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The OECD Agreement on Exchange of Information on Tax Matters

- An Analysis of its Adequateness as a Tool to Combat Tax Havens

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Abstract

The aim with this thesis is to investigate whether Tax Information Exchange Agreements (TIEA) serve as adequate tools to combat the existence of tax havens and its harmful consequences. More specifically, this thesis pursues to establish what features of tax havens that the OECD Agreement on Exchange of Information on Tax Matters helps putting a stop to, and what characteristics of a tax haven that the respective agreement is unable to stop.

The thesis is organized as follows. Chapter one provides the reader with the necessary background information with respect to defining and identifying tax havens. In chapter two, the most common structures within tax havens will be described. The reader will also be provided with examples on how tax havens are used to evade tax. The OECD model TIEA and its commentary will be assessed in chapter three. The TIEA entered into by Norway and Isle of Man will also be studied for illustrating purposes. The incentives among the contracting parties are discussed in the fourth and fifth part of the thesis. Chapter six concludes.

Preface

This thesis represents the final part of my double degree from The Norwegian School of Economics and Business Administration (NHH) and HEC Paris School of Management. The degrees I pursue to obtain through this program are an MSc in Finance, and an MSc in Sustainable Development.

I chose to write about tax havens due to my interest of bridging the gap between finance and sustainable development. Through one of my courses in finance at NHH, I learned that the existence of tax havens halts the development of developing countries. In addition, tax havens facilitate crimes such as money laundering, terror financing and corruption. These insights propelled my motivation for investigating what currently is being done to combat the existence of tax havens. In this regard, I saw the need for an analysis aiming to assess factors regarded as important for the effectiveness of one of the most important initiatives in the fight against tax havens, the OECD model Tax Information Exchange Agreement. The aim of this thesis has thus been to conduct such an analysis.

Tax havens are characterized by secrecy and complexity. The access to adequate data is thus limited. The consequence for the making of this thesis is that the focus has been on making a qualitative analysis. The thesis covers a relatively broad scope of factors whose presence is regarded to be influential on the effectiveness of the OECD Agreement on Exchange of Information on Tax Matters. I thus hope that my analysis provides the reader with a holistic view of the extent to which the OECD initiative is an effective tool for fighting tax havens.

I would like to use this opportunity to thank my professor, Guttorm Schjelderup, whose guidance and comments have been essential. I would also like to direct a thank you to the Senior Public Prosecutor of the Tax and Competition team with the Norwegian Police, Morten Eriksen, for his helpful comments and insights related to chapter three of this thesis.

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1 Chapter I - A note on defining and identifying tax havens:

This chapter aims to give a description of what constitutes a tax haven. Many attempts to identify tax havens have been made. Despite of this, there is currently no consensus on how to define the term tax haven. This calls for a comparison of the various definitions, and the according lists of jurisdictions identified as tax havens.

1.1 Tax Havens:

Most institutions include the trait zero or low tax rates in their definitions of tax havens. In addition, the organizations agree that a jurisdiction needs to be characterized by additional features in order to be identified as a tax haven. Nevertheless, the additional features emphasized by organizations vary. Other definitions than those to be described exist. The three definitions emphasized in this thesis are chosen to illustrate the variation among the organizations, both regarding the definitions and the corresponding lists of tax havens.

The OECD definition: The OECD approach to identifying tax havens revolves around listing practices that are contradictory to the international practices necessary to avoid harmful international tax competition. According to the OECD (1998), harmful tax competition entails that investment and financing decisions are distorted by tax considerations. OECD's work resulted in two lists of factors identifying Tax Havens and Harmful Preferential Tax Regimes. Jurisdictions in the first category are countries that finance their public goods from sources other than taxation. According to the OECD (1998), non-residents use such jurisdictions to get away from taxes due in the jurisdiction in which they are residents. An assumption concerning this group is that the respective countries are unlikely to co-operate on combating harmful tax competition.

Countries in the second category finance public spending from collection of domestic income tax. At the same time, these countries have tax systems with traits that potentially could cause harmful tax competition. It is the opinion of the OECD (1998) that due to their substantial collection of income tax, these countries would suffer potential losses if the harmful tax competition were to increase. Hence, the OECD claims it is reason to believe that jurisdictions in the second category would agree to implement measures towards fighting tax

evasion. In the following, the two definitions will be explained in a more thorough manner.

Tax Havens:

OECD (1998, p.23) lists three[1] key factors necessary to identify tax havens:

1. *No or nominal tax on the relevant income*
2. *Lack of effective exchange of information*
3. *Lack of transparency*

The OECD (1998) points out that although low or nominal taxes are a necessary trait to identifying jurisdictions as tax havens, it is not sufficient. Low or nominal tax on income makes tax havens interesting to non-residents. It is, however, the combination with the second and third feature of the definition that makes tax evasion possible.

The OECD (1998) explains that the lack of effective exchange of information is present when a jurisdiction acts in a way that halts the exchange of tax related information with other governments. As OECD (1998) points out, this can be facilitated through laws or "*administrative practices"* (OECD, 1998, p.22) followed in the jurisdiction.

The OECD (1998) claims that the lack of transparency implies that other governments don't have the opportunity to obtain information on how the laws in the jurisdiction are enforced. Once this is prevented by a jurisdiction, the lack of transparency is present.

Harmful preferential tax regimes in OECD member and non-member countries:

OECD (1998, p.27) lists four key factors to identify harmful preferential tax regimes:

1. *No or low effective tax rates*
2. *"Ring fencing" of regimes*
3. *Lack of transparency*
4. *Lack of effective exchange of information*

[1] The original OECD definition contained a fourth criterion. This is not included in the current OECD definition, and is thus not present here. The criterion will, however, be dealt with in the fifth chapter of this thesis.

The definition of harmful preferential tax regimes contains all criterions included in the definition of tax havens. The only difference between the two definitions is that the definition of harmful preferential tax regimes includes one additional criterion, ring fencing. Thus, this is the only term to be described in the following.

That a jurisdiction has a "ring fenced" regime implies that the part of the tax regime viewed as preferential is "*partly or fully insulated from the domestic markets"* (OECD, 1998, p.27). An implication is that enterprises benefiting from the preferential tax system are *"prohibited from operating in the domestic market"* (OECD, 1998, p.27). According to the OECD (1998), this reflects a double standard within such jurisdictions. The domestic markets within the identified states are protected from certain features of the country's tax system. At the same time, they make no such enforcements to avoid tax evasion harming other countries. By doing this, the jurisdictions, though in an indirect manner, acknowledge that their tax regime consist of potentially harmful elements. A jurisdiction can enforce a ring fenced regime by offering a corporation to be exempted from paying taxes on activities outside the domestic market, while at the same time imposing considerable (i.e. normal) taxes on activities taking place in the domestic market of the respective jurisdiction.

As illustrated above, three of four criterions are the same in the definitions of tax havens and harmful preferential tax regimes. This overlap makes the difference between the OECD view on the harm caused by tax havens and harmful preferential tax regimes challenging to understand. It is questionable how the extra criterion on the list for identifying preferential tax regimes can adequately explain the considerable deviation with respect to claimed potential harmfulness between the two groups of jurisdictions.

The Tax Justice Network (TJN) definition: The Tax Justice Network defines tax havens as "*… any country or territory whose laws may be used to avoid or evade taxes which may be due in another country under that country's laws* " (TJN, 2005, p.67). It is worth noting that both the word avoid and evade are used with respect to taxes. This provides the definition with a broader scope than the one of OECD, since the definition does not draw a line between dispositions enabling companies to avoid taxes, and illegal dispositions made in order to evade tax. Due to this, the tax justice network identifies more jurisdictions as tax havens than the OECD.

The International Monetary Fund (IMF) definition: The IMF focuses on Offshore Financial Centers (OFC). The organization has a program aiming to fight such states, yet they still lack a formal definition of what constitutes such jurisdictions (IMF, 2008). For illustrating purposes, this thesis presents two IMF descriptions of OFCs. The first is collected from an IMF working paper: *"An OFC is a country or jurisdiction that provides financial services to nonresidents on a scale that is incommensurate with the size and the financing of its domestic economy "* (Zoromé, 2007, p.7). The second description stems from the IMF statistics department. Here, an OFC is explained as *"a jurisdiction in which international investment position assets, including as resident all entities that have legal domicile in that jurisdiction, are close to or more than 50 percent of GDP and in absolute terms more than $ 1 billion"* (IMF, 2008, p. 17).

The takeaway from the presented descriptions is that the IMF focuses on OFCs and not tax havens. The consequence is that the IMF emphasizes the activity in the financial sector relative to the domestic economy, instead of matters related to taxes and legislation, which is the main focus of the OECD as well as the tax justice network. The list of OFCs identified by the International Monetary Fund does not build on one definition in particular. The list presented in 2008 includes states whose cooperation regarding money laundering and reporting has been requested by the IMF.

Conclusions: The variations in the definitions of tax havens lead to variations in the lists of identified tax havens among the previously mentioned organizations. This is illustrated in the following figure. The OECD definition is the one producing the shortest list of tax havens. The implication is that the OECD is the organization aiming to fight the fewest tax havens, as an organization only fights jurisdictions identified as tax havens according to their own definition. The number of tax havens fought is important as it may have an effect on the extent to which an initiative to fully end the existence of tax havens is successful. The OECD does not currently view any of the jurisdictions listed below as non co-operative tax havens, as all the jurisdictions have agreed to enter tax information exchange agreements. The jurisdictions are instead referred to as *"jurisdictions that have committed to the internationally agreed tax standard, but have not yet substantially implemented"* (OECD, 2011) if they have signed less than 12 tax information exchange agreements and

"jurisdictions that have substantially implemented the internationally agreed tax standard" (OECD, 2011) if they have signed more than 12 agreements on the exchange of information.

Jurisdiction	OECD 2000	IMF 2008	TJN 2007
Anguilla	x	x	x
Antigua and Barbuda	x	x	x
Aruba	x	x	x
Bahamas	x	x	x
Barbdos	x	x	x
Belize	x	x	x
Bermuda		x	x
British Virgin Islands	x	x	x
Cayman Islands	x	x	x
Costa Rica		x	x
Dominica	x	x	x
Grenada	x	x	x
Montserrat	x	x	x
Netherland Antilles	x	x	x
New York			x
Panama	x	x	x
St Lucia	x	x	x
St Kitts & Nevis	x	x	x
St Vincent and the Grenadines	x	x	x
Turks and Caicos islands	x	x	x
Uruguay			x
US Virgin Islands	x		x
Liberia	x		x
Mauritius	x	x	x
Mclilla			x
Seychelles	x	x	x
South Africa			x
Bahrain	x	x	x
Dubai			x
Hong Kong		x	x
Malaysia		x	x
Lebanon		x	x
Macau		x	x
Singapore		x	x
Tel Aviv			x
Taipei			x
Alderney	x		x
Andorra	x	x	x
Belgium			x
Campione d'Italia			x
London			x
Cyprus	x	x	x
Frankfurt			x
Gibraltar	x	x	x
Guernsey	x	x	x
Hungary			x
Iceland			x
Ireland		x	x
Ingushetia			x
Isle of Man	x	x	x
Jersey	x	x	x
Liechtenstein	x	x	x
Luxembourg		x	x
Madeira (Portugal)			x
Malta	x	x	x
Monaco	x	x	x
Netherlands			x
Sark	x		x
Switzerland		x	x
Trieste			x
Turkish Republic of Northern Cyprus			x
Cook Islands	x	x	x
Maldives			x
Marianas			x
Marshall Islands	x	x	x
Nauru	x	x	x
Niue	x	x	x
Palau		x	
Samoa	x	x	x
Tonga	x		x
Vanuatu	x	x	x

Figure 1: List of tax havens. Source: NOU (2009:19, p.19-20)

2 Chapter II - Structures in tax havens:

In the following, commonly recognized factors within tax havens will be discussed. The factors discussed are considered[2] to be the most representative characteristics of tax havens, all facilitating tax evasion and avoidance. It is, however, worth noting that variations occur with respect to the factors facilitating tax evasion and avoidance in the different jurisdictions. In their report, The Government Commission on Capital Flight From Poor Countries[3] claims that the structures within a tax haven can be divided in three broad parts (NOU, 2009:19). First, general features of the legislation within a tax haven. Second, the opportunity to establish distinctive company structures, and third, the design and regulation of what is referred to as international business companies. The characteristics discussed in the following section are all emphasized and pointed out by NOU (2009:19). Some of the structures are also noted by the Tax Justice Network.

2.1 General features of the legislation within a tax haven:

Secrecy:

According to NOU (2009:19) and TJN (2009d), the secrecy in tax havens leads to information on companies and its owners being difficult to obtain for stakeholders. NOU (2009:19) claims that secrecy legislations contribute to two characteristics of tax havens. First, secrecy imposes considerable limitations considering publicly available information on activities in a jurisdiction, as well as who carries out the activities in question. Second, secrecy makes getting access to information almost impossible unless a legal request is obtained.

As pointed out by NOU (2009:19), a legal request must satisfy certain requirements in the requested jurisdiction in order for it to be interpreted as adequate. NOU (2009:19) claims that considerable documentation regarding the circumstances that create the need for the

[2] The features discussed are the ones emphasized across the organizations working to combat tax evasion such as the OECD, the IMF, the UN, the World Bank and the EU.

[3] The report referred to is Tax Havens and Development, Report from the Government Commission on Capital Flight from Poor Countries. In the remainder of the thesis, this report will be referred to as NOU.

information requested is necessary in order to obtain the information pursued. Required documentation could include bank account numbers and transaction dates. This could easily create a vicious circle, as one usually requests information from another jurisdiction because one does not currently have access to that information or documentation related to it.

NOU (2009:19) further claims that the existence of secrecy legislations impacts the sovereignty of other states in a negative manner. When making various transactions through tax havens, the secrecy legislations cut the links between where a transaction started and where the final destination of the transaction is. Stakeholders, such as governments, have small chances of knowing what goes on in such transactions unless the people responsible for making the transaction choose to provide such information to the public. In cases where information on such transactions is given, there are few possibilities for affected parties to check whether the information provided is legitimate. Thus, secrecy legislations make it harder for non-haven jurisdictions to enforce their domestic laws. This makes secrecy legislations an adequate tool for making tax evasion and other crimes such as money laundering, corruption and terror financing possible (NOU, 2009:19).

2.2 Distinctive company structures:

According to NOU (2009:19) and TJN (2009d) tax havens allow company structures prohibited in other states. This thesis focuses on two types of distinctive company structures, described in the following.

Trusts: A trust is *"a collection of assets where the formal and legal owner of the assets (the trustees or managers) have agreed to undertake to manage the assets for the benefit of those who, according to the basis for establishment (the foundation agreement or the trust agreement/ trust deed) are designated as beneficiaries of the trust"* (NOU, 2009:19, p.39).

As stated by NOU (2009:19), what differentiates a trust from a company with limited liability is the distinction between the formal (legal) ownership, and the subjects benefiting from the trusts' assets (beneficial ownership). Hence, the subjects entitled to the funds are not necessarily the ones legally in control of them.

The individuals benefiting from a trust could be the founders of the trust or subjects the

founders aim to grant funds (NOU, 2009:19). The legal owners of a trust, the trustees, are also the legal owners of the funds in the trust. When a trust is well constructed, the funds are not considered as part of the trustees' wealth. Hence, the trustees need not pay taxes on the assets in the trust. Accordingly, the beneficiaries are not liable for taxes on other than funds formally received from the trust.

As stressed in the NOU (2009:19), the future payments from the trust do not affect the beneficiary's current wealth, given that the beneficiary does not control the trust. This has an interesting implication. From the time funds are being transferred to the trust to the time the beneficiary formally receives funds, the trust funds have their own legal rights and obligations independent from its trustees and beneficiaries. Nevertheless, the trust is not regarded as independent in legal terms. Thus, the trust does not own itself and cannot be part of a lawsuit (NOU, 2009:19).

NOU (2009:19) points out that in order to abuse a trust, it is important to keep the existence of the trust and the identity of the trustee a secret. One recognized (NOU, 2009:19) way of abusing a trust is to make the formalities appear as if the trustee is in control, while in reality, the power lies in the hands of the beneficiary. The beneficiary maintains the control by making the trustees sign letters of resignation etc. so that the beneficiary can make the agreement effective merely by writing a date on the agreement. This allows the founder or beneficiary to dismiss the trustee if the rules are not being followed. In reality this leaves the decision rights in the trust with the beneficiary, yet this is hard to prove for authorities or other third parties.

By transferring funds to a trust situated in a tax haven, the original owner can evade tax by pretending to lack control over the trust. By doing this, the individual secures the respective funds from claims from creditors as well (NOU, 2009:19).

Protected cell companies: Another company structure recognized in NOU (2009:19) and by TJN (2009e) is named protective cell. A business structured as a protected cell company consists of a number of "cells" each representing an entity of the respective company. The outer cell is an independent legal entity, with legal rights and obligations separated from the cells comprised by the outer cell. The comprised cells (i.e. the inner cells) are independent with respect to each other as well as the outer cell. The implication is that

every cell has its own name as well as assets and liabilities. Independency between entities within a company has implications for stakeholders, more specifically for creditors. Following the independency between cells is the fact that a claim towards one company cell only makes the assets in this particular cell available for the creditor in case of default. This means that if one cell is considered insolvent, the creditors with claims on this cell cannot cover their losses from sources outside this cell. This applies even though the particular cell is the only one unable to meet its liabilities.

As pointed out by the tax justice network (2009e), it can be claimed that it is difficult to obtaining information on the activities within a protected cell company. Regardless of the cell of interest, any attempt to obtain information has to start by accessing the outer cell by using the legal system in the respective tax haven. To gain access to another cell inside the outer, the legal process must be replicated. Furthermore, a cell within the outer cell can comprise other cells. The consequence is that it is extremely costly and time consuming to obtain information on the activities in a protected cell company.

2.3 The design and regulations of International Business Companies:

In addition to the secrecy legislations, most tax havens have implemented rules giving international business companies and their owners possibilities not offered in the majority of states recognized as non-havens. These possibilities are classified as exemptions and freedoms by NOU (2009:19) and will be described in the following. First, a description of what constitutes an International Business Company will be given.

International Business Companies (IBC):

In order to be identified as an International Business Company, and thus enjoy the freedoms and exemptions granted by tax havens, a company must intend to operate in jurisdictions other than the tax haven. Companies identified as IBC usually lack activities related to their core business in the country in which they are registered (NOU, 2009:19). Thus the activities related to the core value creation of a company take place outside the tax haven. The implication is that the activities in the country of registration are related to financial dispositions. In the following, the exemptions and freedoms granted IBCs will be described.

Exemption from the obligation to prepare accounts: NOU (2009:19) points out that in most countries, limited liability companies are obligated to maintain accounting records.

Since owners of limited liability companies are protected against the company's creditors, accounts is an important tool to make sure that owners do not abuse this protection. In addition, accounts provide other stakeholders (i.e. actors in securities markets, tax authorities, the company's employees and shareholders) with important information. Companies registered in tax havens are usually not obligated to prepare accounts. It can be claimed that in general, the laws in tax havens are designed in a manner that leaves it up for the managers of the businesses to decide whether they would like to keep accounts or not. Accordingly, guidelines on what constitutes adequate bookkeeping probably fail to exist (NOU, 2009:19).

Exemption from the obligation to preserve accounts: Most states keep companies responsible for preserving its prepared accounts. The reasoning is simply that the validity of the accounts can be questioned and investigated if this is found necessary at some point. In jurisdictions not obligating companies to prepare accounts, there is no obligation to preserve accounts either (NOU, 2009:19). This is the case for most tax havens.

Exemption from the obligation to audit: Since the majority of tax havens exempt IBCs from keeping accounts, these countries have no laws obligating such companies to audit their accounts (NOU, 2009:19). In non-haven countries, businesses are obligated to audit in order to ensure the affected stakeholders that the accounts being kept are truthful.

Exemption from the obligation to keep an updated register of shareholders: In most jurisdictions, it is common to have rules ensuring that companies keep a register over the current owners of the company. The reasoning behind this kind of legislation is based on the needs of the various stakeholders of firms (NOU, 2009:19). It is essential for companies being a counterpart in any agreement to have valid information on the other contracting party. In order to obtain this information, it is necessary to know who the real owners are. More accurately, it could be useful to know the economic situation of the owners, as well as where the owners are residents. As stated by NOU (2009:19), tax havens neglect the importance of these needs by exempting companies from the duty to keep an updated register of shareholders.

The potential difficulties related to this exemption are exacerbated by the fact that intermediaries often represent the real owners in companies registered in tax havens. NOU (2009:19) points out that some tax havens recognize lawyers as adequate intermediaries. This

might impose additional difficulties in the search of the real owner because of the lawyers' obligation of professional confidentiality (i.e. the lawyer client privilege). It can be claimed that concealing ownership is outside the scope of the respective obligation. Nevertheless, this needs to be established in each individual case. It is thus plausible that having lawyers as intermediaries will delay the process of finding the real owners due to the process of deciding whether the lawyer client privilege ought to be kept or not.

Exemption from the obligation to hold the board meetings locally: As described by NOU (2009:19), most states enforce their taxation through the residency principle[4]. This means that an individual or a company is liable to pay taxes to the jurisdiction in which they are considered residents regardless of where the income is earned. For companies, an entity is considered resident in the country from where it is located and /or managed. This implies that the jurisdiction in which the company is registered is of lesser importance than where the owners and board members do their day-to-day duties. This does, among other things, include where the board has its meetings.

Where the board has its meetings is often emphasized when deciding from where a company is managed. In the legislation of many tax havens, NOU (2009:19) notes that it is explicitly expressed that board meetings need not be held within the jurisdiction. This implies that the place in which a company has its board meetings is not conclusive in terms of deciding from where an IBC is managed.

The freedom to redomicile the company: When a company is liquidated, many formalities are imposed on the company by the jurisdiction in which it is registered. Such rules are designed to protect the interests of affected third parties, such as creditors. As pointed out by NOU (2009:19), one of the main features of such rules is that the liquidation and move of the company must be made public. The intent is that creditors should get a chance to present their claims (NOU, 2009:19).

Such rules do not appear in the majority of the legislation in tax havens (NOU 2009:19; TJN, 2009d). As NOU (2009:19) describes, companies registered in such jurisdictions are able to move to another jurisdiction quickly without regards to potential claims of creditors and other third parties. The company is deleted from the register in the old jurisdiction and included in

[4] The term will be assessed later in the thesis.

the jurisdiction in which the company has been moved to. The implication is that third parties probably will be denied access to information on the company in the jurisdiction the company used to be registered in. Redomiciling the company is therefore an effective way of preventing stakeholders from getting information.

The freedom to choose the company suffix or abbreviation, name and address: Many companies are skeptical towards doing business with companies registered in tax havens. The legislation in tax havens is therefore designed to include tools to camouflage where a company is registered. When a company is registered in a tax haven, it is up for the company to decide what suffix to use to state the company form (NOU, 2009:19). If, for instance, a joint stock company wants to use the Norwegian abbreviation for "limited company", AS, to signalize this, it is often not considered a violation to the legislation in a tax haven (NOU, 2009:19).

As noted in the NOU (2009:19), the suffix, or abbreviation used behind a company name is standardized for the purpose of serving as signals on where a company is registered as well as what kind of legal entity a company is to be considered as. Tax havens that leave the choice of suffix up to the companies create confusion and increase the risk that companies send misleading signals to stakeholders. This confusion is strengthened by the rules allowing companies registered in tax havens to refer to an address in another country than one in which it is registered (NOU, 2009:19).

2.4 Are tax havens worth combating?

The description of the characteristics of tax havens shows that such jurisdictions contain features capable of influencing the enforcement of the laws in other jurisdictions in a negative manner (NOU, 2009:19). At the same time, there is no consensus among scholars with regards to the effects tax havens have on the economy. A theoretical model that claims the existence of tax havens to be harmful to non-haven countries is the one developed by Slemrod & Wilson (2006). At the same time, a number of models claim that the world's major economies benefit from the existence of tax havens. Scholars having this particular view are Keen (2001), Hong & Smart (2007) and Desai et al. (2006)[5].

[5] It is worth noting that these frameworks represent a selection of papers aiming to decide whether tax havens are good or bad, presented in an overview (Dharmapala, 2008).

Despite the complexity regarding tax havens' effects on the economy, tax havens have characteristics whose features make considerations in addition to economics and welfare necessary. As described in this chapter, tax havens have structures that facilitate money laundering, corruption, terrorism and other actions regarded as crimes in jurisdictions governed by law (NOU, 2009:19). In addition, the existence of tax havens has a negative impact on the growth and welfare in developing countries (NOU, 2009:19; Torvik, 2009). The welfare effect from actors using tax havens for evading taxes is thus not the only factor relevant to take into consideration when deciding if tax havens are bad. Whether or not to accept the existence of tax havens is a question of justice and ethics as much as it is a question of welfare and economics. Hence, even though the economic effect of tax havens is cumbersome to decide, whether or not to combat tax systems whose features facilitate the previously mentioned crimes does not appear to be the most complex ethical dilemma. This thesis thus concludes that the existence of tax havens is unwanted and needs to be combated.

2.5 What harm do tax havens cause?

As pointed out by NOU (2009:19), the majority of states finance their public spending through levying taxes on individuals and corporations. The exception is tax havens. Due to the business model[6] of tax havens and their structures, tax havens are often accused of decreasing other countries' tax bases. To understand how this theft is made possible, it is necessary to study the two main international principles for taxation of individuals and corporations.

The residency principle: As described by scholars (Hines et al., 2008; Knoll, 2009), the residency principle of international taxation makes individuals and corporations liable for tax in the jurisdiction in which they are regarded residents. The implication is that all income is liable for tax in the country of residence regardless of where the income is earned.

NOU (2009:19) describes that for individuals, the country of residence is based on the number of days spent in a jurisdiction. If in doubt, where the individual has its strongest ties (i.e. family, house, etc.) serves as the conclusive factor. For companies, an entity is considered resident in the country from where it is located and/ or managed.

[6] The business model of tax havens revolves around tax havens financing their public expenditure from other sources of taxation (NOU, 2009:19).

In the following example, all countries are assumed to follow the residency principle. In addition, individuals and corporations are assumed to wanting to maximize their after-tax return. If a person is a resident of Norway, that person is only liable for tax in Norway even though the income is capital income stemming from Malta. Under this taxation principle, investment decisions are independent of the tax rates in countries that the investor is regarded as a non-resident in. The only tax rate of importance is the one applicable in the country of residence. Given that the pre-tax return is the same in non-resident countries, the after tax return will also be the same. This leads to the following relation[7]:

$$\text{Return obtained at home} = \text{Return obtained abroad}$$

$$r^H(1- t^H) = r^A(1- t^H)$$

$$\rightarrow r^H = r^A$$

Seen from the perspective of a resident or corporation in any given country, investments will be taxed at the tax rate of the resident country no matter where the investment is made. The consequence is that one successfully obtains an allocation of investments that is independent of the tax rates of countries.

The source principle: The source principle entails that income is liable for tax in the jurisdiction in which the income is obtained (Hines et al., 2008; Knoll, 2009). The relation explaining investment decisions is thus:

$$r^H(1- t^H) = r^A(1- t^A)$$

$$\rightarrow r^H = r^A \text{ only in cases where } t^H = t^A$$

Rational investors and corporations, whose aim is to earn the highest after-tax return possible, are under the source principle forced to take tax rates into account when making investment decisions. In case of discrepancies between tax rates in different countries, the pre-tax return also have to be different given that the after-tax return is equal. The result is that countries

[7] In this relation r denotes return and t denotes tax. H and A represents investments made home or abroad, respectively.

with low tax rates will receive a larger amount of global investments than the domestic pre-tax returns would suggest (Slemrod & Wilson, 2009).

2.6 The use of tax havens by individuals and corporations:

Scholars (Dharmapala, 2008; Kudrle, 2008) claim that the use of tax havens can be divided into two categories. The use of tax havens by individuals aiming to evade taxes, and the multinational companies' use of tax havens to avoid and evade tax. How tax havens decrease the tax base in other countries are dependent on the taxation principle followed.

The individual use of tax havens under the residency principle of international taxation:

Most states tax individuals according to the residency principle (NOU, 2009:19). There are some challenges related to using the residency principle in international taxation of individuals (Eggert & Kolmar, 2004). In order for the principle to work adequately, one is dependent on an effective, all comprising exchange of information between countries. The tax authorities are dependent on having information on all income of a taxpayer, regardless of where that income is obtained. Tax havens facilitate tax evasion on the individual level by refusing to provide other governments with tax information regarding their residents. In this regard, tax havens decrease the tax base in non-havens by offering itself as a place in which individuals may hide funds for the purpose of evading taxes in the respective country of residence (Dharmapala, 2008; Kudrle, 2008). Evasion on the individual level is, in other words, dependent on secrecy.

The consequence of the existence of tax havens on the individual level is that the taxation principle followed resembles the source principle, as individuals can evade taxes on income earned outside their country of residence through tax havens.

The corporate use of tax havens under the residency principle of international taxation:

If the residency principle is applicable for corporate taxation it can be claimed that the extent to which the principle is effective depends on the criteria for claiming residence in various jurisdictions (NOU, 2009:19). When following the residence principle, a company will be liable for tax in the jurisdiction in which it is located and / or managed from. Where the company is registered is thus of less importance. When this taxation principle is followed, the tax havens can decrease the tax base of other countries by facilitating that a company can

claim to be resident in a tax haven based on artificial terms[8] (NOU, 2009:19). This opportunity can lead to tax planning, which has a negative impact on the efficiency of the residency principle, as well as the tax base of non-haven countries.

This point may be illustrated by studying the inward-bound direct investments to India. Of the total invested funds between 2006 and 2008, 38% was traced to Mauritius (NOU, 2009:19). The majority of these investments was from companies whose company structure prohibited them from having employees in Mauritius. Hence the majority of companies could be classified as IBCs, and it is thus appropriate to assume that residents in jurisdictions other than Mauritius govern these companies. Further, the tax agreement between Mauritius and India gives the rights to taxation to the jurisdiction in which the actor is considered to be a resident. This means that India loses its tax base related to a considerable amount of its foreign direct investments. At the same time, these investments fail to be taxed anywhere else, since the taxation rights are given to a tax haven.

The corporate use of tax havens under the source principle of international taxation:

When corporate taxation is source based, the aim for the corporate use of tax havens is to exploit the current legislation in a way that maximizes the tax base in tax havens while minimizing the tax base in states that impose considerable taxes (NOU, 2009:19; Kudrle, 2008). The following part of the paper describes some of the techniques used by companies having this interest. The list is not exhaustive.

Transfer pricing:

Scholars (NOU, 2009:19; Dharmapala, 2008) explain that transfer pricing is the technique used when trading goods and services between entities within a company. Transfer pricing is necessary and legal given that the chosen transfer price equals the market price for the good or service. The technique causes harm if it is used to shift a company's profits from one part of the company to another. Overpricing transactions from low- tax to high-tax jurisdictions (or under-price transactions of opposite direction) typically does this. This will effectively reduce profits in the high-tax jurisdiction, and increase the profits registered in the low-tax jurisdiction, leaving the company as a whole with a smaller tax liability.

[8] i.e. a company can claim residence in a tax haven despite of being located and / or managed from somewhere else (NOU, 2009:19).

Transfer mispricing[9]: A corporation is assumed to consist of subsidiaries in two different countries. One of the countries is a tax haven. Subsidiary A, situated in the tax haven, produces a good which it in turn sells to subsidiary B. For simplicity, it is assumed that the tax haven offers a zero percent tax rate, while the profits in subsidiary B are taxed by 20%. In the following example, the effect of the transfer price is the only feature considered.

Year 1: Subsidiary A sells the good for $ 1000 to subsidiary B. Both subsidiaries are assumed to make a pre tax profit of $ 800. This gives the corporation a total pre tax profit of $ 1600. Subsidiary A pays zero tax, whilst subsidiary B pays $ 160 tax on its profits. The total tax bill for the corporation is thus $ 160, and the total after tax profit for the company is $ 1440.

Figure 2: Taxes year one

	Subsidiary A	Subsidiary B	Corporation
Pre tax profit	$ 800	$ 800	$ 1600
Tax	$ 0	$ 160	$ 160
After tax profit	$ 800	$ 640	$ 1440

After tax profit for corporation: $ 1440
Corporation tax rate: 10%

Year 2: In year two, the company decides to decrease the tax liability for the corporation as a whole by using transfer mispricing. To achieve this, the tax base in subsidiary A is increased, while the tax base in subsidiary B is decreased. This is achieved in the following manner. Subsidiary A sells the good to subsidiary B for $ 1500. The profit of subsidiary A increases by $ 500, and the same number reduces the profits of subsidiary B. Subsidiary A has thus a pre tax profit of $ 1300, and subsidiary B has a profit of $ 300. The pre tax profit for the corporation as a whole is still $ 1600, at the same time, the taxes paid is $ 60, leaving the corporation with an after tax profit of $ 1540.

[9] The illustration of transfer mispricing is highly simplified, built on an illustration provided by the Tax Justice Network. The basis for the illustration is collected from: http://www.taxjustice.net/cms/upload/pdf/Tricky_Tax.pdf

Figure 3: Taxes year two			
	Subsidiary A	Subsidiary B	Corporation
Pre tax profit	$ 1300	$ 300	$ 1600
Tax	$ 0	$ 60	$ 60
After tax profit	$ 1300	$ 240	$ 1540
After tax profit for corporation: $ 1540			
Corporation tax rate: 3.75%			

Structuring of the balance sheet:

Strategic structuring of equity and liabilities: Dharmapala (2008) points out that this opportunity mainly involves strategic financing of business entities within the company. The common way of doing this is debt-financing entities (subsidiaries) in high- tax countries, and finance entities in tax havens by equity. This facilitates the ability of getting tax deductions in the high-tax jurisdiction, while using equity where this is not liable for taxation. The main tool for achieving this is through the use of internal banks. How this works is best illustrated by an example, which resembles an example provided by NOU (2009:19, p.51).

A multinational corporation with its parent company located in a high-tax jurisdiction sets up a subsidiary in a low-tax jurisdiction with the purpose of using it as an internal bank. The tax rate in the high-tax country is symbolized with t^H, while the tax rate in the low-tax jurisdiction is called t^L. The interest rates are recognized by r. The parent company finances the subsidiary by borrowing one unit of capital, K in the financial market. The after tax cost of this loan is - $(1- t^H)rK$ for the corporation as a whole. The internal bank is financed by the funds borrowed. Then, the internal bank lends these funds back to the parent company. This leads to the parent company having to pay interest to the subsidiary, - $(1-t^H)rK$. The internal bank has to pay taxes on the income stemming from interest on the sum lent, $(1-t^L)rK$. Finally, the entity located in the high- tax jurisdiction, the parent company, invests the funds borrowed, K, in risk free investments. The return on this investment will be liable for tax in the high- tax jurisdiction, $(1-t^H)rK$.

For simplicity, all the interest (return) payments are assumed to be equal in size. The sum of the respective transactions is calculated in order to derive the net effect for the corporation.

$$[-(1-t^H) - (1-t^H) + (1-t^H) + (1-t^L)]rK$$

This may be expressed as $(t^H - t^L)rK$. This term is positive as long as $t^H > t^L$. The rate of return from this procedure will be the difference between t^H and t^L.

Strategic transferring of assets:

NOU (2009:19) identifies that another way of facilitating lower taxation is transferring brand names or patents from entities in high tax countries to subsidiaries in tax havens. The tax haven subsidiary charges royalties for the usage of the brand name or patent, reducing the taxable profit in the high tax countries.

2.7 Concluding remarks to chapter 2:

The mentioned exemptions as well as the freedoms granted to IBCs provide the tax authorities in tax havens with a narrow base from which they can collect information. It is likely that tax authorities in tax havens are unable to provide information on matters that the companies face no obligation to collect or preserve. This enables corporations to minimize the tax base for the corporation as a whole, often by using illegal techniques, without tax authorities in other jurisdictions being able to stop this. In addition, the legislation of IBCs provides corporations with the opportunity to evade tax in a non-haven jurisdiction by claiming to be resident in a tax haven despite of being located and / or managed from somewhere else. The secrecy feature of tax havens facilitates that individuals can evade taxes while running a low risk on getting caught by the jurisdiction in which the taxes are due. The opportunity to establish trusts and protected cell companies provides another way for individuals and corporations to evade taxes as well as escape claims from affected third parties. It is in the opinion of this thesis important to curb all these structures in order to make the battle against tax havens through information exchange a successful one. To what extent the OECD Agreement on Exchange of Information on Tax Matters is successful in doing this will be assessed in the next part of the thesis.

3 Chapter III - Tax Information Exchange Agreements:

The remainder of this thesis is devoted to analyzing the adequateness of combating tax havens through Tax Information Exchange Agreements[10] (TIEA) resembling the OECD Agreement on Exchange of Information on Tax Matters (the OECD model TIEA)[11]. This chapter is studying the OECD model agreement as well as an agreement between Norway and Isle of Man for illustrative purposes (the latter agreement uses the OECD model TIEA as a blueprint). The degree to which the OECD model TIEA will lead to the effective exchange of information, will be assessed based upon the framework to be described in the following section.

3.1 The effective exchange of information:

Keen & Ligthart (2006b) have established three criterions, whose presence is argued to be necessary for achieving full and effective exchange of information.

1. *National tax authorities must have legal power to share with those of other countries such tax information as they have access to.*
2. *Tax authorities need to have the authority to acquire tax-relevant information from domestic institutions and other parties*
3. *Financial institutions and others themselves must possess the complete details of taxpayer relevant information.*

(Keen & Ligthart, 2006b, p.89-90)

According to Keen & Ligthart (2006b), obstacles to full information exchange might occur under any of the three stages. There are multiple obstacles that potentially can arise. The following illustrations are pointed out by Keen and Ligthart (2006b). Related to criterion one, full tax information exchange is difficult when the principle of double incrimination[12] is

[10] Tax Information Exchange Agreements will be referred to as TIEA in the remainder of this thesis.

[11] The OECD Agreement on Exchange of Information on Tax Matters will be referred to as the OECD model TIEA in the remainder of this thesis.

[12] Double incrimination can in the context of this thesis be explained as the requested jurisdiction refusing to provide information in relations with matters that fail to be regarded as a crime in the requested jurisdiction.

present. Another possible limitation of the effective exchange of information is if a jurisdiction only exchanges information whose content is relevant for domestic purposes.

Regarding the second criterion, legal restrictions regarding financial intermediaries, such as banks, might limit the information available to the domestic tax authorities. For instance, secrecy legislations could imply that a bank can choose to provide information only in cases of tax matters under criminal investigation. Such legal constrains must be terminated in order to facilitate the effective exchange of information.

Related to the third criterion, the following may be noted. Given that the legal framework enables the tax authority to obtain and exchange information, this is merely a necessary, not sufficient feature to obtain full exchange of information. As previously mentioned, legal frameworks in tax havens often exempt the IBCs from several obligations, as preparing or preserving accounts, and keeping an updated shareholder register. Hence, the financial institutions may not have adequate information on the requested individual or corporation, *"they may not have enough information to associate the details of a particular account or other asset with a particular individual or company"* (Keen & Ligthart, 2006b, p.90). According to Keen & Ligthart (2006b), these difficulties are exacerbated in countries allowing individuals to open anonymous bank accounts, or trusts to be registered as the owner of an account.

3.2 OECD's work on combating tax evasion:

The OECD's Harmful Tax Practices Project: The OECD's work on combating tax havens begun in 1996. The first quantitative outcome of this initiative was the report "*Harmful Tax Competition- An Emerging Global Issue"* (OECD, 1998). This report created a discussion aiming to find a solution on how to cope with harmful preferential tax regimes within the member states, as well as identifying tax havens outside of the OECD. In 2000, the OECD issued a list of non co-operative tax havens and a list of member states with possibly harmful tax regimes.

As seen in chapter 1, the OECD definitions of tax havens and harmful preferential tax regimes are to a large extent similar. Accordingly, it is difficult for this author to understand the discrepancy between the measures against the respective groups of jurisdictions. The initiative

to combat harmful preferential tax regimes was declared fully achieved by the OECD in 2006 (OECD, 2006c). This was done despite of the fact that some of these jurisdictions have tax systems whose features still make them similar to the tax systems of tax havens (Murphy et al., 2006; TJN, 2009c).

3.2.1 The OECD initiative on creating an agreement to enhance the effective exchange of information on tax matters:

The Global Forum on taxation, a branch of the OECD, issued the OECD Agreement on Exchange of Information on Tax Matters in 2002. This institution was a result of the OECD's Harmful Tax Practices Project. The forum includes OECD member countries, as well as jurisdictions considered as "cooperative partners"[13]. The aim of the OECD model TIEA is combating the jurisdictions recognized as tax havens by the OECD in 2000 through the exchange of information. In the following, the most important features of the OECD model TIEA will be described[14]. In addition, an agreement based upon the OECD blueprint will be discussed for illustrative purposes.

3.3 A description of the articles in the OECD Agreement on Exchange of Information on Tax Matters:

Article 1- Object and Scope of the Agreement:

Article 1 states the purpose of the respective agreement. " *The competent authorities of the Contracting Parties shall provide assistance through exchange of information that is foreseeably relevant to the administration and enforcement of the domestic laws(..)"* (OECD, 2002)[15].

According to the OECD (2002) commentary, the article aims to balance the rights of the investigated entities (individuals and businesses) with the need for effective exchange of information. The article expresses that the domestic rights of subjects in the requested party should apply unless it *"unduly prevents or delays effective exchange of information"* (OECD, 2002). According to the OECD commentary, taking care of these rights does not unduly

[13] The cooperative partners are states identified as tax havens by the OECD in 2000.

[14] The OECD model agreement consists of 16 articles. Each article consists of a varying number of paragraphs. The term article will thus in the following refer to each of the 16 articles as a whole. The term paragraph will refer to the paragraphs within the respective articles. The expression sub paragraph is also used in the following. This term refers to sub paragraphs making up the different paragraphs.

[15] The document containing the OECD model TIEA does not have page numbers. The citations are thus made without referring to a specific page.

prevent or delay the effective exchange of information unless it triggers the applicant party to question the usefulness of the agreement.

Article 2- Jurisdiction:

"*A Requested Party is not obligated to provide information which is neither held by its authorities nor in the possession or control of persons who are within its territorial jurisdiction "* (OECD, 2002).

According to the OECD (2002), the aim of this article is stating the jurisdictional scope of the agreement. Information held by non-residents in the requested jurisdiction is included in the jurisdictional scope.

Article 3- Taxes Covered:

This article makes clear what taxes are covered in the agreement. The bilateral version of the agreement does not specify what taxes the agreement should comprise. This is left up for the entering parties to decide. For the multilateral version of the blueprint, the OECD suggests that taxes on income, profits, capital, net wealth, estate, inheritance and gifts should be covered.

Article 4- Definitions:

Article 4 is devoted to defining terms used in the agreement (OECD, 2002).

Article 5- Information Exchanged upon Request:

According to this article, information is to be exchanged upon request. Information shall be exchanged in both *"civil and criminal matters"* (OECD, 2002). The OECD also emphasizes that all information ought to be exchanged regardless of whether the action is considered a crime in the requested jurisdiction.

Paragraph 2 contains instructions on how the requested party should act in the process of collecting information. If the requested government does not posses sufficient information, the requested party ought to *" use all relevant information gathering measures"* (OECD, 2002) in order to obtain the requested information. *"relevant information gathering measures"* is described in article 4. It typically includes

- *"Requiring the presentation of records for examination*

- *Getting access to records, and making copies of such records*
- *Interviewing persons having knowledge of the information requested"*

(OECD, 2002).

In addition, the OECD (2002) specifies that the requested party shall bring information to the requesting party even though the requested jurisdiction has no need for the information itself. Paragraph 4 states that the "competent authorities" of each jurisdiction need to provide information held by banks, financial institutions and other financial intermediaries. In addition, the competent authorities need to be able to obtain the information on the ownership structure of companies. At the end of sub paragraph b, the obligation to provide information is somewhat limited due the exemption to obtain information on ownership in situations where *"disproportionate difficulties"*(OECD, 2002) are experienced. In the OECD commentary the term is explained as a process *"involving excessive costs or resources"* (OECD, 2002).

Paragraph 5 imposes various claims on the requesting party with regards to what needs to be specified when requesting information.

Sub paragraph a establishes the need for the requesting party to identify the investigated taxpayer by name. This sub paragraph is to be interpreted liberally according to the OECD commentary. This implies that if the requesting party fails to identify a person by name, information such as account number or *"similar identifying information"* (OECD, 2002) is satisfactory.

Sub paragraph d obligates the requesting party to explain their reasons for believing that the requested information is feasible to obtain for the requested party (OECD, 2002).

Sub paragraph g encourages the requesting party to give a statement confirming that it has *"pursued all means available in its own territory to obtain the information, except those that would give rice to disproportionate difficulties"* (OECD, 2002).

Through paragraph 6, the OECD (2002) sets a time frame in which the requested information should be obtained. A receipt confirming the receiving of the request shall be given to the requesting party within 60 days. From the request is being received, the requested party has 90 days to either deliver the information requested, or explain it's reasons for inability or refusal to fulfill the request. The 90-day period may, however, be *"extended if required"* (OECD, 2002).

Article 6- Tax Examinations Abroad:

The article facilitates agents of the requesting party to operate on the territory of the requested party in order to obtain information on the tax matter investigated (OECD, 2002).

Article 7- Possibility of Declining a Request:

Through article 7, the requested party is granted the opportunity to decline providing information given that certain criterions are met. The right to refuse giving information is present when the requesting party would have been unable to obtain such information under its domestic laws. In addition, the article preserves the lawyer, client privilege. The article also makes clear that the requested party is free to decline a request *"in cases where the request is not made in conformity with the agreement"* (OECD, 2002).

Article 8- Confidentiality:

Through the content of this article, the OECD (2002) states that confidentiality is a key feature to achieve the effective exchange of information. Confidentiality may in this context be understood as a feature securing that individuals and authorities investigating the particular tax matter are the only ones able to use the information obtained. Confidentiality is necessary to prevent third parties from exploiting information obtained through information requests.

Article 9- Costs:

With regards to costs, the entering parties are advised to agree upon own rules on how the costs should be distributed (OECD, 2002). The OECD commentary states that generally, the requested party should cover the costs if they would have incurred regardless of the information exchange.

Article 10- Implementing Legislation:

The OECD imposes the requirement to *"enact any legislation necessary to comply"* (OECD, 2002) with the agreement through this article.

Article 11- Language:

This article gives the jurisdictions the freedom to agree on what languages the agreement will exist in (OECD, 2002).

Article 12- Other International Agreements or Arrangements:

The purpose of this article is facilitating that the entering parties are able to use the measure they find most appropriate to get hold of information (OECD, 2002).

Article 13- Mutual Agreement Procedure:

In case of difficulties arising with regards to interpretation or implementation, the aim stated by the OECD (2002) is that the matter is solved by mutual agreement. The agreement allows the contracting parties to solve problems by other means if the parties are unable to reach a mutual agreement. In this context arbitration is a suggested method.

Article 14- Depositary's functions:

The article is designed for the multinational version of the agreement. It describes the functions of the depositary (OECD, 2002).

Article 15- Entry into force:

The article describes when the agreement enters into force. With respect to the multilateral agreement, it is emphasized that a jurisdiction only is bound vis-à-vis a contracting party where it is mutually stated that the parties wish to be bound vis-à-vis each other (OECD, 2002).

Article 16- Termination:

This article deals with the termination of the agreement. The contracting parties are free to terminate the agreement at whatever time they wish to do so (OECD, 2002).

3.4 A discussion of the features in the OECD Agreement on Exchange of Information on Tax Matters:

In the following, features of the previously described agreement will be discussed. It will be made a distinction between the strengths and the weaknesses of the agreement.

3.4.1 Strengths:

3.4.1.1 The principle of double incrimination is not a legitimate reason to deny providing information:

In article 5, it is stated that requested information needs to be delivered regardless of whether the principle of double incrimination is fulfilled or not. The implication is that a requested jurisdiction is unable to deny disclosing information because the action is considered legal

according to their domestic legislation. The author of this thesis agrees with Neslund (2009) that this is a strong point of the agreement.

3.4.1.2 The lack of relevance for the requested party is not a legitimate reason to deny providing information:

In article 5, paragraph 2, it is made clear that the requested party ought to provide information regardless of whether the information is of relevance for the requested party. If the irrelevance for the requested party were to be an adequate reason not to provide information, the information provided due to TIEAs would be scarce (Neslund, 2009). The reason is related to the structures in tax havens described in chapter two. The tax legislations in tax havens do not obligate individuals or companies to pay taxes on income or capital to the same extent as in non-havens. It is thus plausible that it is a discrepancy between the information considered relevant in the haven and non-haven jurisdiction, as tax authorities in tax havens probably need less information to perform their tasks. Hence, if the information needed to be relevant to both parties, the information exchanged would be considerably limited.

The existence of the former and the latter mentioned strength implies that the first condition stated by Keen & Ligthart (2006b) related to the effective exchange of information holds.

3.4.1.3 The contracting parties are obliged to curb secrecy legislations related to banks and other financial intermediaries in order to ensure information exchange:

As pointed out by McIntyre (2009), it is a strength that article 5, paragraph 4, states that the contracting parties ought to curb secrecy legislations related to financial intermediaries to facilitate that requested information is being provided. This is the only domestic structural change the agreement imposes on the contracting parties. It is nevertheless an important structural change since banks and other financial intermediaries probably possess useful information related to tax evasion.

The obligation to overcome bank secrecy implies that the second condition stated by Keen & Ligthart (2006b) related to the effective exchange of information is met. The strength of this structural change can, however, be modified if jurisdictions still allow individuals to open bank accounts without using their own name.

The problem may be illustrated by questioning what would happen if an individual avoided holding a bank account in his own name with help from a lawyer. The extent to which the requested party will find information on this bank account useful, or even know that the

account is existing, is dependent on whether the lawyer chooses to disclose this information. The OECD model TIEA does not prevent banks from allowing the existence of such accounts.

3.4.2 Weaknesses:

3.4.2.1 The OECD model TIEA only facilitates information to be exchanged upon request:

The exchange of information upon request can be defined as *"a situation where one competent authority asks for particular information from another competent authority"* (OECD, 2002).

In the description of article 5, numerous specifications related to making the information request were mentioned. More specifically, article 5, paragraph 5, sub paragraph a imposes detailed requirements with respect to the identification of a taxpayer in order for the request to be adequate.

Despite of the opportunity to use *"similar identifying information"*(OECD, 2002), scholars (McIntyre, 2009; TJN, 2009b, Neslund, 2009) state that having to identify a taxpayer to this extent is unfortunate for the purpose of effectively exchanging relevant information on tax matters. As McIntyre (2009) points out, the goal of an information request is sometimes to learn the name of individuals involved in tax evasion.

The choice to use this kind of information exchange as the only tool to exchange information is a flaw in the design of the agreement (Neslund, 2009; TJN, 2009b, McIntyre, 2009). The reasoning can be divided in two parts.

First, the formal requirements such as the identification of the individual related to the information requested, makes the process of requesting information a complex one. It requires considerable resources, such as time and money (Neslund, 2009; TJN, 2009b).

Second, Neslund (2009) and TJN (2009b) argue that due to the requirements for requesting information, it is seldom possible for the requesting jurisdiction to pursue information related to a suspicion without having evidence before making the request.

Due to the previous arguments, the author of this thesis agrees with the view of Tax Justice Network (TJN, 2009b). TIEAs basing the exchange of information solely upon request will

only provide the requesting party with information in cases where mistakes have been made, or when the requesting party already has a strong case before requesting information.

3.4.2.2 The OECD model TIEA lacks sanctions for violating the time frame:

In article 5, paragraph 6, it is stated that the requested jurisdiction has a time frame in which information ought to be obtained. The failure to provide the information requested within 90 days has no consequences for the requested party. This gives the requested party the possibility to delay giving the information several times, effectively making sure that the requested information fails to be received while it is relevant for the requesting jurisdiction. The only possibility for the requesting party is to extend the time frame or accept that the requested information is absent if the time frame is violated.

3.4.2.3 The OECD model TIEA does not oblige tax havens to change their harmful structures:

Through article 2 (OECD, 2002) it is stated that the contracting parties are exempted from providing information they do not already possess. Due to the characteristics of tax havens described in chapter two, it is plausible that tax havens possess very little information before entering a TIEA. If these structures remain after signing a TIEA, the tax havens will have little information to provide the other contracting party with. This will decrease the potential efficiency of entering a TIEA resembling the OECD model TIEA. In the opinion of this thesis, the structures in tax havens remain after signing a TIEA. The basis for this claim may be demonstrated by assessing what the OECD model TIEA actually make the tax havens change with respect to the harmful structures within their jurisdictions. Such an attempt will be made in the following.

International Business Companies: The OECD model TIEA does not impact the opportunity to be registered as an IBC in a tax haven. In the following, it will be discussed whether some of the exemptions or freedoms granted IBCs are changed by the OECD model TIEA.

Exemption from the obligation to prepare accounts: There are no clauses in the OECD model TIEA forcing the tax havens to start obligating IBCs to prepare accounts.

Exemption from the obligation to preserve accounts: As the agreement imposes no obligation to prepare accounts, IBCs are not obligated to preserve accounts either.

Exemption from the obligation to audit: Following the same logic as above, the OECD model TIEA does not obligate tax havens to make IBCs audit.

Exemption from the obligation to keep an updated register of shareholders: The OECD model TIEA explicitly states that the "competent authorities" of each jurisdiction need to *"use all relevant information gathering measures"*(OECD, 2002) when requested to obtain information on the ownership structure of companies.

Despite of this, the agreement does not attempt on establishing a standard for what constitutes adequate information regarding shareholder registers. The implication is that the tax havens don't commit on obligating IBCs to keep an updated register of shareholders. It can be claimed the competent authorities of tax havens merely are obligated to use *"all relevant information gathering measures"*(OECD, 2002) to pursue information that companies have no duty to keeping track on. The probability of useful information being provided is thus slim.

Exemption from holding the board meetings locally: The OECD model TIEA does not impact the possibility to hold board meetings outside of the jurisdiction in which the company is registered.

An implication of the freedom to hold board meetings abroad is the low probability of board documents being available in the tax haven. This contributes to less valuable information being held in the tax haven. The probability of board documents being in the tax haven increases if the company has local board members. However, the OECD model TIEA does not impose this.

The freedom to redomicile the company: The OECD model TIEA does not restrict the entering parties from allowing companies registered in their territory to redomicile.

The freedom to choose the company suffix or abbreviation, name and address: The agreement does not infer with the freedom companies registered in tax havens have to present itself in a way suggesting that the company is registered in a jurisdiction not identified as a tax haven.

Distinctive company structures: The OECD model TIEA does not make trusts or protected cell companies illegal, nor harder to establish.

With regards to company structures, failing to address how to abolish the use of the trust

structure is of particular importance. This is due to the extensive use of this structure. The existence of trust structures makes it difficult to obtain relevant information from tax havens even if a TIEA is in place. The difficulties likely to arise can be illustrated by an example. A trust registered in a tax haven may have a trustee whose residency is in another jurisdiction. If the authority in the requesting jurisdiction tries to obtain information on the trust, they will start their inquiries in the jurisdiction in which the trust is registered. Here, they will learn that the trustee is resident in another jurisdiction. The requesting authority must thus approach this jurisdiction in order to obtain relevant information about the trust. In the mean time, the beneficiaries of the trust have time to move the trustee position to yet another country. This exercise can be repeated until the investigation is antiquated in the requested jurisdiction, or until the jurisdiction gives up on finding the information.

Another point worth noting regarding trusts is that the OECD model TIEA lacks a definition of what the beneficial owner of a trust is. It can be claimed that this is a flaw due to different definitions of beneficial owners among the contracting parties. For the competent authorities in non-haven jurisdictions, a beneficial owner is the real owner of the funds in the trust (i.e. the individual having the actual control of the funds in the trust). The tax havens could, on the other hand, claim that the beneficial owner is the formal/ legal owner of the trust. The tax havens have an incentive to present this claim, since this could halt the process of obtaining information. The lack of a definition could thus create a complex process for the requesting party in identifying the individual of which useful information is to be found.

Secrecy: The degree to which the secrecy feature in tax havens is reduced depends on the change in the other domestic structures.

Entering a TIEA whose features are relatively similar to the OECD model TIEA does not enforce changes on the legal structures in tax havens. Nevertheless, the OECD model TIEA explicitly states that the competent authorities of the jurisdictions need to have the power to obtain the information that is available within its jurisdiction. This implies that information held by banks, attorneys and financial institutions needs to be provided to the government if requested. This clearly has a potential impact on the secrecy feature in tax havens. Given that the requested party deems the information request to be adequate, such information could be transferred to the requesting party. This could potentially limit the secrecy feature of the tax

haven with regards to information on transactions and investments made by individuals and corporations.

On the other hand, it can be claimed that the net effect from the decreased ability to enforce secrecy are likely to be halted by the fact that the remainder of the structures in tax havens could, and most likely will remain the same (TJN, 2009b). As pointed out in article 2 (OECD, 2002), tax havens are exempted from providing information they do not collect. As described by Neslund (2009), most tax havens collect very little information before entering TIEAs. Since the structures are likely to remain the same after signing an information exchange agreement, the information collected is still scarce after entering such agreements. Financial intermediaries will thus not possess a larger amount of relevant information after signing a TIEA. Hence, the level of secrecy within a tax haven probably remains after entering information exchange agreements.

Another aspect that effectively reduces the extent to which the secrecy feature is curbed is that information is to be exchanged upon request. The process of getting the request to be recognized as adequate in the requested jurisdiction is according to Neslund (2009) and TJN (2009b) labor intensive due to the formal processes of making the request, as well as demanding with respect to required knowledge that needs to be obtained on the tax evasion before requesting information. This legitimizes the tax havens to more easily turn down requests due to the request being inadequate according to the signed agreement. According to NOU (2009:19) this is particularly challenging for poor countries as they often lack the skills and competencies necessary to successfully manage a process of requesting information. In addition, the nature of the information exchange gives the tax havens time to inform the subjects whose actions are being investigated by another jurisdiction. This gives the suspect time to restructure its dispositions in such a manner that collecting evidence from the information provided is impossible for the requesting party.

Last, the lack of sanctions for violating the time frame allows the tax haven to postpone providing information until the case is antiquated in the requesting party. This also contributes to keeping the secrecy feature in tax havens.

Based on the claims presented in this section, this thesis concludes that the secrecy feature in tax havens remains in spite of entering TIEAs resembling the OECD model TIEA.

3.4.2.4 Multilateralism:

The Tax Justice Network (TJN, 2009b) notes that the OECD interpretation of multilateralism differs from the traditional interpretation. This is claimed to represent a weakness since each country has to negotiate in pairs despite of having entered the same multilateral agreement. This makes the process of facilitating the exchange of information costly and time consuming.

3.4.2.5 Territorial limitations on the obligation to obtain information:

McIntyre (2009) claims another weakness is that article 2 limits the requested party's obligation to obtain information to what is found within its "territorial jurisdiction". The information exchange would probably go more smoothly if the requested party also were obligated to obtain information outside their territory, given that the requested jurisdiction is the one with the highest likelihood of obtaining that information.

3.4.2.6 The OECD model TIEA contains vague expressions and fails to establish guidelines for interpretation of terms whose meaning is ambiguous:

The choice of words in the agreement and the explanations in the commentary are intentionally ambiguous and vague. It can be strategic to design a model agreement in such a manner since the purpose of the agreement is to serve as a template for agreements between various pairs of contracting parties. In this context, the vagueness of the agreement is preferable, since it makes it easier for the contracting parties to design the agreement in such a manner that it effectively suits this particular pair of countries.

Nevertheless, this vagueness can be a double-edged sword. The ambiguous nature of the chosen words will give the contracting parties numerous reasons to avoid providing the information requested from the other state. Through the description of the agreement, it was discovered that the OECD model TIEA consists of numerous expressions that could serve as tools legitimizing the refusal of a request to provide information.

The first example of the vague choice of words is found in article 1, and is related to the stated purpose of the agreement. The term "foreseeably relevant" is unclear in establishing what kind of information that is comprised by the agreement (McIntyre, 2009). The OECD (2002) commentary argues that the term foreseeable is used to underline that the agreement includes exchange of information to the widest extent possible. However, the OECD (2002) emphasizes that the agreement does not grant the liberty of starting experimental or unfounded requests. That requests involving *"fishing expeditions"* (OECD, 2002) are

prohibited implies that the requesting party must have the ability to verify the relevance of the information requested (McIntyre, 2009).

Article 1 also includes another example of ambiguous choice of words. This ambiguity is related to that the domestic rights of the indicted should be prioritized unless this *"unduly prevent or delay effective exchange of information"*(OECD, 2002). The OECD claims that information is unduly prevented or delayed if the requesting jurisdiction questions whether the TIEA entered into is useful. What makes a jurisdiction question the usefulness of an agreement is a subjective matter. Hence, the OECD has made a vague attempt to balancing the concern for the taxpayer and the need for effective exchange of information. It seems as though this has been done intentionally, leaving it up for the parties entering the agreement to figure out how the respective needs ought to be balanced. The advantage of this ambiguity is that the contracting parties of each agreement set terms they can relate and act according to. The disadvantage is that this calls for extensive negotiation every time a TIEA is entered into, in order to establish which circumstances that will be identified as significantly damaging for the effective exchange of information.

A third example of the vague choice of words presents itself in article 5, paragraph 2. As pointed out by the tax justice network (TJN, 2009a), the term *"relevant information gathering measures"*(OECD, 2002) does not have a clear meaning. In the OECD (2002) commentary, it is advised that the term "relevant" is to be interpreted as all measures capable of obtaining the requested information. It is, however, up for the requested jurisdiction to decide what constitutes relevant. Thus, what constitutes relevant gathering measures should be specified to avoid jurisdictions using this opportunity to justify not looking for information.

In article 5, paragraph 4, the failure to obtain ownership information is legitimated in situations where *"disproportionate difficulties"*(OECD, 2002) are experienced. A possible problem triggered by the vagueness of this term is the potential discrepancy between what is considered disproportionate in the eyes of the requesting and requested party respectively. The problem could be illustrated with the following example. In chapter two, it was established that IBCs are exempted to provide information on the ownership structure of companies. The implication is that *"disproportionate difficulties"* further explained by the OECD as *"excessive costs or resources"*(OECD, 2002) must most likely be involved when the authorities in tax havens attempt to find such information.

In sum, the lack of clear definitions of important terms increases the likelihood of information requests being labor-intensive processes with low probabilities of obtaining relevant information. The problems related to the lack of definitions are especially pronounced in cases involving "soft" information. In this context, soft information refers to all information apart from information held by banks. The lack of a definition of what is *"foreseeably relevant"* increases the probability of the requesting competent authority receiving documents whose content is irrelevant for an investigation. The requesting authority sometimes receives a random, unorganized box of documents from the company. The likelihood of this occurring would decrease if the OECD model TIEA specified what kind of information that is perceived as relevant for the requesting party.

3.4.2.7 Formal requirements:

The OECD model TIEA imposes numerous formal requirements the requesting party needs to meet when requesting information. Whether or not these criterions are met is up for the requested party to decide. Since the agreement fails to set standards for what should constitute an adequate request in this context, the decision rests solely upon the subjective opinions of the requested party. This also provides the requested party with numerous reasons to deny providing information.

An example of such formalities is article 5, paragraph 5, sub paragraph g. This sub paragraph states that the requesting party needs to declare that they have *"pursued all means available in its own territory to obtain the information, except those that would give rise to disproportionate difficulties"* (OECD, 2002). The sub paragraph contradicts the principle of effective exchange of information, since this formality hardly represents necessary information (McIntyre, 2009). It is plausible that trying to obtain the information within its own jurisdiction is the most efficient measure for obtaining the information. Naturally, one would expect a jurisdiction to use all domestic measures available before asking another jurisdiction for help.

Article 5, paragraph 5, sub paragraph d provides another example of imposed formalities. This sub paragraph obligates the requested jurisdiction to declare that they believe the relevant information to be within the reach of the requested party. McIntyre (2009) states that this can be interpreted as a measure making it more difficult for the requesting party to obtain

information, and accordingly, this sub paragraph makes it easier for the requested party to delay or deny giving the information requested.

A negative consequence of the imposed formalities is to be found in article 7; the possibility to decline a request. Through this article, the requested party is granted the opportunity to deny disclosing information if the formal requirements related to the agreement are not met. What is unfortunate in this context is that the agreement has many formalities attached to it. In addition, the choice of words for describing the necessary process when requesting information is ambiguous. This could provide the requested party with various opportunities to avoid providing information, by claiming that one (or more) of the formal requirements is inadequately met.

3.4.2.8 The OECD model TIEA lacks sanctions if the requested information fails to be provided:

The current OECD model TIEA imposes no sanctions on jurisdictions failing to provide the information requested.

The only potential sanction is related to termination of the agreement. That one of the contracting parties chooses to terminate the agreement may serve as a punishment given that there is a feature of mutual dependence on the effectiveness of the agreement. To see whether the entering parties perceive termination as a sanction, it is necessary to assess the incentives within both groups of contracting parties, tax havens and OECD member countries. Such an attempt will be made in chapter four and five.

3.5 The TIEA between Norway and Isle of Man:

Motivation:

There are mainly two reasons why studying an actual agreement is appropriate. First, it is interesting to see whether some parts of the model TIEA have been left out of the agreement. Second, the study of an actual TIEA aims to disclose whether the jurisdictions have chosen to add features as a supplement to the features proposed by the OECD.

The TIEA between Norway and Isle of Man is chosen since it is considered to be representative for the design of all TIEAs in which a Nordic country is one of the entering parties. In order to save time and money, a Nordic co-operation on taxation was launched in

2006 (Norden). The aim for the project was co-ordination of the Nordic efforts on negotiating TIEAs with tax havens. A feature of this co-operation is that the negotiation and accordingly, the TIEAs entered into by the Nordic countries, are the same. In addition, TIEAs in which one of the entering parties is a Nordic country are interesting since Nordic countries are involved in a considerable amount of the TIEAs currently entered into (TJN, 2010b). Of the 373 TIEAs entered into by September 8 2010, 160 had a Nordic country as one of the entering parties.

3.5.1 A comparison between the TIEA between Norway and Isle of Man and the OECD model TIEA:

The agreement entered into by Norway and the Isle of Man, October 30 2007, does not merely serve as a TIEA. It is also an agreement aiming to avoid double taxation (Finansdepartementet, 2007-2008). For the scope of this thesis, the part of the agreement whose purpose is the exchange of information on tax matters is the most relevant, and is thus the one emphasized. In the following, a description of the articles relative to the articles in the OECD model TIEA will be given.

Article 1- Scope of the Agreement:

This article is to a large extent similar to the first and second article of the OECD model TIEA.

Article 2- Taxes Covered:

Article 2 states that the agreement covers taxes on general, personal and petroleum income imposed by Norway. In addition, taxes on rent income from production of hydroelectric power and the withholding tax on dividends are covered. Regarding taxes imposed by Isle of Man, taxes on income and profit are included.

Article 3- Definitions:

The article defines the terms used in the latter of the agreement.

Article 4- Exchange of Information Upon Request:

The article closely resembles article 5 in the OECD model TIEA. However, there are three exceptions. The paragraph stating what information should be specified in the information request contains a sub paragraph requesting the *"period for which the information is*

requested" (Finansdepartementet, 2007-2008[16]). This additional specification probably creates a broader base for the requested party to deny giving information, due to the request being inadequate in its form.

This argument can, however, be modified. In cases where the requesting authority has a period of time within which the information is likely to exist, increasing the specification of the request may positively influence the likelihood of obtaining relevant information, as there is less data to process for the requested and requesting parties. The clause is thus only harmful if the requesting party lacks a time frame to include in the information request.

Article 4 does also contain a second sub paragraph that differs from the OECD model TIEA. In the beginning of article 5, paragraph 5 in the OECD agreement it is stated that the information specified in sub paragraph a through g need to be provided to the requested party in order to demonstrate that the information requested is of foreseeable relevance for the requesting party. In the TIEA between Norway and Isle of Man, this sentence does not occur in the beginning of the corresponding paragraph. Instead, the requesting party needs to demonstrate the foreseeable relevance of the information requested through sub paragraph e. The difference between the designs is that in the OECD model agreement, adequately answering sub paragraph a through g will ensure the requested party that the information is of foreseeable relevance. In the TIEA between Norway and Isle of Man, this is not necessarily the case. Since the foreseeable relevance needs to be stated in a direct manner instead of answering the remaining sub paragraphs adequately, it could be claimed that the bar for getting information to be recognized as foreseeably relevant is higher in the TIEA between Norway and Isle of Man than in the OECD blueprint. In addition, this additional sub paragraph adds to the formal process of requesting information, which is unlikely to enhance the process of effectively exchanging information.

Paragraph 6 (compared to article 5, paragraph 6 in the OECD model TIEA) differs from the model agreement. It presents a vaguer approach to setting a time frame for what ought to happen in the process of responding to the request. Paragraph 6 merely states that the requested party shall *"acknowledge receipt"* (Finansdepartementet, 2007-2008) of the request. A time frame within which the requested party needs to respond fails to be

[16] The document containing the TIEA between Norway and Isle of Man does not have page numbers. The citations are thus made without referring to a specific page.

mentioned. Correspondingly, a time frame with regards to when the requested information should be forwarded or declared unattainable by the requested party is not present in the agreement between Norway and Isle of Man.

The paragraph vaguely states that the requested party shall use its *"best endeavors"* to obtain the information as soon as possible. The lack of a concrete time frame within which the requested party should handle the request, leaves the requesting party with no possibility to demand a response at or within a particular time. The consequence will probably be that the persecution and the investigation of the subject in question will be delayed. In the most extreme scenario, the investigation could be delayed until it is declared antiquated.

Article 5- Tax Examinations Abroad:

The article corresponds to article 6 in the OECD model TIEA.

Article 6- Possibility of Declining a Request:

Article 6 is based upon article 7 in the OECD model TIEA. The articles are mainly the same, yet the structure is somewhat different.

Article 7- Confidentiality:

Article 7 is based on article 8 in the OECD model TIEA, and the two articles are essentially the same.

Article 8- Costs:

The article is based on article 9 in the OECD model TIEA. The article mainly resembles the OECD commentary to the respective article. Accordingly, the "ordinary costs" in providing assistance is to be covered by the requested party. Further on, extraordinary costs incurred are to be covered by the requesting party. The parties also agree on consulting each other with regards to the distribution of the incurred costs. The latter is also in accordance with the OECD commentary.

Article 9- Language

The article states that the requests and responses shall be in English.

Article 10- Mutual Agreement Procedure:

Article 10 corresponds to article 13 in the OECD model TIEA.

Article 11- Entry into force:

The article is similar to article 15 in the OECD model TIEA.

Article 12- Termination:

This article corresponds to article 16 of the OECD model TIEA.

3.5.2 Concluding remarks on the TIEA between Norway and Isle of Man:

The purpose of the following paragraphs is answering whether the TIEA between Norway and Isle of Man contains significant deviations from the blueprint on which it is based. The time frame suggested in article 5 paragraph 6 in the OECD model TIEA is left out of the agreement between Norway and Isle of Man. The time frame proposed by the OECD gives the requested party 60 days of confirming that they have received the information request. In addition the time frame gives the requested party 90 days to either deliver the requested information or explain why the requested information fails to be provided. The contracting parties have no time frame within which they ought to process the information request in the TIEA between Norway and Isle of Man. This could make it easier for tax havens to avoid exchanging information, since the other contracting party has no ability to oblige the tax haven to explain their inability or refusal to provide the information requested within a specific deadline. The pace at which the information request is processed is thus entirely up for the tax haven to decide. At the same time, the OECD blueprint allows the tax havens to violate the time frame proposed in article 5, paragraph 6 to the extent they wish without sanctions occurring. The effectiveness of the TIEA between Norway and Isle of Man is therefore suggested to be similar to the OECD model TIEA despite of the absence of a time frame. Except from the latter mentioned deviation, the TIEA between Norway and Isle of Man does not exclude essential features of the OECD model TIEA.

Further on, it is not added features in the TIEA between Norway and Isle of Man that makes the potential effectiveness of this agreement significantly different from the OECD model TIEA. The comparison between the OECD model TIEA and the TIEA between Norway and Isle of Man showed that the latter agreement contains two additional specifications related to

requesting information. The agreement encourages the requesting party to specify the time frame within which the requesting party pursues information. In addition, the foreseeable relevance of the information requested needs to be explicitly proven by other means than answering the other requirements in article 4, paragraph 5 adequately. It is the opinion of this thesis that the additional specifications not necessarily change the effectiveness of the TIEA between Norway and Isle of Man significantly from the effectiveness of the blueprint. Both the additional specifications add to the formal process of requesting information. Nevertheless, this author finds that the two additional specifications do not change the nature of the information requesting process in a radical manner. The reasoning is that the process of requesting information is cumbersome and demanding in the blueprint as well.

This author thus concludes that the TIEA between Norway and Isle of Man will have the same effectiveness in combating tax havens as the blueprint on which it is based. The conclusion with regards to the effectiveness of the OECD model TIEA and the TIEA between Norway and Isle of Man will therefore be made at the same time.

3.6 Conclusion: Are the OECD model TIEA and the TIEA between Norway and Isle of Man likely to be effective tools for combating tax havens?

The purpose of the following paragraphs is answering whether the OECD model TIEA and agreements based upon it could serve as adequate tools to fight tax havens. According to the discussion in this thesis, the OECD model TIEA as well as the TIEA between Norway and Isle of Man (hereafter referred to as the Agreements) meet two of the three criterions set by Keen & Ligthart (2006b) for achieving full information exchange[17]. The first criterion states that the competent authorities of each jurisdiction must possess the power to share the information they have access to with the competent authorities of other governments. The second factor describes that tax authorities must be able to collect tax information from domestic stakeholders possessing this information. The third condition explains that financial intermediaries and other significant institutions must be able to obtain information relevant for the tax matters of their clients.

As mentioned, Keen & Ligthart (2006b) state that failure to meet either of the criterions might lead to less than full information exchange. The third criterion is the one inadequately met

[17] The criterions were described and explained in the beginning of chapter 3.

according to the analysis in this thesis. The reason for this inadequacy is that the structures within the tax havens remain the same. According to the framework established by Keen & Ligthart, the Agreements will thus not be an adequate tool for achieving effective exchange of information.

Another approach to determine the effectiveness of the Agreements is assessing whether the methods used for evading and avoiding taxation through tax havens are limited when a tax haven enters into a TIEA. In the opinion of Kudrle (2008) and Dharmapala (2008), secrecy is the essential trait for evading tax on the personal income level when following the residency principle. According to the discussion in this chapter, the secrecy feature is assumed to be a structure that remains in tax havens despite of entering into TIEAs resembling the OECD model TIEA. Hence, the Agreements do not make tax evasion on the personal level impossible.

When corporations are being taxed according to the residency principle, the common way of using tax havens is claiming residence in such jurisdictions whilst being located and/ or managed from somewhere else. The assessment of the Agreements did not discover any features making it more difficult to claim residency based on artificial terms. Thus the Agreements fail to use limit this use of tax havens.

The ways of evading and avoiding taxes on the corporate level when following the source principle do, according to Kudrle (2008) and NOU (2009:19) revolve around exploiting the legislation in a way that provides the smallest tax base for the corporation as a whole. This is facilitated through the exemptions and freedoms granted the IBCs. The discussions of the Agreements made it clear that the Agreements do not oblige the entering parties to change their domestic structures[18]. It can thus be claimed that according to this view, the Agreements do not impose difficulties to evade or avoid taxes on the corporate level.

A third way of determining the effectiveness of the OECD initiative is to study the number of agreements resembling the OECD model TIEA entered into. In order to have TIEAs between all the jurisdictions identified as tax havens by the OECD in 2000, and the OECD member countries, 1230 TIEAs need to be entered into. As pointed out by TJN, (2009b), entering TIEAs is costly and labor intensive. This is mainly due to the bilateral negotiation required.

[18] The exception is the change in the bank secrecy rules. This change was, however found to have little effect since the other structures remain the same.

This might be the reason why only 447 agreements are entered into since the launch of the OECD initiative in 2002, nearly a decade ago. In addition, not all of these agreements have entered into force, and some of the agreements are entered into with a pair of tax havens as contracting parties. The number of effective TIEAs is thus likely to be lower (TJN, 2009b). The implication is the following; even if the OECD model TIEA were effective in combating tax havens, the effect from combating tax evasion through TIEAs would be limited due to the extensive number of agreements necessary to enter into in order to cover all relevant jurisdictions[19]. This serves as another argument claiming that the OECD model TIEA initiative is inefficient.

With regards to the latter way of determining the effectiveness of the OECD initiative, the following may be noted. Having a TIEA between every relevant pair of jurisdictions merely serves as a necessary starting point, facilitating that the OECD initiative could ever be successful. Entering TIEAs is not sufficient to combat tax havens. One can thus not measure the success of the OECD initiative by the number of TIEAs entered into.

The fact that the Agreements only facilitate information to be exchanged upon request makes the success of the initiative dependent on the number of information requests adequately answered (NOU, 2009:19; TJN, 2010c). As pointed out in the discussion of the Agreements, making an information request is likely to be a labor-, knowledge- and cost intensive process. This serves as the first factor limiting the potential number of information requests answered. The second feature influencing the number of information requests answered is the extent to which the requested jurisdiction can escape responding to a request. Based on the discussion of the Agreements, this may be done in four ways. First, claiming that the formal requirements are inadequately met could legitimize refusing to answer a request. Second, the vague terms in the Agreements make it possible to provide irrelevant information. Third, the requested jurisdiction can avoid answering the inquiry by violating the time frame. Last, the jurisdiction may be exempted from answering the request if the information is not collected or possessed by domestic institutions. Based on these possibilities, it is the opinion of this author that the probability of many information requests being answered is low.

[19] In addition, it can be claimed that the necessary number of TIEAs to enter into is considerably higher than 1230. As pointed out by TJN (2009b) the scope of the OECD needs to be extended to cover jurisdictions not members of the OECD, such as developing countries, and tax havens identified by other organizations.

This may be illustrated by studying the information provided through the 30 TIEAs in which Norway is an entering party. The Norwegian Tax authorities submitted four information requests through the course of 2010 (E24, 2011). By January 31, 2010, Norway had received tax information from tax havens on two occasions, since it started entering TIEAs in 2006 (E24, 2011). Based on this example, it is a reasonable claim that Norway has made a limited number of information requests, and that the response frequency of the requests made is low. The low number of information requests prepared could illustrate that a jurisdiction might need information from other sources in order to be able to request information in an adequate manner. The need for information from other sources could decrease the potential efficiency of fighting tax havens through information exchange, as it is plausible that one would wish to request information in cases where one has limited information from other sources.

Based on the previous paragraphs, this thesis claims that the OECD model TIEA and agreements based upon it will be inefficient unless both the contracting parties have the incentives to achieve effective exchange of information. The OECD model TIEA has no legal tools an entering party can apply to ensure that their counterpart is in compliance with the agreement. The consequence is that the contracting parties need to have the incentives to act compliantly in order for agreements of this nature to be effective. In addition, entering TIEAs as well as adequately making and answering information requests demand considerable efforts. This is also a reason why the initiative is dependent on incentives for compliance among the contracting parties.

The next two chapters are devoted to studying whether the contracting parties have the incentives to act in a manner that enhances the effective exchange of information. The first chapter will assess whether the contracting parties have the economic incentives to achieve the effective exchange of information on tax matters. The second chapter aims to establish whether matters related to reputation, political climate and international relations could have an effect on the contracting parties' incentives to engage in information exchange.

4 Chapter IV - The economic incentives among the contracting parties to engage in information exchange:

In the following section, theories concerning when both groups of contracting parties[20] have the incentive to exchange information will be assessed. The aim of this section is to figure out whether entering an agreement based on the OECD model TIEA can be effective in combating tax havens despite of its shortcomings. If both the contracting parties have the incentive to achieve the effective exchange of information, the exchange of information could be effective even though the OECD model TIEA in itself has significant flaws attached to it.

4.1 Incentive Theory

The research with regards to incentives to exchange information is currently small. In the paper *Information Sharing and International Taxation: A Primer,* Keen & Ligthart (2006b) assess the theoretical contributions aiming to study the incentives to engage in the exchange of information. The theoretical contributions presented in this paper are all studied in this thesis. Three of the five contributions assessed in the respective article will, however, not be discussed. The three excluded models are considered to be inadequate for the purpose of this paper since they rest upon assumptions whose features make the situation modeled to be in stark contrast to the situation dealt with in this thesis[21]. In the following, the theories whose features make them relevant for the purpose of this paper will be presented.

4.1.1 Incentive Theory 1: Exchange - of - Information Clauses in International Tax Treaties- Bacchetta & Espinosa (2000):

The main purpose of the paper by Bacchetta & Espinosa (2000) is to understand when countries are likely to cooperate on information exchange. The authors attempt to understand

[20] The groups of contracting parties are the OECD member countries and the jurisdictions identified as tax havens by the OECD in 2000.

[21] The contributions ruled out are: *Information Sharing and Competition among governments* (Bacchetta & Espinosa, 1995), which is ruled out due to the assumption of symmetric countries. Second, the article *Withholding taxes or information exchange: the taxation of international interest flows* (Huizinga & Nielsen, 2003) is excluded due to the assumption of symmetric countries. Third, the article *Revenue Sharing and Information Exchange under non-discriminatory taxation* (Keen & Ligthart, 2005) is left out due to the assumption of non-discriminatory taxation, which is a situation seldom observed in practice.

this by setting up a model expressing a country's welfare gains and losses from not acting in accordance with an information exchange clause. By maximizing this welfare problem, the authors derive situations in which it is optimal to act in accordance with the information exchange clause, and situations in which it is not.

The assumptions; The framework is set up as a two-country model[22]. The negotiating countries are assumed to be asymmetric. The term reflects differences in factors such as country size, the capital flows' sensitivity to information exchange, monitoring technologies and the domestic investors' investing patterns. In addition, repeated interactions among optimizing governments are assumed. Further, the game is assumed to consist of two different instruments; the taxes levied on non-residents and the amount of information provided to the other government.

The authors further assume that it is feasible for the governments to monitor all domestic investment, and that the inhabitants of the respective countries have an incentive to evade taxes by investing in the other country. It is also assumed that the governments weigh the marginal income against the marginal cost of not providing information when considering whether or not to engage in information exchange. By not providing information, the government experiences a one-period welfare gain. This welfare gain is weighed against the welfare loss the government suffers from in the next period onwards. The welfare loss is assumed to stem from the latter government detecting the non-cooperative behavior of the former, which leads to the latter government behaving non-cooperatively as well. If the welfare gain offsets the future welfare losses, the government will lack the incentive to exchange information.

The conclusions, situations in which countries are likely to lack incentives to engage in information exchange; Bacchetta & Espinosa (2000) claim that one of the contracting parties will lack the incentive to exchange information if the information exchange clause imposes a reciprocity requirement between asymmetric countries, if there are one-way capital flows between the contracting parties and if information exchange represents a considerable cost for the country providing the information. Bacchetta & Espinosa (2000) also find that small countries probably will be less eager to engage in information exchange.

[22] the term country is defined as an entity consisting of several similar countries

The intuition behind the conclusions is based on the previously mentioned welfare problem. If a country has few inhabitants in relative terms, or the outward-bound capital flows are small, the additional income extracted from information provided by the foreign country could be insufficient to offset the costs of providing information. For the same reason, the smaller country will fail to have incentives to exchange information when providing information is relatively costly and when the smaller country is obligated to provide the same level of information as the relatively larger country. The smaller countries, in terms of inhabitants or outward-bound capital flows, are thus likely to lose more than they gain by providing information.

Discussion of the assumptions behind the previously explained model: According to Bacchetta and Espinosa (2000), reciprocity is to be interpreted as an agreement in which the same obligations are imposed on the contracting parties. This is an unfortunate trait of an agreement if the entering parties are asymmetric. As previously stated, the groups of negotiating parties relevant for the purpose of this paper are asymmetric. When the features of the Agreements[23] were assessed, it was concluded that the Agreements have a level of reciprocity[24] to them. The situation assessed in this thesis is thus similar to the situation described by Bacchetta & Espinosa (2000) as sub optimal for achieving mutual exchange of information.

As Bacchetta & Espinosa (2000) explain, another situation in which the incentive to exchange information could be absent is if it is one-way capital flows between the two entering parties. Due to the secrecy features of tax havens, the capital flows in and out of tax havens are difficult to quantify. In a report (NOU, 2009:19), it is found that the direct investments to and from major tax havens, such as Cayman Island and the British Virgin Islands, are both of considerable size. It can thus not be claimed that the situation being addressed in this thesis involves one-way capital flows between the contracting parties. The inward- and outward-bound FDI flows related to tax havens reporting to UNCTAD[25] are shown below:

[23] The term Agreements does in this context refer to the OECD model TIEA and the TIEA between Norway and Isle of Man.
[24] Examples of the reciprocity feature are that termination is the only sanction for not providing information, and that costs are to be covered by the requested party.
[25] United Nations Conference on Trade and Development

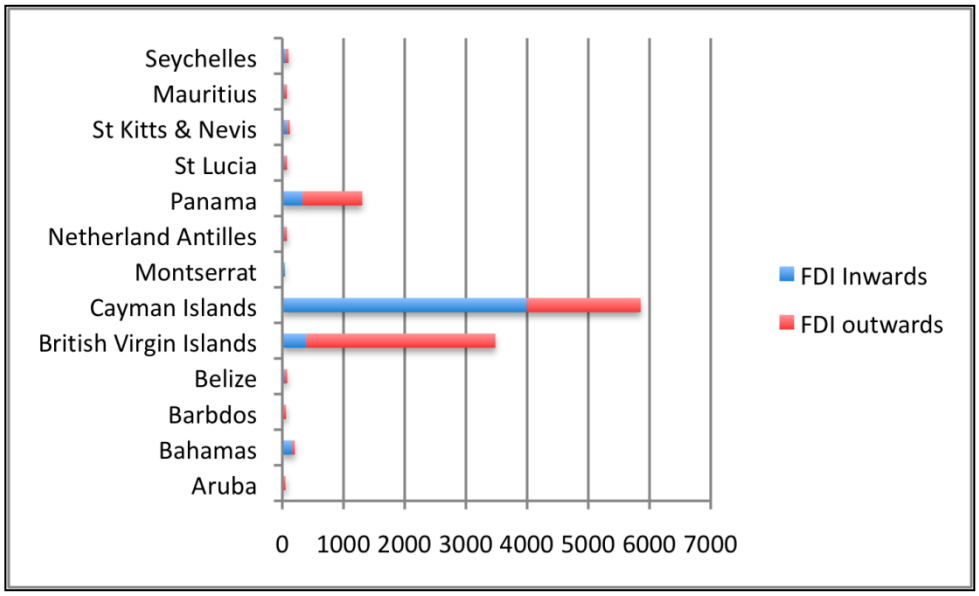

Figure 4: The in- and outward-bound FDI flows from tax havens. Source: NOU (2009:19, p. 76)

This finding does not, however, contradict that the group of tax havens lacks the incentive to exchange information. The claim put forward by Bacchetta & Espinosa (2000) is that the jurisdiction that receives the capital flow will lack the incentive to exchange information. The reason is that the predicted income gain by engaging in information exchange is too small to offset the costs. This is due to the fact that the outward- bound capital stream from which the jurisdiction can extract potential additional income is negligible.

This line of reasoning is logical when dealing with countries that finance public spending through taxes. As pointed out in NOU (2009:19) the business model of tax havens does not include financing public spending through taxes. Tax havens obtain revenues from registration and management fees paid by IBCs registered in the respective jurisdictions. The consequence is that a method using capital flows to determine whether incentives to exchange information exist is irrelevant when dealing with tax havens.

The third situation in which a country could lack the incentive to exchange information is when costs of considerable size occur by providing information to the requesting jurisdiction. Bacchetta & Espinosa (2000) claim that it is expensive for developing countries to provide information. The reason is their lack of a tax system that is adequate for obtaining information without adding a considerable amount of resources. Tax havens often have highly developed financial centers, and are often not considered to be developing countries. At the same time, the tax systems in tax havens are often unsophisticated due to the structures in tax havens

mentioned in chapter two of this thesis. Following the same logic as for developing countries, tax havens might therefore have a high marginal cost of providing information. Thus the costs of obtaining information could be prohibitive for engaging in information exchange for the tax havens.

Concluding remarks; This model assumes that both contracting parties finance their public spending through taxation. The authors thus assume that a welfare optimizing government is concerned with maximizing the value of present and future income streams from taxation. As this is not the case for tax havens, the framework appears to be inadequate for analyzing whether or not tax havens will have incentives to engage in the exchange of information. At the same time, it is trivial that tax havens probably lack the incentive to engage in information exchange according to this framework. The reason is that the purpose of information exchange is enhancing the contracting parties' ability to impose taxes. As tax havens finance public spending from other sources than taxation, the increased ability to impose taxes would represent a negligible potential welfare gain for tax havens. Following the same logic, non-cooperative behavior by the other country will not represent the loss of a potential welfare gain for the tax haven governments, as the income extracted from this information would be insignificant.

4.1.2 Incentive theory 2: Incentives and Information Exchange in International Taxation- Keen & Ligthart (2006a):

The purpose of this study is addressing whether all countries ever could perceive, or be made to perceive, the exchange of information as optimal.

The assumptions; The authors assume that the world consists of two countries. Further, the two countries are assumed to be asymmetric with respect to geographical size and the number of inhabitants. It is also assumed that the residents of each country have one unit of savings to invest. The authors treat the before tax return as fixed and equal for the two countries. Whether or not to make a foreign investment is assumed to depend on transaction costs as well as the tax savings included in investing abroad. Both countries are assumed to be able to keep track of all investments made domestically. It is also assumed that the contracting parties are allowed to exchange information and levy withholding taxes at the same time. The countries are also able to share the revenues from information exchange. Last, the authors assume information exchange to be costless.

The main variables; ρ is the before tax return, while μ denotes the proportion of the income gained from information exchange that is kept by the resident country. (1- μ) of the respective revenue is transferred to the source country. The situation where the residence country retains all revenue is referred to as simple information exchange; $\mu = 1$, as opposed to $\mu = 0$ where all the revenue is transferred to the source country.

The populations are assumed to consist of homogenous and risk-neutral agents, denoted by N and n[26]. The population in the large country is assumed to be at least as big as the population of the small. This yields the expression $\theta \equiv n/N \leq 1$

The conclusions; Based on the assumptions and the main variables, the authors gain insights regarding the feasibility of both the contracting parties preferring information exchange at the same time. The most important results for the purpose of this paper will be described in the following. The authors show that both contracting parties will be indifferent to information exchange compared to simple withholding given that all income from the information exchange is transferred to the source country. Simple withholding may in this situation be understood as a scenario where all income obtained from non-resident withholding taxes remains in the source country. Second, the authors claim that the large country prefers information exchange relative to simple withholding, regardless of how the income from the information exchange is distributed. For the smallest contracting party, information exchange is always less attractive than simple withholding if $\theta < 1/3$. If $\theta > 1/(3-2p)$, the small country will prefer information exchange compared to simple withholding. In the intermediate cases, the small country will find information exchange more attractive than simple withholding given that $\theta \in [1/3, 1/(3-2p)]$, only for $\mu \leq \bar{\mu}$, with $\bar{\mu} \in (0,1)$.

The insight from these results is that the degree of asymmetry between the number of inhabitants in the countries is essential for determining whether mutual incentives for information exchange are present. The intuition behind the result is the following. As previously mentioned, the inhabitants of the countries are assumed to have one unit of savings to invest. The consequence is that an asymmetry probably will arise between the two countries due to the difference in the number of inhabitants that choose to invest abroad. Since the larger country is more numerous, the number of people investing abroad probably

[26] Upper case letters refer to the large country, while lower case letters refer to the smaller one.

will be larger than for the smaller country. If the asymmetry between the countries is sufficiently large (i.e. $\theta < 1/3$), the small country will not have an incentive to switch to a system entailing information exchange even if the potential revenue is shared between the two countries. For the small country, the increase in additional revenues it will be able to collect from inhabitants investing abroad will be smaller than the revenue lost due to the reduction in its share of revenues stemming from residents of the large country who invested in the small country. The small country thus lose more than it gains by engaging in the exchange of information simply because the larger country is more numerous.

To conclude on whether tax havens have the incentives to engage in the exchange of information it is necessary to study the asymmetry between the groups of contracting parties. As pointed out by Slemrod & Wilson (2006), the tax havens are small jurisdictions. The average population in the countries identified as tax havens by the OECD is 284 000. Slemrod & Wilson (2006) also find that the 35 jurisdictions listed as tax havens by the OECD count for 15 percent of the world's countries, while they merely make up 0.15 percent of the world's population. The group of tax havens is thus a group of countries whose population is negligible if the world is made up by two groups of countries, tax havens and non-havens.

Using OECD population data on member countries, it is found that the average population of OECD member countries is 39 121 446,7[27]. The ratio between the average populations in the respective groups of contracting parties, θ, is thus 0,00725944. θ is therefore small enough to claim that the group of tax havens will lack the incentive to engage in the exchange of information. More specifically, this model shows that if the jurisdictions in the group of tax havens levied taxes, all else equal, this group of countries would prefer simple withholding to information exchange.

This theoretical framework implicitly assumes that both the contracting parties aim to finance their public spending through taxes. The framework thus provides further understanding to the circumstances under which a small country, whose public spending is financed through taxes, will have the incentive to engage in information exchange. According to this model, the smaller country will lack the incentive to exchange information even if it seized to be a tax haven. It is thus trivial that the small country will lack any incentive to engage in information exchange when operating as a tax haven.

[27] using data from 2006, with 30 member countries

Discussion of the model; Since the small countries dealt with in this paper are tax havens, it is possible that this theoretical framework fails to address the right issues when determining whether incentives are present.

Whether a country has the incentives to participate in the exchange of information is measured by the collection of tax income in a situation with and without information exchange. The potential inadequacy of this model revolves around the tax haven business model. Another potential inadequacy is related to the assumption of information exchange being costless. As seen in chapter three, it is plausible that both entering TIEAs as well as answering and making information requests are costly. By including the costs related to information exchange, the group of tax havens would probably be even less eager to engage in the exchange of information.

In relations with the previously explained model it is worth noting that concluding on whether incentives to exchange information is present based on the value of one variable has limitations. As stressed by Keen & Ligthart (2006a), the starkness of the results does reflect the simplicity of the model.

4.1.3 Potential weaknesses in the theories presented:

The theoretical approaches to understanding what gives countries incentives to engage in information exchange is useful. Nevertheless, it is important to recognize that the theories fail to assess many of the features related to information exchange. As stressed by Keen & Ligthart (2006b) this may have affected the robustness of the results in a negative manner. Keen & Ligthart (2006b) further recognize that the third country problem will be pronounced regarding the OECD initiative on fighting tax havens.

4.1.3.1 The third country problem:

The theories presented assume that the world consists of two countries. This does not correspond well to the descriptive reality. Therefore, this assumption imposes problems for the models used to explain incentives for information exchange. In order for a country to gain from engaging in the exchange of information, all other countries need to be involved in information exchange. Keen & Ligthart (2006b) claim that in situations where third countries do not engage in information exchange, the third country will always provide investors with the opportunity to make an investment without having to report the funds to the residence country, and at the same time running a low risk on getting caught. Keen and Ligthart (2006b)

also claim that the remaining tax havens will find it increasingly attractive to continue to operate as tax havens as the number of tax havens decrease. The reason is that the decreased competition allows the remaining tax havens to charge a higher price for their services. This implies that the full termination of tax havens could be challenging.

The results derived from the frameworks of Bacchetta & Espinosa (2000) and Keen & Ligthart (2006a) are likely to be exacerbated when taking the presence of a third country into account. Hence, the probability of a tax haven wanting to engage in information exchange is likely to decrease if a third country problem is present.

4.1.3.2 The assumption of homogenous groups of contracting parties:

Another weakness regarding the theories presented is the generalized results from these highly simplified models. When treating the tax havens and the OECD countries as one group, differences within the groups are ignored. By looking at the lists making up the two groups, it is clear that some of the OECD member countries are likely to lack the incentive to engage in the exchange of information. Such countries are Belgium, Luxembourg, Switzerland and the Netherlands[28]. These jurisdictions are regarded as tax havens by organizations such as the IMF and Tax Justice Network. Hence, the incentives for the group in which these countries are placed may not be applicable for them.

4.1.4 Incentive Theory 3: Tax Competition With Parasitic Tax Havens – Slemrod & Wilson (2006):

This article provides a view to the welfare effects from full or partial elimination of tax havens. The authors consider the welfare effect for the world economy as well as the welfare effects on the country level. The paper is interesting in the context of this thesis since it takes the practices of tax havens into account in a direct manner and assesses what would happen in terms of welfare if all or some jurisdictions seized to operate as tax havens.

The main assumptions; Slemrod & Wilson (2006) assume that the world consists of a large number of countries. Some in which they operate as tax havens, and others in which they do not. The countries are assumed to be asymmetrical. The tax havens are modeled as countries offering a tool to escape national taxation imposed by residence countries. The equilibrium price for this tool is assumed to depend on demand. The demand is related to the tax systems

[28] These jurisdictions will be discussed in further detail in chapter five of this thesis.

of countries, the resources used on tax enforcement in the non-havens and the technology the tax havens use.

It is assumed that investors need one unit of capital to build up a company. Once established, the firms hire labor and decide how much income to shelter in tax havens. The firms are assumed to be identical with regards to production technology. The employment and output is thus identical across firms. At the same time, firms are assumed to differ in the cost of setting up operations in tax havens.

The authors assume that individuals maximize their utility functions while companies aim to maximize their expected returns. The governments are assumed to be welfare optimizing.

The individuals can evade tax on their wages, and will engage in tax evasion as long as the costs related to this activity are offset by the benefits from evading taxes.

The companies are assumed to be able to reduce their tax base by purchasing tax haven services. Companies will do this given that the taxes saved on using tax havens more than offsets the costs related to using them. The authors assume that two costs occur when engaging in tax haven activities, a set up cost and a variable cost. The variable cost of buying tax haven services is subtracted from the taxes saved when using concealment services. If the residual exceeds the set up cost of using tax havens, the company will chose to buy tax haven services.

The governments are assumed to be willing to incur costs by engaging in enforcement activities aiming at minimizing tax evasion. The authors recognize that the costs occurring to facilitate tax evasion, as well as the costs incurred when governments engage in enforcement activities, create a deadweight loss in the respective countries. The deadweight loss stems from the "waste" of resources related to tax evasion. Hence, the governments are welfare optimizing by consciously making efforts to minimize the previously mentioned deadweight loss. The governments are assumed to have two tools whose features make them adequate to attempt on minimizing this deadweight loss. This is the effective tax rate and the level of tax enforcement activities.

The situation in which the actors aim to optimize their utility, revenue or welfare is assumed to be the following:

First, the government of each country sets the rates at which individuals and companies will be taxed. In addition, the expenditure on tax enforcement is decided. Second, investors create firms. During the last stage, the costs firms need to pay to evade taxes through tax havens are revealed. Firms then purchase concealment services in a scale that maximizes expected revenues.

The jurisdictions operating as tax havens are assumed to profit from the tax haven activities in two ways. First, the supply and sale of the concealment services generate income. Second, the tax havens benefit from foreign investors investing in their jurisdictions in a growth and welfare enhancing way. The cost related to being a tax haven stems from setting the capital tax rate to an inefficiently low level.

The main variables; The countries are assumed to have a set number of indistinguishable residents, denoted L_i[29]. Each resident has one unit of labor and k^* units of capital. τ denotes the statutory rate at which labor is taxed, while t denotes the tax rate applicable for capital. However, firms can reduce their tax base and thus their average effective tax rate by paying the cost related to facilitating tax evasion through tax havens, θR. This set up cost is a fixed share of the firm's income (size), R. b represents the government's expenses to avoid tax evasion per unit of capital. D^K represents the social cost of tax evasion made by companies and the government's efforts to enforce taxation. D^L represents the deadweight loss per unit of labor stemming from the evasion of labor taxation, and the government's efforts to combat this evasion. The unit price of the concealment offered by tax havens is denoted ρ, and is a function of the global purchase of the respective good, denoted by C. The expected income of firms is symbolized by r, and represents the expected after-tax return on capital.

Conclusions; Slemrod & Wilson (2006) conclude that the elimination of tax havens makes all jurisdictions better off, given that they currently are not tax havens. Under the assumption of constant returns to scale, and that the decision to become a tax haven is endogenous, the authors show that the smaller tax havens may be worse off if they give up their status as tax havens. The intuition behind this conclusion is as follows. The non-haven countries suffer from a welfare loss due to the existence of tax havens since individuals and companies "waste" resources trying to evade taxes. Due to this, the government "wastes" resources

[29] i denotes country i.

trying to combat evasion activities. By eliminating tax havens, these countries will be better off by avoiding this deadweight loss.

This logic does not apply to the smallest tax havens. The model assumes that the cost of becoming a tax haven increases with country size. At the same time, the productivity of offering concealment services remains independent of country size. The cost of becoming a tax haven is related to setting the tax rate of capital to a negligible level, which leads to a welfare loss. Costs can also occur related to increasing the opaqueness of the domestic financial system. The benefits of becoming a tax haven are related to the sale of concealment services. The authors discuss how the optimal level of the supply of concealment services is set. In the view of Slemrod & Wilson (2006), the non-haven countries will attempt to terminate a tax haven if the jurisdiction offers too high a level of concealment services. According to this view, the optimal amount of concealment services sold is a level independent of country size. The consequence is that the revenues from concealment services are independent of the size of a country. This provides the smaller jurisdictions with a greater incentive to become a tax haven, since the revenue is divided on a smaller number of inhabitants, and thus leave these jurisdictions with higher per capita benefits from becoming a tax haven.

For the smallest jurisdictions, the income stemming from the sale of concealment services is considerable relative to the potential welfare gain from raising the capital tax rate to an efficient level. This provides the thesis with a model claiming that the smallest tax havens are entirely rational when refusing to give up their status as tax havens, and thus avoid exchanging information.

4.2 Empirical Approaches

4.2.1 Empirical Approach 1: The OECD's Harmful Tax Competition Initiative and the Tax Havens: From Bombshell to Damp Squib - Kudrle (2008):

Kudrle (2008) has an empirical approach to investigating the effectiveness of the OECD initiative on the exchange of information on tax matters. Kudrle (2008) arrives at the conclusion that the OECD initiative only can be expected to decrease the use of tax havens as a tool to escape personal income tax (i.e. not company tax also). Studying the effect the OECD initiative has on tax evasion on the personal level is thus the purpose of Kudrle's paper.

The author recognizes that holding portfolio assets, either directly or indirectly, in tax havens would be a commonly used tool for evading personal income tax. In order to measure the effectiveness of the OECD initiative, Kudrle (2008) studies changes in the total foreign portfolio investment in a set of tax havens before and after the OECD initiative.

The data set used stems from data reported by the Bank for International Settlements. Through his analysis, Kudrle (2008) cannot find a considerable drop in the amount of stock held in the jurisdictions regarded as tax havens at the time the OECD initiative on combating harmful tax practices first appeared. This result suggests that the OECD initiative failed to limit the use of tax havens when it was introduced.

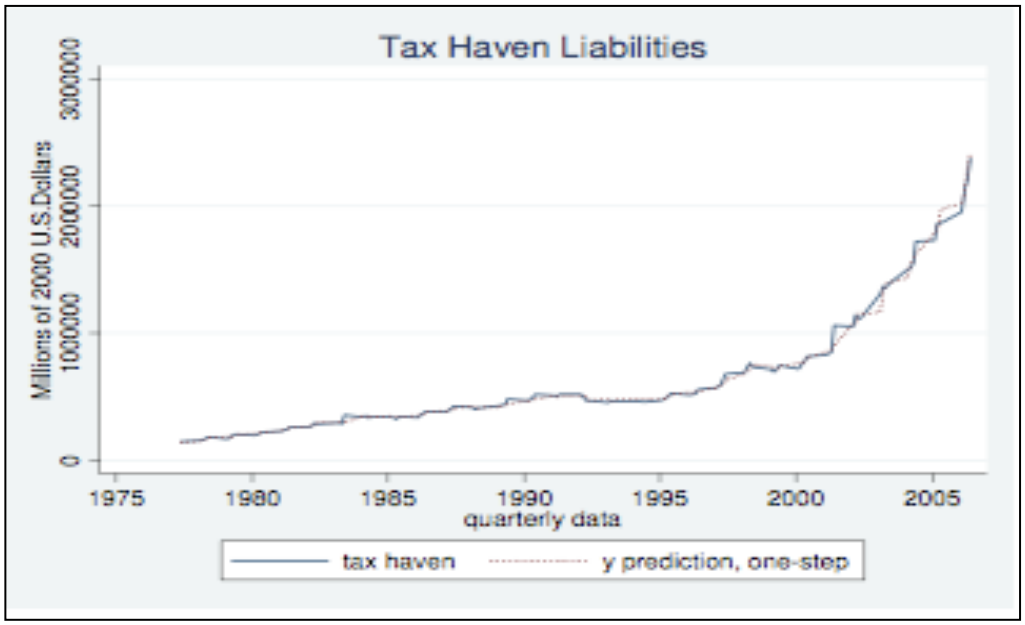

Figure 5: Tax Haven Liabilities. Source: Kudrle (2008, p.13).

The Distribution of Liabilities, the case of the Cayman Islands: According to Kudrle (2008), Cayman Island is the tax haven in which the majority of the tax haven liabilities are distributed. In addition, it was one of the first countries to cooperate with the OECD. Based on this, the author found it useful to study the Caymans alone.

The study of the Cayman Islands did not reveal any impact of the implementation of the OECD project. An intervention analysis was made for the Caymans at the time the OECD project begun. This was also conducted when the bilateral agreement with the US was signed,

as well as the year it entered into force. According to Kudrle (2008), neither the former, nor the latter tests showed any significant relevance of the OECD initiative.

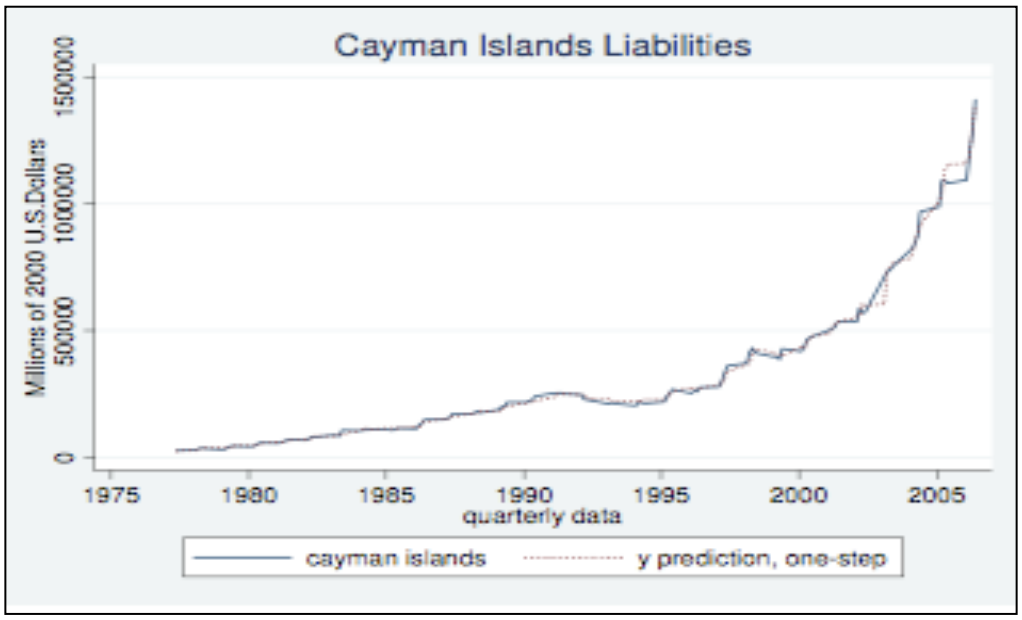

Figure 6: Cayman Islands Liabilities. Source: Kudrle (2008, p. 17).

Kudrle (2008) thus found that the OECD initiative had no significant impact on the volume of tax haven investments. He therefore concludes that the OECD initiative failed to limit investors' use of tax havens for tax evasion on the personal level.

A discussion of the method employed by Kudrle: It is the opinion of this thesis that there are two flaws attached to Kudrle's approach to measure the effectiveness of the OECD initiative on combating tax havens.

The first criticism is that it was too early to investigate whether the OECD initiative has actually had an impact on tax evasion (Kudrle, 2008). Kudrle employs data through 2006. The OECD model TIEA was published in 2002. The publishing of the OECD model TIEA facilitated that pairs of contracting parties could negotiate individual agreements to enter into. This does not imply that the OECD initiative had any practical implications in 2002, or the

first following years. According to the OECD list of TIEAs signed[30], only 11 TIEAs were entered into during the time frame in which Kudrle (2008) measures the effectiveness of the initiative. Based on the low number of TIEAs entered into, it is plausible that the number of information requests adequately answered within the time span Kudrle studies is low. Hence it is possible that the study fails to address the actual impact of the initiative due to the test being conducted too early.

On the other hand, Kudrle attempts to address this problem by studying the Cayman Islands alone. Due to Cayman being one of the first[31] tax havens to enter into agreements in line with the OECD model TIEA, it is possible that the study of the Cayman Islands is more adequate for analyzing the actual effects of the OECD initiative. It is plausible that the results from Cayman Islands would be more pronounced, since the havens whose efforts to adapt to the OECD initiative were late, are left out of the study. Despite of this effort, Kudrle's study is still made while the OECD initiative was at an early stage.

As Dharmapala (2008) points out, a second flaw is attached to Kudrle using portfolio investments as a measure of tax haven activity. The data shows the level of reported holdings in tax havens. Thus, the dataset does not include the unreported holdings in the tax havens, whose size is presumed to be considerable.

Due to the weakness in the data employed by Kudrle (2008), Dharmapala (2008) makes his own analysis aiming to verify the conclusion reached in Kudrle's study. Dharmapala uses employment data from the International Labour Organisation (ILO). He claims that the problem with regards to unreported evasion is avoided by using such data.

According to Dharmapala's study, the employment in the financial sector in Jersey between 1997 and 2005 are shown to follow a similar pattern as the employment number in the financial sector in the UK within the same time span. The pattern is to a large extent the same when studying the average wage in Jersey's financial sector relative to the UK. This is assumed to indicate that the OECD initiative has made little impact on the use of tax havens, since the trends are similar in the tax haven and the non-haven before and after the

[30] The list is available at oecd.org, collected December 10, 2010 from oecd.org: http://www.oecd.org/document/7/0,3746,en_2649_33767_38312839_1_1_1_1,00.html
[31] The Cayman Islands entered into a TIEA with the United States of America on November 27, 2001.

implementation. Dharmapala's (2008) study thus verifies Kudrle's (2008) conclusion. However, Dharmapala's analysis only considers Jersey's development relative to the UK. Hence, the result is not sufficient to draw a conclusion applying to all tax havens.

4.3 The conclusion on the effectiveness of the OECD initiative based on economic incentives and empirical studies:

The aim of this chapter has been to discuss whether both groups of contracting parties have the incentive to participate in the exchange of information.

Theoretical contribution 1 and 2, using incentive theory, assumed that both countries levied taxes. By using these models it was established that even if tax havens were levying taxes, these countries would fail to have the incentives to exchange information.

By assessing the welfare effect related to the existence of tax havens in theoretical contribution 3, it became clear that the smallest tax havens would be worse off if they seized to be tax havens. The smallest tax havens are thus rational if they avoid exchanging information since this could make them less attractive as tax havens. An implication pointed out by Slemrod & Wilson (2006) is that the lack of incentive to seize being tax havens among the smallest jurisdictions will make the full termination of tax havens difficult. Due to the lack of incentives among the smallest tax havens, a third country problem will continue to exist. This could affect the larger tax havens' decision on whether or not to continue being a tax haven in a negative manner.

The empirical approaches presented indicate that the OECD initiative so far has been inadequate in combating tax evasion on the individual level. This corresponds well with the empirical results one would expect from studying the theoretical frameworks.

This chapter thus concludes that according to theory, tax havens will lack the incentive to exchange information. This conclusion is supported by the empirical approaches (Kudrle, 2008; Dharmapala, 2008). The claim that the OECD initiative is effective in combating tax havens is thus weakened. Another insight from this chapter is that the fewer tax havens there are, the more attractive it is for the remaining tax havens to continue their practices. This is mainly due to the remaining tax havens being able to earn higher profits as the competition becomes increasingly imperfect. Thus the insights from this chapter suggest that the elimination of all tax havens could be difficult.

5 Chapter V – Are the incentives to engage in information exchange influenced by matters related to reputation, political climate and international relations?

The models presented in the previous chapter suggested that based on welfare considerations, the group of OECD countries will have the incentive to achieve the effective exchange of information while the group of tax havens will not. The aim of this chapter is to look into whether factors beside welfare considerations could have an effect on the incentives to exchange information among the contracting parties. For the group of tax havens it will be looked into whether a reputational sanction for non-compliance could have an effect on this group's incentive to exchange information. Regarding the OECD member countries it will be considered whether matters related to political climate and international relations could have an affect on the incentives to fight tax havens. Reluctance to fight tax havens among the OECD members could have had an effect on the development of the OECD initiative to fight tax havens as well as its potential effectiveness. To understand how these factors might have influenced the OECD model TIEA, it is necessary to give a description of the original OECD initiative.

5.1 The evolution of the OECD strategy:

According to Eden & Kudrle (2005), the OECD decided to launch an initiative on combating harmful tax competition due to forces within the United States and the European Union wanting such an initiative.

In 1998, the OECD published a report that listed characteristics of tax havens. Based on these criterions, a "blacklist" of tax havens was created. This list was published in June 2000 and contained 35 countries. The jurisdictions appearing on the list were threatened by facing sanctions referred to as the OECD defensive measures if they failed to adequately implement the OECD guidelines (i.e. change policies that met the two last criterions on the OECD list for identifying tax havens[32] (Eden & Kudrle, 2005)). Due to the existence of a blacklist, the initial OECD strategy may be described as confrontational (Sullivan, 2007).

According to Sullivan (2007), the OECD started to deviate from this initial strategy to an approach whose main focus was cooperation. The deadline to avoid defensive measures came

[32] The OECD list for defining tax havens was described in chapter one.

and went without OECD acting. Sullivan (2007) notes that a statement followed the lack of action, in which the OECD admitted that they had no intention of imposing the threatened sanctions on the listed jurisdictions in the future. In addition, the OECD initiative started revolving around making agreements on information exchange upon request with tax havens. As Sullivan (2007) argues, this stands in contrast to the original OECD policy aiming to force the tax havens to curb the structures facilitating tax evasion.

One of the policy changes contributing to the deviation from the initial confrontational approach is referred to as the Isle of Man clause (Sullivan, 2007). This clause allowed the jurisdictions that cooperated to be removed from the blacklist. Cooperation is in this context defined by the OECD as entering TIEAs with at least 12 other jurisdictions (OECD, 2010b). As pointed out by TJN (2010b), the result was that the tax havens entered TIEAs with other tax havens as well as relatively scarcely populated non-havens to be regarded as cooperative. Tax havens and scarcely populated countries are likely to request less information and have less negotiating power than a relatively large country. Hence, the consequences of entering into TIEAs with such countries are believed to be relatively small (TJN, 2010b).

Another change contributing to the deviation from the initial confrontational approach was the removal of the "no substantial activity" criterion from the OECD list for identifying tax havens. According to Kudrle (2008) and Sullivan (2007), the implication is that a jurisdiction is not necessarily classified as a tax haven, even though companies may claim to be resident in that jurisdiction whilst merely having an address there. In the view of Kudrle (2008) this made the OECD initiative lose the ability to curb the corporate use of tax havens.

5.2 The consequences reputation, political climate and international relations have for the incentives to exchange information among the contracting parties:

Blacklisting as a reputational sanction for tax havens acting non compliantly:

The brief historical review shows that the OECD initiative was meant to revolve around more than information exchange. In the view of scholars (Eden & Kudrle, 2005; Sullivan, 2007), the publicly available blacklist made the initial OECD strategy a "name and shame" policy. Further, Sharman (2006, cited by Sullivan, 2007) claims that the tax havens interpreted the blacklist as a potential threat to their existence. In the view of these scholars, the blacklist

would decrease the investors' trust in the blacklisted tax havens, and money would be withdrawn from these jurisdictions. The initial OECD strategy could thus be interpreted as powerful in terms of potential sanctions the tax havens risk being subjected to if violating the OECD guidelines. The implication is that despite of lacking direct economic as well as juridical sanctions, the initial OECD strategy could have been perceived as a real threat by the tax havens (Sullivan, 2007). An example in favor of the effectiveness of the initial OECD strategy is how six of the 41 jurisdictions OECD intended to put on the blacklist instantly obeyed OECD's demands in order to avoid appearing on the blacklist. To emphasize this argument, Sullivan (2007) mentions that Bermuda used its absence from the OECD blacklist as a selling point towards investors.

The former argument is, however, modified by Kudrle (2009b). In his opinion, blacklisting of tax havens can have three potential consequences. One is the consequence of the reputational factor described in the former paragraph. The second consequence is also related to the reputational factor, but has the opposite effect. Hence, the blacklisting of a tax haven will make the jurisdiction a more attractive place in which to evade taxes. The reasoning behind this is that the blacklist will serve as a certification for the non-cooperativeness of the tax haven. This can be interpreted by the investor as a proof of the jurisdiction being an adequate place in which to facilitate tax evasion. Third, Kudrle (2009b) claims that an investor could choose the jurisdiction through which to evade taxes based on other criterions than the reputational factor. If this is the case, the blacklisting of tax havens will have a negligible effect on the use of the listed jurisdictions.

In his attempt to establish whether blacklisting is damaging for the tax havens, Kudrle (2009b) finds that blacklisting does not seem to have a significant impact on the use of tax havens. Based on this it is plausible that tax havens do not have an incentive to engage in the exchange of information to avoid blacklisting. This result does not prove that the initial OECD "name and shame" strategy would have been inefficient. The outcome of Kudrle's (2009b) analysis shows that that the current OECD model TIEA initiative did not become more effective by having the moderated blacklisting as a potential sanction imposed as an exogenous feature of the agreement.

The incentives, political climate and international relations among the OECD member countries:

According to Eden & Kudrle (2005), there are two main problems related to the current OECD strategy. First, it is claimed to exist ambivalence among the OECD members related to the willingness to fight tax havens. In this regard, *"Pressures for national competitiveness, the belief that competition is efficient, and the desire to respect national sovereignty"* (Eden & Kudrle, 2005, p. 127), are believed to make up the basis for the ambivalence. Since the OECD policies need to reflect the political support of the member countries, ambivalence among the member countries could have contributed to the OECD deviating from its original initiative, reducing its potential effectiveness to reflect the ambivalence among the OECD member countries. Scholars (Rahn & de Rugy, 2003; Eden & Kudrle, 2005; Sullivan, 2007; Kudrle, 2008) claim that the change in the political climate in the US in 2001 (i.e. when the Clinton administration was replaced by the Bush administration) was an important driver behind the OECD deviating from its original strategy. At the same time, this claim can be modified by noting that the terrorist actions on September 11 2001 contributed to strengthening the US willingness to step up the fight against tax havens (Eden & Kudrle, 2005; Westin, 2003).

The other problem pointed out by Eden & Kudrle (2005) is that some of the OECD member countries operate as tax havens. The jurisdictions emphasized are Ireland, Luxembourg and Switzerland. It is the opinion of the author of this thesis that this applies to Belgium and the Netherlands as well. As seen in chapter one, the Tax Justice Network identifies Belgium and the Netherlands as tax havens. With regards to the Netherlands, the jurisdiction may be regarded as a tax haven due to considerable loopholes in the tax system, making it possible for companies to avoid tax (Murphy et al., 2006). To be more specific, an arrangement called participation exemption allows subsidiaries from companies registered in other jurisdictions not to be liable for income tax on dividends and capital gains. This, combined with an extensive net of Double Taxation Treaties, has contributed to many companies using the Netherlands as a jurisdiction through which tax planning is facilitated (Murphy et al., 2006).

Regarding Belgium, the jurisdiction may be seen as a tax haven due to the combination of two features. First, the country's legal system has features that make Belgium a secrecy jurisdiction according to the Tax Justice Network (TJN, 2009c). The reason is that Belgium's

legal system produces many of the characteristics of tax havens described in chapter two. Some examples of the features present in the Belgium tax legislation are the failure to impose the disclosure of details about trusts, the exemption to keep an updated register of shareholders and the freedom to redomicile companies. Second, the money flowing through Belgium is among the top 10 amounts in the world according to IMF data (Murphy, 2010). As pointed out by Murphy (2010), Belgium is therefore a good place in which to hide money. Due to the large amount of money flowing through the country, there is a low likelihood of cash being found. Based on these two criterions, the Tax Justice Network lists Belgium among their top ten tax havens (Murphy, 2010).

Further, other OECD members are believed to be involved in harmful tax practices in an indirect manner, and might thus fail to have the incentive to abolish tax haven practices. In this context, the UK is highlighted due to their close relationship to former colonies and overseas territories (Eden & Kudrle, 2005; TJN, 2010a). In addition, the US is pointed out as a nation having close ties to tax havens (Eden & Kudrle, 2005).

5.3 The conclusion, are the incentives to engage in information exchange influenced by matters related to reputation, political climate and international relations?

As seen in chapter three, the effectiveness of the OECD agreement is dependent on the cooperation of both the contracting parties. The insights from this chapter suggest that the use of tax havens remains unaffected by blacklisting. Thus, tax havens probably lack an incentive to exchange information to avoid this sanction. In addition, the insights from this chapter imply that the willingness to cooperate within the OECD member countries is questionable due to direct and indirect links to harmful tax practices and ambivalence towards fighting tax competition. This serves as another argument weakening the potential effectiveness of the OECD initiative.

6 Chapter VI - Concluding Remarks:

The aim with this thesis has been to answering whether entering tax information exchange agreements based on the OECD model TIEA is an adequate tool for combating tax havens. More specifically, this thesis has pursued to reach a conclusion regarding what features of tax havens that are curbed by entering agreements resembling the OECD model TIEA. This thesis has also attempted to establish what characteristics of a tax haven that the current OECD model agreement is unable to stop. The purpose of the following paragraphs is integrating the conclusions derived from the various sections to provide the reader with a final conclusion on the extent to which entering agreements based on the OECD model TIEA is an adequate tool to combat tax havens.

6.1 The OECD model TIEA:

Studying the OECD model TIEA made it clear that the entering parties are not obliged to curb domestic structures whose features could facilitate tax evasion and avoidance. The structures of tax havens described in chapter two will therefore remain in a tax haven despite of having signed a TIEA. That the structures in the tax havens remain implies that the techniques to avoid and evade taxes through tax havens still can be employed by individuals and corporations. Hence, a tax haven will remain a treat towards the tax base of the other contracting party despite of having signed a TIEA.

Nevertheless, individuals and corporations could find it more cumbersome to use tax havens if entering into a tax information exchange agreement made it easier for the non-haven contracting party to enforce their domestic tax legislation. This could have been the case if tax information exchange agreements made it easy to request and obtain information from the other contracting party. It is the opinion of this author that entering TIEAs does not make information from the other contracting party easily accessible. The reasoning may be divided in three.

First, the contracting parties are exempt from providing information that domestic institutions and tax authorities do not collect. Since the structures of tax havens remain after signing a TIEA, the information that potentially could be provided to the contracting party is scarce.

Second, the words and expressions used in the OECD model TIEA as well as in the commentary are vague. This might halt the effectiveness of the information exchange, since the interpretation of the terms and expressions in the agreement needs to be established in each individual case. In addition, the vague terms and expressions, as well as the numerous imposed formalities, could make it possible for the requested jurisdiction to avoid providing information by claiming that the information request is inadequately made.

Third, the nature of the information exchange as well as the imposed formalities raise the bar for making and answering information requests due to constraints related to budget and time. This decreases the potential success of the OECD initiative, as the success of the OECD effort is dependent on the number of requests that results in relevant information being provided in time.

Another feature that limits countries from enforcing their tax laws by using information provided by tax havens is the process of entering TIEAs. Due to the design of the OECD model TIEA, entering a sufficient number of TIEAs is an expensive, labor-intensive process. This affects the potential effectiveness of the OECD initiative in a negative manner.

Based on the shortcomings presented in the previous paragraphs, it is clear that the OECD model TIEA is an inadequate tool for effectively exchanging information, unless both contracting parties have the incentive to achieve this.

6.2 The economic incentives to engage in information exchange among the contracting parties:

The theoretical approaches studying the incentives among the contracting parties suggest that the group of OECD member countries has the incentive to engage in information exchange, while the smallest tax havens lack the incentive to exchange information. This affects the adequacy of fighting tax havens through entering TIEAs negatively. The lack of incentives among tax havens makes it plausible that these jurisdictions will exploit the vagueness and ambiguousness in the TIEAs to their benefit. The consequence is that tax havens can refuse to give away information, without this having any consequences for the tax haven, since denying a request could be legitimized by referring to the agreement.

Another implication of the tax havens lacking incentives to exchange information is that the assumption of reciprocity, upon which the OECD model TIEA rests, is unfortunate. The only

potential sanction levied on the entering parties is the opportunity for either contracting party to terminate the agreement. This is unlikely to be perceived as an actual sanction by the tax havens, as they have no interest in the agreement working adequately.

6.3 The incentives to engage in the exchange of information among the contracting parties, matters related to reputation, political climate and international relations:

The insights from chapter five suggest that tax havens could lack the incentive to exchange information even if blacklisting would have been a sanction for acting non-compliantly. The reason is that blacklisting seems to have a negligible effect on the use of tax havens. Another claim derived from chapter five is that the ambivalence related to the willingness to fight tax havens among the OECD member countries could have a negative effect on the adequateness of fighting tax havens through entering TIEAs. Another trait contributing to making the OECD initiative less efficient is that five members of the OECD are identified as tax havens. The link other OECD members have to tax havens exacerbates this negative effect. Taking these considerations into account makes it clear that the incentives among the OECD countries to fight tax havens can be absent in some cases. If the incentives to fight tax evasion are missing among the OECD countries, the potential success of the OECD initiative is questionable.

6.4 Overall conclusion: To what extent are the TIEAs based on the OECD model TIEA adequate tools for combating tax havens?

The OECD model TIEA makes the entering parties overcome secrecy regulations related to financial intermediaries. There is thus a probability of individual tax evasion being less attractive with a TIEA in place. On the other hand, this author argues that the secrecy feature of tax havens remains after signing a TIEA. Entering an agreement resembling the OECD model TIEA is therefore suggested to have a negligible effect on tax evasion on the personal level in the opinion of this thesis. This is supported by the empirical approaches of Dharmapala (2008) and Kudrle (2008).

When it comes to tax evasion and avoidance on the corporate level, the claim of this thesis is that the OECD model TIEA fails to prevent or limit the corporations' use of tax havens. The basis for this claim is that the OECD model TIEA does not obligate the tax havens to change the structures that serve as tools for decreasing the tax base in other jurisdictions. In addition,

the OECD model TIEA does not prevent companies from claiming residency in tax havens despite of being located and / or managed from somewhere else.

Based on the insights gained from the various chapters of this thesis, it is hard to imagine how TIEAs based on the current OECD model TIEA could be effective in putting a stop to personal tax evasion or corporate tax avoidance and evasion. The reason is that the current OECD model TIEA is unable to curb the structures facilitating the former and the latter mentioned uses of tax havens.

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