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OFFSHORE PILOT QUARTERLY

Commentary on Matters Offshore

Failing Banks, Swiss Cheese and Commitments

Rudyard Kipling speaks of keeping cool under pressure in his poem, "If". "If you can keep your head when all around you are losing theirs..." to which a cynic today might add "you probably haven't heard the news". Well, a lot of people have heard the news about the commitment letters sent to the Secretary General of the Organisation for Economic Co-operation and Development in Paris which have been signed by the majority of offshore financial services centres. Some people, despite Kipling's encouragement, are not keeping their heads because of this development. It seems as if, in the heat of the moment, logic has been relegated to a secondary consideration and analysis of the situation has been replaced by a rationale more in keeping with a piranha feeding frenzy.

The present situation has come about because the OECD feels that globalisation, as well as continuing advances in electronic technology, will ultimately produce a prolific number of tax regimes vying with each other to attract international business, which threatens to deplete the much-needed tax base of the industrialised nations. They anticipate that capital and financial flows will be lured away from traditional channels mainly to jurisdictions which have been categorised as tax havens by the OECD, which, briefly stated, are any offshore centres which cause the erosion of the tax base of one or more other countries. Tax havens are seen by the OECD to have harmful tax practices and an offshore centre which enables taxes merely to be avoided, as opposed to evaded, nonetheless risks the ire of the OECD.

The OECD in May, 1998, issued its now infamous "Harmful Tax Competition – an Emerging Global Issue" report. Within the body of the report a

Forum on Harmful Tax Practices was created which included guidelines and recommendations. The Forum was charged with examining, and then deciding, whether or not a jurisdiction could be classified as a tax haven; the main criteria for being classified as a tax haven by the Forum are an absence of taxes or only nominal effective tax rates; lack of effective exchange of information; lack of transparency and no requirement for the user to have substantial activities in the jurisdiction. The OECD originally listed a total of 47 tax havens (notable exceptions being Hong Kong, Luxembourg, Singapore and Switzerland) and in a subsequent report in 2000 the OECD black-listed 35 tax havens which it classified as unco-operative. In June, that same year, the OECD was able to announce that 6 non-OECD jurisdictions (Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino) had made commitments to remove all harmful tax practices by the end of 2005. The OECD then drafted a memorandum and circulated it to the 35 "unco-operative" jurisdictions on its tax haven black list. The memorandum contained the framework for a collective understanding on the elimination of all harmful tax practices by 31st December, 2005, with a partial phasing-in by 31st December, 2003.

Since then, the black list of recalcitrant jurisdictions has been whittled down to 7, only 2 of which are first league players (Liechtenstein and Monaco) with the remainder (Andorra, Liberia, Marshall Islands, Nauru and Vanuatu) being, in varying degrees, less significant offshore centres. The commitment letters sent to the OECD by some offshore centres had a whiff of duress about them. Some jurisdictions found themselves between a rock and a hard place: several major aid agencies, for example, delayed payouts until

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Niue had itself removed from the OECD blacklist. And the Cook Islands is expecting to receive \$6 million per year from the European Union under the Cotonou agreement with the proviso that international standards of financial regulation are maintained. In some quarters the Gang of 7, comprising the unco-operative jurisdictions, are seen as David battling Goliath as they stand up to the monolithic bureaucracy which the OECD is. Meanwhile, those jurisdictions which have signed commitment letters, undertaking to cease practices which the OECD defines as harmful, and who have been labelled by many as appeasers, have now slipped back into the shadows, whilst the Gang of 7 are now centre stage and under the glare of the OECD's spotlight. Financial sanctions against them have been threatened, but just exactly what form they would take is not clear. What is clear, however, is that the OECD initiative is far from being a tour de force; it more resembles a piece of Swiss cheese: full of holes. In addition to the complications within the OECD itself, as well as the European Union, there is a general insistence that the same degree of transparency and information exchange must apply universally before any offshore commitment given will be honoured. In other words, to use the phrase which is being widely quoted, there must be a level playing field. The offshore centres, however, should bear in mind that when dealing with the OECD bureaucracy, nothing is ever really going to be completely on the level.

Makhlouf's Nightmare

Offshore resistance to the OECD's tax agenda is only one of the organisation's problems. The OECD itself has internal strife which it must tackle. Two of its members, Switzerland and Luxembourg, prominent offshore centres, have consistently, since the tax initiative was launched, refused to fall into line. In fact, Gabriel Makhlouf, chairman of the OECD's fiscal affairs committee, has described both countries as "permanent abstainers" and has emphasised that in the end whether a country is an OECD member or not will be immaterial: there will either be conformists or renegades.

April, 2003, is the target set by the OECD for all its members to have abolished harmful tax practices. Non-OECD members (comprising the vast majority of offshore finance centres) have, as previously mentioned, been given until the end of

2005. If Switzerland and Luxembourg remain defiant, the OECD has declared that sanctions could be imposed after April, 2003. Again, as in the case of the Gang of 7, just exactly what these sanctions could be is not clear.

Then there's the European Union. A common policy on taxation of cross-border investments within the EU remains an elusive goal. Once again, Switzerland, although not an EU member, features large in the mêlée. Last December the EU governments did reach an agreement that information on savings of an EU resident would be shared with the tax payer's home government rather than have a blanket Europe-wide withholding tax introduced. But agreement was only reached after the EU, under pressure from some members, said that the programme would only start after non-EU countries, such as Switzerland and Liechtenstein, followed suit. Luxembourg, already in the bad books of the OECD, was one of the countries that applied pressure to have this proviso included. If an agreement cannot be reached with non-EU countries on savings tax before the end of this year, which is the deadline set, the whole agreement falls apart. In any event, in order to make the EU directive work, the United States will have to come on board and one can only speculate on the likelihood of it compelling its banks to comply with a foreign edict, in this instance an EU information-sharing directive. It is a precedent that the United States government might not want to set, bearing in mind its sensitivity concerning any infringements of its sovereignty. The United States Secretary of the Treasury recently declared support for black-listed Liechtenstein and all small nations defending democratic principles against the OECD (read European Union as well in this context). Without US co-operation, the EU's plans are doomed. In all this the OECD faces the nightmare of reconciling the multitudinous views of its 30 members and the EU has to wrestle with the various positions held by its 15 members. Membership of the EU could eventually reach 28 as more countries join which will only compound the problem.

The offshore centres themselves, of course, can hardly be expected to reach unanimous agreement easily concerning the OECD tax initiative. A new government has been recently elected in the Bahamas, the Progressive Liberal Party of Perry

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Gladstone, which has already stated that it is reviewing 11 pieces of legislation which were previously enacted in order to accommodate, inter alia, the OECD. In particular, the laws which tightened the regulation of offshore banks are being reviewed. In 2004, the year before the 2005 OECD deadline, another offshore finance centre, this time Panama, will have elections which may well bring politicians into power who could also present the OECD with problems. Significantly, the commitment letter to the Secretary General of the OECD sent by the Panamanian government contained the proviso that the undertaking was subject to its Legislative Assembly approving the necessary changes in the law.

When one steps back and considers the international ramifications and imponderables surrounding the OECD initiative, it would be a brave commentator who confidently predicted that the OECD will achieve its goal by the end of 2005. So those commitment letters are not as secure as they might appear to be, any more than a large envelope whose flap is well-sealed, yet the seam, running across the back of the envelope at the other end, has been overlooked. The seam in this case is both the OECD and the European Union. To paraphrase Gandhi, the OECD can draw as much comfort from them as the holder "of a post-dated cheque drawn on a failing bank".

Taxation and Transparency: So What?

Whether or not the OECD, the European Union and the offshore centres can ever reconcile their differences over international taxation policy, there still remains a number of reasons why people, especially Americans, may wish to place assets beyond their shores without any regard to tax savings. The OECD's current crusade against perceived harmful tax practices, in other words, is the furthest thing from their minds.

One compelling reason for Americans to look offshore is litigation which features large in every stratum of their society. The causes of much of it have roots which can be traced back 900 years to the Norman Conquest when the English king's private and intimate council (known as the Privy Council) advised the monarch on matters of justice "throughout his dominions". This Court of the Star Chamber (called this because the meeting place in the palace of Westminster had stars painted on the ceiling) with its omnipotent privy councillors made America's founding fathers all

too well aware of the dangers of centralising and concentrating state power in the hands of a select few. Oliver Cromwell in the seventeenth century only sharpened their focus and strengthened their resolve to protect individual rights. Although Cromwell defended the English Parliament against the dictates of the monarchy, he nevertheless created a tyranny far worse than that which existed under the English kings. Retired Army Lieutenant General Dave R. Palmer (1794: *America, Its Army, and the Birth of the Nation*) wrote that the Constitution of the United States "was written by fifty-five men – and one ghost." The ghost was that of Cromwell which haunted the minds of those 55 men. Unlike Cromwell, the Privy Council lives on, although its jurisdiction now only extends to a few present and former British possessions. Today there are no meetings in the palace of Westminster and one passes through the less-imposing wrought iron gates of Downing Street, in London, to walk some 20 steps until a tall Regency door is reached behind which the Privy Council meets in a 30 ft tall oak-panelled room with gold-leaf centre rose where judges in lounge suits write fountain pen notes on the submissions of bewigged barristers.

But both Cromwell's and the Privy Council's legacy can be found in court rooms today across America. It is best illustrated by Alexis de Tocqueville, the French writer and author of the influential work, "Democracy in America". He commented more than a century and a half ago on America's ingrained obsession with the rights of the individual, going on to observe that in its desire to reject unfettered power by any one individual it went too far by establishing "a network of small complicated rules, minute and uniform" that could reduce citizens and even judges "to nothing better than a flock of timid and industrious animals". Since then the labyrinth of laws and reams of regulations have multiplied beyond, I am sure, anything that de Tocqueville could have imagined or Cicero, centuries earlier, intended when he said "we are in bondage to the law in order that we may be free". This fixation with an individual's rights has, however, eventually led to a common belief that, no matter the circumstances, someone else is to blame for an individual's personal adversity. No longer is a plaintiff even required to demonstrate actual injury. In January, 2000, the Supreme Court (*Friends of the Earth vs. Laidlaw*) introduced a

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standard that permits a plaintiff to claim on the grounds of possible, and not just proven, injury. This blame game avoids issues such as personal responsibility or self-reliance and is the reason why litigation looms large in everyday life in America today. Thus the attraction of insulating assets from lawsuits through a legitimate offshore structure which may well be tax-neutral and provide little or no privacy whatsoever. The tyranny of kings has been replaced by the tyranny

of tort, the process by which a civil action might end in one's own personal financial ruin.

It is not surprising that some people, caught unwittingly in the grip of litigation, may feel that the Statue of Liberty is right where it should be: offshore. That's where an increasing number of Americans are seeking the protection which they feel they need. Most of them probably agree with the poet Robert Frost's sardonic statement that a successful lawsuit is the one worn by a policeman.



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Engaging an offshore representative is an important decision and we advise all persons to seek appropriate legal and tax advice from professionals licensed to render such advice before making offshore commitments.

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