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Governance Convergence of Tax Havens and the Shadow Banking System in Light of the Crisis

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‘structured financial is a euphemism for tax avoidance’

- Nigel Lawson, former UK Chancellor of the exchequer under Thatcher and member of the House of Lords selected to sit on a parliamentary investigation into the Libor-rigging scandal said in Newsnight 30/01/13 that ‘structured financial vehicles in a euphemism for tax avoidance’.
- Shadow banking and tax evasion and avoidance are linked through a web of financial centres, known as offshore financial centres (OFCs).
- OFCs are centres that specialise in non-resident finance and consist by and large of jurisdictions that are also known as tax havens
- BIS estimates that about half of the global stock of money is located in OFCs

A sense of unease

- Various estimates of the size of the SB + current discussions of regulation ignore the location of the registration of these entities
- The use of OFCs is known, but considered not to be an issue at all
- There is no good systematic evidence to dispute this assumption, but prevailing sense of unease among those who study tax havens
- Most of good information derives from regulators and governing bodies because they have access to information unavailable to academics
- But they do not seem to connect the dots...

Separation of fiscal and monetary policies

- For most of the 20th century, economic paradigm and regulatory framework have been built on the separation of fiscal and monetary arms.
- Tax evasion and avoidance were dealt with largely by domestic regulations, bilateral treaties and more recently, OECD-led international initiatives
- Financial supervision were oriented towards market and market stability and did not take the issue of complex inter-connectedness into account at all.
- Often believed that financial de-regulation took place, but in reality, many national financial regulations were simply side-stepped through the offshore financial markets and OFCs

- FATF (the financial action task force) set up after the East Asian Crisis examined the role of OFCs in exacerbating the crisis.
- Some studies had already linked complex financial instruments to financial instability and capital outflows through offshore networks.

- Our argument: Current proposals for tax evasion and avoidance regulations (TEARs) are contributing to the development of a regulatory infrastructure that could also be used for the SBS
- Combined, SBS regulations and TEARs are likely to yield a very different architecture of finance in the future.

Unified fiscal and monetary spheres

- In practice the fiscal and monetary spheres are never separated.
- Although it often denied, there is indisputable evidence that High-Net-Worth-Individuals, financial actors, and the large corporate sector are using tax havens and OFCs for tax avoidance and evasion purposes.
- Financial actors are ‘fiscally-oriented’ in their decisions, and those decisions have important implications in the monetary sphere.
- Monetary authorities were slow in recognizing the true motivation behind the development of some ‘financial’ instruments or entities
- They were also late to recognise that tax avoidance behaviour contributes to financial volatility.

Killing two birds with one stone

- By reducing income volatility and the probability of financial distress, (effective) hedging increases debt capacity.
- As firms add more leverage in response, the resulting increase in deductible interest expenditures reduces taxes and potentially increases firm value.
- Thus, derivatives are often used to increase debt-to-equity ratio in order to reduce tax.
- Consistent with this theory, research finds that hedging is associated with greater debt usage, and that it provides tax shields of 1.1 percent of firm value for both U.S and non-U.S firms.

The Economy of Deferral

- The timing of gain or loss recognition is critical in tax avoidance because current taxes are more costly than future taxes from a present value perspective.
- Deferring gains to future periods or accelerating losses to the present can be advantageous
- Derivatives can reduce taxes by altering the character of gains in order to release suspended capital losses.
- By transforming capital losses into ordinary losses, derivatives can reduce taxable income
- Derivatives can also modify the source of gains and losses.

SPE and OFCs, BIS report

- Many SBS entities such as hedge funds, SPEs are registered in OFCs
- Choosing a jurisdiction for incorporation of the SPE which will maintain tax neutrality of the structure and keep potential additional tax liability to a minimum plays a role in ensuring that the SPE can be perceived as being bankruptcy remote (BIS)
- It is crucial to the bankruptcy remoteness analysis that the SPE is not registered in a jurisdiction where its tax liability may be significant and/or varied.
- Establishing an SPE in a low tax jurisdiction will also mean that there will be minimum tax leakage and consequently more monies will be available to meet the obligations of the SPE towards investors
- In recent bankruptcy cases the trend in US courts is not to accept the ‘sham’ of offshore incorporation, to the concept of bankruptcy remoteness is challenged

SPE and OFCs, BIS report II

- The most common SPE jurisdictions for European securitisations are Ireland, Luxembourg, Jersey, and the UK.
- The most common jurisdictions for US securitisations are the Cayman Islands and the state of Delaware.
- The onshore (Delaware) versus offshore (Cayman) decision will generally be driven by tax considerations.
- Delaware is considered the most opaque jurisdiction in the world by the tax justice network
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The purpose of Special Purpose Vehicles, JCT report 2011

- SPEs have also been used to hide debt, hide ownership, and obscure relationships between different legal entities which are in fact related to each other.
- This proved a key problem in the collapse of Enron, Paramalat and in the current crisis.
- In addition to economic and financial accounting considerations, financial institutions subject to capital adequacy requirements may issue, or hold, financial instruments designed to produce favourable results under those rules.
- In other words, gaming taxation and capital adequacy requirements through SPEs

SEC analysis of derivatives structures

- IMF statistical dept. raised already in 2004 questions about the ambiguities about the location or residency of SPEs for regulatory purposes
- But the IMF was concerned with this as a ‘balance of payment issue’. The statisticians wanted some clarifications.
- The SEC found that the significant use of accounting-motivated transactions had contributed to a reduction in the transparency and credibility of financial statements.
- As a result, FASB introduced new consolidation rules based on risks and rewards rather than ownership and voting rights

SPE in Cayman

- The following is taken from the website of Williamngton Trust one of the shadows of M&T Bank Corporation (U.S) http://www.wilmingtontrust.com/wtcom/index.jsp?fileid=3000129
- The Cayman legal structure allows companies to raise capital off of their balance sheets, often at lower costs, and SPV activities may be insulated from claims of potential creditors.
- While other jurisdictions also offer the opportunity to create SPVs, may not be as easy to arrange as they are in the Caymans.
- Fees are generally modest, and the legal and regulatory framework is extremely flexible.
- Red tape is also minimal
- No governmental authorizations or licenses are necessary in order to establish an SPV in the Cayman Islands.
- Incorporation generally takes less than 24 hours once the process is underway,
- costs are modest. To set up an SPV, government fees range between US $574 and US $2,400, depending on the amount of capital involved, and total costs generally range between US $2,000 and US $3,000.

Cayman II

- Under current Cayman law, most SPVs are established as "exempted companies."
- An exempted company is not permitted to conduct business within the Cayman Islands, and, in return, it is entitled to a complete tax holiday for 20 years, with a possibility of a 10-year extension.
- In any event, there are no direct taxes in the Cayman Islands, so an exempted company will not have to pay any form of income tax, capital gains tax, or corporation tax. Similarly, no taxes will be withheld from any cash flows.
- Establishing an SPV in a tax-neutral jurisdiction such as the Cayman Islands is especially helpful if the ultimate sponsor operates in a high-tax country such as the U.S. or U.K.
- A properly structured SPV may reduce or even eliminate taxes owed to the sponsor's home country.

From Bear Stearns bankruptcy proceedings

- Consider a typical SB entity:
- The two Bear Stearns High-Grade funds were both “Cayman Islands exempted limited liability companies with registered offices in the Cayman Islands.”
- Both entities were open ended investment companies that invested in *asset-backed securities (“ABSs”),* mortgage-backed securities, derivatives, options, swaps, futures, equities, and currencies.
- PFPC Inc., a Massachusetts corporation, administered the funds and performed all back office functions, including accounting and clerical functions.
- The books and records were maintained and stored in Delaware
- Deloitte & Touche, Cayman Islands, performed the most recent audit
- the investment manager was Bear Stearns Asset Management Inc., a New York corporation (“BSAM”)

Bear Stearns II

- the assets managed by BSAM were located in New York.
- The investor registers are held in Dublin, Ireland by an affiliate of PFPC Inc. (Another OFC).
- Two of the three investors in one of the Funds are registered in the Cayman Islands,
- They were both Bear Stearns entities which appear to have the same minimum Cayman Islands profile as do the Funds.”
- Accounts receivable are located throughout Europe and the
- U.S.,
- counterparties to master repurchase and swap agreements were based both inside and outside the U.S. but none are in the Cayman Islands.

Bear Stearns III

- Apparently the only relationships that
- the Funds had with the Cayman Islands were (i) registration there;
- (ii) conducting the business associated with maintaining their standing as registered Cayman Islands companies
- (iii) two of the ('dummy') directors resided there

The fiscal nature of financial behaviour

- These complex structures cost money, a lot of money:
- Financial and legal council, legal fees, licensing, transfers, payment for ‘dummy’ directors, considerable clerical work, the odd long-distance flights
- Huge increase in ‘transaction costs’, not what the textbook economics tell us.
- Little ‘economies of scale’ in this business.
- These are sunken costs + yearly additional costs
- What makes them worth while? They clearly offer some advantages, reduction in taxation and/or regulation
- In fact, some of these costs are logged as ‘expenses’ in high-tax countries and subject to tax deduction...

New principles for dealing with cross-border tax avoidance

- The US has lost patience with international tax avoidance initiatives.
- The instruments developed by the U.S. For tax avoidance purposes, and may be adopted by other countries, and may offers regulatory tools in the monetary sphere as well
- United States’ qualified intermediary system (QI) began operating in 2001
- It was meant to ensure that non-U.S. persons making portfolio investments in the United States were being properly taxed by the United States on income from those investments.
- It was recognised that the complexity of cross-border financial transactions that go through OFCs render the determination of source country investment very difficult
- Source country determination is important than in determination of withholding tax because of double-taxation treaties

QI

- Under QI, non-U.S. Financial institutions agree to collect information from their customers investing in the United States
- QI, was a ‘bargain’ between US and Non-US FIs.
- QI was able to conceal the identity of its non-U.S. customers from both competitor institutions and the IRS.
- QI could ensure that other financial institutions in the chain of intermediation would not be able to steal its customers
- assure its customers that the IRS would not provide information to their customer’s home country tax authority.
- Yet, set up infrastructure for information gathering about all financial institutions and every product

The Foreign Account Tax Compliance Act (FATCA)

- In 2010—following on the UBS scandal, and President Obama's campaign commitment to crack down on offshore tax evasion85—the United States Congress enacted sections 1471 to 1474 (generally known as "FATCA"86) of the Internal Revenue Code.

- Under FATCA, foreign financial institutions are generally required to report information on financial accounts of U.S. persons and foreign entities with significant U.S. Ownership directly to the IRS beginning in 2014.

- Foreign financial institutions must report the account balance or value of each U.S. account, and the amount of dividends, interest, other income, and gross proceeds from the sale of property credited to a U.S. account.

- The data that Victoria Baklanova is asking for will be available to the IRS!
- if foreign financial institutions will not agree to report to the United States on income earned by U.S. individuals through accounts at those institutions, FATCA requires withholding on a wide range of payments.

- Significantly, France, Germany, Italy, Spain and the UK are planning to implement a version of FATCA and work together with the US and with each others.

Legal Entity Identifier (LEI)

- Financial Stability Board six data element:

- The official name of the legal entity;
- The address of the headquarters of the legal entity;
- The address of legal formation;
- The date of the first LEI assignment;
- The date of last update of the LEI;
- The date of expiry, if applicable.

Conclusions

- This is the moment of the regulators
- Change in philosophy on taxation opens new sources of information and monitoring of financial entities
- The change in philosophy overcomes some jurisdictional arbitrage problems
- <u>The Flag of Convenience Principle</u>
- Lacks of transparency becomes a criminal offence