Due Diligence in Tax Havens: Opportunities in a New Regulatory Climate

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Offshore tax evasion was one of the topics discussed at the London G-20 summit on April 2, 2009. The global financial crisis has encouraged governments to put pressure on the offshore industry to fight the plague of tax evasion. Thirty-three nations have already committed to improving transparency and establishing effective exchange of information regarding tax matters. The Organization for Economic Cooperation and Development (OECD) maintains three countries on the blacklist of non-cooperative jurisdictions (Andorra, Liechtenstein, and the Principality of Monaco). The geography of tax havens, however, might gradually change in response to international pressures. Recent political and legislative developments in the fight against tax evasion, bank secrecy, and money laundering signal new resources for due diligence inquiries that are characterized by an increased accessibility to information.

Offshore subsidiaries are traditionally used for reducing tax costs and shielding transactions from public view. A report by the U.S. Government Accountability Office revealed that most of America's largest publicly traded corporations, including several financial companies that received public funding to finance their recovery, maintain offshore operations that could help them to avoid paying U.S. taxes. Tax haven jurisdictions have always been characterized by a lack of transparency and a refusal to provide information to foreign tax authorities and international organizations. The very opaqueness of some of these jurisdictions has made it very difficult to get reliable information through regulatory or public database checks when conducting due diligence inquiries. However, the new regulatory climate spurred by the global financial crisis and the current international efforts to limit the "loopholes" in the tax and banking systems may increase the availability of information disclosed to the public and, in turn, may be of great assistance to due diligence analysis.

While the recent decision by the Swiss government to ease the country's bank secrecy rules prompted fears among Geneva-based private banking and asset management companies about a possible huge outflow of funds, this certainly represents a landmark opportunity for those conducting due diligence inquiries to access information that was previously unavailable. The Swiss move on tax evasion, in which the intense U.S. investigations into the activities of the private banking division of UBS certainly played a big role, followed that of Liechtenstein and Andorra, two European principalities that pledged to relax their bank secrecy role laws in compliance with increasing international pressure. In addition, Singapore is coming under increased scrutiny after emerging, in recent years, as a major private-banking center.

Currently, there are a number of valuable tools to provide information on entities operating or registered in offshore jurisdictions when conducting due diligence inquiries. Certain tax haven jurisdictions, such as the British Virgin Islands, currently offer limited services and information that can help, for example, to verify the registration of an entity and its current standing. Local source checks may also add important details to the due diligence analysis by verifying, for example, the presence of premises and/or offices in a listed location for a company. Currently, checks conducted of pertinent regulatory agencies in these jurisdictions, such as monetary authorities or financial commission, result in limited available public information. These types of public record regulatory inquiries are likely to produce more results and findings in a climate of increasing transparency standards and exchange of information. Due diligence inquiries are able to develop information on companies or investment funds domiciled in offshore jurisdictions by verifying listed auditors and the nature of their affiliation with the subject entity. No evidence of any ties between an auditor and the entity examined may offer important insight in assessing the business reputation of a financial entity. Currently, the information available regarding auditors varies per jurisdiction. However, with increasing transparency standards, this is likely to change, resulting in more information available to potential investors or business partners.

Most offshore jurisdictions now cooperate with foreign authorities in tracking down the proceeds of illegal activities, such as international drug trafficking. Since September 11, 2001, offshore financial centers have gradually opened to greater international counterterrorism surveillance. As a result, global compliance database checks should be conducted as part of any due diligence inquiry in tax haven jurisdictions to determine any connections to financial transactions, companies, or individuals linked to money laundering or terrorist financing. In addition, checks of pertinent regulatory agencies in the United States, such as the Internal Revenue Service, Department of Treasury, and Department of Justice, should be conducted for any possible pertinent information. The new steps aimed at curbing the phenomenon of tax evasion announced by the U.S. government are likely to increase the role of certain U.S. regulatory watchdogs and, consequently, the amount of information available via regulatory database checks.

Recent scandals that have emerged during the turmoil of the current economic crisis are likely to reinforce the need for deeper analysis and due diligence in tax havens. Liechtenstein, one of the most secretive tax havens, and its biggest bank, LGT Group, came under intense pressure in 2008 after a German investigation disclosed a list of hundreds of foreign customers of LGT who were suspected of tax evasion, including members of the European financial elite. The investigation of Bernard Madoff's Ponzi scheme quickly expanded into offshore tax havens as some of Madoff's investors used funds based in offshore jurisdictions to allegedly evade American taxes. Offshore entities also played key roles at Bayou Management, the Connecticut-based hedge fund that collapsed in 2005, as well as at Enron, which made extensive use of offshore entities to perpetrate its accounting fraud. The current investigation of billionaire Allen Stanford includes Antigua.

These events have certainly contributed to boost the pressure and public scrutiny on tax havens, thus increasing the likelihood that authorities in these jurisdictions may agree to abandon the secrecy and disclose more information. While due diligence inquiries on entities and/or individuals operating in tax havens have always been important, they have had limitations. The increased international pressure for more transparency should result in additional publicly available information to enhance due diligence inquiries in these jurisdictions and ultimately reduce risk.

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