Gray Areas of Offshore Financial Centers

Matthew Davis

Chancellor's Honors Program
Senior Project

Introduction

Offshore finance often brings to mind illegal activities such as money laundering and tax evasion. Over the years, these shady dealings have become associated with offshore banking due to its lax regulations and strict adherence to client secrecy. On the other hand, offshore financial centers can also be used for legitimate reasons such as setting up offshore hedge funds.

Many motives drive the move of funds offshore and increase the activity of offshore financial centers. Some are completely legal, while others focus more on criminal activity. Often, the line between these legal and illegal activities is a very thin one. Specific regulations cannot be made to cover every single new situation, and taxpayers are forced to make decisions about how to interpret the law. This creates a gray area where it is unclear as to what is legal or illegal. When an issue falls in this gray area of what is right or wrong, and taxpayers can interpret for themselves what is legal, they often come up with the most beneficial situation for themselves.

This paper will explore some of the gray areas that exist in offshore banking and how taxpayers can utilize them for their benefit. These gray areas provide a great opportunity for people to save on taxes or secretly transfer money into other accounts. Unfortunately, when people try to push the envelope in offshore finance, the legal line is often crossed.

What are OFCs?

Before diving into specifics about how offshore financial centers (OFCs) can be used for personal benefit, it is important to have a good understanding of what they are. The term "offshore financial centers" can have a very broad meaning and has many different definitions attached to it. In fact, there is no specific definition that scholars can attach to the term. Essentially, OFCs are territories whose financial sector is largely separated from regulatory bodies and mostly controlled by non-residents (Global Financial Crime 10). OFCs' separation from regulatory organizations is necessary for them to function as secrecy centers and tax havens and often comes in the form of geographical location.

Geographic location can play a key role in influencing where OFCs can successfully exist. As mentioned earlier, OFCs can use their location as a means to separate themselves from certain regulatory bodies. In order to do so, it is necessary to be located outside the direct control of major developed economies. While being physically removed from these major economies, it is still advantageous to be in close proximity to them. The Caribbean has prospered as a hot spot for OFCs partly because of its location near the United States and Latin American countries (Walter 210). Caribbean islands are only a short flight from the major financial centers of the East Coast yet they are outside the reach of some American regulations. When coupled with advantageous legislation, the Caribbean becomes a very beneficial setting for OFCs. Similarly, Asia has Hong Kong, Europe has Switzerland, and the Middle East has Dubai just to name a few (McKee 5).

Although the Caribbean is often thought of as the center of offshore banking, modern offshore financial centers and tax havens first developed in Europe. Monaco was one of the first to set itself on a path to becoming a tax haven when it abolished all personal taxation in 1868 (Palan 159). Since then, Monaco has evolved in its tax haven status and remains one of the few countries on the Organisation for Economic Co-operation and Development's list of uncooperative tax havens.

Switzerland was also a pioneer in developing offshore financial centers. It created the idea of banking secrecy and invented anonymous numbered banking accounts, for which it is still known. Today, in OFCs around the world, banking secrecy is a traditional trait that can be traced back to Switzerland. The Swiss actually take such a strong stance on banking secrecy that their laws on the subject have become the standard for other offshore financial centers (Palan 162).

OFCs did not exist in the Western Hemisphere until 1936 when operations were set up in the Bahamas by the British and Canadians (Suss 4). The idea of becoming an OFC soon spread to other former British colonies and eventually throughout the Caribbean. Amazingly, in the relatively short amount of time that OFCs have been in the Caribbean, the Cayman Islands have grown to be the world's fifth largest banking center (Owens).

Secrecy and Money Laundering

According to the International Monetary Fund, money laundering is "a process in which assets obtained or generated by criminal activity are moved or concealed to obscure their link with the crime" (Black Finance 109). Once the money has been cleansed of its illegal taint, it is ready to be integrated back into the legitimate market. Money laundering is a large-scale problem, with worldwide annual estimates at two to five percent of total world economic output (Morris 16). This is one of the largest illegal motivations that drive offshore financial centers. Actually, money laundering is so intertwined with offshore financing, that the two will forever be associated with each other. Neither money laundering nor offshore banking can be mentioned without the other coming to mind. While offshore banking encompasses far more than just money laundering, laundering still relies on offshore banks because of their few questions asked mentality.

While it is one of the reasons offshore banking can be used for legal purposes, banking secrecy is paramount to money laundering. Since concealing the money's source is the objective of laundering it, secrecy is obviously very advantageous to the process. Offshore banks offer confidentiality to money launderers that the onshore banks cannot compete with. This available secrecy is what drives much of the illegal market offshore.

The process of money laundering involves a few steps to ensure that the money appears clean and can have many parties involved depending on how elaborate the scheme is. Once illegal money has been obtained, it must first be consolidated and

deposited at a legitimate financial institution to begin the laundering process. Before the funds can be moved to other destinations, the launderers are at a greater risk of detection because the money is easily traceable (Black Finance 104).

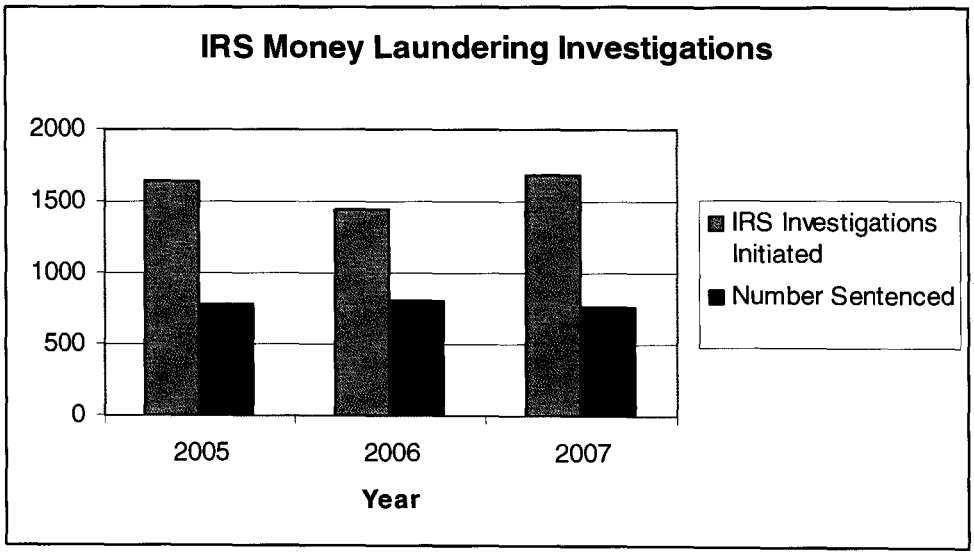
Now that the money is in a bank, the launderer can begin transferring funds and start the true cleaning process. This second stage, generally referred to as layering, is also where offshore financial centers become involved. At this point, the money is moved to an offshore bank account with less strict regulations and is transferred around the world to different accounts and businesses. Often, launderers will create fake transactions to involve other businesses in the process as a means to distance the money from its original source. In addition to business transactions, money can be transferred many times through accounts around the world to create a trail that is difficult for authorities to follow. These other businesses and accounts involved are either owned by the primary launderer or by an accomplice that is assisting with the laundering. Eventually, after many transactions, the money will end up back in control of the launderer.

The final step to successfully laundering money is to integrate it back into the economy. Now that the money is difficult to trace back to its original source, it can be invested however the launderer pleases. Generally, the funds are invested in real estate, luxury items, and business ventures (Black Finance 105).

Throughout the laundering process, offshore financial centers serve multiple roles. First, they create a barrier between authorities where the funds are generated and the money itself. Once the money has been moved offshore, it is often out of these authorities' legal jurisdiction, and at the very least can make them jump through hoops to

form a case against the launderer (Global Finance 78). Even when authorities begin investigations, only about one half of those investigations ever result in sentencing:

Figure 1



Data source: http://www.irs.gov/compliance/enforcement/article/0,,id=113002,00.html

Secrecy is another role that offshore financial centers fill during money laundering. Money is harder to trace offshore than domestically due to laxer banking secrecy laws. These countries are referred to as Lax Financial Regulation (LFR) countries (Global Financial 125). While this secrecy can be utilized for legitimate purposes, it often entices people to cross the thin line into illegal operations.

Tax

Taxes provide one of the largest gray areas related to offshore finance. There are many ways that taxpayers can move or hide their earnings to reduce their tax liabilities. Frequently the taxpayers think they are just capitalizing on legal loopholes, but sometimes they cross the line into illegal tax evasion. It is often unclear at what point avoiding taxes becomes illegal, which poses a serious problem to governments and authorities concerned with regulating tax revenue.

OFCs have become so appealing to use in tax evasion schemes because of their status as tax havens. To attract foreign investment, these jurisdictions have adopted either a very low or, in some cases, no income tax rate. When tax incentives like this are coupled with strict banking secrecy laws, it is easy to see why so many taxpaying entities are utilizing tax havens to reduce their tax liability. In fact, tax havens are being utilized so much that some of the highest estimates approximate that up to half of the world's money passes through tax havens (Palan 151). This extensive use of OFCs reveals the importance of regulations to help ensure that taxpayers do not cross the line into illegal tax evasion.

In 2000, the Organisation for Economic Co-operation and Development (OECD) released a report on global tax cooperation naming many jurisdictions as uncooperative tax havens. Since then, the OECD has made efforts to help these countries increase their financial transparency and become more cooperative in the fight against abusive tax practices. Because of their commitment to cooperation, thirty-five jurisdictions have since been labeled as "Committed to Improving Transparency and Establishing Effective

Exchange of Information in Tax Matters" and an additional three other jurisdictions have been removed from the list of uncooperative tax havens. Only three jurisdictions (Andorra, the Principality of Monaco, and the Principality of Liechtenstein) remain on the list as uncooperative tax havens at this time (List).

Figure 2

Jurisdictions No Longer on OECD's List of Uncooperative Tax Havens		
Anguilla	Gibraltar	Niue
Antigua and Barbuda	Grenada	Panama
Aruba	Guernsey	Samoa
Bahamas	Isle of Man	San Marino
Bahrain	Jersey	Seychelles
Barbados	Liberia	St. Lucia
Bermuda	Maldives	St. Kitts & Nevis
Belize	Malta	St. Vincent and the Grenadines
British Virgin Islands	Marshall Islands	Tonga
Cayman Islands	Mauritius	Turks & Caicos Islands
Cook Islands	Montserrat	US Virgin Islands
Cyprus	Nauru	Vanuatu
Dominica	Netherlands Antilles	

Source: http://www.oecd.org/document/19/0,3343,en_2649_201185_1903251_1_1_1_1,00.html

Tax Avoidance

Tax avoidance generally refers to the use of legal practices to reduce tax liability. To remain legal, avoiding taxes must focus on restructuring income before any taxes are incurred. Once income has been earned and taxes have been incurred, the taxes are due and must be paid. Avoiding paying taxes that have been incurred is illegal and crosses the line into tax evasion. Companies can take advantage of loopholes in tax regulations

to reduce their tax liabilities. Many companies have teams of lawyers and accountants devoted to finding these legal ways of avoiding taxes.

One way that many taxpayers have reduced their tax liabilities legally is through changing their official residency. United States citizens and companies must pay taxes not only on their national income, but on their global income as well. Although rare, some Americans avoid taxes by expatriating and relinquishing their United States citizenship (Abusive).

Recently, OFCs have been used to create marketable securities by repackaging debt and loans (Sullivan). With the crisis in the credit market, billions of dollars worth of loans are becoming delinquent and the original lenders are looking to offload them anywhere they can. Some offshore hedge funds have seized this opportunity to purchase these loans and repackage them into marketable securities hoping to later sell them at a profit. In many cases, the hedge funds are able to avoid taxes on profits from these securities even though they have employees who live in the United States. They take advantage of a loophole in the tax code that does not tax these companies if they are only passively involved in trading and investing. The hedge funds have been lobbying for the Bush administration to clarify their tax exempt status in these circumstances so that they can increase their investment in repackaging delinquent loans (Drucker).

Tax Evasion

Tax evasion sounds similar to tax avoidance and, in a way, it is. Evading taxes does result in a lower tax liability, but it does so by crossing legal and ethical boundaries. Offshore financial centers can be used legally to reduce tax liability, but unfortunately, they can also serve as havens for those who wish to find ways to avoid taxes by circumventing the law.

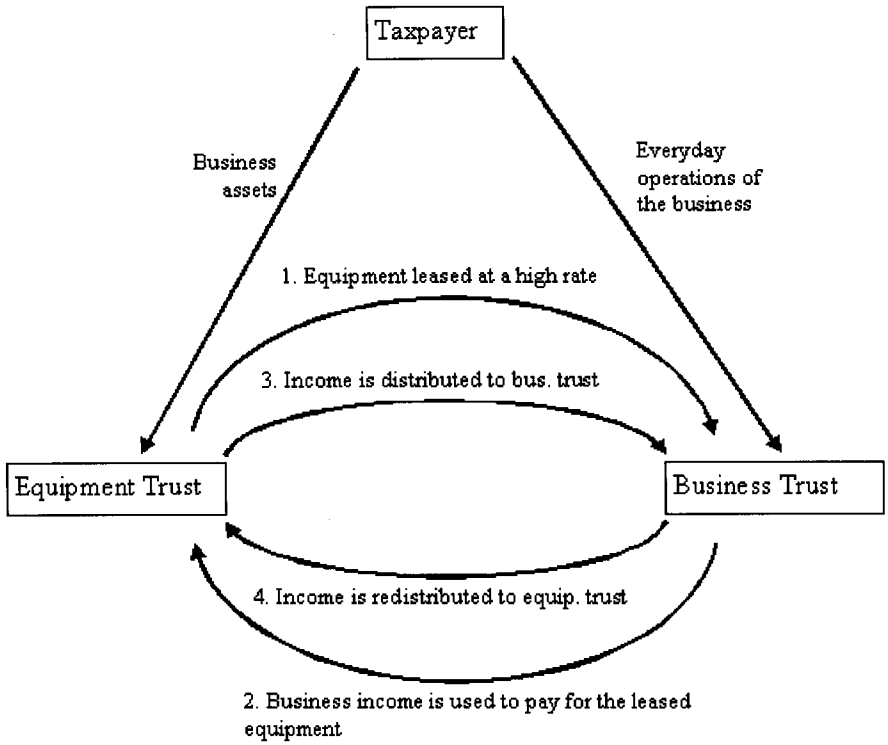
Tax evasion can come in many forms. Some are blatantly illegal, while others are close to the thin line between tax avoidance and evasion. Either way, the combination of both banking secrecy laws and favorable tax rates makes offshore financial centers ideal places for tax evaders to operate.

Foreign trusts are a favorite method of tax evaders when using offshore financial centers. These trusts are established offshore in tax havens that will provide a much more attractive tax rate than the original onshore country. To avoid onshore taxation, however, all profits must appear to have originated offshore. This generally requires more steps than just creating one trust and transferring profits to it.

The IRS suggests one scenario that has been used to illegally transfer profits to a foreign trust. A taxpayer starts by creating a trust and transferring ownership of a business to it. Now that the taxpayer no longer technically owns or controls the business, he does not have any tax liability for its income. Banking secrecy laws in the OFC where the trust is established also help to separate the taxpayer from ownership of the business. Next, the assets and equipment of the business are transferred to another trust that leases them to the business trust at a very high rate to cancel out its profits. To insure that all profits appear to have originated offshore, the income from the lease is distributed to the

business trust, which, in turn distributes that income back to the equipment trust. At this point the equipment trust has accumulated all the income of the business but disguised it as being earned offshore (Abusive). Figure 3 demonstrates the different transferals in this scenario:

Figure 3



Information source: http://www.irs.gov/compliance/enforcement/article/0,,id=105822,00.html

Once a taxpayer has engaged in tax evasion, there is still the problem of getting money from offshore accounts back onshore without raising suspicion. Many tax evaders now use offshore credit and debit cards to access their money. These cards are issued in

offshore financial centers and draw money out of offshore accounts. The money in the accounts can come from anywhere and, because of the banking secrecy in the OFCs, onshore agencies face an arduous process to discover the true origin of the money (Johnston). For instance, in the above tax evasion example, the equipment trust that ended up in possession of all the income could transfer its earnings into an offshore bank account. The original taxpayer could then acquire a credit or debit card that draws from this account, in effect spending income that was never taxed. Another popular method of repatriating funds from tax evasion is issuing a loan from offshore to an onshore accomplice. The money can be transferred this way and is not taxable because it is a loan (Abusive).

Kellogg Brown & Root

Over the last few years, the largest foreign contractor in Iraq has been playing in some of the gray areas of offshore finance and flirting with the legal line. Kellogg Brown & Root (KBR), a contracting firm that has been hired by the Department of Defense to help rebuild the oil infrastructure in Iraq, has avoided paying Social Security and Medicare taxes for many of its employees. The company has more than 21,000 employees that because of corporate structuring are not officially employed by KBR. In 1993 and 1995, KBR created two shell companies in the Cayman Islands that it uses to hire its overseas employees. The use of these companies means that all of these overseas employees are not actually working for an American company, and therefore KBR does not have to pay payroll taxes for them. By use of the shell companies, KBR was able to withhold over $500 million in tax revenue from the government (Stockman).

In this instance, KBR utilized loopholes in the tax code to avoid paying taxes. While this might be on the legal side of things, it surely crosses the ethical line. As a company, saving money is important but so is honesty. Unfortunately, many of the workers were unaware of their status as foreign employees and did not find out until they were back in the United States. Since they had not been contributing to Medicare or Social Security, these workers' benefits will be reduced in the future. Despite acting legally, KBR has done the United States and these workers a disservice by depriving the country of rightful tax revenue and by depriving the workers of future benefits which they should be receiving.

Conclusion

When dealing with offshore finance, there are many areas where it is not completely clear where the legal line is. As people decide for themselves how far to venture into these gray areas, they often cross that line and, with the secrecy laws that exist offshore, it can be very difficult for onshore agencies to ensure that all business is being conducted within the legal limits.

In the end, it all comes down to ethics. Most people know what is right or wrong and decide how to behave. Some people intentionally break the law to launder money or evade taxes, but others try to test the legal boundaries without crossing the line. Unfortunately for those who are pushing the limits, if you play with fire, sometimes you get burned. Acting ethically and doing what you know is right is really the only way to be sure that you stay legal in the gray areas of offshore banking.

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