Offshore Financial Centers and Tax Havens – An overview

Chapter 111

Neha Sinha and Ankita Srivastava

Neha Sinha, a Law Graduate, is a core member of the international tax practice and funds formation practice at Nishith Desai Associates. She advises on structuring of inbound/outbound investments, employment taxation, e-commerce, wealth and succession planning and mergers and acquisitions. She is a regular speaker at conferences and seminars and regularly contributes articles to reputed Indian and International tax journals.

Ankita Srivastava, a Post Graduate in Law from the Vienna University of Economics and Business, Vienna, Austria, is an associate at Nishith Desai Associates, primarily involved with firm's international tax practice. She has contributed articles to reputed Indian and International tax journals. Prior to joining Nishith Desai Associates, she has also extensive experience working with Amarchand & Mangaldas, Suresh Shroff & Co.

Synopsis

1. Offshore Financial Centers

1.1. Meaning and Origin

The term 'offshore financial center' *(referred to as an '**OFC**' in this chapter)* is typically used for a country or a jurisdiction with financial centers comprising of financial institutions that deal primarily with non-residents and/or in foreign currency on a scale out of proportion to the size of the host economy. Non-resident owned or controlled institutions play a significant role within such financial centers.[1] While this is a brief description of a typical financial center, there is no consensus among scholars and practitioners on what actually constitutes an OFC even though various attempts have been made to define OFCs, since they started to have an impact on international financial markets in the early 1970s.[2] As OFCs are of significant interest to the International Monetary Fund (the "**IMF**"), a lot of research has been undertaken at the IMF to define the term. In the year 2000, IMF issued a background paper[3] where an OFC has been defined as *a center where the bulk of financial sector activity is offshore on both sides of the balance sheet, (that is the counterparties of the majority of financial institutions liabilities and assets are non-residents), where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents*. Thus, as per the IMF background paper, a jurisdiction with the following characteristics could be considered as OFCs:

1 http://stats.oecd.org/glossary/detail.asp?ID=5988 (Last accessed on August 7, 2012)

2 In paper titled 'Concept of Offshore Financial Centers: In Search of an Operational Definition' dated April 2007 by Ahmed Zoromé

3 In paper titled 'Offshore Financial Centers – IMF Background paper' dated June 23, 2000, prepared by the Monetary and Exchange Affairs Department, International Monetary Fund

(i) Jurisdictions that have relatively large numbers of financial institutions engaged primarily in business with non-residents;

(ii) Financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies; and

(iii) More popularly, centers which provide some or all of the following services: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity.

The origin of OFCs can be traced back to the 1960s and 1970s when many developed nations and sovereign governments were attempting to regulate capital flows through the imposition of restrictive domestic regulations. These restrictions, in many cases were intended to provide governments with more control over monetary policy. These developments encouraged banks and other financial institutions to shift deposits and borrowing activities to less regulated institutions at offshore centers which had lesser regulations and restrictions.

In explaining the creation and growth of present-day offshore centers, practitioners and academics have put forward at least four factors[4]:

(i) the establishment of capital controls with a view to reducing unsustainable balance of payments deficits recorded primarily by the United States in the late 1950s and also, by many OECD countries in the 1960s;

(ii) the imposition of high taxes, coupled with a tightening of monetary policy, in an attempt to curb balance of payment deficits resulting from fiscal imbalances, particularly in some OECD countries;

(iii) the removal of foreign exchange restrictions on the conversion by non-residents of current earnings in Western Europe; and

(iv) the fact that U.S. banks' interest in conducting business transactions in foreign currencies and to extend their reach to new territories was spurred by the Glass-Steagall Act of 1933, which barred commercial banks from entering the investment banking business.

4 'Concept of Offshore Financial Centers: In Search of an Operational Definition' by Ahmed Zoromé - *Ibid*

1.2. Role of Offshore Financial Centers

While it is generally perceived that corporations or individuals used OFCs primarily because of the minimal taxes and the banking secrecy/anonymity afforded by the OFCs, there are a number of *bona fide* purposes for which OFCs could be and are used by corporations or individuals for conducting business. Some of such considerations are:

(i) OFCs allow businesses to reduce costs by providing centralised group services or shared services within a multinational group;

(ii) OFCs allow effective movement of capital and resources, providing opportunity for global investments;

(iii) OFCs provide facilities to manage financial affairs confidentially and provides legal protection from unjustified claims;

(iv) OFCs permit the use of intermediary holding companies to overcome strict exchange control regulations; and

(v) OFCs are low tax jurisdictions which help corporations save significant taxes and reduce the impact of transfer pricing rules in home countries.

2. Tax Havens

2.1. Meaning

The term 'tax haven' does not have a comprehensive definition. This is primarily because of the comparative nature of tax benefits provided by any jurisdiction. Because of the relative nature of the advantages provided, every country may be a tax haven to some degree. (See 2.2 below.) In this regard, the OECD Tax Haven Report (1997) states that *'any country might be a tax haven to a certain extent, as there are many instances where high tax countries provide opportunities or devise policies to attract economic activities of certain types or in certain locations'*.[5] However in the interest of clarity, OECD has set out the following criteria (to be considered cumulatively) to determine whether a jurisdiction is a tax haven:

(i) Whether the jurisdictions imposes no or nominal taxes;

---

5 Basic International Taxation, Roy Rohatgi, Kluwer Law International; 1st Edition (December 21, 2001)

(ii) Whether there is lack of transparency;

(iii) Whether there are laws or administrative practices that prevent the effective exchange of information for tax purposes with other governments on taxpayers benefiting from the no or nominal taxation.

Transparency is considered a significant criteria as it ensures that there is an open and consistent application of tax laws among similarly situated taxpayers and that information needed by tax authorities to determine a taxpayer's correct tax liability is available (e.g., accounting records and underlying documentation).

Similarly, exchange of information in tax matters is important as, the OECD encourages countries to adopt information exchange on an "upon request" basis. Exchange of information upon request describes a situation where a competent authority of one country asks the competent authority of another country for specific information in connection with a specific tax inquiry, generally under the authority of a bilateral exchange arrangement between the two countries. An essential element of exchange of information is the implementation of appropriate safeguards to ensure adequate protection of taxpayers' rights and the confidentiality of their tax affairs.

2.2. *Example of countries with tax benefits*[6]

Tax Benefit	Countries
No corporate taxes	Cayman Islands, UAE (except banking and oil companies), Bahamas
No tax on foreign source income (due to territorial tax regime)	Singapore
Special free trade zones	India, UAE, China
No estate duty	India, Australia, Mauritius
Special incentives for shipping operations	Panama, Greece, Cyprus
Special incentives for insurance related activities	Gibraltar, Guernsey, Bermuda

6 Basic International Taxation, Roy Rohatgi, Kluwer Law International; 1 Edition (December 21, 2001)

Tax Benefit	Countries
Special concessions for entities engaged in management services and co-ordination services	Singapore, Luxembourg, France
Regional tax arrangements	European Union

3. Selecting an offshore financial center

The selection of an OFC is dependent upon a number of factors which can be classified into tax and non-tax factors. Some of these significant factors have been listed below:

Tax Factors: The most significant tax factors are:

(i) Basic tax rates

(ii) Tax incentives

(iii) Nil or low withholding taxes

(iv) Treaty network

(v) Anti-avoidance rules

(vi) Stability of tax laws

Non-Tax Factors: The selection of an OFC requires one to consider a number of points in addition to the tax benefits provided by the jurisdiction. These are factors which determine the ease of doing business in a particular jurisdiction and the cost involved in setting up operations and ongoing costs involved. These factors include:

(i) Political and economic stability

(ii) Commercial and financial infrastructure

(iii) Currency stability

(iv) Access to capital markets

(v) Government practices and procedures

(vi) Reputation and image of the country

(vii) Exchange control restrictions

(viii) Legal infrastructure, including dispute resolution mechanism

(ix) Ease in formation and liquidation of entities

(x) Flexibility afforded by corporate laws and compliance requirements thereunder, including permissibility to 'migrate' legal entities

(xi) Set up and ongoing costs

(xii) Availability of competent and trained professional staff.

4. Offshore Intermediary Entities

This section deals with the various offshore intermediary entities, which are generally interposed within a group for a particular transaction or purpose, located in jurisdictions which provide specific tax and non-tax advantage. The focus of this section is to outline the features and planning opportunities offered by such jurisdictions which can be based on various parameters such as flexible incorporation, licensing regimes, lower or nil withholding taxes on outbound payments, flexible use of trusts and special corporate vehicles, incentive regimes, etc.

4.1. Captive Insurance Company:

4.1.1. Nature of the Entity

Generally, a wholly owned subsidiary of a multinational group of companies insures or reinsures the risks of companies that belong to the group, which require all of the risk insurance, owing to the costs involved in obtaining external insurance.

A captive insurance company ("**CIC**") is an insurance company within a group that has no insurance business otherwise, and which is set up in order to insure the companies within the group from any business risk that may arise.

A CIC may be used to insure certain risks that the normal insurance market will not accept and to obtain broader types of insurance that commercial insurance companies do not have the flexibility to provide or to reduce the costs of premiums that would normally be paid to an independent insurer.[7]

Unlike general insurers, a CIC insures any business risk, including those not generally covered by regular insurance

7 Taxation issues relating to captive insurance companies/A.A. Skaar – Amsterdam: IBFD, 1998.

companies such as pollution, loss of key customers, terrorism risks, etc. Although a CIC primarily engages in insuring risks of the parent or other related entities, it can also insure risks that may be faced by a third party.[8] A CIC gives the group insurance facilities by utilising its own financial resources to fund any anticipated losses or future insurance claims that may arise.[9] Under the captive insurance arrangement, the insured entity pays premiums to the captive insurance entity so as to be indemnified for loss arising upon the happening of a specified event. Such premiums are claimed as deductions by the insured company. However, it is also possible to establish a CIC for the primary reason to generate deductions. Accordingly, CIC are typically taxed on insurance premiums and are allowed a deduction for insurance payments and provisions for insurance payments. Companies that pay insurance premiums to captives have been allowed to claim such costs as deductions.

Generally, the benefit arising of the arbitrage accrues when CIC is located in a low tax jurisdiction. The captive insurance transaction which results in deductible insurance premiums in high-tax jurisdictions and taxable insurance premiums in a low-tax or tax-free jurisdiction, attracts special attention from tax authorities. The benefits may be subject to anti-avoidance measures, such as transfer pricing, anti-tax haven or controlled foreign company rules. The deduction for premiums paid by the members of the group may also be disallowed on the basis that the nature of the arrangement does not provide sufficient risk-shifting or risk-distribution to constitute true insurance, or that the members of the captive group constitute a single economic family.

It may be interesting to note that the Australian Taxation Office released Practice Statement to provide "*Guidance on the Treatment of Non-resident Captive Insurance Arrangements*"[10] pointing towards artificiality of the arrangement, and therefore listed out the following factors which may help to determine the commercial

8 Phillip England, Isaac E. Druker, and R. Mark Keenan, Captive Insurance Companies: A Growing Alternative Method of Risk Financing, Anderson Kill & Olik, available at: http://www.andersonkill.com/webpdfext/cic-riskfinancing.pdf.

9 Paul Hopkin, Fundamentals of Risk Management Understanding Evaluating and Implementing Effective Risk Management, Kogan Page, 2010, at p. 267.

10 PS LA 2007/8 http://law.ato.gov.au/atolaw/view.htm?docid=PSR/PS20078/NAT/ATO/00001

legitimacy of the arrangement and whether the actual insurance business is being conducted or not:

(i) Whether the entity is exposed to a significant loss and assumed a significant insurance risk;

(ii) Whether it is authorised to conduct an insurance business in the local jurisdiction; and

(iii) Whether it actually has the financial capacity to pay an insurance claim.

If the aforementioned factors indicate that the scheme is artificial, the following factors may impact the deductibility of insurance premiums paid to a non-resident CIC:

(i) Whether deductions claimed are proportionate to the actual insurance coverage provided;

(ii) Whether the deductions are acceptable for transfer pricing purposes;

(iii) Whether the captive insurance entity is a resident under the central management and control test (and therefore may be a part of an Australian tax consolidated group);

(iv) Whether income of the entity has Australian source (and subject to tax in Australia in the absence of a tax treaty restrictions);

(v) Whether premiums paid are subject to taxation under the rules for taxation of foreign insurers;

(vi) Whether the entity is a controlled foreign corporation; and

(vii) Whether the general anti-avoidance rule may apply to the arrangement.

4.1.2. Jurisdictions of preference for CIC

Although the world's leading captive jurisdiction is Vermont (in the United States), Vermont is considered an onshore captive jurisdiction. The primary OFC jurisdiction for captive insurance companies is Bermuda and Cayman Islands. Bermuda had 845 active captives with $118 billion in assets under management and $19.6

11 http://www.royalgazette.com/article/20110315/BUSINESS04/703159963

billion in gross written premiums in 2010.[11] This is mostly owing to the possibility of swift incorporation and its geographical proximity to the U.S, where most parent companies of captives are situated.

Singapore has also taken steps, such as extension of the captive insurance tax incentive scheme till February 2018, an exemption on qualifying income derived from the carrying on of offshore insurance business, to ensure that Singapore remains as a competitive captive location. Other jurisdictions that are favoured for setting up of CICs are the Cayman Islands, Guernsey, Anguilla, Luxembourg, Barbados, the British Virgin Islands and Turks & Caicos**.**

4.1.3. Benefits of using a CIC

(i) ***Flexibility:*** Captive insurance companies offer great flexibility in respect of the types of risks insured. Commercial insurance companies often do not cover risks associated with environmental issues, such as hazardous waste, nuclear risks, and pollution. Captives can be used to provide insurance coverage in these areas.

(ii) ***Reduced premium payments:*** Creating a captive allows premium payments without any extra costs involved in payments made to an outside insurer. Thus, the same coverage can be obtained at a lower cost.

(iii) ***Flexibility as to risks:*** Captives offer greater flexibility as to how to insure risks. If the cost of an insurance premium is low in the open market, the captive can purchase it in the market while if the cost is high, the captive can provide insurance at its own risk.

(iv) ***Access to reinsurance markets*****:** An offshore CIC gives a business access to the international reinsurance market, thereby allowing for possible expense reduction.

(v) ***Tax benefits*****:** As the investments are primary source of income for an insurer, the investment income maybe tax free for a captive if domiciled in the right OFC.

(vi) ***Independent profits*****:** Generally, a wholly owned captive cannot insure its parent unless it also insures third party risk. Owing to the possibility of acquiring third party risk, the captive insurance company can diversify its business and earn its own profits as an independent commercial body.

(vii) ***Higher efficiency:*** Owing to the element of control associated with a captive insurance company, the processing of insurance claims is much more efficient than in the case of a third party insurer.

4.2. *Employee Leasing Company*

4.2.1. Nature of the Entity

An employee leasing company ("**ELC**") is a company set up in a jurisdiction that offers skilled and cost-effective man-power resource that provides for staffing of the company including managing the selection process, setting up and actual staffing operations on behalf of the client company. It involves a contractual relationship between the ELC and the company taking such employees also known as "subscribing company". As per a typical employee leasing arrangement, ELC is obligated to perform specified employer responsibilities of the subscribing company to the leased employees including all personnel-related administrative activities, including payroll, benefits programmes, payment of payroll taxes, workers' compensation, and securing of workers' compensation insurance, etc. The subscribing company has to pay leasing fees (that are in most cases deductible), while every other expense is handled by the ELC.

This format of offshore staff employee leasing is a preferred outsourcing option because it provides a simple format for including an offshore workforce to an organisation without giving up supervision and control and generally leads to building teams. Additionally, the subscribing company is relieved of the usual burdens accompanying the implementation of traditional recruitment processes and staff maintenance. The need for investing in a typical human resources team is done away with and internal costs are reduced.

4.2.2. Jurisdictions of preference for ELC

The popular jurisdiction for ELC where the subscribing company is located in the following regions has been as under:

(i) **Asia and Pacific region:** Bangladesh, China, India, Indonesia, Malaysia, the Philippines, Sri Lanka, Thailand and Vietnam.

(ii) **Europe and the Middle East and Africa region:** Bulgaria, the Czech Republic, Egypt, Hungary, Mauritius, Morocco, Poland, Romania, Russia, Slovakia, South Africa, Turkey and Ukraine.

(iii) **American region:** Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Panama and Peru.

4.2.3. Benefits of using an ELC

(i) ***Cost effective:*** The entire workforce is leased by the intermediary offshore company; the corporation does not have to

pay anything more than the leasing fees, which is usually claimed as a deductible item. Thus, costs are considerably reduced. Further, as these workers are not considered employees of the subscribing company, the personal injuries and workers' compensation claims are not responsibility of the subscribing company.

(ii) ***Less administrative burden:*** As the workforce is under the supervision and control of the ELC, this leads to comparatively lesser management burden for the subscribing company. The subscribing company is relieved of the usual burdens accompanying the implementation of traditional recruitment processes and staff maintenance.

(iii) ***High-skilled labour*:** Since jurisdictions like India and Philippines are able to provide high-skilled, English speaking labour at much lower cost, employment provided from companies set up in such jurisdictions provides for a competitive advantage.

4.3. International Shipping/Aircraft Company

4.3.1. Nature of the Entity

Some OFCs specialise in shipping/air transport and allow registration for foreign ship/aircraft owners. Often companies in jurisdictions with strict regulatory framework and high taxes establish an international shipping/aircraft company in the OFC, so as to take ownership of a ship/aircraft which is then registered in the OFC. Such jurisdictions offer low registration fees and minimal regulations on shipping operations. Further, these jurisdictions offer a minimal tax on profits of the company or dividends paid by the company or profits on eventual sale. Thus, the use of offshore shipping companies in OFCs can eliminate direct or indirect taxation on shipping services. Structuring businesses in the right way across multiple jurisdictions can help achieve tax benefits and cost efficiency. Taxation is perhaps the most important of all the factors that combine to influence where companies register ships and aircraft.

4.3.2. Jurisdictions of preference an international shipping/aircraft company

Panama and Liberia were the pioneers of offshore shipping industry who opened their doors to ship owners regardless of their nationality. Despite OECD's efforts to shut down their operations, they remain world's two largest shipping regimes besides Cyprus, Malta, and Singapore, and more recently the British Virgin Islands which offer such facilities. Another offshore shipping jurisdiction that has risen to prominence in recent years is the Isle of Man.

For international aircraft companies, Bermuda, the Cayman Islands, Bahamas, Aruba, Isle of Man offer beneficial regimes. The Isle of Man has become widely regarded as a one-stop shop for worldwide aviation business supported by well-established banking sector experienced in financing aircraft, insurance companies which can provide cover without the addition of an insurance premium tax and corporate service providers experienced in structuring companies to take advantage of the beneficial tax regime.

Malta has also positioned itself as one of the world's largest shipping registries with a new aircraft registry, by the Aircraft Registration Act, 2010 and providing a tax package wherein there is no withholding taxes on lease/royalty payments made by lessees to non-residents in respect of aircraft operated in the international transport of passengers or goods, no withholding taxes on interest payments made by Maltese lessees to non-resident financial lessors; competitive depreciation allowance for aircraft and engines; tax credits for companies engaged in the repair or maintenance of aircraft; tax refunds to shareholders on distribution of profits.

4.3.3. Benefits of using an international shipping/aircraft company

(i) ***Ease in registration and other facilities:*** These jurisdictions offer flexiblility in terms of ownership, registration, administration and operation of ships and aircraft.

(ii) ***Tax neutrality*:** Owing to the specific characteristics of the jurisdiction concerned, the tax liability on profits earned, dividends paid and profits on sale become limited.

(iii) ***Availability of specialised advisors*:** Since these jurisdictions specialised in shipping/air transport, there is an availability of a wide variety of firms with expertise in the area.

4.4. Offshore trading company

4.4.1. Nature of the Entity

An offshore trading company ("**OTC**") is generally a company set up in an OFC which purchases goods from exporters in one or more foreign jurisdictions and sells them to importers in other foreign countries. An OTC could also be established as a neutral ground for setting up a trading joint venture. Typically, an OTC buys goods from related companies or third parties, and sells them at a profit to the foreign subsidiary, thereby creating a shift of profits away from the foreign subsidiary into offshore trading company which is located in a low tax jurisdiction. The sales income received by the OTC may be paid as dividend to its shareholders tax free. The OTC is generally preferred owing to accumulation of profits in one entity with tax benefits, which can later be reinvested.

4.4.2. *Jurisdictions of preference offshore trading company*

The preferred jurisdictions for setting up of offshore trading companies are Mauritius, the British Virgin Islands, Netherland Antilles, Jersey, Madeira, Cayman Islands, Gibraltar and Isle of Man. The United Kingdom is one particularly developed jurisdiction which is used as an offshore trading location.

4.4.3. *Benefits of using an offshore trading company*

(i) ***Encourage trading operations:*** Certain offshore trading jurisdiction actively encourage trading operations by offering duty-free zones, or warehousing facilities. Apart from ensuring fiscal suitability and confidentiality, the choice of an offshore jurisdiction for trading purposes will depend on a variety of factors, of which some particularly important ones may be good transport links, availability of skilled local labour, ease of obtaining entry and work permits, proximity to markets, local cost levels, effectiveness of local banking and commercial services, modern telecommunications and e-commerce infrastructure, availability of duty-free zones and ease of establishment of offshore entities.

(ii) ***Tax benefits:*** If an OTC is set up for import and export in a tax free OFC, profits accumulated in the OFC can be reinvested tax free, until distributed to the back to the parent entity.

(iii) ***Neutral ground:*** An OTC provides for a neutral ground where all the trading parties have equal knowledge of the local laws.

4.5. *Offshore trusts*

4.5.1. *Nature of the Entity*

An offshore trust is created when assets are transferred to a person known as trustee, who acquires legal ownership and becomes responsible for the management of the assets and distribution of the assets to beneficiaries (which could include the transferor), as per the terms of the trust deed. The offshore trust accrues benefits and distributions to a person or group of persons known as the "beneficiaries" of the trust. Generally, an offshore trust has the additional benefit of far greater offshore asset protection than the onshore trust. The trustee and/or the trust company charged with the management of the trust are bound by a fiduciary duty to uphold the agreement.

Generally, offshore trusts can be used separately or together for asset protection purposes. Although the transferor/settlor usually provides a letter of wishes, detailing how he would like the money to be managed, and distributed, the trustees have legal control over the assets.

4.5.2. Jurisdictions of Preference

Some examples of common law based OFCs with well-established trust law frameworks are Bahamas, Barbados, the British Virgins Islands, the Cayman Islands, the Cook Islands, Gibraltar, Jersey, Mauritius and Hong Kong.

4.5.3. Benefits of using an offshore trust

(i) ***Asset protection:*** Assets in an offshore trust are protected against various risks, including political, economic and legal risks in the settlor's country. Since the assets do not belong to the settlor, there lies no obligation on the settlor to disclose such assets in his own country.

(ii) ***Tax benefits and estate planning:*** By transferring assets to a trust, the settlor reduces his personal wealth, and consequently his personal income tax liability is also reduced. Moreover, if set up in a low/nil tax OFC, there will be no tax on its assets and income and tax will only be payable when assets are distributed to beneficiaries.

4.6. Foundation

4.6.1. Nature of the Entity

A foundation (individual or corporate) is a distinct juristic entity, having no members or shareholders in it, and is generally established to reflect the wishes of the founder captured in the charter document. The founder provides for the initial assets of the foundation known as the endowment. The foundation can be established for a fixed or indefinite period of time and the objects of the foundation can be charitable, commercial or family purposes.

Unlike a common law trust, a foundation is a legal entity more akin to a company and as such, it is usually entered into the company's registry in the jurisdiction concerned. Unlike in a trust, the assets of a foundation are administered as per what is set out in the charter and regulations and is thus, on a contractual basis and not a fiduciary basis. Similarly, rights enjoyed by the beneficiary are contractual in nature. A foundation generally holds shares and stocks, investment portfolios, real and intellectual property, bank deposits, life assurance policies and most other types of assets. A foundation is established for several reasons such as preservation of wealth against uncertainty, tax efficient transfer of wealth, efficient estate planning, consolidation of worldwide assets, minimisation of state taxes, etc. When a foundation is established in a suitable offshore jurisdiction, provided that residents of the offshore jurisdiction do not receive benefits, local tax liability can be excluded.

4.6.2. Jurisdictions of preference for the foundation

Panama is the primary jurisdiction for layered asset protection, estate planning, etc. since the law does not permit freezing of assets in Panama and also because there is no tax liability on foreign income in Panama. Some favourable taxation rules for foundations are found in Austria, Switzerland and Liechtenstein (the *Stiftung*) as well, where private foundations have a tax exemption or reduced taxation of capital gains on the disposal of shareholdings. Foundations have also been introduced in the Bahamas, Isle of Man and Jersey.

4.6.3. Benefits of using an offshore foundation

(i) ***Asset/Wealth Protection*:** The primarily use of trusts is estate and inheritance planning. Since the foundation is not owned by anyone, the assets cannot be claimed/frozen if the founder, council members, protector or beneficiaries have unpaid debt.

(ii) ***Recognition:*** A foundation is recognised in important jurisdictions that follow both common/civil law such as Austria, Belgium, France, Germany, Luxembourg, Netherlands, Switzerland, the United Kingdom, etc.

(iii) ***Estate planning:*** A foundation can be used to hold assets which can be transferred from generation to generation without being affected by the rule against perpetuities in certain jurisdictions. This can also be used for inheritance tax planning or for avoidance of forced heirship rules.

(iv) ***Privacy***: Since the foundation's charter and regulations function as per the wishes of the founder, there is no requirement for registration.

(v) ***Consolidation of worldwide assets:*** Offshore foundations are used to consolidate worldwide assets and can be held by the single entity.

4.7. Royalty Routing Company

4.7.1. Nature of the Entity

Generally, a company owning intellectual property ("**IP**") can either gift or sell its IP rights to an offshore company that licenses some or all of such rights, for the use of the IP to an intermediary or agency company called a royalty routing company created in an OFC offering tax benefits such as a tax treaty network, reduced/nil rate of withholding tax on cross-border royalties or accumulation of royalty income in a nil or low tax jurisdiction. An onshore intermediary company may exploit the rights by licensing its IP for use by companies in multiple jurisdictions. The royalty fees are passed to the onshore intermediary company which may be subject to nil or a low withholding rate due to beneficial tax treaty provisions. Generally, the onshore intermediary company retains a fee for the work done in negotiating contracts and then the onshore intermediary company remits the balance to the offshore company free of any further withholding taxes.

The transfer of IP rights can also be structured as loan transactions where the IP rights are transferred to an intermediary royalty routing company in a tax treaty country for a loan consideration. Subsequently, the intermediary royalty routing company can license the rights to the host country situated in a country where there is a low rate of withholding tax on royalty. Additionally, the accumulated royalty can be set off against the amortisation of the cost of the property rights and interest deduction on loan can also be claimed.

4.7.2. Jurisdictions of preference for Royalty Routing Company

Cyprus, Ireland and Netherlands are considered the best jurisdictions for royalty routing owing to no withholding taxes for royalties and other tax and regulatory benefits. The use of Malta for royalty routing structures has also increased in the recent past.

4.7.3. Benefits of using a royalty routing company

(i) ***Withholding tax benefits:*** The low or nil withholding rates applicable provide for a significant benefit for royalty payments.

(ii) ***Other tax benefits:*** Generally, the cost of acquisition of the IP can be amortised for tax purposes. Further, certain jurisdictions offer research and development tax credit and also grants. Additionally, tax deduction is available on the acquisition of IP.

4.8. International Holding Company

4.8.1. Nature of the Entity

A holding company is a company established purely for the purpose of holding shares of another company for investment purposes. An offshore international holding company is a company which is established in one offshore jurisdiction and holds shares of or invests into companies, usually located in other offshore jurisdictions.

The intermediary holding company is generally set up to achieve a favourable taxation treatment in circumstances where a direct transaction between the parent jurisdiction and beneficiary jurisdiction would result in unfavourable tax consequences with respect to capital gains, dividend distribution, and royalty payments.

Holding company jurisdictions are selected after taking into account several determinants such as time of incorporation, type of investment involved, substance requirements in domestic tax law and treaties, possible advantages such as IP favoured regimes, EU directives, participation exemptions, etc.

4.8.2. Jurisdictions of preference for international holding company

Holding company jurisdictions are chosen with special regard to the investment being made. Although low-tax jurisdictions such as Mauritius, Cyprus, and Singapore, etc. serve as favourable holding jurisdictions, a jurisdiction like Netherlands is generally preferred owing to the infrastructure and facilities available. Netherlands also has several beneficial features such as an extensive treaty network with beneficial withholding rates, participation exemption, a competent innovation box regime, etc.

For specific investments such as an IP holding company, jurisdictions with IP and research and development related benefits such as Ireland are preferred. Other favourable jurisdictions for investment into the US and Europe are Hong Kong, Singapore, the United Kingdom, etc.

4.8.3. Benefits of a favourable Offshore Holding Company

(i) ***Exemption from capital gains:*** Profits realised by the holding company in a favourable jurisdiction on the sale of shares in the subsidiary is generally either exempt from or subject to a low rate of capital gains tax in the holding company's jurisdiction.

(ii) ***Incoming Dividends:*** Incoming dividends remitted by the subsidiary to the holding company in a favourable jurisdiction are either exempt from or subject to low withholding tax rates in the subsidiary's jurisdiction. Moreover, dividend income received by the holding company from the subsidiary is generally exempt from or subject to low corporate income tax rates in the holding company's jurisdiction.

(iii) ***Outgoing dividends:*** Outgoing dividends paid by the holding company to the ultimate parent corporation is generally either exempt from or subject to low withholding tax rates in the holding company's jurisdiction.

(iv) ***Other favourable regimes*:** Specialised IP protection or research and development related regimes will provide for tax benefits in case of such assets or activity.

4.9. Hybrid Company

4.9.1. Nature of the Entity

A hybrid company is a mixture of the two accepted forms of a limited company i.e. a company limited by guarantee and a company limited by shares. A hybrid company can have two or more classes of members. The first class will be the registered members i.e. the shareholders who are the controlling members. The registered members have no right to distributions of profits but have voting and administrative powers. The principle power of the shareholders is to elect directors to manage the company. The second class will be the beneficial members who are anonymous and are entitled to share in the profits of the company although distributions from the company can only be authorised by the directors. Subsets of members with different rights can also be created through the addition of other classes of beneficial members. Hybrid companies are recognised in OFCs such as Isle of Man and Gibraltar and are generally popular business structures owing to the anonymity provided to its beneficiaries. Moreover, difficulty of classification of such entity in foreign jurisdictions also makes it popular as an intermediary.

4.9.2. Jurisdictions of Preference for the Hybrid Company

Only low-tax OFCs recognise hybrid entities as they are utilized specifically to obtain tax benefits. Isle of Man and Gibraltar hybrid companies are most commonly used owing to geographical considerations and low issued share capital requirements.

4.9.3. Benefits of using a Hybrid Company

(i) ***Economic interest separate from control:*** There is a strict separation between the registered members and the beneficiaries, thereby making the beneficiaries anonymous. Such a position can be utilised to the parent company's advantage where it is resident in a jurisdiction with strict controlled foreign corporation rules.

(ii) ***Flexibility in financing and distribution:*** The main attractiveness of such a structure is the flexibility it offers in the financing and distribution of profits within the company.

(iii) ***Low share capital requirement:*** Hybrid companies are inexpensive to set up owing to low share capital requirements, which make them ideal for an intermediary entity.

(iv) ***Asset protection and estate planning:*** Hybrid companies can be used for holding assets for several years as there is no rule against perpetuities applicable and the beneficiaries are anonymous.

(v) ***Provision of Protector:*** The articles of association may provide for the appointment of a third party as a protector who supervises assets and whose authority is required before any disposal.

4.10. Protected cell companies ("PCC")

4.10.1. Nature of the Entity

The concept of PCC's originated in 1997 in the Island of Guernsey on the English Channel. It was set up under the Protected Cell Companies Ordinance of 1997. PCCs were conceptualised in response to the need to adopt a captive approach towards risk management in the Guernsey Fund industry wherein assets of one class were available for the liabilities of another. Ever since, PCCs have become popular special purpose vehicles (SPV) in offshore jurisdiction for structuring investments.

A PCC is based on the concept that a single company is divided into several parts, known as cells. The assets and liabilities of each such cell are kept independent of each other and it is managed in such divided fashion. A PCC is divided into two parts:

(i) cellular assets and (ii) non-cellular assets. The non-cellular assets are called the "core" and consist of "management shares or common shares". The Management shares are held by the promoters or their nominees and do not yield any dividend. Thus, they are known as voting non-profit shares. A PCC is a single incorporated legal entity with a single Board of Directors ("**BoD**") that usually consists of a core and one or more cells for the purpose of protecting cellular assets. Cells consist of shares that are divided into classes. The first directors of a cell are appointed by the cell company. Thus, although the cells share the same directors and administrative system, each cell maintains separate records for measuring profits or loss. PCC's can either be newly incorporated or, alternatively, an existing company can be converted to a PCC. The BoD is required to identify a specific cell to which a particular transaction relates and the liabilities to the creditors are only with regard to that particular cell. Although cells and the cell company may have the same directors, there is no requirement that a cell must share the same board as the cell company. The directors of a PCC have a duty to keep cellular and non-cellular assets separate and separately identifiable. On liquidation, cell holders get assets and liabilities relating to that particular class of shares only. Inter-cell transactions are not permitted in a PCC structure.

4.10.2. Jurisdictions of preference for the PCC

The establishment of cell companies is allowed in several jurisdictions such as Cayman Islands, Jersey, Guernsey, Singapore, Mauritius, Bermuda, Gibraltar, Seychelles and the British Channel Islands.

4.10.3. Benefits of setting up a protected cell company

(i) ***Self-insurance:*** The evolution of the concept of a protected cell company has allowed smaller companies to maintain self-insurance without going for the more expensive option of renting up a captive insurance company as each participant's assets are necessarily protected.

(ii) ***Asset protection:*** Since each individual's participation in a fund or venture is adequately protected, it provides for protection of assets of the individual contributories.

(iii) ***Privacy:*** Since assets and liabilities of each participant are kept independent for the purpose of measuring profits and losses, there is a sufficient level of privacy in funds or joint ventures established in this format.

4.11. Offshore Banking Company

4.11.1. Nature of the Entity

An offshore banking company is generally set up in offshore jurisdictions or a financial center which allows a multi-national company to register in their jurisdiction and obtain a banking licence, by which banking operations such as managing cash, raising capital for the group, providing finance to individual subsidiaries and managing financial risk can be undertaken.

An offshore banking licence allows the holder to operate a bank in one country that provides services to depositors who are residents in other countries. The licence is issued by the country in which the bank is operated, which is not necessarily the country in which the holder is a citizen or resident. Usually these countries have low or even zero tax rates, meaning depositors can lower their tax bills by banking there, rather than in their own country. Such jurisdictions are used for banking activities largely because of privacy and asset protection. A high return on investment is also a factor that comes into play while choosing a jurisdiction. However, owing to allegations claiming the use of bank secrecy laws for tax avoidance and money laundering, banking regulations have been tightened in several OFCs.

4.11.2. Jurisdictions of preference for an offshore banking company

Switzerland and Cayman Islands are the top jurisdictions for offshore banking in the world owing to secrecy, convenience and return on investments. Seychelles, Isle of Man, Luxembourg, Andorra and Lichtenstein are also increasingly used for offshore banking.

4.11.3. Benefits of using an offshore banking company

(i) ***Secrecy and confidentiality:*** Offshore banking jurisdictions provide for very tightly bound bank secrecy laws which keep all information regarding customers and account details completely private.

(ii) ***Tax benefits:*** Storing of funds in a jurisdiction with significant tax benefits can be useful for factors such as low or nil withholding rates on interest payments, etc. Interest is generally paid by offshore banks without tax being deducted. This is an advantage to individuals who do not pay tax on worldwide income, or who do not pay tax until the tax return is agreed, or who feel that they can illegally evade tax by hiding the interest income.

(iii) ***Easy access to deposits:*** Lower level of regulation allows easier access to the money stored by the company.

(iv) ***Higher returns:*** Some offshore banks may operate with a lower cost base and can provide higher interest rates than the legal rate in the home country due to lower overheads and a lack of government intervention.

(v) ***Other benefits:*** Offshore banks can sometimes provide access to politically and economically stable jurisdictions. This will be an advantage for residents in areas where there is risk of political turmoil, who fear their assets may be frozen, seized or disappear. However it is often argued that developed countries with regulated banking systems offer the same advantages in terms of stability.

5. Conclusion

This chapter traces the origin and meaning of OFCs and tax havens while making at attempt to dispel the notion that all OFCs attract businesses because of the 'nil' tax regime and the secrecy afforded to such businesses and transactions and that all tax havens are zero tax jurisdictions which do not tax its citizens and residents. While the OFCs and tax havens have long been criticised because of the tax arbitrage advantage provided by such jurisdictions and also because of it was suspected that the 'below standard' anti-money laundering rules aided money laundering and terrorism financing. Tax havens and OFCs have also been criticised for not co-operating in cases of tax evasion and seeking refuge under their secrecy laws.

While some of these allegations may be true, it is also true that OFCs and tax havens play a significant role in the world economy and with the steps being undertaken by such jurisdictions to tackle issues of money-laundering and terrorism financing by instituting strict KYC regimes, such jurisdictions will continue to play a significant role in the global financial system. It may also be important to consider that the tax advantages provided by the OFCs and tax havens afford tax neutrality to a transaction, by eliminating tax burdens on the proposed transaction or structure in the primary operating market for such business and not imposing any additional tax in such offshore jurisdiction. As regards confidentiality, a majority of the tax havens and OFCs have implemented anti-money laundering laws and have also signed exchange of information treaties to assist tax authorities from jurisdictions where there is a case of tax evasion.