The Five Essential Issues Facing Offshore Financial Centres

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Introduction

This paper addresses the five essential issues now facing Offshore Financial Centres. In my view these can be listed as:

✍ensuring there is an international level playing field;

✍exchanging information and the protection of personal privacy;

✍transparency;

✍non-discriminatory tax regimes;

✍maintaining a competitive advantage.

All five issues are interlinked; exchange of information, transparency, and non-discriminatory tax regimes are all elements for which an international level playing field is required if an individual jurisdiction's competitive advantage is to be maintained.

An International Level Playing Field

An overriding issue for Offshore Financial Centres is to ensure there is an international level playing field, applying, in particular, to all jurisdictions engaged in the provision of offshore financial services. As a starting point it would help if there was general agreement that, in setting international standards on financial regulation, money laundering and harmful tax competition and monitoring their compliance, there is no justification for focusing on OFCs separately from other jurisdictions. This is particularly important as whenever the subject of OFCs is discussed, a major problem is how they are to be defined.

If OFCs are to be defined by international organisations such as the OECD or the G7 Financial Stability Forum, with the threat of sanctions or 'defensive measures' being taken against those that do not comply

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with international standards, it is of utmost importance that the definition is one that embraces all the jurisdictions that are engaged in the same finance centre activities. Otherwise there is not a level playing field and business will simply migrate from jurisdictions that are threatened to those that are not.

The International Monetary Fund, in its working papers on OFCs, has tended to identify such centres as any centre that engages in the provision of cross-border financial services carried on in respect of non-residents. On this basis every major financial centre, including London, New York, Frankfurt and Tokyo, engages in the provision of offshore financial services, and indeed London is often described as the world's largest offshore financial centre.

In an attempt to narrow the focus, many have sought to define an OFC as a jurisdiction where the bulk of the financial service activity carried on is in respect of non-residents, notwithstanding that in absolute terms more 'offshore' business can be expected to be undertaken through London or New York than through the OFCs more narrowly defined. There are always difficulties with the treatment of centres such as Luxembourg and Switzerland who do not like to be considered 'offshore' (as they were by the G7 Financial Stability Forum). There are also substantial differences between well-established centres such as Hong Kong, Singapore, Jersey, Guernsey and the Isle of Man, which can be compared with Luxembourg and Switzerland in the range and level of financial services provided, and smaller centres which engage in providing financial services to non-residents on a much more limited scale and with a much narrower range.

This difficulty of definition is one of the reasons why the international initiatives undertaken by the Financial Action Task Force, the Financial Stability Forum and the OECD have been criticised for, among other things, their unfairness in not adopting a level playing field approach. The OECD, for example, produced an initial list of tax havens in 1998 apparently based on the contents pages of offshore year books but which then, without good reason, excluded Hong Kong, Singapore, Luxembourg and Switzerland.

One of the helpful outcomes of this difficulty of definition is that some international organisations such as the FATF and the Basle Committee on Banking Supervision have been persuaded that the focus should be not on whether a centre is properly described as 'offshore' or 'onshore' but on whether or not a centre complies with or co-operates in the implementation of international standards of financial regulation and anti-money-laundering. This message also appears to have registered with the

OECD Fiscal Affairs Secretariat but Frances Horner, when speaking at the Transcontinental Trust Conference held last December in London, while agreeing that it made good sense to address all jurisdictions equally in terms of whether they are co-operative or non co-operative, said that it could not be deflected from the OECD ministerial edict that a list of unco-operative tax havens, as opposed to unco-operative jurisdictions globally, should be produced.

The United Kingdom Government made its position very clear in March 2000, when congratulating Jersey, Guernsey and the Isle of Man for the way they had responded to the recommendations in the report on the review of financial regulation in the Crown Dependencies (the Edwards Report). A UK Treasury Minister stated:

The policy of the United Kingdom Government on offshore centres can be summed up as follows:

- ✍ *We have no problem, in principle, with centres who earn their living from providing financial services to non residents. This activity is not confined to offshore centres. Many onshore centres, including London and New York, do substantial non resident business;*
- ✍ *It is important that all financial centres comply with world standards regardless of whether onshore or offshore;*
- ✍ *We support the initiatives under way in various international bodies to encourage all jurisdictions to improve standards;*
- ✍ *We consider that the true distinction is not between onshore and offshore centres, but between centres which comply with international standards and those which do not.*

An international statement to this effect would be most welcome.

The OECD's view, which remains untested, is that 'tax havens' will not co-operate in meeting international standards unless threatened by 'defensive measures', and cannot be trusted to implement such standards without first agreeing their implementation plans with the OECD. Other jurisdictions can be trusted to engage in a self-assessment process. There is no level playing field between competing jurisdictions such as Jersey and Guernsey that fall into the first category, and Luxembourg, Switzerland, Hong Kong and Singapore that fall into the second.

There are clear signs, however, in all the international initiatives which focus on OFCs, of a growing recognition of the importance of a level playing field if the co-operation of these centres is to be secured. There is also a recognition that there are many jurisdictions outside the list of traditional OFCs on which attention needs to be focused as much as, if not more than, many of the OFCs.

Thus, in initiating its non-co-operative countries and territories exercise, the FATF included Russia and Israel, as well as a number of more traditional OFCs, in its first list of 15 non co-operative jurisdictions published in June 2000. The second batch of jurisdictions reviewed by the FATF also included many jurisdictions that would not be considered to be OFCs.

The European Union, in progressing its tax package embracing the proposed Directive on the taxation of savings income, has recognised that to preserve the competitiveness of European financial markets efforts are needed to draw non-EU jurisdictions into the adoption of 'equivalent' measures in the case of the USA, Switzerland, Liechtenstein, Monaco, Andorra and San Marino, or the 'same' measures in the case of dependent or associated territories such as the Channel Islands, Isle of Man and dependent or associated territories in the Caribbean. The EU clearly sees the need for a level playing field. However, when the same arguments are advanced by OFCs, they are often portrayed as an unreasonable or 'obstructive' condition.

For their part, individual non-EU jurisdictions have made it clear that they will not respond to the EU approaches until it is clear what the EU member states are going to do and what competing non-EU jurisdictions generally are going to do. A key player in this respect is Switzerland which appears to take the view that it does not want to facilitate 'avoidance' of any measures agreed by the EU member states, but at the same time is determined to preserve the privacy of law-abiding citizens. Accordingly, the Swiss have indicated that if they agree to join with the EU in seeking to establish a sound system of taxation of savings income, they will not adopt the exchange of information provisions in the EU proposal but will be prepared to apply a withholding tax to interest payments made by Swiss paying agents to individuals resident in an EU member state. Other non-EU jurisdictions may decide to follow a similar course. However, while the Swiss may have geopolitical reasons for wanting to work in harmony with the EU, this would seem to be far less the case with the USA; it will probably be more difficult to convince the USA that its interests will be served by the adoption of measures 'equivalent' to those to be adopted by the EU.

The OECD, in progressing its harmful tax competition initiative, has also given increasing recognition to the importance of a level playing field. To quote from an OECD document prepared by the Fiscal Affairs Secretariat earlier this year, 'the OECD member countries in themselves are not a large enough geographical grouping to achieve globally accepted international tax standards and to co-ordinate their dissemination, implementation of administration, and economies outside the OECD must be brought into this process'. In the 1998 Report on harmful tax competition, the OECD, in referring to 'harmful preferential tax regimes', emphasised that a co-ordinated approach, including dialogue by the OECD with non-member countries, is required to achieve the level playing field which the OECD stated is so essential to the continued expansion of global economic growth.

There is still a gap, however, between the preaching and the practice on the subject of level playing fields.

The OFCs that the OECD have been seeking to draw into commitments, with the threat of 'defensive measures' if they do not co-operate, have emphasised that they are willing to play a full part and to participate on an equal basis in a partnership programme through ongoing discussions in a global form involving OECD members and representative non-member jurisdictions. They have emphasised that it is of the greatest importance, if there is to be a global approach and an international level playing field, that all relevant countries should be integrated into the process of setting new international tax standards and in the detailed implementation of both existing and new international standards on harmful tax practices. This would include the terms and conditions for the effective exchange of information for tax purposes and the development of application notes which would be used to guide jurisdictions participating in such a global forum when seeking to eliminate harmful tax practices.

Jersey and Guernsey have made it clear that where legislative and policy decisions are required in order to respond to the OECD tax initiatives, these will be presented to their respective assemblies, having due regard to whether or not equivalent measures are to be adopted by OECD members, and by those non-member jurisdictions which are materially in competition with the Islands in the provision of cross-border financial services. It has also been made clear by the Islands that they will be as determined to protect their economic interests and fiscal autonomy as they expect OECD member and non-member jurisdictions to be.

An international level playing field is of overriding importance when considering the three broad principles that the OECD considers to be the key to a global approach to the removal of harmful tax practices:

✍effective exchange of information

✍transparency

✍non-discrimination.

These principles in themselves have presented no difficulties for the quality OFCs. However, in the absence of clear evidence that a level playing field exists in the interpretation of these principles, and that they are being honoured equally by competing jurisdictions, including members of the OECD, it should not have come as a great surprise to the OECD that only a few 'tax havens' rushed forward to make the commitment requested of them.

Exchange of Information

The Channel Islands, for example, have no difficulty whatsoever in meeting the OECD's requirements for the exchange of information in respect of the investigation and prosecution of criminal tax matters. Existing legislation in respect of all crimes of money laundering, international co-operation and investigation of fraud means that in respect of criminal tax matters the Islands already cover the requirements for information exchange set out by the OECD, and in many cases this will extend to areas of information exchange which in other jurisdictions might be covered by civil rather than criminal proceedings. For this reason, among others, there is no good reason for the Islands to be considered 'non-co-operative' by the OECD and they are confident they will not be so considered. Indeed, it has been suggested that any list of 'non co-operative' jurisdictions that included the Islands would, in the eyes of many, lack credibility.

It is doubtful whether many of the OFCs, and certainly none of the quality OFCs, would have any difficulty in joining with the OECD member states in adopting the report on 'Improving Access to Bank Information for Tax Purposes' published in 2000 with its reference to allowing information to be provided to tax authorities upon specific request for the investigation or prosecution of criminal tax matters. Such procedures could be expected to be readily accommodated in any tax information exchange or mutual legal assistance, agreements or treaties to be negotiated.

There is, however, as yet no consensus about the exchange of information on civil tax matters. Switzerland and Luxembourg have clearly indicated that they will defend personal privacy where no crime has been committed, and the USA also has come down firmly in support of personal privacy in respect of those who are not alleged to be engaged in matters that might lead to criminal prosecution. There is also little apparent support outside the EU for the automatic exchange of information referred to in the proposals for a Directive on the taxation of savings income. Even within the EU countries such as Luxembourg and Austria have opted for the transitional withholding tax approach, rather than the exchange of information approach in respect of that Directive. The USA appears more likely to respond to specific requests for information within the framework of tax information exchange agreements negotiated on a country by country basis.

Jersey and Guernsey have indicated their willingness to engage in discussions on a global basis with a view to the development of a model exchange of information instrument concerning 'civil tax matters', and to join in discussions on the effective adoption and implementation by both OECD members and representative non-member jurisdictions of such an instrument. The OECD appears to have recognised, albeit with some apparent reluctance, that financial centres engaged in the provision of financial services to non-residents are in active competition with each other and that if one centre was required to take action ahead of the others the only result would be that the business would flow to those jurisdictions that were not so forthcoming. Thus, if a jurisdiction such as Jersey or Guernsey was to accept that the OECD tax initiative should extend to a commitment to exchange information on bank deposits held by individuals – and the Islands do not accept that the 1998 Report on Harmful Tax Competition, which refers to business taxation in respect of geographically mobile financial and other service activities, extends to such matters – then business could be expected quickly to flow to a jurisdiction such as Switzerland or Hong Kong where no such commitment had been made.

Transparency

Linked to the exchange of information is the OECD concept of transparency. According to the OECD, effective exchange of information depends on:

- The existence of relevant and reliable information;
- The legal ability of a state requested to provide information to obtain the information for purposes of transmitting it to the state requesting the information;
- A legal mechanism for providing the information to another state for tax administration purposes;
- Adequate safeguards to protect the confidentiality of the information exchanged; and
- Administrative measures to ensure that the exchange of information will function effectively.

Clearly tax information exchange agreements will be worthless if the jurisdictions concerned do not have information to exchange. Again, if an international level playing field is adopted, quality OFCs such as Jersey and Guernsey should have little difficulty in meeting the OECD's requirements (unlike some OECD member states). Information on beneficial ownership of companies, partnerships and other legal entities established in the Channel Islands, including managers of collective investment funds and trustees and beneficiaries of trusts, is information that is held within the Islands. The legislation for the regulation of company and trust company service providers recently enacted in both Jersey and Guernsey make provision for the licensing of individual business entities. This licensing process calls for business to be undertaken in a fit and proper way, and one of the central requirements in this respect is that those providing company and trust company services know with whom they are dealing. In this area it is the OFCs themselves that are setting the standards. The Offshore Group of Banking Supervisors has decided to set up a working group, and invite representation from relevant international organisations, with a remit to translate these standards into an international standard for general adoption.

It is also expected that there would be sufficient information available to enable those who are providing the financial services to understand the scope of the business activities of those they are serving, so that proper safeguards can be in place regarding anti-money-laundering activities and the provision of suspicious transaction reports under the relevant legislation. Hence, if specific requests are made for information in respect of the investigation or prosecution of criminal tax matters, there should be no difficulty for quality OFCs in providing the required information. Indeed, this is already current practice. It would not have been possible for Jersey, for example, to have received the congratulations it has received from judicial authorities, such as the US Department of Justice, on the co-operation that they have obtained in the pursuit of those engaged in organised crime if information was not both available and exchanged.

What is important, however, is that there should not be double standards. For example, it is possible for a company to be incorporated in the UK without information on beneficial ownership being made available to the Company Registry – something that is also possible in respect of Delaware Corporations in the USA but not in respect of the incorporation of a Jersey company. Many jurisdictions, including OECD member states, have taken steps to reduce the administrative burdens placed upon small companies in respect of the requirement to file or audit accounts, and it is doubtful whether in many jurisdictions financial information is available to the same extent as in the quality OFCs.

Non-Discriminatory Tax Regimes

The importance of an international level playing field also applies to the OECD tax initiative – and to the EU Code of Conduct on business taxation initiative – in respect of so-called harmful tax regimes.

Many are now questioning whether tax competition should ever be seen as harmful – and the recent pronouncements by the US Administration lend credence to this view. Other OECD member countries have also indicated that they fear that in attacking certain jurisdictions on the grounds that they are said to be engaged in harmful tax practices, financial services will be diverted to jurisdictions which are less well-regulated and therefore less reputable as far as financial regulation and anti-money-laundering measures are concerned.

Initially the OECD 'tax haven' exercise appeared to be focused on the so-called evils of any jurisdiction with no or nominal tax. However, the OECD has now accepted the zero tax regimes of the Cayman Islands and Bermuda, and has generally accepted that it has no right to seek to impose its will upon jurisdictions in the determination of their independent fiscal policies, providing there is no discrimination between resident and non-resident taxpayers.

The OECD has also accepted, in discussions with the Channel Islands, the logic of the argument that if zero tax regimes are acceptable, then it makes no sense to resist zero tax arrangements for particular areas of financial business activity (providing this is done on a non-discriminatory basis) because otherwise all that would happen would be that the business would migrate to the zero tax regimes. Accordingly, the principle of what has been described as 'salami' slicing has been taken on board. As a result, there should be no difficulty in the Islands or other jurisdictions maintaining favourable tax arrangements for areas of business such as collective investment funds and captive insurance where the removal of any discriminatory arrangements distinguishing between resident and non-resident tax payers can be undertaken without detracting from the Islands' competitiveness as a low-tax jurisdiction.

The Channel Islands have made it clear at all times, not only in respect of the OECD, but also in respect of the EU tax initiatives, that they support the principles of fair tax competition, but are not prepared to make commitments one result of which could be to leave the Islands competing for the provision of financial services with other relevant jurisdictions on an un-level playing field. While the EU member states, for example, see the need to act in unison in removing what they perceive to be harmful tax measures to ensure the effective functioning of the goods, services, capital and labour markets in the EU, so the Channel Islands see the need for an inclusive global response to so-called harmful tax measures if their economic interests are to be safeguarded. Above all, the view is taken that since the EU Code of Conduct on business taxation is designed to support the interests of the EU, member states should put their own houses in order before expecting other non-EU jurisdictions to participate. The Code of Conduct Group's report included a large number of footnotes reflecting the extent to which member states were in disagreement with the listing of individual tax measures, and their wish to enter reservations. For example, there is no apparent agreement on how the Dutch holding company regimes, or the Belgian co-ordination centres, are to be dealt with.

There is also criticism of the OECD initiative for focusing solely on geographically mobile financial and other service activities and for not applying their principles on harmful tax competition to business activities generally.

Under pressure from a number of quarters the OECD proposals on the removal of tax ring-fencing have been watered down. Increasingly, therefore, the main issue on which OFCs will need to respond is the matter of exchange of information. This arises from the requirements of customer due diligence for effective financial regulation, for anti-money-laundering measures, and for the fight against corruption, as well as for the investigation and prosecution of tax crimes.

Maintaining the Competitiveness of OFCs

In looking to the future, it has been suggested that even if OFCs pass the tests set by the international initiatives of the OECD or the FATF, and escape the threat of what has been described by the OECD as a common framework of defensive measures, they will still face the prospect of individual countries continuing to take defensive measures against individual OFCs. However, when considering the impact of any such defensive measures, as they have been identified to date, it is important to keep a sense of proportion.

Many jurisdictions already apply different regimes to financial transactions with low-tax jurisdictions (through controlled foreign corporation legislation or exclusion from double taxation agreements of specific favourable tax arrangements). In many cases jurisdictions will need to introduce legislation or amend international agreements to introduce measures to restrict, condition or even prohibit financial transactions with OFCs. In this context it is to be expected that no jurisdiction would want to act against its own best interests by introducing measures other than at the same time as other countries. For example, the City of London and UK financial institutions could be damaged if their competitive position was to be adversely affected by action being taken by the UK Government which was not also being taken by other countries. The US authorities appear to have recognised the force of this argument in their recent pronouncements.

Without doubt the international initiatives that are perceived to be directed at OFCs have given rise to some uncertainty about the future of some, if not all, of these centres. There is growing recognition, however, that there are quality offshore jurisdictions that are complying with international standards and can be considered partners rather than the enemy, that quality business is being attracted to these quality OFCs and that such centres have a future.

We return to the question of definition. No-one would suggest that the offshore financial services provided out of London, Zurich, Geneva, Luxembourg, Dublin, Singapore or Hong Kong are at risk of disappearing. There is, therefore, no reason why the quality OFCs that might more traditionally be so identified cannot continue to exploit niche market opportunities and have an appeal in the world financial market place.

Many of the reasons for the success to date of quality OFCs such as the Channel Islands will be unaffected by the international initiatives.

- ✍The acceptance by the OECD of zero tax regimes, providing they are non-discriminatory is as good an indication as one could hope for that there is a future for tax differentials.
- ✍The greater speed with which OFCs can enact legislation which meets the needs of the international financial market place will remain.
- ✍The record of political and fiscal stability among many offshore financial centres will be sustained.
- ✍The confidentiality offered to those engaged in legitimate business and who have legitimate reasons for protecting their privacy will remain.
- ✍The greater flexibility of small jurisdictions will remain.
- ✍The quality of the services provided and the expertise available will be maintained.

There will always be room in the market place for quality niche market operators. The advantages of OFCs which have been referred to in this paper, together with a continued growth in wealth worldwide and the globalisation of the financial market place, suggests there is every reason to expect that both small and large OFCs, working to international standards, will continue to find a place in the sun.

More international co-operation will be called for in the pursuit of those engaged in fiscal fraud and other criminal matters; this will manifest itself in requests for greater exchange of information in support of criminal investigations and prosecutions. The work of the Financial Action Task Force on money laundering, and of the Basle Committee on Banking Supervision on customer identification and customer due diligence, also points to the need for more openness. There is, however, no reason why companies engaged in legitimate business should face fewer opportunities for taking advantage of international tax differentials through OFCs, nor should investors engaged in legitimate activities fear for any loss of the privacy they have a right to enjoy and which they will be able to call upon human rights legislation to defend.

There is, therefore, every reason for optimism about the future of OFCs, whether they are being used by corporate bodies or individual investors, providing they are committed to and comply with international standards. This is a process that will require an international level playing field if it is to be fully effective in its application. What the Offshore Financial Centres ask for is that they should be recognised as partners in the application of international standards, and not as the enemy.