

## OFFSHORE STRUCTURES FOR BUSINESS AND PERSONAL USE

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### OVERVIEW

#### I. Motivations for Use of an Offshore Structure

- A. What constitutes "offshore" depends upon the locus of the person interacting with the jurisdiction.
1. Jurisdictions outside of the United States are typically thought of as offshore from our perspective here in California, but the United States is just as "offshore" to a Hong Kong or Singapore or Mexico based company or individual creating in an investment structure or an estate plan.
  2. In some circumstances, the United States or a political subdivision thereof may be utilized by a foreign person as a de facto "tax haven". See Wagner, U.S. Taxation of Foreign Income: The Use of Tax Havens in a Changing Environment, 18S. ILL. U. L.J. 617, n. 15 at 619.
- B. What motivates the use of an offshore entity?
1. Need for a politically neutral tax friendly jurisdiction in the context of a multi-party transaction.
  2. Avoidance of burdensome regulations inhibiting a complex business transaction between sophisticated parties.
  3. Reduction or deferral of total taxes utilizing specially placed entities to access treaty benefits, to produce breaks in connectivity or to defer recognition.
  4. Avoidance of constraints upon gratuitous asset transfers by either avoiding forced heirship rules or accessing jurisdictions which enforce no contest clauses.
  5. Achievement of asset protection by accessing debtor friendly laws even within the United States (for example, Alaska and Delaware).
  6. Desire for confidentiality.

## II. Caveats

- A. "Offshore" jurisdictions do not uniformly guarantee political safety and reliability. See *Plesch v. Banque Nationale De La Republique D'Haiti*, 273 App. Div. 224, 77 N.Y.S.2d 43 (1948), *affd.* 298 N.Y. 573, 81 N.E. 2d 106 (1948). [Government of Haiti confiscates securities left with the Haitian National Bank for "safekeeping" on the ground that the depositor, a stateless Hungarian born refugee of the Second World War, is an enemy of the Republic of Haiti; New York courts determine that the Haitian government's action has a New York situs and, comparing such action to the actions of "thieves or marauders," orders recovery for the refugee out of U.S. based assets of the Haitian bank.]
- B. Even in jurisdictions having a well-established rule of law, the law can change (often with little notice) by reason of judicial interpretation or statutory enactment; and such changes can produce unwelcome tax surprises. See *Exxon Chemical International Supply SA v. Commissioner of Inland Revenue*, (1989) 3 HKTC 57 (Hong Kong Supreme Court) [Middle man profits of a Panamanian company are sourced in Hong Kong and subjected to 16.5% Hong Kong profits tax by reason of the mere booking of purchases in Hong Kong]; see also, Finance Act 1999 and the Companies (Amendment) (No. 2) Bill 1999 (Ireland), [legislation announced 11th February 1999 for the purpose of eliminating longstanding tax concessions offered by Ireland in respect of "nonresident companies .]
- C. Laws which appear superficially similar can be construed very differently in practice. See *Rahman v. Chase Bank (Cl.) Limited*, unreported Jersey Royal Court decision of June 6, 1991. [This judicial decision by a magistrate is cited by many as evidence that, if the trusts laws of England (or of a jurisdiction whose laws are significantly influenced by the laws of England) apply to a trust, the reservation by the trust settlor of significant powers may cause the trust to be construed as a "sham in form" and, therefore, a mere agency voidable on the motion of a disgruntled beneficiary; but see, the very different American view expressed in RESTATEMENT (THIRD) OF TRUSTS (T.D. No. 1, 1996), § 25(1), Comment and the Reporter's Notes on § 25. ["Asking whether something is a "trust" or a "mere agency" is at best question begging. . . assertions that a settlor must relinquish "dominion and control" over the property are simply wrong.']]
- D. Regulations governing offshore activity are sometimes counterintuitive and economically insupportable. See Treas. Reg. § 1.954-2(c) [This regulation is construed by some in Treasury to preclude the characterization of an offshore consolidated real estate group as "active" for controlled foreign corporation analysis purposes where property management and leasing functions are carried out by employees of a single group member.]

- E. Multi-jurisdictional planning and compliance is expensive and occasionally tedious; it is not for the client who wants a "simple" solution for what are essentially domestic problems or, if it is, that is not a client good for the attorney, the accountant or the financial planner who is asked to assist. The Internal Revenue Service has made clear by its words and its actions that it intends to focus compliance efforts as much upon professionals who facilitate unacceptable conduct as upon the perpetrators themselves.

## **COMMERCIAL/BUSINESS PLANNING**

### **I. Tax Mitigation in Respect of Fixed Income Flows**

- A. Holding company organized and resident in a jurisdiction having a bilateral treaty with a second jurisdiction from which a fixed income remittance or capital profit is derived. The essential components of a tax advantaged holding structure utilizing treaty reductions or exemptions in respect of fixed income flows and capital profits include:

1. Substantially reduced tax withholding by the jurisdiction in which this debtor or subsidiary operating company is situated; and
2. Reduced tax at the holding company level by reason of either exemptions, credits or off-setting deductions coupled with a minimum of withholding tax imposed on remittances of fixed income from the holding company itself to the ultimate owner.

- B. Limitations Imposed Upon Treaty Benefits

1. The United States has led the way in imposing limitations upon "abusive" uses of treaties which facilitate avoidance of taxation rather than elimination of double taxation.
  - a. Prior to the inclusion of "limitation of benefit" provisions in bilateral treaties, Treasury sought to curb third country national use of bilateral treaty benefits by arguing that the treaty based beneficiary had no dominion and control over fixed income being derived from U.S. sources. See *Aiken Industries Inc. v. Commissioner*, 56 T.C. 925 (1971).
  - b. Article 22 of the U.S. Model Treaty (1996) which represents the U.S. negotiating position in respect of new tax treaties limits third country national use of bilateral treaties by requiring minimum percentages of local ownership of the holding company and by denying treaty benefits in the case of over-leveraging by third country nationals (sometimes referred as "base erosion" prevention).

- c. Statutory provisions also preclude overly-aggressive use of treaty benefits even where requirements for the enjoyment of such benefits are otherwise satisfied by limiting the deductibility of interest paid by an operating company to a creditor in a tax-favored jurisdiction. See e.g., IRC § 163(j)
2. The Organization for Economic Cooperation and Development ("OECD") and the European Union ("EU") have expressed strong concerns about "harmful tax competition" and "harmful tax practices" in recent reports.
    - a. The OECD's main recommendations in its 1998 report for counteracting harmful tax competition include restrictions on participation exemptions, implementation of controlled foreign companies or similar legislation, restrictions on entitlement to tax treaty benefits and the termination of tax treaties with "tax havens".
    - b. The EU acting in tandem with the OECD has encouraged its members to adopt a code of conduct whereby they would eschew "harmful tax practices" which are defined to include tax benefits which apply only to nonresidents, tax benefits which are not available in the context of the domestic economy and tax benefits which are made available to a beneficiary who has no real or substantive economic activity or presence within the member state.
    - c. Commentators assert that ". . . [t]he real imperative behind the [EU] code of conduct is that member states re getting increasingly concerned that preferential tax regimes. . . are attracting business away from higher tax jurisdictions and undermining their tax base. . ." but that ". . . [t]he reality is that member states are trying to create a cartel to stop their own tax bases from being undermined." Troup and Hale, News Analysis - - EU Initiatives on Tax Harmonization: Do as I Say, Not as I Do?, 98 TNT 197-3 (October 13, 1998).
    - d. The response of the business community to the OECD initiative has been uniformly negative and has strongly criticized the OECD's Committee on Fiscal Affairs ("CFA") for its refusal to allow private sector participation in the OECD's work on tax havens. See Manasterli, OECD, EU, U.S. Representation Discuss Tax Haven Initiatives, 1999 TNT 112-9 (June 11, 1999).
  3. To combat "harmful tax competition" some jurisdictions have eliminated certain of the more self-evident avoidance opportunities including, for example, termination of the vestigial elements of the U.S.-Netherlands Treaty as extended to the Netherlands Antilles effective December 30, 1996 [Protocol between the U.S. and the Netherlands confines the Article

VIII exemption for interest to debt instruments issued on or before October 15, 1984] and termination of tax benefits heretofore available to Irish nonresident companies effective 1st October 1999; but legitimate planning opportunities remain.

- a. In respect of the United States see, for example, Heyvaert (Loyens & Volkmaars) Using Luxembourg and Switzerland for Inbound Investments into the U.S. [materials presented at ABA Section on Taxation/May 1999 meeting]; and Heyvaert, Brouwer (Loeff Claeys Verbeke), Berman (Sutherland, Asbill & Brennan) and Ruchelman (Ruchelman Firm), Life After Limitation on Benefits Provisions in U.S. Income Tax Treaties [materials presented at ABA Section on Taxation May 1999 meeting].
- b. Denmark is currently promoted as an ideal jurisdiction for an efficient holding structure subject to the caveat that such structure is not available where the subsidiary company's activities are "primarily of a financial nature". See Bech-Bruun & Trolle Tax Newsletter (February 1999) describing the "New Danish Tax-Efficient Holding Structure"; comparable claims are made in respect of Spanish holding companies subject to the caveat that the foreign subsidiary entity in respect of which a Spanish: "participation exemption" is sought must be engaged in an active trade or business and a dividend paid by the Spanish holding company is exempt from Spanish withholding tax only if the beneficial owner is not resident in either Spain or in a tax haven jurisdiction. See Lajarte and L'aneza (Uria & Menendez), Tax Treatment of Spanish Holding Companies: An Attractive Alternative for European Investment, X WORLD REPORTS No. 1506 (Summer 1998).
- c. Investments in India and parts of Asia may benefit from utilization of a Mauritian holding company; companies incorporated in Mauritius after July 1, 1998 must be taxed on their income (subject to reduction for foreign tax credits) at a flat rate of 15% (the option of electing a tax rate between nil and 35% having been eliminated for such companies); but a Mauritian company benefits from the advantages of an increasing treaty network (which now includes more than 18 countries); and Mauritius facilitates its use as a holding company jurisdiction by not imposing its own withholding tax on fixed income remittances from its offshore ordinary companies.
- d. Singapore continues to waive taxing rights in respect of non-Singapore source income derived by companies chartered in Singapore but having their management outside of Singapore provided such income is not remitted to Singapore (the system adhered to by the United Kingdom until approximately 10 years ago

and by the Republic of Ireland until 1999). See *TTT Pte. Limited v. Comptroller of Income Tax*, (1995) 2 MSTC 5, 189 (profits from the sale of U.S. treasury bonds in London by a company incorporated in Singapore were not sourced in Singapore because the decisions to sell were made by the non-resident director and therefore were not chargeable to tax in Singapore according to the Board of Review); but note that Singapore does require that a Singapore company have one individual resident director and it imposes substantial annual reporting requirements which discourage its use as a "brass plate company jurisdiction

### **III. Facilitation of Sophisticated Business Transactions in a Politically Neutral Jurisdiction Not Burdened by Excessive Regulation**

#### **A. The Offshore Insurance Industry**

1. Bermuda, which has licensed more than 1,400 insurance and reinsurance companies, is the third largest insurance market in the world after London and New York. A Bermuda solicitor attributes Bermuda's success as an insurance center to low tax and low regulation coupled with sufficient controls to maintain confidence. See Kempe, *The Role of Offshore Jurisdictions in International Finance*, American Bar Association National Institute (February 8-10, 1998), *Doing Business Worldwide*. In addition to Bermuda, the Cayman Islands, Guernsey and the Isle of Man are noted as hospitable and functional jurisdictions for insurance work. The New York Times reports that in the case of Bermuda revenue from international business expenditures (powered by the insurance business) now exceed by a very substantial margin revenues derived from tourism. See Treaster, "Bermuda Takes the Risk", *The New York Times* (national edition, April 28, 1999) at C1.
2. The lack of excessive regulation allows Bermuda and other offshore jurisdictions to remain on the cuffing-edge of new insurance products utilized in the context of highly sophisticated "mega-deals." Kempe cites two examples of Bermuda's ability to appeal both to the narrow audience and to the wider market -- as an example of a narrowly targeted product she cites "finite risk insurance", a product designed to provide insurance coverage for a fixed predictable financial loss; and as an example of a wider market product,

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