The Path of Least Resistance

Ever notice that in general, people like to take the easy way out? There's enough complexity in our daily lives, why should we add complexity to our investments? It seems that at least once a month, the average investor is exposed to another grand scheme that will try to use loopholes to help him keep more of what his investments earn.

Think about all the tax shelters that have come and gone over the years. I think of all of them, only a select few have really done well to stand the test of time (and the tax department). Others are so complex, it takes a team of tax specialists months to figure them out.

Money, like people, will always take the path of least resistance. That's why money's moving offshore -- it flows to where it's treated best. Offshore dollars have it easy -- they are sheltered from tax, protected from lawsuits, and are easily passed on to future generations without estate taxes and probate. Not only that, but when your dollars find themselves parked in an offshore tax haven, they also find they are exposed to some fantastic investment opportunities not available in North America.

What types of investment opportunities? Well, let's take a look at the different classes of investments available. I'll start with stocks. When your investment dollars are invested in the stock market, the returns can be fabulous. The problem is, your great returns will be eroded by taxes on capital gains and dividends. Yet if the same dollars were transferred offshore, and then invested in the stock market, there would be no tax on capital gains. However, you will still pay a withholding tax on dividends, although most often the withholding rate will be lower than your marginal tax rate. Advantage offshore.

Here a bit of information on withholding taxes that may make you think a little about how our governments work. When a foreign investor (or your offshore account) invests in Canada or the U.S., the foreign investor is treated with open arms, receiving all kinds of special incentives -- incentives that are not available to ordinary citizens. It would be nice if we could receive some of the same incentives, such as the ability to invest in our own country without taxes on capital gains.

Next, a little on how bonds are treated offshore. Ever notice that you rarely see a term of less than five years? That's because there is no withholding on foreign investors if the term of a bond is greater than five years. Remember, after your dollars move offshore, when they then come back to be invested they are now considered foreign investment -- a very nice way of improving your investment return by reducing the tax burden. It all adds up over the years.

Just how much does it add up to? Let's take a look at a bond portfolio invested over 20 years, and then we'll look at the same portfolio offshore. Also we will assume a marginal tax rate of 40% and an annual return of 10%. First, the investment as you would normally understand it. After 20 years, \$100,000 grows to \$320,714 after tax. Not bad, you say. Maybe you'll change your mind once you see how the portfolio performs offshore! The same \$100,000, earning the same 10% rate of return, for the same 20 years, grows offshore to $672,750, a difference of $352,036. No wonder dollars are going where they're treated best.

Finally, let's see how the investor's best friend, the mutual fund, is treated offshore. There are quite a few factors that influence the rate of return on a mutual fund, but I think it's best to compare apples to apples. For this I will take a well known fund that is very widely held. Withholding taxes once again become a factor in calculating the overall rate of return. If an offshore holding company purchases the fund, taxes are not withheld on capital gains, although the individual holdings within the fund may have withholding taxes applied in their country of origin. The same fund purchased domestically has both withholding tax on capital gains and withholding tax applied to dividends. Not what you want when you are trying to get your dollars to work hard for you. Advantage offshore.

Remember what I said earlier about offshore dollars having it easy? The best environment will combine a no-tax jurisdiction with strict confidentiality laws, effective telecommunications, and of course a stable government.

The use of a no-tax jurisdiction is critically important –- after all, if you are making a move to simplify your financial affairs by going offshore, why complicate things with taxes? Even a "low tax" jurisdiction like Barbados (2.5% tax rate) can add complications, so unless you have a special reason or a tax treaty you wish to use, stay away from the low tax countries. A sampling of countries that do not impose any taxes at all on foreign accounts include Anguilla, Antigua, Austria, the Bahamas, the British Virgin Islands, the Cayman Islands, the Cook Islands, Gibraltar, Liechtenstein, Malta, Nauru, Panama, St.Kitts & Nevis, and the Turks & Caicos Islands.

Strict confidentiality laws are also important, if for no other reason than the fact that you can keep your financial affairs private. With our constantly improving information technology, it has become much easier for undesirables to track your income and consumption habits, information that can be sold to anyone. Moving your capital to an offshore jurisdiction can provide you the privacy that is so lacking in North America. It's nice to know that you will not end up on some marketing database every time you make a financial transaction. It's also nice to know that your financial assets will be invisible to those who feel that they might have some sort of claim on your hard earned dollars.

Effective telecommunications facilities are important, but even more important are the people on the other end of the line who will provide the real communication between you and your money. Some investment firms are better than others in this area, so my advice is to communicate with your prospective investment advisors in advance, try them out, see how they respond to your calls. Remember, go where your dollars will be treated well.

Naturally, a stable government will ensure that your dollars are treated well, but how can this be determined? An easy way is to evaluate the importance of the financial sector relative to the overall economy. In countries such as the Bahamas, the British Virgin Islands, and Liechtenstein to name a few, the financial sector is vitally important to the overall health of the economy, by producing revenues in the form of modest stamp duties and fees on certain financial transactions. For this reason, most tax havens follow the policy of encouraging offshore business, although for various reasons a minority of tax havens have been ignoring the basic principle of following the “path of least resistance.” Here’s a list of some of the jurisdictions that treat foreign dollars with proper care and respect: Anguilla, Antigua, Austria, the Bahamas, the British Virgin Islands, Gibraltar, Liechtenstein, and St.Kitts & Nevis.

Money, like people, will always take the path of least resistance -- it flows to where it’s treated best -- sheltered from tax, protected from lawsuits, and easily passed on to future generations without estate taxes and probate fees. So what’s the path of least resistance? You be the judge.

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