# **Questionable Values?**
# A review of Capital Economics' report on the British Virgin Islands

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christian aid

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**Cover:** Christian Aid campaigners donned business suits and masks and demanded faster progress towards transparency in a 2014 demonstration outside the Foreign and Commonwealth Office, London.
Photograph: Christian Aid

# List of Acronyms

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| **BEPS** | base erosion and profit shifting |
| **BO** | beneficial ownership |
| **BOSS** | Beneficial Ownership Secure Search System |
| **BVI** | British Virgin Islands |
| **CFC** | controlled foreign corporation |
| **IMF** | International Monetary Fund |
| **OECD** | Organisation for Economic Co-operation and Development |
| **TIEA** | Tax Information Exchange Agreement |

# Executive summary

Following the hurricanes Irma and Maria that devastated a number of Caribbean islands in September last year, the focus has rightly been on supporting the hardest hit and those in greatest need. But as the rebuilding effort develops, many are starting to think more deeply about the long-term sustainability of these islands' economies, and their ability to protect and provide for their populations in an economically and climatically uncertain future. What type of jobs, and what type of economy, should places such as the British Virgin Islands (BVI) be looking to build?

This is a question that extends beyond the storm-hit Caribbean. Defensive measures against tax evasion and avoidance are on the rise in the US, the EU and emerging economies, driven in part by the exposure of these activities in successive leaks of information (most recently, the Paradise Papers). Such developments call into question the sustainability of any economic model that relies on providing various combinations of secrecy and low taxation.

So far, many small offshore centres, and their supporters, have largely reacted defensively to the threat of change, arguing that media coverage has unfairly maligned 'tax havens'; that the problem is not as large as portrayed; and that they are already instituting tax and transparency standards better than many large 'onshore' economies. However, careful scrutiny of one of the most comprehensive efforts to explain the role of international finance centres and to illustrate the impact that such a territory has on the global economy – the prominent report that the government-backed financial lobby group, BVI Finance, commissioned this year from consultancy firm Capital Economics – demonstrates major weaknesses in the arguments and conclusions presented, and suggests to us that such defences are more concerned with maintaining the status quo than a genuine concern for the wider global economy.

In our analysis of the *Creating Value* report we found that:

- The report's assertions about the BVI's compliance with international transparency measures focus on the BVI's willingness to engage in the automatic exchange of financial account information. This is a welcome but largely symbolic gesture, since the BVI has almost no international banking sector on which to provide information. It is almost exclusively a platform for the registration of companies and the formation of trusts, almost all of which will have their bank accounts and other financial assets in a different jurisdiction.
- More than half of the direct investment assets held via BVI companies are in countries with which the BVI does not exchange information about the ultimate ownership of companies for tax purposes, even on request.
- The BVI continues to reject calls for a directly searchable register of the ultimate ownership of BVI companies.
- US congressional investigations and International Monetary Fund (IMF) reporting shows that profit shifting using companies tax resident in the BVI and other small offshore financial and

corporate centres is standard tax planning practice for dozens of multinational companies.

- Capital Economics' estimate for global 'tax leakage' via the BVI – a 'theoretical maximum' of $750m – is highly questionable, considering data from recent tax amnesties in countries like Indonesia and Argentina, which show high levels of straightforward tax evasion using BVI corporate vehicles.
- Capital Economics' estimates of the positive economic and fiscal impacts of the BVI are based on unpublished data and methods that Capital Economics has, to date, declined to release or explain. What is clear, however is that, whatever the data and methodology, the calculations are dependent on assumptions about the BVI's role in generating investment, economic activity and consequent tax revenues that seem to be entirely at odds with the reality of the sources of international investment that the BVI claims to 'mediate', and of the limited legal and economic facilities that the BVI actually provides to such investors.

Our analysis of the Capital Economics report is an example of why we believe that it is time to stop defending the indefensible across all the world's tax havens. With public demand building for new regulation, and the ever-present threat of further mass leaks, the UK Government needs to initiate a serious discussion about alternative economic pathways for the British Overseas Territories and Crown Dependencies. Alternative futures for offshore tax havens are not only vital for the poorest countries of the world that lose tax revenues each year to the offshore system, but also for the ordinary women and men in places like the BVI, for whom a secure future is dependent on the creation of robust, equitable and sustainable economies.

'The UK Government needs to initiate a serious discussion about alternative economic pathways for the British Overseas Territories and Crown Dependencies'

# Foreword

In the aftermath of the hurricanes Irma and Maria that devastated a number of Caribbean islands in September 2017, efforts focused on supporting those in greatest need and the hardest hit. But even as the immediate relief effort unfolded, thoughts were turning to the long term. Billionaire Richard Branson has called for a Marshall Plan to rebuild the BVI, and for the Caribbean to be reconstructed and rejuvenated with clean energy and new jobs. But what type of jobs and what type of economy should places such as the BVI build?

November 2017 saw the emergence of the Paradise Papers, a massive body of documents from the Bermuda-based law firm Appleby. This came 18 months after the Panama Papers, leaked from the Panamanian corporate service provider Mossack Fonseca. While analysis of the data in the Paradise Papers is only just beginning, the Panama Papers featured the BVI as by far the most utilised location for creation of offshore companies. The BVI was the incorporation jurisdiction for more than half of the 200,000 companies whose ownership and assets the leak exposed. The cumulative impact of these and other leaks, alongside growing concerns about the offshore system and its impacts across the globe, pose serious questions for the UK and for those of its Overseas Territories and Crown Dependencies that act as tax havens. Can places such as the BVI continue to maintain an economic model that relies so strongly on providing combinations of secrecy and low taxation? Or is it not time to plan ahead, for a different kind of future? Apart from wider arguments about the damage done elsewhere by widespread abuse of the offshore system, there are at least two clear, prudent reasons for a managed change of direction.

Firstly, public opinion continues to turn against tax havens and tax avoidance, regardless of their legality. Public polling in the UK indicates that the defence that 'nothing illegal' has taken place will no longer hold. Nearly 90% of people, across all sectors of society and all political parties, believe that tax avoidance by large companies is wrong, even if it is legal.[1] A significant majority continue to believe that responses by the government so far are insufficient. Where public opinion goes, so politics will surely follow. With the weight of public opinion swinging so strongly behind further action, it seems unlikely that politicians will be able to continue to resist calls both for greater transparency, and for a move away from extreme tax 'competition' based on zero rates of corporation tax.

Secondly, the ever-increasing flow of information entering the public domain suggests that we are beginning to see the end for tax secrecy. Whatever the debates about the rights and wrongs of the methods by which information is obtained, and the limits of public interest, the reality is that information concerning company and trust ownership and the tax arrangements of global companies can no longer be seen as securely confidential. Information will continue to come out, in different ways and from different parts of the system. The consequent loss of trust must raise questions about whether an economy can survive if it continues to rely on secrecy as a selling point.

In this document, we examine in detail a recent report commissioned by the BVI International Finance Centre from the London consulting firm Capital Economics. *Creating Value: The BVI's Global Contribution* seems to have been commissioned as part of a proactive strategy of defending the reputation of the BVI's financial services industry and countering claims labelling it as a 'tax haven'. The report seeks to reject this label in both senses: that the BVI has a 'harmful tax regime' encouraging profit shifting, and that it is a 'secrecy jurisdiction' facilitating tax evasion and other financial criminality. We review the claims made in the report across three axes – its statements about financial and corporate transparency in the BVI; its statements about the nature and impact of its tax regime; and its claims about global economic value created by the BVI economy through international investment and jobs.

In every area, we believe that the assertions made simply do not stand up to basic scrutiny. We have undertaken this review not just to counter Capital Economics' specific claims, but also to reinforce our wider argument that it is time for the UK and its network of associated tax havens to plot a new path towards financial and fiscal transparency, and serious economic diversification.

The UK's offshore centres themselves regularly argue that it is stability that attracts companies and wealthy individuals to their jurisdictions. This stability can no longer be taken for granted. The UK Government can continue to defend the indefensible, or it can support its citizens in the British Overseas Territories and Crown Dependencies to adapt to a new future.

# The Capital Economics *Creating Value* report on the British Virgin Islands

In June 2017, the BVI International Finance Centre released a report commissioned from the London consulting firm Capital Economics which sought to 'illustrate and where possible quantify the impact that international finance centres (especially the BVIs) have on the global economy'. In doing so the report claimed to have debunked accusations that the BVI is a tax haven. Capital Economics' report also makes substantial claims for the net benefit to the global economy of the BVI's legal and fiscal regimes.

We have examined these claims and present our findings below. We have not examined in detail the report's analysis of the nature of the BVI's own economy, as our interest is primarily on the impact of the BVI's corporate and fiscal regimes on developing countries. However, we do consider that this is an important question in its own right, especially for the sustainable economic future of the citizens of the BVI, and is worthy of greater examination.

## Transparency and secrecy

**'The BVI is not a tax haven. It has no banking secrecy rules and compares well against many other jurisdictions on international standards for transparency, tax information exchange, anti-money laundering and measures to combat the financing of terrorism.'**

*Creating Value,* Capital Economics[2]

In its description of the BVI's compliance with international transparency measures, the Capital Economics report focuses on its adherence to automatic tax information exchange arrangements with other countries, specifically the OECD's Common Reporting Standard, automatic information exchange under the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, and the US Foreign Account Tax Compliance Act (FATCA) regime.[3]

Certainly the BVI has joined all these initiatives since 2014. In the BVI's case, however, they are almost worthless. The reason is simple: all these standards concern the automatic exchange of *financial account* information – the income and assets held in accounts at banks and other financial institutions. Yet companies and individuals outside the BVI hold almost no financial assets in BVI banks or financial institutions. The BVI's banking sector is tiny. Commercial bank deposits in the BVI stood in late 2015 at less than \$2bn,[4] slightly less than commercial bank deposits in Togo.[5] Two-thirds of these BVI deposits, moreover, are domestic in origin.[6]

In short, the **BVI is not an offshore financial centre** – unlike fellow British Overseas Territories like Bermuda or the Cayman Islands. It is almost exclusively a platform for the registration of companies and the formation of trusts, almost all of which will have their bank accounts and other financial assets in a different jurisdiction.

The key issue with BVI secrecy is not financial secrecy, therefore, but commercial and legal secrecy. It is not whether information is available about the contents of BVI bank accounts, but whether information is available about the ownership and control of companies and trusts registered or settled in the BVI.

**'Investors in offshore vehicles, in the likes of the BVI, are not hidden from the Authorities… many [jurisdictions] (including the BVI) willingly share data on the individuals and businesses that use their offshore services with competent authorities in other relevant nations.'**

*Creating Value,* Capital Economics[7]

Corporate ownership in the BVI is considerably more opaque than financial asset ownership.

The BVI falls behind the UK in refusing to place the beneficial ownership (BO) of companies on public record.[8]

In common with most other jurisdictions, the BVI does not exchange BO information automatically with other countries' law authorities. In December 2016, along with 48 other jurisdictions, it signed a 'political commitment to support the development of a new global system for the systematic exchange of beneficial ownership information on a reciprocal basis', but this remains under development and conspicuously does not include a commitment to automatic exchange of information.

This means that other countries' authorities must access BO information by requesting information about particular companies or beneficial owners through bilateral and multilateral agreements with the BVI, particularly Tax Information Exchange Agreements (TIEAs). The BVI's bilateral TIEAs have been signed almost exclusively with wealthy economies.

The situation has improved significantly since 2014 when the BVI, via the UK's extension, signed the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters, an information exchange agreement. Nonetheless, in 2015 – the latest year for which information is available – just over half of all the direct investment assets held by BVI companies overseas, valued at $565bn, were in jurisdictions without an information exchange agreement with the BVI, either bilateral or multilateral.[9]

Even for those countries which *do* have information exchange agreements with the BVI, access to BO information remains extremely indirect, introducing multiple opportunities for non-compliance by those legally responsible for providing the information: non-compliance which historically has often gone unchallenged by BVI authorities. Under BVI law, information about the beneficial ownership of companies is not placed on government record, but is simply recorded by company service providers: the commercial law firms and trust firms in the BVI which form BVI companies and trusts on behalf of others, and in the case of companies serve as their 'resident agents'. By law, these resident agents are obliged to obtain information about the identity of the shareholders and beneficial owners of the companies they register, as part of their due diligence procedures; yet in practice, the OECD

'In 2015 – the latest year for which information is available – just over half of all the direct investment assets held by BVI companies overseas, valued at $565bn, were in jurisdictions without an information exchange agreement with the BVI'[9]

itself found in 2015, *"[t]hree peers [other countries] indicated that beneficial ownership information had not always been available"* on request from these registered agents.[10] The Panama Papers leak provides more detail about such failures: between 2005 and 2008, the BVI Financial Investigation Agency passed on over 100 requests for BO information to Mossack Fonseca, probably the island's largest resident agent. The firm was only able to provide the information in 5 cases. Even after greater due diligence obligations were introduced in 2008, the firm failed to provide ownership information in 70 of around 500 requests. **Throughout this time, despite these clear breaches of its legal obligations, the BVI government continued to licence Mossack Fonseca as a registered agent.** The situation improved significantly in 2015, though the law firm was still unable to provide ownership information for one of the ninety requests it received that year.[11]

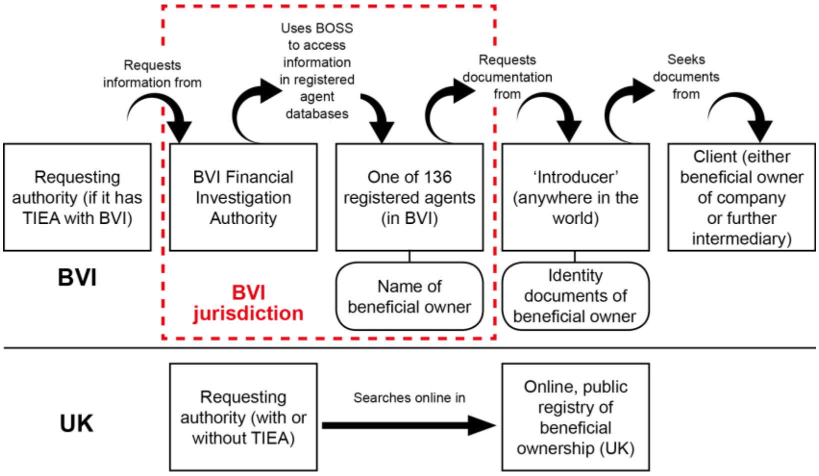
These failures often occurred because the BO information was held by an 'introducer' in another jurisdiction: law firms or other company service providers which had connected clients wishing to set up BVI companies to Mossack Fonseca's BVI office, and which subsequently failed to respond to Mossack Fonseca's requests for the information when it in turn received requests from the BVI authorities. As the Capital Economics report notes, over 70% of BVI company formation agents' business comes from such 'introducers'.[12] In November 2015, the BVI changed its laws to make it mandatory for registered agents to obtain and hold some BO information directly from 'introducers'. Yet these changes *deliberately* maintained a further loophole: although the registered agents should now obtain the BO information from overseas 'introducers', the new law explicitly exempts them from any obligation to obtain any of the underlying documentation itself (for instance, copies of identity documents) which would be required by overseas investigating authorities. These can still be kept by the introducer in another country, only to be provided on request from the resident agent.[13]

In short: recent BVI legal reforms have maintained and in some cases deliberately imposed measures to prevent company ownership information from being gathered centrally in the BVI, and to ensure that the necessary information and documentation is deliberately kept at arms-length from the authorities across different actors and jurisdictions. This includes allowing those holding the actual identity documents to be provided by the beneficial owners to be outside of the BVI government's jurisdiction altogether (Figure 2). And as the Panama Papers leak showed, the BVI authorities have a history of continuing to authorise even those entities that fail to fulfil their legal obligations to obtain or maintain BO information.

Shortly after the Panama Papers' leak, the BVI agreed to a new system. From 30 June 2017 the Beneficial Ownership Secure Search System (BOSS) requires each registered agent on the island to maintain an electronic database of beneficial ownership information about the companies for which they are responsible. These databases will be searchable, again only on request, by a single authorised contact point following a request from law enforcement authorities via the 'BOSS'. Once again, however, the BVI has rejected calls for a centralised database of beneficial ownership whose maintenance and completeness is the responsibility of the authorities themselves. Under the new legislation the duty to gather and maintain the information will remain with the commercial registered agents in 'RA databases', whose fallibility in actually maintaining the data has been repeatedly demonstrated (above). The BVI has also rejected calls for a database that will be directly searchable by overseas authorities. And at the time of writing the BVI has agreed for only one country to submit requests for the BVI to search the RA databases via the BOSS: the United Kingdom.[14]

'Despite these clear breaches of its legal obligations, the BVI Government continued to licence Mossack Fonseca as a registered agent'

**Figure 1:** 'The BVI is as transparent on tax issues as the United States or the United Kingdom' (Capital Economics, 2017).[15]
Procedure for tax authorities to obtain corporate beneficial ownership information and documentation from the BVI (top) and the UK (below).



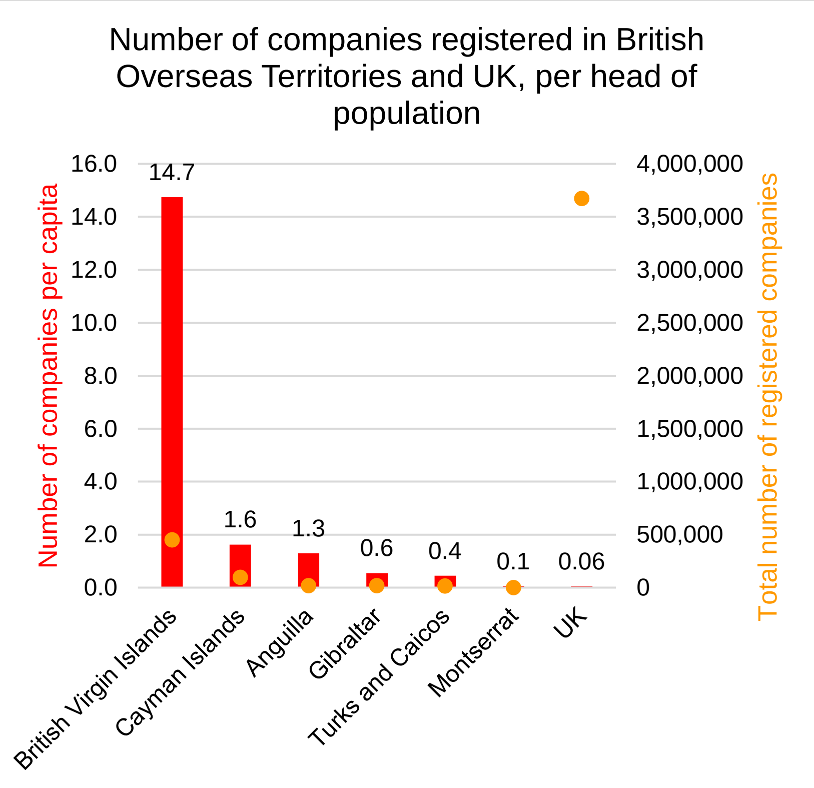

The new 2017 rules, moreover, introduce two expansive loopholes that remove the requirement for a significant class of BVI companies to provide any ultimate beneficial ownership information at all. First, companies that are banks, insurers, private investment funds or corporate services providers in the BVI – or are subsidiaries of such companies -- do not have to provide information about their true owners.[16] Second, BVI companies that are owned by such financial sector companies in any other jurisdiction are also exempt from providing BO information, as long as that jurisdiction has anti-money-laundering rules compliant with the Financial Action Task Force (a comparatively low bar, given that the BVI itself managed to meet these compliance requirements, by dint of having the required rules, throughout the period when registered agents like Mossack Fonseca could fail to maintain any beneficial ownership information for some of its clients and continue to have their BVI agent licences renewed).[17] Since we know that tax evasion schemes quite often use private banks or insurers registered to conceal the beneficial ownership of financial assets, this is a potentially major loophole, which two dedicated sections of the new legislation have ostensibly deliberately introduced.[18]

Finally, the BVI is amongst the small minority of UK Overseas Territories that continues to permit companies to hold bearer shares, and in some circumstances to issue new ones.[19] Such shares are inherently anonymous, since their owner is the individual that holds the shares (like a banknote), not a registered shareholder. All other

UKOTs except Anguilla and Montserrat have now abolished them (and Montserrat has pledged to do so).[20] Fortunately, in the BVI they are small in number: in late 2014 only 275 active companies had bearer shares.[21] Since 2009 under the BVI's 'immobilisation' regime, companies have had to place such bearer shares with a 'Custodian' approved by the BVI Financial Services Commission. This Custodian is required to keep the bearer share on behalf of the beneficial owner and maintain a record of its beneficial owner's name.[22] Nonetheless the keeper and location of this record will be somewhere other than the 'registered agent' responsible for responding to official requests for information, and can even be outside the BVI -- adding yet another layer of potential delay and non-compliance to making BO information available.

In one respect, the Capital Economics assessment of the BVI's transparency regime is accurate: with the exception of Montserrat, none of the other UK OTs has committed to significantly higher standards of corporate transparency.

**Figure 2:** Corporate secrecy in the BVI has a greater global impact than in other British Overseas Territories because the BVI is by far the largest location of company registration among the Territories.




Sources: OECD Global Forum on the Exchange of Information for Tax Purposes; UK Companies House; World Bank population statistics, 2016.

However, the significance of the BVI as a corporate secrecy jurisdiction is not only due to its **comparative secrecy**, but also to the fact that BVI-registered entities are **vastly more numerous** than those of any other British Overseas Territory. At the end of 2015 there were nearly half a million BVI-registered companies, more than 4.5 times as many as in the next most numerous British Overseas

Territory corporate registry, the Cayman Islands. There are 14.7 BVI-registered companies for every resident of the BVI (compared to 0.06 UK-registered companies for every resident of the UK; Figure 2).[23]

# A harmful tax regime?

**'The BVI is not a material centre for corporate profit shifting. Multinational companies seeking to optimise their tax position would presumably look to conduct any "profit shifting" through jurisdictions that gave them protection from double taxation, and where they would be exempt from withholding charges. The BVI offers little protection to businesses from so-called "double taxation" in another jurisdiction or from "withholding taxes" elsewhere. Multinational companies that use their transfer pricing arrangements to shift profits into the jurisdiction will not be sheltered from taxes due elsewhere.'**

*Creating Value,* Capital Economics[24]

The Capital Economics report claims that the BVI cannot be a location for corporate tax avoidance for two reasons. Firstly, it claims that since the BVI lacks an extensive network of double taxation treaties with other jurisdictions, source jurisdictions can impose withholding taxes on inter-group transfers of income to BVI-resident companies and double taxation will not be relieved. Secondly, it claims that the BVI's international business companies are doing real business, with real substance. It then produces a maximum estimate for global 'tax leakage' (covering tax avoidance and tax evasion) via the BVI of just $750m a year.

Neither of these two claims, nor the tax leakage estimate, stands up to scrutiny. Multinational groups can and do place income in low- or no-tax jurisdictions without the need for a tax treaty. In particular, they do this by exploiting differences between different jurisdictions' rules regarding tax residence and incorporation, as in the famous 'double Irish' structure described below. They can also do so by buying or selling assets in one jurisdiction via the sale of shares in holding companies registered and resident in no-tax jurisdictions like the BVI, booking capital gains there and preventing the capital gain on the asset from being taxed, since the direct ownership of the asset does not change hands. The IMF has provided examples showing how the foregone revenue for developing countries through such indirect transfers of assets can be in the order of several billions of dollars for an individual transaction. Again, the tax efficacy of such structures often does not rely on tax treaties.

Very few BVI international business companies have any real substance in the BVI according to in the conventional definitions of substance, such as those promulgated by the OECD's base erosion and profit shifting (BEPS) process – assets, business activities and real functions carried out in the BVI. Instead, Capital Economics' claim relies on a bizarre redefinition of substance not reflected in any international tax norm or standard.

The $750m tax leakage estimate can be shown to be very likely inaccurate. Even disregarding tax avoidance, real data from tax amnesties around the world show that far more than $750m annually must be being evaded by taxpayers concealing assets and financial wealth through BVI-registered companies. This is unsurprising, since the Capital Economics estimate relies on two wholly unrealistic assumptions. Firstly, that there is no more tax evasion via BVI entities than any other jurisdiction in the world, despite the fact that until 2017 the BVI enabled total ownership anonymity of corporate entities and their assets. Secondly, that the only way that multinational corporate groups avoid tax via no-tax jurisdictions like the BVI is by postponing tax on interest income and buying or selling property assets offshore, a claim falsified by a raft of examples including the two mechanisms detailed above.

We examine these claims in more detail below.

## Profit shifting without tax treaties

It is certainly true that the BVI does not have a network of bilateral tax treaties to relieve double taxation with other countries, or to limit the taxes that those countries can apply to income flows from their jurisdictions into the BVI.[25] Yet the argument that tax treaties are essential for profit shifting – or rather, for neutralising other countries' defences against profit shifting – ignores the realities of international tax structuring by corporate groups.

First, it ignores the basic fact that the BVI **levies no tax** on corporate income, profits or gains; thus double taxation cannot arise on income shifted into the BVI from another country. The Capital Economics report is really describing the reduction of single taxation. Even if some tax is levied on that income at source, it can still be tax-advantageous to move the income into the BVI.

'It ignores the basic fact that the BVI levies no tax on corporate income, profits or gains; thus double taxation cannot arise on income shifted into the BVI from another country'

Second, numerous well-known examples attest to the ability of multinational corporate groups to move income from one jurisdiction to another tax free, without a tax treaty to cancel withholding taxes, and without falling foul of anti-tax-haven measures like controlled foreign corporation taxes. They can do this essentially by separating tax residence from the location of incorporation.

For example, major US multinationals have commonly placed intellectual property and the resulting income in tax-free companies resident in jurisdictions like the BVI, despite their lack of extensive tax treaty networks, instead using mechanisms like the double Irish (a structure which will remain available to multinational groups until at least January 2021).[26] In the double Irish mechanism, companies can be incorporated in a European country like Ireland, but be tax-resident in a no-tax jurisdiction. They thereby avoid US controlled foreign corporation (CFC) charges on payments from other Irish-registered subsidiaries to the offshore-resident Irish-registered subsidiary, and can also avoid withholding taxes by routing payments through another EU jurisdiction. In short, the tax outcome that the Capital Economics report argues is impossible has, in fact, been central to many US multinationals' tax strategies for several decades.[27]

For tax purposes, transactions involving income and gains from assets outside the BVI can also be made to take place entirely within a no-tax jurisdiction, thereby placing income in the BVI without incurring foreign tax. For example, an asset, such as a mine, a factory or an entire subsidiary business, can be owned by a chain of companies ending in a jurisdiction where there is no capital gains tax, such as the BVI. The asset can then be sold by one multinational to another simply by selling the shares in the BVI company. Any capital gains on the sale are seen as an increase in the value of the BVI share, and there is no tax on the gain because the BVI has no capital gains tax.

The IMF has pointed out that single instances of such indirect transfers of assets offshore have cost economies several billion dollars in foregone capital gains tax revenues.[28] One famous case involved the sale of the Indian mobile phone company Hutchison Essar by the Chinese firm Hutchison Whampoa to Vodafone. A capital gain of over $10bn on the sale of the Indian firm went untaxed in India because the parties arranged for the sale to take place via share transfers between BVI, Mauritian, Cayman Islands and Dutch companies.[29]

Of course, such outcomes rely in part upon the absence or failure of defensive measures by other economies against the shifting or placing of income in no-tax jurisdictions like the BVI – robust domestic laws on gains arising from indirect transfers of assets; unambiguous corporate tax residency rules; CFC regimes without loopholes like the US 'check the box' measure. Yet undeniably, it is the no-tax regime in jurisdictions like the BVI and the Cayman Islands that make such manoeuvres 'work'. The Capital Economics report labels the BVI's absence of personal and company tax as 'tax neutrality'.[30] In fact, in the examples given above, the result is no taxation in any jurisdiction (just as what Capital Economics calls 'double taxation' is in fact taxation in only one jurisdiction).

## Economic substance of BVI business companies

**'The "substance" exhibited by BVI Business Companies extends to the heart of the services that the BVI as an international business and financial centre provides… Substance increasingly goes beyond the physical.'**

*Creating Value,* Capital Economics[31]

One key aspect of tax regimes labelled 'internationally harmful' by the OECD, the G20 and the EU (among others) is the latitude given by some low-tax jurisdictions for companies to qualify for tax residency and preferential tax regimes, and thus to book income and profits there tax-free, without conducting any of the significant business activities relating to those profits in the territory itself, or holding any of the related capital assets there.

This misalignment of the 'taxation of profits with the substantial activities that generate them' forms the subject of Action 5 of the 2015 BEPS reforms agreed by 102 countries and jurisdictions – including, in theory, the BVI.[32,33] At a more basic level, it forms the basis of OECD-agreed transfer pricing rules intended to attribute profits between different jurisdictions in which multinationals operate, according to the functions, assets and risks in each jurisdiction.

Action 5 of the BEPS Project lays out 'substance' requirements for particular (especially preferential and intellectual property-related) tax regimes, while Actions 8-10 lay out revisions to the OECD Transfer Pricing guidelines, to ensure that profits can only be booked (and taxed) where the underlying economic 'substance' – business activities, assets, personnel – is located.

Despite the Capital Economics report declaring that the BVI is a compliant member of the Inclusive Framework on BEPS,[34] the BVI's tax regime demonstrably fails to meet these standards. BVI domestic tax law includes no transfer pricing rules at all.[35] The BVI Business Companies Act 2004, meanwhile, provides a broad income tax exemption for all BVI business companies – all dividend, interest, rent, royalties, compensation and other amounts paid by a company and all capital gains arising from shares.[36] This is so broad as hardly to constitute a preferential or ring-fenced regime at all for offshore companies' income, though, characteristically, the provision of an exemption for stamp duty on property transactions is limited only to transactions of property outside the BVI. (Despite the Capital Economics report acknowledging explicitly that BVI companies can be used to avoid stamp duty property taxes overseas, the BVI appears not to wish to extend this avoidance channel to property sales in its own jurisdiction.[37])

The BVI's absence of transfer pricing and substance requirements means that the vast majority of BVI-registered business companies qualifying for BVI tax residency can be entirely 'substanceless'. They have no assets, employees or activities in the BVI. Indeed, any such substance is physically and logically impossible in a country where 452,000 registered companies share a landmass of just 153km$^2$, in which there are more than 14 companies for every inhabitant, and whose banks hold financial liabilities of a little more than $2bn. Even if all of this $2bn consisted of deposits or financial instruments owned by BVI companies, it would constitute just over $4,000 for each registered company.

Instead, the Capital Economics report presents a bizarre redefinition of corporate substance as a feature of the BVI as a territory, stating: 'The BVI has substance in that it offers jurisdictional and tax neutrality to clients from all over the world, helping to create investment opportunities to meet the needs of global businesses and internationally mobile individuals. The BVI provides 'legal and contractual substance… Indeed, there is physical substance in the BVI with its high quality commercial court, a branch of the Eastern Caribbean Supreme Court, its new state-of-the-art International Arbitration Centre and its Registry of Corporate Affairs.'[38]

Needless to say, the existence of well-maintained municipal buildings forms no part of internationally agreed definitions of substance in international tax law and standards.

'The vast majority of BVI-registered business companies qualifying for the BVI's no-tax regime can be entirely "substanceless". They have no assets, employees or activities in the BVI'

## Tax leakage in the BVI

**'In total, we estimate that the theoretical maximum amount of tax that could be avoided globally each year through these routes is US$¾ billion. To put this in context, the United Kingdom tax authorities estimate their annual "tax gap" at US$59 billion alone – so any leakage through the BVI is immaterial against other sources of tax loss.'**

*Creating Value,* Capital Economics[39]

Beyond its claims about the BVI's corporate and tax laws, at the heart of Capital Economics' case against labelling the BVI a tax haven is a set of econometric estimates of the BVI's fiscal impact around the world. Capital Economics estimates that the 'theoretical maximum amount' of worldwide tax leakage via the BVI is just **$750m annually**. To put this into perspective, this is less than the amount that the UK estimates is evaded on UK beer duties each year.[40] It would be difficult, therefore, to take this estimate seriously even for the most scrupulously policed, transparent and financially marginal jurisdiction; let alone for a jurisdiction whose corporate entities hold over $1tn of assets around the world, half of which are invested in countries with which the BVI offers no tax information exchange and thus offers absolute secrecy of asset ownership for tax purposes.

Capital Economics' tax leakage estimate is so small in part because it includes tax avoidance via the BVI through just two mechanisms: 'deferred' tax payments on interest income, and untaxed indirect transfers of real estate via BVI holding companies.[41] (Confusingly, earlier in the report such no-tax treatments of 'transactions conducted or assets held in the BVI that relate to economic activity elsewhere' are referred to as 'tax neutrality', which 'does not reduce or eliminate any tax liability in other jurisdictions'.[42] Yet later in the report this becomes a 'tax leakage' of $750m annually.[43])

However the revenue impact of these avoidance mechanisms is calculated, it certainly ignores a range of other avoidance and evasion mechanisms via BVI companies. These include:

- 'Round-tripping' domestic investment – particularly from Chinese investors – via the BVI in order to qualify for tax exemptions on new foreign investment; a behaviour which, in part, explains the huge preponderance of investment routed through the BVI to and from China and Hong Kong. As the head of the China practice at American law firm Harris & Moure (now Harris Bricken) told reporters candidly in 2011: 'The reason for this strong link between China and the BVI is a very simple form of tax avoidance. If you take the money straight back into China you pay capital gains [or income] tax. If you leave it in the BVI, wait a while then send it back, it can be made to look to the authorities like it is a foreign investment, and you don't pay tax on that.'[44]
- Strategies like the double Irish, which permit large US multinationals to place intellectual property in 'no-tax' jurisdictions like the BVI or Bermuda and then to shift income there as royalties via EU-incorporated companies, avoiding withholding taxes and US CFC rules.[45]

- Avoiding capital gains tax on disposals of (non-property) assets by holding their ownership through chains of companies in jurisdictions like the BVI, whose shares can be transferred tax-free.[46]

## Case study: Tax leakage in Indonesia and Argentina

Nonetheless, even examining just one tax leakage channel assessed in the report – the straightforward accrual of investment income in a BVI company free from tax – Capital Economics' estimate is highly questionable.

Recent tax amnesties in several countries have provided concrete figures for previously undeclared taxable assets held in the BVI (Table 1). Under amnesties in the last 12 months in Indonesia and Argentina, taxpayers declared $5.8bn and $84bn, respectively, as previously undeclared assets with income taxable in these countries.

**Table 1:** Substantial hidden taxable assets are held via BVI companies even by taxpayers in small economies

| Country | Year of amnesty | Total hidden assets declared (domestic and overseas, $bn) | Total hidden assets overseas declared ($bn) | Total hidden assets in BVI declared ($bn) | Estimated annual income at 3% per annum ($m) | Estimated tax foregone at 30% ($m) |
|---|---|---|---|---|---|---|
| **Indonesia** | 2016/17 | 366 | 92 | 5.8 | 174 | 51 |
| **Argentina** | 2016 | 116 | 92.8 | 8.4 | 252 | 76 |

Source: See note 61.

Note that this is evaded tax, not avoided tax. The Capital Economics tax leakage figure assumes unrealistically that tax evasion via the BVI is zero, since 'there is no reason to believe that the BVI will offer any greater options for the evasion of "onshore taxes" than are available in the onshore jurisdictions themselves. Indeed, there is every chance that the levels of tax evasion are lower in the BVI.'[48]

Using the same assumptions as the Capital Economics report for estimating the taxable interest income generated by such assets (3% per annum interest rate, income tax at 30%),[49] these concrete declarations of previously undeclared BVI assets suggests **annual tax leakage through BVI-facilitated evasion of some $130m annually just for these two small economie***s.* This is equivalent to a sixth of the entire global tax leakage through all BVI channels estimated by Capital Economics.

Strikingly, these figures also suggest that some 3% of Indonesia's total net household wealth has been held undeclared in the BVI, and more than 11% of Argentina's total net household wealth (Table 2).

**Table 2:** Substantial proportions of countries' total net household wealth are held undeclared via BVI companies.

| Country | Year of amnesty | Total hidden assets in BVI declared ($bn) | Net wealth per capita, 2016 ($) | Total population (millions) | Estimated total net wealth ($bn) | % of total net wealth revealed as previously undeclared in BVI |
|---|---|---|---|---|---|---|
| **Indonesia** | 2016/17 | 5.8 | 750 | 261.1 | 195.825 | 3% |
| **Argentina** | 2016 | 8.4 | 1,660 | 43.9 | 72.791 | 11.5% |

Sources: Estimates of net wealth per capita, Allianz Global Wealth Report 2016, p121, (www.allianz.com/v_1474281539000/media/economic_research/publications/specials/en/AGWR2016e.pdf); World Bank population statistics.

Allianz estimates that individuals in Indonesia and Argentina own just 0.2% of the world's financial assets. Even with a fraction of the rates of offshore BVI concealment revealed in these two countries, the resulting global loss from tax evasion via undeclared BVI assets, according to Capital Economics' own assumptions about the wealth generated by these offshored assets, must be several billions of dollars.[50]

# A source of investment, jobs and revenue?

The second part of the fiscal balance sheet that Capital Economics draws up for the BVI is a set of estimates for overseas jobs, economic activity and consequent tax revenues generated by direct investment 'mediated' by the BVI. These estimates are difficult to assess because Capital Economics provides none of the underlying data it uses to estimate ratios of investment to job creation;[51] and neither the methods nor the data it uses to estimate ratios of jobs to tax revenue.[52] (We have asked Capital Economics twice to share the data and methodology they used, in the interests of transparency; while acknowledging our requests, they had not responded at the time of writing this report.[53])

The estimate of total tax generated per job varies very widely across regions. This is not unexpected, but the ratios used are entirely unexplained in the paper. Likewise, Capital Economics assumes that jobs in different regions will generate widely different proportions of income and corporate tax. Again, this is possible, but it is not explained anywhere how these ratios were determined (Table 3).

**Table 3:** Capital Economics' estimates of employment and tax revenues generated BVI-mediated investment are based on unexplained ratios which vary widely across different regions analysed.

| Region | Employment related to investment mediated by BVI business companies ('000s) | Total tax ($bn) | Tax generated per job ($)[54] | Ratio of corporate tax generated to total tax generated[55] | Ratio of income tax generated to corporate tax generated[55] |
|---|---|---|---|---|---|
| **UK** | 148 | 3.9 | 26,351 | 13 | 4 |
| **EU (non-UK)** | 150 | 4.2 | 28,000 | 14 | 4.3 |
| **Rest of Europe** | 136 | 1.9 | 13,971 | 9.5 | 3 |
| **North America** | 79 | 1.8 | 22,785 | 9 | 4.5 |
| **Latin America/ Caribbean** | 328 | 0.9 | 2,744 | 9 | 5 |
| **China/Hong Kong** | 874 | 2.1 | 2,403 | 10.5 | 3 |
| **Rest of the world** | 439 | 1.0 | 2,278 | 10 | 3 |

The lack of data or explanation in these figures is ironic, given the fact that a long section of the paper takes aim at a series of 'headline grabbing numbers' generated by non-governmental organisations and transparency campaigners to estimate the global scale illicit financial flows, tax evasion or corporate tax avoidance, including estimates by Christian Aid which the report dismisses, without analysis, as 'massive number crunching nonsense'.[55] The data and methods behind these estimates are publicly available and thus widely debated; in contrast to the figures that Capital Economics gives in this report, which are based on an entirely unknown and confidential methodology.

Despite the opacity of these calculations, what can be assessed is the basic argument for the BVI's role in actually generating this investment, economic activity and consequent tax revenue. Here the report's claims and assumptions once again fail to stand up to scrutiny.

The BVI's own economy creates almost none of this investment. As discussed above, it does not even have a materially significant banking sector, and so cannot even claim to generate access to liquidity for investors. Financial assets and instruments owned by BVI companies are, almost without exception, held in financial institutions **outside** the BVI – in other words, the investment that the BVI claims to 'mediate' does not come anywhere near the BVI, **even on paper**. Instead, all that the BVI provides is a register for legal vehicles to hold these assets anonymously. Attributing positive economic impacts of investment passing through BVI companies to the BVI economy, as the Capital Economics report does, is akin to attributing the wealth created by rising UK property values to the work of the UK Land Registry (rather than demand in the housing market, providers of finance for house building, infrastructure development, and so on).

As evidenced by growing evidence for circular financial flows via the BVI, particularly to and from China and Hong Kong, much of the investment mediated by BVI companies is potentially not new foreign investment at all, but domestic investment disguised as foreign investment through round-tripping. Any positive economic impact cannot be attributed to the benefits of BVI-mediated foreign direct investment (FDI), since it is not actually foreign investment.

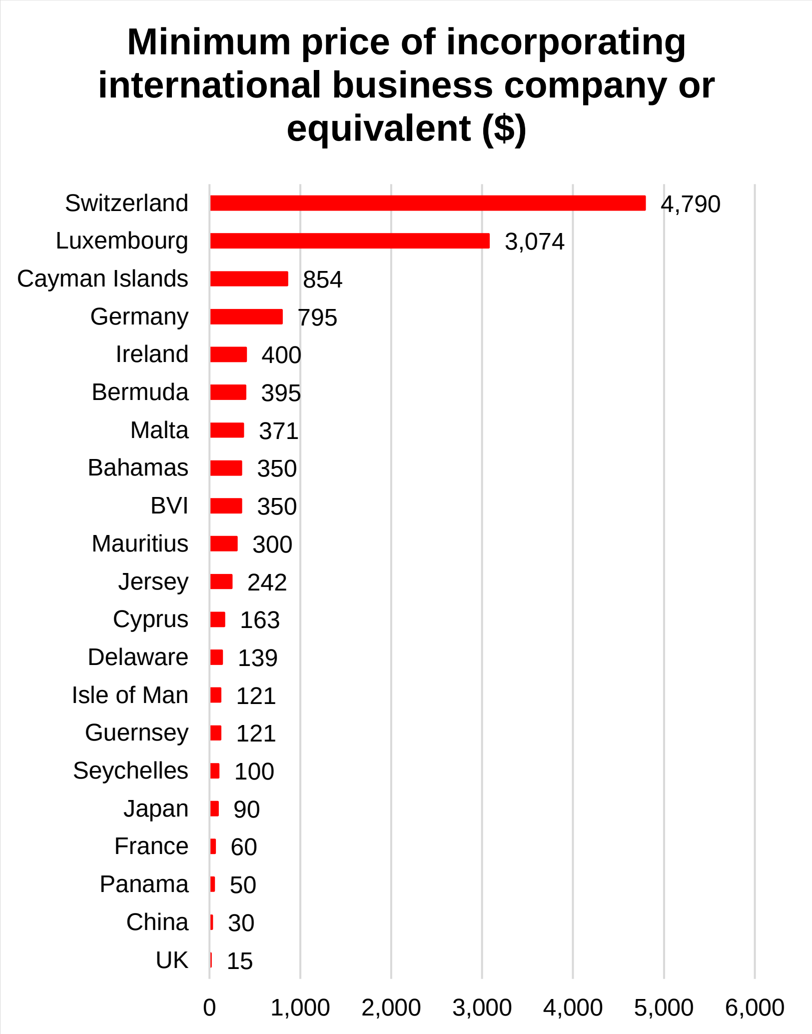
Capital Economics concedes that: 'If the BVI's international business and finance centre did not exist, some (if not much) of the investment mediated through it would likely happen anyway.'[56] (Capital Economics nonetheless attributes the entirety of the value, jobs and tax revenues generated by that investment to the BVI's contribution, and balances it against tax leakage via the BVI). But it argues instead that if the investment were routed through a different jurisdiction, this would add costs to that investment.[57]

In practice, since the BVI provides no significant financial services except company formation and registration, the key cost is that of company registration and management. Yet the report's own figures show that the BVI, though a much less expensive registration site than European FDI conduits like Switzerland or Luxembourg, is far from being among the cheapest. Onshore jurisdictions that are major sources and destinations of BVI-mediated FDI, like China, France and the UK, are considerably cheaper (Figure 3).

Low cost does not correlate to secrecy – the UK is the lowest cost jurisdiction and is also the most transparent, with a publicly available register of beneficial ownership information. The requirement for registrants to use registered company service providers as mediators for company registration and management in the BVI, which is not required in onshore jurisdictions like the UK, also adds costs.

'The investment that the BVI claims to "mediate" does not come anywhere near the BVI, even on paper'

**Figure 3:** The BVI is not among the lowest-cost company registries; nor are lower-cost registries necessarily more opaque or less well-regulated.




Source: Capital Economics (2017), p76, Figure 60; World Bank, Doing Business (2016, www.doingbusiness.org/data/exploreeconomies/beijing/starting-a-business)

In any case, the costs of registering and maintaining companies in any jurisdiction are marginal in comparison to the size of returns on transnational investments.

Capital Economics also argues that if such investment were not 'mediated' by the BVI, it would be pushed to other financial centres that 'have not kept pace with the Government of the Virgin Islands in the adoption of international standards for transparency, tax information exchange, anti-money laundering and combatting the financing of terrorism'.[58] Yet as Section 2 above shows, the BVI has a far from glowing track record in this area.

Finally, Capital Economics claims that the BVI's dependable, well-resourced legal regime and good governance provide legal certainty for cross-border investment. It notes in particular: 'The commercial division of the Supreme Court was established in May 2009 and sits in Road Town. This court, with established judges and processes, has adjudicated on a large number of disputes of significant size… Building on the physical presence of the commercial court in Road Town and the BVI's strong reputation as a high quality legal community, the territory established the innovative BVI International Arbitration Centre in January 2017.'[59]

It fails to mention the reality of this 'sophisticated and highly regarded commercial court',[60] which is that until 2016 the island's commercial court had a single resident judge responsible for adjudicating the multi-million dollar legal claims of the hundreds of thousands of BVI-registered companies.[61] This was reportedly increased to three judges in 2017.[62]

# Conclusion

In our view, the Capital Economics' report tortures the evidence to depict the BVI as a diverse economy, offering real and legitimate financial services, and creating value through cross-border investment. None of these claims stands up to scrutiny. Instead, a realistic picture of the BVI shows its 'financial services centre' is in fact dedicated almost exclusively to the registration of companies with no business substance in the BVI; and offers no real financial services or infrastructure except secrecy to the owners of the half-a-million companies which are crammed, on paper, within the 55 $km^2$ of the main island of Tortola.

As well as serving to disguise the true scale of potential financial crime, tax evasion and tax avoidance facilitated by the corporate secrecy of BVI-registered companies, this depiction of the nature and function of the BVI economy conceals a real economic problem for the BVI itself. Since the 1980s, the BVI Government has shorn itself of the capacity to raise revenues through corporate or personal income tax. Instead, it is substantially dependent upon revenue from company registration fees, which currently constitute over half of all government revenues.[63] This limited and fragile source of public finances is now perilously exposed to the changing tides of public opinion, government regulation and digital insecurity. The same argument can be made for many of the other British Overseas Territories and Crown Dependencies. Continuing this suicidal fiscal strategy is a problem for every one of the citizens in these jurisdictions – citizens for whose security and wellbeing the UK Government ultimately has responsibility.

For those citizens' sake, the UK Government must seriously consider supporting new, sustainable economic and legal directions for the BVI, and for other Overseas Territories and Crown Dependencies with an oversized financial or corporate registration sector. Concealing the problem, as the Capital Economics *Creating Value* report does, is not the way to start.

'Continuing this suicidal fiscal strategy is a problem for every one of the citizens in these jurisdictions – citizens for whose security and wellbeing the UK Government ultimately has responsibility'

# End notes

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[4] *Commercial Banks Banking Indicators (CY 2015),* BVI Government, www.bvi.gov.vg/sites/default/files/commercial_banks_banking_indicators_2015.pdf

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[23] Author calculations from statistics provided to OECD Global Forum Peer Reviews (various dates) and UK Companies House.

[24] See note 2, p 95.

[25] The UK has a DTC with the BVI which covers only individuals/individual income tax, not corporations/corporate income tax. The UK has also extended its tax treaties with Japan and Switzerland to the BVI. Beyond these, the BVI only has tax information exchange agreements with other jurisdictions.

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48 See note 2, p130.

49 See note 2, p131, Box 4. NB Capital Economics assumes that such offshored interest is merely deferred rather than evaded, and thus simply compares the tax that would be paid annually on onshore investments against the tax paid only when an offshore investment in dispersed after seven years. This difference is then discounted by 2% per annum to calculate the net present value of the tax foregone. Since the income and assets in the amnesties detailed in Box 4 are simply undeclared (ie, tax is categorically evaded, not simply postponed), we have simply calculated the absolute tax foregone on a 3% annual return to the asset. We have (conservatively) disregarded capital growth, which the Capital Economics report factors in.

50 We avoid estimating a precise global figure here in deference to Capital Economics' measured critique of previous Christian Aid estimates for the cost of global tax evasion and avoidance, which the BVI report dismisses without analysis under the label 'massive number crunching nonsense' – see *Creating Value,* Capital Economics, 2017, p33, Figure 20.

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52 See note 2, p129, Figure 110.

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