How to Crack Down on Tax Havens

Start With the Banks

Nicholas Shaxson

On October 17, 2008, during the throes of the global financial crisis, officials from the U.S. Department of Justice summoned Swiss banking regulators and executives from UBS, Switzerland's largest bank, to a closed-door meeting in New York to discuss the bank's role in helping American clients evade taxes. It was a sensitive moment: the Swiss government had bailed out UBS the previous day. The bank's game plan was simple, a company insider later told Reuters: "Admit guilt, settle the case quickly, and move on."

But the Swiss were in for a nasty surprise. Four months earlier, U.S. authorities had imprisoned Bradley Birkenfeld, a former UBS wealth manager who had begun to spill the institution's secrets. Cooperating with U.S. investigators, Birkenfeld described a culture of deception at the bank, which circumvented many countries' laws and the bank's own regulations, making use of encrypted computers and offshore shell companies and trusts. (Birkenfeld also claimed to have relied on less sophisticated methods, such as hiding diamonds in a toothpaste tube to smuggle them across borders.) Birkenfeld claimed that UBS, seeking to make inroads with "high net worth individuals"—Silicon Valley entrepreneurs, Russian oligarchs, Saudi princes, Chinese industrial magnates—sponsored events popular with global economic elites, such as the America's Cup yacht race and the Art Basel festival in Miami. In his confessional book, *Lucifer's Banker*, he describes organizing what he touts as the largest-ever exhibit of Rodin sculptures. "I can't even remember how many of those art lovers ended up in our vaults," Birkenfeld writes.

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According to Birkenfeld, other UBS bankers also used such events to introduce themselves to ultrarich attendees and pitch their bank as a safe harbor where vast quantities of wealth could reside, out of the reach of pesky tax collectors. The Department of Justice estimated that in 2004 alone, Swiss bankers visited the United States 3,800 times to find and retain clients. The investigation found that UBS had helped U.S. clients hide up to $20 billion.

But U.S. clients accounted for less than two percent of the assets of the bank's wealth-management division, which was handling around $1.3 trillion globally by the time the financial crisis hit in 2007. Secrecy was a global game for Swiss banks, and the playing field extended far beyond Switzerland and the United States. One former Swiss banker told me that she would regularly travel to Latin America for work and would always arrive with butterflies in her stomach, uncomfortable with the deceptions she had to carry out. On the immigration form, she would write that she was traveling for pleasure, "though my suitcase would be full of business suits and portfolio evaluations." She would remove client names and numbers from documents so that if the authorities found them, they wouldn't be able to connect the dots between assets and depositors. She attended polo matches, operas, and champagne dinners, earning the trust of potential customers. "That is where it happens," she said—meaning the establishment of a mutually beneficial relationship in which her bank would help wealthy elites hide their often ill-gotten gains in exchange for hefty wealth-management fees. "I felt like I was prostituting myself," she said.

UBS was a major player, but just one part of a vast system of offshore tax havens that still thrives. Havens facilitate tax evasion, undermine the rule of law, and abet organized crime. They contribute to the economic inequality that has sapped people's faith in democracy and fueled populist backlashes. They corrupt market economies by favoring large multinationals over smaller local companies for reasons that have nothing to do with productivity, entrepreneurship, or genuine wealth creation. They have supercharged the profits of systemically important global banks, helping make such institutions "too big to fail" and "too big to jail." They help wealthy elites in poor countries loot their treasuries and stash the spoils elsewhere, generating illicit cross-border financial flows of around $1 trillion each year, according to the Washington, D.C.–based research firm Global Financial Integrity.

Before the global financial crisis, few officials in the developed world made much noise about tax havens. But their existence was hardly a secret, and many major financial firms involved in the offshore system employed former officials as executives or lobbyists. At the time that UBS was under investigation, its vice chair of investment banking was Phil Gramm, a former Republican senator from Texas who had served as the chair of the Senate Banking Committee. (I sent Gramm an e-mail asking him what he knew about UBS' activities in this area at that time; a representative said he was not available to comment.)

Whatever political cover the bank may have believed it enjoyed, the Department of Justice officials told the Swiss that if they wanted to avoid criminal charges of defrauding the United States, they would need to supply the names of U.S. tax evaders who held assets at UBS. For the Swiss, this represented an excruciating choice between violating the official policy of banking secrecy that their country had upheld for more than seven decades and risking a criminal indictment that could conceivably destroy UBS. Ultimately, in February 2009, the Swiss government gave its blessing to a settlement in which UBS admitted defrauding the United States and paid a fine of $780 million. Crucially, Switzerland also agreed to implement emergency laws to bypass Swiss courts and allow UBS to deliver the names of 280 high-level U.S. tax evaders.

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But the Department of Justice wasn't done: it immediately hit UBS with a new fraud charge. The bank eventually coughed up 4,450 names. The Department of Justice widened the net to include other Swiss banks, and to date, more than 55,000 U.S. taxpayers have voluntarily come forward with information about their Swiss deposits. By January 2016, U.S. authorities had recovered some $8 billion from these banks' clients in back taxes, interest, and penalties, plus $1.4 billion in penalties paid by the banks themselves. More is likely to have been recovered since then.

The episode marked a powerful victory in the fight against tax havens and provided crucial lessons in how to crack down on them, a task that has taken on renewed urgency in recent years. Last November, the International Consortium of Investigative Journalists, in partnership with 95 news organizations all over the world, published the "Paradise Papers" reports, the result of a giant data leak from the Bermuda-based offices of an offshore law firm, Appleby, which shed light on how the ultrarich avoid taxes and escape other laws and rules. This was a sequel to the ICIJ's 2016 "Panama Papers" reports, which revealed the secrets of another company that specialized in hiding assets, the Panamanian law firm Mossack Fonseca, and exposed a sordid world of criminality and creative tax shenanigans—alongside plenty of perfectly legal behavior. And in 2014, the ICIJ published the "LuxLeaks" papers, another huge data leak, which revealed how the accounting firm PwC helped its clients lawfully avoid paying taxes by using Luxembourg as a platform for exploiting loopholes in other countries' tax codes.

These revelations have turned a harsh spotlight on the questionable financial practices of prominent multinationals such as Disney; the commodity trading giant Glencore and its rival, Koch Industries; celebrities such as Harvey Weinstein and Shakira; criminals connected to the notorious Mexican drug lord Joaquín "El Chapo" Guzmán; and political figures as varied as U.S. Commerce Secretary Wilbur Ross, Russian President Vladimir Putin, and Queen Elizabeth II. What these investigations have shown is that tax havens aren't an exotic side-show to the world economy: they lie close to its heart.

Outrage over tax havens has never been more widespread and deep-seated than it is today. But addressing the harm they cause will not be easy; tax havens enjoy the protection of powerful forces, and the reforms that would be required to rein them in are fairly radical. Successfully tackling the problem will require mobilizing public anger against rigged systems that disadvantage ordinary people.

TAKE THE MONEY AND RUN

There is no generally agreed-on definition of "tax haven," but its meaning can be boiled down to two ideas: elsewhere and escape. Very wealthy people put their money or assets elsewhere—in places usually referred to as "offshore"—to escape the rules at home that they don't like. Those rules may be tax laws, disclosure requirements, criminal statutes, or financial regulations. In exchange, the private-sector enablers of the system earn hefty fees from their clients, and haven governments profit from taxes, which they typically levy not on the capital nominally flowing through these places but on the incomes or consumption of the local resident professionals who handle that capital.

A commonly cited estimate of the total amount of wealth held offshore, calculated by the economist Gabriel Zucman, is $8.7 trillion—a figure equal to around ten percent of global GDP. Zucman arrived at that figure using a novel method: tracking mismatches between cross-border assets and liabilities in countries' balance-of-payments records. He has said that the $8.7 trillion figure probably does not fully reflect the volume of hidden assets, because it excludes nonfinancial assets owned offshore, such as art, or racehorses, or real estate. But in e-mail exchanges with me, he agreed there were further assets his data miss. His method doesn't account for some fairly common tax-evasion tools, such as certain insurance products designed to hide assets, or for situations in which recorded assets and liabilities technically reside in the same jurisdiction but are nevertheless "offshore" because the owner is elsewhere. (One example: U.S. securities held by a custodian bank in the United States but owned by a Brazilian.) Also, although banks don't mind revealing aggregate figures of their assets and liabilities, which form the basis of Zucman's numbers, tax or criminal authorities seek client-level data, which banks are far more reluctant to hand over. It's safe to assume that if authorities could see that information, they would discover many more hidden assets.

Havens exist in almost every region of the world, with each providing a different mix of offshore services.

Using a model that is more inclusive than Zucman's, the economist James Henry has estimated that tax havens hold between $24 trillion and $36 trillion. Even that estimate represents only the stock of individual wealth held offshore and does not fully take into account the assets that corporations park outside their home countries. (Corporate and individual wealth overlap, of course, since individuals hold corporate assets, but the two forms of wealth are taxed differently.) U.S. Fortune 500 corporations alone hold around $2.6 trillion offshore. The UN Conference on Trade and Development has estimated that developing countries lose out on somewhere between $70 billion and $120 billion in annual tax revenue due to multinationals artificially shifting profits to tax havens. And rich countries are hardly immune: according to a 2014 U.S. Senate report, the United States loses around $150 billion in tax revenue each year owing to offshore tax schemes.

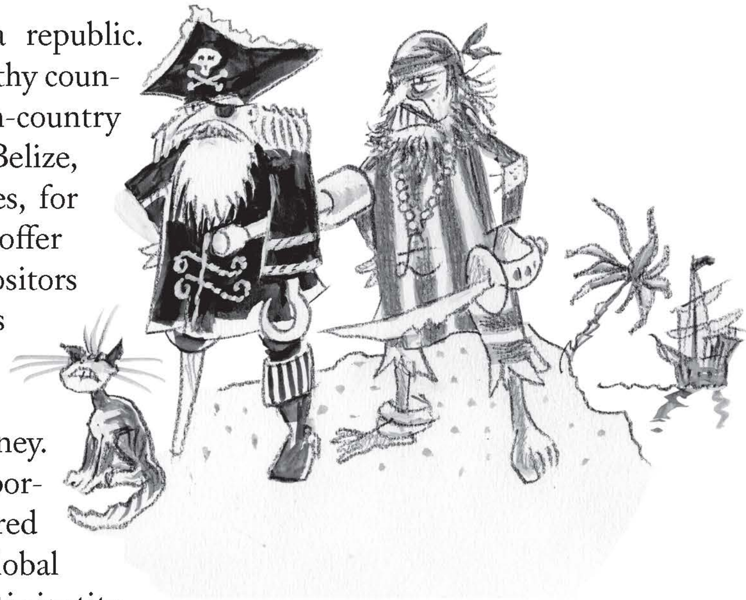
The global offshore system is constantly evolving. Havens exist in almost every region of the world, with each providing a different mix of offshore services. In Asia, Hong Kong serves as China's offshore gateway to the world—a low-tax platform for capital to flow in and out of China, often with minimal scrutiny. Singapore, meanwhile, acts as a haven of choice for wealthy elites from Australia, Indonesia, and Malaysia. In Europe, Switzerland is not the only player. A U.S. Senate investigation published in 2013, for example, showed how Apple had routed some $74 billion through Ireland in the preceding four years, escaping almost all taxes on its profits earned outside the United States. Meanwhile, Luxembourg provides exotic tax-avoidance products, such as shell companies, alongside more mainstream tax-escape facilities. And the Netherlands acts as an offshore stepping-stone for investment funds shifting capital between different countries stripping out taxes along the way.

Then there is the massive British network, which resembles a spider web, with the City of London in the middle, surrounded by an array of British territories and dependencies: the British Virgin Islands, Bermuda, Gibraltar, the Cayman Islands, Jersey, Guernsey, and the Isle of Man. The British Virgin Islands specialize in secretive shell companies and trusts. Bermuda is a big player in offshore "captive insurance," wherein a multinational owns a company ostensibly for insurance purposes but typically with the real goal of cutting its tax bill. Gibraltar is a favored destination for dodgy money from the former Soviet Union, and the Cayman Islands and Jersey cater to the tax-avoidance needs of investors in hedge funds and private equity firms, among others. Such places enjoy some level of autonomy from the United Kingdom, but London ultimately calls the shots and guarantees their legal systems.

Another crucial tax haven is the United States. Delaware, Nevada, Wyoming, and other states encourage people to set up shell companies, which allow their owners to hide behind walls of secrecy so thick that foreign crime fighters cannot penetrate them—and neither, usually, can the Internal Revenue Service or the Department of Justice. Much of U.S. President Donald Trump's wealth is reportedly held by Delaware companies, which would make it easier for him to hide conflicts of interest. The amount of assets held in shell companies based in the United States can only be guessed at; it is likely in the trillions.

The U.S. federal government, for its part, turns a blind eye to this state-level phenomenon and even provides another layer of financial secrecy for foreigners. Federal enforcement efforts focus on finding U.S. tax cheats in overseas havens. Under the Foreign Account Tax Compliance Act (FATCA), Washington requires foreign financial institutions to disclose their American clients' financial information to the U.S. Treasury and imposes a 30 percent withholding tax on certain payments to foreign financial institutions that don't comply. But Washington is stingy when it comes to sharing information in the other direction, often refusing to reveal data on the assets that foreigners hold in the United States to law enforcement authorities elsewhere. As a result, the United States hosts large amounts of criminal and foreign "dark money," some of which finds its way into the political system via campaign spending. In 2011, the Florida Bankers Association estimated that hundreds of billions of dollars had come to the United States in pursuit of this secrecy. The sums are larger now.

Notice that nearly all the places mentioned above are either rich countries or satellites of rich countries. Tax havens need to persuade asset holders that they are safe, reliable, and trustworthy. Nobody wants



to hide assets in a banana republic. There are havens in less wealthy countries and places without rich-country protectors—the Bahamas, Belize, Mauritius, and the Seychelles, for example—but they cannot offer mainstream ultrarich depositors the same level of protection as the big players, and so those places tend to go down market, attracting more illicit money.

All tax havens share an important feature: they are "captured states," in which powerful global forces prevent local democratic institutions from interfering in the elaborate game of offshore finance. This is especially true of smaller tax havens, such as Jersey or Vanuatu, where local legislators are often ordinary folks—former fishermen or hoteliers, for example—who lack the skills, knowledge, or confidence they would need to push back against the flood of money, influence, and financial expertise that suffuses the offshore system and that has drowned entire societies. Locals often fear that challenging offshore players will lead the rich to take their money elsewhere. Haven residents who dare criticize the offshore sector are routinely ostracized as traitors and even frozen out of employment. And if offshore players don't get the laws they want, they have been known to turn to bribery, which can be especially effective in small jurisdictions. As a result of all of this, local authorities often serve as rubber stamps for laws and regulations proposed by offshore private-sector actors.

Most tax havens attract little genuine foreign investment as a result of their offshore strategies. What they generally get instead is "hot money"—rootless capital that flits from place to place in search of the most welcoming home. The constant fear in havens that such assets will flee creates a race to the bottom, as authorities strain to make themselves ever more accommodating. In March

2009, in the depths of a global financial crisis that was brought on in large part by lax regulation, Robert Kirkby, then the technical director of Jersey Finance, the official lobbying body for Jersey's financial sector, proudly described this dynamic. Explaining how Jersey dealt with private-sector demands to loosen regulations related to the risky securitization of various kinds of assets, he told me, "You can lobby onshore, but there are lots of stakeholders, you have to get past them all, and it takes a long time." In Jersey, he boasted, "we can change our company laws and our regulations so much faster." That may sound like a form of free-market efficiency—but those stakeholders and onshore rules that such places bypass represent the lifeblood of the rule of law and accountability.

"A LOT OF THIS STUFF IS LEGAL"

It's fair to ask why tax havens persist and why they have so many defenders if they are so clearly deleterious. Offshore advocates make a number of arguments. But none survives scrutiny.

Officials in tax havens point out that those places are sovereign nations (or autonomous territories) with every right to set their own tax laws. That's true. But by the same logic, countries harmed by havens have every right to take strong countermeasures against them. Officials in havens also note that people have a right to privacy and need relief from unjust laws. But the people who use tax havens are overwhelmingly rich and powerful. Providing them with special forms of protection and immunity from fiscal and legal obligations while leaving everyone else to shoulder the responsibilities and burdens of society creates one rule for the 0.1 percent and another rule for everyone else.

Defenders of offshoring also correctly argue that the practice is not always illegal and arguably benefits ordinary investors alongside the ultrarich. Most large private pension and equity funds touch the offshore system in some way. So do "tax efficient" corporate cash management operations, which circulate capital around a multinational's many global subsidiaries, and "tax neutral" investing platforms, which host pools of capital from various different places and then spread it out around the world, seeking out the highest after-tax returns. If such assets were taxed in havens, too, it would be unfair "double taxation." In this sense, defenders argue, havens serve as frictionless, efficient financial conduits, removing obstacles from the path of capital as it flows in pursuit of investment opportunities around the globe.

Yet this isn't the full story. For one thing, the facilities that prevent "double taxation" are the same ones that allow accounting tricks to produce "double nontaxation," in which no taxes are paid anywhere. What is more, a lot of common tax avoidance that gets labeled "legal" actually is not: often, it's not clear whether a particular offshore strategy or structure is lawful until it has been tested in court. Law firms that set up shell companies for their clients may not be breaking any laws themselves, but many of their clients are. More broadly, what is legal isn't necessarily legitimate. As U.S. President Barack Obama said in 2016, in reaction to the Panama Papers revelations: "The problem is that a lot of this stuff is legal, not illegal."

Tax havens are a pure distillation of all that is wrong with financial globalization: they encourage capital to move across borders, but in the wrong directions. Many developing countries have found that when they open up to global finance, investment doesn't flow in to their capital-starved economies—instead, after being looted by elites, money flows out, into tax havens. Indeed, this represents one of the main reasons why financial globalization has failed to improve the lot of many poor countries.

TO CATCH A TAX CHEAT

No magic bullet can solve this vast political and economic conundrum. Any serious effort to do so would run headlong into some of the world's most powerful interests. So fairly radical solutions are required—as is constant vigilance, since the officials, bankers, accountants, and lawyers who prop up the offshore system will always seek new ways to subvert the rules.

One tactic that some economists (and many lobbyists) advocate would be sure to fail: trying to reduce the incentive for major companies and rich people to park their money offshore by lowering corporate and income tax rates. For one thing, as rich countries have steadily lowered their corporate tax rates since the 1970s, corporate investment has stagnated and tax avoidance has skyrocketed. Major firms now sit on huge piles of uninvested cash—Apple alone had nearly $300 billion at last count. Cutting corporate taxes would simply add to such piles. The same applies to lowering taxes for superwealthy individuals. There is little point in trying to "compete" with tax havens. After all, why would corporations or rich people pay a bit less when they can pay a whole lot less, or even nothing, by going offshore?

What lower taxes might attract, however, is more hot money, which brings few benefits to economies but is associated with a raft of costs: financial instability; asset bubbles; increased economic, political, and geographic inequality (which saps long-term growth); and the potential, especially in smaller open economies, for "Dutch disease," in which financial inflows push up real exchange rates and damage productive parts of an economy.

If governments want to cut havens out of the game, they will have to take far more drastic steps. By late 2017, U.S. taxes on the estimated $2.6 trillion in profits held overseas by Fortune 500 companies were supposedly being "deferred" until such time as the companies decided to "repatriate" them. As Kimberly Clausing, Reuven Avi-Yonah, and other tax experts have recommended, the United States should simply eliminate such deferrals and tax accumulated offshore earnings directly, with exemptions for taxes already paid in other countries. According to the Institute on Taxation and Economic Policy, such an approach to taxing multinationals could raise up to $750 billion for the U.S. Treasury. But the tax bill Trump signed into law last year went in precisely the opposite direction, levying a one-time tax on accumulated offshore earnings at a hugely reduced rate of between eight and 15.5 percent and exempting future foreign profits from tax—thus increasing the incentive for multinationals to keep relying on tax havens.

Advocates for the tax bill cheered in January when Apple announced that it would make a $38 billion tax payment on the cash that it held overseas and would spend $30 billion in capital expenditures over the next five years. Other technology companies will likely follow suit. But Apple's announcement did not say that the investments had anything to do with the tax reforms. Moreover, the reforms will yield less than half of the revenue the United States could have raised by simply taxing Apple's roughly $246 billion in offshore profits at the full corporate rate and then continuing to tax them every year. Instead, Washington will get a relatively modest short-term payment and next to nothing in the future.

An even more far-reaching solution is called "formulary apportionment" and would divide a multinational's total global income between individual countries according to a formula based on the company's sales, assets, and payroll in each country where it operates. After the income was so divided, each country could tax its share at whatever rate it liked. Countries could adopt this measure unilaterally, calculating and then taxing their share of a multinational's income, but international coordination would help iron out complexities. Many U.S. states and Canadian provinces already use a version of this model. It's not without its drawbacks, but it could make a huge difference if properly implemented.

Other solutions are already being tested. In 2014, the Organization for Economic Cooperation and Development set up a useful (although imperfect) global information-sharing scheme called the Common Reporting Standard, in which participating countries automatically share financial information about one another's taxpayers. The CRS is technically similar to the FATCA in the United States but with a big difference: unlike FATCA, the CRS doesn't impose a hefty 30 percent tax on payments to financial institutions that don't comply with it. Most large countries and even most large tax havens have agreed to participate in the CRS, with one glaring exception: the United States. Washington claims that it does participate, in effect, since the CRS is similar to FATCA—but this ignores the fact that although FATCA involves vague promises to share information with other countries, it actually offers other countries very little. To give the CRS teeth, the EU—the largest non-U.S. entity represented by the OECD—should impose its own 30 percent tax on payments to financial institutions that don't comply with the CRS. This would target U.S. banks, which would likely pressure Washington to provide the necessary information.

On the level of U.S. states, the activist Ralph Nader and others have long argued that letting individual states incorporate companies has resulted in a race to lower standards, as states turn themselves into permissive corporate havens in order to attract businesses and maximize incorporation fees. Nader has argued for a federal law that would create "a modern federal chartering agency with comprehensive authority." Limiting corporate chartering to the federal level, Nader contends, would "put an end to the wheeling and dealing that corporations use against state governments."

Another tactic would be to require all countries and territories to establish standardized central registers that would record who owns the various assets they hold—and, ideally, publish that information. The United Kingdom has the power to impose such a rule on every node in its spider web of tax havens, and the EU could force all its member states to do the same thing. Large, powerful countries could also blacklist tax havens that refused to take this step by imposing sanctions ranging from blocking foreign aid to cutting off recalcitrant governments or financial institutions from international payment systems. (The trouble with blacklists, however, is that the big players usually have the political muscle to lobby their way off the lists, leaving behind only the minnows.)

Alongside these measures, the UBS case illustrates an immensely powerful principle for those seeking to tackle tax havens. For decades, countries had tried and failed to crack open Switzerland's famed banking secrecy. The fight launched by U.S. law enforcement against the bank didn't exactly pit the United States against Switzerland: rather, it was chiefly a contest between the rule of law, on the one hand, and wealthy tax evaders and other criminals, on the other. Switzerland was merely the main battlefield. U.S. authorities did not threaten the country's government, at least not directly.

If authorities in one country go after another country, then elected officials and the public in the target country might rally against foreign "bullies." That is what happened in 2008, when Peer Steinbrück, then the German finance minister, publicly threatened to "take a whip" to Switzerland, albeit without providing detailed proposals. In the wake of a furious response from the Swiss public, the Germans backed off.

In tackling tax havens, private companies often make much better targets than governments. Banks can be regulated and penalized. So can the so-called Big Four accounting firms: Deloitte, EY, KPMG, and PwC, which are as responsible as any other group for putting together the nuts and bolts of the offshore system. Little focuses the minds of bankers and accountants like the threat of jail or the loss of a license to operate in a big economy.

TRUMP TIME?

Fatalists argue that crackdowns on tax havens are pointless, like squeezing a balloon: its shape changes, they argue, but its volume stays the same. That is false. Crackdowns are more like squeezing a sponge: yes, there is some displacement, but also a reduction in volume.

The real problem with crackdowns is usually that governments lack the political will to carry them out. In the United States, it seems unlikely that this will change much in the Trump era. But Trump could, in theory, revive his now tattered populist image and drive up his flagging approval ratings by announcing a crackdown on tax havens. He has, in fact, already expressed interest in doing so. When

I interviewed him by telephone in 2016 for an article I was writing for *Vanity Fair*, he told me that, if elected, he would "fix" tax havens and address the issue of banking secrecy. "I fully understand the tax-haven situation, and much of it will be ended," he said. "It is very easy to end it." But when I asked him how, he cut short the interview.

Whether or not Trump acts, it seems likely that the offshore system will come under ever-stronger attack, as public fury rises about inequality and as large multinationals and private elites remain untaxed, unaccountable, and out of touch. Until recently, few people paid attention to tax havens, and those who did considered them to be colorful sideshows to the global economy: the province of a few Mafiosi, drug runners, tax-cheating celebrities, and European aristocrats. But the Panama and Paradise Papers helped expose the truth: the offshore system is a cancer on the global economy. Tax havens are formidable bastions of wealth and power, but because they hurt nearly everyone, the campaign against them could conceivably draw together a vast array of allies. Mafia bosses and drug runners use tax havens, so law enforcement and tough-on-crime politicians should want to shut them down. Every major private-sector financial institution uses tax havens and is significantly implicated in the offshore system, so campaigners against the outsize influence of Wall Street should be laser-focused on the problem. U.S. banks go offshore to escape rules they don't like, accelerating their path toward too-big-to-fail, too-big-to-jail status. So policymakers worried about financial stability should pay more attention to the role of tax havens. Politicians use tax havens to hide bribes and bypass disclosure laws, which means that anticorruption campaigners ought to join the fray. Dictators and their cronies in poor countries use havens to stash their looted treasure, so international development organizations should contribute more to fighting the offshore system.

The list of potential partners in the fight against the offshore system is long, and could grow longer. It is a cause that could attract voters on the right worried about crime and the corruption of markets and voters on the left worried about inequality and growing corporate power. Politicians of all stripes would be wise to get ahead of the story.