prevented some places from becoming a tax haven and may endanger the future of places regarded as tax havens. The existence of tax treaties and double taxation agreements is other aspect which make a tax haven attractive. Having a good treaty network with important countries prevents incomes channeled to the tax haven country from being excessively taxed at the source. The availability of competent professional advisers, such as accountants and lawyers, is also crucial to a company that wants to set up operations in a tax haven.

3. TAX SYSTEMS OVERVIEW

3.1. TAX SYSTEMS AND THE TERRITORIALITY PRINCIPLE

The traditional architecture of capital taxation was created mostly when, for various reasons, such as wars or depressions, the economies of industrial countries were relatively closed and capital hardly crossed national borders. Although economies are now much more open and integrated and capital has gained enormous mobility, that model is still largely intact.

The tax systems developed from that model hold a national or subnational character: taxes are levied by countries or, in some cases, subnational jurisdictions. It is assumed that the subjects taxed by the taxing country are for the most part *citizens* of the country or *national* enterprises and that a special relationship is established between the taxing country and these taxed subjects. This relationship is based on the **principle of territoriality** that gives the government of a given geographic area the right to tax the subjects that reside in that area and the activities that take place in it. This principle means that the country is uniquely responsible for the taxation in its own territory.

It was also assumed that much of the income of the taxpayers originates from within the jurisdiction, since foreign source income played only a marginal role at the time when the architecture of the current tax systems was designed. Other assumption held by the model is that all taxpayers report their total income to the tax authorities, who will be able to verify independently the accuracy of the reported income. No importance was given to the components of the total income, although tax rates were differentiated among different income levels.

The increasing integration of world's economies has changed this picture. Tax systems still remain the exclusive responsibility of particular countries, however the tax authorities have had to deal with the growing importance of incomes earned abroad by their residents.

Thus, assuming a continuation of recent trends, in which individual and companies invest and earn incomes outside their countries in search of differential economic opportunities and differentials in tax rates or in the efficiency of tax administrations, the institutional-legal-administrative structure that remains tied to the principle of territoriality will be in no time unsuitable to face economic activities that will lose more and more their national or territorial character.

The increasing pressures caused by the intensifying process of economic integration, which brings serious difficulties for open economies to impose capital income tax, reveal the weakness of the territoriality principle. However this principle have become the soft underbelly of tax systems, there seems to be no possibility of developing a tax system that transcends the countries' responsibilities. Policy makers and tax theorists believe that tax jurisdictions have no other support base but the tax territory principle, simply because there is no good substitute for it.

Moreover, it must be taken into account that different interests and conflicting objectives hold by particular countries have prevented changes aimed at harmonizing their tax systems or at least making them more compatible with one another, so that tax systems remain the exclusive responsibility of these countries. Indeed, there is no example of any tax levied by a jurisdiction larger than the country. Even within European Union, there has been so far no talk of a European tax administration and a truly European system, although the European Union has been receiving a share of the revenue from the value added taxes collected by the member countries. Concerning European Union, Vito Tanzi believes that "The assumption continues to be that each member country will continue to have its own tax structure and tax administration and that, somehow, such an alternative with some policy and administrative adjustments will be viable".

As multinational corporations, in the process of growing integration of world's economies, extend their operations across domestic borders and intensifies the allocation of financial savings, managed by increasingly sophisticated, global money managers, relying on advanced technologies, countries are faced with increasing difficulties in verifying the incomes reported by their taxpayers. Obviously, tax administrations find it easier to control domestically generated incomes than foreign incomes owing to the differences of legal and accounting backgrounds among different countries and to the difficulties to access information related to international operations.

Actually, the complexity of the mentioned problem deepens when the increasing tax competition from other countries is taken into account. Some countries may decrease their tax rates in order to attract foreign tax bases, inducing mobile capital to flow toward the lower taxation jurisdictions. Agreements of cooperation in exchange information can be settled among countries, although experience demonstrates that, given the scarce resources, tax authorities tend to concentrate efforts in domestic issues at the expense of other countries' information request. Other countries may not only decrease their tax rates, if not exempt completely from tax, but also offer themselves as tax havens in the classical sense given previously, so that any kind of information would be out of reach of foreign tax authorities, protected by secrecy or confidentiality allowed by tax havens to persons transacting business in or through them. The difficulties involved in the exchange of information between countries will be better analyzed in the next item.

As the territoriality principle may sometimes be confused with the source principle, which will also be analyzed in the next item, it is worthy pointing out basic differences. The former is one of the general principles which form the framework of a country's legal system and is closely related to sovereignty. Based on this principle, an independent and self-governing country has complete freedom and power to establish rules, enact laws and enforce their compliance within its territory. On the other hand, the source principle is one of the specific principles that can be adopted by a country's tax system to guide the taxation of capital incomes. Thus, the latter is intrinsically a tax principle.

3.2. RESIDENCE PRINCIPLE X SOURCE PRINCIPLE

To understand how the existence of tax havens and its use can affect a country's tax base, leading its revenue from taxes on capital income to fall, it is important to analyze the two general principles which guides the international taxation of capital income: the residence of taxpayer principle and the source of income principle.

According to the residence principle, the country of residence of the person that receives the capital income (the investor) determines the tax liability and collects the taxes, so that the place where the incomes are generated is assumed to be irrelevant. This principle, being ad personam, fits the tax liability to the person that receives the income and has the merit of making possible the imposition of progressive and global income taxes on all the incomes of the residents of a given country.

Thus, the total world capital income of an individual, be it generated domestically or in other countries, is taxed by the country where the taxpayer reside in. By the same token, nonresidents of the country where the incomes were generated are not subjected to the income taxes levied by that country. In this manner, the residence principle implicitly assumes that government expenditure, financed through taxation, benefits residents but does not contribute to raising the rate of return to capital invested domestically because nonresidents are exempt from country's taxation.

The application of this principle promotes *capital export neutrality* because the allocation of investment among countries would not be influenced by the tax treatment of capital income in the countries that receive the investment and where the capital income would be generated. Under the principle of residence, the only relevant tax consideration to the investors would be the tax rates of the place in which they reside and not of the countries where they invest their savings, so that foreign investments which generate higher rates of return than domestic investments will be chosen.

On the other hand, the source principle requires the capital income to be taxed by the country where that income is generated and not by the country where the funds for the invested capital originated, thus ignoring whether the receiver of the incomes is a resident or not.

The source principle breaks the link between capital income tax and total personal income tax, especially when the taxpayer is a nonresident. Under this principle, the focus is on the income produced, the object of the tax, rather than on the person receiving it, which depersonalizes the tax. A conflict comes up when the taxpayer resides in another country and the taxpayer's country of residence adopts the residence principle, resulting in a situation of double taxation. In these circumstances, the country of residence or the country of origin of the income (source country) may choose to provide some tax relief to the taxpayer, which takes the form of a tax credit or a deduction of taxes paid abroad against the taxable income. So, the problem of double taxation can be alleviated by agreements (tax treaties) between countries.

The universal application of the source principle would imply that the capital income of individuals living in a given country that was earned in different countries, and thus their investment, would be taxed differently depending on the tax systems of the countries in which they invested their money, unless these countries harmonized their tax rates. On the other hand, the source principle treats all foreign investors in a given country in the same way regardless of the tax rates in the countries in which these investors reside or in which the capital originated, so that, by not interfering with the allocation of saving, this principle preserves *capital import neutrality*.

The residence principle is generally considered preferable on allocative and mainly on equity grounds because it is consistent with the application of a global and progressive income tax on all the incomes of individuals and also because it leaves a greater freedom of action to governments to use the income tax for redistributional purposes.

However, countries who adopts the residence principle have given special treatments for some taxpayers (subsidiaries of transnational companies) which leads tax payments not to be made for a long or even indefinite period. The reason is that residence countries often allow the foreign subsidiaries of their national companies to defer tax payments until they repatriate their profits. Thus a residence principle that allowed indefinite deferment of the repatriation of the profits of subsidiaries would de facto reduce to zero the tax rate on these profits.

Furthermore, the existence of tax havens and the possibility of establishing residence or, at least, a "tax address" in such countries challenge the efficiency and presumed superiority of the residence principle on allocative grounds.

Tax havens have been used for reducing tax liabilities purposes and are particularly attractive for individual taxpayers from high-tax countries who would be subject to high marginal tax rates on reported incomes in their countries. Actually, some of these individuals may change their place of residence through migration.

It is also attractive to establish legal headquarters for some enterprises and, especially, holding enterprises, mutual funds, and other such institutions that can attract financial assets from individual in high-tax countries and can invest them wherever the returns are highest. In this manner, earnings are channeled to tax havens where they are subject to zero or very low tax rates and if the residence principle is fully applied, these earnings might end up escaping taxation almost completely, leading the country where the financial capital originated to lose tax revenue.

Although capital neutrality would still be achieved, because capital would still be channeled, or better rechanneled, to the countries with the highest prospective returns, the proliferation of tax havens and their use clearly reduce some of the advantages of the residence principle. The principle can no longer assure equity because of distortions brought about by tax havens in the use of the global income tax for individuals where the savings originated.

As mentioned initially, most of tax havens are very small countries who offer themselves as convenient instruments for reducing tax burden and do not have a large enough economic base to generate through their own economic activities, especially directly productive activities, the incomes received by those who establish residence in them. For this reason, real resources will still go to the investments and the countries where they would have gone if the tax havens do no exist. Thus the world allocation of investible real capital may not be greatly changed by the utilization of tax havens. What changes is the world allocation of taxable income.

It is important to point out that it is not the existence of the tax havens that tends to lower the world tax rate on capital income, but the tax treatment of incomes earned elsewhere and channeled to the tax havens. If source base taxation were widely used, tax havens would not affect tax rates unless the tax haven countries developed large production bases themselves, which is not the case. It is the combination of tax havens with the application of the residence principle that brings about depressing effects on the world rate of taxation on capital income. In this manner, when countries follow the residence principle and are incapable of preventing their taxpayers from establishing tax addresses in tax havens, the effect on the tax rates on capital income and the revenue losses to these countries could be significant.

The unavailability of information is another shortcoming associated with the residence principle. This principle is only feasible and useful only as long as the tax administration of the country of the investor has the capacity to acquire the information about the incomes that their residents receive from foreign sources. Obviously, the information provided by the taxpayers cannot be assumed to be trustworthy, and the taxpayers may not provide any information at all. Therefore, a tax administration will depend on the willingness and the ability of other tax administrations to supply the information.

Incomes earned in one country and not reported or underreported to the country in which the tax evaders reside is the main concern of tax authorities in the context of growing integration of the world economies. However, although a full and efficient exchange of information between tax authorities is the basic condition to tax income on a global basis supported on the residence principle, the absence of cooperation among tax authorities has been the rule. This economic integration is leading to an exponential growth in foreign-earned incomes and thus to growing possibilities for tax evasion. The prevalent perception is that foreign income may become a synonym for evaded income.

Great efforts have been made to improve the cooperation among countries and exchange of information between tax administrations has grown as a result of the increasing number of tax treaties, which usually carry provisions that permit one party to request information from the other party whenever it is necessary. But this process faces many difficulties on legal, technical or political grounds.

Concerning legal difficulties, the requested country may not provide information that involves trade secrets or that is not available owing to special legal or administrative guarantees made to taxpayers. Even when the information is available, the exchange may only happen as long as it is related to taxes covered by the tax treaty or convention. Moreover, as exchange of information is restricted to persons who reside in the countries covered by the treaty, tax evaders who claim tax address in third countries, say, in a tax haven country, will have accounts and other information protected from divulgence, so that the requesting tax authority may not be able to get the information.

Regarding technical difficulties, countries do not keep their record in a standardized format that lends itself to the easy identification of particular information. As many countries face resources constraints, they will give low priority to information requests because of the need to deal with their own domestic tax evasion problems. Even when the information is provided and the requesting country is able to convert the format to a usable one, the quality of the data is sometimes not reliable. Furthermore, language differences may be even a harder obstacle, comprising translation and interpretation difficulties.

As for political difficulties, many countries may show resistance in exchanging information on taxation when this information may discourage foreign investments in them or reduce the competitiveness of their exporters. The policy of some countries, and especially of those classified as tax havens, have been directed at attracting investors and capital from other countries, so that secrecy and confidentiality offered as an attractiveness are not compatible with cooperation in information exchanging. These countries are likely to see this as a zero-sum game in which the revenue gains to other countries may imply revenues or investment losses to them.

3.2.1. BRAZIL AND THE RESIDENCE PRINCIPLE

The Brazilian tax system had always been attached to the source principle because Brazil has been a great capital importer. As long as Brazil deepens its insertion in the process of globalization, domestic and national based multinational companies extend their operations abroad, bringing about the need of adapting and modernizing the income tax laws to a more universal approach.

This different approach was materialized with the enactment of the "Lei nº 9.249/95", which introduced the concept of world basis taxation in the Brazilian tax system, backed by the residence principle. According to the article 5 of this law, the profits and incomes generated abroad will be included in the income tax base of the matrix company in Brazil, which means that resident companies are liable for Brazilian income tax on any profit or income regardless of the local of their generation.

Despite the lack of data and numbers about the increase in income tax revenues, the results of this law tends to be negligible in the short run and maybe also in the long run. The reason is that the "Instrucao Normativa SRF nº 38/96", which regulated that law, established that the profits and incomes originated abroad will only be subject to income tax when they are made available for the matrix company. Actually, as long as the companies defer the distribution of income, the payment of income tax can be postponed indefinitely. Moreover, as previously analyzed, there are many difficulties involved in auditing the information provided by the taxpayer, mainly when the branch is located in a tax haven.

4. TAX HAVENS AS A MEANS OF TAX AVOIDANCE

4.1. MAIN TYPES OF USES OF TAX HAVENS

The main motivation for the use of tax havens is probably the tax advantage they offer, even though many transactions involving these places have little impact on taxation imposed by taxpayer's country of residence, as tax haven countries are also used in some cases for genuine trade or business reasons. The main uses of havens for tax purposes are briefly analyzed as follows.

a) Emigration and shifting of residence.

In countries with a relatively high level of taxation, taxpayers may be tempted to avoid being subjected to domestic taxes by moving their residence to a tax haven country. However, emigration to another country may take place only if it offers a better or at least a equivalent environment to that left behind, accompanied by non-tax motivation, as tax savings can frequently be obtained in more convenient ways than through emigration.

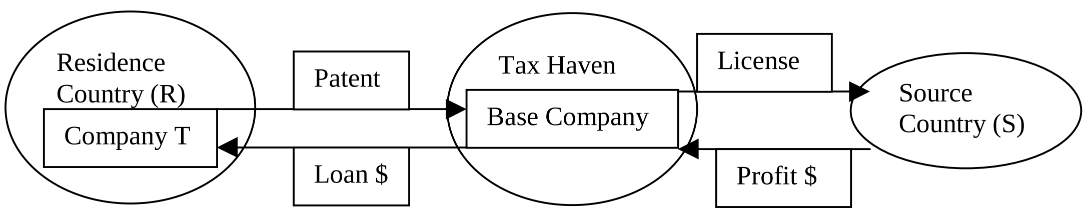
Alternatively, residents of high tax countries may attempt to manipulate rules concerning fiscal residence to avoid domestic taxes. Individuals may set up an artificial residence in a tax haven so as to deceive fiscal residence tests provided for under domestic legislation, even though in practice they retained essential links with their country of origin.

b) Base companies

For tax purposes, the most important function of a base company set up in a tax haven jurisdiction is to collect and shelter income from high taxation in the taxpayer's country of residence. The base company, be it a holding company, an investment company, a finance company or a trade company, is an entity with its own legal personality and is recognized as such in the country of residence, so that the income is no longer subject to the normal taxation regime of his country of residence.

As the tax advantage exists only if the sheltered income is not distributed, the distribution by the base company may be indefinitely deferred so that the tax deferral is prolonged on a medium term or even a long term basis by means of the secondary sheltering mechanisms. This involves changing the character of income to make use of exemptions provided for under tax treaties or domestic rules in the taxpayer’s country of residence or by use of other techniques, such as returning the income to the shareholder in form of loans or alienating a holding in the base company to realize the capital gain which may be exempted or taxed at a lower rate.

The existence of a good tax treaty network in a tax haven is of utmost importance to assure tax advantages, as favorable treaties allow normal withholding tax rates to be reduced or eliminated altogether. Thus, from the taxpayer’s point of view, income derived from intangible assets, such as copyrights, patents and know-how, should be collected in a low-tax country without being subject to high withholding taxes in the source country. The royalty income which arises in a country can be routed through another or several other jurisdictions before ending up at a tax haven. In order for such a system to work the intermediary or conduit company has to be a beneficiary of the double tax treaties involved.

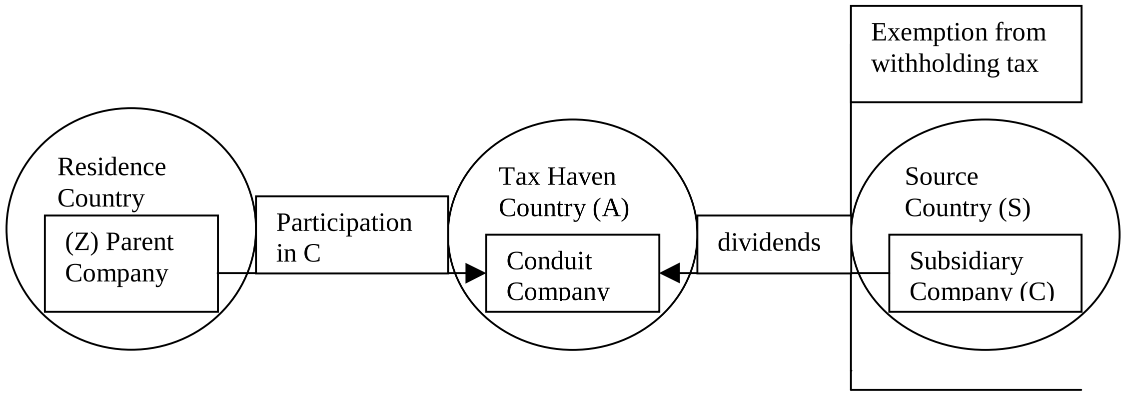


In the example above, the company T, resident in country R, has developed a new product. It is patented in favor of a base company in a tax haven country which gives license do third parties in country S. The income arising from the source country S can be sheltered in the tax haven country or lent to company T against the payment of interest which is deducted from T’s taxable profits.

c) Conduit companies

As mentioned above, some companies are established with the only objective of serving as a channel for the income. Such a company is used by a taxpayer resident of one country to direct flows of income originated in a third country, through a tax haven which has a suitable network of bilateral tax conventions. The objective is to benefit from a more favorable tax treatment in the source countries made available by the tax treaties. Thus, the tax advantage sought is in the source country and not the residence country.

As conduit companies are set up in countries benefiting from double tax treaties, which levy no or little tax on receipts of foreign-source or passive investment income, dividends and other payments they receive pay low withholding taxes at source due to the treaty and are usually transmitted to a base company in a low-tax country.



In the example above, a company Z is a parent company with wholly-owned subsidiary in the source country S. The country of residence of Z has no treaty with source country S. Z transfers its participation in C to a conduit company in the tax haven country A. The dividends received are not subject to a tax because of a participation exemptions or a system of indirect credit existing in the tax haven country. Exemption from withholding taxes in the source country S is claimed on the basis of the treaty network of the tax haven country A. The dividends are reinvested by Z in new subsidiaries.

d) Insurance companies

Captive insurance companies, which use seems to be increasing, are established to deal with insurance of the risks of the parent companies, since no deduction is usually allowed in the source country for self insurance. Tax advantages may influence the choice of locating the captive insurance company in a tax haven, however the deduction for the premium allowed in the country of the parent company is more important than minimizing tax on the profit of the captive in the tax haven.

Should it exist domestic restrictions on the use of foreign insurance companies, similar tax advantages may be obtained by forming a domestic captive insurance company which then reinsures in a captive insurance company situated in a tax haven.

e) Shipping

“Open registration” or “flags of convenience” are expressions that refer to the opportunity that non-resident enterprises have to register a ship in certain countries and to carry that country’s flag although the administrative headquarters is sited and real business carried on elsewhere. There are a number of significant non-tax reasons for using flags of convenience such as low registration fees, lower wage costs, reduced technical standards required and a lack of other operational controls from government.

However, “open registration” may also give rise to significant opportunities for tax avoidance. Generally, low or no income taxes are paid in the country of registration on profits from shipping operations, as the “open registration” country may be a tax haven, or the profits can be routed through a tax haven jurisdiction commonly by using leasing and chartering arrangements.

f) Service companies

Service companies ostensibly performing management functions for non-trading activities are set up in tax havens to avoid taxes, reduce operating costs and avoid government controls. The usual technique used to shift profits from the "high tax" country to the tax haven involves payment of a fee for services rendered.

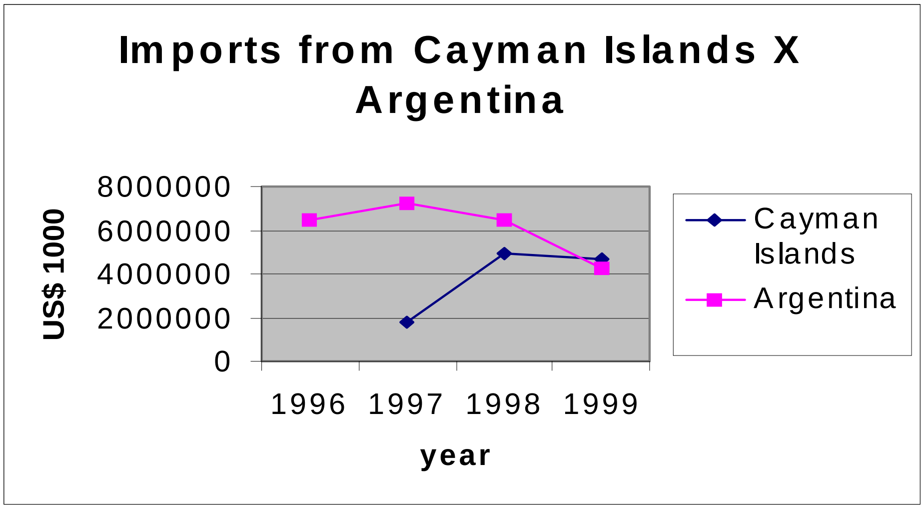
4.2. THE SIZE OF THE TAX HAVEN PROBLEM IN BRAZIL

It is extremely difficult to determine how much tax is lost by relatively high tax countries because data presently available on the use of tax havens are limited and may well be difficult to interpret. Moreover, the very characteristics sought by tax haven users, in particular, confidentiality and secrecy with respect to financial information, make reliable estimates difficult to formulate.

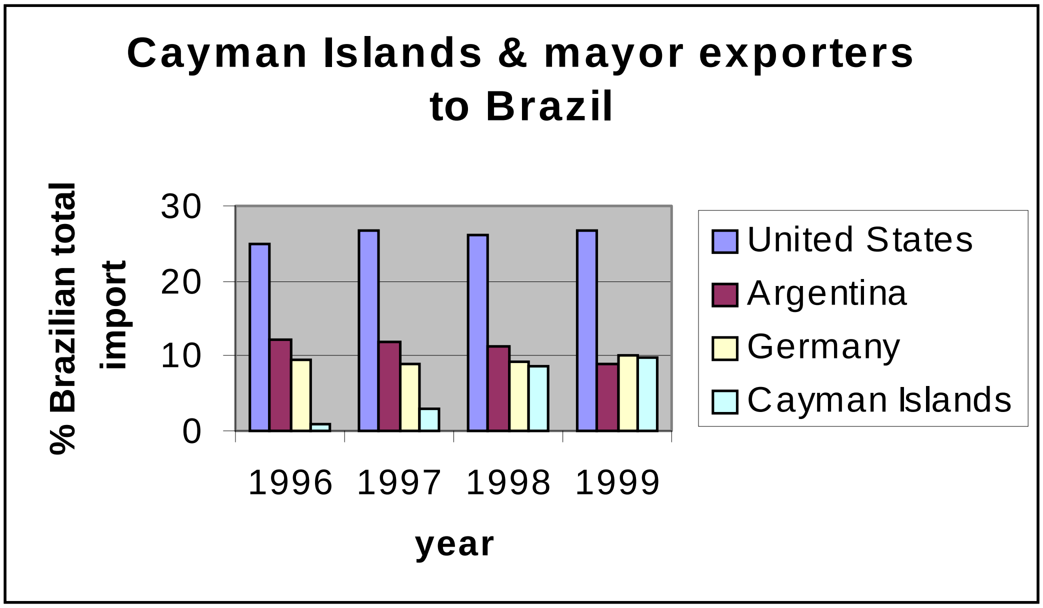
Nevertheless, two major reports on tax haven activities prepared by the American government, the Gordon Report and the Tax Havens in the Caribbean Basin Report, and some other published material give some indication of the size of the problem faced by certain countries.

Assessing the size of the tax haven problem in Brazil is even a more difficult task, given that only recently the Brazilian economy became more open and there are no studies about this subject. Although the data available about operations and activities involving tax havens does not permit a better understanding of the objectives underneath, whether tax saving oriented or not, there is a clear perception that national or multinational companies set up in Brazil increasingly make use of tax havens.

Analyzing the volume of imported goods from major exporter countries to Brazil, extracted from SISCOMEX, helps to shape a perception about the size of the tax haven problem. Traditionally, the three major exporter countries have been United States, Germany and Argentina. However, Cayman Islands, who was not among the 20 major exporter countries to Brazil in 1996, has become the third major exporter country to Brazil, surpassing Argentina in August of 1999, the major Brazilian partner of MERCOSUR, as shows the graphic below.



The graphic below, based on data provided by SISCOMEX, shows the evolution of the participation of Cayman Islands in the Brazilian imports. The third position among the major exporter countries to Brazil in 1999 is amazing, given the small industrial activity in Cayman Islands and lack of tradition of its products when compared to countries with similar volume of exportation to Brazil, say Argentina and Germany. The obvious conclusion is that Cayman Islands has been used as an intermediary for tax and non tax purposes by private economic operators, who take advantage of its characteristics inherent to classical tax havens.



5. ANTI-AVOIDANCE MEASURES

5.1. OBJECTIVES

The prevention of tax revenues losses is undoubtedly the main goal of every legislation designed to curtail tax haven abuses. Analyzing anti-avoidance measures adopted by counties like United States, Canada, Australia and New Zealand, other important objectives can be found, however such goal are relatively more difficult to achieve. The more important goals will be described as follow.

a) Preserving domestic source income

One goal of anti-avoidance measures is to remove tax incentive that domestic taxpayers otherwise would have for making foreign investments rather than domestic investments. To advance this goal, the domestic legislation should impose a current tax on foreign source income of its domestic taxpayers whenever the income is derived from moveable capital, such as interest, dividends, rents, royalties, income from reinsurance of domestic risks and income from foreign currency transactions.

An open economy country that does not have such rules applicable to income from moveable capital can not enforce a traditional income tax on its residents. Taxpayers holding moveable capital are allowed, in effect, to elect whether or not they will pay income tax on significant portion of their income. Many of those taxpayers will elect not to pay as they come to understand the tax avoidance opportunities available to them.

b) Horizontal equity

The horizontal equity is based on the premise that domestic taxpayers earning domestic source income should bear the same tax burdens as otherwise similarly situated domestic taxpayers earning foreign source income.

To achieve this goal, a country's income tax system should impose a current tax on the foreign source income of domestic taxpayers, subject to the allowance of a credit for foreign income taxes paid. Domestic taxpayers should also not be allowed to defer payment of taxes on income earned in a foreign country even if they did not have a tax avoidance motive. Horizontal equity typically advances the efficiency of a tax system as well as its fairness.

c) Backstopping transfer pricing rules

A third substantive goal is to support the transfer price rules for a country's tax code. This support is provided by taking away the tax benefits otherwise obtainable from the manipulation of prices charged on transactions with related persons. To advance this goal, transfer pricing rules should be adopted and applied to business income that has been deflected to a tax haven country through one or more transactions having no substantial economic nexus with that country. Transfer pricing rules will be better explained later.

d) Preventing capital gains conversions

A fourth goal of anti-avoidance measures is to prevent domestic taxpayers from converting ordinary income into capital gains in order to benefit from lower tax rates imposed on capital gains, compared to tax rates on ordinary income. An example of such conversion occurs when a subsidiary established in a tax haven jurisdiction accumulates income that could have been repatriated and the matrix company decides to sell its stock in the subsidiary company. The gain on the sale actually represents the undistributed profits. Obviously, this goal is relevant only for countries that provide a tax preference for capital gains.

e) Preventing perpetual deferral

The fifth goal of anti-avoidance measures is to prevent domestic taxpayers from obtaining a permanent deferral of tax by receiving indirectly through a disguised dividend the income earned abroad by means of a subsidiary company. To prevent tax-free repatriations, a wide variety of transactions made, directly or indirectly, between the subsidiary company in a tax haven country and the matrix company must be made taxable.

5.2. THE WORLD EXPERIENCE

The escalating use of tax havens and the correspondent losses of revenue have led many countries to adopt measures aimed at curbing the abuse of tax havens. General measures applicable to all types of tax avoidance or evasion and more specific measures to deal with tax havens have been incorporated to their domestic legislation.

a) Transfer pricing legislation

Commercial transactions between different parts of a multinational group may not be subject to the same market forces ruling relations between two independent firms. Transfer prices – payments from one part of a multinational enterprise for goods or services provided by another – may diverge from market prices for reasons of marketing or financial policy, or to minimize tax. According to the "arm's length principle", which guides the transfer pricing legislation, transfers within a group should approximate those which would be negotiated between independent firms.

Transfer pricing legislation is a powerful instrument that allows tax authorities to examine international transactions between related persons, to verify the existence of price manipulation and to reallocate income or disallow costs that are not determined on an arm's length basis. Although these provisions are not focused particularly on transactions with tax havens, they are an important tool in preventing the artificial shifting of income to base companies established in tax havens.

b) General provisions on tax avoidance

Some countries have general anti-avoidance provisions that are, in principle, applicable to the whole of their tax legislation. According to these general clauses, the effect of a transaction would be disallowed if the taxpayer obtained a tax advantage contrary to the basic principle of the tax law which would have been applicable had he used the most natural way of carrying out the transaction. These provisions apply to arrangements that are blatant, artificial or contrived and enable denial of a tax benefit obtained by a tax payer as a result of entering into a scheme designed predominantly to achieve that benefit.

However advantageous these general provisions may be, they are unlikely to be the main legislative weapon used by authorities to counter the abuse of tax havens, even because the courts of many countries are unwilling to look beyond the letter of the law, in which case specific legislation is eventually resorted to in order to solve the dispute.

c) Substance over form

The concept of "substance over form" which, in broad terms, can be defined as the prevalence of economic or social reality over the literal wording of legal provisions, has been used to counter the attempted circumvention of tax laws. This approach can be adopted by the courts as a principle of interpretation or explicitly set out in a statute.

However, this principle is applicable only if the tax authorities are able to establish the economic reality of transactions under dispute. Such a process requires information on international transactions which difficulties involved in its obtainment have already been analyzed.

d) Maintaining the withholding tax on income paid to non-residents

High rates of withholding tax on income such as interest, royalties, dividends, rents, management fees and other similar payments, paid to non-residents may also be used as a general weapon in the arsenal of counteracting measures. The maintenance of withholding tax also prevents companies in a tax haven country from being used as "conduit companies", particularly for the collection of interest and royalty payments between a resident of a treaty partner and a resident of a third country.

Obviously, the effectiveness of this measure depends either on the refusal to conclude tax conventions with tax havens or on having safeguarding clauses introduced into the conventions with tax haven countries so as to enable withholding tax reductions or exemptions to be refused in certain circumstances.

e) Shifting the burden of proof

Usually the "burden of proof" (or the "burden of persuasion") lies with the tax authorities but in some countries it will normally rest with the taxpayer, who has to provide detailed evidence when claiming the benefit of tax provisions or challenging the assessment made by the tax authorities. However, even when the burden of proof is imposed on the tax authorities, in some instances it will be reversed to the taxpayer's side in the case of certain types of transactions with low-tax countries. Such provisions aim mainly at discouraging disguised transfers of profits abroad and the accumulation of income in tax havens.

Some countries have found barriers to introduce these measures because of the difficulty in defining what should be regarded as a low-tax country, especially in view of frequent changes in foreign tax legislation and tax rates.

f) Subpart F-type provisions

This is the most significant type of tax legislation directly aimed at counteracting the tax advantages derived from the deferral possibilities offered by the use of tax haven subsidiaries. Broadly, this is achieved by taxing the subsidiary's income in the hands of its domestic shareholders.

g) Offshore investment funds

Financial institutions frequently set up mutual funds, unit trusts and similar investment vehicles in tax havens. The investment concern itself pays nom or nominal, tax in the haven. If income were totally distributed to the investors, they would pay tax on it year by year in the countries in which they are resident. However, the income is often not distributed instead being accumulated and increasing the value of investors' holdings so that, when the investor eventually disposes of his holding, he has a capital gain which will reflect the accumulated income. In the absence of counteracting legislation, investments vehicles in tax havens can therefore be used to convert income into capital gain, with a substantial tax saving for the investor.

The popularity of such investment vehicles has caused a number of countries to take legislative action. Under new provisions, while in some countries investors are taxed annually under rules for calculating the amount of income relating to the year in question, in others investor's gain is taxed as income at the time when the holding in the investment concern is disposed of.

5.3. THE BRAZILIAN EXPERIENCE

Transactions and operations involving foreign countries have been neglected by the Brazilian tax legislation until recently. In view of a significant growth in international trade and movements of capital and factors of production, it was necessary to adapt and modernize the Brazilian tax system and thus efforts have been made to develop a more universal approach.

The first important change was the enactment of the "Lei nº 9.249/95", which introduced the concept of world basis taxation, as already mentioned before. Even though this law does not aim specifically at curbing the abuse of tax havens, incomes generated or sheltered in tax haven countries are subject to its rules.

When compared with other countries' legislation, specifically with Subpart-F type, the "Lei nº 9.249/95", regulated by the "Instrucao Normativa SRF nº 38/96", seems very permissive and thus ineffective as a weapon against the improper use of tax havens. Under this legislation, the payment of income tax can be postponed indefinitely as long as profits and incomes originated abroad will only be subject to the Brazilian income tax when they are made available for the matrix company, whereas Subpart-F type counteracting legislation in many countries provides that, under certain conditions, a resident shareholder may be taxed on profits of a foreign-controlled company which are not distributed to the shareholder, thus preventing the tax payment from being deferred.

However Brazilian tax authorities share the same difficulties faced by other countries to obtain and verify the veracity and accuracy of reported data and information, countries like Canada and United States have accomplished sizeable results in the implementation of subpart-F type legislation by imposing heavy penalties to discourage taxpayers from delaying or refusing disclosure of information concerning foreign affiliates. Thus, the lack of provisions in the world basis taxation legislation to enforce accurate disclosure of foreign affiliations and trading results can jeopardize the effectiveness of its implementation in Brazil.

A second important change came up with the "Lei nº 9.430/96", which introduced the rules about transfer pricing. By and large, the Brazilian transfer pricing rules follows the same guidelines issued by OCDE, although small differences can be found between other OECD member's legislation and ours.

Similarly to other countries, the transfer pricing provisions enable Brazilian tax authorities to examine and assess, in accordance with the arm's length principle, the "right price" of goods transferred between two related persons located in different countries. The determination of the transfer price is guided by complex methods and subject to certain procedures described in the "Lei nº 9.430/96".

As explained before, these are general provisions which apply indistinctly to any transaction involving related persons situated in different countries, regardless of being tax havens or not. However, the "Lei nº 9.430/96", aiming at curbing the abuse of tax havens, provides, in its article 24, that the application of such methods and procedures is mandatory whenever the other part is located in countries with favored taxation ("paises com tributacao favorecida"), even when the persons involved in the transaction are not legally considered to be related.

Although it is known that tax haven countries are also used in some cases for genuine trade or business reasons, the mentioned law extended the application of transfer pricing rules to every transaction involving tax havens, or countries with favored taxation, regardless of the relation between the persons, under the assumption that such transactions hold more likelihood of being aimed at tax avoidance or evasion purposes. Underbilling the price of exported goods or overbilling the price of imported goods are the more basic forms of producing profits in tax havens, where they are subject to no or low taxes.

The "Ato Declaratorio SRF nº 32/98" and the "Ato Declaratorio nº 110/98" listed the places that fit in the definition of countries with favored taxation given by "Lei nº 9.430/96", so that companies transacting with others located in those places are subject to special auditing procedures. The list is reproduced in the item 2.2. TAX HAVENS IN NATIONAL TAX LEGISLATION.

The same places regarded as tax havens were also listed in the "Instrucao Normativa SRF nº 116/98", which provided that, during the period between 10/01/98 and 12/31/98, every good produced, proceeded or imported from tax havens must be subject to customs evaluation control.

The customs evaluation control is not traditionally considered to be a counteracting instrument against the use of tax haven because it aims at preventing the underbilling of imported goods with the objective of evading tariffs and import taxes, and this form of evasion generates profits in the importing country and losses in the tax haven exporting country, thus not consistent with the lower income tax rates offered by tax havens. Notwithstanding, such control was established under the assumption that every import from tax havens potentially involves tax avoidance or evasion.

6. FINAL REMARKS

However tax havens are used for sheltering illegal money and also for legitimate business because of their peculiar characteristics such as secrecy, lack of exchange control, good banking, communication and transport structure, tax advantages end up being their major attraction both to wealthy individuals and large corporations.

As long as economic agents have become more sensitive to differences in effective tax rates and capital gained mobility within the process of growing integration of world's economies, capital tends to flow from high to low tax countries, mainly to those regarded as classical tax havens. Thus, tax havens have imposed an unfair tax competition for international capital, not only by means of reducing tax rates, but also introducing changes or distortions in the tax bases, which is less visible than low tax rates.

As the capital flees from high tax jurisdictions in large amounts, these countries, specially the smaller ones, have faced serious difficulties in maintaining high tax rates on capital income and had their tax base substantially deprived, harming their welfare system. Some small countries may be stimulated to become a tax haven, intensifying even more the tax competition and the distortions among different countries. It has become clear that, due to the differential tax treatments, no capital income tax can be efficiently imposed by open economies if capital flight to the rest of the world can not be effectively stopped.

Should continue the current trends, creation of new tax havens and sharp growth of its use within the process of deepening integration of world's economies, countries will be forced to harmonize their tax legislation, leveling the tax rates and combating the use and proliferation of tax havens, or, being extreme, they will lose their capacity of imposing capital income taxes, at least on the current rates, leading to a gradual deemphasis of capital taxation.

Given that tax systems are intimately attached to the territoriality principle, domestic laws have not been adequate to prevent capital flows towards low tax countries in search of shelter. The lack of collective measures aimed at leveling the tax burden and prevent tax competition caused by tax havens, in addition to the inability of individual countries to stop capital flows, shows the fragility and inadequacy of existent tax systems to face the harmful use of tax havens.

The harmonization of countries' tax systems would be a necessary condition to deal with the problem of capital flight and losses of tax revenue. Without some policy responses, either on the part of countries acting individually and specially acting in groups, aiming at reducing international distortion, caused mainly by tax competition of tax havens, the allocation of the world savings and capital may become progressively more inefficient and reduce world welfare. However, the lack of better possible alternatives to the territoriality principle and the existence of conflicting objectives among countries suggest that coordinating and harmonizing tax systems are far from being achievable.

Concerning capital income taxation, the application of the residence principle is jeopardized by the difficulties in verifying the incomes earned abroad, which tend not to be reported or to be underreported by the taxpayers. Tax administrations can not rely on the exchange of information even among non-tax haven countries due to the substantial legal, political and technical limitations involved. When it comes to tax havens, it is virtually impossible to get the needed information since tax haven countries do not have any interest in sharing information with the countries from which they attract capital and most of them adopt banking secrecy laws as an additional factor of attraction to the foreign capital.

On the other hand, the application of the source principle is not advisable because if capital is mobile, the tax will be more heavily imposed on immobile factors (labor and land) as the capital flees in order to escape from withholding taxes. However, the source principle, with the adoption of withholding taxes, would be preferable if attempts to reduce tax evasion through cooperative actions fails within a tax system based on the residence principle and the concept of global income tax.

Despite the urgent need of collective harmonizing and coordinating actions, there is no world institution with responsibility to establish desirable rules for taxation and with enough political influence to accomplish their compliance. The Committee for Fiscal Affairs, subordinated to OECD, provides room for the discussion of technical issues and diffusion of tax information, thus playing only an informative role, and its influence is limited to the OECD members. There is thus no institution comparable to GATT or the new World Trade Organization for trade issues, or comparable to the International Monetary Fund for general macroeconomic issues, despite the fact that tax matters are becoming as important in relations among countries as trade matters.

Even without a global approach, isolated countries and mainly some OECD Member countries have made great efforts to improve their domestic legislation aiming at curbing the tax haven abuses, however the results have been timid when compared with the increasing volume of commercial operations involving tax havens and the tax revenue losses assessed. Some countries like Canada and United States have accomplished some relative successful measures which have been gradually followed by other countries, including Brazil.

However, Brazil has just started to make some attempts to diminish the tax revenue losses caused by tax avoidance and evasion by means of tax havens. It is too early to assess the results of the implementation of anti-avoidance measures, but the initial perception indicates negligible results in the short run and also in the long run in view of the lack of reliability of the information reported by the taxpayer and of instruments to get the necessary information, such as information exchange agreements with foreign countries and domestic heavier penalties when taxpayers deny to disclosure required information. Thus, besides facing the same problems as other countries with more experience in anti-avoidance measures, Brazil still has much to improve in terms of enforcement and applicability of its tax legislation, as well as of the qualification of its tax administration and exchange of experience with other countries.

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