Follow the Money: An International Study of Tax Havens

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Abstract

Fifteen percent of all countries are considered to be tax havens which are defined by nominal taxes, a lack of transparency in government tax laws and banking regulation, and an economy driven by tax-free activities. Considered to be highly prevalent in the global economy, tax havens are suspected to hold $11.5 trillion in offshore assets. Opponents of tax havens believe tax havens weaken the social welfare and infrastructure of developed countries, hinder the development of developing countries, and undermine voluntary compliance to tax laws.

Proponents of tax havens cite the encouragement of efficient government spending and a tax-haven-based-economic-development-strategy as positive effects of tax havens. Global efforts by regulatory bodies have tried to reduce the negative impacts of tax havens but the issue is still widely debated. It is believed that through a combination of increased transparency, greater efforts of detection, stronger punishments, and support for the tax haven's economy, the negative effects of a tax haven can be reduced.

1. Introduction

What do the foothills of Andorra, the snowcapped Swiss Alps and the warm coasts of Bermuda have in common? These countries, along with many others, are considered to be tax havens. Although there is not a standard definition of a tax haven, there are several characteristics in common amongst jurisdictions that have been named as havens. Tax havens are highly prevalent on a global scale and have a significant impact on the intertwined international economy. While some impacts are positive for both havens and non-havens, there are also a series of negative events that happen because of the practices employed by tax havens. Various governments and regulatory bodies have enacted legislation and initiatives over the years to reduce the negative impacts of tax havens, but problems still exist. Increased transparency, detection, prevention and support of tax haven economies are needed to combat the harmful practices of tax havens. Although ending the harmful practices of tax havens will help non-haven states, the economic well-being of haven jurisdictions must be considered when negotiating changes to the international financial system.

2. Defining a Tax Haven

A standard definition of a tax haven does not exist. However, the Organization for Economic Co-operational Development (OECD) offers four criteria to consider in defining a tax haven. First, examine the tax structure of the jurisdiction (Addison, 2009, pp. 705-706). Under the OECD guidelines, a tax haven would likely impose zero or nominal taxes. Second, determine if there is a lack of transparency for transactions that occur within the jurisdiction (Addison, 2009, p. 706). For example, the availability of accounting records and underlying documentation for financial transactions would play a role in this transparency. Jurisdictions with little transparency are more likely to be tax havens. Third, examine the laws and administrative practices of the jurisdiction (Addison, 2009, p. 706). Countries with laws and practices that prevent the exchange of information between governments and allow taxpayers to benefit from zero or nominal taxation have the potential to be tax havens. Finally, review the investment activity within the jurisdiction to see if such activity is purely tax driven (Addison, 2009, p. 706). A country that attracts investment solely because of its tax structure would likely be identified as a tax haven. If a jurisdiction is found to have the characteristics described above, it is likely to be considered a tax haven by the OECD.

The United States government has its own definition for a tax haven. In 2009, Senator Carl Levin introduced the "Stop Tax Haven Abuse Act" in which a tax haven was defined as a "foreign jurisdiction that qualifies as an offshore secrecy jurisdiction" (Tanenbaum, 2009). The bill defines an "offshore secrecy jurisdiction" as a jurisdiction that "maintains corporate, bank and tax secrecy laws and industry practices that make it difficult to determine whether its citizens are using the jurisdiction to cheat taxes" (Tanenbaum, 2009). As indicated by the definition of a tax haven produced in this bill, the United States government is most concerned with tax secrecy laws and industry practices in other countries that facilitate tax evasion in the United States. Countries with strong secrecy guidelines and low transparency would be under greater scrutiny for being a tax haven.

3. Characteristics of Tax Havens

Tax havens may not have a standard definition, but they have several common characteristics. While not all havens may have all the characteristics considered as "typical" for a tax haven, they will still be characterized by a majority of the generalizations. Characteristics of tax havens can be divided into four categories: financial, demographic, political and legal, and geographic.

3.1. Financial

Not surprisingly, many of the financial characteristics of tax havens revolve around the tax structure present within the jurisdiction. First, tax havens have low personal income tax rates (Erwin, 2010, p. 325). In additional to low personal taxation, tax havens tend to have zero or nominal corporate tax rates (Dharmapala, 2008, p. 662). Furthermore, as one would expect, tax havens not only offer zero or nominal taxation to their citizens, but also to foreign investors (Dharmapala, 2008, p. 662). This favorable tax structure is what entices investors to invest capital in the tax haven jurisdiction; less money paid in taxes means more money in the investor's pocket. Another common practice of tax havens is known as "ring fencing." "Ring fencing" is the act of exempting certain activities and financial segments from taxation and is a common practice in many tax havens (Erwin, 2010, p. 325).

While having zero or nominal taxes is not an illegal activity, it is the secrecy of tax administration that is commonly criticized. Tax havens tend to have little transparency in tax rulings and administration, which leads to little or no information sharing with tax authorities of other jurisdictions (Erwin, 2010, p. 325). This lack of transparency is what causes turmoil among tax authorities of tax haven and non tax haven jurisdictions because the non-haven is not able to collect necessary information about its citizens that are investing in the haven.

In addition to their tax structure, tax havens have commonalities in their financial services industries. Tax havens have well-functioning financial industries (Addison, 2009, p. 712). Furthermore, because tax havens have such efficient financial industries, a large portion of a tax haven's GDP will come from the financial services industry (Addison, 2009, p. 712). The premise of a tax haven is that its economy is driven by financial services and investment opportunities. A successful tax haven has human resources and capital available to create a strong financial industry.

3.2. Demographic

Common demographics exist among tax havens. Research shows that tax havens are most likely to be small countries with a population below one million people (Addison, 2009, p. 712). Furthermore, a common characteristic among tax havens is a lack of natural resources compared to non-haven states (Addison, 2009, p. 712). When a country lacks natural resources, it uses financial services to compete in the global economy. In addition, tax havens have a "relatively sophisticated communication infrastructure" (Dharmapala, 2008, p. 663). Because investing in the world market requires technology and communication, it is not surprising that tax havens invest in their communication infrastructure. Finally, tax havens are more likely to use English as an official language (Dharmapala, 2008, p. 663). English is often cited as the global language for business. The financial services industry spans the globe, so fluency in English becomes a necessity for tax havens.

3.3. Political and Legal

In addition to a strong economic infrastructure, tax havens require a firm political and legal system. A common characteristic of tax havens is high quality governance and low government corruption (Addison, 2009, p. 712). Furthermore, it has been found that the political systems of tax havens are more likely to have a parliamentary structure as opposed to a presidential structure (Dharmapala, 2008, p. 663). In addition to a strong governing system, tax havens have well-established legal markets which are often used to defend the jurisdiction's strong banking secrecy laws (Addison, 2009, p. 712). Without this strong legal system, it is unlikely a tax haven would be able to remain a haven. A legal system that supports financial secrecy is a key aspect of a tax haven. It has also been found that tax havens often lack a tax treaty with the United States (Luscombe, 2009, p. 3). Finally, tax havens do not recognize tax evasion as a crime[1] (Luscombe, 2009, p. 3). While capital flight for the purpose of avoiding taxation is considered a criminal act by non-havens, tax havens recognize this behavior as an investment rather than a crime.

3.4. Geographic

Despite tax havens being located around the world, they still share common geographic characteristics. One such characteristic is location close to a major capital exporting country (Addison, 2009, p. 712). Additionally, research shows that tax havens are less likely to be landlocked and more likely to be islands (Addison, 2009, p. 712). Islands do not always have the benefit of being located in close proximity to another country that could support their economy and trade. Because the financial services industry does not require direct trade of tangible goods, islands can more readily compete in that market. Finally, it has been found that tax havens are most highly concentrated in Europe, the Caribbean and the Far East[2] (Luscombe, 2009, p. 3).

4. Prevalence and Magnitude of Tax Havens

Based on the general definitions of a tax haven, as well as the common characteristics that tax havens have, several jurisdictions have been identified and labeled as tax havens. Countries commonly referred to as tax havens include Andorra, Monaco, Liechtenstein, the Marshall Islands, Switzerland, Aruba, and Bermuda. Tax havens are highly prevalent. In fact, it is estimated that approximately 15% of all countries are tax havens (Addison, 2009, p. 710).

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[1] For example, Switzerland distinguishes between tax fraud and tax evasion, but does not consider tax evasion to be a crime (Jolly, 2009).

[2] Countries from the Far East that are considered to be tax havens include Hong Kong, Mauritius, Vanuatu, Cook Islands, Labaun, Nauru, Seychelles, Niue Island and the Solomon Islands (Azzara, 2003).

The abundance of tax havens is also made clear in the “Stop Tax Haven Abuse Act,” introduced by Senator Carl Levin, which names 34 “offshore secrecy jurisdictions” (Tanenbaum, 2009). In addition to the list created by the United States, the OECD has a “grey list” of more than 30 countries that agreed to international tax standards, but have not implemented them (Tanenbaum, 2009). Together, the lists created by the United States and the OECD identify a large number of countries around the world that are acting as tax havens and facilitating capital flight.

Due to the large number of tax havens around the world, these havens facilitate the flow of assets from non-haven jurisdictions to haven jurisdictions. It has been estimated that approximately one quarter of all United States firms’ foreign direct investment is located in tax havens (Addison, 2009). The United States is not the only country investing in tax havens. In fact, an estimate of the value of assets held offshore by taxpayers, from all countries, is approximately $11.5 trillion (Smith, Bachmann, Cendrowicz, & Mayer, 2009, p. 25). Furthermore, it can be estimated that cross-border illicit financial flows into tax havens are between $800 billion and $1 trillion annually (Spencer, Cross-Border Tax Evasion and Bretton Woods II, 2009, p. 46). In fact, it appears that the magnitude of tax havens is so large that as much as half of the world’s trade appears to pass through tax havens, although they account for only 3% of the world’s GDP (Addison, 2009, p. 703). Cash flows to tax havens are material not only to the country that is losing tax revenue, but to the global economy. Billions of dollars in cash flow and investments are created each year because of the existence of tax havens.

5. Impact of Tax Havens

Tax havens have an impact on the global economy. This impact ranges from non-haven losses in tax revenue to hindrance of development in third-world countries. While not all impacts are felt on a global scale, some are of great concern to a particular non-haven.

5.1. Impact on the United States

Most often, tax havens are scrutinized for causing non-haven jurisdictions to lose tax revenue. It has been estimated that the United States loses $123 to $153 billion in annual tax revenue to tax havens[3] (Addison, 2009, p. 707). This means the United States has lost approximately $1 trillion in tax revenue in the last decade alone (Addison, 2009, p. 707). While $1 trillion is a substantial amount, the actual value of lost revenue is even greater due to the time value of money. Factoring in the time value of money, the amount of tax revenue lost by the United States to tax havens in the last decade is approximately $1.4 trillion (Addison, 2009, p. 707). This $1.4 trillion in lost revenue adversely affects the United States' social systems and infrastructure, which suffer from insufficient funding. The inability to collect these tax revenues further adds to the annual tax gap and deficit encountered by the United States.

Lost tax revenue comes from tax evasion by both individuals and corporations. Estimates show that United States citizens are responsible for over $1 trillion in off-shore assets, resulting in the evasion of $40 to $70 billion in personal income taxes each year (Addison, 2009, p. 707). Tax havens also facilitate corporate tax evasion. If corporate tax evasion through the use of tax havens is factored in, the total amount of lost tax revenue

[3] Cited by Addison from Simon J. Pak & John S. Zdanowicz, U.S. Trade with the World: An Estimate of 2001 Lost U.S. Federal Income Tax revenues Due to Over-Invoiced Imports and Under-Invoiced Exports (2002) (executive summary), available at http://dorgan.senate.gov/newsroom/extras/pak-zdan.pdf.

increases by over $30 billion (Addison, 2009, p. 707). Tax evasion through tax havens reduces tax revenues in non-haven states and accounts for billions of dollars over the past decade.

5.2. Global Impact

The United States is not the only place facing negative impacts from the existence of tax havens. Studies show tax havens have a negative impact on developing countries as well. It is estimated that developing countries are losing tax revenue of at least $15 billion (USD) a year because of tax evasion by their wealthiest citizens (Addison, 2009, p. 708). This estimate may be conservative as others have put the tax revenue loss as high as $50 billion[4] (Addison, 2009, p. 708). Because developing countries are losing tax revenue to tax havens, they are unable to collect funds to support their citizens without taking out loans from developed countries. Developed countries may experience "donor fatigue" because of the call for assistance from developing countries suffering from lost tax revenue (Spencer, Cross-Border Tax Evasion and Bretton Woods II, 2009, p. 46). This donor fatigue causes strain to both the developed and developing countries involved.

Additional resources are also consumed due to the existence of tax havens. For example, non-haven countries need to use additional resources for tax and law enforcement if they wish to collect tax revenue from tax haven jurisdictions (Dharmapala, 2008, p. 671). The resources spent on law enforcement are being taken away from other societal functions, thus reducing the social welfare in non-haven states.

[4] As cited by Addison from Oxfam International, Tax Havens: Releasing the Hidden Billions for Poverty Education, http://publications.oxfam.org.uk/oxfam/display.asp?K=20040623_2316_000034.

6. Debating the Issue

In recent years, the issue and implications of tax havens have been a controversy. While some individuals argue tax havens are a detriment to society and global markets, others argue that tax havens are for the greater good. The arguments of opponents and proponents of tax havens are outlined below.

6.1. Anti-Tax Haven Arguments

One of the most commonly cited arguments against tax havens relates to the loss of tax revenue by non-haven states. As noted above, capital flight and cross-border tax evasion leads to "donor fatigue" of non-haven states (Spencer, Cross-Border Tax Evasion and Bretton Woods II, 2009, p. 46). Developed countries are less willing to donate to developing countries that are unable to keep tax revenues within their borders. When developing countries do not receive donations or funding, their development becomes stagnant and growth becomes more difficult.

Another argument against tax havens is that cross-border tax evasion reduces the aggregate social welfare since lost tax revenue is unavailable for the societal good. Not only is tax revenue lost through monetary flows to tax havens, but also tax havens decrease the tax rates in non-haven states (Addison, 2009, p. 709). Non-haven states reduce tax rates to offer greater incentive to individuals and corporations to keep tax revenues within their borders. Ultimately, a lower tax rate means less tax will be collected in the form of tax revenues and non-haven states will have less revenue to fund their social welfare programs and infrastructure developments. A counterargument can be made to this theory. Proponents of tax havens argue that non-havens should close the tax gap, by eliminating wasteful spending. If non-havens were able to maintain social welfare, despite the decreased tax rate, it would be an indication that the previously imposed tax rates were too high (Addison, 2009). This counterargument has yet to be substantiated by any conclusive study[5].

Finally, the ideology of voluntary compliance for tax law becomes important. It can be argued that tax havens undermine voluntary compliance (Addison, 2009, p. 710). Individuals and corporations do not want to be the only "suckers" paying taxes if they see other individuals and corporations easily evading them without repercussion. Additionally, non-haven states would have to spend more money on tax evasion law enforcement to provide a deterrent to tax evasion.

6.2. Pro- Tax Haven Arguments

One of the most commonly cited arguments in favor of tax havens is based on a theory by Charles Tiebout, an economist and geographer. Tiebout's theory is that citizens should "vote with their feet" (Addison, 2009, p. 709). The idea of citizens voting with their feet encompasses the idea of individuals relocating to a new state if they do not like the mixture of public goods and services provided by their government. Not wanting to lose the tax revenues of their citizens, governments are pressured to efficiently and effectively use tax revenues to improve social welfare (Addison, 2009, p. 709). Under Tiebout's theory, if a government is spending tax revenues to the satisfaction of their citizens, the citizens will not relocate and will continue to pay their taxes; however, if a citizen is unhappy with government spending, they will relocate to a jurisdiction where the individual approves of the way the government spends tax revenues.

Two weaknesses have been identified in Tiebout's theory. First, people are not completely mobile (Addison, 2009, p. 709). Due to bureaucracy and international regulations, it

[5] See Joel Slemrod & John D. Wilson, Tax Compliance with Parasitic Tax Havens (National Bureau of Economic Research, Working Paper No. 12225, 2006), available at http://www.nber.org/papers/w12225.

is not always possible for a citizen to relocate. Second, Tiebout's theory was conceived in a time when states were not connected on a global scale (Addison, 2009, p. 709). Technology today allows for an individual to live in one part of the world and to have their assets located in a different part of the world. A citizen may not agree with the way their government is spending tax revenue, but instead of moving, they simply evade the taxes by placing their assets in a tax haven where the asset will not be taxed. The citizen would not be burdened by keeping their assets in a remote location, because technology allows them to quickly access and retrieve highly liquid assets.

Not all individuals believe tax havens are a detriment to developing and underdeveloped countries. In fact, some believe that becoming a tax haven is a successful economic development strategy for underdeveloped countries (Dharmapala, 2008, p. 665). Evidence of this is cited in a study of tax havens and non-havens from 1982-1999. During this period, tax havens experienced a higher rate of economic growth than non-havens (Hines, 2005). Since nominal taxes attract investment, tax havens are able to entice investors to place their money within the tax haven. Proponents of tax havens argue that a tax haven can be an efficient pass-through for flows of money in situations where "unnecessary" or "uncertain" tax rules exist (Anonymous, 2009). Once the tax haven has the assets within their control, the haven is able to re-invest that money elsewhere, thus developing their economy with the assets of non-haven citizens.

7. Influential Regulatory and Governmental Bodies

Around the world there are regulatory and governmental bodies working to diminish the negative effects of tax havens. Within the United States, the Internal Revenue Service (IRS) is assigned to tax revenue issues. In response to the growing concern regarding tax havens, the IRS formed an international unit composed of 875 examiners plus 600 new members (Browning, 2010, p. B.3). This international unit's task is to review partnerships and wealthy individuals with at least $10 million in assets to identify tax evasion through the use of tax havens (Browning, 2010, p. B.3). With this new task force, the IRS hopes to limit the number of individuals evading taxes through the use of tax havens.

Outside the United States, there are international organizations working to resolve issues that arise from tax havens. One such organization is the OECD which is comprised of 33 member countries (OECD, 2010). The OECD brings together the governments of countries that are "committed to democracy" and the market economy while providing a setting where governments can compare policy experiences, seek answers to common problems, identify good practices and coordinate domestic and international policies (OECD, 2010). Together, the member states of the OECD strive to facilitate agreements among countries in regards to tax information exchange between tax haven and non-haven states. Furthermore, in effect, the G-20[6] has adopted the OECD concept of the "internationally agreed tax standard" (Spencer, International Tax Cooperation: Centrifugal vs. Centripetal Forces: Part I, 2010, p. 41). Ultimately, the G-20 and OECD both call for an automatic exchange of tax information among member countries (Spencer, International Tax Cooperation: Centrifugal vs. Centripetal Forces:

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[6] The G-20 was established to "bring together systemically important industrialized and developing economies to discuss key issues in the global economy." The G-20 is made up of the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, Republic of Korea, Turkey, United Kingdom, and the United States of America. The European Union, represented by the rotating Council presidency and the European Central Bank, is the 20th member (G-20, 2010).

Part I, 2010). Together, members of the G-20 and OECD work to diminish abusive practices by tax havens and individuals who invest in them.

Another organization with international membership is the Joint International Tax Shelter Information Center (JITSIC). The JITSIC was formed in 2004, by representatives of Canada, the United Kingdom and the United States, with the intention of creating a "bilateral exchange of information on specific abusive transactions and their promoters and investors" (Erwin, 2010, p. 317). Today, members of the JITSIC, which now includes Japan, South Korea and China[7], participate in real-time information exchanges on offshore promotions and schemes (Erwin, 2010, p. 317).

8. Legislation and Initiatives to Combat Tax Havens

Over the past decade, legislation and initiatives have been introduced to combat the negative effects of tax havens on non-haven states. Several initiatives have been made in the United States and Europe during recent years with the purpose of increasing transparency in cross-border financial flows and cracking down on tax evaders.

8.1. Foreign Account Tax Compliance Act

The Foreign Account Tax Compliance Act (FATCA) is an initiative started in 2009 by the United States government. FATCA aims at increasing disclosure about American clients who hold assets in undeclared offshore accounts. By 2010, financial institutions will be required by FATCA either to disclose information about their American clients or to withhold a 35% tax on the account (Browning, 2010, p. B.3). By disclosing information about their clients, or

[7] South Korea and China are observers only (Erwin, 2010).

withholding a tax, the IRS will be better equipped to identify individuals responsible for tax evasion through tax haven jurisdictions.

8.2. Green Book

Another piece of legislation aimed at increasing disclosure by tax havens is known as the Green Book. The Green Book was released by the United States Treasury on May 11, 2009 (Marsan, 2009, p. 33). Through the regulation outlined in the Green Book, the Treasury aims to "crack down on" the abuse of tax havens by United States citizens that are illegally hiding income and assets offshore in tax havens (Marsan, 2009, p. 33). Qualified Intermediaries (QIs), or foreign financial institutions, are given greater responsibilities within the scope of the Green Book. Additional responsibilities for QIs include obtaining documentation from their customers and identifying the owners of income held within their financial institution (Marsan, 2009, p. 34). Furthermore, under the Green Book regulations, a QI would be required to file a 1099 with the IRS for each of its account holders with United States citizenship (Marsan, 2009, p. 34). Finally, the Green Book would require a QI to report various transactions about its account holders, such as United States and foreign source dividends and payments made to another United States citizen in excess of $600 (Marsan, 2009, p. 34). Similar to FATCA, Green Book regulation is designed to increase transparency about the assets of Americans held off-shore so that the IRS is better able to determine tax evasion of United States citizens.

8.3. Last Chance Compliance Initiative

The Green Book was introduced in the midst of another initiative by the United States government to combat abuse of tax havens by Americans. This initiative, known as the "Last Chance Compliance Initiative" was a program run by the IRS from March 2009 through October

15, 2009 (Erwin, 2010, p. 323). This program offered reduced penalties to citizens in exchange for coming forward with information about money and assets stored in a tax haven (Erwin, 2010, p. 323). The IRS expected about 7,500 people to participate in the program, but before the October 15, 2009 deadline, more than 14,700 taxpayers came forward to disclose information about off-shore accounts (Erwin, 2010, p. 323). The large response by United States citizens to the Last Chance Compliance Initiative is an indication that when the IRS increases efforts to identify tax evasion through tax havens, citizens prefer current disclosure to facing larger punitive actions in the future.

8.4. Stop Tax Haven Abuse Act

Also in 2009, was the introduction of Senator Carl Levin's "Stop Tax Haven Abuse Act" (Erwin, 2010, p. 327). This act contained four main provisions aimed at reducing the use of tax-havens to facilitate tax evasion. First, there is a call for the establishment of a list of Offshore Secrecy Jurisdictions and transactions that take place within these jurisdictions that are income recognition events (Erwin, 2010, p. 327). The list would allow taxpayers to determine if they are making financial transactions in a secrecy jurisdiction. Second, the Stop Tax Haven Abuse Act calls for an extension of the statute of limitations to six years for cases where an offshore secrecy jurisdiction is involved (Erwin, 2010, p. 327). This extension is designed to allow tax enforcement agencies greater time to collect the information they need about individuals who may be hiding assets in tax haven jurisdictions. Third, any financial institutions that create entities in a listed offshore secrecy jurisdiction would be required to report their actions to the IRS (Erwin, 2010, p. 327). Finally, individuals holding assets in offshore secrecy jurisdictions will no longer be able to cite a "tax advisor opinion" as a reasonable cause for nondisclosure of investment in a tax haven jurisdiction (Erwin, 2010, p. 327). Under this initiative, citizens would ultimately be responsible for their investment actions. Working together, these four provisions are designed to increase disclosure and transparency in the transactions of offshore financial institutions and to place greater responsibility on individuals who hold assets offshore.

8.5. European Union Directive on the Taxation of Savings

Outside of the United States, initiatives have also been made to reduce the negative impacts of tax havens. An example of such an initiative is the European Union Directive on the Taxation of Savings. The directive calls for the automatic exchange of information on interest paid within the European Union to individuals who are residents of the European Union (Spencer, International Tax Cooperation: Centrifugal vs. Centripetal Forces: Part I, 2010, p. 45). Currently, there are plans to expand this initiative. Expansion of the directive would make the directive apply to all sources and recipients of income, regardless of residency or citizenship in the European Union (Spencer, International Tax Cooperation: Centrifugal vs. Centripetal Forces: Part I, 2010, p. 45). Under the expanded directive, disclosure would be increased between European and non-European financial institutions.

8.6. Model Agreement on Exchange of Information on Tax Matters

A global initiative to combat tax havens was introduced by the OECD. In 2002, the OECD created the Model Agreement on Exchange of Information on Tax Matters (MAEITM) which sets the standard practices and principles for cash flows and tax treatments by haven and non-haven countries (Erwin, 2010, p. 325). First, the MAEITM calls for the exchange of information on request when seen as “foreseeably relevant” to the administration and enforcement of the domestic laws of the treaty partner (Erwin, 2010, p. 325). A treaty partner must adequately establish and communicate the relevance of the requested information before the other treaty partner is obligated to comply with the request. Second, under the MAEITM, there are no restrictions on the exchange of information caused by bank secrecy or domestic tax interest requirements (Erwin, 2010, p. 325). In other words, the MAEITM's guidelines for information exchange override the member country's bank secrecy laws. Third, member states that follow the MAEITM have the right to reliable information and the power to obtain it (Erwin, 2010, p. 325). Information produced must be reliable and rendered to the appropriate treaty partner once the treaty partner has demonstrated the relevance of the information. Fourth, the MAEITM calls for the need to respect taxpayers' rights when investigating cases of tax evasion through tax havens (Erwin, 2010, p. 325). In addition to respecting taxpayers' rights, strict confidentiality is required under the MAEITM (Erwin, 2010, p. 325). The MAEITM protects taxpayers by preventing treaty partners from violating the confidentiality rights and personal freedoms of individuals under investigation. Together, these guidelines establish and protect the rights of both taxpayers and jurisdictions.

While the MAEITM is considered to be a respected model by many countries, there are weaknesses within the framework. The first weakness of the MAEITM is that the agreement only allows countries to ask for assistance and information from other countries in well-developed tax evasion cases (Spencer, Cross-Border Tax Evasion and Bretton Woods II, 2009, p. 50). Countries with tax cases not deemed to be well-developed will be considered as mere "fishing expeditions" which may hinder the investigative work of the tax authority. A second weakness of the OECD's model is that if a tax haven jurisdiction signs at least twelve Tax Information Exchange Agreements (TIEAs), that jurisdiction will be considered to have "substantially" implemented the internationally agreed tax standard (Spencer, Cross-Border Tax Evasion and Bretton Woods II, 2009, p. 52). The weakness in this standard is that twelve TIEAs are minimal when it is considered that there are 30 OECD member countries and 162 other countries[8] (Spencer, Cross-Border Tax Evasion and Bretton Woods II, 2009, p. 52). Finally, opponents of the OECD's MAEITM point out that "cooperation pledges" by tax havens are merely symbolic statements that do not require any immediate or decisive action (Addison, 2009, p. 715). Together, these weaknesses undermine the purpose of the MAEITM and reduce its effectiveness in information exchange among haven and non-haven jurisdictions.

9. Proposed Solutions to the Tax Haven Problem

While much of the proposed and enacted legislation is designed to reduce the negative effects of tax havens, any complete resolution to the problem must focus on transparency, prevention, detection, and punishment, as well as support for the tax haven's economy. Together, these four concepts work to decrease capital flight to tax havens and reduce the negative economic impact on non-haven states.

9.1. Transparency

A key problem with tax havens is their opaque tax structure and administration. This secrecy denies non-haven states access to pertinent information that would be used to identify tax evasion. Under current TIEA conditions, "tax havens are not required to help a foreign government identify previously unknown tax evaders" and most TIEAs do not "override back

[8] Example: Bermuda was elevated to the OECD's "white list" after signing 12 TIEAs with the United States, Australia, the United Kingdom, New Zealand, the Netherlands, Denmark, Faroe Islands, Finland, Greenland, Iceland, Norway and Sweden. The Faroe Islands and Greenland have small populations and minimal economic activity. Furthermore, this list of 12 countries does not contain a developing country that would benefit from the exchange of tax information (Spencer, Cross-Border Tax Evasion and Bretton Woods II, 2009, p. 52).

secrecy provision[s] in the tax haven laws"[9] (Addison, 2009, p. 718). To resolve these issues of secrecy, there is a need for country by country reporting (Spencer, International Tax Cooperation: Centrifugal vs. Centripetal Forces: Part I, 2010, p. 51). Requiring all countries to name the individuals who hold investments within in their borders would allow for non-havens, as well as havens, to know where their citizens are holding and investing assets. Mandating countries to name the beneficiary of assets held in their jurisdiction would also increase transparency (Spencer, International Tax Cooperation: Centrifugal vs. Centripetal Forces: Part I, 2010, p. 51). If a haven was required to identify both the investment owner and the primary beneficiary, the non-haven would be better equipped to handle situations of tax evasion.

Although some TIEAs do not adequately address issues of transparency, they can be revised for the benefit of non-haven countries. On November 30, 2010 a new TIEA, between the United States and Panama, was signed. Once enacted, the TIEA will permit the United States and Panama "to seek information from each other on all types of national taxes in both civil and criminal matters for tax years beginning on or after November 30, 2007" (USDT, 2010). In addition, the United States will have access to information related to bank accounts held by United States citizens in Panama (USDT, 2010). Information exchanged between the United States and Panama under the new TIEA, will be used solely for tax purposes, unless an agreement to use the information for other purposes is reached in writing (USDT, 2010). If a revised TIEA adequately addresses the transparency issues experienced in the past, old TIEAs could be rejuvinated to meet the current needs of both non-haven and haven jurisdictions.

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[9] Cited by Addison from the Testimony of Reuven S. Avi-Yonah Before the Senate Finance Committee on Offshore Tax Evasion, 110th Cong. (May 3, 2007), available at http://www.senate.gov/~financehearings/testimony/2007test/050307testra-y.pdf.

An additional solution to the lack of transparency is to change how information is exchanged. To make sure information is provided when it still holds value for the jurisdiction receiving it, there needs to be an automatic information exchange (Spencer, International Tax Cooperation: Centrifugal vs. Centripetal Forces: Part I, 2010, p. 51). Usually, the older the information, the less value it holds. Countries that have statutes of limitations on cases of tax evasion would have the greatest benefit from an information exchange that happens automatically when a citizen invests in, or transfers assets to, a foreign jurisdiction.

9.2. Punitive Provisions

In addition to sharing information amongst countries, there must also be a global agreement defining tax evasion and addressing how evasion through tax havens should be handled. There needs to be an international harmonization of offenses and punitive provisions for tax evasion (Spencer, International Tax Cooperation: Centrifugal vs. Centripetal Forces: Part I, 2010, p. 51). A global effort to identify and prosecute individuals taking part in tax evasion through tax havens would send a strong signal to tax evaders of all jurisdictions. Strong punitive provisions would deter the use of tax havens and reduce capital flight.

9.3. Prevention and Detection

In addition to disclosing information and enforcing punitive provisions to combat tax havens, efforts must be made to prevent and detect capital flight. One form of detection comes in the form of audits. As of 2009, only about 1.03% of all federal tax returns were audited (Addison, 2009, p. 725). While the audit rate of all tax returns is important, the greatest concern is associated with the audit rate for high net worth individuals. In 2007, the

IRS audited approximately 9.25%[10] of individual income tax returns where income was listed over $1 million and 2.26%[11] of tax returns where income was reported between $200,000 and $1 million (Addison, 2009, p. 725). Together, these figures indicate that a large percentage of individuals with high net worth will not face an audit. There needs to be an increase in audit rates for high net worth individuals to detect if income and assets are being held in tax havens (Addison, 2009, p. 726). Increasing audit rates will be beneficial for two reasons. First, higher audit rates will increase detection of capital flight to tax havens. Second, increased audit rates will send a signal to high net worth individuals that non-haven states are not going to sit idly by while their citizens hide assets in foreign jurisdictions.

9.4. Supporting Tax Haven Economies

Tax havens pose a multifaceted global problem that will not be resolved unless non-havens and tax havens are able to negotiate a solution that will be beneficial to both parties. The current approach to dealing with tax havens is for non-havens to legislate punishments for investing in, or for being, a tax haven. But creating punitive regulations alone will not end harmful practices by tax havens. The solution to ending the harmful practices of tax havens resides in aligning the interests of tax havens with non-havens.

The livelihood of tax havens resides in their financial services industry, and without it, many tax havens would falter. Tax havens rely on the investments of foreign citizens and entice those investments through nominal taxes. Because tax havens do not have access to large amounts of natural resources, their ability to enter into the global economy suffers. Non-haven

[10] As cited by Addison, the IRS audited 31,382 of the 339,138 returns over $1 million.

[11] As cited by Addison, the IRS audited 81,723 of 3,603,564 tax returns with incomes between $200,000 and $1 million.

countries need to appeal to tax havens to make changes that would not destroy the tax havens' economies. This idea is supported by Addison who states, "without actually providing economic incentives to compensate the tax havens for decreases in their overall welfare and GDP derived from the tax haven's international finance industry, cooperating with tax enforcement agencies simply does not make business sense for the tax havens" (Addison, 2009, pp. 715-716). Before tax havens are willing to change their financial practices, they will need economic incentive to do so.

10. Conclusions

Although tax havens account for only a small portion of the global population, they facilitate a large flow of assets each year. The nominal tax structure offered by tax havens provides citizens of non-haven countries incentive to participate in capital flight. The social welfare of non-havens decreases when they lose tax revenue to tax-havens. Often, the only individuals to reap the benefits of the tax haven are the haven's citizens who prosper from the foreign investment. There is a need to eliminate the harmful effects of tax havens and this can be reached through increased transparency, punitive provisions, prevention, detection, as well as support for tax haven economies.

There is a global need to for automatic exchange of information. In addition to an automatic exchange of information, there needs to be a system of transparency in place that allows countries to identify where their citizens hold assets. Furthermore, there needs to be a global agreement defining what tax evasion is. Once a standard definition is set, work can be made toward harmonizing punitive provisions for tax evasion. A common definition and set of regulations will facilitate for consistent application of law around the world. Furthermore, after regulations have been created, countries need to work to prevent and detect cases of capital flight to tax havens. Increased audit rates can be used to deter taxpayers from moving their assets to a tax haven.

Non-haven states may find it in their interest to use resources to help tax havens develop industries other than financial services. Resources spent by non-haven countries to develop a tax haven, so that it is prepared to compete in the global economy on a basis other than tax evasion, would be a savings in resources spent to enforce tax evasion laws. Rather than spending money to enforce tax laws in the future, non-havens could invest money in the diversification of the tax havens' economies now.

A joint effort, by tax havens and non-havens, needs to be made in the near future before any further economic damage is done. The longer tax havens exist and continue to operate in the manner they do today, the greater the negative impact that will be felt by non-haven jurisdictions. Developing countries will continue to struggle with growth and developed countries will continue to generate large tax gaps if tax havens are not restructured. An alignment of economic needs must be created and implemented by tax havens and non-havens.

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