OFFSHORE INVESTMENTS

by

ANA MAURA MOTTA SAFRIN

(Under the direction of Professor Hellerstein)

ABSTRACT

This paper presents a study about offshore investments. It offers a broad analysis of the most popular structures used to carry those investments, the reasons why individuals and corporations choose this path and places that offer benefits for foreign investors. It also presents a discussion about the point of view of some international organizations regarding the use of offshore jurisdictions. Since the author is from Brazil, a brief description of the Brazilian laws for investors that “go offshore” is included in addition to the American laws. The work experience of the author with the subject was a good source of information to conclude that the benefits that can be obtained by the use of offshore entities depend on a number of factors, including the investor’s objectives, residency or citizenship, as well as the countries in which the entity will be doing business and that the offshore world will have to put in practice new procedures to keep the offshore industry alive, because of the many recent international reports.

INDEX WORDS: Offshore, Investments, Trusts, Funds, Offshore companies, Tax heavens, Offshore jurisdictions.

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DEDICATION

It was not your choice to come but you did and changed our lives completely. You turned our house into a home. You make us happy, as we have never been before. You show us that life is beautiful. You make us believe that everything is worth it. You are teaching us to love unconditionally. For all that you have done for us in only seven months of life, I dedicate this paper to you, my daughter, Julia Lauren Motta Safrin.

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Family is the most important value that I have in my life. By family I mean those who have the same blood as I do and also those who I chose either by marriage (my husband and his/my family) or by friendship. Although many times they are not aware, they are very important to me in every step I take. Thanks you all for being part of my journey.

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*T*ABLE *O*F *C*ONTENTS

*I*NTRODUCTION

For centuries people have been trying to protect their wealth by avoiding paying taxes. The practice dates back to when Athens was a leading international city and retailer dealers would substitute a longer route to avoid the 2% taxes over the exported and imported merchandise charged by the government of Athens. This trend continued in the American colonies that used Latin American countries to do their trading in order to avoid English duties.[1] Offshore jurisdictions as they are known today began to develop after the end of World War II. Some of the factors that helped the formation of this market were "the uncertain world situation, the increased awareness of corporate treasurers, [and] the advantage of depositing dollars abroad (higher interest)".[2] Currently, the reasons that encourage investors to go offshore are the mostly different, ranging from simply safeguarding their assets to avoiding taxes.

What exactly does the term "offshore investment" mean? The term "offshore investment" basically refers to an investment made in a foreign country, giving the investor the possibility of choosing a jurisdiction with a more favorable investment regulation than the one offered by his/her own country.

Jurisdictions that levy little to no taxes are commonly known as "tax havens" and usually offer diverse investment opportunities and greater privacy. Tax havens can be countries or dependencies and are generally referred to as offshore jurisdictions, or

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[1] *See* RICHARD A. GORDON, TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS – AN OVERVIEW A-32 – A-33 (1981).
[2] *Id* at A-34

simply jurisdictions, because tax advantages are not the only benefit that they offer. As this paper will show, the term "tax haven" has a pejorative connotation and is usually avoided to describe these locations. The majority of the offshore jurisdictions have specific, modern laws governing the structures through which the investments can be made. These characteristics are part of the concept of offshore investment, which also includes fiscal neutrality, political stability, confidentiality and legal certainty. Currently there are almost one hundred jurisdictions that offer these and other special incentives to foreign investors worldwide.

Despite the association of the expression "tax haven" to immorality and illegality, moving assets offshore is not against the law in most of the countries. While there are many people who use tax havens in an abusive way, the majority uses them for legal tax planning. Nevertheless, for the investor it is very important to distinguish between tax evasion and tax avoidance, when citing the reason that brought him/her to invest offshore is tax planning. The main difference is simply the first is illegal, while the second is legal.

Tax evasion is characterized by the false reporting of an investor's taxable business. An example of tax evasion is when a person deposits money in his or her own name into an offshore bank account and then does not comply with the reporting requirements of his or her home country law. Alternatively, tax avoidance is the legal structuring of the investor's business with the objective of achieving a lower tax burden in accordance with the law. However, the definition of these concepts will depend on the national law of each investor's country.

It is very important to note that the proper use of an offshore jurisdiction structure for investment depends on the compliance with the laws of the investor's own country and must always be done under the advice of a competent and qualified professional. Because a study concerning all countries' laws about offshore investing would be extremely long and extensive, this paper will concentrate on American and Brazilian laws pertaining to offshore investing.

The growth of the offshore investment industry is directly linked to onshore development. In the last two decades the changes in the political and economic scenario in many nations had a positive effect on the offshore market. The offshore industry, however, does not rely solely on those kinds of changes to grow; it has implemented other features to attract more business. For instance many jurisdictions have been trying to strengthen their position against narcotics trafficking and money laundering. Nevertheless, nations worldwide are not happy about this growth, since it means less investment onshore and less control over its nationals' investment, therefore, less return. This dissatisfaction is confirmed by the attacks that the offshore jurisdictions have been suffering over recent years lead by international organizations like the OECD and the EU under the cover of a concern about money laundering.

Powerful countries support the actions mentioned in the previous paragraph, since they cannot take measures by themselves. Based on international law principles, offshore jurisdictions can legally pass legislation that refrains from taxing any sort of investments within its borders. Countries are aided not only by international legislations but also by their internal principles that safeguard them from conflicts with other nations. The international principle known as the Act of State Doctrine, states that the act of a government within its own territory is not subject to judicial examination by a foreign court. Some exceptions to the doctrine occur when "a nation is acting in a commercial as opposed to governmental capacity, or when the nation has expropriated property. Generally, to reach the exception, there must have been a discriminatory taking or a violation of an investment treaty. To the extent that one of the exceptions does not apply, the doctrine firmly preserves each nation's right to perform government functions, within its borders, without risk of foreign judicial scrutiny."[3] As a result of this doctrine, countries that are against offshore jurisdictions tax practices can only apply political pressure.

The effect of all the actions taken against offshore jurisdictions might not be as harmful to the industry as anticipated; on the contrary, offshore jurisdictions are implementing better regulations as a response that fortify the industry.

[3] Philip S. LaMar, Jr., *Finding Offshore's Basis in International Law*, *at* http://www.escapeartist.com/efam11/Offshore_Law.html.

*C*HAPTER *O*NE

***R*EASONS *T*O *I*NVEST *O*FFSHORE**

For those who are unfamiliar with offshore investments, the attraction of tax savings appears to be the only reason that would induce this type of investing. Although tax savings remain the primary reason a large number of investors seek offshore investing, there are other enticing factors. One such factor is privacy. As it is known, the right to privacy seems to be increasingly disrespected by countries around the world; not only when it is related to financial transactions, but also in business matters. For example, information about the directors and shareholders of a company can easily be obtained in the majority of the countries. Tax planning and privacy are some of the advantages offered by offshore jurisdictions.

It is questionable if the principal function of an offshore jurisdiction is still tax planning. Other aspects are gaining importance. "They are now on the cutting edge of new corporate, investment, trust, insurance, partnership and banking legislation and are amongst the first to offer unique structures …, while continuing to provide the only effective shield against the dangers of confiscation, expropriation, tort law abuse and sanctions."[4]

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[4] *Why Offshore?,* EDITORIAL OFFSHORE OUTLOOK ONLINE (1999) *available at* http://www.offshore-outlook.com/cgi-bin/cgiwrap/cdr/offshore/query_articles.

Other reasons that lead a person to choose offshore investments include: dissatisfaction with its own home country procedures, regulations and laws. Some of the most common reasons are discussed in this section.

1.1 - TAX PLANNING

A large percentage of the offshore industry continues to be based on international tax planning through the use of lawful investment mechanisms to reduce, eliminate or defer many types of taxes.

Citizens in many countries understand the aim of taxation and agree to contribute to the government under the condition that a return contribution ensues in the form of public services or improvement of the overall quality of life. Displeasure arises when people perceive that the money collected by taxes is being used for suspicious purposes or that taxes are too high. "It creates a sense that labor is punished rather than rewarded" [5].

The offshore industry offers an opportunity to people to invest their capital without the risk of being overtaxed, or simply taxed, on their returns. Even when their home country requires legal disclosure on worldwide investments, taxes can still be considerably reduced.

The idea of legally minimizing taxes has even been confirmed by the Supreme Court of the United States as "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."[6]

As has already been briefly mentioned in the Introduction of this study, when investors opt to invest offshore for tax reasons, they must take measures to avoid tax

[5] Philip S. LaMar, Jr., *Offshore: Who Goes There?*, *at* http://www.escapeartist.com/efam15/Offshore.html
[6] MARSHALL J. LANGER, PRACTICAL INTERNATIONAL TAX PLANNING 1-4 (3rd ed. Supp. J9-0011, Practising Law Institute 1997), (citing Gregory v. Helvering, 293 U.S. 465 (1935))

evasion. While tax avoidance is allowed, tax evasion is not. A basic difference is that "[t]ax [e]vasion involves being taken to court and charged with a criminal offence. With [t]ax [a]voidance the worst case scenario is that the government disagrees with you on a tax issue and they make a strong enough case that you have to pay the tax."[7] In general, countries do not penalize a taxpayer for taking steps to minimize their tax burden. In this respect, taxpayers can, for example, defer income from one year to another, benefit from tax deduction and avoid taxes by taking lawful measures. On the other hand, tax evasion is usually related to a failure of complying with report requirements and constitutes a crime. For this reason, it is indispensable to seek legal advice when investing offshore with the purpose of tax planning.

1.2 – CONFIDENTIALITY

The increasing presence of the government in the private lives of individuals is cited as a strong reason for people to invest offshore: "filings and disclosures to the government, originally intended to establish order, have degenerated into Orwellian systems of citizen monitoring"[8]. Investors also attempt to conduct their business confidentially as a way of protecting their assets from harmful actions, third party interference and to reduce unnecessary disclosure and explanation. Confidentiality is also very important with respect to competition. Very often businessmen try to restrict competitors' access to valuable information. Unfortunately, however, this feature is not always available in their own home country.

In contrast to many countries where, for example, details of bank accounts are accessible to the public, most offshore jurisdiction have no disclosure requirement with

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[7] *Offshore and the Law*, OFFSHORE INVESTMENT SERVICE LIMITED (1997), *available at* http://www.pro-net.co.uk/OIS/text07law.htm.
[8] GORDON, *supra* note 2.

respect to investments. Actually it is commonly a criminal offense for the Trust Companies and Banks to disclose details of their clients, unless expressly authorized by the client. In the case of a lawsuit, such information will only be released under the instructions of a local court order. When not compelled by a court order, it is not common practice for an offshore jurisdiction to release information to other governments, unless obliged by a treaty or an agreement with the respective country.

1.3 – ASSET PROTECTION

Offshore investments are also sought by people who want to protect their assets against potential abusive claims from creditors, professional negligence and divorce.[9] They can use an offshore structure[10] to hold assets in a jurisdiction that offers protective laws against those types of lawsuits. Exposure to possible claims is a common reason that entices professionals, for example doctors and surgeons, to place their assets offshore. These steps reduce the possibility of losing everything to a claim, since it becomes a "very costly, time consuming and difficult procedure for anyone seeking to gain custody by a lawsuit, notwithstanding the fact that offshore jurisdiction have created a climate less favourable *(sic)* to the harassment of individuals and trivial lawsuits, making the aggressor's chances of success significantly slim". [11]

A definition of asset protection could be that it is risk management, "a method of managing [l]egal [r]isks". [12] However, efficient protection will be effective only if assets were transferred according to the correct procedure and do not constitute a sham in the

[9] *See* GORDON, *supra* note 2, LAMAR, *supra* note 5 and *supra* note 4
[10] *See* Chapter 2 – Offshore Structures
[11] *Why Go Offshore?,* OFFSHORE INVESTMENT SERVICE LIMITED (1997), *available at* http://www.pro-net.co.uk/ois/text02wgo.htm.
[12] Jay. D.Adkisson, *The Morality of Asset Protection Planning - An Overview of "Asset Protection", The Adkisson Analysis: Morality of Asset Protection Planning, Fraudulent Transfers, Cheating Creditors, Cheating Spouses, Equity, Right, Wrong, Hiding Assets, Obstruction of Justice, Moral Questions, Moral Issues, available at* http://www.falc.com/morality/morality.htm

investor's home country. In this sense, depending on the investors' home country rules, timing is a very important issue to avoid the possibility of making a fraudulent transfer of assets. For example, a fraudulent transfer "occurs when … property is transferred in an effort to prevent a legitimate creditor from seizing the asset, in order to realize the debt".[13] On the other hand, if the transfer happens before any claim arises, it may be viewed as legal. It is always essential to have the guidance of a professional with experience on estate planning, taxation, civil procedure and debtor-creditor law to take the appropriate steps.[14]

1.4 – TRANSFER OF OWNERSHIP

Through the use of a well-planned offshore structure, "the ownership or title to all manner of things can be easily transferred by hand to a person, corporation, trust, or other entity, anonymously and confidentially."[15] Due to the possibility of transferring shares of an offshore company that holds the respective asset rather than transferring the actual property the transfer of ownership of assets can be simplified by the formation of an offshore entity.[16] Since the transfer of shares is simple, it avoids filing of titles, complexity and costly transactions. This is also a very useful feature on the planning of the transfer of control of a business.

1.5 – DIVERSIFICATION OF INVESTMENTS

Many countries have rules in place that limit their citizens' investments by prohibiting them from investing in certain markets. For example, in the United States

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[13] *Offshore and the Law*, OFFSHORE INVESTMENT SERVICE LIMITED (1997), *available at* http://www.pro-net.co.uk/OIS/text07law.htm
[14] For a deeper discussion on this matter, *see id*.
[15] GORDON, *supra* note 8.
[16] *See* Chapter 2

citizens cannot invest in eurobonds; Japan prohibits their banks to act in the securities sector.

Offshore jurisdictions allow diversification of investments that are limited onshore through the use of offshore entities. The use of offshore structures allows the diversification of investments in the international market, which can be very attractive in a volatile stock market or when fixed investments offer low interest. The main benefit of diversification of investments is probably the balance of the investor's portofolio, reducing risk and volatility. In a globalized world, internationalization of investments is a feature that has been attracting many investors, allowing avoidance of the investment control presented by their national economic demands.

1.6 - PROTECTION AGAINST INFLATION

Generally, business people try to avoid carrying on their professional affairs in places where the government does not control inflation. Inflation can be very harmful for business as well as for individuals, since it takes away the value of the assets. Because an offshore structure can hold different bank accounts in any currency worldwide, investors can enjoy less risk of being affected by inflation in their home countries and, thus, avoid depreciation of their goods. Furthermore, most of the offshore jurisdictions have a very low rate of inflation.

1.7 - AVOIDANCE OF EXCHANGE CONTROLS

Many people prefer to carry their foreign business in a country where currency control is not so strict or complicated, so that they are able to move capital in and out easily. Therefore they look for a place for their business where foreign exchange and capital controls are simplified. When money is restricted from movement it has a higher chance of being subject to seizure.

Offshore jurisdictions normally allow the movement of funds in any currency without imposing exchange controls in the country of domicile. Since an offshore structure can hold a variety of bank accounts worldwide, this is a very useful feature, because it permits the movement of funds in any currency and in any country. Furthermore international businesses seek lack of exchange control in order to "receive exchange for import[s] …, to pay expenses in local currencies, to enjoy free transfer of capital, earnings, royalties, fees, etc.".[17]

1.8 – <u>FORCED</u> <u>HEIRSHIP</u> <u>LAWS</u>

Citizens worldwide are concerned with transferring their assets after their death to those beneficiaries who they wish to benefit.

A large number of countries have in place rules that limit the right of disposition of assets through a will by determining who must be the heirs of the deceased. Frequently, offshore jurisdictions allow a person to determine the way that his/her assets should be distributed upon his/her death, without the hindrance of any laws controlling succession. The formation of the proper offshore structure will provide an individual the ability to pass assets to persons other than the forced heirs; therefore he/she will have the peace of mind that the assets will remain at the disposition of the future generations of their chose heirs.

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[17] TAX HAVENS OF THE WORLD: OVERSEAS PRESS AND CONSULTANTS 23 (Walter H. Diamond & Dorothy B. Diamond eds., 2000).

1.9 – CONCLUSION

Depending on the nationality of the investor, the respective laws have to be analyzed and the requirements met in order to not make the offshore investment an unlawful act. To properly enjoy the protection of an offshore jurisdiction, the investor must comply with the laws of his/her own country.

Following is an excerpt of an article reprinted by the Offshore Library that illustrates one example of a lawful way of moving assets offshore:

> An excellent example of a well-known public figure that is publicly known to utilize tax havens to his advantage is Rupert Murdoch. In 1985, media magnate Rupert Murdoch renounced his Australian citizenship and became a US citizen and so was able to comply with the US law that prohibits foreign ownership of television stations. This very wise business move helped Mr. Murdoch build a global entertainment empire that includes among its many subsidiaries the 20th Century Fox studios. Mr. Murdoch's company, News Corp., earns most of its revenue from US subsidiaries, but through the use of international tax havens, Mr. Murdoch has paid corporate income taxes of one-fifth the rate of his US competitors during the 1990s. US authorities do in no way suggest that there is any impropriety in his business strategies. News Corp. has remained incorporated in Australia in spite of Mr. Murdoch's taking on US citizenship. News Corp. has mastered the use of the offshore tax haven in its many international transactions. The company reduces its annual tax bill by moving profits through multiple subsidiaries in offshore tax havens

> like the Cayman Islands. Mr. Murdoch has taken advantage of the differing tax regimes around the globe and so has been able to make sure his companies keep more of what they earn. Mr. Murdoch provides an excellent example of the proper use of tax havens in business strategy for all to follow.[18]

In order to legally invest and transfer assets offshore, the advice of a competent experienced domestic professional is required. Those advisors have been providing people with lawful ways to reduce tax burdens, protect assets, increase privacy and diversify investments by the use of a well-planned offshore structure.

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[18] Marc M. Harris, *The Use of Tax Havens is Neither Illegal nor Immoral*, reprinted by THE OFFSHORE LIBRARY, *at* http://cyberhaven.com/offshorelibrary/harrismoral.html.

*C*HAPTER *T*WO

***O*FFSHORE *S*TRUCTURES**

In order to invest offshore, it is advisable to use one of the available offshore structures, instead of making a direct investment in the name of the individual or corporation. Forming an offshore structure, through which investments will be held, ascertains the right of saving taxes and invokes confidentiality.

Other than simply holding a bank account or owning real estates, an offshore structure can also conduct many different services. Some of them are exemplified below:

- E-business - an offshore entity can provide tax and operational benefits for companies and their shareholders;
- Reinvoicing - trading companies can use reinvoicing operations to reduce their tax burden;
- International Employee Benefit Programs - multinational companies that offer their international employees participation in a range of benefit programs, use offshore jurisdictions to provide a tax neutral administration base for such programs.

In order to form an offshore structure, the investor must contact an institution specializing in the business. Those institutions, often called trust companies, can provide, among other functions, corporate, fiduciary and fund management services, administering the offshore structures formed on behalf of their clients, representing corporate domicile and managing complex trust and fund structures.

The most popular offshore structures used to conduct those investments are companies, trusts and offshore funds.

2.1 - COMPANIES

Companies are the most widely used structure for offshore investments either by individual or corporate investors. According to a statistic recently published by Ocra World Wide[19], around 60,000 offshore companies were incorporated in 1997 solely in the jurisdictions located in the Caribbean. In Hong Kong some 15,000 companies are incorporated every year and 50,000 in other offshore jurisdictions.[20] Adding all these estimates, more than 130,000 offshore companies are incorporated around the world each year.

An offshore company, often known as an International Business Company (IBC), is similar to any corporate structure of any other country. It is, however, a corporation established in a tax-free or low tax jurisdiction and subject to its domestic laws.

In most jurisdictions, if an IBC does not carry on business activities in the place of incorporation, it is exempt from local taxes and only requires a low annual fee payable to the Government. An IBC can and usually does have bank accounts, deal with lawyers, accountants, and trust companies, hold company meetings and keep its accounting books and records in the jurisdiction without breaching the restriction of carrying on local business.

Companies can be used for the achievement of many different purposes, such as:

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[19] *See* http://ocra.com.
[20] *See* Chapter 3 for a discussion on Offshore Jurisdictions.

- E-commerce - an IBC is able to conduct business by the Internet or other electronic means. In developing an e-business, where the products can be delivered electronically, the server can be located anywhere in the world. If it is operated through an IBC the e-business can, for example, avoid sales or value added taxes (VAT) and enjoy limited restrictive regulations regarding the Internet;

- Employment - when corporations have a considerable number of employees on overseas assignments, the formation of an IBC can be a useful tool to minimize "the costs associated with payroll and travel expense administration, and may provide a tax and social security saving benefit for the employees";[21]

- Holding - when an IBC is used as a holding company it offers more privacy to the owner. For example, the holding company could be used to provide loans to subsidiaries in various countries, on which the subsidiaries may get the benefit of tax deductions on interest paid. Since the holding company is situated in a tax-free jurisdiction, profits can be used to fund subsidiaries' requirements or reinvested somewhere else;

- Patent, royalty and copyright holding - an IBC can purchase or have the right to use an intellectual property right given by its original holders with power to sub-license. It can then make agreements with licensees around the world, who would explore these rights in different countries;

- Personal services - professionals in the areas of construction, engineering, aviation, finance, computer, film and entertainment may take advantage of the use of an IBC to "supply the services of the individual outside the country in which he/she is normally resident and the fees earned can accumulate offshore, free from taxation in the

[21] *See* http://www.ocra.com/sep_general/offshore_tax_haven_ggl.html.

offshore centre *(sic)*. Payments to the individual can then be structured in such a way to minimise *(sic)* income tax”[22];

- Property investment - if an IBC owns real estate, when the owner of the company wants to sell the property it can negotiate the IBC’s shares instead of the property itself, which facilitates the transaction and provides the possibility of having many individuals owning part of the property according to the numbers of shares issued by the company. In this case there is no need of having each shareholder recorded as an owner of the property. The incorporation of an IBC for this purpose also offers the possibility of lawfully avoid capital gains, inheritance and property transfer taxes;

- Ship management and yacht owning - the use of offshore shipping companies can eliminate direct or indirect taxation on shipping. Those companies can own or lease ships and have tax-free profits, if the leasing is carried outside the place of incorporation. Some offshore jurisdictions have in place simple registration procedures and low registration fees related to vessels;

- Trading - a company engaged in international trade of goods can have benefits if it is established as an IBC. If a company in one country buys goods in a second country and sells them to a third country, there is no need for the business to be established in the home country. By using an IBC it will probably be possible to defer taxation on the profits and avoid complicated regulations. For example if an offshore company obtains products from one country, and then sells them in another country, the profits arising from the transaction may be accumulated in the offshore company, free from taxation in the offshore jurisdiction.

[22] *See id.*

Although it varies from jurisdiction to jurisdiction, the incorporation of an IBC is quick and simple and sometimes can be done in 24 hours. The main corporate documents are the Memorandum, the Articles of Association and the Certificate of Incorporation. The Memorandum presents the basic structure of the offshore company, including the name, the purposes for which the company is formed, authorized capital, details on the shares which may be issued including denomination, classes and shareholders' rights. The purpose of the company can be specific or can simply refer to any business that is not prohibited by the law of the jurisdiction. The Articles of Association are the by-laws of the company, which determine the relation between its members. They specify the procedures for calling meetings of shareholders, passing resolutions and transferring shares. They also establish the powers of the directors and shareholders of the company. The Certificate of Incorporation is issued by the Registrar of Companies, or its equivalent, after the original Memorandum and Articles of Association are filed and the proper fees paid. It shows the name of the IBC, the date of incorporation and its number. It is the evidence of the company's existence.

It is important to note that none of the above-mentioned documents contains the names, or any other personal information, of the directors and shareholders of the company. In most cases, these are the only documents that are required to be publicly filed.

Generally, an offshore company is required to have a minimum number of directors and shareholders, who do not have to be physically in the jurisdiction of incorporation. Very often there needs to be only one shareholder and one director and the same person can hold both positions and can be either an individual or a corporation.

Meetings can be held by telephone or other electronic means. The local legislation usually requires the existence of a domestic registered office and agent that are represented by the trust company that will intermediate the formation of the structure.

In most of the jurisdictions the first director of a company is appointed by the subscriber to the Memorandum and Articles of Association, normally the registered agent. Another possibility is to have a nominee director, which is a person who works for the trust company to perform this assignment. It is an additional service for which payment is due annually. There are some ways of mitigating the concern that the nominee director will not respect the wishes of the client and will act on his/her own behalf. Some steps that can be taken are "having the assets titled in the name of the corporation and in the name of the [c]lient or a trusted friend, requiring that the nominees put up a bond, or by simply utilizing a well-respected offshore trust company as an additional protector of the company's assets"[23]. The most common and secure way, however, is having the nominee director issuing a power of attorney in the name of the client or a person designated by him/her, giving the right to the attorney in fact to act in the name of the company instead of the director.

The shareholders can, in some jurisdictions, hold registered or bearer shares. When registered shares are issued, the name of the shareholder appears on the share certificate. Registered shares are safer than bearer shares because only the holder of the certificate can claim its ownership. However, it is less confidential, although the name of the shareholder is not public information in most jurisdictions. The advantage of bearer shares is complete confidentiality, since the name of the shareholder does not appear on the share certificate or anywhere else. The disadvantage is that any person who has the

[23] Jay. D.Adkisson, *The Adkisson Analysis*, *available at* http://www.falc.com/corps/corporat.htm.

certificate can claim its ownership. Bearer shares have been forbidden in some jurisdictions as a consequence of the many international recommendations and reports of the past years as will be discussed on Chapter 5. Another possibility is having nominee shareholders, which is a feature similar to the nominee director explained above. It combines the certainty of property of the company and the benefit of confidentiality. In this case, registered shares will be issued in the name of a nominee shareholder that is a person who works for the trust company and an annual fee will be charged for this service. Normally, a private document called Declaration of Trust will be signed between the client and the trust company, to assure that the real owner of the offshore company is the first.

It is important to mention once again that all of the above characteristics are common for most of the offshore jurisdictions but not for all of them. Therefore, when incorporating an IBC the investor should get proper information about the requirements and procedures of the place of incorporation.

2.2 – TRUSTS

The concept of trusts was developed by the English Courts and goes back to medieval times. It was used by the knights at the time of the Crusades when they had to leave for a long period of time, with the possibility of not coming back. They used to transfer their assets to a family member who would keep them in trust and who would have the duty to administer the property for the knights or for those designated by them, in case of their death. It is, therefore, a creation of English Common Law systems and does not exist in civil law countries, although there is an equivalent concept, which will be briefly discussed in subheading 4.3, Chapter 4 – “The Brazilian Laws”.

A trust can be defined as a private legal arrangement, where assets are transferred to a person, a group of persons or a trust company, the trustees, with instructions to keep the assets for the benefit of others. It is characterized by the facts that the trustees are the legal owners of the assets but hold them for the benefit of the beneficiaries, and the assets of the trust constitute a separate fund from the trustees' estate. Trusts can be formed by any person through a Trust Deed, which is a written agreement where the duties and responsibilities of the trustees, the names of the beneficiaries and the assets that will form the fund of the trust are designated.

The Hague Convention on trusts defines the structure as follows:

> For the purposes of this Convention, the term "trust" refers to the legal relationships created - inter vivos or on death - by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.
>
> A trust has the following characteristics:
>
> a) the assets constitute a separate fund and are not a part of the trustee's own estate
>
> b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee
>
> c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.[24]

[24] Hague Convention on the Law Applicable to Trusts and on their Recognition, (1985), *available at* http://www.hcch.net/e/conventions/text30e.html.

The components of a trust are:

- the Settlor – also called the Grantor, is the person who forms the trust. The settlor transfers property to the trust, appoints the trustees and indicates the beneficiaries. After transferring the property to the trust, the settlor must not have any direct control over these assets;

- the Trustees – the legal owners of the trust's assets and those who will administrate them for the beneficiaries. Although they can be represented by a person, in the offshore industry they are always represented by a corporation, which can be "(1) subsidiaries of major international banks; (2) subsidiaries of private banks; (3) trust corporations managed as subsidiaries of accounting firms or legal firms; and (4) independent or private trust companies"[25]. Their duties are legally enforced and involve "make[ing] sure that a property interest gets to the right person at the right time under the right circumstances"[26];

- the Beneficiaries – the ones designated by the settlor to benefit from the property transferred to the trust;

- the Protector – or Guardian is an additional person indicated by the settlor to act as a guardian over the trustees. It is normally a person known by the settlor that will have some control over the trustees' acts.

Any assets can be transferred to a trust, from money to works of art. Generally the assets will be held by an offshore company, which will have as a shareholder the offshore trust, allowing a more flexible way of managing the trust fund.

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[25] Denis A. Kleinfeld, *Letter from Miami*, OFFSHORE INVESTMENT MAGAZINE, June, 2001.
[26] LANGER, *supra* note 6.

The settlor is supposed to have no more control over the assets transferred to a trust or it can be considered a sham. However, there are some ways for the settlor to make sure that his/her wishes will be respected. He/she can, for example, make the trust revocable under certain circumstances (see below for a more detailed explanation); appoint a protector who has the right to approve or disapprove the actions of the trustees, being also able to indicate a new trustee to substitute the original one (as discussed above); and/or issue a letter of wishes to indicate to the trustees the way the assets should be administrated. The letter of wishes is a document that, despite not having legal enforcement, is normally part of the Trust Deed and describes the way the settlor would like the assets to be administrated.

The following excerpt relates the most important characteristics of a trust:

> A trust is usually established through a written legal document called a Trust Deed. Much like a corporation, a trust is a distinct legal entity with its own property separate from the assets of the individual who initially established it. At the time a trust is created, the original owner of the assets (the Settlor) places personal property, real estate, cash, investments or any other assets into a trust to be administered by a trust company, bank, or individual (the Trustee). The trustee then administers the assets for the benefit of certain persons named in the Trust Deed (the Beneficiaries).
>
> The Trustees are required to hold the property in accordance with the terms of the Trust Deed including the administration of the property for the benefit of the beneficiaries.

As a matter of law, the beneficiaries have an equitable interest in the trust assets, whereas the Trustees have the legal title to the property.

[…]

Trusts can be located either in the settlor's home country or offshore. A trust may be made, signed or administered anywhere in the world. The only requirement is that the jurisdiction under which the trust is established recognizes the legal concept of the trust. Accordingly, an offshore trust is simply any trust that has been created and is to be administered by trustees located in a jurisdiction other than the settlor's home country.

[…]

It should be noted that offshore trusts can be very expensive to set up and maintain. Forming an offshore trust is not usually worthwhile unless the trust property is substantial.

Transferring certain assets offshore may be illegal depending on the category of the assets and the country of origin. Professional advice should be sought in one's own home country prior to establishing a trust offshore as well as in the country in which the trust is to be set up.[27]

Some of the most popular reasons for the establishment of a trust are:

- Facts related to family – it creates an efficient way of transferring property from generation to generation and protects the assets from family members that have no experience in business administration;

[27] *Offshore Trusts, at* http://investingglobal.about.com/money/investingglobal/library/weekly/aa062900a.htm.

- Tax planning – since the settlor gives up the legal ownership of the assets it may be possible to avoid some income taxes, as well as gift and wealth taxes;
- Protection against political and social instability – trusts can be used to avoid government confiscation of assets and to offer a safe financial situation outside of the individual's home country in the event of instability;
- Succession rules – some countries have laws that determine the way that the wealth is distributed on the death of the owner. Forced heirship rules, for example, can be avoided by transferring assets to a trust;
- Avoidance of probate – with the death of a person many steps have to be taken during a probate, which are time and money consuming. A trust can offer confidentiality, continuous administration of the property and a simple way of transferring the assets in this event because it is governed by the laws of the country where it is located.

As an offshore company, an offshore trust is also a confidential matter, there is no public record regarding its details.

There are several variations of trusts: the basic dichotomy is between revocable and irrevocable trusts. While the revocable trust allows matters to revert to their original status, on the irrevocable trust once property is transferred to the trust it is not possible to get it back. If there is someway that the settlor can directly or indirectly control the trust, it is probably going to be considered a revocable trust. If not, it will most likely be an irrevocable trust. The revocable trust can be terminated upon the settlor's decision and, in this event, the assets return to the settlor. The irrevocable trust cannot be terminated by the settlor. In general it has a predetermined period of existence or its termination is attached to a certain circumstance stipulated on the Trust Deed. Offshore trusts are usually irrevocable.

The main distinctions between an offshore trust and an offshore company are that while the trust has no owners, only beneficiaries, the company is owned by its shareholders; some jurisdictions do not allow a trust to exist indefinitely, while most allow a company to have an eternal life; a trust is managed by a trustee and the company, by its director; a trust does not have personality, while a company has a separate legal personality from its owner.

The future of offshore trusts are very bright not only because of the growing internationalization of investments but because of its characteristics, as for example the fact that it is a flexible legal mechanism based on a solid and old concept. However, as any other offshore structure, trusts will have to satisfy the new international regulations against money laundering and drug trafficking.[28]

2.3 – FUNDS

A mutual fund is "[a] system of group investment which allow investors to purchase interests representing pro rata shares of the net assets of a pool of securities and other assets"[29]. Offshore funds are funds registered outside the country of residence of the investor, regulated by the laws of the offshore jurisdiction. Being an alternative way of investment, they collect money from investors to invest in a variety of stocks, securities and other papers. In order to keep up-to-date with the demand, an offshore fund issues and redeems stocks.

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[28] *See* Chapter 5 – What to Expect

[29] Hal S. Scott & Phillip A. Wellons, INTERNATIONAL FINANCE, 2000, at 1297.

> Offshore funds are most often sponsored by well-know financial institutions. Sponsors may receive annual management fees, commissions, placement fees, and/or an agreed initial fee that may represent a small percentage of the money invested in the fund. The sponsors of the offshore funds appoint professional managers to advise the fund on daily operations.[30]

Upon the formation of an offshore fund some basic elements usually have to be specified. First, the underlying investments will determine the focus of the investment of the fund, such as bonds, stocks, currencies, although in some jurisdictions funds can invest in different markets at the same time. Then, the nature of the returns must be determined, for example the way and the frequency that it will occur. Another important element is the payment of the professionals involved on the administration, activities and records of the fund.

Offshore funds have been having an increase preference as an offshore structure for investment. In the past decade some 5,000 funds have been established by the offshore industry. They have became the preferred vehicle for institutional and wealthy individuals, because they are flexible, tax neutral, and have the ability to build a structure to match the needs of investor groups.

Other advantages of offshore funds are:

- Lighter regulation than onshore funds - it facilitates the establishment and administration of the funds, reducing costs. The regulation applicable to funds available in many offshore jurisdictions allow more flexibility for the fund structure and the portfolio investment;

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[30] *Id* at 1073-74.

- Diversification of portfolio - maximizes returns and minimizes risks;
- Reduction of tax burden – usually, there is no onshore tax on interest income because offshore funds are not registered for sale in the investor's home country. Also "[t]ax exempt status in the offshore jurisdiction enables the fund to reinvest the approximately 30% taxes on profits and gains that would otherwise be payable in high tax jurisdictions, without the need to obtain investment company or similar status."[31];
- Confidentiality - unlike most onshore funds, offshore funds do not have the duty to report shareholder information to the Government or tax authorities.

The main division of offshore funds is into open-end and close-end funds. The first type is characterized by the option that the investors have to subscribe and redeem their shares for cash more often, making the investments more liquid. On the other hand, in a close-end fund the number of investors is demarked by the number of shares or limited by time, furthermore investments are more focused in illiquid assets.

The growth of the offshore funds can easily be understood by the following excerpt: "It simply makes good sense for investors in an increasingly global economy to invest in higher yielding vehicles with inherent tax benefits and little or no cross-border constraints. The urge to invest directly in emerging markets is driving the growth of offshore funds still further."[32] By May 1999 it was estimated that offshore funds summed 1,023 billions of dollars in investment[33] and the prediction is that it will continues to grow.

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[31] *Offshore Mutual Funds*, ELAN CORPORATE SERVICES LTD., *available at* http://www.elanbvi.com/mutual.html.
[32] *Why Offshore?*, OFFSHORE OUTLOOK ONLINE (1999), *available at* http://www.offshore-outlook.com/cgi-bin/cgiwrap/cdr/offshore/query_articles.
[33] *See* Gazeta Mercantil, June,1999 at B-17 (Br.)

Investing in offshore funds is an excellent investment strategy for those investors who want to take advantage of a globalized economy, diversify their portfolio, minimize risk and/or obtain tax advantages that are not available in their own country.

*C*HAPTER *T*HREE

*O*FFSHORE *J*URISDICTIONS

An offshore jurisdiction can be defined as a foreign country or dependency that offers lower tax rates than other countries or charges no taxes at all in some circumstances and have in place bank secrecy and privacy rules. Those jurisdictions are commonly called "tax havens". However, this term is not accepted by the offshore industry since it has a pejorative sense, suggesting illegal activities. Although it is not possible to deny that some of the offshore investments derive from unlawful sources, it is known that just a minority of the money that goes offshore can be categorized as criminal.

The history of offshore centers dates back to the end of the Second World War. The below excerpt presents a summary of the evolution of the offshore industry:

> Offshore tax havens which preceded the modern form of offshore financial centre *(sic)*, were of British origin designed to shelter assets from the economic uncertainties following WW II.
>
> The tax haven's key product was private banking to manage the estates of rich families in a tax-free environment. The motivation for remote islands to establish such centres *(sic)* was economic, to create good local employment opportunities. Early pioneers were the Channel Islands of

Jersey and Guernsey near the coast of Normandy, and Bermuda in the mid Atlantic.[34]

Therefore the growth of the offshore industry is directly connected with the Second World War, as a consequence of increase on taxation in the most important countries as well as the worldwide political crisis at that moment.

Nowadays, offshore jurisdictions continue to expand their role as international financial centers, although the reasons for the expansion have changed. Researches show that business such as shipping, aircraft financing and captive insurance are primarily conducted offshore. They also show that more than one million companies were incorporated in those jurisdictions until now and the largest corporations, like IBM, Microsoft and CNN, have offshore activities.[35] Still, according to a recent research conducted by the U.S. Federal Reserve the offshore jurisdictions hold some $5 trillion dollars and just a minority of these funds represents illegal investment or proceedings of criminal activities. Most of the offshore jurisdictions have legislation in place to avoid criminal activities and money laundering. They also have increased their due diligences procedures regarding the background of the investor and the source of the funds. Besides that, the professionals who deal with offshore investments are trained to detect suspicious activities.

There is a variety of offshore centers spread worldwide and they can be found in every continent. Some examples of jurisdictions where local economy is based on the offshore industry are: Antigua, Anguilla, Bahamas, Barbados, Bermuda, Cayman Islands, British Virgin Islands, Nevis, Netherlands Antilles, Panama, Turks & Caicos (all in the

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[34] *Supra* note 32.
[35] *See* id.

Caribbean), Gibraltar, Malta, Madeira, Cyprus (all in the Mediterranean), Netherlands, Switzerland, Liechtenstein, Andorra, Luxembourg, Monaco, Guernsey, Jersey, the Isle of Man (all in Europe), Hong Kong, Vanuatu, Cook Islands, Singapore, Labuan, Mauritius and Uruguay. Some are more specialized in certain activities than others. In this sense Bermuda has a large number of insurance and reinsurance business; Luxembourg and Guernsey, of offshore funds, the British Virgin Islands, of companies; Jersey, of trusts; the Caymans and the Bahamas, of banking.

With so many options, investors must pay attention to some details when choosing an offshore jurisdiction to conduct their business. Examples of key elements to be analyzed are listed below:

- Geographical location – in case the investor decides to go in person to the jurisdiction it must be of easy access from the investor's home country;
- Political and economical stability – the jurisdiction should have no history of instability so that business can be conducted with certainty and confidence;
- Laws governing companies, trusts and other entities must be modern, flexible and provide simple procedures for the incorporation of the entity;
- Guarantees against future taxation that eventually could be created by the jurisdiction;
- Tax treatment of non-resident and foreign income;
- Confidentiality and privacy regarding the investors' business;
- Redomiciliation, which is the flexibility of restructuring an offshore entity in another jurisdiction;

- Treaties – it is important to make sure that there are no information exchange agreements to keep the benefit of confidentiality;
- The conducting of active business in the tax haven country itself;
- Good level of banking, professional, commercial, transportation and communication systems to assure that business will be conducted in an effective way;
- Lack of currency exchange and capital control;
- International reputation – it is also important that the jurisdiction has a good reputation for controlling abusive financial practices, such as money laundering.

The selection of the most suitable jurisdiction for an offshore investment is in some ways complicated and professional guidance is advisable. It is important to select a jurisdiction that corresponds to the personal needs of the investor and that offers good condition for the kind of offshore entity chosen by him/her to conduct the business.

CHAPTER FOUR

REGULATION

AN OVERVIEW OF THE AMERICAN AND THE BRAZILIAN LAWS ON TAXATION ON OFFSHORE INVESTMENTS

4.1 - INTRODUCTION

Countries around the world use different bases to determine taxable income. Some use a combination of methods; others do not use any. Income can be taxed based on source, territory, residence and/or citizenship basis. In brief, a residence-based tax taxes income based on its origin, regardless of source, while a source-based tax taxes income based on where the activities giving rise to the income occur. On the other hand, the territorial method taxes income that originates only inside the country's boundaries. Residence based tax taxes income on the residence status of the person, while the citizenship method, taxes income based on its citizenship.

The United States and Brazil have similar ways of taxing income as summarized below. However, it is not the intention of this chapter to offer a profound study of the said laws but merely an overview.

4.2 - THE AMERICAN LAWS

In general, United States citizens are taxed on their worldwide income and capital gains regardless of their residence or where their tax returns are filed.

They are required to notify the Internal Revenue Service (IRS) if they hold controlling interest or similar influence in an offshore entity and they have to report any income from offshore investments for the purpose of taxation.

Some activities are considered tax crimes, such as failure to file return (§ 7203 of the Internal Revenue Code), tax evasion (26 USC § 7201) and false statements and records (18 USC § 1001).

Both the Securities Exchange Commission (SEC) and the IRS create barriers to restrict offshore investments by Americans:

> The Securities Exchange Commission (SEC) has severely limited the ability of Americans to purchase securities outside of the United States. This was accomplished in *(sic)* the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act). The 1933 Act is meant to compel full disclosure in public offerings and prevent fraud in connection with the original issuance of securities, while the 1934 Act is intended to ensure a fair and honest market for the trading of securities once in the marketplace. Section 5 of the 1933 Act requires that, unless there is an exemption, all offers or sales of securities in the United States must be registered with the SEC. The 1934 Act makes corollary requirements in Section 12, which requires registration and periodic reporting of foreign issues that have securities listed on a United States exchange. While there are certain exceptions to the registration requirements, from a practical standpoint what this means for United States investors is that all foreign investment opportunities are prohibited unless they have been properly

registered with the SEC. This means United States investors are confined to the U.S. domestic market and foreign issues that have been registered, and further, that they do not enjoy the right to invest freely in the world market.

If an American can discover a way to invest offshore in non-SEC registered securities; there is the second challenge facing the offshore aspirant of tax liability. Most people who go offshore seek not only flexibility of investment, but also desire to minimize the tax consequences of the returns that are earned. However, United States citizens are taxed on gross income, which is broadly defined as "all income from whatever source derived," hence meant to include income generated worldwide. Therefore, whether a United States citizen has domestic gains or gains from offshore sources, there will be a tax liability. Many Americans do not understand from a philosophical standpoint why gains earned offshore are taxable when the ventures have not enjoyed United States protections. In fact, they find this repugnant.

These are the two central challenges facing Americans interested in offshore.[36]

4.2.1 - TRUSTS

The IRS has passed many regulations regarding American citizens involvement with offshore trusts. An American settlor, for example, has to complete the 3520-A Form giving information about the trust and appoint a U.S. Agent to take care of the annual

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[36] Philip S. LaMar, Jr., *Proper Structuring Essential for Offshore Investment, available at* http://www.moneysearch.com/guestwriters/offshore2.html.

reporting. On the other hand, American beneficiaries of an offshore trust will be taxed upon the receipt of the benefits.

Despite the laws in place, offshore trusts still can be used for asset protection but not for tax benefits.

Recently the IRS conducted a very intense criminal investigation on offshore trusts formed by Americans, with the aim of combating tax evasion through the use of what is called "abusive trusts".

As the IRS explains

> A trust is a form of ownership, which is controlled and managed by a designated independent trustee that completely separates responsibility and control of assets from the benefits of ownership. The IRS recognizes numerous types of legal trust arrangements, and they are commonly used for estate planning, charitable purposes, and holding assets for beneficiaries. The independent trustee manages the trust, holds legal title to trust assets, and exercises independent control.
>
> All income a trust receives, whether from foreign or domestic sources, is taxable to either the trust, the beneficiary, or the taxpayer unless specifically exempted by the Internal Revenue Code (IRC).
>
> A legitimate trust is allowed to deduct distributions to beneficiaries from its taxable income, with a few modifications. Therefore, trusts can eliminate income by making distributions to other trusts or other entities as long as they are named as beneficiaries. This distribution of income is key to understanding the fraudulent nature of the abusive schemes. In

fraudulent schemes, bogus expenses are charged against trust income at each trust layer. After the deduction of these expenses, the remaining income is distributed to another trust, and the process is repeated. The result of the distributions and fraudulent deductions is to reduce the amount of income ultimately reported to the IRS.

…

Foreign trusts are subject to special filing requirements. If a trust has income that is effectively connected with a U.S. trade or business, it must file Form 1040NR, *U.S. Nonresident Alien Income Tax Return*. Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Foreign Gifts*, must be filed on the creation of or transfer of property to certain foreign trusts. Form 3520-A, *Annual Information Return of Foreign Trusts With U.S. Owner,* must also be filed annually. Foreign trusts may be required to file other forms as well. Foreign trusts to which a U.S. taxpayer has transferred property are treated as grantor trusts as long as the trust has at least one U.S. beneficiary. The income the trust earns is taxable to the transferor under the grantor trust rules. Grantor trusts are not recognized as separate taxable entities, because under the terms of the trust, the grantor retains one or more powers and remains the owner of the trust income. In such a case, the trust income is taxed to the grantor.

In addition to filing trust returns as just described, a taxpayer may be required to file U.S. Treasury Form TD F 90-22.1, *Foreign Bank and*

Financial Accounts Report if the taxpayer has an interest of over $10,000 in foreign bank accounts, securities, or other financial account. Also, a taxpayer may be required to acknowledge an interest in a foreign bank account, security account or foreign trust on Schedule B, *Interest and Dividend Income* that is attached to Form 1040.

…

Investors of abusive trust schemes that improperly evade tax are still liable for taxes, interest, and civil penalties. Violations of the Internal Revenue Code with the intent to evade income taxes may result in a civil fraud penalty or criminal prosecution. Civil fraud can include a penalty of up to 75% of the underpayment of tax attributable to fraud, in addition to the taxes owed. Criminal convictions of promoters and investors may result in fines up to $250,000 and up to five years in prison. Criminal statutes that maybe applicable are as follows:

Title 18 USC 371, Conspiracy to Defraud the IRS

Title 26 USC 7201, Tax Evasion

Title 26 USC 7206 (1), Subscription to a False Tax Return

Title 26 USC 7206(2), Aiding or Assisting in a False Tax Return

Title 26 USC 7212(a), Corrupt or Forcible Interference with the Administration of Internal Revenue Laws

Title 31 USC 5314, Records and Reports on Foreign Financial Agency Transactions.[37]

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[37] INTERNAL REVENUE SERVICE (2002), *available at* http://www.ustreas.gov/irs/ci/tax_fraud/docabusivetrustschemes.htm#Intro.

The IRS also mentions a number of case law such as: United States v. Reinke[38], United States v. Sather[39], and United States v. Gaskill[40].

4.2.2 - FUNDS

Through the use of offshore funds American citizens can obtain the benefit of a tax-exempt investment and avoid some U.S. regulations. However, the SEC has enacted a regulation concerning investment in offshore funds by U.S. investors. For example, it requires limits on U.S. offerings, including the following:

1. Section 7(d) of the 1940 Act.

(a) Section 7(d) prohibits an offshore fund from using the U.S. mails or facilities of interstate commerce in connection with a public offering of its securities, except pursuant to an SEC order.

(b) To issue an order permitting an offshore fund to register under the 1940 Act and make a public offering of its securities in the U.S., the SEC must find that is both legally and practically feasible to effectively enforce the provisions of the 1940 Act against the offshore fund.

2. Private offerings.

(a) An unregistered offshore fund may make a private offering of its securities to U.S. residents and claim an exemption from the 1940 Act under -

(i) Section 3(c)(1), so long as no more than 100 beneficial owners of its securities are U.S. residents, or (ii) Section 3(c)(7), so long as all U.S. residents who are owners of its securities are qualified purchasers.

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[38] United States v. Reinke, 118 F.Supp. 2d 966 (D. Minn. 2000)
[39] United States v. Sather, 242 F.3d 392 (10th Cir. Okla. 2001)
[40] United States v. Gaskill, 2000-2 U.S. Tax Cas. (9th Cir. Cal. 2000).

(b) Who is a "U.S. Person?" - Regulations under the 1933 Act.[41]

Furthermore, the anti-fraud rules apply to funds even though private offerings funds don't have to be registered according to the existing United States securities law.

For the reasons presented above, public offshore funds are not widely offered to American citizens. However, the same does not apply to private investment funds that are broadly used by American investors.

The following excerpt summarizes the rules for U.S. investors in offshore funds:

> Shares in a non-U.S. investment fund can be offered and sold to U.S. persons if care is taken to ensure that the transaction does not involve a public offering in the United States which would require registration of the fund under the Investment Company Act of 1940 and registration of its shares under the Securities Act of 1933.
>
> *Regulation D.* Shares in non-U.S. funds are typically offered to U.S. persons under Regulation D adopted by the U.S. Securities and Exchange Commission (SEC), which provides a non-exclusive definition of an exempt non-public offering. The basic requirements of Regulation D are relatively straightforward. No general solicitation or advertising may be used within the United States. U.S. purchasers must be "accredited investors" as defined by Regulation D (generally U.S.$1 million net worth for individuals and U.S.$5 million net worth for other investors), although up to 35 qualified non-accredited investors may also participate in limited circumstances if additional disclosure information is provided. Shares sold

[41] Brian S.Vargo, *Mutual Fund Basics* (1999), *at* http://www.pepperlaw.com/pepper/show_article.cfm?RID=79.0.

to U.S. investors must not be freely transferable, and may only be resold under a further exemption from registration. Form D, a relatively simple notice, must be filed with the SEC to report certain information concerning sales made to U.S. investors. Regulation D does not impose any requirements regarding the scope or quality of information which must be disclosed to U.S. accredited investors, although general anti-fraud requirements apply.

Regulation S adopted by the SEC provides a further exemption for offers and sales of securities that occur outside the United States. Offers and sales of shares of a non-U.S. fund will generally fall within the Regulation S exemption if both the offer and sale of the shares physically occur outside the United States, and if no "directed selling efforts" (activities undertaken to condition the U.S. market) are made in the United States. Contemporaneous offers and sales of shares of a non-U.S. fund may be made outside the United States in reliance upon Regulation S and within the United States in reliance upon Regulation D.

Investment Company Act. It is not possible as a practical matter for a non-U.S. investment company to register under the Investment Company Act. Accordingly, an investment company which is organized outside of the United States must qualify for one of the exemptions from the requirement to register under the Investment Company Act. There are two principal exemptions potentially applicable to offshore investment funds.

The most common exemption is the exemption under Section 3(c)(1), which, as applied to non-U.S. investment funds in a series of SEC no action letters and releases, exempts a non-U.S. investment fund if the securities of the fund are beneficially owned by less than 100 U.S. investors. In order to determine the number of U.S. investors owning beneficial interests in a fund, it is necessary under certain circumstances to look through an entity which is an investor and count the number of investors in the investing entity. It is necessary to look through if:

- the investing entity was organized for the purpose of investing in the investee fund;
- investors in the investor entity are entitled to determine individually whether or not to participate in the investee fund; or
- the investor is itself a private investment company acquires more than 10% of the outstanding interests in the investee fund.

The second exemption on which non-U.S. investment funds may rely is Section 3(c)(7) of the Investment Company Act, which permits an investment fund to have an unlimited number of U.S. investors provided that all of the U.S. investors meet the definition of a "qualified purchaser". The definition of a qualified purchaser is more restrictive than the accredited investor test, and includes:

- a natural person with at least $5 million in investments (as defined under SEC rules),

- a company with at least $5 million in investments and which is owned by certain related individuals (generally immediate family members) or by a trust or foundation established for the benefit of such related persons,
- a trust not formed for the purpose of making the investment, for which the person making the investment decision meets the qualified purchaser test,
- any other person or entity which owns or invests on a discretionary basis at least $25 million in investments, or
- certain directors, executive officers, general partners and other knowledgeable employees of the issuer or an affiliated person of the issuer.

A non-U.S. fund previously operating in reliance on the exemption under Section 3(c)(1) may elect to rely on the new Section 3(c)(7) exemption if it has not accepted any investments after September 1, 1996 from investors not satisfying the qualified purchaser test. However, it must give all existing investors notice and an opportunity to redeem their interests in the fund. A new fund relying on the exemption under Section 3(c)(7) will not be integrated with a fund operated under Section 3(c)(1) for purposes of the 100 person test, so it will be possible to create parallel funds, one operating under each exemption.

Investment Adviser Registration. Registration of a non-U.S. investment adviser with the SEC will not generally be required if the investment adviser has less than 15 U.S. clients in any twelve month period and does not generally hold itself out to the public in the United States as an investment adviser. For this purpose, an investment fund will be considered a single client so long as the investment adviser does not provide advice to individual investors in the fund.

State Securities Laws. Most states have so-called "Blue Sky Laws," which require the registration with the appropriate state agency of shares being offered or sold within the state or to residents of the state. If an offering is made only to accredited investors under Regulation D, then it is not necessary to register under any state laws, although it will be necessary to make a notice filing and pay a fee in certain states where interests in the fund will be offered.

Futures. An adviser or sponsor of a non-U.S. fund may be required to register as a commodity pool operator with the U.S. Commodity Futures Trading Commission if the fund trades in any commodity futures and has any U.S. investors. For this purpose, commodity futures include stock index and other financial futures and options on such futures, but not stock index options or forward foreign exchange contracts traded in the interbank market. Registration may not be required if U.S. persons do not own directly or indirectly more than 10% (measured by either number or value) of the fund, or if a non-U.S. commodity pool operator makes certain filings with the CFTC. However, there may be limits on the types of commodity interests and commodity futures contracts and related options which may be traded by a fund relying on either of these exemptions.[42]

4.2.3 - COMPANIES

By law, United States citizens must declare any controlling interest on an offshore company and they will be taxed over profits or interests obtained from this company.

Additionally, when an offshore company has an American shareholder that holds at least 10% of the shares or if 50% or more of the shares are owned by U.S. citizens, the company is classified as a "Controlled Foreign Corporation", in accordance to American laws. When this is the case, the U.S. shareholder will have to comply with certain requirements that treat the offshore company like a national company.

Despite these requirements, U.S. investors still form offshore companies because there are no public files on the offshore jurisdictions related to the ownership of the companies. Some use bearer shares, based on the belief that it will not be possible to find out who owns the company.

The offshore company itself will only pay tax if it conducts business inside the United States according to Section 882 of the IRC. The same happens to capital gains from securities trade, which will be sourced outside the United States as stated by Section 865 (a) (2) of the IRC.

It is worth mentioning that "Limited Liability Companies" formed in Delaware are considered to be similar to offshore companies, although onshore, for all the tax benefits that they offer if business is conducted outside the United States.

[42] Christopher M. Wells, *U.S. Investors in Offshore Funds*, THE NEW GAZETTE (October, 1995), *available at* http://www.coudert.com/practice/usinvest.htm.

4.3 – THE BRAZILIAN LAWS

There has been a lot of discussion in Brazil about the use of offshore structures for tax planning and although it is a new subject for the local policy, it has been catching the attention of those in the tax field.

Brazilian laws do not forbid a citizen to invest abroad but do insist on compliance with certain rules in order to make it a legal investment.

Corporations in Brazil are subject to corporate income tax and surtax on the amount of the annual taxable income exceeding a certain minimum amount. Local income taxes are collected from profits and capital gains earned inside or outside Brazil. There is, however, a relief from certain income tax, since corporations have tax credit from any income that is earned out of the boundaries of Brazil and subject to taxes in the country of origin. This credit is limited to the Brazilian corporate income tax on the same income. However, in 1996 a regulation concerning transfer pricing was introduced in Brazil. It is applicable to transactions that involve related and non-related parties through countries that charge no taxes or charge less than 20% of the income. Therefore offshore jurisdictions are included by this law.

4.3.1 - TRUSTS

The concept of trusts does not exist in the Brazilian law since its legal system is based on Civil Law. However, there is a similar concept that can lead to confusion, entitled *fideicomisso*. Very often the term is used as synonym for trusts but this is a mistranslation.

The *fideicomisso* is a testamentary disposition by which assets are transferred to a person, the fiduciary, with instructions to give them to another person, the fideicomissary, in a certain time or upon a certain event occurring at the death of the testator. Therefore, there are two beneficiaries that succeed one another: the fiduciary, who receives the property to transfer it at a point in time to the fideicomissary, the last beneficiary. It is a concept of Descent Law.

Although they share many similar aspects, *fideicomisso* and trusts are not the same. The main differences are set below:

- a trust comes into existence during the life of the settlor. A *fideicomisso* starts upon the death of the testator;
- while a trust is a relationship between the trustee, the settlor and the beneficiaries with rights and obligations that were set a long time ago by the Common Law, the *fideicomisso* is a contract, where the terms are set by the parts through a testament or by the Civil Code;
- the assets of a trust are protected against creditors and if the trustee is considered bankrupted, the assets of the trusts are protected. On the other hand, if the fiduciary of a *fideicomisso* becomes bankrupted, the assets of the *fideicomisso* can be used to pay the fiduciary’s creditors;
- according to Common Law the trustees have more responsibilities than a fiduciary of a *fideicomisso* and their actions are subjected to more severe penalties. Since a *fideicomisso* is created by a contract, the misconduct of a fiduciary is considered contract breach and he will be penalized according to the terms of said instrument.

This does not mean, however, that a Brazilian citizen cannot form an offshore trust. Brazilians can use this vehicle to protect their assets, to escape from forced heirship laws, and also for tax planning.

4.3.2 – FUNDS

Since the well-known international banks started to manage offshore funds, they have been a good alternative for those Brazilians who want to avoid the risk of investing in their own country and to diversify their investments. However, because offshore funds are not registered in Brazil, neither are they subject to the control of the local authorities, they cannot be marketed in any way. Another hindrance is that Brazilians who want to invest in offshore funds have to send the money through a bank authorized to deal with currency exchange. Since the Brazilian Government has in place heavy regulations to combat money laundering they can be asked to show the origin of the funds. Furthermore, there is income tax of 20% over the investment on the funds and the investors have to report these investments annually.

Recently, investments in offshore funds had a surge of popularity in Brazil, when the Government decided to stop charging a contribution, CPMF, which is similar to a tax, over foreign investments on the stock market. Since Brazilians are treated as foreigners when they invest on offshore funds, they are now having one less expense to pay on their investments.[43]

4.3.3 - COMPANIES

Brazilians incorporate offshore companies to hold assets, invest capital and avoid forced heirship rules. Offshore companies give to those investors the certainty of secrecy, privacy and security that the onshore investment does not give them. Also, depending on where the income is received, there is the possibility of reducing income tax. Dividends

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[43] *See* Marta Barbosa, *É a Vez dos Fundos Offshore? available at* http://www/terra.com.br/istoedinheiro/166/seudinheiro/seu_din_offshore.htm and Fabiana Godoy, *Lucros Além da Fronteira, available at* http://www.terra.com.br/dinheironaweb/178/especial/178_lucros_alem_da_fronteiras.htm. (Br.).

are not subject to withholding tax if the company is formed in a jurisdiction that is free of taxation. However, sometimes an authorization from the Brazilian Federal Bank is needed to send money offshore. If the investor is going to hold real estate, income tax can be avoided if the company receives the asset by the same price that the investor reports to the local fiscal authority, so that no capital gain will be obtained.

4.4 - CONCLUSION

The objective of any tax laws is to keep funds in the country to finance the local government. The use of offshore entities is a powerful tool to minimize exaggerated taxes and can be done legally.

All the efforts of the IRS and the SEC, as well as of the Brazilian authorities however, are not able to stop citizens of investing offshore. There are various strategies in practice aiming the elimination of the existing rules in order to avoid taxes.

The excerpt below referring to U.S. laws can also be applied to the Brazilian situation:

> It is in no way illegal to take your money offshore, even though the government has done its part to try to persuade you to not do so. To this end, the IRS would have the public believe that tax havens are used exclusively for tax evasion, but that is just not the reality of the matter. The IRS agents' handbook carefully notes that taxpayers use havens to avoid taxes, not evade them. Tax avoidance is the legal reduction of taxes, while evasion is any illegal means of reducing or eliminating taxes. Furthermore, the IRS guide concedes that US taxpayers may also use tax havens for tax planning reasons. This same guide also admits that some

transactions conducted through tax havens have a beneficial tax result that is completely within the letter of US tax law. In fact, the US Supreme Court stated in Gregory vs. Helvering (1935), 293 US 465 that taxpayers can arrange their affairs so that they can make their taxes as low as possible. Given that admission, it becomes highly probable that many Americans are overlooking tax havens, private international banking and offshore investing as a fully legal means of restructuring their income and reducing their tax liability …

Every student of American taxation is required to memorize Judge Learned Hand's declaration, "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."[44]

[44] Marc M. Harris, *The Use Of Tax Havens Is Neither Illegal Nor Immoral, at* http://cyberhaven.com/offshorelibrary/harrismoral.html.

***C*HAPTER *F*IVE**

***W*HAT *TO E*XPECT**

Despite the tentative efforts of some countries in taking unilateral approaches to avoid the increase of investments in offshore jurisdictions, effective steps were taken by international organizations in the form of reports with the aim of forcing offshore jurisdictions to introduce new regulations regarding offshore investments. Although the main goals of the reports are to improve existing anti-money laundering laws and practices in offshore jurisdictions and to increase access to information available from those jurisdictions relating to tax matters, some specialists argue that the offshore industry has been under attack and the real target is the industry itself. It has been said that the reports are nothing else than an effort to eliminate the main business of the offshore jurisdictions and to put an end to tax competition. Accepted or not, the fact is that those reports have been having direct effects on the legislations in place in many of the jurisdictions.

The most important reports are directly related to money laundering, which can be defined as "the processing of [ ] criminal proceeds to disguise their illegal origin [being] of critical importance, as it enables the criminal to enjoy these profits without jeopardising *(sic)* their source"[45]. The path chosen by these criminals to invest the profit

[45] *Basic Facts about Money Laundering*, FATF, *available at* http://www.oecd.org/fatf/MLaundering_en.htm.

without attracting attention is very often the transfer of the money to a place that does not require much information about the source of the funds. In this sense, offshore jurisdictions are, frequently, the best solution because of the lack of control over the investments. However, it is important to note that not just "dirty money" is invested in offshore jurisdictions, but also proceeds from legitimate sources. Like a gun that just makes news when it is improperly shot, offshore investments are only brought to the attention of the public when they are related to illegal activities.

A summary of the main international organizations' reports is set forth below. Notice, however, that the first three reports discussed below are addressed to various offshore jurisdictions around the globe, while the others are more limited but still important.

5.1 – THE OECD

With headquarters in France, the Organization for Economic Cooperation and Development, is a multi-national organization established in 1961 and formed by 30 members, including most of the industrialized countries. Its main objective is to promote policies in order to increase international trade and development.

In 1998 the OECD published a report entitled "Harmful Tax Competition – An Emerging Global Issue"[46]. Switzerland and Luxembourg, members of the OECD, abstained from the vote to adopt the Report. The work was produced under the responsibility of OECD's Forum on Harmful Tax Practices and the supervision of the Committee on Fiscal Affairs, the main tax committee.

In summary, the Report, which contains nineteen recommendations, focused on the loss of tax revenues in member countries as a result of capital being attracted to

[46] *Available at* http://www.oecd.org/daf/fa/harm_tax/Report_En.pdf.

offshore jurisdictions. The OECD understands that offshore investments are harmful for the flow of capital between countries and for the economic growth of countries. The Report classified not only the so-called offshore jurisdictions, but also member and non-member countries as tax havens or preferential tax regimes. It contains recommendations, including time limits, for listed jurisdictions to comply with various requirements established by the OECD to remove those preferential tax regimes and to exchange information regarding tax issues. In addition, the Report requires more transparency and elimination of aspects of the regimes in place in the listed jurisdictions for financial and other services that attract business with no substantial domestic activities. The due date for the jurisdictions to confirm that they agree to comply with the terms of the Report was July 31st, 2001, with a possibility of extension. A disagreement or silence means that the respective jurisdiction will be placed on a list of Uncooperative Tax Havens and OECD member countries, as well as other non-member countries, will be encouraged to take steps against them. Those countries with onshore preferential tax regimes are required to eliminate them by December 31st, 2005. Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino were the first jurisdictions to formally agree to observe the OECD requirements. In June 2000 the OECD released a list of thirty-seven countries categorized as tax havens and other forty-seven, as "potentially harmful" preferential tax regimes. The list excluded the six above mentioned jurisdictions because of their written promise but included other jurisdictions such as Andorra, Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Barbados, Belize, British Virgin Islands, Cook Islands, Dominica, Gibraltar, Grenada, Guernsey (including Sark and Alderney), Isle of Man, Jersey, Liberia, Liechtenstein, Maldives, the Marshall Islands, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, Samoa, the Seychelles, St. Lucia, St. Christopher & Nevis, St. Vincent and the Grenadines, Tonga, Turks and Caicos, the U.S. Virgin Islands and Vanuatu as tax havens. Included on the list of preferential tax regimes were some countries that are members of the OECD, for example, Australia, Belgium, Italy, Ireland, Portugal (Madeira), Luxembourg, the Netherlands, Switzerland and the United States, because of some specific activities conducted by them. The OECD requires that those member states eliminate harmful tax practices by April 2003 and that they do not create new ones.[47]

The OECD itself will not apply any retaliatory measures to the countries that do not comply with the Report requirements because it does not have the proper mechanisms for that. It will be the task of the OECD members to impose the sanctions.

The OECD claims that it does not intend to eliminate all forms of tax competition but only the harmful ones. Its main objective is not to impose tax rates for each country nor tell them what their tax system should be, but to eliminate harmful tax practices, implementing fair tax competition around the world and reducing financial crimes. According to Frances M. Horner, Head of Tax Competition Unit, Fiscal Affairs of the OECD, the organization considers a harmful tax system the one that limits the "availability of information about the amount or existence of offshore investments."[48] Mr. Horner further states that

> [A] low, no, or nominal tax rate alone would not be seen as constituting unfair tax competition under the OECD's current work. Predatory tax practices may exist when a low/no/nominal tax rate is combined with

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[47] *See* David Grech, *OECD Releases List of Tax Havens* (2000) *available at* http://www.bakerinfo.com/.
[48] Frances M. Horner, *The OECD, Tax Competition, and the Future of Tax Reform* (2000), *available at* http://www.oecd.org//daf/FSM/taxcompetitionarticle.html

> other indicia that indicate that a jurisdiction's regimes will present significant obstacles to a home country's ability to enforce its own tax laws."[49]

The Report has also been the target of criticisms. Some relate to the report's inconsistency with the international competition incentive of the OECD; the fact that OECD staff enjoy tax privileges since they are taxed on a different status than other workers in France; the natural tendency of global business to abolish exchange controls; the fact that investors seek offshore jurisdictions in order to escape over taxation and high operational costs in their own home countries; and the generalization of offshore jurisdictions as tax havens.[50] Another criticism is that:

> The choice of the little-used OECD as the venue to rid the world of tax havens was no accident: The OECD is completely controlled by the US and the European Union and, unlike the World Trade Organization, the tax haven countries have no standing to register complaints. In other words, the OECD issued its report without having to consider arguments in favor of tax havens. In contrast, if the OECD used the WTO to complain about the unfair tax competition, there would have been a long, complicated and uncertain legal process with which to contend.[51]

It cannot be ignored, however, that the OECD Report is probably the most feared and important report concerning offshore jurisdiction practices.

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[49] LAMAR, *supra* note 3.
[50] *See* Tim Bennet, *View on the OECD Report "Harmful Tax Competition – An Emerging Global Issue"*, THE JOURNAL, 1999, at 20-21.
[51] Robert L. Sommers, *The U.S. Role, at* http://www.taxprophet.com/hot/july2000.htm.

5.2 - THE FATF

The Financial Action Task Force was established in 1989 by the Group of Seven (G7) - formed by Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States - exclusively to examine measures to combat money laundering. The FATF is composed by 29 countries and jurisdictions, which includes the major developed countries of Europe, North America, South America, and Asia - Argentina, Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States - and also the European Commission and the Gulf Co-operation Council. Although the FATF has its headquarters at the OECD building in Paris, it is not part of the organization.

In 1990 it issued a report called "Report on Non-Cooperative Countries and Territories" and a list of recommendations, the "40 Recommendations", [52] to implement programs to combat money laundering. The Recommendations contained principles and gave the opportunity for countries to implement them according to their own internal laws. The Report analyzed a number of offshore and onshore jurisdictions according to the criteria of the 40 Recommendations and listed fifteen countries that, on the FATF's point of view, had not yet met its standards regarding anti-money laundering regulations. The list of countries included: the Bahamas, Cayman Islands, Cook Islands, Dominica, Israel, Lebanon, Liechtenstein, Marshall Islands, Nauru, Niue, Panama, Philippines, Russia, St. Kitts & Nevis, St. Vincent & the Grenadines. The punishment for those countries that do not adopt the Recommendations will be counter measures against them.

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[52] *Available at* http://www.oecd.org/fatf/pdf/AR2000-en.pdf.

Several countries had unofficially committed to enhance their policies to combat money laundering in accordance to the Recommendations. The Report was updated by the FATF in 2000.

FATF also published a brochure summarizing the most important Recommendations, as follows:

- Criminalizing the laundering of the proceeds of serious crimes (Recommendation 4) and enacting measures to seize and confiscate the proceeds of crime (Recommendation 7);
- Requiring financial institutions to identify all clients, including any beneficial owners of property, and to keep appropriate records (Recommendations 10 to 12);
- Requiring financial institutions to report suspicious transactions to the competent national authorities (Recommendation 15) and to implement a comprehensive range of internal control measures (Recommendation 19);
- Ensuring adequate systems for the control and supervision of financial institutions (Recommendations 26 to 29);
- Establishing international treaties or agreements and to pass national legislation that will allow countries to provide prompt and effective international cooperation at all levels (Recommendations 32 to 40).[53]

On June 2001, the FATF removed the Bahamas, the Cayman Islands, Liechtenstein and Panama from the list of non-cooperative countries and territories.

[53] *Economic Perspectives* (2001), *available at* http://usinfo.state.gov/journals/ites/0501/ijee/fatffacts.htm.

Recently it has updated the list that now includes the following countries: Cook Islands, Dominica, Egypt, Guatemala, Hungary, Indonesia, Israel, Lebanon, Marshal Islands, Myanmar, Nauru, Nigeria, Niue, Philippines, Russia, St. Kitts & Nevis, and St. Vincent and the Grenadines.[54]

This year the "40 Recommendations" were adopted by the International Monetary Fund and World Bank as international standards for the fighting money laundering.

Contrary of the OECD, the FATF is willing to assist the listed countries to comply with the Recommendations. Thus, while the OECD is taken unilateral measures, the FATF is working together with the jurisdictions.

5.3 - THE FSF

Established in 1998, also by the G7 countries, as a result of the Russia and Asia financial crisis, The Financial Stability Forum's main goal is to study areas that might be harmful to the flow of the international financial markets.

The FSF's Report[55], "Report of the Wo rking Group on Offshore Financial Centres", concentrated its attention to finding out whether or not an offshore jurisdiction could be taken as a threat to the global financial system and if it had in place appropriate supervisory structures. After publishing an updated Report in 2000 with recommendations for the improvement of internal regulations in all offshore centers, the FSF grouped 37 jurisdictions according to three categories based on their level of regulation: Group 1 - the best; Group 2 - medium; Group 3 - the worst. These three groups were formed as follows:

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[54] *See Industry News - FATF Removes Bahamas And Cayman Islands From List* (2001), *at* http://www.tridenttrust.com/general/news.asp

[55] *Available at* http://www.fsforum.org/Reports/RepOFC.pdf.

- Group One: Jurisdictions rated as cooperative, having a high quality of supervision and largely adhering to international standards. These top honors go to: Hong Kong, Luxembourg, Singapore, and Switzerland. Also singled out are Dublin, Jersey, Guernsey, and the Isle of Man but with the proviso that improvements should be encouraged.
- Group Two: Jurisdictions rated as having procedures for supervision and cooperation in place, but with performance falling below international standards and substantial improvement advised are: Andorra, Bahamas, Barbados, Gibraltar, Labuan, Macau, Malta, and Monaco. Gibraltar immediately complained on the grounds that it is a member of the European Union meeting EU standards and also has passed muster with the United Kingdom. British overseas territories and the Bahamas have also protested.
- Group Three: At the bottom of the scale are jurisdictions said to be blemished by a low grade of supervision, and/or not being cooperative with onshore supervisions and making little or no attempt to adhere to international standards. The jurisdictions named are: Anguilla, Antigua, Aruba, Bahamas, Belize, British Virgin Islands, Cayman Islands, Cook Islands, Costa Rica, Cyprus, Lebanon, Liechtenstein, Marshall Islands, Mauritius, Nauru, Netherlands Antilles, Niue, Panama, St. Kitts, Nevis, St. Lucia, St. Vincent, Samoa, Seychelles, Turks and Caicos, and Vanuatu.[56]

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[56] TAX HAVENS OF THE WORLD: OVERSEAS PRESS AND CONSULTANTS 13-14 (Walter H. Diamond & Dorothy B. Diamond eds., 2000).

Although the conclusion was that offshore jurisdictions might not have been the major cause of the worldwide systemic financial problems, the report still expressed its concern regarding the lack of supervision and cooperation offered by those jurisdictions in order to check illicit activities and abusive market behavior. The result of the categorization of the jurisdictions was that some of the countries started to take appropriate measures recommended by the report, for example, exchange of information, improvement of "know your client" rules, and record keeping.[57] An updated consideration on the development of the FSF Report was expected for September 2001 on the meeting of the G7 to discuss the issue.

Like the FATF, the FSF also offers assistance to the listed jurisdictions to implement important international standards.

5.4 - THE EDWARDS REPORT

The Edwards Report was prepared by the United Kingdom in 1998 with the aim of analyzing the regulations in force in Jersey, Guernsey and Isle of Man, collectively known as the "the Crown Dependencies". The Report's official title is "Review of Financial Regulation in the Crown Dependencies"[58].

The Report stated that the Crown Dependencies "are clearly in the top division of offshore financial centers". In other words, it confirms they can be viewed as having in place effective regulations, despite the following main criticisms that were stated within the report: "(1) refusal to help foreign tax authorities investigate tax evasion in Jersey; (2)

[57] *See supra* note 55.
[58] *Available at* http://www.official-documents.co.uk/document/cm41/4109/4109.htm.

use of thousands of secretly owned unsupervised companies on the Isle of Man; and (3) use of fictitious nominee directors in Guernsey and Sark."[59]

The Report presented suggestions for changes in the Crown Dependencies' laws regarding administration of trusts, offshore companies and the role of Directors. Proposals to make it easier for foreign governments to get information in order to prosecute individuals involved in tax evasion were also addressed in the report, as well as public account filings, disclosure of ownership of offshore companies and more severe regulations regarding offshore service providers.

The Crown Dependencies have taken steps to comply with the Report by reviewing internal laws and practices.

It is crucial to the United Kingdom that the mentioned offshore jurisdictions comply with international standards, since the UK is part of many international bodies that are combating money laundering worldwide.

5.5 - THE WHITE PAPER

The White Paper is a document published by the United Kingdom in 1999, entitled "Partnership for Progress and Prosperity: Britain and the Overseas Territories"[60]. It proposes revaluation of the financial services legislation in force in the British Territories - Anguilla, Bermuda, the British Virgin Islands, Cayman, Montserrat and Turks and Caicos - and the importance of those territories to comply with international standards.

The White Paper reaffirmed the OECD Report. Its main goals are to improve:

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[59] DIAMOND & DIAMOND, *supra* note 56, at 18,19.
[60] *Available at* http://www.fco.gov.uk/news/newspage.asp?17/03/99.

- Legislation for the effective regulation of the offshore sector to fully meet accepted international standards;
- Comprehensive measures extending to all financial institutions to combat money laundering and improved regulation of company formation and those involved in it;
- Powers to insure that regulators and law enforcement authorities in the Territories cooperate with their foreign counterparts in investigations and enforcement matters, "whatever the secrecy laws";
- Licensing and regulation of all financial activity to allow fair competition between the Overseas Territories; and
- Establishment of independent of regulatory bodies that meet accepted international standards.[61]

5.6 - THE EU

The European Commission elaborated in 1997 a Code of Conduct[62] related to harmful tax competition. The Code developed from the tax harmonization proposal within European Union members that established a standard withholding tax over some non-resident's income. The code presented a series of tax directives aiming to avoid new tax regimes and also directed to offshore jurisdictions existent between the EU members and their territories. Sixty-six tax regimes were classified as harmful.

The main criticisms of the Code are that it will "reverse the flow of funds and have a negative impact on the newly formed Eurodollar"[63].

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[61] DIAMOND & DIAMOND, s*upra* note 56, at 20
[62] *Available at* http://europa.eu.int/.
[63] DIAMOND & DIAMOND, s*upra* note 56, at 17

Although not directed exclusively to offshore jurisdictions, the proposal affected Luxembourg, Isle of Man, Gibraltar and also "onshore jurisdictions" like Switzerland and Ireland, to name a few, but excluded Madeira from its terms.

The EU Code reinforces the OECD Report and vice-versa. However, there are some significant differences between both reports. For example, the OECD Report is addressed mainly to offshore jurisdictions worldwide and the EU Code does not set up practices regarding exchange of information.

5.7 - CONCLUSION

The lesson to be learned from the foregoing reports is that offshore jurisdictions will most likely have to go through a change, as some have already done, in response to the criticism voiced in the reports. However, the level that the reports' requirements will be fulfilled is still unknown. Many of the changes suggested would put an end to offshore jurisdictions business; others would make the offshore world to be viewed as having more integrity. Another positive effect stemming from the changes that offshore jurisdictions will have to go through is that local professionals will become more qualified, which is good for that country's economy from an international point of view.

The following excerpt presents a clear conclusion of what is going on in the offshore industry as a consequence of the reports:

> […] Offshore governments are being pressured to expand their prosecution departments, investigation units and regulatory bodies and to increase the number of local investigations and prosecutions. […] [P]ressure is [also] being put on regulators offshore to ensure that those running regulated entities are fit and proper persons, are training their staff

> in anti-money-laundering vigilance and procedures, have adequate record-keeping procedures and have proper mechanisms for reporting suspicions of money laundering, internally within the organization and then externally to the relevant reporting authority.
>
> […]
>
> It is thus that tackling the money-laundering problem will also substantially address the offshore tax evasion problem. With tax evasion addressed, onshore taxpayers using offshore accounts and structures will have to disclose them, information on them will be available to onshore tax authorities and they will be able to adjust the tax rules onshore to ensure, where government policy dictates, that today's tax-free income, gains or assets are tomorrow's taxable income, gains or assets and that today's tax avoidance is tomorrow's tax evasion.
>
> The result is an extraordinary and unparalleled shift of power - onshore and offshore - to the state - and not merely to individual nation states but to an emerging supranational state of which the E.C. is just a primitive prototype. […] The only people able to launder money, both onshore and offshore, and escape paying their due taxes will be governments, their supporters and their cronies - but it will continue.[64]

Therefore, despite the efforts of some international organizations to put an end on the offshore industry, it is more likely it will continue to grow. First, because many of the

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[64] *The FATF Initiative – Eliminating the Offshore Black Hole, available at* http://www.offshoreinvestment.com/current_issue/cicero/main.html.

offshore jurisdictions heavily depend on this business to survive and because the simplicity and secrecy offered are very difficult to find onshore.

> Apart from tourism, many tax havens have no means of earning an income. Lacking natural resources, capital and manpower, or significant agricultural or industrial enterprises, they are dependent on the outside world for supplies.
>
> Offshore financial business generates foreign exchange, tax revenues and employment, as well as indirect benefits. It offers a chance of economic diversification and is far more profitable than tourism once the necessary infrastructure is in place, requiring less manpower and foreign exchange spending. Moreover, even a moderate degree of success can have a big impact in the smaller locations.[65]

Second, because rich countries and their citizens make use of offshore centers, the changes in those jurisdictions will be minor.

However, the way that the offshore jurisdictions will deal with technological development, combating money laundering, the quality of services provided and the minimal standards imposed by some international organizations will be the guidelines to determine the future of the industry.

Some of the realistic changes that can be foreseen are elimination of secrecy regarding the ownership of offshore structures, abolition of bearer shares and abolishment of nominee directors, both with respect to offshore companies.

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[65] *What is a Tax Haven?*, OFFSHORE OUTLOOK ONLINE (1999), *at* http://www.offshore-outlook.com/cgi-bin/cgiwrap/cdr/offshore/query_articles?do=do_pay&file=0002txhvn.HTM&uname=&passwd=.

In spite of all the talking about the reports "there is nothing to fear yet and it's still to early to know the long term effects of the [changes required by the reports] – they may even be beneficial […]" [66].

[66] Jennifer Gearey, *Losing Millions*, OFFSHORE FINANCE USA, 2001, at 32-33 (transcribing the pronouncement of Wendy Warren, Executive Director of the Bahamas Financial Services Board).

CONCLUSION

The offshore world is in a state of transition due to recent critical international reports. In order to keep the offshore market alive, new procedures and principles must be put in practice.

Despite all the measures introduced by the international organizations in trying to combat money laundering and harmful tax competitions, the trend of the offshore industry will grow, partly because of changes in the world's economy. The United States economy, for example, is in a recession. The European economy shows signs of dropping, since over half of its population are the elderly, meaning that the governments' expenses with retirement will increase and government income from the population will decrease. In response to these facts, investors will diversify their investments and look for a new, but safe, market. This, in turn, will benefit offshore jurisdictions.

Another factor that favors offshore jurisdictions despite tax legislation is that offshore jurisdictions are stable with respect to their tax laws. Put simply, offshore jurisdictions hardly ever change their legislation with respects to taxation, differentiating themselves from many onshore countries. Additionally, offshore jurisdictions have been updating their communications technology, to help decrease the distance and to facilitate the transactions between themselves and their investors.

However, in order to have a prosperous future, the offshore industry will have to attend to illegal investments and create a means to filter new investments. In this sense, some jurisdictions, such as the Bahamas and the Cayman Islands, have already changed their legislation to abolish or to limit the use of bearer shares. Bearer shares have been a popular tool to guarantee confidentiality and flexibility, since they allow the easy transfer of the ownership of companies because they do not record the name of the shareholder. Nevertheless, bearer shares can be misused to hide the real owner of the company, which helps illegal investors to launder money.

Another potential change introduced by offshore jurisdictions is the ability to break off confidentiality in certain situations in order to cooperate with the war against money laundering. Therefore, more transparency on business conducted in offshore centers can be offered.

Supporting this optimistic future of offshore jurisdictions, The Center for Freedom and Prosperity published in 2002 a report entitled "U.S. Government Agencies Confirm that Low-Tax Jurisdictions are Not Money Laundering Havens"[67]. The study was based in information collected from institutions such as the CIA and the FATF and concluded that those jurisdictions are used to launder money no more than any onshore country.

A consequence of an offshore jurisdiction resistance to comply with acceptable standards will be a potential decrease of business, since it will be considered an obstinate and uncooperative jurisdiction. Additionally, it could suffer retaliation from other countries in the form of prohibiting by law citizens and/or institutions, such as banks, to do business with that particular jurisdiction.

A recent event raised new concerns about the use of offshore jurisdictions: the terrorist acts of September 11, 2001. International organizations are now not only fighting money laundering, but also terrorism financing. Organizations like the European Union,

[67] *Available at* www.freedomandprosperity.org.

the G-7, the FATF and the United Nations are working quickly to put measures in place to stop terrorists from using the offshore industry to financially support their acts. The FATF, for example, released a report called "Special Recommendations on Terrorist Financing"[68], consisting of eight recommendations that should be observed by every country, specially the offshore centers. Some of these recommendations were: the freezing and confiscating of terrorists' assets; cooperation between countries; and reporting any suspicious transactions.

Offshore jurisdictions need to adjust to international requirements to continue their business as "tax havens". They cannot, however, cease to offer advantages that attract investors because those investments are essential for their economy and create income for the government and jobs for the population. Offshore jurisdictions were created to offer an option to investors from countries that impose high taxes. These jurisdictions survive due in part to the offshore industry, once they lack natural or industrial revenue sources. Ultimately, each country can legitimately decide whether or not to tax investments. In other words, "tax havens" are not acting against any law when they try to attract business by offering a more advantageous tax regime. They act against common sense, however, when they accept capital derived from proceeds of crime.

[68] *Available at* http://www1.oecd.org/fatf/SRecsTF_en.htm.

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