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# Multinationals and Their Quest for the Good Tax Haven: Taxes Are But One, Albeit an Important, Consideration**

When a U.S company ventures into the world market for the first time to sell its products or services, it often chooses to negotiate and conclude its foreign transactions through the home office. This procedure is a relatively safe means of testing the international waters before committing substantial resources. If the international market expands, an offshore presence can be established at that later time to better serve the overseas client base.

Implicit in this decision to locate abroad is the question, "In which foreign country should this offshore presence be situated?" An overseas-based company may be highly successful if established in Country *A*, yet an abominable failure if established in Country *B*. The degree of success depends on a myriad of factors. But given that success often is measured in terms of after-tax profits, the search for a foreign location is incomplete without some consideration of the world's so-called tax havens.

This article discusses the meaning of the term "tax haven" and explores the characteristics of a good tax haven. It examines both tax and nontax factors. To justify international tax strategies, multinationals often must point to nontax, business reasons for organizing in a particular country or for doing business in a particular way.[1] Thus, nontax factors are not only important from a purely economic perspective, they also provide indirect support in the tax area.

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1. *See, e.g.*, Dave Fischbein Mfg. Co. v. Commissioner, 59 T.C. 338 (1972), in which the taxpayer forwarded two nontax reasons to justify its assembly of bag-closing equipment in Belgium. First, tariffs and quotas of the Common Market could be avoided if a certificate of Belgian origin could be obtained. Second, labor and overhead costs were cheaper in Belgium than in the United States.

## I. Misconceptions About Tax Havens

The term "tax haven" sometimes carries with it connotations of illegality and wrongdoing. The tainted image is directly attributable to the unscrupulous use of some offshore locations to evade taxes through double trusts, numbered bank accounts, transactions lacking substance, and repatriation of unreported income.[2] Because most illegal uses of tax havens are by individuals, not multinational corporations,[3] the multinationals have propagated more respectable terms over the years, such as the euphemism, "offshore financial center."

As with any other tax planning, the use of tax havens, per se, is entirely legal and is even encouraged and promoted by many nations. Indeed, the selection of the best country to set up foreign operations is just as crucial as any other business decision, perhaps more so. The general aim is to maximize after-tax profits, while being careful to stay within the letter and spirit of both foreign and U.S. laws. Though not speaking directly about tax havens, Judge Learned Hand eloquently expressed the legitimacy of this objective in two of his opinions. In the first: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[4] And twelve years later:

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.[5]

Furthermore, the Business and Industry Advisory Committee to the Organization for Economic Co-operation and Development (OECD), in responding to some of the recent backlash against tax havens, has emphasized that the motivation to use tax havens in many cases is an "economic necessity to reduce costs, including taxes, to a bearable level in circumstances where the laws of countries are uncoordinated, and even the laws of individual countries are inconsistent . . . ."[6]

## II. Nontax Characteristics of the Good Tax Haven

In line with this perspective, this article defines the "good tax haven" as any location outside the United States that offers a multinational company several important advantages, including low taxes, that are conducive to a profitable

2. For a detailed discussion of tax haven abuses and specific examples, see the following studies: U.S. DEP'T OF THE TREASURY, TAX HAVENS AND THEIR USE BY U.S. TAXPAYERS—AN OVERVIEW (1981); U.S. DEP'T OF THE TREASURY, TAX HAVENS IN THE CARIBBEAN BASIN (1984).

3. U.S. DEP'T OF THE TREASURY, TREND ANALYSES AND RELATED STATISTICS 135 (1986).

4. Commissioner v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

5. Commissioner v. Newman, 159 F.2d 848, 850–51 (2d Cir.) (Hand, C.J., dissenting), *cert. denied*, 331 U.S. 859 (1947).

6. OECD INTERNATIONAL TAX AVOIDANCE AND EVASION 37 (1987).

business operation abroad. While low taxes are a necessary ingredient, they are not the only one. Succinctly summarized, the most important nontax features of the traditional tax haven are (1) a stable foreign government, (2) equitable treatment of foreigners, (3) freedom from government controls, (4) the existence of free trade zones, (5) a high degree of financial secrecy, (6) local consumer and labor markets, (7) a highly developed infrastructure, (8) local banking and professional services, and (9) investment incentives.

This is not an exhaustive catalog of attributes; rather, the list includes some of the major considerations for multinational companies.[7] All of the above characteristics need not be present, nor even be desirable, to qualify the country as a good tax haven. Traditional tax havens, however, possess most of these characteristics, which are discussed below.

### A. Stable Foreign Government

To many U.S. investors contemplating a foreign business operation, the preeminent concern is the risk of expropriation or, in some cases, outright confiscation. Expropriation is the lawful act of claiming ownership over business assets. As such, it is similar to the power of eminent domain and is generally prompted by some public purpose. A taking of property for the purpose of protecting national security, for example, is for a public purpose. In contrast, public purposes do not include acquisitions that are retaliatory in nature or that enrich the monarch.[8] Unfortunately, compensation for expropriations may be neither prompt, adequate, nor effective. Furthermore, expropriation is not normally accompanied by the right to appeal if the settlement is unsatisfactory.

Expropriation can be disguised if it occurs through a series of steps or over a period of time. This so-called "creeping expropriation" is no less devastating than a sudden seizure, but may be more difficult to prove. It can take several forms. For example, taxes may be raised to a prohibitive level, currency restrictions may be severely tightened, necessary government approvals such as import licenses may be denied or routinely delayed, or temporary government controls may be imposed indefinitely. Such disincentives may become so burdensome that the investor is left with no choice but to pull out.

Because expropriation may result in the total loss of a foreign business and its market, concern for this possibility may overshadow the attractiveness of the tax environment.[9] Some developing countries must offer very attractive investment

7. *See* Diamond & Diamond, Tax Havens of the World (MB) (1990); M. Langer, Practical International Tax Planning (PLI, 3d ed. 1987). In addition, useful background information on a particular foreign country or region is available for a nominal fee from the Investor Information Service of the Overseas Private Insurance Corporation, which is discussed later.

8. M. Akehurst, A Modern Introduction to International Law 91 (5th ed. 1984).

9. Two businesses that assess the risk of investing abroad are Business Environment Risk Information, Ltd. (BERI), with an office Washington, D.C., and Frost & Sullivan (F&S), located in Syracuse, New York. BERI offers several subscription services, including triannual profit opportunity ratings in forty-eight countries, triannual lenders' risk forecasts in fifty countries, and detailed

incentives to offset the disincentive of a relatively unstable political environment. Shaky national governments spawn coups and insurrections and may cause the economy to falter or stumble, any of which may lead to the sequestration of foreign assets.

A friendly, cooperative government is not necessarily the sought-for political environment; a country's political history is important also. A checkered history of coup d'états may suggest, for example, that the favorable current regime is a mere temporary lull; a company may have too little incentive to commit substantial funds. Fidel Castro's seizure of power in Cuba, for example, caused many American businesses to lose large sums of capital. The estimated value of expropriated property exceeded one billion dollars.[10] A more recent example, still in the minds of many, was the seizing of U.S. property in Iran.[11]

Government guarantees against expropriation have become the sine qua non of foreign investment. In fact, many foreign governments offer such guarantees as part of their local laws or, in some cases, their constitutions. Application to the appropriate government agency in the country (for example, Ministry of Economic Affairs, Ministry of Finance, or Ministry of Commerce) is often all that is necessary. Caution should be exercised, however, since guarantees may be subject to exceptions. If property may be expropriated for the "national interest," for example, the cautious investor should request a list of illustrative situations. The investor also should scrutinize the integrity of the incumbent regime and the sacredness of contractual and licensing agreements when evaluating the reliability of a government guarantee.

Some countries provide guarantees through separately negotiated, bilateral investment treaties to alleviate foreign investment fears. These agreements often define investments broadly so that protection also is extended to intellectual property and other intangible rights. These treaties usually substitute specificity for what might be the vague and ambiguous language of guarantees in internal laws. Further, an investment treaty may spell out the types of expropriations subject to the treaty terms, how compensation is determined, and the methods for resolving disputes.[12]

Insurance against expropriation of assets may be obtained from the Overseas Private Investment Corporation (OPIC), which is a component of the U.S. In-

forecasts of business environments for strategic planning in twenty-seven countries. Subscription services offered by F&S include annual economic and political forecasts in eighty-five countries and a political risk newsletter. Also, the Overseas Private Investment Corporation offers several programs to aid those contemplating a foreign investment, including the opportunity to talk with government officials and businessmen in the target country.

10. *See Castro's War on U.S. Enterprise*, BUS. WK. 107 (Oct. 29, 1960); *The U.S. Investment Stake in Cuba*, 118 FIN. WORLD 11 (Nov. 14, 1962).

11. *See* Tarnoff, *Few U.S. Claimants Collecting from Iran*, 17 BUS. INS. 1 (Sept. 5, 1983).

12. Pogany, *Bilateral Investment Treaties: Some Recent Examples*, 2 ICSID REV.—FOREIGN INVESTMENT L.J. 457 (1987).

ternational Development Cooperation Agency.[13] This quasi-government organization provides coverage for new investments, substantial enlargements or modernizations of existing businesses, and new infusions of working capital for expansion. For an additional premium, OPIC insures against transfer risk (currency inconvertibility) and losses resulting from political risks, including war, revolution, insurrection, terrorism, sabotage, and even civil strife. Currency devaluation and losses that result from labor or student demonstrations normally are not covered by the OPIC policy. Also, the United States has concluded with foreign countries many treaties that provide investment guarantees through OPIC.

An additional source of insurance is available to U.S. exporters through the Foreign Credit Insurance Association. This organization is an agent of the Export-Import Bank and can insure eligible parties against defaults stemming from either commercial or political circumstances. Exporters can secure names of private insurers from the International Insurance Advisory Council of the U.S. Chamber of Commerce.

Of course, the best insurance against expropriation simply is to keep most business assets in the United States and to transfer only what is absolutely necessary to the foreign location. A base company that primarily manages patents, trade secrets, and other intellectual property, for example, might have few tangible assets at risk. The bulk of its assets, because of their intangible nature, could be shifted discreetly and inconspicuously to a related subsidiary on very short notice.

### B. Equitable Treatment of Foreigners

The investor should seek also a government guarantee of fair treatment. Fair national treatment means that the manner of dealing with foreign investors is no more restrictive, but may be more lenient, than the treatment afforded local investors. Fair international treatment may be available through a most-favored-nation article in a Friendship, Commerce, and Navigation Treaty. It entails investment standards that are no more restrictive than those faced by third-country investors. Essentially, most-favored-nation standing affords the U.S. investor the opportunity to scour periodically the tax haven's treaties and trade agreements with other investors to determine whether a more favorable treatment is merited.[14]

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13. Background information on OPIC, including programs and services, can be found in Office of the Fed. Reg., Nat'l Archives & Records Admin., the United States Government Manual 1987/88, at 698–708 (1987). For an excellent discussion of OPIC's insurance programs, see Shanks, *Insuring Investment and Loans Against Currency Inconvertibility, Expropriation, and Political Violence*, 9 Hastings Int'l & Comp. L. Rev. 417 (1986).

14. For further information on this topic, see Jackson, *The Most-Favored-Nation Policy* and *National Treatment Obligations and Non-Tariff Barriers*, in The World Trading System chs. 6, 8 (1989).

Notwithstanding these guarantees, U.S. investors may consider fair treatment to be unsatisfactory at times. For example, some countries require that the government or nationals be granted a hefty percentage ownership of all enterprises operating in certain industries, sometimes 50 percent or more, while others exercise control over employment practices and movement of capital. Such restrictions often are buried in the country's investment laws, necessitating experienced local counsel. The lack of restrictions, on the other hand, usually is trumpeted in the country's promotional literature.

### C. Freedom from Government Controls

Foreign governments may impose numerous, complex restrictions that hamper trade. Some countries have significant currency controls, which limit the ability to exchange currencies, and therefore make it difficult to satisfy obligations denominated in dollars or to remit dividends and profits to the United States.[15] In most countries, local banks administer currency exchange controls, and approvals for remittance abroad are easy to obtain. Registration of investments and loans with the foreign central bank of issue often is all that is required to remit profits. In times of trade imbalances, however, existing regulations may become more restrictive. Nevertheless, the investor can negotiate with foreign governments to relax exchange controls for particular purposes, especially if the local economy will benefit in some way.

Some currency exchange laws distinguish between residents and nonresidents and between local and foreign currencies. Under these dual control systems, specific restrictions apply to residents. However, a company formed within the country, but beneficially owned by foreigners, may be eligible for special consideration if most of its business transpires abroad. These nonresident companies are exempt from the normal controls when dealing in foreign currency.

Finally, the investor should investigate the requirements for establishing and maintaining a foreign subsidiary. Government regulations and bureaucratic hurdles might besmirch an otherwise promising location. Among the questions to ask are the following: Are bearer shares available? Is there a minimum capitalization rule? Can shares be issued no par? Are any restrictions placed on redemption of shares? Must directors own shares? How many directors and shareholders are required? Can some of the directors be corporations? Is there any requirement that directors or shareholders be residents? Are nominee directors and shareholders allowed? What is the minimum number of required board and shareholder meetings each year? Can these meetings be held outside the country? Are proxy meetings permissible? Must the corporation be managed and con-

15. Exchange controls are absent or very lenient in the following countries: the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, Hong Kong, Ireland, Jersey, Liberia, Nauru, the Netherlands, Panama, Singapore, Switzerland, the Turks and Caicos Islands, the United Arab Emirates, and the United Kingdom.

trolled from its country of incorporation? Does an office have to be maintained within the country? What financial records must be kept? Must financial statements be audited? To what extent must information regarding finances, ownership, and other matters be disclosed or reported? Are there any restrictions on the corporate name? Is a license required for a new business? How much are franchise taxes and registration, license, and maintenance fees? Do any acts, such as reducing share capital or redomicilation, exceed the powers granted to the corporation (ultra vires acts)?[16]

### D. Existence of Free Trade Zones

Some tax havens, perhaps because of exchange shortages, impose stiff import duties or quotas. These restrictions often can be sidestepped easily by importing into a free trade zone. Free trade zones are areas where products can be imported without the normal customs duties and controls. Thus, a product may be imported into the zone, further processed, stored until a buyer is found or until market conditions appear favorable, and then exported. As long as the product does not leave the zone and actually enter the foreign country, normal import restrictions are completely avoided. In addition to the import benefits, special services are available in many of these zones, including warehousing, assembling, packaging, labeling, and showroom displaying.

Outside the United States, there are approximately 160 free trade zones, located in more than eighty countries around the world. The popular Shannon Free Port in Ireland, for example, specializes in export processing. Because of its location and facilities, U.S. companies view this zone as a favorable ingress to the European Economic Community, without the usual trade restrictions. Goods manufactured in Ireland and exported from Shannon are exempt from the value-added tax. Panama's Colon Free Trade Zone is well known for its extensive warehouse facilities, its easy access to North and South American markets, and its 100 percent exemption from customs duties, consular fees, and all taxes when goods are manufactured for export. Similarly, the Kingston free zone in Jamaica offers an excellent harbor, an income tax exemption, freedom from import duties, and an exemption from import and export licensing when goods are sold to Caribbean Common Market (CARICOM) members.[17]

### E. High Degree of Financial Secrecy

A high degree of secrecy is not uncommon and, indeed, is the hallmark of traditional tax haven countries. Secrecy is not a necessary ingredient for many

16. *See* Grundy's Tax Havens: A World Survey (Sweet & Maxwell) (5th ed. 1987); Diamond & Diamond, Capital Formation and Investment Incentives Around the World (MB) (1988).

17. *See* Diamond & Diamond, Tax-Free Trade Zones of the World (MB) (1990). Also, the Office of the U.S. Trade Representative helps U.S. companies gain access to foreign markets by providing helpful information about investment incentives and about ways to deal with foreign import barriers.

legitimate offshore operations, however, and secrecy should never be sought for the purpose of evading taxes. Those who do so incur great risks. For instance, the Internal Revenue Service (IRS) has demonstrated a surprising talent for discovering hidden, unreported funds in supposedly impregnable Swiss bank accounts.[18] Bank secrecy laws in many countries, although still a formidable obstacle for the tax collector, are not what they used to be.[19] One erudite tax professional observed that "[s]ome of the bank secrecy laws are not nearly as foolproof as bankers in leading tax havens and offshore financial centers proclaim. If the success or failure of any tax plan depends upon secrecy, look for another plan. There is no such thing as absolute secrecy."[20]

The United States has been vigorously negotiating mutual assistance and exchange of information agreements in recent years, particularly among Caribbean nations, albeit with mixed results.[21] Many Caribbean tax havens hesitate to cooperate with the United States in its efforts, without some quid pro quo. The Reagan administration attempted to provide the needed incentive with the Caribbean Basin Initiative of the Caribbean Basin Economic Recovery Act of 1983.[22] For example, under that Act, Caribbean nations that agree to mutual disclosure are eligible locations for foreign sales corporations, and the expenses of conventions held in these locations, unlike in most foreign outposts, are deductible.[23] The OECD also has taken aim at bank and commercial secrecy laws in tax haven countries.[24] Some experts believe that continued pressure by the United States and other developed countries eventually will force most tax havens having strict secrecy laws to assist tax enforcement agencies, such as the IRS, in catching tax evaders.[25]

To the extent secrecy is sought for valid business reasons, however, secrecy laws have their raison d'être. For example, investors in volatile areas of the world prefer to keep their holdings private to prevent confiscation should a hostile political party assume power. Anonymity also is sought for ownership, profit, and remittance information that might be damaging in the hands of a terrorist, competitor, or political-solution-seeking public that believes too much profit is

18. *See* United States v. Leonard, 524 F.2d 1076 (2d Cir. 1975), *cert. denied*, 425 U.S. 958 (1976).

19. *See* Crinion, *Information Gathering on Tax Evasion in Tax Haven Countries*, 20 INT'L LAW. 1209 (1986); Scherschel & Zanker, *Why It's Getting Tougher to Hide Money*, 100 U.S. NEWS & WORLD REP. 43 (June 2, 1986).

20. M. LANGER, *supra* note 7, ch. 20, at 20-1.

21. *See, e.g.*, Freud & Gurwitz, *Exchange of Information Agreements under the CBI Program: The Monroe Doctrine Revisited?* 14 TAX MGMT. INT'L J. 111 (1985); Beard, *Offshore Financial Centers in Caribbean Basin Secrecy Jurisdictions: Current Trends and Developments in United States Anti-Tax Haven Policy*, 12 SYRACUSE J. INT'L L. & COM. 520 (1986).

22. Carribean Basin Economic Recovery Act of 1982, Pub. L. No. 98-67, § 222, 97 Stat. 395 (1983).

23. I.R.C. §§ 274(h)(6), 927 (e)(3) (1989).

24. *See* the report entitled *Taxation and the Abuse of Bank Secrecy*, in OECD, *supra* note 6, at 107-12.

25. *See* M. LANGER, *supra* note 7, ch. 93.

itself evidence of exploitation and, therefore, inherently evil. In this regard, a tax haven should have stringent laws against the disclosure of private financial information, along with strict enforcement and severe penalties for noncompliance. The use of bearer shares and nominees is common in many parts of the world and provides an effective means of shrouding personal information in secrecy.[26] Among the countries with confidentiality laws are Anguilla, the Bahamas, the Cayman Islands, Liechtenstein, Luxembourg, Panama, and Vanuatu.

### F. Local Consumer and Labor Markets

Many traditional tax havens are characterized by weak economies and unskilled labor. This does not significantly detract from the haven's attractiveness, except in two cases. First, if the intent is to exploit the regional market, some economic integration is highly desirable to circumvent trade barriers, such as tariffs and quotas, and to bolster market potential. For example, Costa Rica is a popular site for foreign distribution centers because of its accessibility to the Central American Common Market (CACM). Within the CACM, specified goods are allowed to move freely, without the normal import duties. Other multinational markets with similar trade benefits include the CARICOM, the European Economic Community (EEC), the Andean Common Market (ANCOM), the Association of Southeast Asian Nations (ASEAN), and the Latin American Free Trade Association (LAFTA). Second, a weak economy, coupled with high unemployment, provides fertile ground for the seeds of social discord. Political and economic instability always present some risk.

On the other hand, a weak economy may carry some favorable implications. Labor costs may be low vis-á-vis U.S. standards. The availability of clerical and stenographic help offers a commercial advantage. Still, finding sufficiently qualified nationals to run a business in some developing countries may prove Sisyphean. If sufficient skills are lacking, the foreign government may require that local nationals be trained to fill some positions.

If U.S. managers are transferred to the country, additional questions arise. Can visas and work permits be obtained in a reasonable period of time? Are these employees subject to foreign tax and labor laws? How is the climate? Are there sufficient cultural and recreational activities? Is adequate housing and domestic help available? The extra overseas allowances and fringe benefits used to entice U.S. executives to foreign posts may devour much of the savings from the low labor costs.[27]

26. Shares of stock issued without owner registration are known as bearer shares. Shares are bought and sold by personally transferring possession. Privacy is assured since ownership can only be known if disclosed by the owner. Nominees are surrogate names used to register ownership. The true beneficial owner often protects his identity by registering shares in the name of an attorney or bank.

27. If certain requirements are met, U.S. persons working abroad may exclude up to $70,000 of foreign earnings each year from their gross income. In addition, they can exclude housing expenses

If local labor is used, government regulations or normal business practices may dictate that minimum employee benefits be provided. For example, some foreign locations mandate in-kind housing, social insurance payments, employee profit-sharing, severance indemnity, and maternity leave with pay. Employee fringe benefits easily may consume half the total payroll; a knowledge of foreign labor laws is indispensable. In addition, some foreign countries have lifetime-employment laws, while other countries may require the sharing of ownership and management with locals.

### G. Highly Developed Infrastructure

On the positive side, many tax havens can boast of strong communication and transportation facilities, which lessen the reluctance to locate outside the home country. Dependable telecommunications, including direct dial telephone, telex, telegraph, and wire transfer services, should be present. Postal services should be prompt and dependable. Facsimile services might be desirable also.

Proximity to reliable air transportation, coupled with cooperative climatic conditions, is usually a necessity. Company executives and other personnel should be able to fly in and out of the area on short notice. Likewise, bulk cargo sea transportation and an efficient, deep-water harbor with modern container handling facilities, an adequate number of quays, and warehousing are desirable, especially if the haven is used for manufacturing, assembling, or packaging activities.[28] The transportation facilities, both internal and external, should be reliable enough to assure a ready supply of spare parts and raw materials. Main roads should be paved and well maintained. Convenient piggyback and railway service is an advantage.

Hospitals with qualified medical staffs are necessities in the minds of most U.S. employees abroad. Similarly, overseas personnel with dependent children are interested in the quality of schools available in the area. Often, American employees stationed abroad expect a U.S.-type school. An adequate supply of water for industrial use and dependable power generating and sanitation services may be important.

### H. Local Banking and Professional Services

Some traditional tax havens, such as the Bahamas and the Cayman Islands, feature good commercial banking services. Depending on needs, trust and fiduciary services may be important. Also to be investigated is whether a bank has

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that exceed a base amount ($8,055 in 1990). *See* I.R.C. § 911 (1989). In high-tax countries, the foreign tax credit in I.R.C. § 901 (1989) often proves more beneficial than the exclusions. For more information, see Arthur Andersen & Co., U.S. Taxation of Americans Abroad (1987).

28. Three tax havens that are well-known for their shipping industry are Greece, Liberia, and Panama.

the equipment and personnel to handle complex, multinational transactions involving different currencies. The availability of safe deposit boxes, secure vaults, government insurance against loss, financial planning services, and convenient hours might be further considerations.

The close proximity of accountants, lawyers, and other professionals is indispensable. In addition to being affordable and knowledgeable, local professionals should be fluent in English or some other language in which the corporation's primary attorney also is fluent; this is not a time to risk misunderstandings.[29] United States attorneys always should call upon local counsel to communicate with the foreign government. No matter how capable a U.S. attorney may be at mapping an overall international strategy, resident counsel should deal with the oftentimes overlooked questions and procedures of local law. Moreover, foreign investment and tax laws are sometimes more pliable than they appear on paper.[30]

In most well-known tax havens, advisory firms can guide investors and businessmen with alacrity through the procedures of establishing a corporate entity. Among other things, these firms may provide legal and tax advice, assist in financial planning and investment decisions, facilitate foreign currency exchanges, administer local bank accounts, train those unfamiliar with business practices in the country, arrange suitable office space, procure nominee directors and shareholders as needed, register patents and trademarks, form and register the company, and if requested, actually manage the assets or business.

## I. Investment Incentives

Investors must carefully review and understand investment incentives which can vary considerably from one country to the next. Foreign countries may provide cash grants, tax and fee rebates, low- or no-interest loans, free utilities, liberal depreciation allowances, free use or low cost of land, reduced factory rents, exemption from fees, investment credits, waivers of remittance controls, reimbursement for training locals, and/or other incentives to businesses that locate in designated depressed or underdeveloped areas. Oftentimes the foreign country will provide an income or property tax holiday or a tax waiver for businesses willing to locate in recognized enterprise zones. For example, Jamaica grants "approved" enterprises seven-year exemptions from income taxes. And, as noted earlier, free trade zones can provide manufacturing and export services, while insulating a base company from the normal customs restrictions.

29. English is the official language in havens that at one time were or presently are British colonies. English is widely used to conduct business in most other recognized tax havens.

30. A listing of attorneys by foreign country appears in 7 MARTINDALE-HUBBELL LAW DIRECTORY (1988). For pointers on choosing local counsel, see D. WILSON, INTERNATIONAL BUSINESS TRANSACTIONS IN A NUTSHELL 12–27 (2d ed. 1984), and Hoagland, *U.S. Lawyers and Transnational Business Transactions—An Introduction,* in THE LAW OF TRANSNAT'L BUS. TRANSACTIONS (Clark Boardman) ch. 1 (July 1985).

Some incentives target specific industries. Banks and trust companies favor such havens as the Bahamas and Luxembourg, which have liberal banking laws (for example, minimal reserve requirements). Insurance companies and maritime activities abound in other havens where the government has adopted a laissez-faire attitude toward, or has actively promoted, these industries. Bermuda, for example, has no income tax and does not impose taxes on insurance premiums. These are just two reasons why more multinationals establishing captive insurance companies offshore locate in Bermuda.[31] Similarly, special incentives often promote the tourism industry by bestowing substantial benefits on hotels and resorts.

Finally, government economic policies can themselves be incentives or, conversely, disincentives. Is the government meeting its debt repayment schedule? Are anti-inflationary policies followed? Does the government actively seek foreign investment? Are capital expenditures encouraged? Answers to these and similar questions provide some clue to the overall environment for foreign investment.[32]

## III. Enticing Tax Benefits: The Necessary Ingredient

The tax implications of selecting a base for the operations of a foreign subsidiary are often unique and can be quite complex.[33] The foremost tax concern in cross-border transactions is the potential exposure of the same income to tax from two different countries. The United States mitigates the debilitating effect of double taxation through a foreign tax credit, while other countries may exempt income taxed elsewhere. Not all foreign jurisdictions grant similar benefits, however.

### A. Importance of Treaties

Bilateral income tax treaties are sought and negotiated to prevent double taxation and, therefore, to facilitate international trade.[34] When seeking a foreign country in which to base overseas operations, the available treaty network always should be thoroughly investigated. Tax treaties with countries other than the United States may have important consequences in the event additional foreign

31. The Tax Reform Act of 1986 removed most of the tax incentives for establishing a captive insurance company offshore. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, § 1221 (1986).

32. *See* Diamond & Diamond, *supra* note 17; Investment Laws of the World: The Developing Nations (Simmonds ed. 1990).

33. For a short synopsis of taxation in foreign countries, see W. Diamond, Foreign Tax and Trade Briefs (1990) and B. Spitz, Tax Haven Encyclopedia (1989). More detailed descriptions of foreign tax laws are available in the following publications: Tax Laws of the World (Foreign Tax Law Publishers) (1987) and Eur. Tax'n (IBFD) (1988).

34. *See generally* W. Diamond & D. Diamond, International Tax Treaties of all Nations (1989).

subsidiaries are established later, as the international market expands. For this reason, the Netherlands, with its formidable arsenal of tax treaties, is a popular place to establish a foreign holding company.

Withholding taxes on royalties, management fees, interest, and dividends often can be reduced or eliminated on payments between treaty countries. As a general rule, remittances should be taken in the form of royalties, management fees, and interest, because many countries allow a tax deduction for these types of payments. Dividends normally are not deductible. Furthermore, the withholding tax rate on dividends often exceeds the rate on other remittances. The form of the remittance has no implications to the U.S. recipient, since dividends from foreign corporations are ineligible for the dividend-received deduction in most cases.[35]

Income tax treaties can provide benefits beyond lower withholding taxes. Business profits in a treaty country where no permanent business establishment exists typically are exempt. The compensation paid to an executive or technician on short visits to a treaty country are normally exempt as well. Treaties also may prohibit tax discrimination relative to local businesses. Further, treaties provide redress procedures through competent authorities (for example, the IRS and its foreign counterparts) when problems do arise.

### B. Variety of Havens

Every nation is a tax haven in some respect, relative to other countries. The United States, for example, is a tax haven for many foreign investors, because it does not tax foreign parties on their portfolio investment interest or their investment interest received from deposits with U.S. banks, savings institutions, and insurance companies.[36] Notwithstanding this observation, a country generally must boast of low taxes or special tax breaks to merit the tax haven distinction. Though there is some overlap, most tax havens can be grouped into the following categories: (1) countries that have virtually no taxes; (2) countries that impose virtually no taxes on specific types of companies; (3) countries that exempt most foreign source income; (4) countries that impose relatively low taxes; and (5) favored U.S. possessions.

Most no-tax havens are developing countries. Since taxes do not exist, double taxation problems do not arise. Hence, these tax havens usually do not have tax treaties with other countries. Among the "pure" no-tax countries are Andorra, Anguilla, the Bahamas, Bahrain, Bermuda, the Cayman Islands, Djibouti, Nauru, Nevis, Turks and Caicos Islands, and Vanuatu.

No significant taxes are levied on "international business companies" established in the island nations of Antigua and Barbuda, Jamaica, or Montserrat. Nor

35. I.R.C. § 243(a) (1989). *But cf. id.* § 245, in which a dividend-received deduction is allowed for certain remittances from 10-percent-owned foreign corporations.

36. I.R.C. §§ 871(h), 871 (i)(2)(A), 881(c) (1989).

are "international companies" in the Cook Islands taxable entities.[37] Generally speaking, an international business company or an international company is a corporation limited by shares (a corporation with limited liability) that, with few exceptions, may not conduct business activities within the tax haven. Depending on the specific country, other restrictions may apply. "Exempt companies" in Gibraltar, the Isle of Man, and Seychelles are also zero-tax entities.[38] An exempt company is similar to an international business company in its geographical restrictions, but "exempt" does not necessarily allude to tax exemption. In Bermuda, for example, the designation refers to a corporation that is immune from the normal rule that restricts the ownership interests of foreign parties in local companies. Among other no-tax entities are "exempt companies" (known as "corporation tax companies" before 1989) controlled and managed outside Guernsey or outside Jersey: this exempt company is a nonresident company that pays an annual fee of £500 and does no business in the haven. Resident corporations do not pay the fee, sometimes referred to as a corporate tax. Finally, "enterprises" in Grenada that engage in manufacturing or fishing activities and "holding and trading corporations" in Naura generally escape taxation.

Other tax havens impose significant taxes, but exempt earnings derived from specified activities taking place outside their borders. Among these countries are Costa Rica, Hong Kong, Jordan, Liberia, Macao, Malaysia, Nevis, and Panama. In addition to an income tax exemption on foreign earnings, the entire colony of Hong Kong is a free port, collecting no import duties on most goods.

Relatively low taxes are imposed on an "international business company" in Barbados or the British Virgin Islands, an "offshore company" controlled and managed in Cyprus or established in the Netherland Antilles, a "public limited company" in Ireland, and an "exempt company" or a "nonresident company" in the Isle of Man. Likewise, an "establishment" (*Anstalt*) or a company limited by shares (*Aktiengesellschaft*, abbreviated A.G.) in Liechtenstein, a holding company in Luxembourg or the Netherlands, certain corporations in Oman or Uruguay, and a company limited by shares (*Société Anonyme*, abbreviated S.A.) in Switzerland will pay low taxes. Switzerland is unusual because it is one of the few developed nations, that depending on the availability of special concessions, imposes a lower overall tax burden than the United States. Switzerland's bank secrecy laws, which encourage foreign investment to a great degree, and its historical avoidance of wars have enhanced the combined attractiveness of its federal, cantonal (state), and communal (municipal) taxes.[39]

Although some commentators do not consider U.S. possessions to be tax havens, U.S. possessions are mentioned here because of their attractiveness (as

37. *See* Miller, *The Cook Islands: An Overview of the Off-Shore Legislation*, 16 INT'L BUS. LAW. 300 (1988).

38. *See* Beckett, *Taxation of Companies in the Isle of Man*, 16 INT'L BUS. LAW. 293 (1988).

39. Further, cantonal taxes have been lowered recently. *See* Ernst & Whinney, *Switzerland—Local Tax Rates Reduced*, TAX NEWS INT'L (Dec. 1988).

a haven from taxes) to the U.S. investor. Puerto Rico and the U.S. Virgin Islands have unique benefits under the Internal Revenue Code. United States corporations operating out of these possessions are entitled to a special credit if 80 percent of their gross income from the preceding three-year period is sourced in that possession and at least 75 percent of their gross income for the same period is derived from the active conduct of a possession trade or business.[40] The tax credit, in effect, exempts qualifying corporations from U.S. taxation on their foreign source taxable income from business activities in the possession and, later, from the sale or exchange of substantially all assets used in the possession business. In addition, net income derived from reinvesting profits in the possession economy, or in some cases, into business ventures or development projects in a qualified Caribbean Basin country are eligible for the credit.[41] If, instead of reinvesting the earnings, they are repatriated, a 100 percent dividend received deduction is available to the corporate shareholder.[42] Finally, so-called possession corporations are exempt from the accumulated earnings tax on income that qualifies for the tax credit.[43] Coupled with this almost complete extinguishment of U.S. taxes, Puerto Rico grants 50 to 90 percent tax exemptions for periods of ten to twenty-five years, depending on the particular industry involved.[44]

The U.S. possessions of Guam and the Virgin Islands are popular venues wherein to establish foreign sales corporations.[45] Under U.S. law, foreign sales corporations receive an exemption for a portion of their foreign trade income. The exemption varies, depending on the extent of foreign activities and, consequently, the transfer pricing rules that are available, but it generally reduces U.S. income taxes by 15 percent. In addition, these U.S. possessions have voluntarily granted a tax holiday to foreign sales corporations on their foreign trade income through the end of 1996.

### C. Measurable Tax Benefit

The use of tax havens may enable a multinational to expand its global market without a percentage increase in worldwide income taxes. For example, consider a U.S. company that wishes to establish a foreign subsidiary in either Country *A*, where the income tax rate is 50 percent, or Country *B*, where the income tax rate is 20 percent. Currently, the company has annual net profits of $600. If its market can be expanded overseas, annual net profits are expected to reach $1,000 ($600 from U.S. sources and $400 through the foreign subsidiary). Assuming for this

40. I.R.C. § 936(a)(2) (1989).
41. *Id.* § 936(a)(1), (d)(2), (d)(4).
42. *Id.* § 243(b)(1)(C).
43. *Id.* § 936(g).
44. *See*, Boles, *Tax Incentives for Doing Business in Puerto Rico*, 22 INT'L LAW. 121 (1988).
45. O'Keefe & O'Keefe, *Foreign Sales Corporations: Exporter Reactions*, 37 TAX EXEC. 309 (1985).

illustration that the U.S. income tax rate is 30 percent, does it matter where the subsidiary is established?

To address this question, ignore the possibility that some of the foreign earnings may be deferred. That is, assume that all of the earnings are repatriated to the U.S. parent at the end of each year. The United States taxes the full $1,000 profit, regardless of which country is chosen as the incorporation situs.[46] Thus, the U.S. tax, before considering the foreign tax credit, is $300 under both scenarios.

If the subsidiary is organized in Country *A*, that country imposes a tax of $200 [$400 × .50], and the United States allows a foreign tax credit of $120, which is the portion of U.S. tax, before credit, attributable to the foreign source income [($400/$1,000) × $300]. Accordingly, the U.S. tax after the credit is $180 [$300 − $120.]. Worldwide taxes equal $380 [$200 + $180], which is 38 percent of worldwide income.

If instead the subsidiary is organized in Country *B*, the foreign income tax equals $80 [$400 × .20], all of which qualifies as a foreign tax credit. The U.S. tax after the credit amounts to $220 [$300 − $80]. Worldwide taxes equal $300 [$220 + $80], which represents only 30 percent of total income. Thus, establishing a foreign subsidiary in a country with an effective tax rate lower than the U.S. rate (in a tax haven) allows the multinational to expand its market without incurring an overall income tax liability higher than would be applied if the entire income were taxed only in the United States. Any excess foreign tax limitation that results, here $40 [$120 − $80], is available to absorb any excess foreign tax credit from other similar activities in the current year or a carryover year. Moreover, the multinational may find it can defer recognition of some foreign earnings for U.S. tax purposes.

Subpart F constitutes the major impediment that hinders the multinational from deferring the income of a foreign subsidiary.[47] Under subpart F, foreign corporations controlled by U.S. shareholders are deemed to distribute all earnings arising from certain tainted transactions. Though the identified transactions are far-reaching, they are not all-encompassing. Suppose, for example, that a U.S. multinational is engaged in the business of buying electronic components from various domestic manufacturers and of selling the components to end users abroad. If the multinational establishes an offshore trading company in, say, Bermuda, through which all international sales are made, subpart F can be circumvented. As long as neither the suppliers nor the customers are related to the multinational, the transactions do not generate tainted income. So, foreign earnings of the Bermudian corporation completely evade current taxation. Ber-

46. The $1,000 is composed of $600 in U.S. source income, the after-tax foreign earnings remitted as a dividend, and the I.R.C. § 78 (1989) gross-up for foreign taxes deemed paid by the U.S. parent.

47. I.R.C. §§ 951–964 (1989).

muda does not impose a tax on income, and the United States does not tax the income until it is repatriated to the U.S. multinational.

Notwithstanding this simple example, the U.S. multinational must clear several other hurdles beyond subpart F before it can savor the coveted, but difficult to achieve, deferral from U.S. taxation. These include the passive foreign investment company and the foreign personal holding company provisions. In addition, foreign subsidiaries owned by U.S. parties may be subject to the personal holding company and the accumulated earnings tax rules. Each provision presents a formidable obstacle in its own right. Combined, they create a Solomonic challenge for even the most erudite tax professional.[48]

Multinationals contemplating the establishment of a foreign subsidiary should attempt to quantify the tax component of the decision as much as possible. Estimated profits derived from the subsidiary may be subject to tax in the United States, in the tax haven country, and in the country where the market or consumers are located. The tax in the United States usually is mitigated by taxes paid to the other two countries. Withholding taxes on remittance of profits must be considered also. Tax treaties should be checked to determine whether the withholding rates are reduced below the normally applicable percentage. Finally, any deferred taxes should be taken into account on a present value basis.

## IV. Conclusion

Organizing a base company on foreign soil is a sizable undertaking. The success of the venture often depends on the amount of preparation and research that precedes the financial commitment. Finding a good tax haven can increase the likelihood of success significantly because of the direct impact on cash flow and, therefore, investment return. This article examines the major factors to consider, including taxes. Any one factor, if left to chance, can have a detrimental impact on investment return.

48. Since the primary emphasis of this article is placed on finding a good tax haven, an analysis of these special topics is beyond the scope of this article. For a detailed discussion of these topics, see Larkins, *Engaging in International Commerce Through a Foreign Subsidiary: Navigating in the U.S. Anti-Haven Tax Shoals of the Internal Revenue Code* (to be published in the Winter 1991 issue of INT'L TAX & BUS. LAW.), and Isenbergh, *Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 TAXES 1062 (1988).