

International tax havens and money laundering



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Introduction

Layering is the procedure of sorting out the capital gained from illegal actions from their source using different levels of composite fiscal transactions, for instance changing cash into traveller's checks, shares, investments, or acquiring expensive assets, for example painting or jewellery. 4

Introduction

“ In this world nothing can be said to be certain, except death and taxes.”

Benjamin Franklin (1789) Cited in Sharon (2009), p333

International tax havens and money laundering is becoming a major issue in the current world economy. A tax haven country is a place where certain taxes are levied at a small rate or does not exist. People and/or businesses can find it smart to move into those places which will create tax competition amongst governments which also include illegal activities such as profits gained from unfair trading or frauds in a company's accounts and corruption. Goerke (2008) study shows that there is a negative relationship between tax havens and corruption. This is because a country with tax evasion policies, the normal tax rate has to be high in order to generate the same level of income as a country with no tax evasion policy. High tax rate has a tendency to ease corruption.

In the UK, Her Majesties Royal Court (HMRC) is trying to gain access to details of overseas accounts of UK citizens in tax havens countries (Riem,

2009). The Financial Times in July 2008, reported the Swiss bank UBS will no longer have overseas accounts for U. S. citizens following a law suit by the U. S. government in May, 2008 (GFIP, 2009). The US Treasury has lost on an annual basis around US \$ 100 billions in revenue because of the accounts held in tax haven countries. The U. S. congress introduced the Stop Tax Haven Abuse Act (STHAA) in March 2009 which includes a list of tax haven countries. Companies are planning to move away from the place where the Act is in force. The Italian Finance Minister, Giulio Tremonti had the fight against tax haven countries as his main priority in the G-8[1] summit in Aquila in July 2009.

Money laundering is the procedure to cover the correct source, possession, route and use of capital, largely gained from illicit actions with the intent of making appear as if it was obtained legally. There are three main ways of doing this, namely: placement, layering and integration (Shehu, 2003).

Placement occurs when an individual deposits money gained from illegal activities into financial services providers such as banks.

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Integration is when an individual uses legal means to hide illicit money, therefore leaving the illegal funds to be distributed back to criminals. These can take the form of fake import/export invoices.

Advantages and Disadvantages of International Tax Havens and Money Laundering

Offshore financial institution offers access to steady political and economic matters. This is advantageous to the residents who lives in areas of political turmoil who fear their assets may be frozen. Some banks operate at a low cost base and provide high interest rates than what is legal in the home country due to the lack of government interference in the affairs. Money laundering in remote islands and countries helps increase the economy growth. The services of offshore banks are advantageous when compared to domestic banks, they offer number of bank accounts, risk is based on high and low rates of investments. Some individuals have specific tax advantages because these banks are linked to other offshore companies, trust or foundations.

However, through money laundering the banks have been involved to help terrorist groups, crime gangs, and other state and non-state actors. Money laundering encourages tax evasion, by helping them deposit their hidden income in an attractive place. Access to offshore banks are difficult as they operate in far distant places. Yet accounts can be created by online and other modes, a country such as India finds it difficult to deal with the issue of money travelling in and out without restrictions. Offshore accounts aid this money, and this can cause financial problems in the country. The charge to uphold these accounts is possible by the high earners . The tax load falls for the middle income group. Also the people who earn more are left to pay more taxes to facilitate the economy. Acquisition, possession or use of property, knowing at the time of receipt that such property was derived from

criminal activity or from an act of participation in such activity (Lockett, 1999).

Government review fiscal transactions to make sure the work is carried out properly on the administrative side, prevent welfare and other benefits fraud, prevent money laundering and to detect any other illicit doings (World Bank Institute, 2008). These advantages, however, government employees gaining access to these data and other individual might misuse these financial data (World Bank Institute, 2008). These advantages, however, government employees gaining access to these data and other individual might misuse these financial data (World Bank Institute, 2008). People who are involved in trying to hide or transfer properties that are used for criminal purposes will face legal sanctions (Lockett, 1999). For instance, these properties may be used for drugs dealing, hide “dirty money”, and any other criminal activities.

Global Overview

International tax havens and money laundering is having a global impact. For instance, in India, money laundering is become a huge problem as money generated from illegal activities, such as crimes, terrorism and drug-trafficking, is instantly transferred to tax havens countries such as Switzerland. India are made up of tax havens, laws allowing secrecy, disguised corporations, anonymous trust accounts, fake foundations and assorted money laundering mechanisms which are designed to move money and keep hidden their sources (Financial Times, 2009).

The local government and authorities, for instance, the Indian Chamber of Commerce and Industry, seems to have no interest investigating into the matter. Even during the G-20 meeting in London (2009), the Indian representative thought this topic would be “out of line” when actually tax haven countries and money laundering was making the headlines. In February 2009, an Indian newspaper reports that several Indian ministers visited Switzerland on private voyage. (Vaidyanathan, 2009)

Kar and Cartwright-Smith (2008) in a report for the Global Financial Integrity (GFI) that illicit financial outflow from India for the period 2002-2006 was on an average low of US \$ 22.7 billions and high of US \$ 27.3 billions per year ranking India as the 5th largest outflow of illegal money outflow in the world. These come from mainly second hand goods markets which are not accounted for and largely processed by a financial service provider named Hawala Bank.

Hawala Bank is a financial services provider which is unlicensed and therefore under no government authority. The financial institution accepts money in all its form in one country and pays out in another country but does not find it important to keep proper records of clients and transactions. Their main trading activity is transferring money from developed countries into the Middle East and North Africa where the firm originated. Institution trading often goes through Pakistan; Dubai and Africa countries such as Nigeria before reaching the customer as a means to protect the privacy of clients and that is the main reason it is used for money laundering as shown in Appendix 1. No studies manage to analyse the amount of money traded by the company but it is believed that Hawala bankers are hugely involved for <https://assignbuster.com/international-tax-havens-and-money-laundering/>

tax evasion and money laundering. Since it has no legal obligation, preventing them from trading is almost impossible as it is done in an informal way. (van de Bunt, 2008)

As compared to this, Italy is showing a great concern in tax haven countries and money laundering. Italy has the highest corporate tax rate in Europe as shown in Appendix 2 which triggers Italian base companies to send profits in tax haven countries. De Mooij & Ederveen and Dharmapala (2008) argued that company profits and income is more responsive to taxes that where the company or individual is situated. On 3 October 2009, the Italian government granted a grace period for company and individuals to return profits from tax haven countries for a small charge of 5% of the capital. They expect around US \$ 148bn to flow back in the country generating tax revenue of US \$ 7bn mostly from Switzerland as in the past, the latter was responsible for 58.3% of inflows of profits from overseas. The Finance Minister of Italy, Giulio Tremonti, said in an interview in July 2009:

“ The true benefit of this measure is that it will close Ali Baba’s cave and measures are useless if they leave tax havens open.”

Financial Times (16 July, 2009)

In 2008, Giulio Tremonti made the account of all Italian tax payers available online which was one of his approaches to track incomes of Italian tax payers. Scherer & Salzano (2008) discussed that this would not help the government as it could induce financial crime as private details of individuals such as income earned and address were made public and consequently the website was closed.

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Furthermore, some countries enjoy labelling themselves as 'tax haven' countries such as the Caribbean Islands. However, offshore financial services firms prefer to promote themselves as 'wealth management centre'. A recent approximation by the Tax Justice Network (2009), show that around a third of the world's assets is held in these countries (i. e. US \$ 11. 5 trillion). Countries such as France, UK and Holland have no interest in to crack down these tax haven countries as many of them form part of the colonies. Nevertheless, following the September 11 attack, the U. S. government wants to eliminate these countries tax policies as it prompts money laundering therefore helping terrorist groups. Their main targets in the Caribbean are Antigua and Barbuda, Bahamas, Belize, Cayman Islands, Costa Rica, Dominican Republic, Haiti, Guatemala, and Panama. This is because these countries have slack financial authorities which benefit money laundering. Caribbean islands are consequently joining force to establish guidelines to combat money laundering mainly because of world regulators (Rosdol, 2007).

Legal Side and Policies

Since the 9/11 incident there has been an interest and growing concern for the rules and regulations made against serious crimes including money laundering and tax havens. The Indian government took advantage of the Organisation for Economic Co-operation and Development (OECD) sanction threats against tax havens and money laundering. They took a hard look at the country's Double Taxation Avoidance Agreements focusing on restricting the outflow of black money and adopting measures to arrest anyone involved within the country. In their urge to stop black money funding growth, the

Indian government began a negotiation with Switzerland to help release their infamous secrecy laws and share data on tax evasion cases. Since OECD drives against tax havens, many countries have started to sign international standards on transparency and exchange of information.

For instance the Cayman Islands have recently signed a joint agreement with seven other countries, which allows them to exchange information on tax matters unilaterally. If similar agreements like the one Caymans Island took were taken by India, it would allow tax authorities to track down tax evaders and money launderers by gaining access to financial information that are hidden. (Basu, 2009)

Before the 2008 tax haven and money laundering laws caused a lot of conflict with the Caymans and U. S, however political stability, strict and clear regulations has helped the country escape the OECD clampdown on tax havens. Financial services comprise around 40% of GDP and have made the Caymans the world's fifth largest financial centre. Strict laws against money laundering got the Caymans removed from the Financial Action Task Force blacklist in 2001 but since then they have maintained a good relationship with the main hosted banks. Regulations in the Cayman Island are provided by the Cayman Islands Monetary Authority, which also manage their currency. (Oxford Economic Country Briefings, 2008)

In the Bahamas the government is considering introducing VAT, but this is a challenge for them as the country has built their fortunes on their tax haven status. The financial sector has undergone a deep transformation recently,

since they brought down the reputation by introducing all surrounding anti-money laundering legislations. (Oxford Economic Country Briefings, 2008)

The Financing and Money Services Act was enforced by the British Virgin Islands (BVI) in November 2009. The aim of this act is to make sure BVI laws and regulations are on the same level with international regulations and policies to fight money laundering and financing of terrorist. A board will be setup following the act to monitor licensing, regulation and supervision of financial services provided in the BVI, which will also include reviewing firms which do not comply with the law (Heath, 2009). There are number of offences which now these financial services providers will have to be line with so as not to break the law, otherwise fines can go up to US \$ 60, 000 applicable for offenders.

U. S. Policies on International Tax Havens and Money Laundering

The approach of U. S. law enforcement and regulatory agencies have faced relatively remarkable changes over the past decade such that money laundering and tax havens have been now operated as a primary issue. This change in approach and focus has brought improvement regarding tax havens and money laundering. The assessment of Obama's policies consolidates a tremendous amount of information in this perspective.

In May 2009, president Obama presented a set of proposals focusing at international tax policies. The objective of Obama is to eradicate the benefits for those companies and well off individuals that transfer their cash in offshore accounts. He described the current system as: “ a tax code that

says you should pay lower taxes if you create a job in Bangalore, India, than if you create one in Buffalo, New York". The key feature of this proposal is to restrict the companies which are exempted of tax payments on profits earned offshore. The plan of administration is to keep a strict hold on those companies which are not paying their taxes in U. S. pretending that they paid a huge amount of foreign taxes.

During his presidential campaign Obama's party promise to work on tax havens and money laundering ACT. In February 2009, he said in a conference:

" We need to simplify a monstrous tax code that is far too complicated for most Americans to understand, but just complicated enough for the insiders who know how to game the system, finally ending the tax break for corporations that ship our jobs overseas."

U. S. President – Barack Obama

This was his outmost priorities in a speech to the Congress that he guarantees to make the tax code more reasonable.

According to the white house Mr. Obama is trying to close the international tax gaps. Companies which are investing in foreign countries and creating job opportunities overseas, will loose their tax advantages as planned by the U. S. President, companies which are creating job opportunities in U. S. will be offered tax advantages with incentives.

The President and Treasury Secretary Timothy F. Geithner proposal of tax policy could help in increasing revenue over next year. The estimated income according to the studies carried out is US \$ 210 billion. However, this proposal has some drawbacks and has been opposed by several business communities. Congressional leaders, in March 2009, suggested that this change in tax code result in making USA companies less competitive around the business globe. About 200 companies and trade associations, including Microsoft Corp., General Electric Co. and the U. S. Chamber of Commerce, collectively signed a letter stating that the following changes to the tax code would set them at a disadvantage with their competitors.

This proposal faced considerable opposition by democrats who are hugely represented in senate creating a bug opposite for President Obama. During his election campaign Obama criticised the tax code policy as American companies deferring their tax liabilities on corporate profits. According to democrats the profit earning by overseas investment allows American companies to invest this money in their foreign subsidiaries operations.

The loophole which is not covered by Obama's policy is transfer pricing. Transfer pricing is the biggest source of tax avoidance in corporate America. An economics professor at Rutgers, (Altshuler, 2009), called transfer pricing " the elephant in the room" as it is a major problem which was not addressed under Obama's proposal.

According to Ernst Young, reforms in Obama's policy for outsourcing have no affect on offshore corporate companies. By creating separate business entity these offshore corporations can contract with entity to outsource the job.

Obama tax reforms have faced a lot of criticism from critics and the leaders in senate but the only purpose of these tax reforms is to encourage the U. S companies to invest locally to create more job opportunities for Americans. The Central Board of Direct Taxes (CBDT) said that after evaluating the benefits of outsourcing in India, if the cost of revenue is lower than the tax paid by multinational companies in USA. They would stop investing in foreign subsidiaries.

To pursue the dream, Obama's administration announces their budget policy for the year 2011 which is increasing the tax on richest individuals and decreasing taxes for the individuals earning less. Individuals earning more than \$200, 000 have to face increment of US \$ 970billion tax on their earnings. For businesses there is an addition of US \$ 400 billion.

Conclusion

From research a number of laws and regulations have been put in place to improve tax haven and money laundering crimes however, most of the countries still manage to avoid those regulations and laws. In future many countries have decided it is best they work together to put together laws and regulations to decrease the crimes in the financial system if not like India it could become part of their economy and may be difficult to resolve in the future.

The Caribbean's, India and Italy have undertaken the laws and regulations of the OECD. They undermine the legal economy because money laundering affects normal competitive conditions of markets which is a threat to the efficiency and stability of each country's financial system. In Italy the

prevention of money laundering plays a strategic role in fighting crime and is based in the Anti-Money Laundering (AML) requirements which are:

- Customer due diligence
- Record-keeping requirements concerning business relationships and occasional transactions
- Adoption of adequate organisational procedures and internal control measures
- Suspicious-transaction reporting.

On the other hand, financial privacy is has to be accounted for before deciding whether to investigate a person's account and income which may end up on morality issues. With all the measure enforced recently and future prospects, tax evaders may want to consider paying the taxes rather than being sued for fraud for moving money to tax haven countries (Economist, 2009). Money laundering is a different case however as however strict the laws are, governments do no any proper knowledge on the amount of illegal paper money circulating. This capital flows to tax haven countries and they are the one who have to have laws in place to determine the origin of this money. The Swiss Ambassador in India, H. E. Mr Philippe Welti, said:

“ Switzerland was accused of giving shelter to black money and there has been a lot of inflow of such wealth from India and other countries of the world. I would not say it would be stopped 100% (under a new law). But through this measure, it would be controlled up to a certain limit.”

Cited by Vaidyanathan (2009, DNA Read the World [Online])

The capita lost in money laundering can be gained back if there if a political will as shown in the case of Nigeria, Italy, Philippines and Israel (Vaidyanathan, 2009).

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