

Hastings Business Law Journal
Summer 2011

Comment

***205 AN UNSTOPPABLE FORCE: THE OFFSHORE WORLD IN A MODERN GLOBAL ECONOMY**[Michael J. Burns \[FN1\]](#)James McConvill [\[FNaa1\]](#)

Copyright (c) 2011 UC Hastings College of the Law; Michael J. Burns; James McConvill

I. INTRODUCTION

Offshore financial centres (“OFCs”) have been out of favour with many world leaders since the global financial crisis took hold of world markets, resulting in failed businesses, high unemployment rates, and deteriorating taxation revenues for economies—including the powerhouses of the United States and United Kingdom.

It was argued by the likes of U.S. President Barack Obama and then U.K. Prime Minister Gordon Brown that OFCs such as the Cayman Islands, Bermuda, and the British Virgin Islands (“BVI”), are used to evade paying taxes onshore, taking away revenue for onshore economies at a time when this revenue was needed to fund bank bailouts, the nationalisation of large enterprises, and the greater demand for unemployment benefits. According to Obama, Brown, and other world leaders, OFCs were bad and needed to be stopped.

During the 2008 U.S. presidential campaign, Obama referred to Uglund House, the premises in the Cayman Islands for the offshore law firm Maples & Calder, which is also the registered address for approximately 18,000 companies domiciled in the Cayman Islands, as “the biggest building in the world or the biggest tax scam in the world.” [\[FN1\]](#) Obama also believed that OFCs could be costing the U.S. economy as much as U.S. \$50 billion a year in lost tax revenue. [\[FN2\]](#)

In 2009, former U.K. Prime Minister Gordon Brown stated “the old tax havens have no place in this world,” [\[FN3\]](#) and “[w]e want the whole of the world to take action. That will mean action against regulatory and tax ***206** havens in parts of the world which have escaped the regulatory attention they need.” [\[FN4\]](#)

The Organisation for Economic Cooperation and Development (“OECD”) also heightened its scrutiny of OFCs in response to the uncertainties of the global financial crisis, placing jurisdictions that had not attempted to meet its standards for transparency in tax matters on a “black list.” The “black list,” along with a “grey list” (jurisdictions that had attempted to implement, but had not yet implemented, the standards) and a “white list” (jurisdictions that had substantially implemented the OECD's standards) were prepared in consultation with the G-20, and released in April 2009. [\[FN5\]](#)

The view of world leaders accords with the commonly held perception of OFCs as “tax havens”, used only for reasons that relate to avoiding or evading tax. [\[FN6\]](#) However, this view is mistaken. Tax advantages are one

of many reasons why OFCs are heavily used in the modern world of global commerce; there are even more new reasons for using OFCs as the nature of global commerce becomes more sophisticated. [FN7]

Many working in the offshore world responded to the attacks on OFCs by world leaders as the global financial crisis rolled on. In 2009, the IFC Forum was formed to restore balance to the debate over OFCs and to engender greater understanding worldwide (but particularly among policy-makers in Europe) of the advantages of offshore finance in the global economy. [FN8]

In one article, two commentators noted “there is . . . no reason for G-20 and OECD member-nations to punish OFCs disproportionately--other than to plunder their protected wealth to pay for massive bailouts and stimulus packages.” [FN9]

***207** Further, Charles Jennings of the Cayman Islands law firm Maples & Calder wrote that “banning offshore centers won't make a blind bit of difference in making financial markets safer or less volatile, and in fact could make things worse Bashing offshore banking is just a convenient smokescreen for the shortcomings of 'onshore'oversight.” [FN10]

Thanks to the efforts of the IFC Forum and other groups, it seems as though the calls for OFCs to be brought to an end have calmed down, and, thankfully, OFCs will continue to perform their many functions and offer the numerous products which have made them such a crucial feature of the modern global economy. This was indeed predicted by Bickley in the most recent version of his treatise on Bermuda, BVI, and Cayman Islands company law, stating that “[t]he world is presently going through an historic economic retrenchment. However, once the tide does come in, and it will certainly come in, Bermuda, BVI, and Cayman Island structures will be there to oil the wheels of world commerce.” [FN11]

Prime Minister Brown has now gone, President Obama has a number of other issues to confront, and the G-20 and OECD seem to have moved on. Notwithstanding this drop in attention, there remains a general misunderstanding of the operation of OFCs. While some understand OFCs were not responsible for the global financial crisis, most people (including the very well educated) believe that OFCs are simply utilized for (perhaps somewhat shady) tax reasons.

This article does not respond line-by-line to the attacks leveled at OFCs in recent years. Enough ink has been spilt on this topic already. Instead, the article tackles head on the widespread view that OFCs can be appropriately labeled “tax havens.” The authors do this by outlining some of the key reasons why OFCs are used in practice, and in doing this, highlight that tax is but one reason.

There are sound, indeed strong, business advantages behind the use of OFCs. OFCs, and in particular Cayman and the BVI, are used literally across the globe and, despite recent uninformed cries, they will continue to be used. Even in different parts of the world, for different kinds of businesses, and for different types of transactions and deals, OFCs can serve the business needs of all-comers. [FN12]

***208** The next section of the article sets out some of the main reasons, why OFCs are so popular throughout the world. Given that the authors are most familiar with the BVI, the references given in the next section will mainly be to BVI. However, the references to BVI in many cases are equally applicable to other leading OFCs.

II. PRACTICAL USE OF OFFSHORE FINANCIAL CENTRES IN THE MODERN COMMERCIAL WORLD

This section goes through some of the key reasons why individuals and businesses around the world utilize OFCs. As will be seen, tax is but one of many reasons why OFCs are a regular feature of the modern global economy.

A. Joint Ventures

Offshore entities (typically companies, but occasionally also limited partnerships) are commonly used as joint venture vehicles when there are investors from different jurisdictions coming together to fund a project. This could be, for example, an energy project in Latin America, a technology project in Asia, or a mining project in Africa or Eastern Europe. Thus, as the number and size of cross-border transactions involving joint ventures has increased substantially in recent years, there has been a concomitant increase in demand for offshore entities.

If the project is in Chile, for instance, and there are four joint venturers with one being Chilean, the three other joint venturers may prefer to use an offshore company as the joint venture vehicle through which funds are invested to avoid what has been referred to as a “home court advantage” for the Chilean investor. [FN13] Using this same example without OFCs, the joint venture vehicle would be domiciled in Chile and the project would naturally be steered towards Chile, which may make the other investors uncomfortable.

The beauty of using an offshore entity is that it is completely neutral, as investors into a joint venture project are very unlikely to come from the offshore jurisdiction that is used. Accordingly, this removes a potential *209 deterrent for investors to get involved in the joint venture project and may encourage other investors to participate at a later time if the original investors believe that the project requires additional funding.

The use of offshore entities also provides flexibility for the joint venturers with regard to the rules governing the joint venture company and its participants. If the joint venturers were to incorporate a company in the jurisdiction where the joint venture project is located, there is a risk that the jurisdiction's rules may be overly restrictive, complex, and costly to comply with on a day-to-day basis. It may also be the case that the jurisdiction has a legal system that one or more of the joint venturers is not familiar with, which again may raise some questions as to whether it is the appropriate investment for them. [FN14]

The BVI is perhaps the most common offshore jurisdiction used for joint venture companies [FN15] as, through the BVI Business Companies Act of 2004 (“BC Act”), it offers perhaps the greatest amount of flexibility for joint venture companies. In the BVI, there is generally no requirement for an auditor or resident directors, no requirement to have annual general meetings, no regulations as the preparation of financial accounts, and companies have a great deal of discretion in terms of how they can distribute profits (other than the need to satisfy a solvency test). [FN16] There is also a provision to enable directors of BVI joint venture companies to act in the interests of joint venturers, when required for commercial reasons, rather than in the best interests of joint venture companies themselves, so long as this is allowed in the company's Memorandum & Articles of Association (“M&As”). [FN17]

At the same time, BVI company law provides for some important shareholder rights in case the joint venture company confronts directors and/or shareholders working against the interests of the company. The rights include the ability to institute a derivative action on behalf of the company and to sue for unfair prejudice that the shareholder believes to have experienced. [FN18]

***210** Another benefit of using offshore entities as joint venture companies is that it is easier to list the entity on a recognised stock exchange (e.g., London's Alternative Investment Market (“AIM”)), [FN19] which provides joint venturers with access to additional funding should it become necessary during the life of the joint venture project. This advantage of using an offshore domiciled entity is explored further below.

B. Cost and Ease of Use

In close to all transactions, cost and ease of use are central reasons why companies choose one or more offshore entities. All of the main OFCs (e.g., Bermuda, BVI, Cayman, Guernsey, Isle of Man, Jersey, Mauritius, and Seychelles) are very competitive when it comes to their pricing for setting up a company or other vehicle, as well as ongoing maintenance fees. This is very important given that a large number of OFCs are set up as special purpose vehicles (“SPVs”) for particular projects or as holding companies, rather than being ongoing operating vehicles. Thus, it is attractive to keep costs as low as possible.

When it comes to offshore companies, the BVI remains the premier jurisdiction for incorporations. The BVI currently has close to 500,000 companies, with around 50,000 to 60,000 companies incorporated each year. It is estimated that approximately forty-five percent of offshore companies worldwide are BVI-domiciled companies. [FN20]

One of the primary reasons for the high numbers of companies incorporated in the BVI is that the jurisdiction's low fees are very attractive to Asian businesspersons (particularly in Hong Kong). In addition, the jurisdiction's strong reputation and the protections that come from being a British Overseas Territory, make BVI the perfect choice. [FN21]

In terms of government fees, it currently costs \$350 to set up a standard BVI company that is limited by shares and can issue up to 50,000 shares (for a company authorised to issue more than 50,000 shares, which ***211** is rarely needed, the incorporation fee is \$1100). The annual maintenance fee is also very low at \$350 (or \$1100 for a company authorised to issue more than 50,000 shares).

Tied in with the low cost of incorporating and maintaining an offshore company, BVI being the prime example, the company laws of OFCs are typically much more flexible and not as burdensome as onshore company law requirements. This flexibility does not provide carte blanche for a company's management to act contrary to the interests of the company or unfairly to the company's shareholders, as there are mandatory rules dealing with directors' duties and shareholder rights. What it does do, however, is remove many of the questionable compliance requirements that companies face onshore, giving companies greater power to focus on the performance of the company, rather than conforming to governance requirements.

Under the BVI's BC Act, for example, which blends elements of Delaware, English, and New Zealand company law, there are certainly a number of provisions setting corporate governance standards for BVI companies. However, the beauty is that many of these provisions are subject to the company's M&As so that a company can choose to “opt out” of these provisions if they believe it is unsuitable for their business. In addition, a company can create a rule that is more appropriate or preferable, and then include it in the company's M&As.

For example, the provisions in the BC Act dealing with rights attaching to shares and classes of shares (section 34), distribution of profits (section 57), passing of shareholder resolutions (section 81), shareholder meetings (section 82), appointment of directors by shareholders (section 113), removal of directors (section

114), and meetings of directors (section 126) are all expressed as being subject to the company's M&As. There may be occasions when these BC Act provisions do not precisely fit with the needs of every company. The BC Act respects this by enabling a company to do something about it if the company wants to operate with an alternative rule.

C. Relationship with, and Access to, Regulators

A key characteristic of the leading OFCs in the world is that they are relatively small islands, with a small population that works together as a close-knit community. This is an attractive feature of OFCs because regulators are much easier to contact and generally much more open to being contacted than their counterparts in the major onshore financial markets.

Businesses see this as an advantage because, even if their key personnel are not on the ground in the relevant OFC, their advisers are typically there. Thus, businesses can organise meetings with regulators, *212 often at short notice, to discuss important developments, such as, possible changes to the existing law, ideas for new legislative initiatives, or proposed transactions-- which may require the approval of the regulator.

This is not to suggest that regulators in the OFCs do not act independently and professionally--in fact quite the opposite. Through a close association between regulators and professionals, regulators in OFCs are typically very efficient and responsive to the needs of business while still applying the letter of the law. It also means that OFCs are quite often market leaders in introducing cutting-edge legislative initiatives to respond to the contemporary needs of international business.

One such example is segregated account legislation, now a feature of most leading OFCs company law, which enables an offshore company (usually an insurance company or mutual fund) to create separate cells by resolution of its directors, with the assets and liabilities of each cell then segregated from each other cell within the company. [FN22] Segregated portfolio legislation is truly a revolution in company law, has been embraced by a number of states in the United States., and there is interest in introducing the concept in the United Kingdom.

Bickley makes the same point about the importance of a close relationship between business, advisers, and regulators/government in OFCs:

Bermuda, BVI and Cayman Islands have all been at the forefront in trying to make their legislation as user friendly as possible to accommodate the demands of international business and, particularly, the fields where each jurisdiction has been prominent. The fact that each of the jurisdictions is relatively small in comparison to other countries has meant that the local business and legal communities cooperate with the government in each jurisdiction and respond relatively quickly to the demands of the market place. This allows innovative legislation or enhancements to existing legislation to be implemented expeditiously.

An example of this is the Private Act procedure in Bermuda. Bermuda legislation is divided into public acts, which apply generally to the public, and private acts, which are requested by particular institutions. The latter can allow the general laws of Bermuda to be tailored to the needs of a particular institution. [FN23]

D. Access to Financial Markets

Another reason for using an entity domiciled in one of the main OFCs is to enable certain businesses to effectively raise financing in leading financial markets (e.g., New York, London). Businesses that are located and incorporated in an emerging economy or politically unstable *213 jurisdiction may have good prospects and solid fundamentals, but often do not obtain the level of finance they need. If a question mark is raised with a business due to where it is domiciled, potential investors may just as easily choose an alternate, conventional investment.

Because investors are already familiar with utilising OFCs for raising debt and equity capital, an offshore SPV provides another simple way to connect with investors in the leading markets and is a simple way for companies to overcome problems obtaining financing. There is no reinvention of the wheel. It is for this reason that OFCs are becoming very popular in Latin America, for example, with businesses in emerging Latin American economies needing access to global capital in order to expand.

We regularly see Latin American businesses incorporate BVI companies (and to a lesser extent Asian businesses) as an SPV to raise equity finance in the U.S. market through a so-called “Rule 144A offering.” [FN24] Rule 144A allows entities to raise financing in the U.S. by way of private placement, with no required registration or licensing with the U.S. regulator (the U.S. Securities & Exchange Commission) if the shares are privately placed with an investment bank or broker-dealer who then concurrently sells the shares to “qualified institutional buyers” (who generally must have at least U.S. \$100 million under management). [FN25] Cayman Islands and Bermuda entities are also commonly used for 144A offerings.

Offshore entities are also used regularly to raise financing through their listing on a major stock exchange. The Hong Kong Stock Exchange, Singapore Stock Exchange, London Stock Exchange (and its Alternative Investment Market), New York Stock Exchange, and NASDAQ are commonly used for listings utilising offshore companies. Bermuda and Cayman Islands have traditionally been the main offshore jurisdictions used for listings; however, a number of BVI companies have recently been listed on the AIM exchange, and, since late 2009, BVI companies have been able to list on the Hong Kong Stock Exchange. [FN26]

Eurobonds are another area of corporate finance where there seems to be growing use of offshore vehicles. A Eurobond is a corporate bond that is sold to investors in countries (often numerous countries simultaneously) apart from the country where the relevant issuing company is domiciled. [FN27] For example, a U.S. company would offer Eurobonds in countries outside of the U.S. (and denominated in a currency other than U.S. dollars). *214 Eurobonds are commonly traded in London, Singapore, and Tokyo, but also in numerous other markets. Once again, the use of offshore companies as the SPV to issue the Eurobonds can be important if the company seeking to raise financing is based in a jurisdiction, which is not well known and/or raises question marks for the wrong reasons. Using an OFC, such as Cayman, BVI, and Bermuda, all of which are regularly used in Eurobond markets, effectively addresses this problem.

E. Securitisation

Securitisation refers to the process where rights to a particular income stream due to a person (the “originator”) are repackaged and sold as securities. The securitisation market has developed quite significantly in the past ten to fifteen years as it allows corporations to fundraise without a direct impact on their balance sheets, and provides the originators with early access to the particular income stream being repackaged. [FN28]

Notwithstanding the recent global financial crisis, which many attributed to major banks in the U.S. and

parts of Europe engaging in complicated securitisation arrangements involving sub-prime/“low-doc” home mortgages, it is recognised that securitisation continues to play an important role in contemporary finance. Indeed securitisation, as well as structured finance transactions linked with securitisation, is starting to make a comeback in relation to certain types of receivables.

Both before and after the global financial crisis, the Cayman Islands have become one of the main jurisdictions used for the incorporation of SPVs to facilitate a securitisation arrangement. [FN29] We also regularly see the BVI as the domicile of choice for offshore SPVs.

In the typical securitisation arrangement where a bank is the originator, the bank is seeking to receive an immediate source of cash flow whilst removing a certain book of loans off its balance sheet, to continue to meet its capital adequacy requirements and to maintain a favourable credit rating. The bank will set up a separate SPV (which is referred to as the “issuer”) to transfer a portfolio (or “pool”) of its assets. The issuer is designed to be “bankruptcy remote” so that the assets cannot be distributed to the originator's creditors if the originator collapses. An investment bank (or “arranger”) will usually be involved in setting up the issuer.

To provide for complete separation between the financial institution as originator and the SPV issuer, it is now common that a “purpose trust” will be established to hold the shares in the issuer. A purpose trust departs from the traditional position at general law that a trust must either have one or ***215** more beneficiaries or be set up for a charitable reason, by allowing a trust to be created for a particular purpose (the purpose being simply to hold the shares in the issuer). [FN30]

A purpose trust is a creature of the offshore world, thus making the use of OFCs a central component of securitisations worldwide. For example, each of Bermuda, BVI and Cayman Islands have established rules in place facilitating the establishment of purpose trusts. [FN31] In the BVI, section 84(1) of the Trustee Act (Cap. 303) provides that a person may create a valid trust for any purpose if “the purpose is specific, reasonable and possible” and “the purpose is not immoral, contrary to public policy or unlawful.” When an offshore purpose trust is created to hold the shares in the SPV, when the transaction is completed, the SPV is wound up and any remaining funds are distributed to a charity.

It is also expected that over time offshore SPVs will become even more common in securitisation arrangements, with issuer SPVs being structured as offshore segregated accounts/cell companies with different cells in the SPV each issuing different shares with reference to different pools of assets acquired from one or more originator. [FN32]

F. Access to Director and Shareholder Information

In a number of OFCs, the identity of a company's directors and shareholders is not publicly available. This is certainly the case in the BVI. This does not mean that OFCs operate contrary to contemporary international standards on anti-money laundering and terrorist financing. Indeed, far from it. The leading OFCs have worked hard to ensure that they not only meet, but also exceed, international standards in this area. [FN33]

While the identity of shareholders and directors does not need to be disclosed to regulators in OFC jurisdictions like the BVI (unless the company is a special regulated entity, such as a bank or insurance company), the company's registered agent (the initial subscriber to the company's constitutional documents) must be given the identity of, and ***216** supporting information to verify the identity of, directors and substantial shareholders in

the company. A registered agent will not take steps to incorporate a company if it does not have sufficient information about the directors and shareholders or if for any reason that information raises alarm bells.

Most OFCs are also party to tax information exchange agreements, or “TIEA,” [FN34] with the major onshore economies. For example, as of March 2011, the BVI was a party to 20 TIEAs, including with China, the United States, the United Kingdom, and India.

Between TIEA contracting jurisdictions, one contracting jurisdiction can request that the other contracting jurisdiction provide information about a company (and/or individuals behind the company) domiciled in that second jurisdiction if there is: (1) a well-grounded belief that the company is unlawfully being used to evade tax in the first jurisdiction; and (2) all domestic avenues of investigation have been explored by the first jurisdiction. [FN35] Accordingly, just because there is no requirement to initially disclose director and shareholder information when incorporating a company in certain OFCs, it does not mean that regulators (both offshore and onshore) will continue to be kept in the dark if it turns out that the company has been unlawfully used to evade tax.

Thus, a degree of secrecy when it comes to the identity of shareholders and directors does not mean that offshore companies facilitate criminals wanting to engage in illegitimate activities. Instead, the secrecy is a showing of sensitivity to the fact that in some cultures, particularly in China and other parts of Asia, people are adamant in wanting to keep their personal and business affairs private as much as possible. [FN36] As Simon Raftopoulos and Samuel Banks remarked in the context of bank secrecy, “[b]anking secrecy is not a smokescreen for tax evasion. Confidentiality is a core principle for banks everywhere--not because people have something to hide, but because they wish to keep their financial affairs private.” [FN37]

This should be, and will be, respected as long as the individuals behind the company use the company for legitimate reasons. Overwhelmingly this is indeed the case.

*217 G. Territorial Tax System

While tax considerations are not the sole reason why offshore entities are used, it is incorrect to simply apply the label “tax haven” to OFCs. It would be misleading to say that tax considerations never come into play when utilising an offshore entity--just as it would be misleading to say tax considerations never come into play when using an entity domiciled onshore.

Hong Kong has been for many years a heavy user of offshore companies (primarily BVI business companies that are referred to on the street as “BVIs”). [FN38] One reason for this reliance is that Hong Kong has a purely “territorial” system of taxation. What this means is that a Hong Kong resident is only taxed on income “arising in or derived from” Hong Kong. [FN39] As a general rule, income earned outside of Hong Kong is not taxed in Hong Kong.

To clearly distinguish between their Hong Kong-sourced income and foreign-sourced income, Hong Kong residents with business or financial interests outside of Hong Kong set up offshore companies to operate businesses and hold assets outside of Hong Kong. A key advantage in using an offshore company for this purpose is that in the BVI and other leading OFCs, there are no taxes on interest, royalties, profits, and/or dividends distributed from the offshore domiciled entity back to the individual or business in Hong Kong at a later time. The income thus remains free of tax. [FN40]

Singapore's tax rules are slightly different to those in Hong Kong as service income from consultancy, technical or professional services earned outside Singapore can be taxed if not performed from a fixed place of operation in the foreign jurisdiction, yet Singapore does have a territorial tax system in which foreign income will generally not be taxed. [FN41]

Thus, while the territorial system of tax used in Hong Kong and Singapore provides clear avenues to use offshore entities to minimise tax, reviewing these jurisdictions also highlights why any claim that OFCs can be simply and appropriately slapped with the label "tax haven" is ***218** misguided. This is because the overwhelming majority of other countries where offshore entities are used, and most notably China and Russia, do not operate with a territorial system of taxation. Rather, residents in these jurisdictions are taxed on their worldwide income, regardless of whether it is derived from an offshore company or not. If a Chinese resident receives substantial profits as the sole shareholder of a BVI-domiciled company doing business in Latin America, the Chinese resident will pay tax in China on the income derived from this Latin American business.

Therefore, there must be reasons aside from purely tax considerations as to why residents in China and other jurisdictions with this "residency" system of taxation use offshore companies. When paying tax in China, these residents would certainly not consider their preferred OFC to be a "tax haven."

H. Mutual Funds

OFCs are also very important in relation to mutual funds. Mutual funds are investment vehicles in which money from different investors is pooled and invested in a variety of different ways. [FN42] Mutual funds are generally characterised as being either an open-ended fund (where securities in the fund are bought (redeemed) and sold by the fund on a regular basis), or a closed-ended fund (where the securities are usually only issued once by the fund, and then not redeemed until the fund liquidates).

The Cayman Islands is by far the market leader when it comes to offshore mutual funds, with there being more than 9,000 funds domiciled in Cayman. [FN43] Perhaps less well known is that the BVI is the second largest offshore jurisdiction for funds, with there now being close to 3,000 funds registered in the jurisdiction. [FN44]

As with equity and debt capital market deals discussed earlier in this article, using a Cayman or BVI-domiciled fund can be important to take advantage of "group think." The path of investing in a Cayman fund has not only been followed, but generally followed with success, over the years and provides a better chance of raising money and gaining new investors in key financial markets than by using, say, an Iranian fund or Brazilian fund.

Offshore funds are also typically used in a master-feeder fund structure, which is common in the United States. With a master-feeder ***219** arrangement there will usually be both a domestic, U.S. feeder fund (for U.S. investors), which is structured as a limited partnership (so as to be a flow through entity for U.S. tax purposes), and a feeder fund domiciled offshore (usually in Cayman or the BVI) to accommodate foreign investors from parts of the world outside the United States. The sole purpose of the feeder funds is to raise money to distribute to the master fund, which is also usually domiciled offshore, with the master fund pooling this money and making a series of investments with a view to profit. [FN45]

Using a U.S.-domiciled feeder fund appeals to U.S. investors because, if these investors participated in an

offshore feeder fund, the fund could be characterised as a “passive foreign investment company”--which would then subject them to very complicated and strict guidelines set by the U.S. Internal Revenue Service. [FN46] The non-U.S. offshore feeder fund appeals to foreign investors who want to participate, but do not necessarily want to be exposed to the U.S. tax system. Without the option of utilising an offshore feeder fund, U.S.-based fund managers could be severely restricted in attracting investors outside the U.S., who often contribute a substantial percentage of the fund's capital.

The master fund is domiciled offshore for the same reason, which relate to its ability to attract foreign investors, in addition to the usual cost and regulatory benefits that flow from using an offshore entity. The master fund will typically elect to be subject to U.S. tax to avoid the risk of being characterised as a passive foreign investment company.

I. Political and Legal Stability

A common feature of all successful OFCs is that they offer political and legal stability. A number of OFCs are British Overseas Territories (e.g., Bermuda, the BVI, and Cayman Islands) or Crown Dependencies (e.g., Guernsey, Isle of Man, and Jersey), with the Queen of England as the ultimate Head of State. [FN47] In the BVI, as well as a number of other OFCs, not only is the law heavily influenced by English common law decisions, *220 but the Privy Council in England is the final court of appeal, instilling confidence and certainty among those coming before the courts.

These features may not be of much practical significance to those doing business in or from within developed Western economies like the U.S., Canada and the U.K. For those, however, doing business in or from within developing economies and countries where there is political instability and often the concomitant risk of businesses and private property being nationalised, offices being invaded, and needing to comprehend and comply with arcane and incomprehensible laws, political and legal stability can be a major attraction of OFCs. This is why the BVI, for example, is heavily used, not only in major financial markets, but also in countries all over the world with people doing business in or from within these jurisdictions valuing the certainty and protection offered by the common law and the British flag.

As Raftopoulos and Banks commented, “[w]hen Europe was embroiled in warfare and private property was frequently nationalised or stolen, Swiss banks remained an oasis of stability, where assets were secure.”

OFCs are still important in protecting people victimized by crime, corruption, or persecution by shielding them from venal governments. The existence of OFCs is a reflection of the uncertainties and turmoil onshore. Even the OECD's Owens admitted, “tax havens are essential for individuals who live in unstable regimes.” [FN48]

III. CONCLUSION

If it was simply the case that OFCs were only used to avoid or evade tax, then in this new age of heightened global economic uncertainty and pressure on government taxation revenue, we would acknowledge that the end of OFCs is near. OFCs would be a force to do “bad,” and domestic governments worldwide would have a duty to do what they could to protect their revenue base.

The purpose of this article is to show that OFCs are far from being “bad” or a threat to the healthy, effective

functioning of the world economy. Indeed, there is a rich tapestry of reasons why OFCs are used, as well as reasons that show why OFCs are both fundamentally important and central to the transactions that are driving global business. The examples given in this article in relation to securitization, mutual funds, and joint ventures all highlight the depth and extent of this phenomenon.

In a modern, sophisticated world economy that continues to change and evolve, it is crucial that the world properly understands how OFCs are utilized in practice and realizes the important benefits that OFCs offer to *221 businesses and nations across the globe. OFCs are not about tax scams, shadow banking, or shady individuals. OFCs touch upon every type of business, and upon every type of transaction, in every part of the world. That is not going to change any time soon. Indeed, OFCs are an unstoppable force.

[FN1]. Managing Partner and Local Group Head of Corporate & Commercial, Appleby, British Virgin Islands.

[FNaa1]. Consultant, Appleby, British Virgin Islands; Victoria Law School, Melbourne, Australia.

[FN1]. See Landon Thomas, Offshore Haven Considers a Heresy: Taxation, N.Y. Times, Oct. 3, 2009, http://www.nytimes.com/2009/10/04/business/global/04cayman.html?_r=1.

[FN2]. See Obama plans crackdown on UK tax havens, AccountancyAge (Nov. 10, 2008), <http://www.accountancyage.com/aa/news/1748734/obama-plans-crackdown-uk-tax-havens#ixzz19x4QxiD3/>.

[FN3]. See Brown urges tax haven regulation, BBC News (Mar. 6, 2009), http://news.bbc.co.uk/2/hi/uk_news/scotland/7927084.stm.

[FN4]. See James Kirkup, Gordon Brown says world must 'take action' on tax havens, Telegraph, Feb. 19, 2009, <http://www.telegraph.co.uk/finance/personalfinance/consumertips/tax/4695513/Gordon-Brown-says-world-must-take-action-on-tax-havens.html>.

[FN5]. Naresh Chand, BVI and Cayman elevated to OECD White List, Appleby (Aug. 2009), http://www.applebyglobal.com/uploaded/Publication/1337_File_5.pdf.

[FN6]. See U.S. Gov't Accountability Office, GAO-09-157, International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions (Dec. 18, 2008), available at <http://www.gao.gov/products/GAO-09-157>.

[FN7]. See, e.g., James R. Hines Jr., Soc'y of Trust and Estate Prac., International Financial Centres and the World Economy (2009), available at <http://www.ifcforum.org/files/STEP-International-Financial-Centres-and-the-World-Economy.pdf> (arguing that OFCs improve the availability of credit and encourage competition in domestic banking systems onshore, with the result being greater investment and stronger jobs growth in major economies).

[FN8]. About IFC Forum, Int'l Fin. Centres Forum, <http://www.ifcforum.org/about.php> (last visited Mar. 27, 2011). The founding members of the IFC Forum included the leading international offshore law firms, including Appleby, Mourant Ozannes, Ogier and Conyers Dill & Pearman. Id.

[FN9]. Simon Raftopoulos & Samuel Banks, Tax Havens: The Red Herring of the Global Financial Crisis, Cayman Islands Journal, May 2009, available at http://www.applebyglobal.com/uploaded/Publication/1258_File_5.pdf.

[FN10]. Charles Jennings, A Healthy Economy Needs Offshore Financial Centers, Forbes.com, Apr. 1, 2009, <http://www.forbes.com/2009/04/01/offshore-banking-caymans-g20-opinions-contributors-tax-havens.html>.

[FN11]. Christopher Bickley, Bermuda, British Virgin Islands and Cayman Islands Company Law, at xv (Sweet & Maxwell, 3rd ed. 2009).

[FN12]. Bickley, supra note 11, at preface. "The development of the offshore jurisdictions can be traced to three particular important features, the development over time of flexible but clear company legislation based on English common law principles, a partnership between government and the private sector to ensure that each jurisdiction meets the demands and the challenges of an ever-changing world and tax neutrality." Id.

[FN13]. See Jennings, supra note 10 ("International businesses with stakeholders from several countries frequently have to choose where to incorporate a business without giving any one stakeholder a 'home field advantage.' Also, many international investors will not invest directly in a U.S. company for a variety of good business, tax and legal reasons, such as class action litigation risk. Cayman solves these problems by enabling businesses and investors from around the world to form an entity in a neutral jurisdiction with stable political and judicial institutions, a deep reserve of local professionals, and a legal system that safeguards the rights of creditors and investors.").

[FN14]. Chetan Nagendra, Using BVI Companies for Joint-Venture Transactions Involving India, in A Guide to International Financial Centres 16 (Longtail International, 2010), available at <http://www.harneys.com/files/publications/Book%20Chapter%20%20BVI%20companies%20for%20joint%20ventures%20with%20India.pdf>.

[FN15]. See Bickley, supra note 11, at [4.016] ("The BVI has proven an extremely popular jurisdiction for the establishment of joint venture or private equity vehicles. The provisions of the Business Companies Act are flexible and annual maintenance costs of the vehicle are not excessive. Balanced against this, of the three jurisdictions, BVI is perhaps the least well known for listing purposes although this is perhaps changing with the recent listing of a number of BVI companies on the London Stock Exchange's AIM.").

[FN16]. See BVI Business Companies Act, 2004, No. 16 of 2004, §§ 57, 58.

[FN17]. See BVI Business Companies Act, 2004, § 120(4).

[FN18]. E. Mandryko & J. Daley-Aspinall, Advantage BVI: Cross-Border Transactions and Joint Venture Vehicles, Harneys (Dec. 2008), <http://www.harneys.com/files/publications/Advantage%20BVI%20%20Crossborder%20transactions%20and%20BVI%20joint%20venture%20vehicles.pdf>.

[FN19]. In February 2007, 7.6% of the 303 international companies listed on AIM were BVI companies. See BVI Companies, AIM Listings and the Takeover Code, Harneys, available at http://www.harneys.com/files/BVI_Companies_AIM_Listings_and_the_Takeover_code.pdf (last visited Mar. 27, 2011).

[FN20]. See Bickley, *supra* note 11, at [2.01] (“The financial services sector constitutes a substantial part of the BVI's economy and it is believed to have a 45 per cent share of the international market for offshore companies. In 2005, investments through BVI companies represented the second largest source of investment from developing countries amounting to US\$123 Billion”).

[FN21]. See Ray Wearmouth, *BVIs, Their Evolution and Hong Kong*, *Offshore Rev.*, Jun. 2005, at 2-4, available at <http://www.harneys.com/files/publications/BVIs%20-%20their%20evolution%C20and%C20Hong%20Kong.pdf>.

[FN22]. Bickley, *supra* note 11, at [15.001].

[FN23]. *Id.* at xiii.

[FN24]. See Private Resales of Securities to Institutions, Securities Act Rule 144A, 17 C.F.R. § 230.144A (2010) (known as 144A offering).

[FN25]. 17 C.F.R. § 230.144A(a)(1).

[FN26]. See Michael J. Burns, Frances Woo & Judy Lee, *BVI Companies can now List in Hong Kong*, Appleby (Dec. 2009), http://www.applebyglobal.com/uploaded/Publication/1426_File_5.pdf.

[FN27]. See, e.g., Yong Cheol Kim & Rene M. Stulz, *The Eurobond Market and Corporate Financial Policy: A Test of the Clientele Hypothesis*, 22 *J. of Fin. Econ.* 189 (1998).

[FN28]. Bickley, *supra* note 11, at [14.001].

[FN29]. See, e.g., Julian Black & Simon Raftopoulos, *The Cayman Islands: Different Structures for a Challenging Regulatory Environment*, Appleby (Apr. 2009), http://www.applebyglobal.com/uploaded/Publication/1529_File_5.pdf.

[FN30]. See, e.g., Alexander A. Bove Jr., *The Purpose of Purpose Trusts*, 18 *Real Prop., Trust and Estate L. J.* 34 (2004).

[FN31]. See Bickley, *supra* note 11, at 389 (“The ownership of the shares of the SPV is typically vested in a trust established in the offshore jurisdiction. The trust will commonly take the form of either a purpose (or in the case of the Cayman Islands, a STAR Trust) or a charitable trust.... Purpose trusts are a deviation from the common law relating to trusts which provides that a trust must either have definite beneficiaries or objects or charitable objects. Each of Bermuda, the BVI and the Cayman Islands now have statutory provisions enabling the establishment of a trust for a particular purpose whereas the establishment of trusts for charitable purposes will follow common law principles.”).

[FN32]. See, e.g., Gary B. Gorton & Nicholas S. Souleles, *Special Purpose Vehicles and Securitization, in The Risks of Financial Institutions* (Mark Carey & Rene M. Stulz eds., 2006).

[FN33]. See, e.g., *BVI Anti-Money Laundering Regulations, 2008*; see also *BVI Anti-Money Laundering and Terrorist Financing Code of Practice, 2008*, available at <http://www.bvifsc.vg/LegislationLibrary/tabid/211/DMXModule/626/Default.aspx?EntryId=388>.

[FN34]. The model TIEA used by most countries was developed by the OECD Global Forum Working Group on Effective Exchange of Information. See Tax Information Exchange Agreements (TIEAs), OECD, http://www.oecd.org/document/7/0,3746,en_2649_33767_38312839_1_1_1_1,00.html (last visited Mar. 27, 2011).

[FN35]. See Tax Information Exchange Agreements, Expat Intelligence, <http://www.expattelligence.com/tax-information-exchange-agreements.shtml> (last visited Mar. 27, 2011).

[FN36]. See Bickley, *supra* note 11, at [2.015].

[FN37]. See Raftopoulos & Banks, *supra* note 9.

[FN38]. See, e.g., Wearmouth, *supra* note 21.

[FN39]. See Inland Revenue Department of Hong Kong, A Brief Guide to Taxes Administered by the Inland Revenue Department 7 (2010-11), available at http://www.ird.gov.hk/eng/pdf/tax_guide_e.pdf.

[FN40]. See Bickley, *supra* note 11, at xiv-xv (“Tax has historically been a major driving force behind the off-shore industry. It is commonly recognised in the international business community that many international transactions need an investment vehicle which provides a neutral tax base through which investments may be channelled. Each of Bermuda, BVI and the Cayman Islands levies no tax on its offshore companies based upon profits, income, gains or appreciations, and there is no taxation in the nature of inheritance tax or estate duty in respect of the shares of such companies.”).

[FN41]. See Filing tax: Know what is taxable, what is not, Inland Revenue Authority of Singapore (Sept. 3, 2010), <http://www.iras.gov.sg/irasHome/page04.aspx?id=154>.

[FN42]. See Mutual Funds, SEC.gov (Dec. 14, 2010), <http://www.sec.gov/answers/mutfund.htm>; see also BVI Securities and Investment Business Act, 2010, § 40(1).

[FN43]. See Statistics, Cayman Islands Monetary Authority, http://www.cimoney.com.ky/Stats_Reg_Ent/default.aspx?id=300 (last visited Mar. 27, 2011). As of September 2010, there were 9,438 mutual funds in Cayman. *Id.*

[FN44]. At the end of the third quarter of 2010, there were 2,951 funds (comprising 1,929 professional funds, 811 private funds and 211 public funds) domiciled in the BVI. See Statistical Bulletin, BVI Fin. Services Comm'n (Sept. 2010), <http://www.bvifsc.vg/DesktopModules/Bring2mind/DMX/Download.aspx?EntryId=672&PortalId=2&DownloadMethod=open>.

[FN45]. See, e.g., John Buscema, Master-Feeder Funds: Structuring for Maximum Efficiency, Hedgefundnews.com, available at http://www.hedgefundnews.com/news_n_info/article_detail.php?id=89 (last visited Mar. 27, 2011).

[FN46]. A “passive foreign investment company”—a concept that became a part of U.S. tax law as part of reforms implemented in 1986—refers to a foreign company which satisfies either an “income test” or “asset test.” 26 U.S.C. § 1297(a) (2010). The income test is satisfied if 75 percent or more of the foreign company's income is passive income—meaning that it is based on investments rather than business operating income. 26 U.S.C. § 1297(a)(1). The asset test is met if 50 percent or more of the foreign company's average assets produce (or could produce) passive income, or are assets that produce no income. 26 U.S.C. § 1297(a)(2).

[FN47]. See Michael Foot, Final Report of the Independent Review of British Offshore Financial Centres 3 (Oct. 2009), available at [http:// webarchive.nationalarchives.gov.uk/http://www.hm-treasury.gov.uk/d/foot_ review_main.pdf](http://webarchive.nationalarchives.gov.uk/http://www.hm-treasury.gov.uk/d/foot_review_main.pdf).

[FN48]. See Raftopoulos & Banks, *supra* note 9.
7 Hastings Bus. L.J. 205

END OF DOCUMENT