

Bank Secrecy is over – bank secrecy jurisdictions on par with OFCs?

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On 2 April 2009, the G20 released a communiqué announcing that “the era of bank secrecy is over” and pledging to “take action against non-cooperative jurisdictions, including tax havens”. Time and time again, offshore financial centres are lumped together with bank secrecy jurisdictions in the pejorative term ‘tax havens’. The G20, along with the OECD, the FATF, the IMF and others purporting to ‘clamp down on tax havens’ consistently miss the fact that offshore financial centres are not bank secrecy jurisdictions.

This article looks at offshore financial centres and the transparency rules in place, and considers whether offshore financial centres should be treated differently from bank secrecy jurisdictions. Specifically, the article considers whether the term “tax haven” is misleading and offensive to those jurisdictions which, for several years now, have willingly signed up to international standards, and whether it is inequitable to include all the jurisdictions in a grey list, as the bank secrecy jurisdictions have only recently and very reluctantly agreed to enter into tax information exchange agreements (TIEAs) with the OECD countries.

Offshore Financial Centres

The fundamental feature of an offshore financial centre is that it is a neutral place for parties from different jurisdictions to structure their international affairs.

Structure

As a starting point, let us look at the typical offshore vehicle – the company. Why do people set up companies in the first place? As anyone who has read the first chapter of a company law text book

knows, the principle features of a company are the following:

- unlimited duration and continuity of life;
- ownership by shareholders and management by directors;
- limited liability;
- a separate legal personality;
- ease of transfer of interests.

It is for these reasons that companies make good sense. In the British Virgin Islands, over 850,000 companies have been incorporated and it is believed that 450,000 remain active. The reason for there being so many companies is not secrecy, but rather because companies are an excellent vehicle to structure ones affairs.

The next question that is usually raised is that yes, companies are an excellent vehicle to structure ones affairs, but why would anyone go offshore? There are virtually as many answers to this question as there are offshore companies. However, certain themes arise when companies are incorporated offshore.

A person will go offshore when he is involved in cross jurisdictional transactions and needs a corporate vehicle in a neutral jurisdiction.

Examples

A person may go offshore to set up a joint venture company. No one would likely go offshore to structure a joint venture with their neighbour to sell pottery in their local town. However, you would, for example, consider using an offshore company if you are a multinational establishing a joint venture with a Chinese partner to manufacture your product in China. In this instance, you will have a manufacturing company in China. This is the company that owns the factory and hires the workers. You may even have a holding company in

China. However, will you, as a non-Chinese person, want to put your joint venture company in China? Are you confident enough with the Chinese legal system to be comfortable that any dispute between you and your Chinese partner will be decided by an established and well known legal system capable of settling such a dispute? Will you feel you are on an equal footing with your Chinese partner when discussing legal issues governing the joint venture?

Most joint venture partners would prefer to incorporate the joint venture vehicle in their own jurisdiction. However, in my example, the Chinese partner may not agree to establishing the structure in your home jurisdiction, as it then gives you home field advantage. Further, by setting up the joint venture company in your home jurisdiction, the joint venture company may be taxed in your home jurisdiction, meaning that the Chinese partner now has to pay tax in your jurisdiction, although he has no connection to your jurisdiction and no reason to pay tax in your jurisdiction. This is just not efficient.

As a result, joint venture parties often agree to establish their joint venture vehicle in a third and neutral jurisdiction. It is here where the reasons for incorporating a company in the British Virgin Islands become apparent.

First, the zero rate of taxation is important. The manufacturing company will pay tax in China and the joint venture partners will pay tax in their home jurisdictions. However, there is no reason for the intermediate joint venture vehicle to also pay tax. Tax neutrality is an important attribute.

Second, a British Virgin Islands company is cost effective. The annual government fee is low, USD350 or USD1,100 depending on the number of

shares the company is authorised to issue. Further, the cost of incorporation is generally low as well. As a result, persons can obtain the benefits of a corporate vehicle for a reasonable cost.

Third, in the event of a dispute, the parties can be comfortable that a strong rule of law will prevail to settle the dispute. Specifically, the company will be governed by the BVI Business Companies Act 2004. This is a very modern piece of legislation originally modelled on the Delaware statute (although anglicised to take into account the fact that the British Virgin Islands is an English common law jurisdiction). Coupled with strong legislation, is a strong court system. Specifically, the British Virgin Islands has a dedicated commercial court whose sole purpose is to hear British Virgin Islands company cases. The ultimate court of appeal is the Privy Council (House of Lords) in London, England. In the joint venture example, this legal system gives comfort to all parties, whether from China or elsewhere, that their dispute will be settled by the rule of law.

Of course, not all companies are incorporated for joint ventures. Hedge funds are an example where companies are incorporated offshore as a result of the international aspect of the hedge fund business. Investors in hedge funds do not come from only one country. Rather, hedge fund investors, usually sophisticated investors such as university endowments, institutional retirement plans or charitable trusts, come from around the world. These investors need to invest in a neutral vehicle. A United States manager will usually incorporate a domestic US fund for its US investors, but will then establish an offshore vehicle for investors from Europe or the Middle East, most of whom will not want to invest directly into a US fund. It is the neutrality of the offshore vehicle which makes it such a desirable entity.

Yet another example for using offshore vehicles is the fact that not all countries' company laws are as well developed or as easy to use as those derived from the English common law system. For example, it is often the case that a multinational investing in South America will want to hold the shares of the South American company via an offshore vehicle. In the event the multinational ever needs to sell its South American interest, or perhaps use its interest as collateral on a loan, it is much easier for the multinational to sell or pledge the shares of the offshore company than to sell or pledge the shares of the underlying company.

None of these examples have anything to do with bank secrecy or tax

evasion. They all merely demonstrate instances where companies are set up offshore for good corporate law purposes.

Transparency

As evidence of the fact that offshore financial centres are not bank secrecy or tax evasion jurisdictions, we can look at the tools which have been put into place to ensure transparency and effective exchange of information.

In 1997, the British Virgin Islands enacted the Proceeds of Criminal Conduct Act, creating a robust all-crimes anti-money laundering regime, meeting and sometimes surpassing international norms. The legislation makes it a crime to launder money, and its confiscation powers have been used on occasion to recover sizeable amounts. Further, there is a positive obligation to report any suspicion of money laundering to the local policing authority.

The Anti-Money Laundering Code of Practice requires regulated entities, including registered agents responsible for incorporating British Virgin Islands companies, to know their clients.

The Financial Services (International Co-operation) Act 2000 and the Financial Services Commission Act 2001 allow the Director of Financial Services to request of any regulated person, including registered agents, the production of information or documents, and permits the exchange of that information with recognised foreign regulatory or law enforcement authorities.

In 2002, the British Virgin Islands entered into a TIEA with the United States, and more recently has entered into TIEAs with the United Kingdom and Australia. In total, the British Virgin Islands has entered into ten TIEAs.

All of this legislation and supporting regulations and agreements ensure that there is transparency in the structures, and that there is effective exchange of information in the case of all jurisdictions, when there is a suspicion of criminal conduct including money laundering and in the case of tax evasion or criminal tax avoidance for those jurisdictions, where there is a TIEA.

Secrecy Jurisdictions

The activities of the offshore financial centres contrast starkly with the activities of the bank secrecy jurisdictions, although all are lumped together as tax havens. Bank secrecy jurisdictions will set up structures, including bank accounts, for their clients on the basis that there is no transparency. It is the secrecy which is the selling feature of these jurisdictions.

In these cases, while there are "know your client" rules, there is no transparency because there is not always effective exchange of information.

In the most notable bank secrecy jurisdiction, Switzerland, there is transparency for tax fraud, but not tax evasion which is merely a civil offence, whereas tax evasion would be considered a serious crime in most other jurisdictions. The structures being set up in these jurisdictions are not usually being set up as a result of international transactions between parties from different jurisdictions. Rather, such structures are often set up in reliance on the bank secrecy laws in those jurisdictions.

The difference in the products being offered by the different types of jurisdictions could not be more stark.

Conclusion

The good news for the offshore financial centres is that each of the bank secrecy jurisdictions has been forced to sign a commitment to the OECD to enter into TIEAs with OECD countries, effectively ending their lack of transparency. However, it is disappointing that the offshore financial centres, notwithstanding almost a decade of compliance with international standards for transparency and effective exchange of information, are lumped together with the bank secrecy jurisdictions in the grey zone of the new OECD white/grey/black list (of which no countries are on the black list).

In the case of the British Virgin Islands, the jurisdiction has passed all the required legislation, has shown a compliance attitude for over a decade, has entered into 10 TIEAs, including one as early as 2002 with the United States, and by the time this article is published will have agreed a total of 12 TIEAs. However, the British Virgin Islands is listed in the same category as the European bank secrecy jurisdictions which only agreed to enter into TIEAs on the cusp of the G20 conference in April 2009 and even then, there are some suggestions that the bank secrecy jurisdictions cannot enter into any TIEAs without local referendums.

As such, the OECD and the G20 continue to favour the European bank secrecy jurisdictions, as has been the case for almost a decade. Is it too much to ask that the phrase "tax haven" be dropped entirely and for the G20 and the OECD to adopt a white list for their favoured member countries, a light grey list for the offshore financial centres and a dark grey list for the bank secrecy jurisdictions? It would only be fair given the demonstrated compliance to date by the offshore financial centres.