Tax Havens and the Financial Crisis

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- Is there a **common definition** for a tax haven?
- Is there a **consensus** in the academic world?
- The **political debate** about tax havens
- Tax havens and the **financial crisis**

Is there a common definition for a tax haven?

- **According to OECD (1998),** a jurisdiction is identified as a tax haven when it may be ”…*used by non-residents to escape tax in their country of residence*” (p. 22)
- The key factors in identifying tax havens are
- (a) no or nominal taxes
- (b) lack of effective exchange of information mechanisms
- (c) lack of transparency regarding legislative, legal or administrative provisions
- (d) no requirement for corporations to have substantial activity in the jurisdiction

Is there a common definition for a tax haven?

- The description provided by the **US Internal Revenue Service (IRS)**
- "*A tax haven is a country, which provides a no-tax or low-tax environment. <u>The U.S. is considered a tax haven by some countries.</u> In some offshore jurisdictions the reduced tax regime is aimed towards entities organized in the country with all operations occurring outside the country. These countries seek to encourage investment and make up revenue losses by charging a variety of fees for the start up of the entity and on an annual basis.*"

Is there a common definition for a tax haven?

- Most of the **academic literature** uses a more conceptual definition based on the ultimate purpose of tax havens.
- Accordingly, tax havens are simply defined as low-tax jurisdictions that provide investors and corporations opportunities for tax avoidance and tax planning, (Desai, Foley and Hines, 2006a; Dharmpala, 2008; Dharmpala and Hines, 2006; Hines, 2004)
- Although such a broad definition may serve as a good conceptual tool, <u>it is less useful</u> for identifying jurisdictions in practice

Is there a consensus in the academic world?

- Investigating the “**business uses” of such jurisdictions**, attempting to verify empirically whether the jurisdictions are used to lower the tax obligations of multi-national corporations
- A common finding is that a 10 percent corporate tax rate reduction in a particular jurisdiction leads to approximately 6 percent rise in inflow of foreign direct investments into that jurisdiction, (Hartman, 1985; Slemrod 1991)
- Investigating how **pre-tax profits respond to domestic tax burden**
- A common finding is that foreign affiliates of US multinational enterprises post higher pre-tax profits in countries with lower levels of taxation, effectively confirming the income-shifting hypothesis (Grubert and Mutti (1991), Harris et al. (1991) Hines and Rice (1994) and Demirgüç-Kunt and Huizinga (2001))

Is there a consensus in the academic world?

- These empirical studies confirm that businesses and investors do respond to tax opportunities globally
- **The question that remains to be answered is the extent of damage caused by these practices**

1. Continued international tax competition will ultimately yield a system where the entire tax burden is borne by immobile factors, such as labour (Gordon (1986))
2. The “race-to-the-bottom” in taxation could also have a negative impact on the capability of larger economy to raise revenues
3. The availability of international tax-planning opportunities may induce multi-national corporations to use valuable resources to locate and benefit from tax loopholes, (Slemrod and Wilson, 2006)

Is there a consensus in the academic world?

- But, there appears to be little evidence of a general decline in effective tax rates on capital in recent years (Slemrod, 2004)

- While tax planning may reduce the tax revenues of high-tax countries, it may also make being located in such countries **more attractive for investment**, (Hong and Smart, 2006)

- Desai, Foley and Hines (2006b) and Rose and Spiegle (2006) show that tax havens **do enhance economic activity in surrounding countries**

- As an additional benefit, Hines and Rice (1994) point out that the low-tax rates offered by tax havens may **reduce the tax credits** provided by the US government to US multinationals on their foreign income, paradoxically **enhancing tax revenues**

Is there a consensus in the academic world?

- However, it should be underlined that there has been <u>no study</u> that has effectively tested the welfare losses through the use of valuable sources for wasteful purposes. The question on whether tax havens are beneficial or detrimental to the rest of the world economies is therefore open

The political debate about tax havens

- **OECD** became the body responsible for achieving international cooperation on tax policy, which has led to a 1998 report on *Harmful Tax Competition: An Emerging Global Issue*, OECD (1998)
- The **Financial Action Task Force (FATF)** was held responsible for putting forward international best-practices to counter first money laundering (via the 1989 “40 recommendations), later terrorist financing (via the 2001 “9 Special Recommendations”) and more recently the misuse of corporate vehicles
- The **Financial Stability Forum (FSF)** launched in 1999 to promote international financial stability through the effective exchange of information exchange and coordination among national and international institutions that have the shared purpose of assisting financial stability in their respective spheres of influence and more recently became the Financial Stability Board.

The political debate about tax havens

- The EU has also applied pressure on jurisdictions within its direct and indirect jurisprudence by pushing through the "Code of Conduct for Business Taxation" by the end of 1997, which identified several areas to combat harmful tax competition within its borders: **Business taxation, taxation on interest income from savings, fiscal State Aid, and withholding taxes on cross-border interest and royalty payments between companies**
- The 2003 European Directive on the taxation of savings (which was implemented by 2005 and amended in 2008) required jurisdictions to engage either in automatic exchange of information or withhold a portion of interest savings

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- The discoveries of hidden accounts held in Liechtenstein by German residents and alleged involvement of UBS employees in illegal advice to US tax-payers in early 2008
- The role of SPV and other complex vehicles incorporated in tax havens (e.g. Cayman Island)
- The role of hedge funds and other players domiciled in tax havens
- The massive government bail-outs of banks having subsidiaries and branches in tax havens
- **have increased the media attention and political pressure on these jurisdictions**

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- The “Stop Tax Haven Abuse Act”, introduced in February 2007 by Democrat representatives Levin and Obama, creates a list of 34 “offshore secrecy jurisdictions”, authorizing the US Treasury to impose sanctions against jurisdictions, financial institutions and others (i.e. advisors) that help US tax-payers impede the law.
- On March 2009, **a “lighter” version** of the bill was announced by the Senator Baucus, chairman of the Senate Finance Committee, which focuses on individual compliance measures only and disposes with the list
- **The question is: how credible is this bill and if so, will it be enforced?**

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- At their London summit in 2 April 2009, G20 countries agreed to a **blacklist for tax havens** drawn up by the OECD
- The list differentiated between countries that have substantially implemented the OECD information exchange standards (the so-called "white-list") from those that have shown a commitment but not yet implemented ("grey-list"). The 2 April 2009, which was prepared ahead of the G-20 meeting, included a list of countries that have not committed to the standards ("black-list"), comprising of Costa Rica, Malaysia, Philippines, and Uruguay
- This list was later updated in 7 April 2009 **to remove countries from the non-cooperative category** since they have been upgraded to a higher commitment level after they provided arguments or shown their willingness to cooperate with the OECD standards
- **Is this commitment credible?**

Tax havens and the financial crisis

- Political pressure (as long as it lasts) for tax havens (what ever definition applied) to cooperate and abide by international rules
- Threat of economic sanctions is more credible?
- Countries such as Belgium, Austria, Luxembourg, Switzerland which are not categorized as tax havens (but very close) will have to honor their commitment to implement the OECD information exchange standards
  - Should change opposing behavior in the adoption of the European taxation of savings directive

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