House of Commons
Treasury Committee

Offshore Financial Centres

Oral and Written Evidence

Tuesday 1 July 2008

Witnesses:

Mr John Whiting, PricewaterhouseCoopers
Mr John Chown, Chown Dewhurst LLP
Mr John Cullinane, Deloitte
Mr Kari Hale, Deloitte

Mr Chris Meares, HSBC Private Bank
Ms Catherine Weir, Citi Private Bank

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The Treasury Committee

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Witnesses

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on Tuesday 1 July 2008

Members present
John McFall, in the Chair
Mr Graham Brady Mr Andrew Love
Mr Colin Breed John Thurso
Jim Cousins Mr Mark Todd
Mr Michael Fallon

Witnesses: Mr John Whiting, PricewaterhouseCoopers; Mr John Chown, Chown Dewhurst LLP; Mr John Cullinane and Mr Kari Hale, Deloitte, gave evidence.

Q1 Chairman: Welcome to this the first of a number of evidence sessions on offshore financial centres. Mr Whiting, would you start by introducing yourself?
Mr Whiting: John Whiting, PricewaterhouseCoopers.
Mr Chown: John Chown, Chown Dewhurst, but acting in a private capacity.
Mr Cullinane: John Cullinane, Deloitte.
Mr Hale: Kari Hale, Deloitte.

Q2 Chairman: Welcome. Just a general question to start with. What is the relationship between an offshore financial centre and a tax haven? You seem very keen to answer, Mr Chown.
Mr Chown: An offshore financial centre is a place where financial activities take place outside the control, one way or another, of large countries. A tax haven is a place which enables people to hold money in a tax-free form. The problem with a tax haven from a taxpayer’s point of view is that legislation in this country, the United States and various other countries, looks through such activities successfully unless it is evasion. A tax haven only distinguishes itself from an offshore financial centre if it encourages tax evasion. That would be a rough definition—which none of them would accept.

Q3 Chairman: Would you agree with the view put forward by one of the submissions to us that it is impossible to expect a tax haven state to regulate the offshore financial centre that operates from within them?
Mr Chown: I think the best offshore financial centres have low taxes; but I think they would regard themselves as being properly regulated and not encouraging any form of illegal tax evasion.
Mr Cullinane: I think it really depends on definitions, does it not? If you define “tax haven” to mean somewhere which is competing by promoting illegal tax evasion then clearly such a place is not likely to have a very effective regulation, because you have decided to go down that route. Most of these centres get quite worked up and emphatically deny that they are tax havens. I suspect the man in the street might happily apply the term “tax haven” to somewhere where there were very low rates of tax, or where some of the taxes you expect to find do not exist. That sort of place, whatever you think about it, might very well have effective regulation.

Q4 Chairman: Of the tax haven places that you know, do they regulate the offshore financial centres very well?
Mr Cullinane: It is a huge generalisation but I think most of the countries you would think of as being offshore financial centres, whether or not you call them tax havens, increasingly have effective regulation, because it is not a competitive advantage any longer not to be regarded as being well regulated.
Mr Whiting: Most tax financial centres (perhaps we should blur the term) are determined to be legitimate in terms of attracting and retaining legitimate business; therefore they want to regulate properly; they want to stand up in the same way as the UK or many other centres do in terms of attracting and retaining financial business.

Q5 Chairman: To what extent would you consider the City of London as an offshore financial centre?
Mr Chown: I think it could come within the definition.
Mr Whiting: Yes, it could. In many ways “offshore” could be just simply defined as some place where business is attracted from another country, from another territory. To that extent virtually any territory in the world is offshore to somebody else. Certainly the City of London has, in many ways, built its reputation on being a very international financial centre, attracting business from around the world; so to many countries we are here in an offshore financial centre.

Q6 Chairman: Given that quite a bit of our work in the past has been on financial stability, how far do you regard offshore financial centres as posing a threat to UK tax authorities’ ability to undertake their work or to the UK’s financial stability?
Mr Cullinane: I think there are two questions there, are there not? There is the financial stability, and perhaps I will hand over to my colleague on that. On the tax point of view I think you can look at it two
Treasury Committee: Evidence

1 July 2008 Mr John Whiting, Mr John Chown, Mr John Cullinane and Mr Kari Hale

ways: firstly, insofar as other countries do not exercise the taxing rights that they could, there may be a direct benefit to the tax authorities here in that income received here gets taxed with less credit for foreign taxes paid. On the other hand, if those centres are engaging in tax competition, if you like, making a more attractive environment that would lure people away there is a negative feature. I think there are a huge number of swings and roundabouts from the UK’s tax position.

Mr Hale: I think in regard to financial stability, it is something which the Financial Stability Forum focussed on quite early in the years after its formation. The combination of the attention that was received then and the implementation of the Basel principles, which are pretty much adopted across most of the centres that I think you would look to cover from this study, has created an environment where there is pretty good oversight by home country regulators and the institutions where they have operations in the offshore centres, and where it is in the interest of the offshore centres to have reasonable parental supervision in any event because they do not want their own financial—

Q7 Chairman: Do you think the Financial Stability Forum has done a good job?
Mr Hale: I think in many areas it has done a good job.

Q8 Chairman: What else is required to be done, because there is a perception problem here?
Mr Hale: What else is required to be done in relation to the regulation of the centres?

Q9 Chairman: Yes, to make them better.
Mr Hale: I think there is a lot that has already been done in relation to the adoption of the FATF rules. A lot of pressure in the early years of this decade was brought to bear perhaps less on the financial stability side and more on the conduct of business side.

Q10 Chairman: I think you are suggesting we are wasting our time in this inquiry. Everything is okay. We just pack up and go. The good weather is here—go out and sunbathe!
Mr Hale: That is for you to decide. What I would say is that there has been a great deal of progress made and most of these centres are now observers of most of the international standards.

Q11 Chairman: We are here to try and probe exactly what the situation is. When you say “a great deal of progress made” we want something for the public record. What more can be done, Mr Cullinane?
Mr Cullinane: What I would say is, on the regulatory side I think things have passed the tipping point where it is now perceived of as an advantage in a location to be well regulated, because everybody who puts their money there wants to feel it is protected. Trading counterparties want to feel people are less likely to go bust. I do not really feel, whatever the issues around these centres, they have played much of a role in the credit crunch, which as we all know emanated from the United States. I think on the tax side things are not quite at that tipping point. Certainly as a general matter, if we were advising jurisdictions on how to promote their financial centres we would not advise them to play a sort of “no tax card”. I believe, as I said before, that countries which do not, for example, charge tax on the profits generated in their centres are leaving money at the table, and it is no longer a sensible competitive way of going about things. Having said that, we all know there are plenty of places that still do that. I think the jury is more out as to how the market reacts to tax competition.

Q12 Chairman: What should be on the Financial Stability Forum’s agenda in that particular area?
Mr Cullinane: I would see more issues on the tax side. If I was looking to improve our response to the tax competition from the centres I would look at a range of things, both making our system more competitive and looking at the information requirements that are imposed; because there is every evidence that the market accepts, notwithstanding it’s onerous in compliance cost terms, the imposition of information requirements, partly because that is linked with anti-money laundering and counterterrorism, in a way that they have not reacted well to the imposition of withholding tax and other tax protection devices.

Mr Hale: I think on the regulatory side, Chairman, the focus on the application of the Basel Core Principles and the focus on home host supervisory cooperation and coordination is the right way forward. I think that happens to be where the regulatory community is already focussing. I do not think that is bad thing; I think that is a good thing. Certainly the enhanced coordination of the supervisory effort, with good information sharing and good cooperation, within the overarching framework of the Basel Core Principles is the right way forward.

Q13 Chairman: Can we do more in the area of anti-money laundering, Mr Chown?
Mr Chown: I think we could. I do not think that is the most important issue here. May I just add one thing on tax. What a rational company or business does is to maximise its after tax profits; and to that extent it will choose to operate in one country or another—it may go to Slovak to manufacture cars, or it may go somewhere else for some other purpose—and the capital is mobile. We have tax competition. I am glad to say which has civilised the tax system since it was led by Nigel Lawson and Geoffrey Howe many years ago. I have advised quite a few countries on this sort of thing and a lot of them are under the misapprehension that reducing their tax rates will attract business—5% instead of 10% and 10% instead of 15%—and I have to explain to them it is not so, particularly (a little point made already) to some extent if you are dealing with offshore financial centres who want to attract major banks for their presence, these people are going to be subject to the tax rules of the parent company. If you
do not charge tax at the offshore financial centre level you are just giving a present to the government of the other country.

Q14 Mr Brady: Following on directly from that, how has the use of financial centres developed over the last ten years? What is it that particularly concerned the commercial banking centre? What is it that drives the involvement in and the use of these centres?

Mr Chown: I think the use of the booking centre as a place to write profits is becoming increasingly difficult. Anti-tax avoidance is a perfectly reasonable stance for the government to take. I think we have got a much more rational system now of transfer pricing rules and looking to see where the profits really arise. I think it is more difficult than it was. It attracts a certain type of client, if you are a bank if you want to attract a client who is impressed by the tax status. A foreigner could get a perfectly good tax-free deal in the United Kingdom, but the rules in the United Kingdom change so frequently that some of them are afraid of it and are much happier to go to somewhere like Dubai or even Bermuda.

Mr Whiting: My comment on your point as to what has “driven” in a sense the growth or the use of offshore financial centres is largely that those centres have in many cases decided to specialise in something. They have done a great deal of self-analysis and one of the conclusions, harking back to previous comments, is that they want to get proper regulation; they want to be seen as genuine business centres rather than tax havens, if you like. Then they have decided that they need to specialise and offer a particular service or a particular area of expertise—Bermuda being a good example in insurance—that is what they do. Dublin is perhaps another one; Ireland—general funds management. I think that is one of the things that has driven the growth of offshore financial centres. Harking back to the Chairman’s question about threats to the UK tax revenues, what we have got is the growth of a number of small, specialist units that might just take business away from the UK. To that extent, yes, there is a threat to the UK tax revenue.

Q15 Mr Brady: Surely all those specialisms are available in the City of London, so what is it that drives the use of the specialist offshore centre?

Mr Whiting: As simple as competition. You could say that all goods are available in virtually all supermarkets, but they all compete vigorously with each other, and many of us choose to go to one rather than another. What we do have to recognise I think in the UK is that for many years the City of London has done an unparallelled job, not without competition, but it is facing more competition and some quite fleet-footed specialist competition. That is not to say that those services are not available in the City; it is that there is competition. If those services can be offered at a lower cost, which might include lower tax, then naturally some at least of those services, the business, will go there.

Mr Chown: The very success of the City of London means the earnings of the City of London are high, which means the prices for certain sorts of services are also very high. The number of countries who want to set up as international financial centres vastly exceed the number who succeed. They are always going to be looking for a niche. They want to get into this business so what can they do more competitively than the City of London? A lot of this, quite frankly, is labour costs, premises costs and things like that. Both of these are very, very high indeed in the City.

Mr Cullinane: I agree with everything that has been said. Another factor is, quite simply, repetition. If people are doing complex transactions where there are a lot of costs just putting it together, if they have done something that works in some place they will go on doing it until something changes that maybe does not work. London is probably the biggest and most successful financial centre in the world at the moment; it just does not have a universal monopoly that is all. There are plenty of things we do here that are offshore in a perfectly legitimate sense to other places.

Q16 Mr Brady: You said earlier that we had passed the tipping point so it is no longer seen as a competitive advantage to be non-regulated or less well regulated. Could I ask for a particular comment on the perception of UK Crown Dependencies or the UK Overseas Territories in that regard? Are they seen as being particularly well regulated in the pecking order, or in the middle?

Mr Hale: I think they are seen as being quite well regulated, and increasingly well regulated. There may have been a time, certainly over a decade ago, when the perception might have been different; but I think there is a general view now that they are applying good international standards and that the regulatory authorities are doing their job in a way which most overseas regulators are seeing fit to deem as equivalent, which is very important in terms of the efficiency of the operation for overseas owned businesses in those dependencies.

Q17 Mr Brady: Are some of those Crown dependencies or the overseas territories better regarded than others? Do you have a sense of who is doing best?

Mr Hale: I think perhaps there was a view that Gibraltar was lagging but has now been working quite hard to catch up.

Q18 Mr Brady: Do you think that tax competition is healthy for the UK economy?

Mr Chown: Yes. Tax competition is not a race to the bottom, for reasons I will explain. Let us look at personal tax as an example. If the rate of personal tax is 90% and you reduce it to 80% you double the take-home of the chap and you will increase the tax base quite substantially. The loss of revenue on a constant tax base is only 11%. If you reduce the tax rate from 20% to 10% you only increase his take-home by 11%. You are not going to spend a lot of trouble to achieve that. It is not going to be much of
an extra incentive; but the tax take, on a constant base, halves. What you have got to do is to find a tax system which optimises economic wellbeing, which is not quite the same as optimising revenue but it is fairly close to it. There is an acceptable tax rate somewhere in the 20s–30s which will not drive business away, will not discourage innovation, but will bring in revenue.

Q19 Mr Brady: Our offshore financial services, how important are they in setting that kind of benchmark?

Mr Chown: They are. In terms of manufacturing competition from places like Slovakia is more interesting, or Estonia. These countries try to attract business by offering a low tax regime. In my view they have not quite optimised what their own position should be. I do not think you would find that tax competition is a race to the bottom. I remember, going back many years, the first report on tax harmonisation in Europe gave countries the choice of a range of corporation tax rates between 45% and 55%, which did not get anywhere. When we brought our rate of corporation tax down, tax competition did more to harmonise rates in Europe than any reports by the Commission.

Q20 Mr Fallon: Mr Whiting, you suggested that offshore financial centres are moving from being traditional tax havens to becoming niche financial centres. To the extent that they remain tax havens, would it be possible to measure the quantity of tax either evaded or avoided?

Mr Whiting: Almost by definition, if you are talking about “tax evaded” it is almost impossible to measure it, because if it is measurable you are at least on-track to try and capture it. I can answer your comment slightly elliptically in one sense that, if you are looking at the tax haven v(DJW) versus offshore financial centre, one of the key things is the quality of exchange of information. Bermuda, for example, relatively recently signed up to proper exchange of information with overseas tax authorities, and that is going to be a major step in allowing other territories to tackle avoidance evasion that they see as unacceptable.

Q21 Mr Fallon: We are not otherwise able to estimate the extent of tax leakage?

Mr Whiting: I do not think that is easy to do at all. You could certainly try and estimate what a profit of an international business is, and try and see if it seems to have paid a reasonable amount of tax. As we all know, there are many reasons why people can quite legitimately reduce their own tax bills, be it from investing in ecologically friendly equipment, or down to just managing certain financing such that they do get a deduction for costs and they do operate, and genuinely operate; and I think that is one of the keys, that operations are genuine in the territories concerned.

Q22 Mr Fallon: Mr Chullinane, in your memorandum you draw attention to the particular role of offshore financial centres in the field of securitisation. Could you explain to us why that has developed?

Mr Chullinane: I would say it is less of a factor now than a few years ago. I think the reason it developed is simply that those are quite complex transactions which will involve an interaction of general commercial law, company law, regulation, tax etc. When you put them together there are all kinds of reasons why there might be glitches or problems thrown up by any one of those factors. The competition to find locations and regimes where you can do things and find the results more predictable is quite intense. Having said that, that would also be a good example of where you theoretically could do things in a whole range of places, but once you have worked out how to do them it tends to stick. Actually the vast majority of cross-border securitisations in the European area have probably been in Jersey, Ireland, Luxembourg, the Netherlands and increasingly the UK.

Q23 Mr Fallon: Was it a helpful development? Given that it was essentially a repackaging of various cash flows, as you say, to take account of different risks and so on, would not the directors of Northern Rock have known a little more about the risks they were taking if their Granite vehicles had not been quite so complex, because of the fact they had to be securitised offshore?

Mr Chullinane: I do not think the problems there had anything to do with the complexity of securitisation. Fundamentally I think securitisation is a very healthy thing. It is the equivalent in the debt markets to the joint stock company in the equity capital markets. It is easy to laugh at this idea that, by slicing and dicing risk and putting it in little parcels and selling that to the joint stock company in the equity capital markets, they would not be the success they are today. Securitisation enables the same thing to take place in the debt markets. Because we had the South Sea Bubble the Stock Exchange did not cease to exist—thank goodness. The securitisations have not been a factor in the development of that. Indeed, in some of the emerging markets and some of the areas that have not been affected by the credit crunch, or not to the same degree, is still big business. For example, I have been involved in advising recently on a Ukrainian mortgage securitisation with the offshore (to Ukraine) vehicle in the City of London, because the UK provides a much more predictable regime now for those sorts of vehicles. I have no doubt that the transaction was a great competitive advantage to the Ukrainian bank that undertook it, but also has reduced the cost of mortgages in the Ukraine. I think the big picture there is a very positive one, and it is very positive that the UK policy has reacted very
sensibly to it, in my view, and accommodated it and meant that it is less likely to be necessary in the future to use other jurisdictions.

**Mr Chown:** Could I add two points to that. One is that Granite could have been a perfectly honest operation—I do not know whether it was or whether it was not, I do not know whether anybody else does—but it is an interesting question to ask. The question is that while securitisation could in principle be done in the United Kingdom or anywhere else, the problem is that anything to do with financial instruments, financial flow and things like that have been used for tax avoidance in the past—I have been guilty of it myself. There is a vast raft of anti-avoidance legislation. People being faced with this, they are given a whole—

Q24 **Chairman:** Mr Chown, I am sorry we are running out of time.

**Mr Chown:** With the complexity of the UK or American tax system it could be all right but you have to look at so many different anti-avoidance provisions which is what drives it offshore.

Q25 **Mr Fallon:** The IMF told us that banks are using special purpose vehicles offshore to make it easier for them to raise tier one capital. Would it not be more beneficial in a regulatory environment if some of that activity was actually brought back onshore?

**Mr Hale:** I am not sure I would draw a distinction between the location of the vehicle in relation to the nature of the capital instrument. The details of the instrument are pretty well published in prospectuses. It strikes me that there are fundamentally two stakeholder groups who need to be very confident they know what the deal structure comprises: one is the regulators, in particular the parent company regulators, and they would look all over the document to ensure that the instrument once issued does satisfy the criteria, which are quite highly defined; and the second is the investors. My personal view is that the complexity you refer to in your earlier question has been more of an issue in relation to the inability of many investors to have properly grasped the nature of the risks that they were investing in, rather than the issues. I think that is a question of due diligence, if I may say so. The information is there; it is the fact that they were willing to accept a label which had been stamped on by the rating agencies as a proxy for due diligence, which perhaps led them into a number of mistakes they made.

Q26 **Mr Fallon:** I understand that. What I am asking you is whether the due diligence might not be easier if more of the securitisation was not in fact UK-based?

**Mr Cullinane:** I doubt it would make much difference. It is what the vehicle does and what the instruments do that are issued out of it.

**Mr Hale:** I would have to say I have not made a study of the differences between an offshore and an onshore disclosure document, but I would not imagine there is a huge difference.

**Chairman:** We are up against time pressure. I am sorry. Maybe if one of you could answer the question that would be helpful to us because we have another group coming along.

Q27 **John Thurso:** Mr Whiting, can I pick up on something you said in your response to Mr Brady which was about specialisation in various areas. This morning we have talked about tax, pretty much individuals, corporate, all in the round. To what extent should we be focussing dividing those two and looking at some offshore centre as being places that are used by individuals, and others that are of benefit to companies?

**Mr Whiting:** I think most offshore centres will try and seek both types of business, but frankly many will specialise. I have alluded to Bermuda, which I think is a good example of one that has definitely gone for business rather than private wealth. If you look at Jersey, which I have some experience with, they are definitely trying to be an offshore banking financial centre, but are also very interested in high net worth individuals, entrepreneurs, because they feel that will help generate indigenous business. I do not think you can necessarily separate the two.

Q28 **John Thurso:** If there is no quick answer to this just tell me and we will move on. To what extent is the scale of what is leaking from the UK a corporate problem; and to what extent is it individuals?

**Mr Whiting:** I do not see an easy answer to that.

Q29 **John Thurso:** Then let us move on. Mr Chown, could I ask you: how effective do you think the European Savings Directive has been at combating tax evasion, and what it means for tax competition within the EU?

**Mr Chown:** It is an interesting question for which I have got a PhD student doing some work at the moment. It is a dilemma. The Japanese have reduced the rate of withholding tax for certain purposes. Withholding tax on interest in particular is a tax not on the foreign investor but a tax on the person raising the money. There is a tendency to reduce withholding tax to attract business. If you limit this Savings Tax Directive to EU members, people would just move outside the EU. A lot of Commission thinking has been misled for that reason. I think it is unlikely to be effective, quite frankly.

Q30 **John Thurso:** You would prefer information exchange to a withholding tax?

**Mr Chown:** I think I prefer information exchange. Again, you will only catch the honest people. The only way to deal with tax evasion is that as soon as somebody produces some money and tries to spend it they suffer serious penalties.

**Mr Whiting:** I would echo the information exchange route rather than the withholding tax; that is definitely the way forward.

Q31 **John Thurso:** Mr Cullinane, to what extent do you think the Lichtenstein case, where information was purchased by foreign authorities as stolen data,
has proven that there is a need for greater oversight by the authorities of what is happening in tax havens?

**Mr Cullinane:** I certainly do not blame the authorities, as it were, for taking that (I would not say "extreme") out of the ordinary route in that case. On your point as to what is the largest concern, I do not know what the largest concern is but certainly I would have thought from a public policy point of view the thing of absolutely overriding concern is enforcing the laws you have got and clamping down on illegal evasion. I think there is quite a lot of evidence that the authorities are having increasing success in identifying that information exchange and information provision regimes have been much more successful than some of the traditional anti-avoidance devices that have been used. I would certainly encourage them to do more in that regard.

**Mr Whiting:** What it did show is that information exchange is working, because of course in Liechtenstein you have a territory that does not subscribe to information exchange; and that was one way of proving perhaps that information exchange is very necessary because they have got some useful information, we think, and will no doubt track down some evaders with it.

Q32 **John Thurso:** The end might well have proven worthwhile for HMRC and for the German equivalent, but it began with a theft. Do we condone that?

**Mr Whiting:** It is always difficult, is it not? Do two wrongs make a right? You are right, there is a theft at the beginning, but the information in many cases is about criminal activity—evasion. It is a very difficult moral dilemma, but I think what it does do is perhaps highlight the need that the authorities do need to try and persuade the Liechtensteins of this world (and thankfully there are fewer and fewer of them) to come clean and cooperate. Like John Cullinane, I have a lot of sympathy with the German and UK authorities for what they have done, although it is an uncomfortable position.

Q33 **Mr Breed:** You will be aware that last year HMRC instituted its tax amnesty, for those who held money abroad. Briefly, could you tell me how successful you felt that was?

**Mr Whiting:** Of course they would say it was not actually formally an amnesty, because an amnesty has the connotation, as the Irish have practised, come clean and we will forget about it. This was an opportunity to settle for a fixed rate of penalty. I think it has been pretty successful. As much as anything it has raised the profile of coming clean, and I think done a good deal to get the message around that information exchange happens; that if you try and conceal the money that you have then the tax authorities have ways of tracking you down, and therefore capturing you as a tax evader. I think it has done quite a lot of good in just this (you might almost term it) “PR” angle. It has raised some money. Has it got everybody into the net that they wanted? Probably not; and there is still some work to be done on tying up information they have received with people who have cooperated.

Q34 **Mr Breed:** Does anyone have anything to add to that?

**Mr Cullinane:** I would agree with that.

Q35 **Mr Breed:** Broadly, we think that captures a bit of money, but a bit to go. What about the extent to which you think Section 20 notices from HMRC are an effective tool to combat tax evasion via offshore financial centres?

**Mr Cullinane:** It clearly can be effective because they can require banks and others to provide a great deal of information, and there is a lot of this still rolling out. Obviously banks have obligations to their clients and they might feel themselves in legal jeopardy if they simply voluntarily provided information to the authorities; so there are many circumstances in which they actually prefer to be compelled to do so. Properly used I would think it is a very good device.

Q36 **Mr Breed:** Do you think you need to develop other tools to combat tax evasion in a similar way?

**Mr Cullinane:** They have been in the middle of a fairly comprehensive review of their powers which are being reflected in successive Finance Bills going through. I think they are still probably at the early stages of this much more systematic use of the powers they have got. I would certainly encourage them to continue with them.

Q37 **Mr Breed:** Given the international nature of the problem, what actions do you think the UK can take faced with the competition posed by offshore financial centres? We have talked about tax competition. How can HMRC ensure that it can combat effectively tax evasion, and also tax avoidance?

**Mr Cullinane:** I think on evasion, as we have said, greater use of the domestic information powers they have got and an information exchange route.

Q38 **Mr Breed:** So the information exchange route is the most effective way we can do it?

**Mr Cullinane:** Yes.

Q39 **Mr Breed:** The expansion of that and the degree to which they pursue that is probably the best course of action?

**Mr Cullinane:** Yes, indeed.

**Mr Whiting:** I think so. I think one of the examples which in many ways is quite a good development is JITSIC—Joint International Tax Shelter Information Committee—the five-country (soon to be six, I think) system of information exchange which is possibly a route you might expect more fiscal authorities to join in with. The more coordinated approach to policing what is seen as perhaps semi-acceptable avoidance planning, which can then be tested in a little more coordinated manner as to whether this really is acceptable, or whether there is some abuse going on.
Q40 Mr Breed: Those of us who have been connected with the finance bill in the last five or six weeks will understand the degree of complexity and everything else which we believe is adding to the problem. Have we got a real difficulty here that, is some of that complexity now adding to the whole problem and what we are trying to do—in other words, obscuring the ability to actually get that. If that is the case how can we try to get ourselves out of this jungle?

Mr Whiting: I would totally identify with that issue that you identify, Mr Breed, that complexity is a problem. As we have alluded to, one of the problems the UK system has is its very complexity. If somebody contemplating an international securitisation, to return to an earlier topic, sees that the tax system in the UK is complex, does not have rulings, creates uncertainty, then they may well prefer to base it in another territory, to use another territory where tax is less complex, it is more certain and there are clear rulings available. If you are looking to how the UK system might develop, then some of this management of the tax system is a route that I think needs to be considered.

Mr Chown: Certainty and stability are the keys.

Mr Cullinane: I would try and simplify it systematically over a period of years. I would be very, very consultative about that process so people have a feeling in advance of what direction you favour; and you can take their response into account. I would try and focus anti-avoidance measures, which you are always going to need to have, on measures to protect the tax base, and not on the rather over-convoluted area which actually discourages having head offices companies here, and leaves us more likely to be in the position of just picking up what others leave at the table.

Q41 Mr Breed: Were you surprised at the omission or qualification of some British overseas territories or crown-dependencies from the so-called “white list”, whilst countries like Russia were somehow included?

Mr Hale: Yes, but they are also, through the relationship with the UK, given an equivalent treatment. I am not sure to what extent that is purely optics. I do not think that the net impact, in the way that they are then treated through the system, is that substantive.

Q42 Jim Cousins: Mr Cullinane, in your submission of evidence to the Committee you have drawn attention to the United States Internal Revenue Service voluntary disclosure regime, and you have said that it has been effective and has increased United States tax take. Would you advocate a similar regime for the United Kingdom?

Mr Cullinane: I think we would always advocate with tax law changes or proposals not to suddenly announce something but be very consultative and explore it. I think it certainly is worth exploring because when you say “voluntary”, technically it is voluntary because it operates outside the US jurisdiction; but it is actually competitively for a bank or financial institution almost impossible not to take part in it because the exemptions they apply from withholding tax on US securities would be withdrawn if they did not comply with it. It is an example of what I was saying earlier, that the market has come to accept that information has to be made available on quite a detailed basis to the authorities.

I think it is partly because of IT and software being more readily available that provision of information in a form and on a scale that would have been prohibitively expensive in the past, and does still have costs for them today, is nevertheless acceptable. Certainly an exercise in learning the lessons of the US experience and seeing whether there is anything in it for us I think would be very well worthwhile.

Q43 Jim Cousins: I think it might be useful for the Committee, having said that, if you could set out for us, not necessarily verbally now but in writing, what differences there are between the United States so-called qualifying intermediary system, and the section 20 system the Committee has just now discussed, so we could compare the two. That might be quite useful to us.

Mr Chown: You have referred just this morning to the complexity of anti-avoidance devices by the tax authorities. What would you suggest we do about that—give up anti-avoidance?

Mr Chown: No, you cannot give up anti-avoidance, but anti-avoidance legislation has to be very precisely drafted. I have been involved with the Russian Ministry of Finance which is in dispute with the Kremlin. The Russian Ministry of Finance, and I, think that anti-avoidance legislation, which Russia needs desperately, has to be very precisely drafted; the Kremlin thinks that the answer is to have administrative discretion. The Kremlin’s idea of administrative discretion creates the sort of thing we are seeing going on with BP at the moment at the higher level. At the lower level it would mean the brown envelopes. Some of the tax fiddles that one hears about in the United States, which one reads about, actually involve tax avoidance techniques that were legislated against many, many years ago and have been reinvented because of the sheer complexity of the legislation. Some of them did not actually work. They only reason they work is because the IRS did not have the capacity to get to the bottom of it. Complexity creates more opportunities for avoidance. There are no simple answers. There is no such thing as a simple tax system.

Q44 Jim Cousins: Indeed. The Committee takes note of your endorsement of the Russian tax police system. I would hesitate to commend it to the present Government! You first used to the Committee this morning “illegal tax evasion”. How would you distinguish between “illegal” tax evasion and “legal” tax evasion?

Mr Chown: I think tax evasion is by definition illegal. If what you do would be caught by the legislation if the facts were known then it is evasion and it is illegal. If the transaction gets through even though they take your case up to the House of Lords and go

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through all the details with full disclosure then it is avoidance—but there is no such thing as legal tax evasion.

Q45 Jim Cousins: Mr Whiting, first of all, I would like to congratulate you on the honour you recently received. I understand it was on the basis that you could make these issues very simple to the lay person. That is a formidable challenge. How would you view the distinction between illegal tax evasion and legal tax evasion? Mr Chown has drawn the boundary very comprehensively to say that there is no real distinction—that all tax evasion is illegal. Would you take the same view?

Mr Whiting: Firstly, Mr Cousins, thank you for your congratulations—they are much appreciated. As far as I am concerned, yes, I try and keep things simple and, to me, evasion is illegal and that is an end to it. I do not see there is a possibility of legal tax evasion—evasion is illegal. Avoidance is legal; some of it is seen as acceptable—investing in an ISA or whatever you like to say. Some of it, because of complexity in how it is structured or against the spirit of the legislation, is very often targeted as unacceptable avoidance; but it does not become illegal; it may or may not work; it may or may not be acceptable; but that, to my mind, is a separate question. If a country, if a legislature, wants to tackle what it sees as unacceptable tax avoidance then it must make sure it has got clear rules, because then it is clear as to what is going on. It must make sure there is good disclosure, because what often is the case is that some avoidance tips into evasion simply because the perpetrator does not disclose it properly or deliberately obfuscates. In that way, that starts to tip what perhaps started out as planning avoidance into evasion.

Q46 Jim Cousins: In the United States they have made a much more robust use of disclosure regimes, through the Internal Revenue Service. A number of accountancy firms have been taken to court in the United States. I am thinking here of KPMG which is not represented on the panel who have been taken to court in the United States for their tax avoidance marketing—their marketing of tax avoidance schemes. In this country we have recently introduced the tax avoidance scheme disclosure system. Would you favour an equally robust use of those mechanisms here?

Mr Whiting: I think we have a disclosure regime, introduced in 2004, which has been proven to be very successful in terms of disclosing schemes by those who are inventing them. You will be well aware that in the current finance bill there are some tightenings of the system to make sure that the information flow is working well, because in many ways the disclosure regime has two parts to it: one is to disclose the scheme; and the other is to identify the users. To my mind it is quite a reasonable system; it has come about, to go back to something Mr Cullinane said, through good consultation; and we have got a workable system and I think it is working well to the benefit of all concerned.

Q47 Jim Cousins: How many users do you think have been disclosed? Users as opposed to schemes?

Mr Whiting: I do not think that data is available, because that comes about when users actually put the scheme number on the tax return, individual or corporate, and that information as far as I know only flows to the tax authorities.

Q48 Mr Love: Mr Cullinane, to what extent do you think transparency is a key issue in relation to offshore financial centres and regulation?

Mr Cullinane: To my mind in public policy terms that is a kind of overriding issue because while nobody can really be sure of its scale, it is illegal activity that you would prima facie want to combat first. Also the information that comes with transparency gives you a better handle on all the other issues. As an issue I would say it is the top priority.

Q49 Mr Love: Is there more that could be done by onshore regulators to facilitate information exchange with offshore centres?

Mr Hale: I think it is hard for onshore centres to compel, so this must be a case of cooperation. What I think we are seeing is an ongoing movement caused by peer pressure and the implications of that peer pressure for the operations of those companies doing business in these centres causing the offshore centres to become more transparent and to become more cooperative. There is a more of a move now, and I mentioned earlier the Basel Core Principles, for these centres to market themselves on the basis of their full compliance with that. I think that mechanisms that step up the pressure on these centres to be seen to be compliant with those measures are ways that can helpfully be used to keep the pressure up. I am thinking about things like the IMF FSAP reviews, to the extent that those can be used to help make more transparent the centre’s degree of compliance and the quality of that compliance. Within the EU perhaps one of the things the UK has been pressing for is more peer review of the implementation of directives and of the equivalence of supervision. I think those kinds of peer reviews would also be helpful in encouraging through that peer-to-peer pressure the behaviours to continue to move towards good and potentially best practice.

Q50 Mr Love: Earlier on and in your submission you expressed what I suspect some people would think was a touching confidence in the market to improve the regulatory environment in offshore centres; yet clearly there are profits to be made in offshore centres. Why do you have such confidence that the market alone will improve things?

Mr Hale: I am not sure I would have confidence that the market alone will improve things, but I think that the market is a powerful influence. As has been mentioned on a number of occasions, I think that there is an increasing awareness amongst the regulated community and the firms who operate on a multinational basis, that if they are doing business in places which are seen to be badly regulated that
has a poor implication on them and on their own reputations. Indeed, it has an implication for the risk management of their activities where they would feel they are more exposed in relation to the management of their businesses in those areas where regulation is poor. There is always a trade-off in regulation which requires proper cost benefit analysis to be performed as regards the identification of what is the market failure; because the market is not perfect and that is why regulation exists; and the nature of the regulatory intervention you put in place and whether it is proportionate. I think a number of the offshore centres continue perhaps to operate in a way which is quite flexible in relation to the cost benefit equation, and can be quite responsive to companies—not seeking to dilute the standards below minimum levels, but seeking to provide the sort of certainty that John is talking about and perhaps keeping out of prescriptive details in areas that certain onshore centres would seek to start to regulate for.

Q51 Mr Love: Could I turn to terrorist financing. You state in your submission in relation to the US Sanctions Regime, “... most offshore centres ... have done a great deal, some others have passed laws but done little by way of implementation, and a small minority have done even less”. Can you tell us who are doing more, and why they are not doing more? Mr Hale: I cannot tell you why. In regards to the names of the individual centres which have done more or less, I am afraid I will need to come back to you.

Mr Love: You tell us the ones who are doing more, and it seems to be the Channel Islands and the Cayman Islands, but you do not tell us who is not doing so well—perhaps surprisingly.

Q52 Chairman: You could write to us on that? Mr Hale: Sure.2

Q53 Mr Love: Finally, and I am quoting here from the submission from Christian Aid and it says, “The secrecy provided by offshore financial centres is a fundamental obstacle to effective taxation and to the prevention of grand corruption in developing countries”. Would you in any way sympathise with that point of view? I know it comes from an entirely different source than we have in front of us here. Do you think that the concern expressed there is one that offshore centres should be concerned about?

Mr Cullinane: I certainly would be concerned with it as a phenomenon. As we said before, we encourage more to be done in using information powers. I do not think it is an issue on the scale implied by that report; but I think whatever exists by way of concealment is quite likely of ongoing concern to the authorities and should be tackled.

Mr Whiting: I would echo that. To hark back to one of the original questions—differences between tax havens and offshore financial centres, if we could distinguish—in many ways a tax haven always did trade on secrecy. As we have mentioned, what an awful lot of the havens or ex-havens have tried to do in turning themselves into legitimate business centres is to have regulations, as Kari has alluded to, proper regulation; and to move into proper information exchange, and to breakdown the secrecy barriers. I recognise the comment, and I think it is a barrier, and it is something authorities need to do to bring pressure on such locations that still practise excessive secrecy.

Q54 Mr Love: Mr Whiting, if I was to say to you, in the light of recent cases that have been exposed about secrecy and taxation matters, are you being somewhat a tad complacent on these issues?

Mr Whiting: No, I do not think I am being complacent. I think I am recognising that it is an issue and that, in many cases, authorities are making good progress. I have mentioned as examples, Bermuda bringing in a better information exchange relatively recently; and you could say that is a result of pressure. We have talked earlier about Liechtenstein where you are looking at a territory that does not do information exchange. I think in its way that has made a very important point as well. I would say, I recognise the issue and I think progress is being made.

Chairman: Mr Whiting, I missed your honour of the OBE, so please accept the congratulations of the Committee on that because we value your advice to us over the years. Mr Chown, I was sent your biography and I note that you are an ex-Gordonstoun pupil and a holder of the Adam Smith Prize from Selwyn College, Cambridge. It is hugely reassuring to know that have an intimate knowledge and are best friends with the Kremlin. May I thank you for the time you have given us. We have overrun but it has been hugely interesting and is a good start to our inquiry. Thank you very much.

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Q55 Chairman: Welcome. Could you introduce yourselves, please, for the shorthand writer.

Mr Meares: Certainly, Chairman. Chris Meares. I am the CEO of Group Private Banking for HSBC. I have worked for them since 1980. It is a global role but I am based here in London.

Ms Weir: Chairman, I am Catherine Weir. I am the Chief Executive Officer, Global Wealth Management, for Citi Europe, Middle East, and Africa.

Q56 Chairman: Welcome to the Committee. In the written evidence that we have received, as you heard earlier, there has been some discussion as to whether there is a meaningful distinction to be made between offshore and onshore. Do you think there is still a distinction to be made? How would you define an offshore financial centre?

Ms Weir: For us, in Citi—this is, again, similar to some of the comments you have already received—offshore is from a perspective of where you begin. For us in the Private Bank at Citi, from the UK, offshore, for the purposes of this discussion, would be Jersey. It is an example of a location in which we operate certain services.

Mr Meares: The only thing I would add is that there clearly are a lot of international financial centres as well as offshore financial centres. I think the distinction has become blurred. If you look at the IMF list there are some 50-odd countries in there. We operate both domestically and internationally in places like Hong Kong, Singapore, Qatar, Dubai. These all would be considered international financial centres and offshore for many people, just as much as Jersey and Guernsey.

Q57 Chairman: Referring to a presentation you made, Chris, in September 2007, when you presented a chart suggesting a decline in the proportion of investments going offshore (for example, it was 33% onshore in 1996, which went to 20% offshore; and 66% onshore in 1996, which went to 80% onshore in 2005), what is the driving force behind such a change?

Mr Meares: This is from a Capgemini/Merrill Lynch study of the market. It has gone from about one-third to 20% in their estimation. I think there is a number of drivers. First, a lot of wealth has been created during that period—a lot of it is in the emerging markets but, equally, in places like the UK—and the industry has become much better at managing that wealth in the territories in which they are involved, whether that be because of a change in legislation or production of funds that are more capable of deploying that money. I just think that the industry has become more sophisticated at handling that money and the wealth is being generated domestically. I think the regulation and the focus on OFCs over the last eight to ten years has probably helped a little bit also to make people aware, but it needs to be two things: it needs to be also the development of the onshore centres as well.

Ms Weir: Chairman, I would agree with Chris. It comes from a standpoint that the additional emphasis from regulatory bodies, the work of the OECD and the work of the FATF, has moved the industry and the robustness of the various infrastructures along quite considerably.

Q58 Mr Todd: When we listened to the previous witnesses, I was struck by the non monetary drivers behind decision-making over where to place resources. Would you agree that stability, certainty, reputation and the cost of compliance are perhaps among the key drivers as opposed to just a straightforward issue of “I want to pay less tax”?

Mr Meares: Certainly in my experience that is the case. First, investors, particularly the private client investors, are looking for returns. They are looking for security, they are looking to make sure that their wealth is secure and enhanced, and they look at reputation, and they are looking for investment. Our job, a lot of the time, is trying to find the best investment around the world. A lot of those investments are made within their own country, but if, say, they are trying to invest in China at the moment, they will probably invest through Hong Kong as the best route into China. That is the driver and tax, in my experience, has not been the driver of where clients are investing.

Ms Weir: I would echo what Chris has said. From a client’s perspective, the client will decide their investment criteria, what they are trying to achieve through investments, and then look at how best to achieve those objectives. We, as an example, as a financial services company, would follow that client and attempt to help them achieve those goals. There are a number of criteria with regards to the considerations into that. Predictability, ability to forecast events, ability to try to make a determination on what sort of a risk/return balance, the infrastructure around which to ensure, as much as possible, those events occur are a number of the considerations, and, of course, tax is one of a number.

Q59 Mr Todd: If one looks at this in terms of a market-place, which it is, and the regulatory framework which governments then provide, among the elements they need to care most about are not merely what tax they are seeking but the method of consultation and the certainty of expectation about any fiscal framework or the method of consultation and the certainty of expectation about any fiscal framework or regulatory obligations that may be placed on the institutions within their territory are critical. Any reputational issues which might scare off some companies quite significantly is another area of possible difficulty, complexity. The difficulty of complying with the costs of employing nice, expensive people like yourselves to advise them may have some factor in that too. Are those the sorts of areas that governments may need to look rather harder at, rather than simply, “How much money are we trying to take from you”? Ms Weir: If the objective is to be a service centre, there are two perspectives. One is a service centre to the financial services industry and the second one is to attract investment in the domestic economy. All those factors are appropriate to consider, but from a...
regulator’s standpoint, of course, the better framework, the more core infrastructure that can be created, will possibly contribute to attract both.

Q60 Mr Todd: Do we chase the wrong hares here sometimes? Much of the media attention in this area is about people avoiding large amounts of tax and how very unfair that is, without perhaps looking at some of the other critical drivers that are involved in some of this decision-making.

Mr Meares: It is natural that the media focuses on that but the reality is that it is a global market. People invest in London for very good reasons, for all the reasons you have mentioned. I think they will continue to do so if they feel that it is the place that is generating good ideas and it is an effective place. But it is a global market: there are lots of places where investors will invest.

Q61 Mr Brady: What criteria do you use in deciding whether to advise clients to invest in one offshore centre as opposed to another?

Ms Weir: From our perspective, we do not advise an offshore centre. We deal with our clients from a standpoint of understanding their objectives: What are they trying to achieve? –there could be a number of considerations—and then how best to execute that. Advising one centre over another is certainly not the way that we work with our clients. Our clients, by nature and by profile, are typically international-type clients. They have an international business style, they would have an international personal style with regards to how they want to end up. One man’s onshore is another man’s offshore. Advising one centre over another is certainly not a first consideration. It is a consideration of execution after a number of other, more principled execution considerations.

Q62 Mr Brady: Once you have reached that point of the decision of execution, how do you choose one centre over another?

Ms Weir: Various service centres have skill sets. I think it was discussed a bit earlier. There are some skills more readily available; infrastructures are more developed to support certain aspects of financial industries. As I mentioned earlier, we work quite a bit with Jersey, and Jersey has created a good infrastructure for assisting clients and administering. Funds administration is an example. If that was an important part of the execution plan, that may be a useful service centre.

Q63 Mr Brady: Is the quality of regulation/the degree of transparency an important factor in that choice as well?

Ms Weir: Yes.

Q64 Mr Brady: Over the last few years, have you seen changes in the way in which offshore sectors are used? Are your products structured in different ways to take account of that?

Mr Meares: I do not think there has been much change over the last few years, but, just to echo what Catherine was saying, there are areas of expertise. For example, Jersey has a well developed trust law. They have been one of the leading jurisdictions in making sure that the trust industry is well regulated and a very well established legal system. The Middle East clients, for example, are in a similar time zone, they like to invest in Europe and they will use Jersey, for example, as a place for their trust business, but it is because of the professional skills and the regulatory/legal environment that has been created as much as anything else.

Q65 John Thurso: My question follows on a little bit from what Mr Brady was talking about with regard to location. You run Europe, Middle East and Africa. If we took an African client, for example, that person might well choose to administer their wealth from, say, London. The investments might well be, nowadays, quite substantially in alternative hedge fund, fund of funds, things of that nature, which might be located all over the world, so you can get investments in different places by various vehicles, and it could be that for the purposes of tax planning the legal jurisdiction could be Jersey. Is that a model that you recognise as being how it might well be done?

Ms Weir: I think that could be one profile, yes.

Q66 John Thurso: The point about being onshore and offshore is that it really all depends on where you start from, what your objective is, and where you want to end up. One man’s onshore is another man’s offshore.

Ms Weir: Yes, that is correct.

Q67 John Thurso: How mobile, then, are your investments on behalf of your clients, both within offshore centres and between off and onshore centres? Or is that a decision that is taken at the beginning of the process rather than movement during the process?

Mr Meares: Generally, it is at the beginning. They go through a lot of hoops to open accounts these days. If you ask anybody, it is very difficult. By the time they have given you all the data and information, it is unlikely that they are going to move their account and business around the world just at a whim. That is not to say that they will not open an additional account. If they happen to travel to Asia at all, then they may have an account there for expenses and things like that.

Q68 John Thurso: How much of your work as a private bank is about keeping your clients informed as to where the best place is? Or is that coming back to the start of the process?

Mr Meares: More the start of the process, rather than evaluating each jurisdiction as time goes on.

Q69 John Thurso: I presume that you have a duty from a regulatory standpoint to ensure that tax evasion is prevented when you are dealing with your clients and with offshore financial centres. Can you confirm that? How do you give it effect?

Mr Meares: Correct. We prohibit our bankers from encouraging or being involved in tax evasion.
Q70 John Thurso: What do you do?

Mr Meares: If our bankers, say, sitting here in the UK, get any hint that there is tax evasion, then under the legal and regulatory system they have to file a suspicious transaction report. That is the main way. If they have a suspicion that it is happening, then we file a suspicious transaction report to the authorities.

Q71 Chairman: Have you filed quite a number of suspicious transaction reports?

Mr Meares: Not huge numbers. I am pleased to say, but there are a few and they all get dealt with. Ms Weir: It is similar, Chairman. Could I also say that it is not just tax evasion—which of course is illegal, whilst it is not our role to try to police that. But a suspicious activity report (a SAR, as it is referred to) could be raised on any number of circumstances as an alert and surveillance mechanism that would then instigate further evaluation, and the conclusion could be a number of things.

Q72 Mr Breed: Turning now to the EU Savings Directive, can you tell us how effective you think it has been in combating tax evasion and gross tax competition in the EU and, more specifically, how it has affected your clients?

Mr Meares: I have to say that it is pretty hard to know. We did not see any real impact. I was in the previous session and obviously the gentleman said he thought it had been pretty effective. It did not really affect a lot of our clients because they are already taxpayers in their countries, but we did not see a huge impact.

Ms Weir: I could not call it a huge impact. Certainly we comply and disclose, and generally the issue of disclosure is positive.

Q73 Mr Breed: It has not had a major effect on your client business.

Ms Weir: I have not seen it.

Q74 Mr Breed: If you were in the last session you would have heard that we had a very brief discussion about whether information exchange or withholding tax was a preferable route. Do you have a view on that?

Mr Meares: I do not know which one is preferable. To be honest, you have all types around the world. We are in 40-odd countries. Each one has either information exchange or withholding tax and, basically, if we operate in that country we have to go along and operate with that. Reference was made to the qualified intermediary system in the US—which Catherine will be very familiar with, but we also are. In many countries we are qualified intermediaries, and you just go through it. That process was incredibly complex to put in place, but the US were able to, and to put the burden very firmly on the industry and the auditors and accountants to police it, so it was effective. Whether every country in the world or the IMF could introduce it... It might be possible but it is quite difficult. It would be hard to see every country being able to have the clout that they do.

Q75 Mr Breed: Do you have anything to add?

Ms Weir: No different view.

Q76 Mr Breed: Without going into the rights or wrongs of what is coming to be known as The Liechtenstein case, has it proved that there is a need for greater oversight by authorities of what is happening in tax havens generally?

Mr Meares: For the large global institutions, like ourselves, it has to be self-policing. Our reputation is the first thing. In running our business, I can assure you, the Chairman and the Chief Executive would not want us to have anything that would affect our reputation. There is a big element of self-policing, but clearly the regulators and the institutions like the IMF and the FATF have got involved in the last ten years and I think it was a positive development. We certainly try to operate in those places that score highly.

Ms Weir: Similarly. We operate very similarly. I would say that I think the exchange of information, the co-operation between the various authorities, whatever the perspective may be, is quite constructive. There is visible more engagement over the recent years, perhaps the last decade... Certainly from a regulator’s standpoint that is a constructive relationship, it is a very constructive partnership, and certainly from the practical experience we have, it has been, on balance, positive.

Q77 Mr Breed: In relation to the information which is obtained in one way or another—let us put it that way. Do you believe that that now demonstrates that we really have to have a greater oversight by the authorities of what is happening in various tax havens?

Mr Meares: Yes. For the large global institutions, like ourselves, it has to be self-policing. Our reputation is the first thing. In running our business, I can assure you, the Chairman and the Chief Executive would not want us to have anything that would affect our reputation. There is a big element of self-policing, but clearly the regulators and the institutions like the IMF and the FATF have got involved in the last ten years and I think it was a positive development. We certainly try to operate in those places that score highly.

Ms Weir: Yes. We can only comment from a standpoint of where we operate. We operate the same around the world in every location in which we operate, whether they be client selection or such as “Know your Client” (KYC), Anti-Money Laundering, suitability, et cetera. Our standards are the same no matter where we operate.

Q80 Mr Breed: Were you rather surprised at the lengths the authorities were prepared to go to get hold of this information?
Mr Meares: Globally?

Q81 Mr Breed: Yes.
Mr Meares: Not really. What is important is the certainty of law. As an institution dealing with private clients, we want to comply with the law of that jurisdiction. We also do not want to be sued by clients. We need to know that we are acting in the law and that we can defend any actions that we can take. For example, when there is a request for information, we like to receive that through a legal channel, so that we have the law behind us rather than any doubts. Certainty is quite important.

Jim Cousins: I have been trying to work out what happened in all of this. You may have heard the previous evidence session, where there was some discussion of the qualifying intermediary programme in the United States. I was able to turn up a deposition made in a court in Southern Florida within the last month, following a plea bargain in a tax case. It involves an employee of a well-known Swiss bank (which if I named it would be familiar to us all). I hasten to add that neither of your two banks are mentioned in all this deposition. I am going to turn through some of the things that are recorded here.

Chairman: Could I just make the point that if it is an ongoing case we cannot discuss it in this Committee.

Jim Cousins: No, it has been settled. This is from a deposition that has been tabled in front of the court. It has been agreed by all the parties as being a fair statement.

Chairman: On you go.

Jim Cousins: With the assistance of this well-known Swiss bank, US clients were prepared false and misleading IRS forms through sham entities in Liechtenstein. Is this the sort of thing you yourselves have come across?

Q82 Chairman: The reason I mentioned that is that this involves a well-known Swiss bank (which Jim has not identified) but I think there is another case coming up with a well-known Swiss bank, and whether it be the same bank or not I do not know. That is the reason for my intervention.

Mr Meares: It is an ongoing case.

Jim Cousins: It is not an ongoing case.

Mr Fallon: The other one.

Q83 Jim Cousins: Okay.

Mr Meares: We are all fully aware of it and the answer is: no, we do not promote that sort of thing. Any US clients that we might have outside of the US—we would have an investment banker who may be working in London as a US client—have to fill out their W8 forms under the qualified intermediary and they have to fill out all the other forms. We certainly would not be encouraging any fraudulent forms.

Jim Cousins: I went through all this very interesting stuff that comes to light: placing cash and valuables in Swiss safety deposit boxes; purchasing jewels using the funds in the Swiss bank account while overseas; misrepresenting funds; destroying all offshore banking records existing in the United States; using Swiss bank credit cards; and, on one occasion, rather entertainingly from some points of view, purchasing diamonds and smuggling the diamonds into the United States in a toothpaste tube. All of this is recorded in this court in Southern Florida within the last month. All of these activities are completely unknown to you. I mean, neither of your organisations would ever have recommended that somebody uses a Swiss bank credit card or the credit card based in an onshore jurisdiction. You would not have done anything like that.

Mr Meares: We would not have done all the rather bizarre things mentioned there. Yes, clients may have a credit card in Europe or Switzerland or other jurisdictions, but most of the other things, I have to say no.

Q85 Chairman: Nothing interesting in your tube of toothpaste.

Mr Meares: Unfortunately not.

Ms Weir: We have no direct knowledge of those activities currently.

Jim Cousins: I would not have asked you if there had been any mention of your organisation in this deposition. But it makes entertaining reading.

Q86 Mr Fallon: Chris Meares, we heard discussion earlier this morning about amnesties. Do you think tax amnesties are an effective tool?

Mr Meares: They have been used in a number of countries. I really cannot comment on how effective they are because I do not work for the governments and see the numbers and see whether they have really made a big difference. We are conscious that countries like Italy and Germany have introduced them. I really do not know how effective they have been. I mean, Italy at the same time repealed estate duty. Whether that had an impact as well, I am not sure.

Q87 Mr Fallon: How would you describe the relationship between private banks and HMRC? Is it adversarial?

Ms Weir: From Citi’s perspective—I can only comment on Citi—we like to think our relationship is sound. I have no knowledge that our relationship is not sound. I am not personally responsible for that relationship for the company. It is much beyond the scope of Private Bank, but we have no outstanding issues that I am aware of.

Q88 Mr Fallon: Have either of you had experience of section 20 notices?

Mr Meares: Yes.

Q89 Mr Fallon: What has that experience been?

Mr Meares: HSBC has received a section 20 notice. It was first served on HSBC Bank plc. We have a section 20 notice served on the Private Bank.
Ms Weir: We have not.  

Q90 Mr Fallon: What has happened as a result of that?

Mr Meares: We are processing that and we will be providing the information that is being asked for.

Q91 Mr Fallon: You are able to comply with the scale of information required?  

Mr Meares: Yes.  

Chairman: No further question. Thank you very much for your time.
Written evidence

Memorandum from the Financial Services Authority

1. This Memorandum is submitted to the Committee’s inquiry into Offshore Financial Centres. We address those matters within the inquiry’s terms of reference that are relevant to the FSA, fall within our remit, or where we feel we can make a useful contribution. Additionally, we detail the international work, in which we are involved, which is relevant to the Committee’s inquiry.

2. The key points we make in this submission are:
   — There is no internationally agreed definition of what constitutes an offshore financial centre (OFC), but there are common perceptions.
   — There has been considerable focus on OFCs within the international regulatory community in recent years, and they have been subject to extensive review.
   — These reviews have tended to conclude that OFCs per se do not pose a threat to global financial stability, and that standards of regulation are generally comparable to those that apply in other jurisdictions.
   — The FSA, in its regulatory procedures, does not draw any distinction between OFC and other foreign jurisdictions.
   — The level of cooperation received from OFC regulators has generally been good, and has not typically been determined by factors that are unique to OFCs.

Definitions of Offshore Financial Centres

3. There is no internationally agreed definition of what constitutes an offshore financial centre (OFC). Generally, there is a tendency to adopt the approach of “you know one when you see one”. Over the years, there have been many attempts to define the concept by academics, international organisations, regulators and others, and while there are common themes in the various proposals, there has been no real consensus. Definitions tend to be centred on the concept that an OFC provides financial services (usually in currencies other than that used domestically) primarily for non-residents, for whom it offers a favourable tax regime. While many jurisdictions are attractive to non-residents for the provision of financial services, it is typically the case (but not universally so) that OFCs are seen to be those where there is a significant imbalance of scale between the external business and the domestic financing needs of the local economy.

4. As a consequence, there has been a tendency to perceive a classic OFC as being a small island state that has legislated to create a highly favourable environment for the development of a financial services sector, which far exceeds what would have evolved naturally to meet domestic needs. However, at the other extreme, several commentators consider that OFCs include those financial markets that have developed naturally on the back, for example, of the provision of goods and services for foreign trade and related activities. Within this category these commentators might typically include the City of London, due to the highly international character of its financial services industry. In recent years, there has been a trend towards the creation of OFC enclaves within developing economies, for example the Labuan Offshore Financial Centre in Malaysia, or the Dubai International Financial Centre in the United Arab Emirates.

5. The majority of OFCs exist because they are able to offer an environment which isolates the financial service providers from the constraints that might arise in “onshore” financial centres. These include the results of measures designed, among other things, to address domestic economic, monetary and financial policy considerations. Onshore centres may have rules that are considered by service providers and their customers as too demanding, tax policies that are too restrictive, disclosure requirements that are too extensive, or overall costs that are simply too high. Successful OFCs will generally have legal, regulatory and tax structures that avoid these “problems”, although it should be stressed that the standards to which they operate are not necessarily out of line with international expectations of a jurisdiction which wishes to offer appropriate incentives. Increasingly, financial institutions in primary onshore centres demand high operational and regulatory standards in OFCs with which they are associated.

6. The majority of OFCs tend to provide relatively traditional financial services. They do not seem to play an especially important role in the development of complex financial instruments, except to the extent that such instruments may be heavily used by entities based in such centres. Onshore financial centres, such as London and New York, remain the major development locations for new financial instruments, but the “engineers” of these instruments will naturally seek to identify the best legal, regulatory and tax environment in which to market the product.
INTERNATIONAL WORK ON OFFSHORE FINANCIAL CENTRES

7. While, in principle, the FSA, draws no distinction between OFCs and other financial markets in its regulatory and supervisory policies and procedures (see below), it participates actively in various international fora in which OFCs have been a focus of attention, either as a discrete issue or as part of a wider review of jurisdictions’ adherence to international standards. The most comprehensive work looking solely at OFCs has been undertaken by the Financial Stability Forum (FSF). Shortly after its creation it established a working group to consider whether OFCs posed a threat to global financial stability. The working group’s report was published in April 2000,1 and concluded that, “OFCs, to date, do not appear to have been a major causal factor in the creation of systemic financial problems. But OFCs have featured in some crises, and as national financial systems grow more interdependent, future problems in OFCs could have consequences for other financial centres”.

8. The report recognised the extent to which international standards relating to the regulation of financial services and the prevention of money laundering varied significantly from one OFC to another, and it also recognised that the failure to implement appropriate standards adequately could pose a future threat to financial stability. It identified 42 jurisdictions that it considered to be OFCs, and grouped them into three categories, based on the perceived level of compliance with international standards, drawing on a survey of the views of onshore and offshore financial services supervisors undertaken by the working group.

9. In the light of these findings, the FSF asked the International Monetary Fund (IMF) to assume responsibility for instituting an assessment process to determine the true level of compliance by these 42 jurisdictions. While priority was to be given to those OFCs that had been considered weakest, the IMF’s OFC Program, which came into being in 2001, captured all 42 jurisdictions referred to in the FSF report, together with another four identified by the IMF. The initial phase of the programme was completed in 2005, and concluded that the OFCs’ compliance levels with the four main international standards against which they were assessed2 were broadly comparable to those of other jurisdictions, and, in some cases, better. However, the IMF noted that compliance levels were generally weaker in the securities and insurance sectors than in banking.3

10. To date, only a limited number of assessments have been undertaken in the second phase of the OFC Program since 2005. The IMF has reported that it continues to see improvements in the levels of compliance with the banking and insurance standards, but that the sample of OFCs with material securities sectors is currently too small to be statistically relevant. However, it notes that concerns remain about the implementation of some of the FATF Recommendations on anti-money laundering and the combating of terrorist financing (AML/CFT), for which revised standards were published in 2003. The IMF concludes that, while compliance by OFCs is broadly comparable with other jurisdictions, there are common weaknesses in the areas of customer identification, the monitoring of transactions, and international cooperation. However, such weaknesses are not restricted to OFCs; the levels of compliance globally with the FATF’s customer identification requirements are currently poor (eg both the UK and US have been evaluated as only “partially compliant” with the standard).

11. The OFC Program has, by design, included all 46 jurisdictions referred to above, but the IMF Board agreed in May 2008 to merge this programme with its standard Financial Sector Assessment Program (FSAP). This will allow a more risk-based approach to the assessment process, in that it will focus resources on both the key jurisdictions and the significant activities within each jurisdiction. It will also allow the use of more developed assessment techniques, and extend the potential scope of the assessments to cover a broader range of international standards (eg corporate governance) than the four included within the OFC Program.

12. The FSA has strongly supported this move in the course of its participation in the IMF’s annual OFC Roundtable discussion, and through its membership of the FSF’s OFC Review Group. This group was established in 2005 to monitor the results of the IMF work and any other relevant initiatives by the standard-setters, and to advise the FSF on any follow-up action that it might consider appropriate. In September 2007, the FSF reported4 that it considered that significant progress had been made in improving levels of compliance in OFCs (although acknowledging that some deficiencies remained), but that the Review Group stands ready to examine any material problems that might emerge.

13. Within the European Union, in September 2004, the Financial Stability Table of the Economic and Financial Committee invited the 3L3 Committees (CEBS, CESR and CEIOPS) to examine, in liaison with the Commission, “non-cooperative jurisdictions that are unable and/or unwilling to provide foreign regulators cooperation according to international standards”. The 3L3 Committees decided to term such jurisdictions as OFCs, whilst recognising that the scope may extend to onshore jurisdictions. As part of this

2 The supervisory principles promulgated by the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors; and the anti-money laundering standards published by the Financial Action Task Force.
3 The staff reports on the progress of the OFC Program, together with copies of the jurisdictional reports can be found on the IMF website at www.imf.org. A summary of the finding for the UK’s Crown Dependencies and Overseas Territories may be found in the NAO report “Managing the Risk in Overseas Territories” (www.nao.org.uk)
4 http://www.fsforum.org/publications/publication_23_89.html
project the Committees have been asked to establish “common databases on the existing problems in relation to OFCs”, and to develop a common approach for the supervision of business operations in such jurisdictions. In the latest report on this initiative, published in August 2007,¹ the Committees summarised the findings from a survey of European supervisors, seeking information on their experience in dealings with OFCs. These indicated that, on the banking side, “the vast majority of [the 30] respondents reported that they have no issues to be raised about OFCs and also stated that they had satisfactory dealings”. A similar picture emerged from the securities side, while the insurance supervisors mostly indicated that their dealings with OFCs were very limited, but that they also had identified no particular problems. In most cases, the supervisors generally felt that any difficulties could be, and were best dealt with bilaterally with the relevant OFC.

14. The FSA participates in several other international bodies which have looked more generally at the issue of “non-cooperative jurisdictions”. Although these initiatives have not focussed exclusively on OFCs, several of the jurisdictions that have fallen within their scope have been involved predominantly in offshore activities. The most high profile of these initiatives has been the FATF’s Non-Cooperative Countries and Territories (NCCT) exercise, which resulted in the publication, in June 2000, of a first list of jurisdictions deemed to have significant deficiencies primarily in terms of their ability or willingness to cooperate internationally. This initiative has been highly successful in bringing about reform in the AML defences of several jurisdictions, with the result that there are currently no names on the list. A total of 47 jurisdictions were reviewed under the initiative (including 30 OFCs), leading to the nomination of 23 to the NCCT list (of which 11 were OFCs). After extensive engagement with the FATF, the last of the OFCs was removed from the list in October 2005. The FATF continues to monitor international cooperation issues very closely, and in February 2008 issued a statement reflecting its concerns about the AML/CFT regimes in five jurisdictions and one geographical area, one of which is considered to host offshore activities.

15. In 2005, the International Organisation of Securities Commissions (IOSCO) launched an initiative to raise the standards of cross-border cooperation among securities regulators. This involves identifying jurisdictions that appear to be unable or unwilling to co-operate; prioritising follow-up work with those presenting the greatest risks to IOSCO’s objectives of investor protection, maintenance of fair and efficient markets and financial stability; and entering into a dialogue with priority jurisdictions to develop a mutual understanding of their ability and willingness to cooperate, and to assist them in resolving problems. This initiative, which is not targeted specifically at OFCs, is undertaken on a confidential basis, and the identity of jurisdictions is not disclosed.

16. One benchmark for the exercise is a jurisdiction’s ability to comply with the terms of IOSCO’s Multilateral Memorandum of Understanding (MMOU), which establishes the framework in which securities regulators are expected to cooperate. To be a signatory to the MMOU jurisdictions have to subject to a rigorous vetting process. Currently, approximately eight of the signatories are recognised OFCs, and several others either have applications pending or have formally notified IOSCO of their intentions to effect legal changes to permit signature.

FSA SUPERVISING RELATIONSHIP WITH OFFSHORE FINANCIAL CENTRES

17. In its bilateral relations with its foreign regulatory counterparts, the FSA draws no distinction between OFCs and other jurisdictions. This also applies to those OFCs that have close constitutional links with the UK (ie the Crown Dependencies and Overseas Territories). The basis of the relationships is typically determined by the presence of firms for which the FSA and the foreign counterpart have some form of common supervisory interest, and the need to obtain or exchange information for supervisory or investigatory purposes. For the most part, the cooperation sought from foreign counterparts relates to exchanges of supervisory information about individual firms, or the provision of very specific intelligence to assist an investigation or enforcement matter. Where there is a clear business case, the FSA may seek to enter into a Memorandum of Understanding (MOU) or similar arrangement with a foreign counterpart in order to lay down the framework for continuing cooperation. Currently, the FSA has MOUs with agencies in ten jurisdictions that may be considered OFCs.² The text of these documents is published on the FSA’s website.³ In addition, the FSA, as a signatory to the IOSCO MMOU, is entitled to expect cooperation from fellow signatories without the need for a bilateral arrangement.

¹ http://www.ceiops.eu/component/option,com_docman/task,cat_view/gid,250/Itemid,151/
³ Bermuda, Cayman Islands, Dubai, Gibraltar, Guernsey, Hong Kong, Isle of Man, Jersey, Singapore, Switzerland.
⁴ http://www.fsa.gov.uk/Pages/Library/corporate/Memorandums/International/index.shtml
⁵ http://www.fsa.gov.uk/Pages/Library/corporate/Memorandums/International/index.shtml
20. The FSA will continue to promote, through whatever fora it considers appropriate, the implementation of international standards of regulation, transparency and cross-border cooperation. However, it does not see these issues as being specific to OFCs, however defined, and it will continue to advocate that the performance of individual jurisdictions should be judged on their own merits, rather than under some generic label.

16 June 2008

Memorandum from the Tax Justice Network UK

TAX HAVENS CREATING TURMOIL

1. EXECUTIVE SUMMARY

“We feel that this (lack of provision of an effective regulatory system) might be a grave omission, since it is notorious that this particular territory, in common with Bermuda, attracts all sorts of financial wizards, some of whose activities we can well believe should be controlled in the public interest”.


The Treasury Committee (TC) announced on 30 April 2008 that it had “decided to undertake an inquiry into Offshore Financial Centres, as part of its ongoing work into Financial Stability and Transparency” and asked for written evidence to be submitted.9 This document is the submission of evidence prepared by the Tax Justice Network UK.

This paper argues that it is a mistake to confuse the term “Offshore Financial Centre” (OFC) with “tax haven”. These two are quite separate and distinguishable if intimately related phenomena that jointly make up the offshore economy.

We argue that the power in this relationship lies with OFCs and the companies that work within them, not the tax havens, so the focus of regulation must shift onto limiting the powers and impact of OFC operators within the global economy.

Tax havens are places that create legislation designed to assist persons—real or legal—to avoid the regulatory obligations imposed upon them in the place where they undertake the substance of their economic transactions. This is not by accident or chance: we provide clear evidence that these places, some of them countries, some not, but all with the power to pass legislation, set out to undermine the impact of legislation passed in other jurisdictions. These are deliberate acts of economic aggression targeted at sovereign states.

Offshore financial centres are not the same as tax havens. OFCs are the commercial communities hosted by tax havens which exploit the structures that can be created using the tax haven’s legislation for the benefit of those resident elsewhere. In other words, the offshore financial centre is made up of the accountants, lawyers, bankers, plus their associated trust companies and financial intermediaries who sell services to those who wish to exploit the mechanisms the tax haven has created.

Until now all attempts to regulate the offshore economy have been focussed on tax havens. We argue that this has been a mistake. Tax havens are geographically located and have fixed spheres of influence. OFC operators, many of them multinational companies or banks, and some like the Big 4 firms of accountants present in every major and most minor tax haven jurisdictions around the world, can move their operations to wherever they want at a moments notice. They have used this power to threaten to leave any jurisdiction that does not comply with their wish to secure the legislation they desire. This has recently been used as a tactic in the UK, itself a tax haven.

The result has been that in the last decade new and highly abusive forms of offshore company and trust have been developed. These evolutions have been little documented and much less understood, but have allowed both companies and trusts to float free of almost any regulatory control. Again, this did not happen by chance. As we show, it is the OFC operators who have demanded and secured this benefit on behalf of their clients.

The consequence is obvious: whilst tax haven regulation is important it is impossible to expect the tax haven states to regulate the OFCs that operate from within them. Those OFCs hold all the power in this relationship. In effect they have taken these states captive, showing in the process complete indifference to the local populations of these places and their elected representatives.10 It is not by chance that the degree of compliance with tax haven regulation that OFC operators demonstrate in their behaviour is astonishingly low, since they appear to consider themselves beyond the law of these places.

9 http://www.parliament.uk/parliamentary_committees/treasury_committee/ic0708pn42.cfm accessed 8-5-08

This is not only the case in the archetypal micro-state that populates the tax haven world in popular perception. As we are now seeing this behaviour is being replicated in the world’s major tax havens, of which, the UK is without doubt the most important. It is no longer possible for any objective person to deny the obvious fact that the UK is a tax haven and that the City of London is an OFC seeking to exercise control over our state. The evidence also shows that the City of London is also intricately connected to a web of satellite tax havens spread across the globe, including Crown Dependencies, British Overseas Territories and various members of the Commonwealth, which have served as conduits for capital flows into London whilst also providing facilities for tax evasion on an industrial scale.

The consequences are easy to see. The developing world is denied the capital resources it needs to establish stable, self supporting democracies. The UK’s tax base is eroded and in the process its own democracy is threatened as electors note that large corporations representing nothing but the power of money seem more important to those holding office than their constituents. Corruption is enabled. Crime can take place almost unimpeded. These are the realities of tax havens, even if, as we acknowledge, the race to the bottom in taxation has been averted (as yet) as a consequence of the sheer exuberance of the boom economy. But that boom has now passed and exuberance has given way to turmoil. Hard times are upon us, just at the very moment when the consequences of tax and regulatory avoidance are impacting most heavily on the UK economy.

As we show though, there are solutions to the turmoil that tax havens create. We recommend that:

1. The focus of regulation must shift onto limiting the impact of OFC operators within the global economy.
2. This can only happen by massively extending the transparency of the financial world, whether offshore or not. The UK must show its commitment to this task and call for broader based, more accessible and much better regulated and enforced registers of companies, trusts, charities and other entities created by statute law, and abolish the use of nominees within them.
3. In addition banking secrecy, whose only impacts are pernicious, must be outlawed. To this end the UK must seek that the EU extends the EU Savings Tax Directive to all privately owned entities (whether they be companies, trusts, foundations, partnerships with limited liability or their like).
4. Furthermore, the UK must seek that the EU extends the EU Savings Tax Directive to all forms of income derived from capital including all forms of interest, without exception, income from insurance policies and pension funds, dividends of all forms, trust distributions and the payment of royalties, licence income and similar payments derived from the ownership of intellectual property, and:
5. The UK must seek that the EU extends the EU Savings Tax Directive to additional territories to ensure that its effectiveness is not undermined by tax havens such as Hong Kong, Macau and Singapore.
6. Next the UK must seek to end the secrecy that has been exploited by multinational companies to hide the abuses that they have perpetrated in seeking, legally and illegally to deny states of the revenues due to them by the use of offshore structures. This requires that the secrecy that consolidated accounts permit on intra-group trading and the location of group transactions must be ended and the UK should actively require the adoption of country-by-country reporting by the International Accounting Standards Board and by individual countries.
7. Corruption is endemic within offshore financial centres. The UK must extend ratification of the UN Convention Against Corruption and the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions to all territories for which it is internationally responsible and require their active participation in its implementation.
8. As a pragmatic step the UK should recognise the role of OFCs in supplying the mechanisms used in many corrupt transactions, and actively promote research into methods of curtailing this supply that do not rely solely upon the actions of tax haven governments who have neither the power, resources or inclination to regulate that supply.
9. The role of the UK as a tax haven has to end if it is to have the necessary authority to tackle the issues identified in this report. This means that one of its most notable tax haven characteristics, the domicile rule, must be abolished.
10. As this report notes, because of its tax haven status the UK currently provides a taxation environment that favours large companies over small ones, quoted companies over unquoted companies and international entities over those operating solely in the UK. This is despite the fact that at least half of all the UK workforce work for companies whose activities are located solely in the UK. The UK should now commit to a tax strategy that ensures that all companies have equal access to markets, all can enjoy equivalent tax rates (there is serious risk that smaller companies are paying taxes at higher rates than large ones) and that undue regulatory burden is not placed on companies operating solely in the domestic market as a result of the action of those working on a multinational basis.
11. To reduce the impact of offshore tax competition the UK should work with the EU to promote adoption of a Common Consolidated Corporate Tax Base that limits the possibility for companies to arbitrage the taxation laws of one country against those used in another, and that allocates profit to country on the basis of a unitary apportionment formula taking into consideration solely where a company’s employees, assets and sales are located, so limiting the possibility of profit being shifted to a tax haven.

12. This would represent a new development in the relationship between the UK and Europe on tax matters. The UK is believed to have been an obstacle to implementation of some aspects of the EU Code of Conduct on Business Taxation. The UK should commit to this Code, seek to extend it to personal taxation and require that the Conduct Group monitoring its implementation publish reports on its work.

13. The UK has a special responsibility for the considerable number of tax havens that exist under its international protection. In 1998 the UK published the Edwards Review of the Crown Dependencies, but failed to subsequently require the proper implementation of the recommendations of the resulting report. The world has changed substantially since 1998 and another review is required, with Royal Commission status, to determine the UK’s future policy for all the tax havens for which it has responsibility.

14. It is classic tax haven practice to allow “offshore activity” to be regulated more lightly than that supposedly “onshore”. The UK should require that its tax havens operate systems of accountability and transparency with regard to corporate and other disclosure equivalent to those of the UK, and as recommended in this report.

15. The need for improvement in regulation in the UK’s tax havens has been graphically described by the National Audit Office in a report published in November 2007. It is vital that the weaknesses identified by the NAO are tackled, meaning that the UK must:

- Improve the quality of its training for all staff seconded to Overseas Territories and the Crown Dependencies.
- Second such staff as are needed to ensure that the financial services regulation of all territories for which the UK is responsible is operational and effective.
- Ensure that deficiencies in current legislation for regulatory regimes are remedied with immediate effect, if necessary by way of Orders made in Council.
- Require that contingency plans be put in place for the demise of the financial services industry in each of these locations.
- Create plans to diversify the economies of these territories so that they might have alternative sources of income available to them.
- Make clear that funds to ensure that this development is possible are dependent upon adopting recommendations on transparency included in this report.

16. The Crown Dependencies are particularly associated with the UK and are especially vulnerable to political capture by the financial services industry. The Isle of Man can only operate because of subsidies amounting to more than £200 million a year provided to it by the UK; Jersey and Guernsey are likely to run substantial government deficits as a result of tax changes adopted to comply with the EU Code of Conduct on Business Taxation. Neither gives indication of having contingency plans available to manage those budgets given the current likely down turn in their trade as the world financial crisis develops. The UK government should:

- Make explicit the terms of its support for the Isle of Man government and make explicit its requirement that the Isle of Man comply with both the spirit as well as the letter of the EU Code of Conduct on Business Taxation in exchange for that support.
- Require that each of the Crown Dependencies prepare contingency plans based on the premise that there will be no growth in their financial services sectors for the next five years.
- Make explicit that support will only be forthcoming for these territories in future if they are willing to comply with recommendations on transparency included in this report.
- Require that each Crown Dependency develop a plan to break its dependency upon financial services as the main source of its income and demonstrate the viability of doing so.

17. No one suffers more from the existence of tax havens and OFC abuse than the developing countries of the world. For them this is not a question of ensuring the effectiveness of financial regulation or the efficiency of the tax system (although both have significance in developing countries): it is also a matter of life and death. The UK needs a policy on tax havens that is coherent with, and integrated into, its work on development. This must include commitments to:

- Provide technical support and training to developing countries to ensure they can engage effectively with tax haven abuses, whether relating to corruption, crime or taxation abuse.
— Provide technical support to developing countries to ensure that they can negotiate effective contracts with significant commercial trading partners that provide them with access to adequate information to ensure that appropriate taxes are paid within their domain as required by their law.

— Develop models for development that break the dependence on fiscal degradation that has been the pattern of incentive used to date, so undermining the credibility of developing country tax systems and their prospect of becoming effective, self governing democracies that are not dependent upon aid.

— Support developing countries in creating effective information exchange agreements with other nations and with tax havens to ensure they have access to the information they need to ensure they can collect the taxes due to them.

— Assist developing countries in recovering stolen assets that are their rightful property, including those that have arisen as a result of tax evasion, and to create effective mechanisms for the repatriation of these assets from locations over which the UK has control (including the City of London) to those places that need these assets to fulfill their development objectives.

— Ensuring that international and domestic civil society is represented in the processes recommended here to ensure that governments are held accountable for the actions they take in the name of the people they govern and that where appropriate training is provided to ensure that those groups are empowered to undertake these tasks.

18. The first recommendation of this report was that the focus of offshore regulation should now shift from the tax haven as such to OFCs. All the recommendations since then have had that goal in mind, and yet none, as such, tackles the OFC operators; all instead seek to curtail their access to the abusive products that they sell. We believe that in the absence of a world tax authority this is the most pragmatic approach to this issue. Two actions would assist this task, however. The first would be to support the creation of a Code of Conduct for Taxation to be adhered to by governments. Progress is being made on this issue at the United Nations, and we recommend that that the UK support the development of that Code.

Second, there is an action that could be taken to tackle the OFC operators, and it is within the UK’s power alone to enact it. The UK should promote a Code of Conduct for Taxation that would uphold the highest ethical standards of conduct, including a commitment to making full disclosure of all information noted in recommendation 2 above and to desisting from the promotion of all forms of tax avoidance on the part of all engaged in the taxation profession, whether in the UK or offshore. This should be enforced by refusing to extend UK government contracts for services to any company or firm that did not commit itself and all its group members and their affiliates trading under similar or associated names to that standard of conduct.

We are under no illusion about the size of the undertaking that implementation of these recommendations would require.

We also believe them wholly justified. The benefit of the actions proposed here, which would, for example, have reduced the impact of the current world financial crisis by substantially increasing the transparency of the world’s financial systems, substantially exceeds any cost to the UK and its citizens of implementing these regulatory changes.

In addition, the UK, its international status, its tax revenues and its democracy would all be substantially enhanced by implementation of these recommendations. Tax havens are a pernicious cancer undermining all of these from deep within the heart of our society, the epicentre being in the City of London. Regulatory reform is essential if that cancer is to be prevented from both destroying our social order and replacing it with an undemocratic infrastructure intended solely to service the whims of an international elite drawn from the financial services sector.

Developing countries would benefit as much as developing countries from these recommendations. Tax havens and OFCs harm development processes by distorting capital accumulation and investment patterns, and facilitating grand corruption and embezzlement. Unless this cancer is tackled, there is no prospect for an end to aid dependency or for the creation of economically stable, democratic states able to feed, educate and provide health care for their populations.

Tax havens undermine effective democratic government and deny the supply of information that markets need if they are to operate properly. So significant is the challenge they pose to global economic and social stability that the risk cannot be assessed within the financial domain alone; it permeates the infrastructure of our society and this report reflects that perspective. As the author of the memorandum cited at the start of this chapter noted as far back as 1961, the offshore economy has attracted financial wizards whose activities should have been controlled at that time, and who urgently need to be controlled now. Since the 1960s the problem has become manifestly more urgent and the risks to public interest have become that much greater as a result of half a century of inaction. The UK government can no longer turn a blind eye to problems that it has played a major role in creating.

11 As an example, see http://www.taxjustice.net/cms/upload/pdf/AABA-TR-Code_long.pdf accessed 13-6-08
2. Introduction

“We feel that this (lack of provision of an effective regulatory system) might be a grave omission, since it is notorious that this particular territory, in common with Bermuda, attracts all sorts of financial wizards, some of whose activities we can well believe should be controlled in the public interest”.


The Treasury Committee (TC) announced that it had “decided to undertake an inquiry into Offshore Financial Centres, as part of its ongoing work into Financial Stability and Transparency” on 30 April 2008 and asked for written evidence to be submitted.12 This document is the submission of evidence prepared by The Tax justice Network UK.

The Tax Justice Network (TJN) is a non-aligned coalition of people and organisations with a shared concern about the harmful impacts of tax evasion, tax avoidance, tax competition and tax havens. The international secretariat of TJN is located in the UK. It is stressed that this submission is not made by the International Secretariat but by UK based members of the organisation and they have sole responsibility for this submission. Some of those submitting this report are also closely associated with the work of that International Secretariat.

The approach that this evidence takes is broad based. We note the Committee’s concern for financial stability and transparency. We share that concern, but believe that the role of the world’s offshore financial centres (or, as we would prefer to call them, for reasons explained in chapter 3, tax havens) is so important that they cannot be considered in that context alone. As such this submission considers the impact of tax havens and the offshore financial centres located within them (the distinction between the two will be explained in chapter 3) on the matters that the TC refers to in its brief, but in doing so makes clear that this does, in our opinion require consideration of the following issues:

1. Tax competition and its impact.
2. Transparency and accountability both within tax havens, and the way that their opaque nature can be exploited as a result of weaknesses to be found in the accounting structures promoted by company law in the UK and elsewhere, and by the accounting profession.
3. The UK’s own role as both a tax haven (which we will show that it is) and as a promoter of many tax havens (which is a widely acknowledged fact)13 and the impact that this has on the UK’s international relations.
4. The impact of tax havens on development and the developing countries of the world.
5. The domestic implications of tax haven policy, both with regard to the UK’s own status as a tax haven, and as to the impact of other havens on its domestic regulation and tax haven.
6. The social implications of tax haven policies including the impact of increasing wealth disparities, the undermining of democracy and the alienation of the UK electorate from the process of government.
7. The undermining of corporate social responsibility and the failure of effective corporate governance.

In doing so this report takes a broad view of the issues that tax havens raise when their impact upon the UK is assessed. In this context issues relating to taxation, financial stability and transparency are themselves important, but this limited financial horizon does not reflect the full impact of tax havens on the UK, or the impact being a tax haven has upon the UK. This report will therefore consider the matters raised within this narrow domain but also within the broader perspectives of economics (as opposed to finance), ethics, political economy, development, corruption and criminal behaviour and politics. Along the way issues relating to sociology and anthropology might also be touched upon. It is our belief that the issue can only be properly considered in this way.

This reflects the authors’ opinion that effective markets are essential to ensuring the supply of the resources that the people of the world need, and want. It also reflects our opinion that efficient markets are dependent upon two things: the first is the existence of an effective legislature that can provide the appropriate infrastructure in which markets can operate, and we know of no better way to ensure that this happens than by upholding the democratic process. The second requirement is symmetrical access to information.

Tax havens undermine effective democratic government and deny the supply of information that markets need if they are to operate properly. So significant is the challenge they pose to global economic and social stability that the risk cannot be assessed within the financial domain alone; it permeates the infrastructure of our society and this report reflects that perspective. As the author of the memorandum cited at the start of this chapter noted as far back as 1961, the offshore economy has attracted financial wizards whose activities should have been controlled at that time, and who urgently need to be controlled now. Since 1961

12 http://www.parliament.uk/parliamentary_committees/treasury_committee/ev0708sp42.cfm accessed 8-5-08
13 See, for example the report of the Public Accounts Committee of the House of Commons dated 1 May 2008 http://www.publications.parliament.uk/pa/cm200708/cmselect/cmpubacc/176/176.pdf accessed 8-5-08
the problem has become manifestly more urgent and the risks to public interest have become that much greater as a result of half a century of inaction. The UK government can no longer turn a blind eye to problems that it has played a major role in creating.

SECTION 1

3. UNDERSTANDING THE ISSUE

In offering evidence to the Treasury Committee (TC) on Offshore Financial Centres (OFCs) we are reminded of the proverbial response to the person asking directions that the respondent “would not start from here”. To explain, our concern is that in using the term “offshore financial centre” in its call for evidence the TC has already made an assumption about the issue into which they are making enquiry which we would wish to challenge. It would seem that the TC has decided to use the term OFC when referring to what are called in popular parlance “tax havens”. This, we submit, will cause confusion. The two are not the same.

What is a tax haven?

Tax havens are places that create legislation designed to assist persons—real or legal—to avoid the regulatory obligations imposed upon them in the place where they undertake the substance of their economic transactions. This is not by accident or chance: we provide clear evidence that these places, some of them countries, some not, but all with the power to pass legislation, set out to undermine the impact of legislation passed in other jurisdictions.

Tax havens can be geographically identified. The characteristic that they have in common is that they have the right to create legislation. This does not mean that they are all, by any means, sovereign states. The Crown Dependencies14 and the British Overseas Territories15 are not sovereign states. The state of Delaware in the USA is not a sovereign state either, but it is generally considered a tax haven. Some tax havens are, of course, sovereign. Singapore, Panama and, of course, the UK are all sovereign states and are tax havens.

What tax havens have in common is that they create legislation designed to assist a person to avoid the regulatory obligations imposed upon them in the place where they undertake the substance of their economic transactions.

This needs explanation. First of all the difference between the substance and form of a transaction has to be understood. The form of a transaction is the legal identity given to it. So, for example, if a CD is sold by a UK limited company to a UK resident person the legal form of the transaction is that a UK company made the sale under UK law to a UK person. UK taxes will be paid on any profit arising from the sale, UK VAT will be paid, and a UK court could arbitrate on any resulting dispute that might have arisen. UK trading standards will apply.

Suppose now that the same CD was shipped from the same warehouse in the UK to the same person in the UK, but with the CD being routed through the Channel Islands on its way from the warehouse in the UK to the customer in the UK. The sale in this case is recorded as having taken place from the Channel Islands. The substance of the transaction has not altered. A CD that was in the UK has been sold to a person in the UK. However, in this second transaction the form of the transaction has been changed significantly. The sale is now recorded as having taken place in a Channel Islands company. The sale may be subject to the law of one of the Channel Islands. Tax on any profit arising on the transaction may either be paid solely (if at all) in the Channel Islands, or may be split between the UK and the Channel Islands (since presumably the warehouse operator still requires remuneration for their services in shipping the product from the UK). UK VAT may well not apply in this case, since a loophole is available that prevents this charge on this form of transaction. UK trading standards may not apply. UK courts may not be able to intervene in any dispute that arises on the transaction. And all this has happened because a wholly irrelevant step (as far as the customer is concerned) has been placed into the transaction requiring that it be shipped to the Channel Islands and back en route to them. As far as the customer is concerned nothing has changed. The substance of the transaction is unaltered and yet the legal form is entirely different. The transaction is now subject to the laws and regulations of a domain outside the UK even though the substance of the transaction took place wholly within the UK.

Tax havens create legislation to achieve this effect. They do not do it by accident. It is their deliberate intent that the structures created under their legislation should have impact either solely or mainly outside their territory to enable a person resident in another country to avoid regulatory obligations in the country or countries in which they undertake the substance of their economic transactions.

14 Jersey, Guernsey and the Isle of Man.
15 Anguilla, Bermuda, British Antarctic Territory, British Indian Ocean Territory, British Virgin Islands, Cayman Islands, Falkland Islands, Gibraltar, Montserrat, Pitcairn Islands, St Helena and Dependencies, South Georgia and the South Sandwich Islands, the Sovereign Base Areas of Akrotiri and Dhekelia in Cyprus, and the Turks and Caicos Islands.
This same argument also succinctly shows the economic impact of such transactions. The consumer in the UK appears to benefit from this deal. They do not, of course. The lost tax has to be recovered from them in some other way. It may be, of course, be recovered from someone else, but there can be no doubt it will be paid. They don’t really win at all as a result. The deal that has been done is clearly one that extracts more resources, and has greater impact on the environment than that which should have been done more simply in the UK alone. The company that does this sort of tax avoiding deal beats its local competitors. The small shop on the High Street goes out of business. The community is blighted, young people who used to gather there are no longer encouraged to talk about and play music. The big international retailer gets bigger, extracts more monopoly profit. And the consumer loses again, whilst the richest who own such companies get richer and the poorest become poorer.

A perfect example of this pattern and the legislation used to create it might be found in the case of the Liechtenstein foundations that have been so much in the public eye in 2008\(^\text{16, 17}\). The citizens of Liechtenstein are taxed, albeit at relatively modest rates, on their world wide income.\(^\text{18}\) In blocking tax evasion they have no use for the Foundation that is one of the major export products of their jurisdiction, or of the zero per cent tax rate that it enjoys, but that is not available to them locally, or of the secrecy that it provides, that they cannot use as they must declare their income locally. These Foundations only have any real use outside Liechtenstein, and it is for that purpose alone that they were created.

There is a second characteristic that most tax havens share in common. They create an environment of secrecy that allows the user of the structures created using its law to do so either wholly anonymously, or largely so. This secrecy may be backed by statute: the Swiss created their banking secrecy laws in 1934 and they have been much copied.\(^\text{19}\) Despite claims that this was done to hide Jewish deposits from Nazi investigation it was actually enacted to prevent French authorities making enquiries on Swiss bank accounts to enforce French taxation laws. The facilitation of tax evasion in another country was Switzerland’s motive.

Other arrangements are commonplace to ensure secrecy is maintained. Few tax havens require the identity of the real owners of companies to be disclosed; they allow nominee directors to manage such concerns so that those really operating them remain hidden from view and few tax havens require accounts to be placed on public record. Those that do usually provide a mechanism for avoiding the obligation for those rich enough to take advantage of it. For example, when the Wall Street Journal investigated the activities of Round Island One Limited, Microsoft’s main operating subsidiary in the tax haven of Ireland, Microsoft took advantage of Ireland’s law that allowed companies to register with unlimited liability, so avoiding the obligation to file its accounts on public record in the future.

What is important to stress is that secrecy is key to most tax haven operations. Without it many of those using tax haven structures would not do so. This is either because, in the case of those using them for criminal purpose, including tax evasion, they fear they would be too easily identified and so pay for the consequences of their crime, or in the case of those using them for regulatory avoidance (which may be legitimate, but is often ethically questionable) because of the damage that discovery would do to their reputations. This is especially true of the corporate sector and may have been a reason for Tesco suing the Guardian for malicious falsehood even though it is an acknowledged fact that Tescos did set up an offshore structure in the Cayman islands to avoid UK taxation liabilities.

In this context low tax rates and lax regulation, with both designed to undermine obligations elsewhere, are the lure to attract business to tax havens. It is however the secrecy that guarantees that a sale of tax haven services takes place. It is impossible to imagine one without the other.

**What is an offshore financial centre?**

Offshore financial centres are not the same as tax havens. It is unfortunate that the terms have been confused. OFCs are the commercial communities hosted by tax havens that exploit the structures that can be created using that tax haven legislation for the benefit of those resident elsewhere. In other words, the offshore financial centre is made up of the accountants, lawyers, bankers and their associated trust companies that sell services to those who wish to exploit the mechanisms the tax haven has created.

\(^{16}\) Some notes on Liechtenstein foundations may be found at http://www.investec.com/NR/rdonlyres/14C9811C-D15C-46CA-AD7D-737F237FC5BD/6426/IntroductiontoLiechtensteinfoundations.pdf accessed 8-5-08.  
\(^{17}\) See http://taxjustice.blogspot.com/2008/02/liechtenstein-emerging-scandal.html accessed 8-5-08.  
\(^{19}\) http://swiss-bank-accounts.com/e/banking/secrecy/Handelsbank.html accessed 8-5-08.
This means that tax havens and OFCs are very different. Most importantly, the OFC community is very largely expatriate (at least in the smaller tax havens) and is usually very mobile. This characteristic makes the OFC community quite different from the tax haven community, and quite often leaves them in real or potential conflict. That is because the tax haven community is local and committed to their geographic space. The OFC community is international, transient and only interested in following money. If money does, for any reason, leave a tax haven you can be fairly sure that the OFC community will follow it very rapidly. The tax haven community, who are the real local populace, will be left behind to tend the wreckage. This is a scenario imagined recently by the leader writer of Cayman’s leading newspaper, who said:20

Regrettably, however, the numbers of people with the long-term interests of the Cayman Islands at heart has been substantially reduced as a result of the rollover policy and the foreign elements in the private sector will, when push comes to shove, take their money and run, leaving everyone else wondering what happened.

Little more graphically demonstrates the relationship between the communities than this. It is a theme to which this report will return.

Are all tax havens OFCs?

Every tax haven aspires to be an OFC. It is the way they make money from the structures whose creation their legislation enables. Unless those entities are created, and the associated fees paid they get no return on their investment from creating that law. In addition, without attracting the employment and spending that an OFC brings into their domain they enjoy little or no growth from being a tax haven.

Despite this it must be stressed that some tax havens have not really achieved the objective of being OFCs. Examples are to be found in the list of havens that follows in this section. More than 40 such locations that have been identified at one time or another have not been successful at exploiting that status by attracting sufficient business to be considered OFCs. Some of the British Overseas Territories, such as Montserrat and Anguilla might reasonably be considered to be in this category. Although they allow the creation of tax haven structures, the local financial services communities who seek to exploit these facilities are small in both cases, being just 200 people in the case of Anguilla and 150 in Montserrat.22 The scale is insufficient to justify the claim that an OFC has been created.

Quite clearly though some places have developed strong OFCs that dominate their local economies. This is, for example, obviously true of places like Cayman and Jersey. In the latter case there are some 11,800 people engaged in the OFC22 and the activity contributes more than 50% of the island’s GDP.23

The offshore world

Tax havens and OFCs together make up the “offshore world”. By implication of course, the accountants, lawyers and bankers who are the main population groups to be found within the OFC community are also key members of the “offshore world”.

It is important to stress some consequences of this combination if the term “offshore” is to be understood. Offshore does not describe geography. It most certainly does not refer to island locations (many of which are microstates with populations of less than 1.5 million), even though some tax havens have that characteristic and host OFCs from within their palm-beach lined domains. Liechtenstein is an OFC and is one of only two double land locked states in the world, as if emphasis of this point were needed.

The term “offshore” refers to the location of the customers of the OFC, those people the tax haven intended should make use of the structures they allow to be created. What characterises these customers is that they are not in the tax haven where the OFC is located. They are elsewhere, and since this concept was first recognised in London, that elsewhere was “offshore”. The term stuck, even when the geography to which it related had little or no meaning.

What this means is this: in the offshore world transactions are recorded in one place (a tax haven) on behalf of parties who are actually elsewhere in the world (offshore). Those transactions might have the legal form of taking place in the tax haven in which they are recorded. The reality is that their substance, and benefit, occurs elsewhere. If that “elsewhere” is in a major state (ie with a population exceeding 1.5 million) it is sometimes called “onshore”, though this term also has misleading geographical overtones and is therefore best avoided. What onshore should, but does not always, mean is that the substance of the transaction takes place in the location where it is recorded and regulated. There is no conflict between form and substance in this case.

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20 http://www.caymananetnews.com/cgi-script/csArticles/articles/000149/014910.htm accessed 8-5-08.
22 Ibid
The conflict is created as a consequence of the actions of the accountants, lawyers and bankers working in the OFC. That is their primary purpose. They have been very successful in developing a market for their services. But the very fact that an OFC only houses these professions must be the clearest indication that nothing really happens in such places: they simply provide the legal form for transactions that take place elsewhere. It is this conflict between substance and form, hidden behind a legal veneer protected by considerable secrecy that is the core of the offshore dilemma that justifies the TC undertaking the review in which it is engaged. The offshore world is designed to make things appear other than they are, and by and large succeeds in doing so. This, in a nutshell, is the threat that they pose to the world.

The offshore world is designed to make things appear other than they are, and by and large succeeds in doing so. This, in a nutshell, is the threat they pose to the world.

How the “offshore world” came about

This is not the place for a full history of the offshore world. A short note as to the reasons for its development, and the key role of London within that process is, however, appropriate.

The first tax havens were created in the USA when Delaware and other states offered lower taxes and a relaxed regulatory environment to entice the relocation of business out of New York State in the late nineteenth century. Delaware remains the leading location for corporate formations in the USA to this day, for precisely this reason, which only now is the US government considering regulating, with Barack Obama a notable supporter of change.24

Further development was limited until after the First World War: the reason is simple to explain. What international trade there was largely within empire blocks before this time and as such subject to a single tax and regulatory administration. A notable exception was the Cobden-Chevalier treaty of 1860, signed between France and Britain, which enshrined the principle of equal protection in law to non-resident person and capital. The Cobden-Chevalier treaty was subsequently adopted as a model treaty by many other states.

After the First World War this changed: cross-border trade increased and problems of double taxation of income between states began to be an issue. Pressure for reform of the UK tax system to prevent double taxation came from a number of sources, including most notably the Vestey family, owners of Dewhurst the butchers and of extensive cattle ranches in Argentina who brought a series of test cases on this issue in those years.25 Inevitably change followed. It is known that Jersey was first used as a tax haven, exploiting the availability of UK trust law in a reasonably anonymous environment, from the 1920s onwards. In 1929 the House of Lords26 decided that if the directors of a UK registered company met in another country then the centre of that companies control was outside the UK and, so long as it did not trade in the UK it was not subject to UK tax on its profits. This decision had a profound impact on the development of offshore financial centres. In one decision the “offshore” company, registered in a domain but neither trading nor taxable within it had been formed. In the years that followed the offshore company became the main selling point of the City of London’s many satellite tax haven jurisdictions, and in combination with the UK’s almost unique use of trust law created opportunities for secrecy and the avoidance of taxation that Switzerland could only vaguely emulate with its banking secrecy laws of 1934.

The Second World War put a halt to further offshore development: some havens, such as the Channel Islands were put out of action. This provided a curious indication of their own dependence upon world economic and social stability if they are to pursue their own trade that undermines both, as this report will show.

The immediate post-war world was not conducive to much tax planning: there were real issues like rebuilding Europe to deal with, but as the 1950s progressed the consequences of that rebuilding emerged. The Marshall Plan had pumped Europe full of dollars. It is hard now to understand the degree of regulation that existed at that time with regard to currency dealing, or the repatriation of dollars back to the USA. These dollars, liberated from that constraint stayed in Europe. As a result the Euromarket developed in dollars outside the US (and to some degree in other currencies outside their country of origin, but clearly to much lesser degree: the dollar was the dominant world currency of the period), but once again the UK played a unique role in this process. In October 1957 the UK was confronted with a crisis. Facing mounting speculation against the pound after the Suez Canal crisis, the British government imposed restrictions on the use of pound sterling in trade credits between non-residents. Consequently, British and other international banks sought to use the US dollars in their international dealings. Transaction between non-residents and in a foreign currency (ie not the British pound) mediated by banks located in London, British or not, were considered by the Bank of England as if they were taking place abroad or “offshore”, ie not under the regulatory laws and supervision of the British state.27, 28

It was this decision of the Bank of England to treat certain type of financial transaction between non-resident parties undertaken in foreign currency as if they did not take place in London and hence not under the regulatory and supervisory arm of the Bank of England that created “offshore”. Economic historians are still unable to trace the precise origin of this decision or a recorded rationale for it. What is clear is that whilst the transactions were physically taking place in London and no other regulatory or supervisory agency could intervene they were as a consequence of this action only deemed “offshore”. The consequence of this decision was that they were unregulated and unsupervised by any jurisdiction. We do not know whether the decision was taken intentionally or not, but we know that the market emerged in September, 1957.29

There can be little doubt that the Bank of England had little inkling of what they had given birth to when creating the “offshore” London Euromarket, but it is equally without doubt that it was the Bank of England which created offshore, and the consequences were rapid and marked.

First, and as a curious by-product of this decision, UK resident banks were excluded by the Bank of England from operating in this offshore market. They rapidly got round this by creating branch operations to achieve the same result in the Channel Islands. This was done with Treasury consent.

This was noticed by US banks too small to have an operation in London, or who needed to overcome the still considerable communication issues that existed across the Atlantic at the time, as well as the important time difference. They realised they could achieve the same result that London banks had achieved in the Channel Islands by setting up similar operations in the British Caribbean. In the early to mid 1960s tax havens of that area came into being. Cayman, for example, began to develop from 1966 onwards.30 Eventually the International Banking Facility was offered in New York from 1981, followed by the Japanese Offshore Market (JOM) in 1986. Both were modelled on the Singapore Asian Currency Market (ACU) which was set up in 1968 under the influence of that post Euromarket expansion of the tax haven sector. Bangkok also followed suit by setting up the Bangkok International Banking Facility (BIBF). Malaysia has somewhat similar arrangement in Labuan, as indeed, does Bahrain. According to some estimates, about one third of international banking in the U.S. is undertaken in IBFs and nearly a half of Japanese are in JOM.31

The structure of the offshore world now existed: it took one major kick for it to become a fully fledged component of the international financial scene and that came with the onset of capital account liberalisation in the late 1970s and early 1980s. This was driven by an ideology constructed upon ultra-orthodox liberal economic theory, laced with massive flows of petrodollars originating from the Middle East, which had much the same effect as the Eurodollars of the 1950s. The impact was dramatic. This graph shows the rise in cash deposits in Jersey over an extended period, expressed in constant value:

![Growth of Banking Deposits in Jersey Since Financial Market Liberalisation](image)

Source: Jersey Finance data analysed by John Christensen, Tax Justice Network

The offshore world grew exponentially, stimulated by financial deregulation and improvements in communications and information technology including fax machines and the internet.

But these are not the sole reasons why so many tax havens around the world enjoy British protectorate status or are members of the British Commonwealth. This has arisen because the UK encouraged many of its former colonies to turn themselves into tax havens. The intention was simple: it was hoped that by so doing they would cease to be financially dependent upon the Foreign and Commonwealth Office. This process has been evidenced on a number of occasions, and international opposition to the UK’s policy has been documented, for example by academic Greg Rawlings with regard to the creation of the Vanuatu tax haven despite the opposition of the Australian government. The location of tax havens within the offshore world is by no means accident: in many cases it is deliberate and by UK design. This explains why the UK now has a moral obligation to lead the process of remedying the consequences of that short-sighted policy, which is harmful to UK interests, to the interests of developing countries, and those of our trading partners in the developed world.

The consequences of tax havens and OFCs being different

The fact that not all tax havens are OFCs does have serious consequences. The fact that the terms are not synonymous, but are on many occasions used interchangeably is also a matter of serious concern because it has had considerable implication. This is most particularly true with regard to regulation of the “offshore economy”. This is because, as will be noted later, the regulation of the offshore economy has been focussed almost entirely upon places i.e the tax havens themselves. They have in turn been expected to regulate the offshore financial centres located within them.

This however ignores two issues. The first is that those OFCs are made up almost entirely of firms with no strong economic ties to the tax haven they are using and are, secondly, staffed by people with, if anything, even lower commitment to that place. It is apparent from the published career information relating to many OFC practitioners that they do not originate from the places where they work and have usually worked in more than one tax haven. They are clearly highly mobile, which creates the real possibility that they will have relatively limited regard for the law of one jurisdiction, knowing how easily they can relocate if problems arise.

The failure to recognise this means that the OFC part of the offshore world is not effectively regulated, with processes of regulation being devolved to authorities that, as will be noted, have few resources to undertake the task devolved to them. The consequence is that regulation of the offshore world remains largely ineffective.

Types of tax haven

There are broadly speaking seven types of tax haven. These are as follows:

1. Incorporation locations, examples being Montserrat and Anguilla. In these locations there is no effective OFC. The tax haven is primarily used for the registration of entities such as offshore companies used in transactions recorded in other tax havens. These places have tended to be associated with very low effective regulation and minimal information disclosure.

2. Secrecy locations, examples being Liechtenstein, the Turks & Caicos Islands, Singapore and Dubai where secrecy is considered absolutely paramount and is heavily protected.

3. Specific geographic market suppliers. An example being the British Virgin Islands, which creates large numbers of corporate entities to service the Chinese demand for offshore entities, many of which are associated with what is known as “round tripping”. Other examples include Panama, which serves the US market, and Jersey that specifically targets the London market whilst Vanuatu has served Australia.

4. Specialist service providers. These are tax havens that secure a specific type of business activity. For example, Bermuda and Guernsey target the reinsurance market whilst the Isle of Man has specifically set out to secure a market in companies floating on the UK’s AIM market and Cayman has attracted hedge funds.

5. Market entry conduits. These tax havens seek to earn a margin from the routing of transactions through their domain because little tax is charged when this is done. Most seek to exploit their network of double tax treaties in the process and tend to be those that many would not consider tax havens. They include Malta and Cyprus who compete for funds being routed from the developing world into the EU; Mauritius which is a conduit for investment in India; the Netherlands, which acts as a location for holding companies for investment throughout Europe; and Belgium and Luxembourg which have at various times sought similar roles for themselves.

6. High net worth providers. These have the resources to actually manage the funds deposited within their domain by the world’s wealthiest people and have the means of access to ensure that those people can get to see their fund manager with relative ease. They include Switzerland, New York and London.

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7. The tax raider. This is a country that sets out to attract the relocation of profits to its domain where they are taxed at a lower rate than they might be elsewhere, but where there is a high degree of financial security and limited risk of the transactions being identified as taking place in a tax haven. Foremost amongst these locations is Ireland.

It is stressed, many tax havens play more than one role although by no means all of them combine all these roles. Offshore transactions are designed by offshore advisers to meet the needs of their particular clients and the choice of location in which transactions are registered and recorded (which need not be the same place) may be influenced by factors such as those listed above.

Where are the world’s tax havens?

A number of lists have been prepared over many years that seek to identify the places known as tax havens. Based upon both an academic literature review and the various lists produced by regulatory agencies and others, mainly over the last decade, the following list of those places suggested to be tax havens over the last 30 or more years has been prepared by Tax Research LLP. 33

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Notes as to sources:
4. OECD, IMF, FSF, FATF listings in the year noted
It will be noted that there is remarkable agreement over a long time period with regard to the tax haven status of some locations; indeed the Bahamas, Bermuda, Cayman, Guernsey, Jersey, Malta and Panama appear on every list over this extended period. 22 locations appear on at least eight lists.

In practice those that appear on fewer than three lists are unlikely to be of consequence, with the exceptions of Dubai, Latvia, Uruguay, the US Virgin Islands, the USA, the Netherlands and Belgium. In addition Austria has never appeared on any list, but has significant tax haven characteristics. Ghana, although not currently on any of these lists, is creating the basis for becoming a tax haven, joining Somalia as the only other country on mainland Africa with such a status.

In effect this suggests there are about 56 countries worthy of serious consideration as tax havens at present. In saying that it should be noted that this excludes some countries such as Tonga listed as tax havens by the OECD where this activity now appears inconsequential.

Who are the world’s OFCs?

An indication of where the world’s most important OFCs might be found from a review of the locations in which the world’s Big 4 firms of accountants operate. The following study was published in February 2007.

34 Deloittes, Ernst & Young, KPMG, Pricewaterhousecoopers.
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Eav 32  Treasury Committee: Evidence

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Source: Tax Havens from Tax If You Can, a TJN publication.
Source: Accountancy and Audit firms column “1” from firm’s own websites accessed during the autumn of 2006.
Source: Accountancy and Audit firms column “2” from Google search engine accessed during the autumn of 2006.
Research undertaken by Chris Steel BSc, ATTAC and TJN Jersey http://www.jersey.attac.org/

It is apparent that some havens have not developed as OFCs. Those that have enjoy remarkably consistent coverage amongst these firms.

It is notable that the firms do not seek to openly declare all locations in which they work, bar PricewaterhouseCoopers.

The services tax havens supply

The fundamental tax haven service is the supply of a means of avoiding the regulation that would be imposed on a transaction if it were to be recorded in the location where that transaction really takes place. This service is combined with secrecy, which ensures that there is limited opportunity for the jurisdiction affected to find out either that the regulation has been avoided, or by whom.

The regulations that might be avoided are:

1. Taxation. This can be with regard to taxation on natural persons (real people) or legal entities (such as companies) and cover issues as diverse as taxes on income, gains, inheritance, transactions, gifts, wealth, property or even currency. Payroll and other indirect taxes of those who locate transactions in tax havens can also be avoided.
2. Accounting. Accounting requirements are often lax in tax havens, avoiding obligations that apply in many mainstream democratic nations. In addition, accounts are rarely put on public record in tax havens but are in the majority of mainstream states. Non-disclosure of commercial transactions and who might be party to them is a major attraction for those using tax havens.
3. Matrimonial, family and insolvency. Assets are often hidden from spouses, other family members or creditors through tax haven structures.
4. Other regulations. The regulation of states with regard to financial services, health and safety, environmental issues, labour protection, property ownership, monopoly, trade, shipping, and just about any other issue can be avoided through the use of tax havens.

It is a mistake to assume that tax is the primary motive for everyone using the services of tax havens. It is not. However, those seeking to use them for the other purposes noted will typically also avail themselves of the secrecy a tax haven supplies to keep that fact from the authorities in their home location. This might include the tax authorities of that state since it is commonplace for tax returns to be produced in court in many countries when disputes relating to the noted issues arise. As such many will, once they use a tax haven for another purpose fail to report the income they have that arises there and which should be declared to their home authority. Once that happens they are also party to tax evasion, whether or not that was their original intent for using the location.

None of these things is possible without secrecy.

That secrecy is also used to hide criminal activity, but it should be noted that tax evasion and regulatory abuse is by far the most common criminal activity in tax haven. The following practices undoubtedly occur in tax havens, but are not limited to them:
1. Bribery and the purchasing of favour.
2. Hiding the proceeds of corrupt activities.
3. Money laundering the proceeds of crime.
4. Drug and other trafficking, including the trade in people and children.
5. Piracy.
6. Counterfeiting.
7. Racketeering.
8. Illicit political funding.
10. Evading political sanctions.
11. Tax evasion (where this is the primary motive of the transaction).
12. Theft (for example, from an employer).
13. Insider dealing.
As a proportion of transactions undertaken these are likely to be more commonplace in tax havens than in other banking systems because of their strongly applied secrecy rules. This does not mean that these transactions are not undertaken and found in other countries or their banking systems.

**Tax haven secrecy**

Tax haven secrecy takes many forms. Perhaps the most commonplace is banking secrecy. It is normal for all banks to provide their customers with banking secrecy and confidentiality, but in many locations (the United Kingdom included) this is considered best commercial practice and is not mandated by law. In the UK, for example, banking secrecy is far from sacrosanct. All banks are, for instance, required to report interest earned on all accounts they maintain to HM Revenue & Customs on an annual basis, so breaking all UK resident persons’ right to privacy of information with regard to this source of income.

This is not the case in many tax havens, and some locations which are not considered tax havens, where banking secrecy is protected by law. Switzerland is considered the originator of the legal concept of banking secrecy which it enshrined in 1934. Although the Swiss would like to claim that this legislation was enacted to help Jews seeking to hide assets from the Nazis (and it may subsequently have been used for this purpose it was actually enacted following a public outcry in France, when wide scale tax evasion by eminent French personalities through the use of Swiss bank accounts was discovered. Rather than cooperate with the investigation Switzerland facilitated their tax evasion by guaranteeing bank secrecy by making it a criminal offence for any bank employee to disclose bank information for any reason whatsoever. The right of the government to bank information was also limited, and in most tax havens this combination of legalised banking secrecy combined with a very limited government right of enquiry (usually now restricted to criminal matters, which may exclude tax evasion and anti-terrorist enquiry) remains normal in most tax haven jurisdictions.

One of the exceptional aspects of the Liechtenstein tax scandal that broke in February 2008 was that it involved an employee of a Liechtenstein bank selling data stolen from his employer. This is exceptional. Many bank employees in tax havens are relatively low paid and are natives of those locations. They cannot take the risk of breaking bank secrecy laws without facing a long prison term or a lifetime in exile from their natural home. This has made breaches of banking secrecy rare because this group of employees of the offshore financial services industry are, unlike the more highly qualified members of staff within OFCs, internationally immobile.

Trusts provide another effective form of secrecy. Trusts can be described as a relationship in which a person or entity (the trustee) holds legal title to certain property (the trust property) but is bound by a fiduciary duty to exercise that legal control for the benefit of one or more individuals or organizations (the beneficiaries), who hold “beneficial” or “equitable” title. To put it another way, one person says to a second “please look after this asset for me, but when doing so make sure (for example) that the income goes to this third person during their life and when they die the remaining property goes to another, fourth person”. All trusts are meant to incorporate this split of roles, responsibilities and entitlements. If they did not then there would be no need for a trust. The property would be owned absolutely by one person for their own benefit. This is not the case in a trust, the essential feature of which is that the original owner of the property has gifted it for the benefit of others, but with an intermediary (the trustee) managing that arrangement. For the trust to be effective the person making the original gift should have no further part in the arrangement.

Trusts are a feature peculiar to Anglo-Saxon (English) law but have become commonplace in many jurisdictions, especially in the tax haven world. It should, however, be stressed that some countries survive quite happily without the concept, France being a case in point.

Trusts provide secrecy because they do not require any form of registration in most jurisdictions and even where registration is required (as it is with HM Revenue & Customs in most cases in the UK) that registration is not placed on public record. Nor is the trust deed which regulates management of the trust placed on public record, which might in any event not be possible in some cases: it is still possible for a trust to be created verbally and to be adhered to on that basis.

Trusts are very commonplace in the offshore world, and some jurisdictions, such as Jersey, Cayman and the BVI specialise in supplying them. Almost no tax haven is without trust law, however. The attraction is simple: the person creating a trust (the settlor) has considerable secrecy about doing so since the trust deed is not required to be registered in any tax haven, and in some it is not even required that they be named in the trust deed, creating a trust affords considerable anonymity for the settlor.

It is the trustees of a trust who are taxable upon the income they receive on the trust assets unless that income must be paid by them to another person under the terms of the trust deed. Most offshore trusts are what are termed discretionary trusts, where at least notionally the trustees can allocate the income to almost anyone they wish, which is almost invariably the case with a tax haven trust. Since the trustees will be professional people (accountants, lawyers, trust company officials or even trust companies) in the case of an offshore trust this ensures the trust earns and accumulates its income tax free. Because the trust is located

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36 Chile is one of the unexpected countries where this is the case, where it is protected by the constitution and would require an 80% vote in support of change for its abolition.

37 See http://taxprof.typepad.com/taxprof_blog/2008/02/a-liechtenstein.html for many links to original stories.
offshore it does not have to declare the payment of income that it makes to a beneficiary to any tax authority so long as they do not live in the tax haven in which the trust is located, and there is no reason why they should. The payment of income can, therefore, be paid to the offshore bank account of the beneficiary without anyone in their home jurisdiction knowing. This obviously makes tax evasion through trusts relatively easy and safe.

This is made even easier as a result of legislation that has been created in the last few years in locations such as Cayman (Star trusts), the BVI (Vista trusts) and Jersey (trusts with reservation of powers). These trust arrangements, all of which appear to have been inspired by members of the Society of Trust and Estate Practitioners (a "professional" body based in London) considerably distort the concept of a trust.

As was noted when Jersey proposed this sort of legislation:

Jersey will now allow the creation of what can only be called “sham trusts”, although they’re calling them trusts with “reserved powers for the settlor”. What are those reserved powers? Well, the settlor can tell the trustee what to do, which means the trustee only has a nominee role. And the settlor can claim the property back, which means that no gift of assets into trust has taken place since they clearly remain in the ownership (and under the control) of the settlor in that case. And, because they can be claimed back the settlor is always likely to be the beneficiary of such a trust. In other words, the settlor continues to have complete beneficial ownership of the asset and there is in fact no trust in existence at all, just a sham that suggests that there is.

In that case what is Jersey actually doing by passing this law? It is creating a situation where a person can claim they have put an asset into trust but the reality is they have done no such thing. This is a completely bogus transaction. And why would Jersey want to do this now? I have no doubt that a primary reason is to assist people who wish to avoid declaring their income under the EU Savings Tax Directive or suffer tax withholding at source, which is the alternative. These new trusts assist that objective and shoot a massive hole through Jersey’s claim to only want legitimate business in the Island.

There is only one purpose for this new law. It is to promote secrecy, and the prime use for that is to assist tax evasion.

Jersey was aware of this. In September 2006 the Observer newspaper was sent, apparently in error, an email exchange which showed the alarm within the government and civil service in Jersey at the potential abuse that the new Jersey trust law could be put to use in abusing Jersey’s own domestic law by those of its residents who were so minded to evade their responsibility to pay tax in Jersey on their world wide income.

The entire transcript was published by Tax Research LLP on behalf of the Tax justice Network. Of note was this comment from Malcolm Campbell (Comptroller of Tax, States of Jersey) issued to the press on this leaked correspondence:

I am . . . content that I will have . . . powers to attack any tax avoidance.. on the domestic tax front . . . It is a matter for other jurisdictions world-wide to take powers to themselves in their own domestic tax laws if they feel that their citizens are avoiding or evading their own domestic taxes.

At its core this made clear that Jersey knew of the potential use of these new structures in what it called tax avoidance (but which was actually tax evasion) but whilst it was content to say it had powers to deal with the matter it was entirely indifferent to the tax loss that might arise to any other country as a result of their use. This is the tax haven attitude summarised succinctly.

The fact that places like Jersey, Cayman and the BVI have developed abusive structures of this sort since the crack down in regulating them has got under way shows that they are committed to their tax haven status, are committed to providing the means for tax evasion and are committed to developing what they consider to be innovative products that ensure they stay ahead of the regulators and their desire for information.

With this form of structure now available the offshore trust is doubly dangerous. Whilst this once provided anonymity for those who had genuinely placed assets into trust offshore, now it is little more than a legitimised sham behind which fraud can be hidden, unbeknownst to those tax officials and regulators making enquiry who have reasonable right to assume they are dealing with a legitimate entity created under law passed by a legislature acting with reasonable and legitimate intent.

38 http://www.thelawyer.com/cgi-bin/item.cgi?id = 113609&d = 122&h = 24&f = 46 accessed 13-5-08.
41 http://politics.guardian.co.uk/economics/story/0,1874125,00.html accessed 14-5-08.
Companies

Alongside trusts, companies are the most common offshore entities.

The limited company is an invention of English law, dating back to the Elizabethan era, but becoming readily available without separate Acts of Parliament for each company incorporated from 1844 and with limited liability form 1855. Yet again, a key feature of the offshore world is a UK invention.

A limited company is a corporation whose liability is limited by law. Most tax haven registered companies are limited by shares. That means each shareholder (either a natural or a legal person, and quite possibly a trustee) acquires one or more shares in the company (and it is rare that more than two shareholders in total are required, with one now being quite commonplace) and so long as they have paid the full subscription price for the share, which rarely exceeds one US dollar, a Euro or a pound sterling, the member will have no further liability for the debts of the company even if it becomes insolvent and is unable to pay its creditors.

A company is regulated by its Memorandum of Association, which states what it may do, and its Articles of Association which outlines how it will manage its business.

The company is run by a director or board of directors and its legal affairs are managed by its company secretary. The latter is not required in all tax havens. It is unusual for more than one director to be required.

A company is a legal entity in its own right and in the vast majority of tax havens has to prepare accounts annually to record the transactions it has undertaken. It is now rare for these to be required to be audited.

A copy of the accounts should usually be supplied to the shareholder of the company.

So far this seems entirely reasonable. However, when the UK Parliament granted limited liability it realised that this was a privilege that might be abused and consequently built in a series of safeguards intended to protect both shareholders and those trading with a company from potential abuse. Those safeguards included:

1. Maintenance of a public register of companies, listing all those in existence.
2. A requirement that each company have a registered place of business at which it might be contacted.
3. A requirement that the company place on public record its Memorandum and Articles of Association so that those trading with it might know the powers that it had to engage in trade.
4. Details of its issued share capital and the names and addresses of those owning that capital so that an assessment might be made of its likely financial capacity to undertake its proposed trade, and that those providing it might be known.
5. Full information on its directors and company secretary had to be placed on record.
6. Its annual accounts had to be filed for public inspection.
7. If it borrowed money on a mortgage this had to be declared so that those trading with it might know there were preferential creditors who had higher claim upon its assets than they did.

In addition, laws were developed on what was, and was not, proper trading that regulated the conduct of directors.

Only with these safeguards in place was the right to trade with limited liability, which clearly prejudices the financial entitlements of others, granted to those willing to comply with the obligations placed upon them.

In tax havens almost none of these safeguards are in operation. Put simply, the information noted above that is required to be placed on public record to protect those dealing with a tax haven company can either be kept secret in a tax haven, or a nominee can be used to hide the true identity of the person really undertaking the function that must be registered. So, and for example, it is very rare for Memorandums and Articles of Association to be on public record. If a registered office is filed it is simply a ‘brass plaque’ address and has no bearing upon the real location of the entity. Directors, shareholders and company secretaries can all be nominees. Accounts are almost never on public record in a tax haven. In most tax havens they need not be sent to any regulatory authority, including those responsible for tax because no tax is due by most tax haven companies. As such there is almost no oversight of the action of limited companies in a tax haven by the authorities located within it, simply because they have ensured that they have no information to appraise for regulatory purposes. This cannot be by chance; we suggest that this is deliberate and undermines the whole intent of the regulatory process imposed on such places by the Financial Action Task Force and others (as referred to later in this report).

Shareholdings can in some places be issued in the form of ‘bearer shares’ which means that simply possession of share certificate is indication of ownership of the share. That ownership need not be registered. This is mechanism that can be—and is—used for money laundering.

Regrettably it must be highlighted that the UK is also a party to great many of these abuses. It is possible to use nominee registered offices, shareholders, directors and secretaries in the UK. Bearer shares are allowed. Accounts are required to be filed, but little action is taken by Companies House if they are not:

44 The Joint Stock Companies Act 1844 (7 & 8 Vict. c 110).
45 The Limited Liability Act 1855 (18 & 19 Vict c 133).
46 See http://www.coddan.co.uk/s-4-uk-company-formation.html for a supplier of many of these services.
indeed there are perverse incentives to never file them because of the structure of the penalty arrangements. The UK acts as a tax haven in this respect and has to remedy these defects in its own company administration arrangements as a matter of priority to stop the tax evasion that doubtless occurs as a result.

The consequence is that tax haven companies provide an obvious opportunity for abuse of almost anyone who might trade with them.

This problem has been exacerbated by an offshore innovation that has also been developed in the last decade in response to the increase in offshore regulation. This is the creation of the process known as redomiciliation. The legal basis for redomiciliation was adapted from Delaware law. The process involves relocating the legal domain in which a company is registered from one territory with the power to register companies to another. So, for example, a company registered in Gibraltar might be redomiciled to the Isle of Man. Most tax havens now allow this process. Upon redomiciliation, the original date of incorporation and company existence remains the same and are unaffected by the change but the statute under which they are registered, the law that governs their regulation, the regulator with responsibility for them and the place of their registered office (which is invariably required to be in the domain of registration will all have changed. The advantages to the tax evader are obvious. At the first hint of an enquiry arising within a domain they can apply to have their company redomiciled to another location. It then legally ceases to exist in the place where the enquiry has arisen and is now somewhere else. The agency making enquiry of the company now has to (expensively and laboriously) start the process of enquiry all over again in another place. Of course, there is nothing to stop this game of cat and mouse happening time and again, in which case all chance of securing effective information exchange from a persistent abuser has virtually been lost. It cannot be chance that such structures have been created: the tax havens of the world have created this opportunity to facilitate tax evasion. There is no other logical reason for redomiciliation. Unsurprisingly many financial intermediaries operating offshore promote the attraction of redomiciliation.47

Other forms of limited liability entity have also been developed in the last decade to promote secrecy and to protect tax haven registered companies from claims. Amongst these are limited liability partnerships (LLPs). These are now to be found in the UK, but only because the Big 4 accountancy firms PricewaterhouseCoopers and Ernst & Young promoted legislation to create similar entities in Jersey, and threatened to leave the UK if not provided with similar opportunity in the UK.48 These entities or variations upon them are now widely available in tax havens. They have a particular role in tax planning of major corporations as they are considered “tax transparent”. In other words, whilst they legally exist in the tax haven they have no tax residence in that place and the embers of the entity are instead taxed as if they undertook the limited liability partnerships transactions. This allows legal ownership of assets and the location in which income arising from them to be split between countries, and this arrangement has featured in much complex tax planning, and much recent anti-avoidance legislation in the UK, including some to be included in the Finance Act 2008 with regard to both stamp duty avoidance and the loss of corporation tax. For those wishing for secrecy LLPs add another layer of opacity to obscure ownership of and entitlement to assets.

Protected cell companies (PCCs), and their variants achieve the same result. These entities were first created by Guernsey in 1997.49 That territory has a specialisation in the provision of offshore re-insurance arrangements. In effect a PCC operates as if it were a group of separate companies except all are part of the same legal entity. There is, therefore a “parent level” which provides management services for the company but in addition there are a number of further segregated parts called cells. Each cell is legally independent and separate from the others, as well as from the “parent level" of the company.

As has been noted:50

The undertakings of one cell have no bearing on the other cells. Each cell is identified by a unique name, and the assets, liabilities and activities of each cell are ring-fenced from the others.

If one cell becomes insolvent, creditors only have recourse to the assets of that particular cell and not to any other.

This use within the insurance sector is worrying. Anyone insuring with such an entity cannot be sure what assets might be used to cover their risk. No doubt that is the intent of those using them. More worrying though is their further possible use, of which some are now becoming aware:51

The astute offshore practitioner can employ an offshore protected cell company as an effective asset protector and privacy enhancer.

With an offshore insurance corporation, it is market practice that provides tangible benefits; with the protected cell company, it is the structure of the entity itself—think of a house with a locked front door, and rooms inside, each with a separate lock and key.

41 See for example, and without any suggestion of impropriety being made http://www.claristrustees.com/maltacompanyredomiciliation.htm accessed 14-5-08.
42 For a description of what happened see http://www.parliament.the-stationery-office.co.uk/pa/cm199899/cmselect/cmtrdind/59/81201a19.htm accessed 14-5-08.
45 ibid
Protected Cell companies have—in concert with other entities—been used to construct what has been called “an impenetrable wall” against creditors and prying eyes. Whilst these claims can only be tested by time, this novel use of a PCC for asset protection and financial privacy is an interesting approach and a valuable piece of intellectual property.

This is the logic of offshore: professional people use legislatures to create structures that they can sell to those wishing for secrecy, the only realistic use for which is the evasion of obligations arising under the laws of other countries, even if the motivation for creation of the original entity was honourable and had commercial logic inherent in it.

Guernsey is no longer alone in supplying these companies. It was quickly followed by Delaware, Bermuda, the British Virgin Islands, the Cayman Islands, Anguilla, Ireland, Jersey, the Isle of Man, Malta, the Seychelles and Gibraltar and others. They are now becoming commonplace. Information exchange arrangements will have to take them into account, although as yet it appears that no one has considered how to do so.

So rapid is development of structures in the tax haven world that Guernsey is now having to revise its 1997 laws for these entities because of the degradation in regulation offered in the intervening periods by other jurisdictions if it is still to attract entities wishing to use this form of structure to its territory. This is clear evidence of a regulatory “race to the bottom”.

Foundations are another example of secretive structures. Most commonly associated with Liechtenstein and Panama, foundations might best be described as a form of trust that is recognised as having separate legal existence akin to a limited company.

The Liechtenstein foundation, which is that tax haven’s principal product, has existed since 1926. There is almost no official record of the activities of a foundation so long as it is set up for personal or family use by a person not normally resident in Liechtenstein. The name of the person creating the foundation is not recorded. The foundation must have a constitution, or deed but many of the foundations used for tax evasion will not require any form of registration at all to acquire their legal identity. Their existence is known only to the lawyers and bankers supplying services to them. They are bound by absolute secrecy by law. If registration is required (for example, because the foundation is charitable) no information of any sort concerning the foundation, including even its name is available to the public.

Foundations that do not trade in Liechtenstein do not keep to keep accounting records if they do not wish to do so. No accounts ever have to be sent to any authority. A tax charge of between 1/4 and 1/3 of the value of the foundation’s capital assets is paid annually, although without records being required this is presumably not policed. Despite this 30% of Liechtenstein’s state income comes from this source.

In combination this absolute secrecy backed by some of the strictest banking secrecy laws in the world mean that Liechtenstein offers no transparency at all.

The foundation’s success arises from its combination of secrecy, legal existence separate from the layer managing it and from the settlor and non-taxable status.

This has not gone unnoticed. At the very time when the Liechtenstein foundation was creating massive new stories Jersey was proposing its own foundation laws. The race to the bottom in regulatory abuse goes on.

Tax haven tax

It is generally assumed that the attraction of tax havens are the low tax rates they have to offer. Quite clearly, this has to be true. Secrecy would be of no benefit if tax liabilities were not being hidden behind the veil it provides. Similarly, if tax evasion was not commonplace as a result of the low tax rates tax havens offer that secrecy would not be needed. The same is almost universally true of the other regulatory abuse that tax havens have to offer.

That said, tax havens do not offer low taxes without reason: the primary reason for them offering tax haven services is to raise revenue. They have economic interest in this process. They also do, of course, have their own domestic revenues to raise and the idea that they are tax free zones is not true. They have governments to run, and governments need revenue, however it might be raised. The nature of tax in tax havens does, therefore, need to be explained.

A central feature of tax haven taxation is the “ring fence”. This arises when the tax haven decides to charge its resident population to a tax that it does not wish to apply to those using its tax haven services. For example, it might apply income tax on a worldwide basis on its resident population (Jersey, Guernsey, the Isle of Man, Switzerland and Liechtenstein do this, for example) but provide a mechanism that ensures that high net wealth individuals (HNWIs or Hen-Wees) using its domain do not su...
tax on their corporate profits but do not do so on companies owned by person not resident within their territory. This is a blatant ring fence, discriminating against that local population who also suffer serious anti-avoidance legislation to ensure they cannot make use of tax haven services offered by other territories without suffering taxation penalty.54

The OECD described a ring fence as follows:55

Some preferential tax regimes are partly or fully insulated from the domestic markets of the country providing the regime. The fact that a country feels the need to protect its own economy from the regime by ring-fencing provides a strong indication that a regime has the potential to create harmful spillover effects. Ring-fencing may take a number of forms, including:

— a regime may explicitly or implicitly exclude resident taxpayers from taking advantage of its benefits.

— enterprises which benefit from the regime may be explicitly or implicitly prohibited from operating in the domestic market.

Many countries have operated these in the past. As will be noted below, The EU Code of Conduct on Business Taxation has been particularly effective in removing them from the taxation regimes of many EU member states but some tax havens, notably the Isle of Man, Malta and Jersey remain committed to them with regard to the taxation of corporate profits, and the UK has retained the domicile rule despite its abusive nature. In each case this means that significant taxation is raised from resident populations whilst non-resident populations and those claiming non-domiciled status maintain low or no taxes.

Other tax havens have no such issues. They do not operate taxes on income. These include, for example, Cayman, where most tax is raised from tourist levies and import duties. In that case there is no direct discrimination between local and non-resident tax rates and this particular feature of tax haven abuse does not arise.

All tax havens charge fees for the operation of non-resident entities. For example, in Vanuatu it costs US$150 to register a company and $300 a year to maintain it on the register of companies.56 In the Isle of Man the annual fee for a non-resident company is somewhat more at £320 a year.57

These sums can constitute a significant contribution to a tax haven economy, but how much is hard to assess. For example in the Cayman Islands the most recent published budget is for 2004–0558 and a breakdown of government income was not included in the hundreds of pages of published data. Tax haven secrecy extends this far.

This secrecy is commonplace. It has, for example, been used to hide the fact that the government of the Isle of Man has enjoyed subsidies from the UK government now amounting to more than £200 million a year, a fact little known even in its direct competitors of Jersey and Guernsey. This is the result of the so called “common purse” agreement59 by which VAT revenues between the UK and Isle of Man are supposedly shared, but which has been designed since 1911 (in an earlier incarnation) to provide subsidy to the Isle of Man, since at that time it was suffering near famine conditions amongst its population. This is, of course, no longer the case, it having GDP per head greater than the UK, despite which the subsidy continues. The UK’s reason for granting this subsidy, renegotiated60 as recently as 2007, cannot be established and has been seriously questioned recently.

The UK’s National Audit Office has also noted the anomaly of other, smaller subsidies such as the considerable cost the UK bears for regulating civil aviation in places like the British Virgin Islands even though they too have GDP per head higher than the UK.61

Even some forms of regulation intended to prevent tax haven abuse have actually boosted the coffers of the havens. For example, the EU Savings Tax Directive62 requires that banks and other financial institutions in havens for which the UK and the Netherlands have responsibility as well as Switzerland and Liechtenstein deduct tax at a current rate of 20% on payment of interest to individuals resident in an EU state if the account holder refuses to disclose information on the income they have earned to their home state. The haven perversely receives 25% of the sum deducted as an illogical reward for its facilitating the tax evasion that is taking place.

54 Section 134a of the Income Tax (Jersey) Law 1961 is a general anti-avoidance provision designed in part to achieve this aim, and believed to be effective in doing so.
4. **The Use of Tax Havens**

Describing the services havens supply is one thing: describing how OFCs exploit them on behalf of their clients is another issue altogether.

**Basic money laundering**

The classic tax haven operation is sold as a package by many tax haven operators. Hawkes Law, a correspondent firm of KPMG in Vanuatu, offers a classic tax haven package to its clients. They advertise it as follows:

- **International Company, Bank Account & Trust Package**
  - For individuals requiring an additional level of confidentiality.
  - Services Provided:
    - Setting up a discretionary trust
    - Trust maintenance fees to 30 June
    - Incorporation of an international company
    - Registered agent/office fees to 30 June
    - Assistance with a Vanuatu corporate bank account application, including debit card and internet banking.
  - US $2,350

It is stressed: there is nothing abnormal about this package. The combination of a trust, using local people as trustees, owning a company, using local nominees as director, secretary, shareholders and of course for the registered office. The agents introduce a bank (almost certainly from Australian banks Westpac or ANZ) who will supply an internet service so the account can be run by the real owner from anywhere in the world, and a debit card is issued. This is commonplace. Debit cards issued by either Visa or Mastercard are now widely used for money laundering. This web site offers anonymous credit card services, advertised as tax free when operated from offshore:

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On phoning this company on 15 May 2008 the caller was advised that this was a New Zealand owned company based in the tax haven of Uruguay that could provide the services noted.

The debit card of this sort allows a person to spend the money they have deposited illegally in an offshore bank account in their home jurisdiction with little risk of discovery. Prepaid debit cards have the same function. The role of credit card companies in providing these services through many tax havens has to be seriously questioned. It is hard to see what legitimate function they think these services could fulfil.

In combination these facilities provide a classic money laundering operation, regardless of whether the funds come from drugs trafficking or tax evasion.

The tiering of the operation, using a trust to hide a company which in turn may not have its name on the debit card is classic tax haven practice: it makes the arrangement harder to break when enquiry arises. Redomiciliation might allow the company to flee to a new jurisdiction if enquiry does arise. These arrangements usually fail for one reason: the card user has goods supplied to their home address making them easy to connect with the card.

More complex structures

The majority of tax haven deposits, excluding those of an inter bank nature are believed to be by individuals, not major corporations. The Tax Justice Network estimated that in 2004 some US$11.5 trillion68 was held by individuals in the tax havens of the world using data from sources such as Cap Gemini, Merrill Lynch and Boston Consulting Group.

The basic structure noted above does have risk in it, not least because it is all in one jurisdiction. More sophisticated operations take this matter further, and will frequently use multiple jurisdictions in the course of their transactions. In doing so they seek to exploit the “secrecy spaces” that tax havens allow an OFC operator to create. The secrecy space is created by the “ring fence” that exists within any tax haven. The ring fence, whether of direct tax consequence as noted previously or not, has the purpose of determining in which section of the tax haven a transaction is located. In every tax haven there are of course real transactions that take place within that economy, and which are accounted for and even regulated within it. These are not a matter of concern. They can be located somewhere: that somewhere is the tax haven.

There are however other transactions that whilst notionally taking place within the tax haven actually have little or nothing to do with it. They take place “elsewhere”. For example, in the case of the Vanuatuan offshore package noted above, the transactions that the structure will permit will notionally take place in Vanuatu, but in practice they will have little or nothing to do with that Pacific location. The nominees who supposedly run the trust and company that is being supplied will have little or no knowledge whatsoever of what it actually does, or why, and will not seek to know in all likelihood. The real operation will be run “elsewhere” by a person operating a computer in their country of ordinary residence and the debit card will enable the transactions they control to be settled. These transactions, as far as Vanuatu is concerned are “elsewhere” in a “secrecy space” (simply defined as “somewhere not here” (or “offshore”).

As was the case with the Bank of England when establishing the offshore world in 1957, those in the tax haven permitting this to happen will simply turn a blind eye to what is happening either entirely or in very large part because they know that any infringement of regulation is not happening where they are. This does not just happen in remote places like Vanuatu. In May 2008 the president of the Swiss Bakers Association, Pierre Mirabaud told journalists that his members don’t regard themselves as responsible for their clients’ actions. “We are not a tax authority and we are not a police authority,” he said.67 It should be assumed that this attitude to what happens elsewhere is commonplace. This is despite the fact that tax evasion in another state is defined as money laundering in the law of most countries. In section 2.7.5 of its new money laundering handbook (which has the basic force of law) the Jersey Financial Services Commission says:69

2.7.5 Fraud related offences

Fraud, including fiscal offences (such as tax evasion) and exchange control violations, are commonly and mistakenly regarded as distinct from other types of crime for money laundering purposes. They are not. Any fraud related offence is capable of predating an offence of money laundering in Jersey where it satisfies the requirements of the definition of criminal conduct within the Proceeds of Crime Law.

It is these secrecy spaces that the OFC world manipulates, whether the law allows them to or not. It is the secrecy spaces that really make up the “offshore” world where the transactions that cause concern take place. The space cannot, of course, exist without the secrecy jurisdictions that create them. It is, however, not in those jurisdictions, at least for legal purposes (and this will usually be made very clear in local law, for example on company residence). As such in many, if not most cases, the secrecy jurisdiction will argue it has no duty to regulate the transaction undertaken using the mechanisms it supplies from within the secrecy space, its logic being that these transactions are undertaken “elsewhere”. That is why some Swiss banks comment as they do, as noted above, though for the record we would note that other Swiss Bankers are more

overtly aggressive in their attitude: in an interview in Der Spiegel published in May 2008 Konrad Hummler, a partner in Wegelin & Co., Switzerland’s oldest private bank justified tax evasion as a legitimate defence by citizens attempting to “partially escape the current grasp of the administrators of a disastrous social welfare state and its fiscal policies . . .”. Saving outside the system, he argued, is something to which not only the wealthy, but also productive small and mid-sized businesses are entitled: “These people must be protected,” he said.

It is important to note that this lack of clarity over the location of transactions was not always the case. For example, when in 1929 the concept of the “offshore company” was created by the House of Lords in the United Kingdom those seeking to prove that their company was not in the UK for tax purposes did at the same time have to prove it was somewhere else, not just elsewhere. This concept of “somewhere” is important. If a company created in a tax haven operates outside its regulated area but it is known despite that to be operating somewhere else then the risk of regulatory abuse is limited. The regulatory environment might be weakened by being located across more than one domain but regulation is intact. This diagram might make this clear:

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<table>
<thead>
<tr>
<th></th>
<th>“Here”</th>
<th>“Somewhere”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country providing the transaction structure</td>
<td>Jurisdiction A</td>
<td>Jurisdiction A</td>
</tr>
<tr>
<td>Country providing regulation of the transaction</td>
<td>Jurisdiction A</td>
<td>Jurisdiction B</td>
</tr>
<tr>
<td>Transaction type</td>
<td>Onshore</td>
<td>Regulated offshore</td>
</tr>
</tbody>
</table>
```

It is stressed: this diagram describes regulated transactions. What is happening here is entirely legal. Jurisdictions A and B might, for example, fully cooperate to ensure that the transaction is properly accounted for. But, as a matter of fact, for Jurisdiction A to consider that the transaction is “somewhere” it must know the identity of Jurisdiction B and that that location in question has assumed responsibility for the transaction. If it does not know that then the claim that the transaction is regulated somewhere else is wrong.

Now the concept of “elsewhere” as created by tax havens has to be added into this diagram.

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<table>
<thead>
<tr>
<th></th>
<th>“Here”</th>
<th>“Somewhere”</th>
<th>“Elsewhere”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country providing the transaction structure</td>
<td>Jurisdiction A</td>
<td>Jurisdiction A</td>
<td>Jurisdiction A</td>
</tr>
<tr>
<td>Country providing regulation of the transaction</td>
<td>Jurisdiction A</td>
<td>Jurisdiction B</td>
<td>Unknown</td>
</tr>
<tr>
<td>Transaction type</td>
<td>Onshore</td>
<td>Regulated offshore</td>
<td>Secret offshore</td>
</tr>
</tbody>
</table>
```

The secret space has now been created and the transaction that takes place within that space is now categorized. This concept of “elsewhere” is critical: without understanding it the ideas and motivations of those working in the secrecy space in which “elsewhere” is usually to be found cannot be appreciated.

There is one other transaction type to be noted. These are those that take place “nowhere”. “Nowhere” is the space that is the ultimate goal of the operator in the offshore world. If added to the diagram it looks like this:

```
<table>
<thead>
<tr>
<th></th>
<th>“Here”</th>
<th>“Somewhere”</th>
<th>“Elsewhere”</th>
<th>“Nowhere”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country providing the transaction structure</td>
<td>Jurisdiction A</td>
<td>Jurisdiction A</td>
<td>Jurisdiction A</td>
<td>Jurisdiction A</td>
</tr>
<tr>
<td>Country providing regulation of the transaction</td>
<td>Jurisdiction A</td>
<td>Jurisdiction B</td>
<td>Unknown</td>
<td>Nowhere</td>
</tr>
<tr>
<td>Transaction type</td>
<td>Onshore</td>
<td>Regulated offshore</td>
<td>Secret offshore</td>
<td>Unregulated offshore</td>
</tr>
</tbody>
</table>
```

“Nowhere” in this case means that the jurisdiction which supplies the regulatory structure for the transaction cannot be identified. In the diagram it is Jurisdiction A that should have obligation to identify where the transaction undertaken by an entity created under its law is regulated. It does not do so though because it is a secrecy jurisdiction and has, therefore, no intent of making enquiry of the use made of such entities beyond its domain. In fact, even if it were to do so no jurisdiction can be identified in which the transaction is located for regulatory purposes, even if enquiry is made.69

This does not happen by chance. It happens through the interaction of “secrecy spaces” provided by tax havens. An example might be where a person resident but not domiciled in the UK creates a trust in a tax haven such as the British Virgin Islands that in turn owns a company incorporated in the Isle of Man that

69 Examples of this phenomenon are to be found in the report of the US Senate Permanent Subcommittee on Investigations Hearing: Tax Haven Abuses: The Enablers, The Tools & Secrecy that reported in 2006. See http://www.senate.gov/~levin/newsroom/release.cfm?id=260036 accessed 15-5-08.
Treasury Committee: Evidence  

has a bank account in Jersey and directors in Cayman. The income of that company and trust are retained within the company. This sort of structure is costly, but that is a price of being “nowhere”. This structure might achieve the aim or being unregulated almost everywhere and lightly regulated at best in just one location, being that where it has its bank account.

This is because the individual creating this trust is allowed to do so without breaching UK law subject to meeting the non-domicile requirements of that country. If they can then they are not taxable in the UK on their income arising outside the UK even though they are resident in the UK. Nor do they have to make any declaration of that income or their involvement with the trust in question to the UK tax authorities, or any other tax authority assuming they are not resident anywhere else (and are not a citizen of the USA, which uses a citizenship rather than residence basis to determine liability to its taxes). If this is the case the regulation of this trust does, with regard to the settlor, happen nowhere.

This can happen because trusts do not have to be registered or file tax returns in most tax havens. Nor do most tax haven companies have to file accounts with anyone. And if a bank account is located in a different tax haven from the company that owns it who regulates it? Maybe the jurisdiction of location is responsible for money laundering aspects of the account, but in the vast majority of cases they will satisfy themselves that tax evasion is not taking place by simply noting that no liability could arise in the jurisdiction in which the company was incorporated because no tax could be due there. Splitting structures in this way over different jurisdictions makes it much easier for offshore financial intermediaries spread across a variety of jurisdictions to state that they have satisfied their local requirement to prevent money laundering even though the structure as a whole is abusive. Having the directors in a location with no tax achieves the same result.

The combined result is that a structure can be created which is nowhere for tax purposes, and almost entirely so for all other purposes and yet apparently quite legitimately so.

More than that though, none of those involved, be they the settlor, the trust or trustees, the company or its directors, would need to file a tax return in that capacity anywhere by reason of this careful choice of structure. This is the ultimate aim of the offshore operator. For regulatory purposes this structure is nowhere. Achievement of this might not be possible in the physical world, but it is in this strange regulatory and secrecy space.

There is a final twist in the diagram that this represents. Another line is needed to explain what is, and is not in the secrecy space. This is indicated as follows:

<table>
<thead>
<tr>
<th>Country providing the transaction structure</th>
<th>“Here”</th>
<th>“Somewhere”</th>
<th>“Elsewhere”</th>
<th>“Nowhere”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country providing regulation of the transaction</td>
<td>Jurisdiction A</td>
<td>Jurisdiction A</td>
<td>Jurisdiction A</td>
<td>Jurisdiction A</td>
</tr>
<tr>
<td>Transaction type</td>
<td>Jurisdiction A</td>
<td>Jurisdiction B</td>
<td>Unknown</td>
<td>Nowhere</td>
</tr>
<tr>
<td>Space name</td>
<td>Onshore</td>
<td>Regulated offshore</td>
<td>Secret offshore</td>
<td>Unregulated offshore</td>
</tr>
<tr>
<td></td>
<td>The transparent, regulated space</td>
<td>The secrecy space</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

It is clear that there is a substantial difference between the transparent space, which includes transactions undertaken internationally where full disclosure is made to all who have need of information relating to that transaction, and the secrecy space where transactions are either legitimately not disclosed (when they take place “nowhere”), or where required disclosure is suppressed (which is the case of those transactions that are “elsewhere”).

**Offshore providers**

There is then a further matter to be addressed. Quite clearly structures of the sort described in the preceding paragraph do not come into place by chance. They are created by people seeking to exploit the secrecy spaces which tax havens permit. These people may be (and often are) located in a tax haven themselves. They might even seek to establish their own operations in a secrecy space. But they are not part of the structure of any one tax haven, nor are they part of the secrecy space, which they exploit but do not create.

These people are the secrecy providers. They are the lawyers, accountants, bankers, trust companies and other financial intermediaries who provide the services needed to manage transactions in the secrecy space. Working in combination, these providers form the nucleus of Offshore Financial Centres. Individually they are offshore providers.

70 For examples, ibid.
Using the definitions noted here the following diagram of a not untypical, but complex, offshore structure spread across many tax havens can be created for an arrangement where a Guernsey adviser creates a structure for a UK non-domiciled person who has a trust in the BVI owning a company in the Isle of Man which has directors in Cayman, banks in Jersey and manages investments in the USA:

```
+---------------------------+    +---------------------------+    +-----------------+    +-----------------+    +-----------------+    +-----------------+
| Investments              |    | Offshore provider         |    | Unregulated entity       |    | Tax haven entity  |
| located in USA           |    | Guernsey                  |    | Settlor                  |    | located in UK    |
|                          |    |                            |    | Trust                    |    | BVI             |
|                          |    |                            |    | Company                  |    | Isle of Man     |
|                          |    |                            |    | Directors                |    | Cayman          |
|                          |    |                            |    | Bank                     |    | Jersey          |
```

The importance of this diagram is not so much the white space. That white space is the identifiable geographic location in which certain structures, people and commercial organisations can be located. It is even possible to locate the offshore provider and the target for the whole structure within the white space: that investment target is in the USA in this example. But the important point is not the white space. The real issue about this structure is the grey space. That grey space is the secrecy space.

It is in the secrecy space that the unregulated entities, none of which have a duty to report to anyone, operate. The secrecy space surrounds, but is not in any of the secrecy jurisdictions. The secrecy provider might work from within a secrecy jurisdiction (very often, indeed, they might sell services to unregulated entities working within that same jurisdiction) but they too, by selling services into the secrecy space can also work (at least in part) outside the regulated place in which their activity resides, and very often regulation exists to make sure that this can be achieved.

So it is in the grey secrecy spaces that the unregulated market exists, established by secrecy providers using unregulated entities registered in tax havens to move transactions from the regulated local or international sectors that are “here” or “somewhere” else that is identifiable into the secretly or knowingly unregulated spaces that are in mythical locations “elsewhere” or, maybe “nowhere” at all.

It is the grey, secrecy space that is the offshore world that the sophisticated user of tax havens seeks to exploit.

**The corporate use of tax havens**

International tax planning can take place whenever a company trades across an international boundary, but it is much more likely to take place when a company actually undertakes its activities in more than one country. When this happens it becomes a multinational corporation (MNC). It is likely that less than 10% of the world’s companies are part of MNCs and maybe less than 1% are the parent companies of multinational groups but it is estimated that their intra-group sales (ie transactions across international borders but between companies with common ownership) account for more than 60% of world trade.

To understand this it is important to note that whilst MNCs like to appear to be one entity, and indeed will publish accounts that suggest this is the case, MNCs typically consist of large numbers of separate companies. A parent company usually owns all or most of the others, and controls all the others because

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71 This section is based, in part, on Chapter 4 of “Closing the Floodgates” published by the Tax Justice Network in February 2007 and produced with financial assistance from the Norwegian government. Available at http://www.innovativefinance-oslo.no/pop.cfm?FuseAction=Doc&pAction=View&pDocumentId=11607 accessed 16-5-08.
72 This is based on the fact that only 0.5% of all companies in the UK are ples. Even if each has 20 subsidiaries on average in the UK that means 90% of the register is UK based. Proof of this is not possible.
73 OECD Observer April 2002.
ownership of a company’s shares provides that right in company law. The companies that the parent owns are called its subsidiaries. There can be just a few of these. There may be thousands. For example, a recent count at BP suggested it had more had more than 3,000 subsidiary companies around the world.74

This means that whilst the corporation may like to present a single front to the world, and one published glossy set of accounts, the reality is that when it comes to taxation there is no such thing as an MNC. Each company that makes it up is taxed separately. It will usually be taxed in one of two places. The first is the country in which it is incorporated. For example, a company established under English law is always taxable on its worldwide income in the UK. Secondly it may be taxed where it trades. So, for example, a company incorporated in England but which has a branch in France will be taxed in France in the first instance on the income of the French branch and then, for a second time in the UK, but with credit given for the French tax already paid under the terms of the double tax treaty between the UK and France which has as its intention the elimination of double taxation. It is precisely because of the complications that this arrangement causes that most MNCs have separate companies for each activity they undertake in each country in which they operate. As a by product the resulting complex structure is guaranteed to provide enormous opportunity for an MNC to plan its taxation liabilities, and this is only increased when the options that tax havens create are added to the list of options available.

The ways in which a company can plan its tax affairs might include decisions on the following:

1. Where it will incorporate its head office.
2. Where it will incorporate its subsidiary companies.
3. Whether it will use tax havens or not.
4. What companies it will, or will not include in its group structure (which means which ones are added into the glossy accounts, and which ones are not).
5. On what terms it will trade between group companies.
6. Where it will record its sales.
7. Where it will incur its costs.
8. Where it will locate its assets.
9. Where it will employ its staff.
10. Where it will borrow money.
11. Where it will locate its intellectual property.
12. How it will structure its operations.
13. Whether it will seek special tax privileges.

This is a long list. Tax havens can be used at almost every stage. Each needs to be explored to show how a group of companies might plan its taxation affairs.

1. Where to locate a head office

This requires deciding in which country a head office will be located. Sometimes the decision relates to what are called “intermediate holding companies” instead.

The importance of the decision is determined by the fact that a company usually has to pay tax in the country in which it incorporated. So, choosing to locate a company in a high tax territory such as the USA (which has amongst the highest corporate tax rates in the world) can be expensive. However, major quoted companies usually need to be incorporated in a major financial centre such as London, New York or Frankfurt. The result is that tax cannot be minimised in those locations, although this is an arrangement now being challenged as some companies quoted on the London Stock Exchange seek to do so via parent entities registered in Jersey and tax resident in Ireland.75

Instead companies set up what are called “intermediate holding companies”. These are owned by the parent company and in turn own the operating subsidiary companies. Little or nothing happens in the intermediatelocations, except that they collect dividend income from the subsidiary companies they own and then usually loan, but not pay as dividends, the resulting cash that they hold to the parent company in London, New York, or wherever. The intermediate location is chosen for having low tax rates on dividend income received, a lot of double tax treaties with other countries to ensure that it is not treated as a tax haven (even though it is) and a favourable regime for taxing interest income, of which it may have a great deal. The most popular locations are Ireland, the Netherlands, Luxembourg and Switzerland, all of which offer these arrangements.

74 BP Annual Return appendices dated 5 May 2005, lodged at Companies House in the UK.
As has been noted above though, the possibility of this situation changing and what has, to date been the intermediate location now becoming the parent looks possible now, at least for London Stock Exchange companies. This is a process called “corporate inversion”, which was popular in the USA until about 2002, using Bermuda as the place to relocate a head office to achieve considerable tax savings. It was stopped by a combination of public outcry and legislation. 76

2. Where a company will incorporate its subsidiaries

A combination of tax law and other regulation makes it almost certain that an MNC will have subsidiary companies in each territory in which it operates. But then it has to decide if it needs others in locations that are purely tax driven.

Non-tax haven countries tend to have higher tax rates than the tax havens. A few geographically smaller developed countries, such as Ireland and the Netherlands also offer low tax rates on profits of some or all sorts. In this they join with the tax havens in seeking to increase their tax revenues by attracting profits to their shores which were not earned there but which are relocated to that country using some of the mechanisms described elsewhere in this report.

Any group of companies has a simple decision to make. It has to decide if it wants to relocate its profits from the place in which they were really earned to places in which they may be declared, with reasonable chance of getting away with the relocation, with lower taxes being paid in consequence.

Many MNCs claim they have a duty to their shareholders to minimise the tax that the company pays. 77 There is in fact no such requirement in the law of most countries, including that of the UK where a much wider degree of discretion is provided to the directors of companies as to how they might manage the affairs of the entity they manage. This claim of a “duty” is actually used as an excuse to justify chosen corporate behaviour which palpably benefits the self-interest of the directors.

3. Whether a company will use tax havens or not

This question is related to that of where subsidiaries may be located, but not entirely. There may of course be a valid reason for locating a subsidiary in what is called a tax haven if a real trade is undertaken there. For example, a retail company running a store in Guernsey may wish to have a Guernsey based company for that purpose, and no suggestion of tax avoidance would result. However, when planning a group structure a company does have to decide if it not only wants the tax advantages some countries, such as the Netherlands, supply but also the lack of transparency that is also usually associated with tax havens where accounts and even proper ownership details do not have to be filed on public record.

Some companies undertake transactions which they would prefer not to disclose to the public, their shareholders, competitors, or regulatory agencies, including tax authorities. The anonymity provided by tax havens allows them to obscure the reporting of the trades they undertake in order to secure profit for their groups of company.

It is now almost universally agreed that transparency reduces risk, enhances the quality of corporate governance, reduces corrupt practices (including fraud) and must therefore be of benefit to society. But not all companies behave as if the interests of society coincide with those of their shareholders. If that is their opinion tax havens may well be attractive to them because the risk of their trade being subject to serious scrutiny is reduced. On the other hand, they face questions as to the reasons for their choice of location from both taxation authorities and others, but might believe this a price worth paying for secrecy.

Such decisions are rarely made for taxation reasons alone.

4. Which companies will, or will not be included in the group structure

It seems logical to assume that all companies over which an MNC has control should be included in its group accounts and so be subject to scrutiny as part of its operations. Many companies, however, choose to hide transactions “off balance sheet”. This may be because the companies in question include liabilities that they would rather not recognise since they would make the MNCs’ finances look weaker; or those companies are being used to undertake transactions that change the view of the MNCs financial results eg by inflating profit (as was the case in the notorious situation of Enron).


77 This issue was the subject of much debate during the passage of the UK’s Companies Act 2006 through Parliament and it is clear as a result that whilst profit is important a much broader range of obligations need also to be considered by UK company directors. See section 172, Companies Act 2006 available at http://www.opsi.gov.uk/ACTS/acts2006/ukpga_20060046_en.pdf accessed 25-1-07.

78 It would be interesting to speculate what change in behaviour might result from explicit changes in legislation in this area. Clauses requiring companies to comply with the spirit of taxation law in all the territories in which they operated were introduced to the House of Lords during the debate on the UK Companies Act (partly at the suggestion of the Tax Justice Network) but were rejected by the government.
MNCs can take advantage of situations where they can create “orphan” companies. These are usually companies which are heavily dependent on the MNC for the trade that they undertake but which are theoretically not owned by it. This is usually achieved by placing ownership of the orphan company in a charitable trust located in a tax haven. This structure is then claimed to move both ownership and control of the orphan company outside the group so that its transactions may be treated as if undertaken by an independent third party. This technique is often used for financing debt eg from credit card customers, the customers of utility companies or mortgages, but the technique can also be used for other purposes, as Enron proved all too clearly.79

The use of what are clearly artificial structures created by professional people eg lawyers and accountants who claim independence from their clients whilst clearly working under their direction and control, raises questions about the ethical standards of these professions and the companies that use their services.

5. What terms of trade will be used between group companies

When companies engage with their customers or suppliers (“third parties”) it is assumed that each party is out to get the best deal possible for themselves and that the resulting prices set for the trade will reflect that fact. These are called “arms length prices”. However, when two companies that are under common ownership trade with each other they do not necessarily want the best price for each individual company but may be motivated to set a price that gives the best overall result for the MNC of which they are a part. This will be influenced by the amount of tax that is, or is not, paid as a result of the consequent allocation of profit between the two subsidiary companies. For example, a company in Cyprus (tax rate 10 per cent) selling to a French company (tax rate 33.33%) has a strong incentive when both are owned by a UK parent company to overstate the selling price in Cyprus if the third party selling price in France is fixed because this will mean more profit is taxed in Cyprus at a lower rate than is charged in France than would otherwise be the case. This process of selling between related companies in an MNC is called “transfer pricing” and is completely legal. Abuse of transfer prices may be illegal however, depending upon the countries involved.

MNCs have to set transfer prices. There can be no trade within the group if they do not. When doing so, however, they are in a position to make choices. Since before the Second World War the principle has been established in international law that prices between related companies in an MNC should be set on an “arms length basis”. This is believed to result in the allocation of the profit earned to the country in which it was generated and this is considered a just and equitable outcome.

Companies can decide whether they want to achieve this outcome. They can use their best endeavours to do so. It must be stressed however that this is not straightforward. There may be no way of determining the “third party” price for some products transferred across international borders eg the price of a part finished component that will never be sold in that state to a customer has by definition no “arms length price” and so estimates have to be made. Such process of estimating can be undertaken in good faith, or with the intent of disguising the reallocation of profit. Likewise, companies can decide to only operate “arms length prices” in locations where a challenge to their policy is likely eg in the major developed economies where these matters are now subject to routine enquiry by tax authorities. This is not the case in developing countries. In December 2004 the multinational accounting business Deloittes reported in South Africa that they had never seen a successful transfer pricing challenge out of Africa,81 and most countries in Africa do not at present have the legislation, the expertise or the legal and political confidence to raise such challenges against the MNCs that operate there.

6. Where a company will record its sales

It is inevitable that an MNC will trade internally. When doing this it can relocate transactions to give rise to favourable outcomes for taxation and other purposes. One transaction that can be relocated is where a sale is recorded.

Some products can be recorded as being sold from almost anywhere, and it is hard to prove that the claim is wrong. This is particularly the case with software and other intellectually based products sold on-line over the internet or where the sale represents a licence to use knowledge.

Where real, physical products are involved it can be harder to relocate where a sale is recorded, but by no means impossible. For example, in the case of a mining company ore is extracted from the ground. That ore is, in the vast majority of cases destined for export. Decisions can be made as to where the sale of that ore is to be recorded. In the first instance, there must be a sale from the country in which it was extracted. That is obvious. But the condition in which it is sold is clearly a decision, and that can be tax driven. If the tax rate in the country of extraction is high, the ore may be shipped in unprocessed state even if that increases transport costs. The added value resulting from processing then takes place elsewhere, with lower tax

charged. Alternatively, the ore can be processed first. That changes its value. The decision as to where to undertake this process changes the location in which the sale of the processed ore is located, and the tax bill that arises.

Even if the ore is not processed, alternative arrangements can be made for its sale. For example, it might be sold straight to a third party for processing. Alternatively, it may be sold within the MNC to a central marketing organisation (a common arrangement) which then adds a profit margin for the work it undertakes. This marketing organisation may be (and typically is) located in a tax haven. As a result part of the sale price has been relocated from the country of origin of the ore to the country in which the marketing operation is located, and this may well be a tax based decision.

Some of these decisions may be determined by genuine external factors eg the capacity of the country of origin to process the ore. Often they are not.

7. Where a company will incur its costs

Just as there is an incentive to shift sales to low tax areas, there is an opposite incentive to shift costs to high tax areas where they will benefit from the greatest value of tax relief. This can be of importance for developing countries with relatively high tax rates. For example, many South American countries engaged in the extractive industries have nominal tax rates in 2006 of around 25%.

Companies may decide to load costs into territories with relatively high tax rates. This trend may be exacerbated if this “cost loading” gives rise to other benefits as well. Such a benefit might arise by inflating the apparent cost of production in the extractive industries, which can have the benefit of both reducing tax and reducing the proportion of production due to the host government under some mining and oil concessions, so giving a double benefit to the company engaging in such practices.

Cost loading can be as hard, or harder, to identify than sales mis-pricing since in many cases it will be even harder to establish a market price for the items in question. The principle of the “arms length rule” of pricing still applies in these cases, but companies have considerable discretion over how they can interpret that obligation.

Amidst the costs that can easily be loaded are finance charges, central management costs, insurance, charge for the use of intellectual property and brands and the cost of supply of staff on secondment. In the widely reported case of WorldCom, accounting firm KPMG created an entirely new intellectual property right termed “management foresight” which was used to shift billions of profits offshore, though the foresight in question clearly failed to predict that company’s dramatic demise.

8. Where a company will locate its assets

A company has to buy certain physical property to undertake a lot of the work that it does. In the extractive industries, for example, this might include all the mining or drilling equipment it uses. Logically these would be owned in the country in which they are used by the entities which have the benefit of using them in their operations. In tax planning little is that simple.

The reason is that many countries offer special incentives to companies that invest in capital assets and give them tax reliefs and allowances which are much more generous than the accounting charges made for their use in the owning company’s published reports. The result is that the effective tax rates of the companies are reduced and the dates for payment of tax are deferred.

These reliefs can be exploited when combined with asset leasing arrangements. Some countries provide tax relief on the cost of assets that are leased to the legal owner ie the lessor. Others provide it to the lessee who hires the asset. If the lessor company gets the tax relief on ownership then it is also liable to tax on the income arising on the asset. Conversely, in countries where the lessee gets relief on the expenditure incurred on creating the asset they rent the lessor who has legal ownership of that asset is usually exempt from tax on most of the income it gets from renting it.

Companies can decide to exploit these rules for their benefit. They do this by a process called “tax arbitrage” where they chose to locate transactions so that they get maximum tax benefit from them by trading off the rules of one country against the rules of the country that is taxing the other side of the arrangement.

So, for example, they might lease an asset from a country which gives generous reliefs both for expenditure on capital assets and also on the incomes received by the lessor company. The outcome of these favourable treatments is that the lessor company generates considerable up front tax losses on the deal, which are only cancelled out over a considerable period, and that company then leases the asset to a territory where the lessee company gets the relief on the capital cost of the expenditure, but no tax relief on the rentals paid. This means that the companies also obtain considerable up-front tax relief compared to cash expense incurred. The result is something called “double dipping” in tax terms, where two lots of tax relief have been
generated on one expense in effect, with in this case the transaction taking many years (maybe 25 years) to reverse, about which no one cares much since they will no longer be in their jobs by the time any reversal of the effect takes place.

As a result assets are frequently legally owned in locations far removed from those where they are actually used.

9. Where a company will employ its staff

It seems logical that a company would employ its staff where they work. And so it can be for those who are on average earnings for the location in question. The company is likely to rely on these people to be the backbone of their operation, and those people are also unlikely to be either significantly mobile as to the location in which they wish to work or to be willing to engage in any serious tax planning on their employer’s part.

But this might not be true for the more senior management of an MNC, many of whom will have joined it precisely because it offers the opportunity to work in a number of locations. They will most probably be internationally mobile and will be willing to participate in tax planning for their own and their employer’s benefit.

The result is that these senior managers might be employed in locations which suit tax planning even if their duties are undertaken elsewhere. In fact, the split between the employment location and the place in which duties are undertaken may be deliberate. The reasons are:

(a) Managers might obtain a favourable tax treatment for their earnings if they are employed in a location which is not their long term home. This is because part of their income might not be taxed anywhere.

(b) The employer may choose to place the employment in a location where the tax or national insurance charges on employing the manager are low, as is typically the case offshore.

(c) Having a manager employed offshore allows the employer to create a new business based in the offshore location which supplies “management services”, the value of which for transfer pricing purposes is hard to prove so that profit can be extracted in this way from the company that receives the charge for these services.

A company might decide to organise their employment structures in this way for three reasons:

1. It allows them to manipulate their tax arrangements by adding another international service into the group which can be used for the purposes of profit reallocation to low or zero tax jurisdictions.

2. It can reduce the cost of employing staff.

3. It can increase the net reward to staff, so encouraging them to stay at no extra cost to the employer.

But in each case the local market for labour is upset. Overseas staff are favoured over local people. Allegiance to the company is greater as a result than allegiance to place. The duty of the staff to any particular country is undermined. And mobile staff who are dependent on their employers to create artificial structures which inflate their earnings tend to be more compliant, less inclined to whistle blow and more tolerant of other abuses if they happen within or without the company because that culture will pervade their own employment environment.

Companies might also engage staff through tax havens to save their own payroll obligations. This is currently an issue in the USA where many defence contractors with staff in Iraq and elsewhere engage their services through locations such as Cayman to avoid social security and health insurance costs. This has been the subject of much media and political debate.82

10. Where a company will borrow money

All business activities require finance to establish a physical presence in a location and to fund the day to day activities of the business. This money can be provided in two ways: share capital or loan capital. Share capital earns dividends payable from profits. Loan capital is paid interest regardless of whether or not profits are generated. Loan capital can be supplied by an external source eg a bank or venture capitalist group, or from an internal finance company within a group of companies. Internal finance companies are often set up offshore in locations such as the Netherlands and Ireland which have deliberately created tax structures to attract such “businesses”.

Interest is much more favourably treated for tax than dividends. Interest is deducted from the paying company’s profits for tax purposes and so reduces its tax bill. This does not apply to a dividend. Dividends can be subject to tax withholding from the country in which they arise ie part of their value has to be paid to the host country government. This is by no means always true of interest. A company can often arrange to receive interest in a low tax area and create a permanent tax saving. This is harder to achieve for dividends, especially if there has been tax withholding before they are paid.

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The outcome of this different treatment is predictable. Companies have a bias to loan capital. So great is this incentive that by choice they will use almost no share capital and will have substantial loan capital in a foreign subsidiary. This is called “thin capitalisation”. This reduces the profits in high tax areas because interest is paid from them, and also reduces the overall tax bill within the group because it allows for the interest to be received in a low tax area. The company might also, unless there is regulation in place to stop it, seek to charge whatever rate of interest it likes to maximise the profit it can extract from subsidiary company in a high tax area to then transfer it to a low tax location.

Companies undertake this activity to maximise their financial return from the activities in which they invest by creating what can, quite often, be arbitrary financial structures motivated not by the needs of group financing but by a desire to abuse tax rules for the sake of increasing the after tax profit.

The abuse is often complex. For example, third party funds are borrowed in territories with relatively high tax rates and efficient capital markets where there is no restriction on the use of those funds when it comes to giving tax relief. The UK is an example of such a location.

The funds are then lent with very low margins earned to a financial centre eg Dublin. From there they are loaned on to foreign subsidiaries and the charge is inflated, especially if that subsidiary is in a high risk area such as a developing country, with the justification being that the funds to be used there if borrowed directly would have been subject to a higher rate of interest even though the group itself is not.

In effect this is another form of transfer pricing abuse, but this time on financial products created specifically for this purpose.

This practice is normally well regulated in developed countries, but this is not generally the case in developing countries.

11. Where the company will locate its intellectual property

This decision perpetuates a recurring theme throughout this discussion, which is one of how an MNC might structure its affairs in order to maximise the number of transactions crossing international borders. Doing this maximises the opportunities for relocating profit to low tax areas.

Intellectual property comprises patents (on which royalties are paid) and copyrights (on which licence fees are paid). There are other variations on this theme but these two categories are sufficient to cover most issues.

Intellectual property may have been acquired by an MNC from a third party or, more likely, has been created by it. For example, Audi claim they filed 9,621 patent applications when creating their new A6 car. Any company might decide where it wishes to locate ownership of its patents or copyrights and this need not be the country of their creation, with little or no tax penalty arising on relocating them to a low tax country before they have been used and have therefore been proved to have commercial worth. The same is true of copyright material, such as logos. The Virgin corporation, for example licences the use of its Virgin logo to all Virgin operations from the British Virgin Islands. Microsoft holds the copyright of most of its products for sale outside the USA in Ireland—a low tax state.83 The result is that it appears to be largest company in Ireland, though the vast majority of its income in that country has little to do with its activities located there.

It is notoriously difficult to prove the value of intellectual property. This means it is an especially popular mechanism for shifting the location of profits from both developed and developing countries into low tax locations.

Almost any company can “create” licensed intellectual property. Even its own name can fall into this category. In many cases the legal registration of this property is quite unnecessary. The charging of a fee for its use is quite often even less justified.

An MNC has to decide if it wants to undertake this activity which is largely designed to facilitate the shifting of profits to tax havens. This issue is at the core of the debate in the UK in 2008 on companies seeking to leave as a result of the UK’s threat to tax income earned in tax haven subsidiaries from exploitation of intellectual property as if those tax haven companies were located in the UK.84

12. How a company will structure its operations

This theme brings together a number of previous threads. It involves decisions on:

1. Where to incorporate.
2. Where to borrow.
3. Where to place subsidiaries and intermediate holding companies.

83 For an extract of the Wall Street Journal article on this see http://www.finfacts.com/irelandbusinessnews/publish/article_10009467.shtml accessed 16-5-08.
Each of these, and indeed the other issues addressed above, can be seen as discrete decisions. But they are also viewed collectively by most MNCs. What they are seeking to do is to create a structure for their MNC which minimises tax. In doing so they are likely to:

1. Make full use of taxation treaties between countries to ensure that the least possible tax is deducted at source from any dividends, royalties, interest or licence fees paid, thus ensuring they arrive in the parent company with as little paid in tax as possible.
2. Secure favourable tax treatment by accumulating reserves in low tax jurisdictions such as the Netherlands, Ireland and Switzerland with an extensive range of double tax treaties.
3. Seek to use “conduit” companies to turn income from relatively unacceptable sources eg those subject to a tax holiday (eg in a developing country) into an acceptable source to which a double tax treaty exemption from further taxation can be applied. Cyprus is frequently used for this purpose.
4. Seek to exploit loopholes between double tax treaties to minimise tax obligations eg by double dipping as noted above. This practice has recently been attacked by a number of tax authorities.

Other possibilities occur and are exploited by some companies.

The decision the company makes on this issue is essentially political. It is one of deciding whether the corporation exists within national spaces called countries, and is therefore subject to the rules and regulations of those spaces, or whether it wishes to float above and between those spaces and exploit the gaps between them by finding loopholes in the double taxation treaties that regulate the international taxation environment. These spaces are, of course, the secrecy spaces referred to in the preceding section of this chapter.

The current structure of accounting encourages MNCs to see themselves as independent of any nation state. The accounts that they publish are “consolidated”. They do not actually represent the results of any individual company within the group. Instead they represent the net outcome of the transactions between all the MNCs and third parties. But transactions within the MNC are entirely eliminated from that reporting. In this way consolidated accounts do themselves create another special form of secrecy space in that they are an artificial construct that hides much from view, to the advantage of those who can use them.

As a result the local base for each and every company within the MNC is ignored in the published accounts, which consequently float above the national spaces as if independent of the locations in which the company works.

This perception is one that many companies now replicate in their tax planning. They can create complex group structures knowing that they do not have to report on them. They can also exploit the gaps between the countries in which they either work, or in which they choose to locate operations for the benefit (as they see it) of their investors (even though they are, inevitably rooted in those self same national spaces) because whatever they do is similarly unaccountable.

The structures of international tax have also until recently encouraged this because they have been poor at exchanging information between nation states or at enforcing international taxation liabilities. The consequence has been that an ethos of abuse has developed, with the interests of the company being seen as superior to those of the state.

The company has to do decide whether to accept this philosophy, or not.

13. Whether a company will seek special tax privileges

There is a final option available to companies. They might simply ask the state for special tax concessions.

Sometimes these are given by way of grants or subsidies. On occasion they are given by special tax allowances eg by granting accelerated tax allowance for capital expenditure in certain industries which have the effect of ensuring that MNCs in that sector do not pay tax for an extended period even though they are profitable. They can simply involve taxation holidays granted to particular companies whilst they are establishing themselves in a territory eg a 10 year period is common in this respect. Alternatively, they can involve specially negotiated tax rates as is frequently possible in tax havens.

The final option is to negotiate what is called a “fiscal stability clause” which guarantees the company that the state’s tax laws will not be changed to its prejudice for the foreseeable period. This period can be 25 years or more. These provide certainty to the company undertaking inward investment but seriously limit the scope for future economic management through use of fiscal policy on the part of the country that offers them.

The acceptability of these practices varies. Some subsidies and grants are almost above suspicion. Special tax allowances are usually beyond international reproach if offered to both local as well as incoming businesses. This is sometimes acceptable to a government because there is almost no local trade of similar type. Tax holidays and negotiated tax rates are widely frowned upon and income subject to such regimes is usually denied the benefit of the favourable treatment often afforded by double tax treaties. However conduit tax havens such as Cyprus can often be used to convert income of this unacceptable sort into income that is acceptable under double tax treaties.
In all cases there is a direct conflict in these arrangements between the state and the MNC, with the balance being decided between the amount of estimated economic benefit the state secures when traded against the tax it loses. If, however, the incentives offered are linked to unacceptable commercial practices the balance of the equation quickly moves into areas where fraud and other malpractice is either suspected or occurs in practice. When that is the case the state is unlikely to benefit from the negotiated arrangements even if the MNC does.

In deciding whether to avail itself of these options the company has to assess the risk to its reputation from doing so. A company might also consider whether it is allowing tax to cloud its commercial judgement: there are studies showing that tax incentives often result in business activities being undertaken in areas which are not favourable and that the outcomes do not meet the expectations of either the business or the government.

There is limited risk in taking opportunity of available tax reliefs or grants. There is increasing risk as a company moves into negotiating special allowances, tax holidays, special rates and fiscal stability clauses. Some companies choose not to do this. Others use the opportunities provided by the rules of corporate reporting, which allow intra-group transactions to be largely ignored to suppress details of such trading. This is done in the hope that the negative aspects of such deals can be kept out of scrutiny whilst the positive advantages to cash flow are enjoyed.

Along with many of the decisions to be taken by a company with regard to the issues listed in the paper, this is an ethical choice and the MNC has a position to take on this issue which it cannot avoid, and about which it should be open and accountable.

The use of tax havens by individuals

The use of tax havens by corporations can, in many cases, be legitimate, even if the consequence may appear unacceptable to many.

In contrast the use of tax havens by individuals tends to be for illegal purposes, although there are, of course, exceptions. The main uses individuals’ make of tax havens have already been discussed in chapter 2 and are not repeated here.

Conclusion on the use of tax havens

Tax havens are used for a range of purposes. In most cases though the secrecy spaces that they permit, and which accounting rules also permit, are abused to ensure that transactions take place in secret, beyond apparent regulation or accountability.

This results in considerable harm. First they hide corrupt practices. This usually involves bribery or the corruption of public officials, and this is the definition of corruption that has been widely promoted by Transparency International, who state it to be “the misuse of entrusted power for private gain”.85 This issue is of great significance, and often involves the use of tax havens, but its role should not be overstated. When estimating the relative importance of different forms of capital flight, almost all of which go through tax havens, Raymond Baker of Global Financial Integrity has estimated that just 3% relate to corruption.86 Baker’s figures are accepted by the World Bank as the best currently available.

There is no doubt though that this corruption, which would be hard to undertake without the existence of offshore, is immensely harmful. It undermines confidence in aid, which reduces aid budgets. The process of government in many countries in the world is also fundamentally harmed by widespread corruption, which because it permeates from the heart of government down to all layers of the administration erodes the relationships of trust between people and government, causing incalculable harm to the economies of the countries in question, failure of the rule of law, difficulty in promoting local enterprise because of the increased cost of capital that results and the misallocation of resources in these places. The arising cost, whilst impossible to estimate, is largely attributable to tax havens.

Tax havens also facilitate crime, whether it be money laundering, drugs trafficking, human trafficking, racketeering, fraud, insider dealing, piracy, and the purchasing of favour. Baker estimates that this represents 30% to 35% of illicit financial flows.87 Terrorism financing, which is of course a principal focus of the FATF, makes up a tiny part of this. It is apparent that these activities, all of which also lead to tax evasion, are the cause of considerable harm to society. The closure of tax havens would not eliminate these activities, but it would make them harder. This is an area where Britain could act unilaterally since some locations, such as the British Overseas Territories, are known to be vulnerable to these activities due to their poor application of money laundering rules.

85 http://www.transparency.org/news_room/faq/corruption_faq accessed 2-6-08.
87 ibid
As importantly, tax havens promote tax evasion and aggressive forms of tax avoidance (the distinction between the two often being hard to make because of the interaction of laws). Baker estimates that tax driven illicit cash flows amount to 60–65% of all illicit flows. This suggests that flows motivated for this purpose have a value of between US$600 billion and US$7 trillion a year. Half of this might come from developing countries.

The Tax Justice Network has estimated that US$11.5 trillion of funds are held offshore by individuals, based on data published by major banks and financial services institutions in 2004. They estimate that US$255 billion of tax is lost to the countries of the world as a result.

The OECD estimates a lower level of funds held offshore, at between US$5–US$7 trillion, but their estimate excluded non-financial assets, which the Tax Justice Network estimate included.

Christian Aid has estimated that the cost of lost corporate taxes to the developing world is currently running at US$160bn a year (£80bn). That is more than one-and-a-half times the combined aid budgets of the whole rich world—US$103.7bn in 2007. As a result of transfer pricing abuse alone they estimate that lost revenue contributes to the death of 350,000 children a year.

These though are the more obvious impacts of tax havens. Their indirect consequences are at least as harmful, and yet have been almost entirely ignored by economists although the reality is that economic theory provides the clearest evidence that tax havens must harm the health of the global economy. This is because neo-classical market economics says that three things are needed to ensure an optimal outcome results from the operation of a market. Those things are equal access to capital, equal access to markets and the availability of perfect information to ensure the optimal allocation of economic resources to efficient activity.

Tax havens deliberately set out to subvert all three of these requirements. They do this by exploiting the one, so called, competitive advantage they have. That advantage is not low tax rates. Indeed, the tax rates for many ordinary people who live in tax havens are not that low when compared to middle classes elsewhere. It is secrecy that provides that advantage, coupled with the fact that only some, highly selected groups of people are can hide behind that secrecy veil to claim that they locate their activities in tax havens that gives them their advantage.

That secrecy is used to ensure that those who can use these places, legally or illegally, have access to capital at lower rates than those who do not have that access. This lower cost of capital results from the fact that those who can hide behind the veil of tax haven secrecy accumulate their capital faster because it is in a tax free environment.

Second this limited access to tax haven secrecy is used to deny access to markets on an equal footing. Of course this happens in the tax havens themselves: in most such places tax haven operations are ring fenced from the local economy for fear they will undermine local markets and tax revenues. The irony of this is extraordinary.

More importantly though, given the inevitable and appropriate nationally based measures to tackle tax avoidance and evasion that countries must implement if they are to fulfil their democratic mandate, most ordinary people and almost all small and medium sized businesses in the world cannot use offshore structures to access the markets that the wealthy, law breakers and multinational businesses can access at lower cost using tax haven facilities. This puts the ordinary person, the law abiding person and small business at a deliberately constructed competitive disadvantage.

Third, the secrecy that allows this to happen also undermines all the principles of open access to information that are essential to ensure that the effective decision making resulting in optimal allocation of resources in market economies takes place.

The result is obvious. Tax havens set out to undermine effective markets, and that is the goal they succeed in achieving. As a result tax havens do not extend liberty, as some would claim, they are actually designed to grant monopoly rights to a privileged few, and that is exactly what they do.

Those few are the wealthiest of the world, the largest businesses of the world and the lawbreakers of the world. Those groups exploit that monopoly advantage as all monopolists do, to close down effective competition. The result is simple. The richest have got wealthier at the expense of the middle class and the poor who have to pay the taxes to provide the services multinational business demands. Multinational business meanwhile squeeze out medium and small nationally based business that have an unfair higher cost structure than their larger rivals and the poorest nations of the world that do not have the resources to challenge the haemorrhage of illegal and mispriced money from their shores subsidise the tax take of the richest nations of the world. Throughout all this democracy is undermined, as is the rule of law.

The economics of this then are simple, and unambiguous. Tax havens must, and do, harm economic well being for all but the minority who can use them because they do wrongly allocate economic resources and inappropriately allocate the reward of economic activity.

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In that case it is unsurprising that attempts have been made to regulate tax havens. It is to these attempts that we turn next.

5. The Silence of the Regulators

Tax havens and OFCs have emerged as one of the key areas of concern for international economic organisations in the past 15 years. Due their complexity and diversity they have attracted the attention of a number of organizations for different reasons. As a result, a number of campaigns, running in parallel, are currently aimed at tax havens/OFCs. The main actors in these campaigns are the familiar international financial institutions (IFIs) joined, from time to time, by national agencies such as tax authorities, treasury departments, trade and other agencies of the state. The international organizations have been primarily concerned with four issues: harmful tax competition, financial stability, money laundering and the need to track terrorist financing.

The principal campaign against tax havens in terms of resources and political capital invested began in the late 1980s and is concerned with laundering the proceeds from narcotics trafficking and, more recently, terrorist finance. This campaign has been led by the Financial Action Task Force for Money Laundering (FATF) with support from the IMF, the World Bank and the Financial Stability Forum (FSF).

The second campaign, initiated in the late 1990s, was concerned with harmful tax competition. This campaign has been led by the OECD, but the EU has subsequently emerged as a significant player, with a number of national tax authorities, including the UK, and more surprisingly, the Irish and the US, playing a significant part.

A third concern is with financial stability and the so-called New International Financial Architecture (NIFA). The organizations most concerned with these issues are the International Monetary Fund (IMF), the Financial Stability Forum (FSF) and the Bank of International Settlements (BIS).

Perhaps unsurprisingly, each of these organisations has defined tax havens and the issues relating to them in different ways, resulting in their taking differing approaches to the campaigns they have pursued. That said, in many cases their involvements overlap with each other and between themes. Importantly, despite the plethora of initiatives, there are major gaps on issues where the IFIs have been largely silent, most notably in respect of commercially related illicit financial flows arising from trade mispricing, and tax evasion. This silence is significant since the available evidence suggests that trade related illicit financial flows account for the major part of illicit capital flight from developing countries into the financial centres linked to the North.

This section offers an analysis based on the approach each organisation has taken to the campaign against tax haven activity. This analysis is followed by a commentary on the effectiveness of these campaigns and analysis of how the tax havens have reacted to them.

The Bank for International Settlements (BIS)

Among the premier international organizations, the Bank for International Settlements (BIS), the so-called central banker’s bank, whose customers are central banks and international organizations, has been most assiduous in insisting on use of the term OFC when engaging with the tax haven issue.

The BIS used to describe OFCs as territories whose financial activities did not develop “organically”. The BIS, however, never defined the meaning of organic growth of financial centres. More recently, the BIS has adopted a variant of the IMF definition of offshore centres as “an expression used to describe countries with banking sectors dealing primarily with non-residents and/or in foreign currency on a scale out of proportion to the size of the host economy” (BIS, 2000).

The BIS has over time had difficulty in defining those countries and territories it considers to be OFCs. In 1995 it maintained two lists of countries reporting to it in which OFCs might be located, being industrialised reporting countries and what it described as “other banking centres”. The major industrialised countries included:

1. Austria 10. Japan
2. Belgium 11. Luxembourg
3. Canada 12. Netherlands
4. Denmark 13. Norway
5. Finland 14. Spain
6. France 15. Sweden
7. Germany 16. Switzerland
8. Ireland 17. United Kingdom
9. Italy 18. United States

Other banking centres were:

20. Bahrain 23. Netherlands Antilles

(BIS, 1995, p5)

The principal anomaly with this list has to do with those classified as “other” centres which are clearly tax havens as well as OFCs (as previously defined). However, the report notes that:

“The reporting includes in the case of the United States and Japan separate information on the International Banking Facilities and the Japan Offshore Market respectively. As far as the other reporting centres are concerned, two of these (Bahrain and Singapore) include in their data only those institutions, or departments of institutions, that are exclusively engaged in offshore business. In the case of Bahrain these are the so-called ‘Offshore Banking Units’ (OBUs), while for Singapore they are the ‘Asian Currency Units’ (ACUs) of the commercial banks and merchant banks operating in the country’” (1995, p5).

The BIS recognised, therefore, as early as 1995 the problem in the distinction it made between industrialized and “other” OFC centres as it is clear that the U.S. IBFs and the Japanese JOM as offering something equivalent to Bahrain and Singapore.

Over time the BIS has sought to widen participation in order to improve the quality of its data. In doing so it achieved considerable success. Among the latest reporting countries providing locational banking data, the BIS lists Guernsey (from 2001), the Isle of Man (2001), Jersey (2001), Bermuda (2002), Panama (2002) and Macao SAR (2006). As a result of the addition of these tax haven states to its list of reporting territories, the BIS replaced the category of “other” centres with a new category of OFCs listed under the heading of “Caribbean and Asian offshore centres”. The list of Caribbean and Asian OFC is changing from time to time and includes, rather inconveniently, some European centres as well. Currently the list consists of Aruba, Bahamas, Bahrain, Barbados, Bermuda, Cayman Islands, Gibraltar, Guernsey, Hong Kong SAR, Isle of Man, Jersey, Lebanon, Macau SAR, Mauritius, Netherlands Antilles, Panama, Singapore, Vanuatu, and something rather nebulously called “West Indies UK”.

Notably, and importantly, the money markets of London are not regarded by the BIS as an offshore financial centre, despite London being the epicentre of the offshore financial market, as the Financial Stability Forum has noted:

For example, the growth of London as the largest offshore banking centre has been linked directly to regulations imposed on the U.S. banking sector (FSF, 2000, 11, footnote 1).

This raises the obvious question: why has the BIS chosen to not categorise the City of London as an offshore financial centre? To add to the obvious confusion within the BIS, their database on global FDI flows treats London as an OFC!

The BIS is clearly tied up in knots over what definition it should use for the Euro-currency market and OFCs. This is not surprising; as a club of central bankers the BIS is bound to shy away from controversy. In classifying offshore financial centres as it does, the BIS is undoubtedly catering to its constituencies, such as the American Fed, the Bank of England or the Bank of Japan, who do not wish to be treated as OFCs. Furthermore, the BIS has no particular agenda with regards to tax havens, but seeks to obtain best available information from different corners of the world. It accepts, therefore, the self-denomination of reporting countries as OFCs at face value regardless of the ensuing conceptual and analytical confusion that results. In so doing, it sets the tone for those who follow in its wake.

The Organization for Economic Cooperation and Development (OECD)

The OECD has positioned itself on the other end of the spectrum from the BIS among the premier international bodies. Established in 1961, The OECD serves as a “think tank” for the world’s advanced industrialized countries; those countries that are committed, in the OECD’s own words, to democracy and market economies.

The OECD is located in Paris and is considered to be particularly sensitive to the interests of the European powers, such as Germany and France; countries that have traditionally been critical of tax havens.

Since launching a campaign against “harmful tax competition” in 1998 at the request of the (then) G7 group of nations, the OECD has never shied from describing tax havens by that name. This is almost certainly because the OECD is concerned largely with the question of taxation, and less with the nature of tax havens as offshore financial centres. As such to describe them as tax havens suits their purpose. In summary, the OECD considers there to be four key factors that help define whether a jurisdiction is promoting harmful preferential tax regimes and as such might be considered a tax haven. They are:

— Whether that jurisdiction imposes no or only nominal taxes on some or all activities legally located there.
— Whether there is a lack of transparency within the jurisdiction.
— Whether there are laws or administrative practices that prevent the effective exchange of information for tax purposes with other governments on taxpayers benefiting from the no or nominal taxation; arrangements the jurisdiction provides.
— Whether there is an absence of a requirement that the activity undertaken in the jurisdiction be substantial.

This said, the OECD has also recognized the concept of OFC. A 1995 OECD report provides the following rather straightforward definition. OFCs, it said, are:

“Financial centres set up to avoid regulations or taxation by operating outside the countries of the main parties to financial transactions” (quoted in Edey and Hviding, 1995).

In contrast to the BIS, who stress the high ratio of non-resident finance in its definition of OFCs, the OECD definition emphasizes avoidance as the defining characteristic of OFCs, demonstrating a long term concern with tax matters.

The OECD was forced, however, to shift its position by 2001 and as a result has been increasingly using the more neutral term OFC in the way the BIS does. This change has arisen as a result of international pressure. The original OECD report of 1998 saw no problem in denouncing what it described as harmful tax competition. Many states, led by Switzerland, Luxembourg and the Caribbean havens argued that a tax regime is a more general issue and the OECD campaign amounted to a new form of imperialism whereby powerful states dictated terms to weaker states. This argument gained a powerful ally once the first Bush administration came to power in 2001 and broke ranks with the OECD, notably just before 9/11.

The first George W Bush administration was critical of the OECD harmful tax competition campaign on two grounds. First it agreed, implicitly, with the imperialist theory and as such it came to the defence of the sovereign right of even the smaller states in the world to create whatever tax regime they wished. Second, the Bush administration advanced the theory that just as market competition is good in principle, so tax competition is good as well, because it prevents governments from imposing unnecessarily high and punitive taxation. Hence, the US administration argued the tax haven campaign should not be aimed at competition, whether in taxation or anything else, per se.

In more recent documents the OECD has succumbed to these pressures and as a result has shifted the onus of its definition of tax haven away from the level of taxation as such, to the question of preferential treatment of foreign residences. According to the new definition, countries can impose zero taxation, and not be considered a tax haven provided they impose such taxation uniformly on those resident and non-resident in the territory. Of course, countries who wish to maintain very low level of taxation would have then to find other source of income. This has had significant impact, as will be noted later, but not, it must be said, as a consequence of OECD pressure, but mainly as a result of that emanating from the EU.

The OECD also appears to be more ambiguous in its attitude to the Eurocurrency market. In the early 1980s, the OECD commissioned a number of studies of the fledgling Euromarket. A study from 1983 into the effect of the Eurocurrency on global stability begins by noting the conventional definition of the Euromarket as a market for non-resident currencies (Bryant 1983). Bryant attributed the rapid rise of the Euromarket to growing interdependence among nations (interdependence was a popular theory in the 1980s), but, significantly, he adds,

“A second explanation is also important. Banks have been able to offer somewhat higher deposit rates and extend credits at somewhat lower lending rates in international banking than in traditional domestic banking by exploiting differences in national regulatory and tax environments. Eurocurrency banking in particular has benefited from this phenomenon.”

Edey and Hviding, in a report written twelve years later for the OECD, stress already the lack of regulation and avoidance as the defining characteristic of Euro-currency market. They speak of a shrinkage of the regulatory base which

“occurred through various types of regulatory avoidance (for example, the development of offshore financial centres and off-balance-sheet methods of financing by banks) as well as through a more general tendency for banks and other regulated institutions to lose business to the less regulated parts of the financial sector” (Edey and Hviding, 1995, p2).

This suggests that the OECD is aware of the difference between OFCs and tax havens, and yet now seeks to avoid the distinction. One explanation is that there is genuine confusion in the OECD as to the difference, and this has been observed during meeting at which they have attended. More likely though is the possibility that the OECD does not wish to create internal divisions among its members, some of which would be classified as offshore financial centres if the 1995 definition noted above were to be used. By avoiding this issue it manages to concentrate on tax alone where OECD members appear, on the whole, in much better position, and to be more unified (in the main) than non-OECD members—provided, of course, that we exclude the British and Dutch dependencies from the equation.
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The Financial Stability Forum (FSF)

Both the Financial Stability Forum (FSF) and the Financial Action Task Force for Money Laundering (FATF) refer to tax havens from time to time, without offering any clear definition of such entities. Both prefer the term OFC. The FSF, in particular, has taken a rather positive attitude to OFCs, arguing that under the right set of circumstances—circumstances defined, of course, by the FSF—these centres have a positive contribution to make to the world economy.

The FSF was convened in April 1999 by the G-8 group of nations to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. The FSF works closely with the IMF and the OECD. Its definition of an OFC does, however, differ from both. The FSF agrees that “OFCs are not easily defined”, continuing “they can be characterized as jurisdictions that attract a high level of non-resident activity” but adding:

Traditionally, the term has implied some or all of the following (but not all OFCs operate this way):

- low or no taxes on business or investment income;
- no withholding taxes;
- light and flexible incorporation and licensing regimes;
- light and flexible supervisory regimes;
- flexible use of trusts and other special corporate vehicles;
- no need for financial institutions and/or corporate structures to have a physical presence;
- an inappropriately high level of client confidentiality based on impenetrable secrecy laws; and
- unavailability of similar incentives to residents”.

(FSF, 2000, 12)

The list of attributes that “traditionally” were attached to the OFC is, it will be noted, almost identical to the one that the OECD used to characterize tax havens. This is unfortunate and has contributed to confusion on this issue.

Despite the secrecy and lax regulation, the FSF claims that it does not object to OFCs in principle. Indeed, it declares, “there are, however, highly reputable OFCs that actively aspire to and apply internationally accepted practices, and there are some legitimate uses of OFCs” (FSF 2000). Precisely what the legitimate uses of (for example) “light and flexible supervisory regimes and/or flexible uses of trusts and other special corporate structures” are is not made clear.

Reading between the lines, it appears that OFCs can play a positive role in world finance, (according to the FSF) because all the major financial centres are OFCs and hence they must, by default, play a positive role. The FSF recognizes the problem this poses by implication:

“While OFCs are commonly perceived to be small island states, a number of advanced countries have succeeded in attracting very large concentrations of non-resident business by offering economic incentives either throughout their jurisdiction or in special economic zones” (FSF 2000).

In other words it recognises that ‘incentives’ to non-residents are common practice. As a result is appears to recognise, implicitly, that some advanced countries may be considered as OFCs.

True to its task of international financial stability however, the FSF is interested in large scale financial flows and the potential difficulties lack of regulation and transparency may lead to. As a result and not surprisingly the FSF plays down the role of tax issues in its analysis, despite its list of characteristics of OFCs which centres on tax, because it does not help its main purpose to strengthen the “regulatory, supervisory, cooperation and information exchange arrangements” between OFCs and advanced industrialized countries. In order to co-opt tax havens into its regime, recognising their value by noting “some legitimate uses of OFCs”, the FSF appears willing to compromise on definitional accuracy to achieve that goal.

The International Monetary Fund (IMF)

The IMF has gone through an interesting transformation on the tax haven issue. The IMF was among the first international economic organizations to raise the alarm about tax havens (Cassard 1994). In the early years of the new century (and facing its own crisis of identity), the IMF is attempting to wrest the lead in analytical and research work on tax havens from other organizations (helped in this by the FSF) and as a result it is conducting some of the more innovative analytical work on tax havens.

Like other organizations, the IMF notes the objective difficulties in identifying what tax havens and OFCs are, and how to differentiate them. Perhaps because of its failure to properly address this issue the term “tax haven” creeps into IMF documents without attendant definition. Officially the IMF recognizes only the term OFC. In a widely cited “background paper” it sought to define OFCs as centres:

“where the bulk of financial sector transactions on both sides of the balance sheet are with individuals or companies that are not residents of OFCs, where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents. Thus many OFCs have the following characteristics:
1. jurisdictions that have financial institutions engaged primarily in business with non-residents;
2. financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies; and
3. more popularly, centres which provide some or all of the following opportunities: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity” (IMF 2000).

This by now familiar definition creates great confusion because it lumps tax havens together with OFCs. That is because this background paper of 2000 is (atypically) rather muddled and confusing: the more so since it begins with the following entirely different definition:

Offshore finance is, at its simplest, the provision of financial services by banks and other agents to non-residents (IMF, 2000).

It follows, the document logically concludes, that “any financial centre where offshore activity takes place” is an OFC, although such definition, the briefing paper admits, “would include all the major financial centres in the world”.

If all the major financial centres in the world are OFCs, which is the logical conclusion, then the IMF must either accept that OFCs are fine, or that global finance must undergo fundamental change if OFCs are an issue that needs addressing. The IMF seeks, however, a third position, that the global financial architecture is fit for purpose but some action is required to reform centres that provide some or all of the following services:

— low or zero taxation;
— moderate or light financial regulation; and
— banking secrecy and anonymity.

This clarification, in the name of “practicality”, pulls the IMF in the direction of stressing lack of regulation as defining characteristics of offshore. It also pulls the IMF towards the suggestion that OFCs are really, for all intent and purpose, tax havens.

There is little doubt as a result that this IMF briefing paper of 2000 is conceptually problematic. The IMF never conceded its contradictory position, but clearly felt that something was not right with its 2000 briefing paper. In a recently published working paper (Zoromé 2007), the IMF appears to have shifted its position—although the working paper clearly states that it does not represent the views of the IMF.

In this paper, which is devoted entirely to the definitional problem, Ahmed Zoromé argues that all existing definitions fail to capture the essence of the OFC phenomenon. According to him the essence of an OFC is “the provision of financial services to non-residents, namely, exports of financial services” (Zoromé 2007, p8). This is problematic as well because all financial centres service non-resident as well. Zoromé says, therefore, “Although one could argue that any given economy, to some extent, provides financial services, the peculiarity of OFCs is that they have specialized in the supply of financial services on a scale far exceeding the needs and the size of their economies”. As a result Zoromé suggests therefore the following definition of OFCs.

“An OFC is a country or jurisdiction that provides financial services to non-residents on a scale that is incommensurate with the size and the financing of its domestic economy” (2007, pp12–3).

Zoromé provides an objective definition of offshore centres which does not rely on biases or prejudices, but nonetheless still conflates the jurisdiction (the tax haven) with the hosted sector (the OFC). He proposes techniques for measuring and defining the size of the financial service sectors vis-a-vis domestic needs. His methodology shows very clearly that countries such as Luxembourg, Switzerland as well as the City of London do, indeed, host offshore financial centres—which is certainly the case. His methodology also reveals Latvia as a new and surprising addition to the list of OFCs (which is not a great surprise, though, to residents of the former Soviet Union).

There are, however, problems with such methodology. First, a statistical methodology shows only the relatively successful tax havens/OFCs. There are a good number of “failed” OFCs among the small Pacific Islands and some Caribbean islands which tried but failed to develop from being a tax haven to hosting a functional OFC, and hence do not show up in his methodology. Second, statistical data is not available for many of the territories identified by other agencies as both tax havens and OFCs and as such this approach is limited in application and might result in incomplete outputs as a result of incomplete inputs. Third, Zoromé’s methodology fails to acknowledge what may be described as “inner” tax havens: states or regions within federal states such as the U.S. (Nevada, Delaware) or Russia (Ingushetia) or Malaysia (Labuan) which use relative autonomy within a domestic market to enact similar type of laws to those usually associated with tax havens. Fourth, there must be doubt about the wisdom of thinking of offshore financial centres as a “service” economy in the traditional sense of the word, or of ignoring completely the issue of taxation as Zoromé does.

In conclusion, the IMF seems as confused as the other agencies noted so far when tackling this issue and remains largely silent on matters relating to tax evasion.
The Financial Task Force on Money Laundering (FATF)

The Financial Task Force on Money Laundering (FATF) was established by the G-7 summit held in Paris in 1989, in response to mounting concern over money laundering. The FATF secretariat sits in the OECD building in Paris, a fact probably of some significance when it comes to the definitional problem.

Early on the FATF decided to stay away from the definitional debate on the nature of tax havens and OFCs. Instead it concentrated on issues relating to drugs money laundering, and since 2001, terrorist financing. The FATF has identified certain practices as such as lack of regulation and obstacles on customer identification as potentially facilitating the flow of money laundering. As a result it created a list of “non-cooperative countries and territories” (NCCTs), or countries that had detrimental rules that might facilitate laundering. Their list of required actions to address money laundering initially contained forty recommendations. Another nine were added after 9/11 to address terrorist financing issues. In practice these, in combination, describe tax havens.

The European Union

The European Union is surprising one of the most effective players in the attack on tax havens. Their work has resulted from two initiatives. The first (and from a definitional point of view by far the most important) is the EU Code of Conduct on Business Taxation. This Code was issued in 1997 by a committee that was chaired for a decade by Dawn Primarolo in her capacity as the UK’s Paymaster General. It was notable that when issuing the report the EU said that:

The Council, when adopting the Code, acknowledged the positive effects of fair competition, which can indeed be beneficial. Mindful of this, the Code was specifically designed to detect only such measures which unduly affect the location of business activity in the Community by being targeted merely at non-residents and by providing them with a more favourable tax treatment than that which is generally available in the Member State concerned. For the purpose of identifying such harmful measures the Code sets out the criteria against which any potentially harmful measures are to be tested.

In so doing the focus was specifically on tax issues, but the term tax haven was not itself used. However, as reflected the mood of the period, the focus was on inducements, whether offered by taxation or lax regulation that encouraged the relocation of business activity by means that the EU considered unfair. There can be little doubt that this meant that the Code was intended to tackle tax haven activity and that the actions of OFCs were considered secondary in this matter. This is clear from the fact that the EU said that the criteria for identifying potentially harmful measures included:

- an effective level of taxation which is significantly lower than the general level of taxation in the country concerned;
- tax benefits reserved for non-residents;
- tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base;
- granting of tax advantages even in the absence of any real economic activity;
- the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD; and
- lack of transparency.

The EU’s Finance Ministers established the Code of Conduct Group (Business Taxation) to assess the tax measures that may fall within the scope of the Code of Conduct for business taxation. In its report of November 1999 the Group identified 66 tax measures with harmful features. Notably, of these 40 were in EU Member States, three were in Gibraltar (which has an unusual status in Europe, being for its purposes part of the UK) and twenty three were in the dependent or associated territories of the UK and the Netherlands. The latter were considered to be included since the respective nations have responsibility for the foreign affairs of the territories in question.

For beneficiaries of those regimes in use on or before 31/12/2000, a “grand-fatherling” clause was provided which provided that the benefits of the schemes had to lapse no later than 31/12/2005. In addition, an undertaking was provided by all states and associated territories that they would not introduce new measures that contravened the Code and the standing committee set up to monitor the Code was tasked with ensuring this did not happen. Unfortunately that committee has always met in secret, making it nigh on impossible to assess its progress towards achieving its remit, but what can be concluded with certainty is that on this issue the EU was concerned with tax haven activity, and in so doing was remarkably broadminded, taking action that affected almost all its member states as well as their associated tax havens. There can be little doubt that this bold step, which meant most EU member states had to take action of some sort, contributed to the success of this initiative, as noted later.

91 http://www.fatf-gafi.org/pages/0.2987_en_32250379_32235720_1_1_1_1_1_00.html accessed 2-6-08
The other EU initiative of importance is the EU Savings Tax Directive. As the EU noted:

The Directive on taxation of savings income in the form of interest payments adopted on 3 June 2003, formed one element of the “Tax Package” aimed at tackling harmful tax competition in the Community.\(^9\)

In practice the negotiations to implement this package had begun in the mid 1990s, and are another indication of the concern on tax haven activity that arose during that decade. As the EU noted,\(^9\)

The need to avoid distortions to the movement of capital and allow effective taxation of interest payments received by individuals in Member States other than the Member State of residence have led to the adoption of a Directive on the taxation of savings income in the form of interest payments. This Directive enables such interest payments to be made subject to effective taxation in accordance with the laws of the Member State of residence of the individuals concerned.

In plain English, the Directive is intended to tackle tax evasion on interest earned in tax haven states where the failure to implement effective tax information exchange agreements has made it difficult for tax authorities to secure the data they need to effectively tax their residents on their world-wide income, as is their normal intent.

Starting on 1 July 2005, the provisions of the Directive were applied by all EU Member States, ten dependent or associated territories of EU Member States through the implementation of bilateral agreements signed by each of the 25 EU Member States with these jurisdictions; and equivalent measures have been applied, from the same date, in five European third countries, including Liechtenstein, Switzerland, San Marino, Monaco and Andorra.

Just three member states—Belgium, Austria and Luxembourg—were allowed to withhold tax from payments of interest made to non-residents instead of undertaking to make automatic information exchange with the country of normal residence of the recipient. They joined the British Virgin Islands, Guernsey, the Isle of Man, Jersey, the Netherlands Antilles and the Turks and Caicos Islands in offering this arrangement, which also applied in the five European third party countries. Anguilla, Aruba, the Cayman Islands and Montserrat have all undertaken to provide for automatic exchange of information.

The focus of this initiative has been unambiguous: it is targeted at tax haven activity and does little to disguise the fact. In consequence the EU’s approach to these issues is about as far removed from that of the BIS, with which this review started, as it is possible to be whilst tackling fundamentally similar issues.

**The confused regulator**

This review has revealed that:

1. The terms OFC and tax havens can be defined to mean the same thing or things that are quite different. The terms have been treated as though they are synonymous even when applied to regulation of, on the one hand governmental bodies, and on the other, private sector financial intermediaries.
2. This confusion on the part of regulators has undoubtedly had an impact on the focus of their activities and, as will be shown, upon the effectiveness of actions taken.
3. The lack of consistency in approach between these international regulators, all of whom are dominated by a small group of powerful countries, has been to the advantage of the tax havens who have, to a considerable degree, been able to exploit this difference for their own benefit.
4. The policy change on the part of the US administration in 2001 undermined the effectiveness of the combined efforts to tackle tax haven activity that existed to that date. Again, as will be shown, it is only the FATF and the EU that have been able to make significant progress in their dealings with tax havens since that time.

The consequence of this is clear. Lack of clarity in defining the issues and risks surrounding tax havens and offshore financial centres has reinforced misconceptions and held back progress towards creating effective regulatory systems designed to tackle systemic problems. Achieving this clarity may be the biggest single issue to be addressed in the tax haven debate at this time.

6. **REGULATION AND THE TAX HAVEN RESPONSE**

Having noted that a range of bodies have tried to regulate tax haven activity it is important to now note what form that regulation has taken and what the response of tax havens to that regulation has been.

The attempts at regulation have been, it should be noted, aimed almost entirely at tax havens. The regulation of the OFCs that operate from them has been made their national responsibility. This is a major omission in the whole regulatory environment to which further attention will be given later.

\(^9\) ibid
The regulatory processes that have been created have a number of themes, as follows:

1. The creation of regulation to reduce the risk of illicit financial flows occurring. This type of regulation is most closely associated with the work of the FATF with its initial 40 and subsequent further nine requirements for rules required to be in place to mitigate this risk. In practice, this has also been the focus of the IMF in this area, which has used its resources to monitor compliance in this area. It has done this through its Reports on the Observance of Standards and Codes in member states, a process that has been extended to almost all the major tax havens. These reports are published.95

2. The publishing of “black lists” of states not in compliance with required international standards. The process has been most notably associated with the OECD initiative on harmful tax practices, and gave rise to considerable controversy, as is noted below. It was also used by the EU when listing harmful tax practices. The latter had the advantage, however, of being able to enforce its requirements on its own member states.

3. The issue of specific directives. This has been an activity particularly associated with the EU which has undertaken this activity on both money laundering and with regard to tax evasion (the latter being the EU Savings Tax Directive). As a member organisation with the power to require compliance this has been an opportunity peculiarly available to this organisation, but no other.

4. The regulation of specific activities, especially relating to the financial sector. This is the focus of the work of both the BIS and FSF, the latter for example, most recently looking at issues relating to prudential oversight of capital, liquidity and risk management, enhancing transparency and valuation, changes in the role and uses of credit ratings, strengthening the authorities’ responsiveness to risks and the creation of robust arrangements for dealing with stress in the financial system. Some, but by no means all of this, relates to tax havens.

It is the first three of these types of regulation that are the focus of attention here, the latter being too generic to require specific comment even though it has tax haven impact.

The impact of regulation

The responses to the processes of regulation have varied significantly in each case. It could quite reasonably be argued that the FATF has been by far the most successful regulator. Put simply, governments, including without exception those of the tax havens, have responded to its demands by creating legislation which does, by and large comply with the FATF requirements. This is an extraordinary achievement in a period of a decade. What was once an almost unregulated sector, especially offshore, is now subject to substantial regulation, worldwide. The scope of that regulation is also regularly monitored. For example, the UK’s National Audit Office was able to review the IMF ROSC assessments for the British Overseas Territories and produce this summary of regulatory compliance in November 2007:96

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96 http://www.nao.org.uk/publications/nao_reports/07-08/07084.pdf accessed 2-6-08.
International Monetary Fund assessment regulation of offshore financial services in Overseas Territories\(^1\)

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<td>33</td>
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<td>11</td>
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<td>(39)</td>
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<td>(31)</td>
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<td>29</td>
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<td>70</td>
<td>70</td>
<td>60</td>
<td>81</td>
<td>81</td>
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<tr>
<td>Broadly Implemented</td>
<td>38</td>
<td>30</td>
<td>30</td>
<td>30</td>
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<tr>
<td>Partly Implemented</td>
<td>38</td>
<td>30</td>
<td>30</td>
<td>30</td>
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<tr>
<td>Not Implemented</td>
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<td>(3)</td>
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<td>(3)</td>
<td>(3)</td>
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</tr>
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</table>

Source: National Audit Office

Notes

1 The table shows the first round of IMF assessments for each jurisdiction. At the time of this report, the first second round report, for Gibraltar, had been published with highly favourable results; assessment in Turks and Caicos Islands, Anguilla and the British Virgin Islands had been deferred at local request and the reports on Bermuda and the Cayman Islands had not yet been published.

2 The table summary on compliance in six of the seven Offshore Financial Centres. Turks and the Caicos Islands were excluded because the International Monetary Fund has not published its detailed breakdown of results. Percentages are rounded and may not always add to 100 per cent.

3 The smaller centres were not assessed for insurance and securities business.

4 The Crown dependencies are Jersey, Guernsey and the Isle of Man.

It is not clear why Gibraltar was not assessed for money laundering, but it is apparent that in most cases systems of regulation exist and that, with few exceptions noted (eg insurance in Bermuda and banking in Montserrat) those regulations are more than 50% compliant with required standards. Full compliance is, it should be noted, rare, but it is also fair to note that the same can also be said of many major nations and that overall the level of regulatory compliance in the Crown Dependencies and Gibraltar is good.

This apparent success gives an altogether false picture though. As the same report shows, having regulation in place does not mean it is used. For example, the key requirement of much of the regulation noted is that those operating in the financial services industry within the OFCs located in the above noted territories should report any suspicious transactions that they note in the course of their work to the local regulatory authorities. As the Jersey Financial Services Commission Handbook for the Prevention and Detection of Money Laundering and The Financing Of Terrorism for Regulated Financial Services Businesses\(^9\) says (page 6):

> The Jersey Financial Services Commission (the “Commission”) strongly believes that the key to the prevention and detection of money laundering and the financing of terrorist crimes lies in the implementation of, and strict adherence to, effective systems and controls, including sound customer due diligence procedures based on international standards. The Handbook therefore establishes standards which match international standards issued by the Financial Action Task Force on Money Laundering (the “FATF”).

Suspicious transaction reports are to be made, it says, when money laundering is suspect, but it then fails to define just what money laundering is. This omission also occurs in the Money Laundering (Jersey) Order 2008. This is remarkable, and no doubt contributed to the fact that whilst such Orders exist, and the Jersey Financial Services Commission is dedicated to regulating the local financial services industry, and produces a mass of paperwork in the course of doing so, much of which makes clear the duty to report any suspicion of money laundering to the Joint Financial Crime Unit of the Jersey police, the official report of that police

service for 2006 made clear that no suspicious activity reports were received by that unit in that year.\(^98\) Maybe that is because Jersey is also extremely circumspect about defining tax evasion as money laundering. It managed to do so in paragraph 2.7.5 of the April 2007 version of its money laundering handbook\(^99\) this has been removed from the latest version, issued in February 2008.\(^100\)

It should also be noted that in the 2007 Jersey Police Report it was said that 1,517 suspicious activity reports were submitted in that year, and that apparently 1,034 had been in the previous year. However, only one case of money laundering crime was detected as a result. The evidence remains clear: the rate of compliance with regulation is incredibly low in a jurisdiction rated as having good systems in operation and the conviction rate so abysmal that there is no implicit risk to the money launderer at all. The lessons are obvious:

— First, regulation has failed to deter money laundering.
— Second, the regulations are in place but the commitment to using them is low.
— Third, if this is the case in Jersey then it is likely to be much worse in the smaller and more remote jurisdictions covered by the National Audit Office report.

It is reasonable to conclude that no effective measures to prevent money laundering have been created as a result of all the effort expended to date. This is implicit in Table 9 of the same NAO report which shows the following rates of suspicious transaction reports and prosecutions:

### 9. LEVELS OF MONITORING AND INVESTIGATING SUSPICIOUS FINANCIAL ACTIVITY IN THE TERRITORIES ARE VARIABLE

<table>
<thead>
<tr>
<th>Territory</th>
<th>Number of suspicious activity reports (2005)</th>
<th>Estimated number employed in Financial Services</th>
<th>Reports per hundred employed(^4)</th>
<th>Financial Intelligence and Investigative capability(^2)</th>
<th>Number of successful local prosecutions(^3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bermuda</td>
<td>313 (2006)</td>
<td>4,000</td>
<td>8</td>
<td>11</td>
<td>0</td>
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<tr>
<td>Cayman Islands</td>
<td>244</td>
<td>5,400</td>
<td>5</td>
<td>21</td>
<td>2</td>
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<tr>
<td>British Virgin Islands</td>
<td>101</td>
<td>1,600</td>
<td>6</td>
<td>7</td>
<td>20 (pending)</td>
</tr>
<tr>
<td>Gibraltar</td>
<td>108</td>
<td>1,500</td>
<td>7</td>
<td>8</td>
<td>0 (1 pending)</td>
</tr>
<tr>
<td>Turks and Caicos Islands</td>
<td>17</td>
<td>700</td>
<td>2.4</td>
<td>5</td>
<td>0 (3 pending)</td>
</tr>
<tr>
<td>Anguilla</td>
<td>2</td>
<td>200</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Montserrat</td>
<td>1</td>
<td>150</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Jersey</td>
<td>1,162</td>
<td>11,800</td>
<td>10</td>
<td>22 (2003)</td>
<td>0</td>
</tr>
<tr>
<td>Isle of Man</td>
<td>1,652</td>
<td>7,010</td>
<td>24</td>
<td>22</td>
<td>0</td>
</tr>
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</table>

Source: Summarisation by National Audit Office and latest IMF assessment reports

Notes:

1 Very high levels of reporting can be indicative of defensive reporting of trivial cases, so the numbers here indicate relative reporting activity and not performance against a benchmark.

2 Full time equivalents. Professional staff.

3 In some cases investigations are ongoing and charges have been laid. Cayman authorities report five successful domestic prosecutions since 1997.

4 Included at the time seven staff seconded from the UK.

The impact of blacklisting

The impact of the OECD’s campaign that sought to shame the tax havens into compliance with the wishes of major OECD nations has been almost as limited as the campaign to prevent money laundering through regulation.

Whilst the campaign was supported by the US administration of President Clinton it appeared to have a real chance of success. Some of the tax havens on whom pressure was placed gave letters of undertaking to remove their harmful tax practices prior to 2001. Others resisted, assisted, quite notably by the Commonwealth Secretariat\(^101\) who seemed to consider it their duty to support the small tax haven members of the Commonwealth on this issue without apparently taking account of the impact of tax havens on the development of non-tax haven members of the Commonwealth.

The thrust of the argument of those opposing the OECD was simple but effective: the OECD had acted discriminately in targeting the 35 blacklisted locations because some OECD member states, and most especially Switzerland, but to a lesser degree London, New York and other significant tax havens, offered similar facilities to those the OECD considered harmful when offered from microstate jurisdictions. This,\(^98\)\(^99\)\(^100\)\(^101\)

\(^{98}\) http://www.taxresearch.org.uk/Blog/2007/03/02/jersey-officially-a-money-laundering-free-zone/ accessed 2-6-08.


\(^{100}\) See for example http://www.thecommonwealth.org/press/31555/34582/34632/joint_commonwealth_oecd_working_group_on_h.htm from 20/1, accessed 3-6-08.
they claimed, created an “unlevel playing field” which discriminated against them. In an effective counter-
attack, the blacklisted tax havens represented the OECD campaign as anti-competitive behaviour on the
part of a “cartel” of major states.

It was a powerful image successfully exploited by two organisations. The first was formed with the direct
assistance of the Commonwealth Secretariat and is called the International Trade and Investment
Organisation,102 which appears heavily influenced by the Isle of man, the UK based Society of Trust and
Estate Practitioners103 and UK law firm Stikeman Elliott, which appears to have created a speciality business
out of opposing OECD and other tax haven initiatives.104

The second was a US think tank, seemingly spun out of the Heritage Foundation and Cato Institute, both
of which are committed to very low rates of taxation, called the Center for Freedom and Prosperity.105 They
mounted a campaign, supported by the likes of Milton Friedman, who argued in a letter to President Bush
on its behalf in June 2001106 that:

We urge you to reject the OECD’s so-called harmful tax competition initiative. Tax competition
is a liberalising force in the world economy, something which should be celebrated rather
than persecuted.

It forces governments to be more fiscally responsive lest they drive economic activity to lower-tax
environments.

These arguments won the day with President Bush: in August 2001 he withdrew his support for the
harmful tax competition dimension of the OECD’s work even though just a month later, following 9/11 he
rushed the Patriot Act through the US Congress to impose harsh money laundering rules, and set in chain
the FATF initiative on this issue which has impacted significantly on the volume of regulation in tax havens,
even if not its effectiveness.

The withdrawal of US support empowered the tax havens in their relationship with the OECD and after
this change of heart most tax havens agreeing to cooperate with its activities have done so on the basis of
what has been called the Isle of Man condition, which said that further cooperation with the OECD on
harmful tax practices was conditional on the same requirement being imposed on all OECD members as was
imposed on it.

In effect the promotion of this condition and the change of heart by the USA fundamentally undermined
the OECD initiative. Since 2001 it has evolved into an initiative aimed at promoting information exchange
agreements, particularly in the form of what are called Tax Information Exchange Agreements (TIEAs)
between major nations and the world’s tax havens. In practice, useful as this initiative might be the number
of agreements signed to date are fewer than 50 in number, most involve a very few havens (the Crown
Dependancies leading the field in this respect) and the use of those agreements that have been in place for
some time is believed to have been very limited. For example, the Cayman—United States agreement signed
in 2001 is not believed to have been used on more than ten occasions. This is because the terms of these
agreements make it very hard for an enquiring nation to assemble a request for information, since they
basically have to be in full possession of all the facts they are requesting before actually making the request,
and it is very easy for the tax haven to refuse the information on the grounds that they do not think there
are reasonable grounds for supplying it. The whole arrangement does, therefore, appear to be a window-
dressing exercise designed to imply progress rather than any real indication that such progress is being made.

As a result the boldest initiative on tackling tax havens has failed.

The EU initiatives

The EU initiatives on tax havens have enjoyed considerably better fortune than those already reviewed.
There is good reason for saying this. First, while the other initiatives mentioned have only impacted on
legislation on money laundering, with almost no consequential apparent change in behaviour, the EU
initiatives focussed on tax. The changes in legislation there almost invariably have impact. Second, whereas
compliance with the other initiatives has been, if not quite voluntary because of the power of political
pressure that those creating them can exert, at least little more than token. In contrast, the EU has effective
power to require compliance, even with the Code of Conduct on Business Taxation, which has not had
statutory backing.

The result has been that both EU initiatives have been enforced. However, neither has had quite the
expected outcome, which makes this an appropriate moment to consider how the tax havens have reacted
to regulation, rather than just consider what that regulation might be. We start by looking at the EU
initiatives and then explore some of the other changes in tax haven practice over the past decade or so.

102 http://www.itio.org/ accessed 3-6-08.
103 http://www.step.org/ accessed 3-6-08.
106 http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2001/06/06/cnoecd06.xml accessed 3-6-08.
The EU code of Conduct on Business Taxation would have drawn little notice if it had only applied to the EU's member states. It is true that as a result of it many of them had to reform their tax practices, withdrawing many tax regimes considered harmful ranging from head office coordination arrangements in Belgium, to rules on foundations in Austria; from rules on non-resident companies in Ireland to rules for the film industry in the UK. It was, however, the extension of the package to the overseas dependents of the UK and the Netherlands that cause most controversy.

This extension had least impact in the British overseas territories, largely because relatively few have taxes on business. The impact on the Crown Dependencies was significant because their reliance on taxes on corporate profits is high, especially in the cases of Jersey and Guernsey: the former deriving up to 50% of its state tax income from taxes on corporate profits. The ratio is slightly lower in Guernsey, but much lower in the Isle of Man where taxes on corporate profit represent just 7.5% of total state income in 2006.

The EU Code of Conduct—how the Crown Dependencies have responded

The wide disparity is important. Jersey and Guernsey relied on taxing the banks and other financial services institutions that had located in their domains to provide their state income. The Isle of Man had a quite different strategy. Under an agreement with the UK dating back to 1911 (the so-called “common purse”) it had charged sales based taxes applying in the UK in the Isle of Man and received a disproportionate share of the resulting revenues, this being intended as a subsidy when the Isle of Man was an impoverished island. Since 1973 this has applied to VAT, which the island charges as if a member of the EU, which it is not.

As Tax Research LLP showed in research published in March 2007, as a result of this pooling arrangement the UK government provides the Isle of Man with a hefty subsidy each year, amounting to a sum of not less than £220 million per annum. Although the arrangement was renegotiated for the first time in many years in 2007 the level of subsidy is not thought to have changed. So absurd is the subsidy that Tax Research showed that the VAT income of the Isle of Man is 21.7% of the Island’s GDP, an impossible ratio when the tax rate is only 17.5%. In contrast, the ratio of VAT contribution to government income to GDP in the UK is just 6.1%.

The Isle of Man quite deliberately exploited this difference in relative fiscal strength when the EU Code of Conduct was announced. In June 2000 the Isle of Man announced that it would comply with the EU requirement that ring fences be removed from within its domestic tax arrangements by introducing a zero per cent corporation tax for all companies, whether Manx resident or not, with the sole exception of some banks and finance companies which would have to pay 10% (which arrangement would allow it to retain part at least of its existing revenues, most of which came from that source).

There can be little doubt that this was not the arrangement that the EU (or the OECD, come to that) had anticipated in response to the requirement to eliminate dual tax rates. It is likely that they assumed that there would be an increase in the rates charges to tax haven companies registered in the Isle of Man instead.

This policy initiative from the Isle of Man, which it could easily afford because of its heavy state subsidy amounting to almost half its state income from the UK, gave its closest tax haven competitors, Jersey and Guernsey almost no choice but to follow suit and introduce the same arrangement. The Isle of Man has had its 0/10 arrangement in force since 2006 and Jersey and Guernsey have had these tax rates since 1 January 2008.

But all is not as it seems. First of all, whilst Guernsey has genuinely introduced the tax rate that it advertises for all companies, and has also increased social security rates to make goods its shortfall (probably wishful thinking on their part), the Isle of Man and Jersey have been devious in their approach. This has been so much the case in the Isle of Man that its new tax laws have been deemed non-compliant with the EU Code of Conduct. As an Isle of Man press release on the issue said:

The EU Code Group met on 16 October 2007, and considered the Distributable Profits Charge (DPC). It considered the DPC only and not the Isle of Man’s “0/10” taxation system for companies which conforms to the principles of the Code of Conduct. The DPC, however, was found by the EU Code Group not to conform to the principles of the Code of Conduct.

This statement was disingenuous. The 0/10 tax system the Isle of Man has (and which Jersey and Guernsey has copied) is simply a system where companies are charged to 0% corporation tax unless they are finance companies when they’re charged to 10%. The Code of Conduct was never meant to regulate tax rates. As such the Isle of Man has always been free to set whatever tax rates it likes and the EU is going to do nothing to stop them.

That means that the Distributable Profits Charge was in fact the only part of the new tax system that had to meet EU approval. This charge, according to the IoM:

Treasury Committee: Evidence

is not a corporate income tax; it is a measure designed to maintain income tax revenue flow from individuals now that the standard rate of corporate income tax is 0%. It is a charge on Manx resident members of companies; accounted for by the company on their behalf, and creditable against their personal income tax liability when distributions are eventually made.

Which is true, but far from the whole truth. The purpose of the charge was succinctly summarised in the same press release noted above:

The introduction by the Isle of Man of a standard corporate income tax rate of 0% in 2006 could have led to broader loss of revenue. Manx resident individuals and the trustees of certain trusts . . . owning companies taxed at the standard rate could have chosen to leave profits in the company rather than paying them out as distributions which would be taxable as part of their personal income. The DPC was introduced at the same time as the 0% corporate tax rate specifically to limit the impact of this sort of planning.

And as the IoM then notes:

We understand that as the DPC is paid by companies on behalf of their Manx resident shareholders only, it is viewed by the EU Code Group as differentiating between resident and non-resident owned companies and therefore “ring fencing” the latter group from parts of the tax system. Ring fencing is considered harmful in the context of the Code of Conduct.

The EU Code Group was absolutely right: the DPC was a deliberate ring fence introduced even though the IoM had given an undertaking to remove them. Curiously the Tax justice Network had warned them of this since 2005, during which year Richard Murphy, an adviser to the Tax justice Network, issued a similar warning to Jersey when advising a committee of the States of Jersey. That warning was subsequently endorsed in comments PricewaterhouseCoopers made to Guernsey, but the Jersey authorities proceeded with their tax reform none the less.

The IoM now says it has:

given a commitment to the EU that its business taxation system will conform to the principles of the Code of Conduct.

They say this will do this by introducing a new charge to tax which is different from that rejected by the EU in just one way, which is hard to spot. The explanation of the difference requires a little understanding of the two schemes:

1. Under the DPC regime if an IoM company that had IoM resident shareholders did not distribute 55% of its profits as calculated for tax purposes to its shareholders then it had instead to pay 18% of that profit to the IoM government. This payment was deemed to be income tax paid by it on behalf of those shareholders. Of course the EU realised that this was in fact a corporation tax on the profits of locally owned companies by any other name and the claim that these companies therefore paid tax at 0% was disingenuous, to say the least, not least because the company had to pay the tax as deemed agent on behalf of its members.

2. The new arrangement is called the Attribution Regime for Individuals (ARI). Under it the way of calculating the profits of IoM companies does not change at all. And companies with IoM resident shareholders still have to distribute 55% of their profits to their members or the ARI comes into play (notice the similarities with the DPC already?). And if they do not make that distribution then, as the IoM notes:

The ARI will apply to Isle of Man resident individuals with an interest (in e as a member) in a “relevant company”. Such individuals will be taxed on their appropriate share of the distributable profits of the company (the "attributable profits"). Distributions out of such attributed profits when subsequently received by resident individuals will be tax-exempt.

Isle of Man resident individuals will generally be treated for income tax purposes as receiving any attributed profits 12 months after the end of the accounting period of the relevant company.

It is not a coincidence that the tax due by most such shareholders will be due at 18%, because that is the basic rate of income tax in the Isle of Man. So the tax due will be calculated as:

    Distributable Profit x 55% x 18%

But this is identical to the formula for the DPC except the formula now reads:

    Attributable Profit x 55% x 18%

Attributable and distributable profits are the same in both formulas. As a result the way in which this tax charge is calculated has not changed at all. The only change is that now the company will not be required to pay the tax on the individual’s behalf. Instead it will have to tell the IoM tax authorities what those individuals might owe and then the person to whom the profit is attributed will have to pay the tax instead of the company, regardless of whether or not they have actually received a penny.

That is the total change the Isle of Man is making to its unacceptable tax to seek to make it EU compliant. It is not changing the tax at all. It is instead seeking to claim that the tax is now outside the scope of business taxation and therefore the EU Code of Conduct on Business Taxation does not apply to it.
This is a charade since to make the ARI work the company is going to have to:

1. Be sure whether it has Manx resident shareholders or not. If it has not its taxable profit is likely to be zero and no tax computation is needed. Indeed, no tax return will be submitted. On the other hand, if it has local shareholders it has a whole raft of tax accounting to do. That, of course, is a tax ring fence in its own right. The simple difference in the basis of calculation of the liability is enough in itself for this to leave the ARI in breach of sections 4 and 5 of the EU Code.

2. It will have to calculate its taxable profits using tax rules, not accounting ones, but only if it has Manx resident shareholders. And then it will have to tell those shareholders what that taxable profit is and how much of it is attributable to them. It will not have to do this for non-resident shareholders. That communication requirement is another ring-fence.

3. Then it will have to tell the Manx tax authorities what its taxable profits are, and what part is attributable to which shareholder, as it has to under the DPC. After all, how otherwise will the tax authorities know that tax is being paid in the correct amount by the right person?

4. Finally, the shareholder will have to pay the tax whether or not they have received any income from the company—which seems to be a blatant abuse of human rights—and the IoM has legislation on this.

So the only change is that the Isle of Man now has no recourse to the company to recover the tax due. But since the company has at all other stages to be a party to the process of supplying the information so that the tax can be paid this is a tiny change in the system. As the above makes clear, the difference in procedure for locally owned and internationally owned companies remains massive. That difference is designed to maintain the ring fence to ensure that, as the IoM itself says, its residents cannot enjoy the benefit of owning companies paying 0% corporation tax, although that benefit is offered to the residents of all other countries that wish to incorporate a company in the Isle. That is in direct contravention of section 2 of the Code.

In the process a massive abuse of human rights is introduced and Manx owned companies are effectively forced to distribute an arbitrary 55% of their profits, putting them at a competitive disadvantage to foreign owned companies working in their economies who can retain all their profits to finance growth at lower cost then locally owned companies. This is in breach of section 4 of the Code.

It is obvious as a result that the ring fence is still alive and well, and bar recourse to the company, operates exactly as in the case of the now outlawed DPC. That’s because both are designed to ensure that the tax advantages of the 0% tax rate are:

- ring fenced from the domestic market so they do not affect the national tax base.
- Those words come straight from the Code of Conduct and are a criteria for rejection of any tax practice as harmful. The DPC was harmful. So is the ARI. And to claim it is not within the scope of business taxation when its sole purpose is to collect tax due on business profits is pushing credibility beyond any acceptable limit. As a result I have no doubt the ARI will be as unacceptable to the EC as was the DPC.

- It is worth noting, Jersey is trying a variant on the same trick.

Both make clear one thing, which is that they remain committed to acting as tax havens, with all the inherent abusive structures identified as existing in those places being retained, albeit under different names.

The EU Code of Conduct—the consequences for Jersey and Guernsey

There is, however, another dimension to this. Whilst the Isle of Man can take a robust approach to these matters Jersey and Guernsey cannot: they have been dependent on taxes on corporate profits to support their government spending, which despite their apparent low tax rates is actually at rates equivalent to those found in OCED counties.

To make good the shortfall in revenues they will inevitably face from 2008 onwards they have taken different steps. In Guernsey they have introduced higher rates of social security: a move that penalises the local population and that is both regressive and a disincentive to work. In Jersey they introduced a Goods and Services Tax in May 2008 at the rate of 3% on almost all sales. This is equivalent to the UK’s VAT in all but name, though without the exemptions on food, children’s clothing, etc, which render the UK scheme less regressive in its impact on low income households. There has been massive social resistance to the GST scheme: 19,000 of the island’s total 87,000 population signed a petition opposing the move in 2007. This gives an indication of a particular feature which is now being noted within several tax havens: local opposition to these places having this continuing status from those long terms resident in the places. The reason is obvious: these places became tax havens to attract revenue to reduce the burdens on their local populations. Now their local populations are suffering a burden to support the existence of a tax haven within their domain. The logic of this is becoming increasingly hard for real local people to appreciate and in those places where there is a democratic mandate the possibility of real political change as a result of this change in perception now exists.

111 http://news.bbc.co.uk/1/hi/world/europe/jersey/7084731.stm accessed 6-6-08.
112 http://www.taxresearch.org.uk/Blog/2008/05/06/is-this-a-trend/ accessed 6-6-08.
This possibility is increased in the case of Jersey and Guernsey because the tax charges they are imposing on the local populace will not make good the shortfall in tax lost as a result of introducing 0/10 tax strategies. Local politicians deny this, saying that the gains in competitiveness that the locations will secure from offering zero corporation tax rates will attract sufficient new business to ensure that enough financial services workers will be attracted to the locations to make good the deficits because they will pay additional tax. This argument must be wrong because:

1. Many of the local financial services markets, such a securitisation in the case of Jersey have virtually collapsed as a result of the credit crunch.

2. The EU Savings Tax Directive is having greater impact as the rate of tax withholding rises.

3. The breaking of local tax secrecy by HM Revenue & Customs in 2007 will have substantially reduced confidence in these locations.

4. The locations lack sufficient room to house new workers.

5. The new zero tax rate only affects businesses really located in the islands; those using it as a tax haven always enjoyed this rate. There is little physical capacity to accept real businesses in the islands and their cost base is very high, precisely because hosting the offshore financial centre on such scale has exerted huge inflationary pressures within their domestic economies.

This has led to widespread belief that there will be a “black hole” in Jersey’s finances. Some local politicians have suggested the figure might be £95 million.\(^{113}\) Others have suggested a figure as high as £118 million.\(^{114}\) The States finance minister has agreed a figure of £80 to £100 million.\(^{115}\) Each has any income from GST offset against it, but the States Budget for 2008 has no such estimate in it: by 2012 it says the deficit will be only £12 million.\(^{116}\)

<table>
<thead>
<tr>
<th>Actual 2006</th>
<th>Probable 2007</th>
<th>Forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td>£m</td>
<td>£m</td>
<td>£m</td>
</tr>
<tr>
<td>States Income</td>
<td>Income Tax</td>
<td>£460</td>
</tr>
<tr>
<td>— — 0/10% Corporate Tax Structure</td>
<td>£9</td>
<td>£77</td>
</tr>
<tr>
<td>— — Goods and Service Tax</td>
<td>£30</td>
<td>£45</td>
</tr>
<tr>
<td>53</td>
<td>52</td>
<td>Imports Duty</td>
</tr>
<tr>
<td>23</td>
<td>26</td>
<td>Stamp Duty</td>
</tr>
<tr>
<td>— — Tax/Stamp Duty on Share Transfer</td>
<td>£1</td>
<td>£1</td>
</tr>
<tr>
<td>42</td>
<td>34</td>
<td>Other Income</td>
</tr>
<tr>
<td>9</td>
<td>10</td>
<td>Island Rate</td>
</tr>
<tr>
<td>525</td>
<td>562</td>
<td>States Income</td>
</tr>
<tr>
<td>States Expenditure</td>
<td>Net Revenue Expenditure</td>
<td>£505</td>
</tr>
<tr>
<td>39</td>
<td>42</td>
<td>Net Capital Expenditure Allocation</td>
</tr>
<tr>
<td>504</td>
<td>524</td>
<td>One-off expenditure</td>
</tr>
<tr>
<td>— — Income Support—Transitional relief</td>
<td>£10</td>
<td>£6</td>
</tr>
<tr>
<td>21</td>
<td>38</td>
<td>Revised Forecast Surplus/(Deficit)</td>
</tr>
</tbody>
</table>


In doing so, however, it assumes that at least £45 million a year can be raised from GST, and those designing the tax thought that unlikely, and that income taxes will, despite the cut in the corporate tax rate for all local companies by at least 50%, increase in total amount collected from £460 million in 2008 to £535 million in 2012. This is utterly implausible, not least during the financial recession after the dot.com crash in 2000 Jersey’s state income tax income flat lined for five years:

![Source: Jersey budget, 2008](image)

The top line would read 1999, £324 million; 2000, £334 million; 2001, £347 million; 2002, £366 million; 2003, £370 million; 2004, £370 million. The actual income in 2004 was, according to the 2006 budget £363 million and 2005 was £370 million. So, for five years (2001–05) real growth was 1.5% on aggregate, and effectively 0% from 2002 to 2005 inclusive, a real decrease when inflation is considered. But on the back of two good years Jersey is now forecasting growth of 5% when there is every sign that its only core business sector is in crisis. 0% might be a very optimistic substitute at present.

If the loss of tax revenue from the zero/ten policy of £118 million is used rather than the modest £77 million which Jersey forecasts, and growth in other revenues is projected at a much more likely 1.5% then Jersey’s forecasts becomes:

<table>
<thead>
<tr>
<th></th>
<th>2006 £m</th>
<th>2007 £m</th>
<th>2008 £m</th>
<th>2009 £m</th>
<th>2010 £m</th>
<th>2011 £m</th>
<th>2012 £m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per Jersey budget</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>If grows at 1.5%</td>
<td>398</td>
<td>440</td>
<td>460</td>
<td>480</td>
<td>495</td>
<td>515</td>
<td>535</td>
</tr>
<tr>
<td>Gap</td>
<td>0</td>
<td>0</td>
<td>−13</td>
<td>−27</td>
<td>−35</td>
<td>−48</td>
<td>−61</td>
</tr>
<tr>
<td>Revenue loss per Jersey</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Likely revenue loss</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>9</td>
<td>72</td>
<td>82</td>
<td>87</td>
</tr>
<tr>
<td>Extra loss</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>−21</td>
<td>−46</td>
<td>−48</td>
<td>−58</td>
</tr>
<tr>
<td>Total gap</td>
<td>0</td>
<td>0</td>
<td>−13</td>
<td>−48</td>
<td>−81</td>
<td>−96</td>
<td>−119</td>
</tr>
</tbody>
</table>

**Source:** Tax Research LLP

The conclusion is obvious. Jersey is facing a significant budget deficit. It has at best strategic reserves of around £500 million.\(^\text{118}\) With the level of deficit it might be facing it could shortly be bankrupt. Guernsey faces the same dilemma.


\(^{118}\) Jersey in Figures 2007, States of Jersey.
The EU Savings Tax Directive\textsuperscript{119}

After intense negotiation the EU Savings Tax Directive came into force in July 2005. The Directive applies in all EU member states and the dependent or associated territories of EU member states, being Anguilla, Aruba, British Virgin Islands, Cayman Islands, Gibraltar, Guernsey, Jersey, Isle of Man, Montserrat, Netherlands Antilles, and the Turks and Caicos Islands. In addition other jurisdictions that have agreed to participate are Andorra, Liechtenstein, Monaco, San Marino and Switzerland.

Singapore, Hong Kong, Macao, Bermuda and Barbados have been asked to participate and have so far declined to do so.

The main method of application of the Directive is to permit the exchange information between tax authorities. The automatic exchange of data on interest paid has been agreed by all member states except Austria, Belgium and Luxembourg. This means that details of interest paid to a person who is resident in another EU member state is automatically sent to that other member state annually. This enables tax declarations by the person receiving the interest to be checked for accuracy, and allows each state to collect its own taxes appropriately.

As a temporary measure, the option of a withholding tax is allowed, and has been agreed for Austria, Belgium, Luxembourg and in all the non-EU jurisdictions that participate. This allows the taxpayer to choose either to have data on the interest paid to them sent to their country of normal residence, or to have tax deducted at source from the interest payment made to them. If they choose to be taxed at source, details of the interest paid are not exchanged with their usual country of residence. The tax collected this way is shared between the country collecting it (25\%) and the country where the person earning that interest resides (75\%).

These options are significantly different. The first option ensures that the correct tax should be paid by the resident of a country in that country. The second option ensures only that a withholding tax is paid, which is likely to be lower (the rates are given below) than the full liability due in the recipient’s country of residence. In addition, part of the benefit also goes to the country where the account is held, rather than that in which the recipient resides. For these reasons, the second option is not an effective measure to stop tax evasion, and has only been accepted as a temporary measure by the EU, which does eventually need to eliminate this option if the prevention of tax evasion is its objective. It is notable that it is the tax haven states that have opted for this sub-optimal alternative, the only possible reason for doing so being that they know this facilitates continued tax evasion in their banking systems by the residents of other countries.

The Directive applies to any individual who is resident in one EU country who has interest paid to them in another EU country or participating state. The Paying Agents (usually banks) are required to verify the identity and location of their clients. Every bank in a tax haven state operating tax withholding under the Directive has to ask their client if they want to information exchange or have tax withheld. In each and every case where there has been a refusal to exchange information the suspicion must exist that this is because of a desire to tax evade on the part of the customer: it is hard to think of another plausible reason for not exchanging. But there is no evidence that any suspicious transactions have been reported for this reason. This failure of the paying agents and the authorities in the locations in question is exceptionally hard to explain given the nature of their money laundering laws.

If withholding rate apply they are:

- 15\% from 1 July 2005 until 30 June 2008.
- 20\% from 1 July 2008 until 30 June 2011.
- From 1 January 2011 tax will be deducted at 35\%.

The impact of the EU STD has been modest to date. For example, in 2006 Jersey collected just £21.9 million of tax under the EUSD. Some £67 billion was on deposit from the EU in Jersey in December 2006.\textsuperscript{120} Interest paid on those deposits probably exceeded £2.7 billion in that year and it is claimed that 50\% of all relevant accounts were subject to information exchange. A withholding of £21.9 million in that case suggests that only 11\% of all EU resident owned cash on deposit in Jersey is subject to the Directive, giving some indication of how easy it is to avoid. It can be avoided by:

- Placing the funds on deposit in the name of a limited company.
- Transferring the sums on deposit into a trust or foundation. In these arrangements the funds on deposit are usually held by professional nominees on behalf of the beneficial owners. These arrangements are not covered by the Directive.
- Moving the investment out of cash and into any other form of investment eg shares.

\textsuperscript{119} This section based on http://www.taxjustice.net/cms/upload/pdf/European_Union_Savings_Tax_Directive_March_08.pdf, with permission accessed 6-6-08.

\textsuperscript{120} Source: Jersey Finance statistical data.
— Putting the investment into an insurance “coat” or “wrapper”: popular in many European countries.
— Moving the sum deposited to a non-participating location such as Singapore or Dubai.

There can be no doubt that all these options have been heavily promoted in the tax haven states to which the Directive applies.

Four actions are needed to remedy the defects in the EU Savings Tax Directive:
— The withholding tax option should be removed so that information exchange is required in all cases.
— The Directive should be extended to all legal entities, especially private companies and trusts.
— The income covered should be extended to include all forms of investment income and insurance based products and not just interest on bank deposits.
— The provisions of the Directive should be extended to places like Hong Kong, Singapore and Dubai which are currently marketing themselves on the basis of being outside this scheme and so available for use by tax evaders.

These actions should be taken immediately without waiting until the current transitional arrangements are supposed to expire in 2011. The EU should make it clear that it cannot accept economic cooperation with countries that refuse to accept these standards of disclosure.

So far, the EU has been trying persuasion, although acceptance of the Directive has also been proposed as a condition in the current EU negotiations for an economic agreement with Singapore. Non-cooperating countries have far more to lose from a worsening of economic relations than the EU. It is time to take a strong line and insist that financial liberalisation also requires cooperation to enforce regulations, including taxes.

If these changes are made the resulting standard should be considered the template for negotiation of international agreements to help tackle tax evasion on a global basis.

The tax that might be recovered as a result of these changes is hard to estimate. However, for the UK alone, and based on data for investments held denominated in sterling in Jersey, Guernsey and the Isle of Man alone, the total tax loss from tax evasion is likely to be at least £3.6 billion a year. This indicates the enormous scale of tax recovery likely from full reform of the EU Savings Tax Directive, and the ending of the cloak of secrecy provided by tax havens for banking, investment flows and the beneficial ownership of assets.

Other response to the attacks from regulators on tax havens

It is already clear that many of the attempts at regulation of tax havens have had little impact. Those that have had impact have been resisted, or to borrow tax parlance, aggressively avoided by the tax havens so that the OFCs that are located within them, and their clients, can continue to evade tax.

There have been other significant reactions with tax havens to the attacks upon them. The three main legal ones have been changes to trust laws, the creation of protected cell companies and the creation of the concept of redomiciliation. Each will be dealt with in turn.

As noted in chapter 3, trusts are an instrument normally only available in Anglo Saxon common law. A trust can be defined as:

a relationship in which a person or entity (the trustee) holds legal title to certain property (the trust property) but is bound by a fiduciary duty to exercise that legal control for the benefit of one or more individuals or organizations (the beneficiary), who hold “beneficial” or “equitable” title.

Note that a trust is an arrangement where the settlor gives the property away. This imposes a cost on the settlor. Few like the risk implicit in this: giving their funds to a professional person who they do not know who then has unfettered power over that cash is not a risk all tax evaders wish to take. Jersey and some other jurisdictions, including Cayman and the British Virgin Islands sought to get round this in the early years of this century using guidance that appears to have been provided by the Society of Trust and Estate Practitioners, based in the UK. The consequences have already been noted in chapter 3. The result is the existence of trusts in many of the major tax havens of the world which bear no relationship with those arrangements as found, for example, in the UK. They are mere nominee arrangements or shams in which professional people in those locations lend their names to persons who can wish to use them for little other purpose, it would seem, than evading tax.

Second, protected cell companies have been created, as noted in chapter 3. Once again the intention seems unambiguous when their use is extended beyond the reinsurance market: they extend secrecy and prevent effective information exchange.

Third, as noted also in chapter 3, redomiciliation now allows companies as well as natural persons to flee a tax haven when enquiry is made of their activity. There can only be one purpose for the creation of this legal concept: it is to help the tax evader escape the consequence of their crime.
Finally, and as importantly, tax havens have at the same time as they have been agreeing to some very
limited information exchange agreements under the terms of the OECD initiative have been doing all they
can to divest themselves of information they might exchange. So, and for example, one of the consequences
of the zero/ten taxation now in operation in the Crown dependencies is that, at least theoretically, companies
no longer pay tax in those places. As a result they no longer have to submit tax returns to the local tax
authorities. The consequence is simple: they no longer have information to exchange, so undermining the
whole principle of information exchange agreements into which they have entered. This, it is suggested, is
not coincidence. This is deliberate policy.

Conclusions
Regulation of tax havens has failed to date.
The offshore financial centres that operate from them remain unconstrained in their activities.
New methods of tackling the offshore economy are now needed.
These will be considered later in this report, but first it is necessary to consider the UK’s role as a tax haven.

7. THE UK AS A TAX HAVEN
In the context of this report it is important to note why comments about tax havens must refer to the UK
as well as those territories more often considered to have that status.

In July 2007 Alistair Darling said:121

claims that the UK was a tax shelter were seriously flawed”. . . [T]he IMF does not categorise the
UK as a tax haven. This was suggested by some organisations on the back of some seriously flawed
experimental methodology for identifying tax havens. The government is committed to ensuring
that everyone pays their fair share of tax.

The truth was that it was Darling who was making the wild claim: although the methodology used by
Ahmed Zorome for the IMF122 had flaws within it, they were, as previously noted, ones mainly of limitation
of scope due to lack of data. The conclusion that the UK was an offshore financial centre was justified despite
the reluctance of many in the UK to recognise this fact.

This section of the report presents the case for the UK being considered a tax haven, a case that can be
made, as will be noted, under many headings.

Historical consideration
As has previously been noted, it was in the 1920s that the UK created the concept of the offshore company,
where registration could take place in one location but residence could be considered elsewhere. This has
been central to the development of tax havens.

The UK has also contributed the concept of the trust to the world, and codified regulation with regard
to their use in 1925 in the Trustee Act of that year,123 which is still in use and which codified the regulation
of trusts, so spreading their availability. Crucially, it enshrined the secrecy of trusts, neither requiring that
they be registered unless taxable, or that they have accounts on public record, so creating the perfect
instrument for offshore secrecy that could be easily incorporated into the legislation of tax havens by simply
copying and developing this legislation.

Then in October 1957 the Bank of England created the regulatory concept of offshore when it declared
that transactions that took place in London but which were undertaken between two parties resident outside
the UK were not subject to UK financial regulation as they were deemed to take place somewhere
“elsewhere” to London, even though it was obvious to all involved that this was a fiction. As such the UK
created all the key components that underpin the fiction of the “secrecy space” that is critical to offshore
activity. Only banking secrecy was created elsewhere, but since, as the Swiss like to point out, the same result
can be achieved by the use of UK trusts owning UK companies registered in the names of nominees even
this distinction is somewhat arbitrary.

Finally, the UK quite literally created more of the world’s tax havens than any other state, it being the
deliberate policy of the Foreign & Commonwealth Office over many years to encourage small island states
to develop as tax havens. It is not chance that so many of the world’s tax havens are small states closely allied
to the UK or its Commonwealth.

There can also be no doubt that the UK is responsible for perpetuating this situation. As the National
Audit Office report on the British Overseas Territories published in November 2007 noted:124

The Territories are a UK Government-wide responsibility. The Foreign and Commonwealth Office, ("the Department"), leads overall policy and maintains the main UK presence in Territory, with other Government departments helping to discharge specific aspects of the UK responsibilities.

Areas, such as the regulation of offshore financial services, clearly pose important and growing risks, though these have not yet resulted in direct costs to the UK.

The implication is clear though: the UK has the responsibility and the risk. As such it can and should manage these havens better than it does.

The Euronmarket

The decision of the Bank of England to open an unregulated space for the trading of dollars located outside the UK had the consequence of creating the Euronmarket. This remains focussed on London, and continues to avoid most banking regulation.

So significant is this market believed to be that the economic policies of the UK have been heavily influenced by its existence in London. In particular, it has contributed to the notion that London is lightly regulated. More important still, it has been the reason for the UK’s commitment to refusing any suggestion of tax withholding on the payment of interest to persons not resident in the state in which payment arises. This has been to the enormous benefit of other tax havens, both by allowing the flow of tax free funds to them and by ensuring that they can defend their known refusal to apply withholding taxes by saying they are already emulating best practice in the UK. The flow of illicit funds around the world has benefited enormously as a result. There can be little doubt that the UK would have acceded to general European desire for withholding taxes but for this reason. The refusal marks it out as a state dedicated to tax haven policies.

The Domicile rule

The domicile rule is the quintessential evidence that UK is a tax haven. Albeit now modified and reduced in scope from April 2008 its impact is in practice little reduced for it has always been of greatest benefit to the very wealthy migrant person, and they still have easy access to the benefits it provides.

Those benefits remain a considerable cost to the UK economy. The rule has two other considerable adverse consequences. The first is that other tax havens say that it is the domicile rule that makes the UK a tax haven. This is frequently heard in the Channel Islands, for example.

Secondly, and regretfully, they are right because this rule means that the UK deliberately maintains a “ring fence” within its tax laws to benefit those who are only temporarily resident in the country (even if the definition of temporary in this case somewhat stretches normal usage of this term). Ring fences have been identified as harmful tax practices by the OECD.125 They were right to do so. In addition they’ve also been identified as harmful by a UK Treasury minister—Dawn Primarolo to be precise. She chaired the committee that gave rise to the EU Code of Conduct on Business Taxation. It said:126

When assessing whether such measures are harmful account should be taken of, inter alia: . . . (b) whether advantages are ring fenced from the domestic market so they do not affect that national tax base.

That is precisely what the domicile rules do. As a result it is clear that if this definition applied to personal tax as well as business tax, for which it was designed, the domicile rule would be considered a harmful tax practice by the EU. In consequence it is just chance that the domicile rules survive as legal under EU rules. Or maybe it was not chance. It is widely believed in Brussels that Dawn Primarolo was the main obstacle to extending the rules in the EU Code of Conduct on Business Taxation to the individual, behaviour also indicative of the UK’s status as a tax haven state.

Ease of company administration in the UK

One of the characteristics of a tax haven is the ease with which entities may be incorporated and the ease with which anonymity can be secured when doing so, and subsequently with regard to the operation of the resulting limited company. It is regrettable to note that the UK is very lax in these matters. Some of the considerable weaknesses in UK company administration that make it a favoured location for residents of other countries to incorporate their companies are as follows:

1. Ease of incorporation. It is possible to form a company within hours in the UK. No proof of identity of any sort is requested by the UK state agency responsible; Companies House. This omission is quite extraordinary.

125 http://www.oecd.org/dataoecd/33/0/1904176.pdf accessed 4-6-08.
126 http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm accessed 4-6-08.
2. Companies can be bought “off the shelf” from registration agents. When this is done although the agent will ensure they have forms to ensure that their agents are removed as company director and secretary they are under no obligation to make sure that the form is properly completed by a person whose identity they have proven. As such it is very easy to establish a company using false names and information.

3. It is possible to issue bearer shares in UK companies even though this practice is heavily frowned upon in tax havens since it facilitates money laundering. This cannot be by accident: the right to issue bearer shares survived into section 779 of the Companies Act 2006. As one formation agent who seems to specialise in the more esoteric end of the market has noted, UK companies with bearer shares are “our most popular package with UK residents”. It’s not hard to see why: this option allows the names of the real owners of the shares in a company to not just be hidden: they simply aren’t recorded anywhere. As one source notes:

   A bearer instrument is a document that indicates that the bearer of the document has title to property, such as shares or bonds. Bearer instruments differ from normal registered instruments, in that no records are kept of who owns the underlying property, or of the transactions involving transfer of ownership. Whoever physically holds the bearer bond papers owns the property. This is useful for investors and corporate officers who wish to retain anonymity, but ownership is extremely difficult to recover in event of loss or theft.

   This means that not only can the ownership of a company be hidden, it can be transferred at will without this being known, stamp duty or capital gains being paid, and without any organisation dealing with the company being any the wiser. Money laundering regulation becomes virtually impossible in that circumstance.

4. UK companies can also use nominees as directors, company secretary and shareholders, all of whom can be recorded as being located at an accommodation address. So significant is this activity that one well respected company formation agent advertises that:

   In addition, we can administer many of the business operations of a UK company, including the opening and operation of company bank accounts; raising and despatch of invoices; payment of suppliers etc.

   What this means is that, in effect that you can set up and run a company in the UK without Companies House or the public having any idea at all who is behind the activities it is pursuing. It may even be quite hard for HM Revenue & Customs to find out the chance of a tax authority in any other country doing so is remote indeed. And that company might really have no substance in the UK at all, which is a classic feature of a tax haven exercise. After all, unless there is no one here in the UK why would you need someone to invoice on your behalf from the UK, as Jordans offers to do?

5. One of the chief characteristics of a tax haven is that it provides a secrecy space—an opportunity for something to happen about which it is almost impossible for anyone, including tax authorities, to ask questions. The UK makes this possible because any company trading in the UK need never file a set of accounts.

   The reality is that a UK company can be incorporated by a formation agent, run by nominees and then after it has been in operation for a period of 21 months or so be due to file its first accounts. However it can instead simply file form 652(a) with the Registrar of Companies to ask to be struck off instead. Being struck off means that the company is dissolved without the need for a formal liquidation. As if by magic the company simply disappears instead. All that the directors have to state in making this application is:

   I/We as DIRECTOR(S) apply for this company to be struck off the register.

   In the past three months the company has not:

   — traded or otherwise carried on business, or changed its name;
   — disposed of for value any property or rights which it would have disposed of for value in the normal course of trading or carrying on business; or
   — engaged in any other activity except for the purpose of making this application, settling its affairs or meeting a statutory requirement.

   Note that there’s nothing there that requires them to say if they have ever traded, if they have paid their tax, or if they have settled all their obligations to file accounts.

   In that case a director of a company that wants to disclose no information can cease trading after 18 months and they can then honestly sign this form after 21 months when the accounts are due to be filed with the Registrar. It costs £10 to file and the company is usually dissolved within a few months. Companies House never asks for the accounts in that case.

127 http://www.coddan.co.uk/s-9-uk-bearer-shares-company-formation.html accessed 4-6-08.
129 http://www.jordans.co.uk/jordans3.nsf/Main/UK+company+administration+for+non-UK+shareholders.
HM Revenue & Customs can object. But in practice they almost never do, especially if they know nothing about the company (and the director in question will have ensured that is the case). As a result anyone can run a limited company in the UK behind a charade of nominees and quite simply no-one will ever know what it does because it will never file accounts. And no one seems to care.

More than 100,000 companies are dissolved in the UK each year using this method of dissolution.

6. Even if it is decided to file accounts with the Registrar of Companies if the company is deemed in law to be a “small entity” (and about 97% of all companies are) then the information filed is very limited in scope, being restricted to the balance sheet and some notes to the accounts. No profit or loss account data has to be filed. This makes the information put on record almost meaningless. There is no commitment to transparency in this process.

7. These small companies also enjoy low tax rates. Now charged to tax at 20%, this rate is lower than those charged in many other European countries, and is a benefit provided to small companies alone. It might be seen as a tax haven inducement by other states. For example, information supplied to the authors of this report suggests that more than 15,000 Norwegian enterprises are run through UK based limited companies.

8. One other form of UK entity, the Limited Liability Partnership is “tax transparent”. This means that the entity itself, although incorporated with limited liability under UK law is not taxable. Instead its profit is apportioned to its members who are then taxable if resident in the UK. This provides opportunity for such entities to have income arising in the UK on which they can seek to avoid UK tax liability, providing them with an unfair competitive advantage. This situation needs to be changed since it creates a ring fence in favour of those not normally resident in the UK operating in the UK domestic economy.

The trust regime

The UK trust regime, already noted in this report is the other characteristic of the UK that makes it a tax haven. There is no register of trusts in the UK; worse it is apparent that HM Revenue & Customs’ data on trusts is seriously deficient and is likely to result in their incomplete taxation.130 This looks dangerously like tax haven behaviour, especially when trusts can, in combination with nominee companies be used to create banking secrecy.

Inflated financial services sector

Lastly, and importantly, the UK is host to an OFC, as the IMF have shown in work by Ahmed Zorome.131 Put simply, the UK’s financial services activity is excessive for domestic market needs. As such it is clearly set up to service offshore clients, some of whom will undoubtedly use the other tax haven characteristics of the UK noted above.

Conclusion

The UK is a tax haven and hosts a massive OFC. It is therefore part of the tax haven problem for the rest of the world.

At the same time the UK suffers from tax haven activity.

It is within this dual context that the answers that follow to the questions raised by the Treasury Committee are offered.

Section 2—The Treasury Committee Questions

8. To what extent, and why, are Offshore Financial Centres important to Worldwide Financial Markets?

As has been noted in the introductory section of this report, tax havens and the OFCs they host have been critical to the development of the global financial system because they have provided the unregulated spaces in which the financial markets have developed.

Worldwide financial markets have been critically dependent upon offshore activity since the UK effectively created the unregulated, offshore Euromarket in October 1957 (see introduction for details). It is now fair to say that many of the most significant instruments in the financial markets are heavily dependent upon the OFCs located within tax havens to operate. These include:

1. Hedge funds. In 2003, offshore locations accounted for 40% of the number of funds and 49% of assets under management.132 By January 2006, 55% of registered hedge funds were located from

offshore. The most popular offshore location was the Cayman Islands (63% of offshore funds), followed by British Virgin Islands (13%) and Bermuda (11%). The US was also a popular location (with funds mostly registered in the tax haven of Delaware) as was Ireland. The absolute value of funds had also risen by this date from US$900 billion to about $1.5 trillion, meaning that by 2006 there were more offshore hedge fund assets than there were total hedge fund assets in 2003. In true offshore style the actual management of the hedge funds located offshore generally happens in the major financial centres. In 2006 it was estimated that around 36% of global hedge fund assets were managed in New York in 2006, down from 45% in 2002. London is the second largest global centre for hedge funds managers after New York. Its share of the global hedge fund industry more than doubled between 2002 and 2006 to 21%.

2. Private equity. A substantial part of the private equity sector is located offshore. The Observer newspaper has estimated that 80% of the main UK private equity earners are domiciled outside the UK. Private equity funds they are linked to will all be located offshore to ensure that they do not pay UK capital gains tax. Jersey based lawyers advertise their private equity client base on their web site as including CVC Capital Partners, Alpha Group, AXA Private Equity, Terra Firma, Carlyle Group, Investindustrial and Mercapital. Major private equity groups, such as Permira, owners of the AA are based wholly offshore. The first company quoted on the London Stock Exchange’s Specialist Fund Market on 29 May 2008 was The Da Vinci CIS Private Sector Growth Fund Limited, based in Guernsey. The Specialist Fund Market was launched by the London Stock Exchange in November 2007 as a regulated market for highly specialised investment entities. Its lighter regulations are aimed at attracting hedge funds and private equity funds.

3. Accountancy. As has been previously noted, the major accountant firms operate in all the world’s major tax havens, however small they are. This can only be because of the international role of the OFC’s located in these territories. There is little or no local demand for their services in these places.

4. Collateralisation and securitisation are undertaken almost exclusively offshore. Northern Rock’s Granite entity was partly based offshore. HBOS has a £40 billion securitised fund in Jersey called Granite Funding Limited. That’s £28 billion, near enough. A figure just a little less than the UK spends on public order and safety a year.

5. Private wealth management is almost entirely located offshore. The sector is dominated by Switzerland and London, although funds may be in any satellite location. As previously noted, the Tax Justice Network has estimated that in 2004 $11.5 trillion of funds were held offshore by private wealthy individuals, basing this finding in turn on reports from Merrill Lynch, Cap Gemini and Boston Consulting Group. CapGemini estimated in 1998 that one third of these assets were held offshore, and in 2002–03 refined that to 31%. They have not commented since. There is no reason to think the ratio has changed: indeed, funds on deposit offshore have continued to grow markedly, as data earlier in this report on funds in Jersey shows. A recent survey of dividend payments showed Cayman to be the fifth largest recipient.

6. Various estimates suggest that 50% of world trade passes through a tax haven. Proving this is hard: what is clear is that more than 60% of world trade is intra-group (ie between companies under common ownership) and it is much more likely that this trade will involve a tax haven step than trade which does not have that linkage in it. An example of how this might happen was published in the Guardian newspaper in November 2007, using a case study on banana trading which showed the extent to which offshore re-pricing was used to ensure that the profits form this trade ended up offshore.

The evidence is unambiguous: tax havens and OFCs are central to the world financial system.

9. To what extent does the use of Offshore Financial Centres threaten financial stability?

The threats arising from the use of tax havens and the OFCs that together make up the offshore world are substantial. They also extend beyond financial markets. They can be summarised under the following headings:

138 ibid
141 http://www.oigier.de/Landmark_London_listing.aspx accessed 9-6-08.
142 http://www.timesonline.co.uk/tol/news/politics/article3406368.ece accessed 9-6-08.
143 http://www.guardian.co.uk/business/2007/nov/06/12/privateequity.observerfocus
144 ibid
147 http://www.guardian.co.uk/business/2007/nov/06/12/privateequity.observerfocus
Corruption undermines stability

As the Tax Justice Network has persistently argued, corrupt activities that fall into the category of grand corruption cannot happen without the existence of tax havens and the OFC companies that operate from them. And yet tax havens are considered some of the least corrupt countries in the world by Transparency International, as this table shows:

<table>
<thead>
<tr>
<th>Country rank</th>
<th>Country</th>
<th>CPI score</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Iceland/New Zealand</td>
<td>9.6</td>
</tr>
<tr>
<td>5</td>
<td>Singapore</td>
<td>9.4</td>
</tr>
<tr>
<td>7</td>
<td>Switzerland</td>
<td>9.1</td>
</tr>
<tr>
<td>9</td>
<td>Netherlands</td>
<td>8.7</td>
</tr>
<tr>
<td>11</td>
<td>Luxembourg/United Kingdom</td>
<td>8.6</td>
</tr>
<tr>
<td>15</td>
<td>Hong Kong</td>
<td>8.3</td>
</tr>
<tr>
<td>16</td>
<td>Germany</td>
<td>8.0</td>
</tr>
<tr>
<td>18</td>
<td>Ireland</td>
<td>7.4</td>
</tr>
<tr>
<td>20</td>
<td>Belgium/USA</td>
<td>7.3</td>
</tr>
<tr>
<td>24</td>
<td>Barbados</td>
<td>6.7</td>
</tr>
<tr>
<td>26</td>
<td>Macao</td>
<td>6.6</td>
</tr>
<tr>
<td>28</td>
<td>Malta/Uruguay</td>
<td>6.4</td>
</tr>
<tr>
<td>31</td>
<td>UAE</td>
<td>6.2</td>
</tr>
</tbody>
</table>

As one former Nigerian politician commented about protracted negotiations to secure the repatriation of assets stolen by former Nigerian President Sani Abacha:

“It is rather ironical that the European based Transparency International does not think it proper to list Switzerland as the first or second most corrupt nation in the world for harbouring, encouraging and enticing all robbers of public treasuries around the world to bring their loot for safe-keeping in their dirty vaults”.

Tax havens undermine global stability by enabling most of the corruption that takes place in many developing countries.

The capital flight they enable is even more harmful. As has been noted in the introduction, Raymond Baker estimates that tax driven illicit cash flows amount to 60–65% of all illicit flows. This suggests that flows motivated for this purpose have a value of between US$600 billion and US$1 trillion a year. Half of this might come from developing countries.

The Tax Justice Network has estimated that US$11.5 trillion of funds are held offshore by individuals, based on data published by major banks and financial services institutions in 2004. They estimate that US$255 billion of tax is lost to the countries of the world as a result.

The OECD estimates a lower level of funds held offshore, at between US$5—US$7 trillion, but their estimate excluded non-financial assets, which the Tax Justice Network estimate included.

Christian Aid has estimated that the cost of lost corporate taxes to the developing world is currently running at US$160bn a year (£80bn). That is more than one-and-a-half times the combined aid budgets of the whole rich world—US$103.7bn in 2007. As a result of transfer pricing abuse alone they estimate that lost revenue contributes to the death of 350,000 children a year.

These flows undermine more than financial stability: they threaten lives.

146 ibid
147 Former Education Minister Professor Aliya Babs Fafunwa quoted in This Day, 6 June 2005.
151 http://www.ft.com/cms/s/0/e0c68ed4-0c3e-11dd-86df-000077956d2a.html accessed 9-6-08.
152 http://ap.google.com/article/ALeqM5h1FI0GhdKYET8xBkitwnzl-odYkwD90TCHVG0 accessed 9-6-08.
Ev 78  Treasury Committee: Evidence

Tax havens undermine corporate governance

Tax havens undermine good corporate governance. This arises because they provide the facilitating infrastructure for corrupt and illegal payments. Recent examples include Samsung and Siemens. In the former over 1,200 accounts were secretly operated for the benefit of senior executives.\(^{153}\) In the latter case\(^{154}\) it is stated that:

Siekaczek, 57, is charged with 58 counts of breach of trust. Prosecutors allege that he set up a complex network of shell corporations that he used to siphon off company money over several years. The money allegedly was used as bribes to help secure contracts abroad by paying off would-be suppliers, government officials, potential customers. Testifying as the trial opened, Siekaczek acknowledged having set up slush funds. “The whole sectoral management was naturally informed that this function was carried out by me,” he told the Munich state court.

The defendant’s case makes it clear that this was company policy. There can be little doubt that this remains commonplace: corrupt funds do not arrive in tax havens without someone being complicit in paying them.

There is another, more insidious way in which tax haven-based structures undermine corporate governance. It is commonplace for the special purpose vehicles that issue many of the complex financial instruments associated with tax havens to be owned by charitable trusts. This arrangement it adopted to ensure that the entity promoting the special purpose vehicle can claim that it neither owns nor controls the resulting company and as such can keep it “off balance sheet”. The objective is clear: the company creating the structure wants to hide the true nature of is financial position. The charitable trust is supposedly controlled by professional trustees. In practice the whole arrangement consists of smoke and mirrors, managed and controlled in practice by the entity whose debt the SPV issues.

This creates an enormous ethical issue, which poses a significant challenge to good corporate governance. In fact the structure of the SPV is a charade: it is not what it appears to be. It is neither independent, nor charitable (as was noted during the Northern Rock/Granite debacle, the charity supposed to benefit from the trust owning Granite had never received a penny from it).\(^{155}\) In that case the management who promote such schemes know that they are, in effect, promoting a fraudulent structure. The language is correct: fraud does not need to imply criminality, it actually means “deceit, trickery, sharp practice, or breach of confidence, perpetrated for profit or to gain some unfair or dishonest advantage”.\(^{156}\) This is exactly what was achieved through the use of the SPV: as Northern Rock again proved, its SPV called Granite enjoyed a higher credit rating and therefore a lower cost of borrowing than the bank that sponsored it did. That was the financial advantage it secured as a result of this trickery that misrepresents the true nature of the economic transactions that are taking place.

When the use of such deception is commonplace a fine line has been crossed: deception is accepted as a normal part of corporate practice. Good corporate practice is bound to be undermined as a result. Since offshore has facilitated many of these structures it has played a key role in creating the financial instability that has resulted from the creation of mechanisms that have now been seen to undermine the credibility of financial market regulation, not least in the UK.

Tax havens destabilise governments

There can be no better indication of this than the BAe affair: Tony Blair’s government was under threat from the disclosures that might have taken place as a result of the BAe affair, most of which occurred offshore,\(^{157}\) without which, no doubt it would not have happened. Whatever happens, the debacle will remain as a stain on his record and that of the UK, which because of transactions like this has a poor international standing on corruption issues.

This affair did not bring down a government: on another occasion it might have done. The use of offshore arrangements has the power to undermine the instruments of government itself in the developed world.

Tax havens can destroy OFC operators

The fifth largest firm of accountants in the world in 2000, Arthur Andersen was destroyed as a result to the damage to its reputation arising from the offshore trading of its client Enron.\(^{158}\) KPMG agreed to pay US$465 million in settlement of a federal investigation into tax shelters it had marketed to its clients in the US.\(^{159}\)

The same debacle has also resulted in Barclays, Merrill Lynch, Credit Suisse and other banks have all had their reputations harmed by involvement with Enron.\(^{160}\)

\(^{153}\) http://www.f1.com/cms/s/0/e6e86ad-0363-11dd-86df-000779fd2ac.html accessed 9-6-08.

\(^{154}\) http://ap.google.com/article/ALeqM5h1F0GdGKKVETxtxKwikD9OCTI9VG0 accessed 9-6-08.

\(^{155}\) http://www.guardian.co.uk/money/2007/dec/05/banks.northernrock accessed 9-6-08.

\(^{156}\) http://dictionary.reference.com/browse/fraud accessed 10-6-08.


\(^{159}\) http://www.guardian.co.uk/business/2006/nov/03/corporatefraud.enron accessed 9-6-08.

\(^{160}\) http://www.guardian.co.uk/business/2006/nov/03/corporatefraud.enron accessed 9-6-08.
**Tax havens facilitate crime**

Extensive reference has been made in the introduction to the ways in which tax havens facilitate crime. These flows amount to hundreds of billions of dollars a year.\(^{161}\)

**Tax havens create Financial instability**

Tax havens significantly increase the risk of financial instability in the world. Fundamentally they do this by ensuring that information is not available. Markets are always inefficient when there is less than perfect information available to them. Tax havens set out to create asymmetric access to information. As a result risk is increased because:

1. In many cases a person will have no way of knowing the true identity of who is being dealt with.
2. Counterparty risk in many financial transactions will increase as a result.
3. Default risk increases as a result, whatever the trade.
4. There is increased risk of moral hazard as it is easier to allow a company to fail in a tax haven where there is little or no chance of the true nature of its ownership being established than there is in a mainstream economy where such information is more likely to be disclosed for public record. A perfect example is to be found in the case of Carlyle Capital Corporation (CCC), a unit of the private equity firm Carlyle Group, which said on 13 March 2008 that it would not be able to meet lenders’ demands for money.\(^{162}\) Astonishingly, as reported by Prof Prem Sikka of Essex University:\(^{163}\)

On February 27 2008, Carlyle Capital Corporation published its annual accounts for the year to 31 December 2007. These accounts were audited by the Guernsey office of PricewaterhouseCoopers, the world’s biggest accounting firm, which boasts revenues of $25bn.

Amid one of the biggest credit crises, the accounts claimed on page five), that the directors were “satisfied that the Group has adequate resources to continue to operate as a going concern for the foreseeable future”.

The auditors were satisfied, too, and on 27 February 2008 gave the company a clean bill of health (page 6).

Less than two weeks later, on March 9 2008, Carlyle announced that it was discussing its precarious financial position with its lenders. And on March 12, the company announced that it “has not been able to reach a mutually beneficial agreement to stabilize its financing”.

The company collapsed with debts of £11 billion.\(^{164}\) If evidence were needed of the difficulty in assessing stability in the offshore world, and the risk it poses, then this must be a prime example.

If PricewaterhouseCoopers can be caught out within 11 days on the basis of having had full access to the books of this company no-one else has a chance of assessing the risk in such companies.

5. The offshore economy deliberately exacerbates risk with the structures it creates. For example protected cell companies (see chapter 3, above) create what are, in effect, ring fenced limited liability companies with what are already almost opaque offshore entities. These are used within the insurance sector, in particular, when party to legitimate activity but will, inevitably make it difficult to determine what, if any assets are available to creditors. This is particularly disturbing in a sector where the insurer is meant to act as payer of last resort.

6. Offshore is prone to the creation of what might best be called Ponzi style risk. As was argued by Anastasia Nesvetailova\(^{165}\) in her book *Fragile Finance, Debt, Speculation and Crisis in the Age of Global Credit*;\(^{166}\) written before the credit crunch began, derivatives, securitised debt, the Collateralised Debt Obligations\(^{167}\) that guarantee them and the hedge funds that trade them all form a part of Ponzi scheme. As Dr Nesvetailova notes\(^{168}\) there are three models of finance according to Hyman Minsky; hedged, speculative and Ponzi:

An advanced financial system goes, he says, through three stages: it begins with hedged finance, whereby borrowers raise money against collateralised assets. But as the period of growth continues, borrowers over-estimate the potential for growth, and borrow against future asset growth: in short, they speculate. Eventually, the bubble of speculative finance develops into what Minsky called Ponzi finance. The term comes from Carlo Ponzi, the most

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\(^{162}\) [http://news.bbc.co.uk/1/hi/business/7293663.stm accessed 9-6-08.](http://news.bbc.co.uk/1/hi/business/7293663.stm)

\(^{163}\) [http://www.guardian.co.uk/commentisfree/2008/mar/14/watchingthedetectives accessed 9-6-08.](http://www.guardian.co.uk/commentisfree/2008/mar/14/watchingthedetectives)


\(^{165}\) [http://www.city.ac.uk/intpol/Sta](http://www.city.ac.uk/intpol/Sta)%0230006906 accessed 9-6-08.


\(^{168}\) [http://www.city.ac.uk/intpol/Staff/Nesvetailova.html accessed 9-6-08.](http://www.city.ac.uk/intpol/Staff/Nesvetailova.html)
By the time the model has reached the Ponzi stage the only way it works is for more and more people to join the scheme. When for any reason that stops the scheme collapses. This stage has not yet been reached in the credit crunch. It has obviously been approached with regard to the collapse in the collateralised sub-prime mortgage sell off through securitised debt. If this risk reaches the market for collateralised debt obligations, almost all of which is denominated offshore, crystallises into falling confidence in the value of CDOs then the next stage of the credit crunch would arise. The market is hard to value. One estimate suggests it is worth $4 trillion. Others suggest more.

Many think this melt-down could happen. Dow Jones was discussing the risk on the day this report was written. If monoline insurers fail to cover the risk then melt-down is likely. Their capacity to do so is also in doubt at the time of writing.

7. In this situation accounting becomes unstable. Under both US and international accounting rules assets of major corporations have to be stated at their market worth on the balance sheets of major corporations. This is called “mark to market” accounting and is part of the model of accounting adopted since the 1990s called “fair value accounting” which replaced the previously accepted “historical cost accounting”. The impact in the credit crunch has been enormous. Historical cost accounting leaves assets stated as having a value equivalent to the price paid for them unless that value materially declines. This creates stable balance sheet accounting. Fair value accounting replaces historical cost with current value, thus creating volatile balance sheet values. This suits companies, and especially financial corporations very well if asset values are rising: they can book that increase in value as profit even if they have not sold the assets in question. There can be no doubt that this simple fact motivated enthusiasm for this form of accounting.

In a downturn the reverse happens. Losses have to be booked. This is why such substantial provisions have had to be made on the accounts of so many banks during the first half of 2008. But the situation in a credit crisis has the capacity to deteriorate fast: if the market for an asset fails (and there is always the potential for this in a downturn when buyers for some forms of asset evaporate) then balance sheet values collapse in an inverse Ponzi related accounting crisis that can spiral out of control with insolvency resulting.

This risk exists at present. It has not all been created by offshore. It could not have happened without offshore allowing the creation and sale of the assets that have precipitated the crisis of confidence in asset value due to the limited information available on them (not least to credit rating agencies).

The evidence is clear: using a wide variety of indicators the capacity of offshore to both create and contribute to instability is enormous. Within the financial sector it would have been impossible for the current credit crunch to have happened if offshore had not existed.

Things may still get much worse.

10. How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom’s Tax Authorities and Financial Regulators?

Secrecy is at the core of tax haven activity, even more than tax is. They exist to create secrecy spaces, as explained in chapter 4.

As a matter of fact the vast majority of tax havens do not have information sharing agreements of any sort with the UK. In addition, double taxation agreements are discouraged as they provide benefits to the havens, eg allowing some form of income to be received there without tax being deducted at source in the UK. This is resisted because that would increase the tax loss to countries like the UK from tax havens.

Some tax havens, such as Jersey, are resisting even entering into limited information sharing agreement with the UK called Tax Information Exchange Agreements (TIEAs) because they claim they do not get UK. This is resisted because that would increase the tax loss to countries like the UK from tax havens.
TAX INFORMATION EXCHANGE AGREEMENTS (TIEAs)—IN FORCE

Reciprocal Agreements relating to the EU Directive on taxation of savings income in the form of interest payments.
- Jersey (PDF 187K)
- Gibraltar (PDF 280K)
- Guernsey (PDF 187K)
- Montserrat (PDF 149K)
- British Virgin Islands (PDF 250K)
- Netherlands (PDF 124K)
- Arbua (PDF 107K)

Non-reciprocal Agreements relating to the EU Directive on taxation of savings income in the form of interest payments.
- Anguilla (PDF 117K)
- Cayman Islands (PDF 217K)
- Turks and Caicos Islands (PDF 219K)

An agreement with Bermuda is in negotiation.

The reality is, therefore, that under the terms of tax treaties the tax havens of the world are largely closed to enquiry from HM Revenue & Customs, and the systems of public enquiry available in such places is also decidedly limited, as has been noted in the introductory chapters. This is in marked contrast with most countries in the world, where the UK has one of the strongest networks of double tax treaties that exists. These provide for relatively straightforward information exchange.176

That said, all is not lost in some criminal cases, where request for information can be made using what are called Mutual Legal Assistance requests for specific information known to be held by specific persons. The difficulty with these is, however, that in some cases even this is not possible: for example, when there is no local equivalent offence to that being investigated in the UK, as can happen in tax related issues when there is no equivalent tax in the tax haven then the request for assistance can be denied. Second, the pace of cooperation can be slow. Third, the system is exceptionally bureaucratic and often fails for this reason. Fourth, it is not always known precisely what information is needed and so specific requests cannot be made.

This means that in its most successful attacks on offshore arrangements, HM Revenue & Customs is still dependent on more conventional sources of obtaining information. It was, for example, by means of accessing bank data held in the UK that the data to undertake the UK’s 2007 tax amnesty took place. Data on Liechtenstein has been purchased. Informants and tax investigation methods still provide a lot of the data used to break these arrangements. Cooperation from the tax havens remains decidedly limited and it looks as though they intend that it should stay that way.

This is unsurprising. Many tax professionals worldwide think that it might be their duty to comply with the law of the state in which they are resident. Few think they have duty to comply with the law elsewhere: most have little or no knowledge of whether they might be doing so and an indifference to finding out if that is the case. The already quoted statement of the chairman of the Swiss Bankers Association who said his members do not feel responsible for their client’s actions, and that they do not consider themselves to be a tax authority is typical of most tax “professionals” around the world. As such there is indifference to tax evasion as an offence requiring reporting under money laundering rules. This is why so few money laundering reports are generated or come out of those locations. It is not that the offences do not happen. Those arranging them are complicit in the process of fraud that takes place, and HM Revenue & Customs is largely powerless to obtain information from those territories about what is happening there.

As such it is reasonable to conclude that the world’s tax havens and the transactions that pass through them are opaque to the United Kingdom’s tax authorities and financial regulators.

11. To what extent does the growth in Complex Financial Instruments rely on Offshore Financial Centres?

It is appropriate to note that complex financial instruments can and do exist without the involvement of OFCs. However, complexity comes at a price. Offshore has been used to reduce that price. It does so in a number of ways.

First of all it provides what many OFC operators like to call a “tax neutral” environment. Actually, this means that no tax is charged. That is not tax neutral, of course.

Second, and as importantly, it provides a “light touch” regulatory environment. There are two aspects to this. This first is that almost without exception regulation is undertaken reluctantly and under duress in tax havens. As a result minimum compliance is accepted. In addition, this is encouraged wherever possible. For

176 See http://www.hmrc.gov.uk/si/double.htm accessed 10-6-08.
example, in September 2007, just as the current global financial crisis began to develop, Jersey announced that it was to offer a “zero regulation regime for funds where investors have put in a minimum of at least £1 million”. As the *Wall Street Journal* said of this development:177

The small English Channel island of Jersey—a haven for funds thanks to its light regulatory touch and low taxes—is relaxing its rules even further.

It described the issues this raised as follows:

— The Issue: Jersey, an offshore center for hedge funds and other alternative asset managers, will offer a “zero regulation” regime for certain funds. Will rival centers follow, to attract business with the lightest regulation?

— Why It Matters: Some politicians and regulators want more, not less, oversight of hedge funds.

— Bottom Line: Offshore financial centers are outside the purview of U.S. and European regulators, placing oversight of the funds out of reach, even if fund managers are based in financial centers like London and New York.

As the *Wall Street Journal* noted, “It is a shift that could trigger a race to the bottom amongst offshore financial centers”. This comment is almost certainly correct: it may be that Jersey was simply responding to Guernsey, which has had a system since 2004 that allows a new hedge fund to be registered in 72 hours, largely by streamlining regulatory checks.

Third, this light touch regulation extends to other activities. If no tax return has to be submitted (as is becoming increasingly common in locations where there is no corporate income tax) and if accounts do not need to be prepared or audited, consideration of how to comply with these requirements and the technical issues they might raise in other locations, such as how a tax regime might apply to an instrument or how it might be disclosed under relevant accounting rules, can simply be ignored.

Fourth, many tax havens have very lax attitudes towards the regulation of charitable activity. As noted in chapter 9, charitable trusts administered by professional trustees in offshore jurisdictions are often used to own the structures that create complex financial instruments. Without such structures being readily and cheaply available offshore many of those instruments would not be available or viable. Lax regulation in this area has, therefore, significantly contributed to this problem.

Fifth, there is another way in which offshore facilitates complexity: because so many of the complex financial instruments that are issued are structured offshore the expertise to create these instruments is now concentrated there. In saying this it is stressed, most structures will be designed in locations such as London. The expertise that offshore provides is in wrapping those structures within SPVs, trusts and other vehicles and in supplying the administrative services that ensure that the resulting SPVs comply with local regulation. This task may not be onerous: the transactions undertaken by most SPVs are of decidedly limited extent, but someone needs to make sure they are properly recorded and centres such as Cayman and Jersey that focus on this market provide that expertise through a relatively limited number of law firms. This concentration also provides cost effectiveness, which was arguably the original incentive for producing the protected cell company since this structure allowed easy repetition of complex structures for similar deals between different entities.

Finally, throughout all this, of course, non disclosure is the norm. If a structure is fraudulent (as defined above) then that is of considerable importance because it means that the ‘off balance sheet’ liabilities of the entities promoting complex financial structures can literally hide what is within them and so complete the process of deception that they are undertaking. Offshore is an essential element of this deception since the key service provided by tax havens is the “secrecy space”, without which all their other supposed advantages would be worthless.

12. *How important have the levels of Transparency and Taxation in Offshore Financial Centres been in explaining their current position in Worldwide Financial Markets?*

As was noted in the previous chapter, and has been discussed in more detail in chapter 4, the lack of transparency is vital to the offshore economy. That world is one of deliberately constructed “secrecy spaces” that are usually, in a legal sense, neither in the locations that provide the legislative structure they use or anywhere else come to that. Sometimes these creations comply with the law of the other jurisdictions on which they impact, willingly or unwittingly. As often they do not.

Without secrecy almost nothing would happen in tax havens. Low tax rates are of no benefit to the tax evader if it is obvious to their domestic tax authority that they are availing themselves of them. That is why information exchange is so heavily resisted by the providers of offshore services.

Non-disclosure of accounting information is vital to the corporate abuse of these locations, whether for legitimate or illegitimate purposes. The “legitimate” reason has been noted in the previous chapter: secrecy enables corporations to make use of complex financial instruments without being held accountable for doing

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so, not least because if such structures are used for intra-group transactions they disappear from view again when included in consolidated financial statements as issued to shareholders which only reflect transactions with genuine third parties.

Illegitimate corporate abuse of tax havens involves transfer pricing abuse and capital flight: the resistance of corporations to country-by-country reporting is based in no small part on the fear that such tax abuse would be exposed if the veneer of consolidated accounts when used in combination with tax havens was shattered using this method of reporting.

For the fraudster using such arrangements as sham trusts and nominee companies secrecy is vital, and the tax haven jurisdictions and the offshore financial centre operators based there fight tooth and nail to preserve it. This includes major UK institutions. The five UK banks whose records were disclosed to form the basis of the 2007 UK “tax amnesty” by HM Revenue & Customs fought hard in the UK’s tax commissioner system to prevent disclosure of the information they had in their system even though the evidence that doing so would assist tax evasion was overwhelming. The culture of secrecy runs deep, and at very high level.

Corruption could not take place in transparent tax havens. Crime would be harder.

Compared with secrecy low tax rates are simply the bait that attracts the customer and keeps them present once hooked. Secrecy is the essential component that makes tax haven activity possible. Without it the whole offshore charade would be shattered.

13. How do the taxation policies of Offshore Financial Centres impact on UK Tax Revenue and Policy?

If those who defend tax havens are to be believed tax havens exist to impact on UK tax and revenue policy. In the libertarian view government is an oppressor of liberty and tax havens exist to limit the role of government by placing competitive pressure on them to reduce the scope of their activity and the charge they make for it, called tax.

This is the core philosophy of the Center for Freedom and Prosperity, set up to defend tax havens against challenge form the OECD. Dan Mitchell of that organisation has said:178

Tax competition occurs when individuals can choose among jurisdictions with different levels of taxation when deciding where to work, save, and invest. This ability to avoid high-tax nations makes it more difficult for governments to enforce confiscatory tax burdens. In effect, tax competition pressures politicians to be fiscally responsible in order to attract economic activity (or to keep economic activity from fleeing to a lower-tax environment).

Tax competition promotes responsible tax policies. Lower tax rates reduce the burden of government on businesses and create an environment more conducive to entrepreneurship and economic growth. Without competition, politicians can act like monopolists, free to impose excessive tax rates without fear of consequences.

Competition between jurisdictions creates a check on this behavior. Whether this is desirable, of course, depends on one’s perspective. Those who want lower tax rates and tax reform favor competition between countries. Those who want more power for the government and higher tax rates do not like such competition.

The Tax Justice Network disagrees with the logic of these claims: indeed, TJN argues that they cannot be supported either by political economic theory or ethics. This is not least because even if the claims were right as a matter of fact most people do not have choice about where they can live: immigration policy usually restricts this for all but the most wealthy in the world and citizens of the EU. That means tax competition can only, as a matter of fact benefit the wealthiest and the capital they own. We believe it inappropriate that any policy be promoted from which this group in isolation can benefit.

As important, the economics is simply wrong. The micro-economic theory of the firm (itself open to serious questioning as to applicability in that sector) certainly cannot be extrapolated to explain the behaviour of states. The capacity to fail is integral within the micro-economics of the firm. It is the sanction for getting decisions wrong. The world cannot afford failed states. The economics cannot as such work.

Politically we also disagree: tax competition is not the appropriate constraint on government, the ballot box is. The policy promoted by the Center for Freedom and Prosperity is fundamentally anti-democratic as a result since it ignores the right of electorates to choice the tax policies they wish without external interference undermining their right.

Since tax havens are the main low tax states of the world those who promote the idea of tax competition, including the Institute of Economic Affairs in the UK,179 believe that they are at the forefront of the initiative to constrain what they see as the unwelcome tax policies of the UK and other OECD nations. In doing so they come remarkably close to endorsing tax evasion. Richard Teather, a chartered accountant and lecturer at Bournemouth University has written, when discussing the advantages of a person placing their savings offshore (emphasis added):180

In practice, however, if the investor does not report his income, then the home country can have great difficulties in discovering and taxing it, particularly if the haven country has strong banking secrecy laws.

While I am not seeking to condone dishonesty or criminal activity, from an economic perspective this is merely another example of tax competition; indeed, it is often necessary behaviour in order to take advantage of tax havens. Without the willingness of some to engage in this sort of activity, tax competition would be much less effective and therefore reduce the benefits that flow from it for the rest of us.

It is a curious benefit that can in some cases only be secured by breaking the law. Other commentators have been even more overt: Konrad Hummler, a partner of the Swiss bank Wegelin & Co., commented to Der Spiegel in May 2008 that tax evasion by his German citizens was a legitimate defence “to partially escape the current grasp of the administrators of a disastrous social welfare state and its fiscal policies. Swiss-style saving outside the system” is something that both wealthy people and small and medium sized businesses are entitled, he added, saying “These people must be protected”\(^\text{181}\)

The reality is that in practice decades of what has been described as tax competition has not resulted in a cut in overall tax rate changes in the OECD from 1998 to 2005, as the following graph shows:\(^\text{182}\)

It will be noted that the UK had seen modest growth; that overall more countries saw growth than did not, and that the OECD as a whole saw growth of tax as a proportion of GDP of 1.3%. It might be concluded that the evidence for tax competition working does not exist.

Even if that is true, and we suggest it is, this does not however end discussion of this issue. This is because whilst it is true that the overall level of tax in the UK has been under the control of the UK parliament, and the burden has risen as a result of government policy over the last decade or so, this does not represent the totality of the argument.

\(^{181}\) http://www.spiegel.de/international/business/0,1518,554284,00.html accessed 17-06-08.

\(^{182}\) Source http://www.oecd.org/document/58/0,3343,en_2649_201185_39498298_1_1_1_1,00.html accessed 10-6-08.
The reality is that the tax policy of the UK since New Labour came into office has been a carefully plotted two strand strategy.\textsuperscript{183} Proportionately over the 10 years Gordon Brown was Chancellor he raised exactly the same level of tax as proportion of GDP, to the second decimal place (38.56%), as his Conservative predecessors did in the previous decade.\textsuperscript{184} Gordon Brown succeeded in raising tax when many doubted his ability to do so. He balanced his “golden rules”. Time and again he has confounded the City and economic pundits by finding tax revenues to balance his books. And he did so whilst apparently cutting tax rates. The corporation tax rate was 33% when he came to power. It’s been 30% throughout much of his tenure. Now it is 28%. The top rate of income tax might have been constant at 40% throughout his decade in office but the basic rate has fallen from 23% to what is now 20%. Capital gains tax fell from what was typically 40% to rates as low as 10%, although that has now increased to 18%. Through all this New Labour succeeded in raising substantial amounts of tax. In absolute terms that sum amounted to £316 billion in 1997–98, increasing to over £500 billion now.

Despite this, the UK’s commitment to supporting tax havens survived under his tenure to such extent that at the close of his time in office the UK has become the most populous tax haven in the world according to an IMF study.\textsuperscript{185} It has been for enough to some to say that his contribution has been to make the UK the billionaire’s first choice of residence despite the recent changes in the domicile rule. Only three of the top 10 in the \textit{Sunday Times} rich list\textsuperscript{186} for 2007 were actually been born in the UK. The rest were likely to be non-domiciled in the UK. It is no coincidence that those featured on that list saw their wealth increase by an average of 200% over the previous 10 years in contrast with an average 120% wealth increase for the population as a whole.

The dichotomy in approach is obvious. New Labour has on the one hand been prudent and careful Chancellor, whilst being accused of running “tax haven Britain”. The position is, however, entirely reconcilable using the definition of a tax haven and OFCs offered in the introduction to this report. The dichotomy can also be explained: New Labour has not had one tax strategy for the UK. It has had two. There has been a domestic strategy and an international one, and the policies used for each have been fundamentally different. It is the domestic strategy to which New Labour has wished to draw attention: it is the international strategy that has attracted the attention of the wealthy.

The domestic strategy has been consistent. Gordon Brown, whether as Chancellor of Prime Minister, has been unambiguously political in pursuing his agenda whilst seeking to secure the revenues he needed. The early tax cuts were designed with this objective in mind. They won political favour. They were matched however, and have been matched time and again by moves to raise revenue elsewhere. That is a process that has not, despite the name attributed to it been one of stealth taxation: it’s been too explicit for any such attribution. So in early budgets there were the notorious moves to abolish advance corporation tax, which simultaneously prevented tax credit repayments to pension funds. Single windfall taxes on previously privatised utilities raised about £5 billion. Innovative financing, such as the sale of digital phone licences raised much more. Moves to raise council tax have been increasingly regressive. Later moves involved a reversal of early policy on cutting national insurance: it’s now at rates well above those he inherited. Additional national insurance charges on benefits in kind have hit employers, whilst the self employed have seen politically popular moves to encourage them to incorporate their businesses, followed by expressions of surprise that they took opportunity to do so, and subsequent reversal of the policy.

And all the while the tax planning industry sought to mitigate tax due by those whom they serve, who are clients that can afford to pay their bills. A prevailing theme of Brown’s period in office has been his attempt to beat this industry. He has scored hits despite the claim of one accountant in 2004 that,\textsuperscript{187}

No matter what legislation is in place, the accountants and lawyers will find a way around it. Rules are rules, but rules are meant to be broken.

In December 2004 he effectively closed all tax avoidance schemes that had become a feature of City bonus payments as more and more esoteric planning arrangements involving payments in such things as fine wines, carpets, currency futures and platinum sponge. Despite claims that this law was retrospective it has survived challenge. The national insurance and tax avoidance industry that featured so heavily in this sector has had to look elsewhere for business.

This action was matched by the introduction of rules requiring the disclosure of tax avoidance schemes within days of their being marketed. The scheme has worked despite continuing abuse from what the Revenue estimate\textsuperscript{188} to be less than one hundred “spivvy” tax planning boutiques. As soon as it was introduced the Revenue learned of large numbers of schemes that would have otherwise been unknown to them for years hence. The result was that over a relatively limited period the Tax Justice Network estimated that at least 40% of all new tax legislation was aimed at tackling tax avoidance.\textsuperscript{189} This makes clear with whom much of the responsibility for complex legislation lies: the tax avoidance industry generates the need for the bulk of it.

\textsuperscript{183} The commentary that forms the basis of the argument to be found here can be found in an essay by Richard Murphy at http://www.taxresearch.org.uk/Blog/2006/12/06/41-of-all-uk-tax-legislation-tackles-tax-avoidance/ accessed 10-6-08.
The disclosure scheme was updated and extended in 2006. The number of disclosures has fallen. It is generally assumed this means that the level of abusive planning, which rode the crest of a wave in the heady dot.com days and arrived in the UK from the USA, has fallen. The measures to contain it, which represent so much of Gordon Brown’s legislative legacy may lie unused on the statute book. New Labour may well be paying a price as a result. This strategy has worked, even if it’s been the cause of considerable complaint. Falling tax rates have been matched by sustained revenue for HM Treasury.

The profile of the tax paid has changed however. Between 2001 and 2007 (for which period comparable statistics are available) the proportion of income tax as a part of total tax revenue fell slightly, national insurance contributed more than 1% more of the total, the VAT contribution fell by the same amount (almost certainly as a result of fraud) whilst corporation tax revenues rose by just over 1% to a little over 11% of total tax revenues.190 This reflects the buoyancy of the economy in that period. As the proportion of profits in GDP has risen during Brown’s tenure the actual proportion of corporation tax paid as part of GDP was constant over the period.191 This can only be explained by a fall in the effective rate of corporation tax actually paid on profits as shown by the TUC report “The Missing Billions”.192 Capital gains tax receipts showed the same constancy.

The net change resulting from this activity has, however, been small. It is possible that the wealthiest 5% in society increased the tax they paid as a proportion of the total by about 1% to 24.3% over the period for which data is available whilst the bottom 25% of income earners might have seen their share of tax paid fall by 0.6% to 8.3%. Tax credits probably explain the benefit for those on the lower end of the scale. The fact is that New Labour has maintained the status quo in its domestic tax strategy. Against the challenge of the combined tax avoidance industries over a period of a decade tax has basically been consistently collected in the same way.

Remarkably, and more surprisingly given all the challenges that have arisen in the offshore economy, consistency has also been New Labour’s parallel achievement with its international tax strategy. Throughout this period the UK has stood remarkably firm. As much as New Labour has been the tax avoider’s foe in the UK it has been their friend offshore. Lip service has, of course, been paid to all these initiatives, but on occasion little more than that. The EU Code of Conduct on Business Taxation is an example. Despite holding the chair of the committee responsible for its oversight there is a widespread feeling amongst EC officials that the UK did all it could to delay implementation of this Code in the tax havens for which is responsible, persistently helped by Dawn Primarolo’s insistence on behalf of the UK Treasury that the Code related solely to business tax and would never be extended to personal tax. It was on the basis of this assurance that the Isle of Man introduced its now failed scheme to company with the code. And, of course, the UK was aware that it was subsidising the Isle of Man to allow its abusive zero/ten tax strategy. Without having a policy to promote tax haven activity it is very hard to explain why the UK has continued to sustain this arrangement, or to allows its renegotiation in 2007 without imposing any significant change, by which time average GDP per head was higher in the Isle of Man than in the UK as a whole.

Explanations can be found for why the UK government has supported its dependent tax havens. First, it was and remains vital to the UK that the EU Code of Conduct is restricted to business taxation. If it were extended to personal taxation then the UK’s domicile rules would undoubtedly fall foul of that Code. Second, domicile rules are of little use to the UK unless there are convenient nearby offshore locations in which the wealth of those persons who wish to utilise them can be recorded as being located whilst they live virtually tax free in London. As such for Labour’s policy to work the havens had to stay, and New Labour’s promise to reform their activities, made when they came into office193 have been quietly forgotten.

In combination these factors suggest that, for example, the retention of the domicile laws is symptomatic of the UK having a fundamental economic problem that can only by plugged by using tax competition to attract portfolio capital to the UK. This problem is a legacy of the Thatcher years. First the UK has given up on many of its former industries, including manufacturing. As a result it runs a perpetual trade deficit. This has to be financed and financial services do that. Second, despite the trade and current account deficits UK politicians have desired a strong independent currency to keep inflation at bay. Large inflows of external savings keep sterling buoyant, but it only stays on a tax free basis.

The dilemma this has created explains the UK’s quite deliberate obstruction to the second major EU initiative on tax, the EU Savings Directive. This was introduced to tackle the problem of tax evasion by those who seek to place their funds outside their country of residence with the intention of not declaring the income for tax in the place where they live. This is, obviously, most effective when the state in which the funds are relocated does not tax them when the interest is paid. Europe’s desire was twofold. First it was to ensure that all funds held (bar those of companies) could be attributed to the individuals who might own them, even if managed through a trust arrangement. Second, they hoped to arrange for a withholding tax when interest was paid and an information exchange arrangement between the countries in which the funds were located and the country in which the owner resided to make sure all such investment income was subjected to appropriate tax, split between the states involved.

The UK undermined this process in two ways. Firstly it led the opposition to tax withholding because of its commitment to the Euromarket, which is dependent upon interest not being deducted at source on the payments made. Second, it allowed the Directive to be negotiated with the European Commission believing that it would require information exchange on funds held in trusts. Trust law is only found in Common Law countries and as such is mainly a matter for UK concern and expertise in Europe. We have been reliably informed that only after the Directive was signed did the UK make clear that it could not apply to trusts as drafted. This both supported the significant trust business in many UK dependent territories, and especially Jersey, and created a significant loophole for those seeking not to comply with the Directive’s requirements. This is one of the defects that the EU now wishes to remedy in the Directive following the Liechtenstein revelations of 2008.

The result of this policy of supporting tax haven activity whilst maintaining the domicile rules and by itself operating as tax haven to support the over-blown presence of the City in the UK economy has meant that the UK has attracted substantial numbers of wealthy foreigners to live in the country. In its commentary on the Blair legacy the BBC noted194 that “The wealthiest Britons have become far wealthier in the past 10 years, something which critics attribute to non-domicile tax concessions favouring the rich”. This policy has not been benign as the domicile debate of 2007 made all too evident.

The conclusions are clear. Gordon Brown has achieved his objectives. He has raised the tax he has needed, but in doing so he has had to be tough. He would not have needed to be so tough on tax avoidance if he was not simultaneously promoting tax avoidance; the obvious folly of which was shown by the 2007 “tax amnesty” for those UK tax residents who had not declared income on their offshore bank accounts; accounts on which they may well have had no tax liability if they had been living in the UK as a non-domiciled person. The credit crisis, the crisis of the domicile rule, the private equity crisis, the capital gains crisis and most of the other tax problems of the last year can be laid at the door of this policy.

So too can the crisis in corporation tax taking place in 2008. The UK pursued a policy of having an open door to all comers who wished to use its generous corporation tax regime. When it became apparent as the economic down-turn began that those used to not paying UK tax (and as research has shown, most of those protesting have not been used to paying UK tax)195 might leave the government panicked and set up a committee to investigate the competitiveness of the UK tax environment. When doing so it only invited big business to take part.196 The inference was clear: competitiveness within the UK economy did not matter; the creation of a level playing field on which all UK business could fairly compete one with another did not matter, all that was of concern was the UK’s status as a tax haven.

It is against the background of this policy, set in the political philosophy of tax competition that the Prime Minister appears to have embraced, that the comments that follow on the impact of tax haven policies on the UK are made.

The UK operates a policy that makes it very much easier for UK based publicly owned companies to operate offshore than it is for UK privately owned companies and individuals. For example, recently disclosed tax haven operations by Tesco197 were legal when created. They would almost certainly not have been if created by either a private limited company in the UK or a UK resident and domiciled person. The impact of tax havens has in this way created a two tier economy in the UK made up of some companies who may use a wider range of tax avoidance techniques than others. There can be no doubt that the increasing willingness of large companies in the UK to use these schemes has contributed to the 5% fall in the effective tax rates of the largest 50 companies quoted on the UK stock exchange over the period 2000 to 2006 as shown here:198

194 http://news.bbc.co.uk/1/hi/business/6641759.stm accessed 11-6-08.
195 http://www.taxresearch.org.uk/Blog/2008/05/20/britains-big-companies-arent-paying-tax/ accessed 12-6-08.
196 http://business.timesonline.co.uk/tol/business/money/tax/article3842529.ece accessed 12-6-08.
198 http://www.tuc.org.uk/touchstone/Missingbillions/1missingbillions.pdf accessed 16-6-08.
The difficulty of controlling this trend has been all too apparent. The EU’s rules on capital mobility were, in particular, used for a long period to undermine any attempt by national governments within the EU to control the haemorrhaging of their own tax base. This issue has now been addressed by the European Court of Justice which has reversed this trend in its own decision making, but the test case on the UK’s controlled foreign company (CFC) rules brought by Cadbury Schweppes has left the situation ambiguous.199

The EU has ruled that these rules cannot be used if it can be shown by objective factors, which are ascertainable by third parties, that the subsidiary company established outside the UK is actually established in the overseas jurisdiction (which means it really is managed there) and carries on genuine economic activities there. In the latter case even if there is a tax motive in setting up the CFC company overseas this should not, of itself, be sufficient to bring it within the UK’s CFC regime. The difficulty that remains lies, however, with proving what are genuine economic activities, and the issues relating to this have given rise to the current problems for HM Revenue & Customs in determining just how to tax foreign profits. In effect this issue resolves around the question “when is a company in a tax haven for the sole purpose of avoiding tax, or not?” The impact of the issue is so significant that some companies (albeit ones that pay little or no tax at present in the UK) have threatened to leave for Ireland.200

Despite the evidence of both abuse, tax lost, attempts being made to mitigate this and high profile dissent to such behaviour, the thing that is remarkably absent from this debate is evidence. Except for the TUC data, noted above, which suggests that major UK corporations seriously underpay tax when compared with the rate at which they are expected to pay, amounting to approximately £12 billion a year, or approximately a quarter of the actual total corporation tax yield, it is almost impossible to say what the cost of tax haven practice is to the UK for the corporate sector. There is one reason for this. Companies do not publish the information in their accounts to allow this data to be compiled.

Although companies are required to reconcile their declared tax liabilities with those that might be due at the UK’s statutory tax rate almost none declare any impact of tax haven activity when doing so (GlaxoSmithKline being an exception). Few acknowledge differing tax rates as even having any impact, and those that do on average, and paradoxically, note that this has the consequence of increasing, and not reducing their tax rate. And yet it is abundantly clear that companies do use tax havens and do so, at least in part, to reduce their tax rate. What is obvious as a result is that the reporting of companies in this area is wholly insufficient to enable their shareholders, stakeholders or governments to determine what is happening, and we recommend changes in accounting disclosure in this report so that this defect can be remedied.

In the area of personal taxation it is easier to measure the impact. It has been argued that the domicile rule costs the UK at last £4 billion a year.201 Since the changes made in 2008 are expected to raise less than £1 billion it is reasonable to presume that there is a remaining cost of at least £3 billion.

The Tax Justice Network has argued that in total the cost to the government’s of the world from private wealth held offshore is not less than US$255 billion per annum (£130 billion).202 Since this is based on data now five years out of date this is likely to be higher now. It is not possible to say with certainty how much

200 http://business.timesonline.co.uk/tol/business/money/tax/article4045464.ece accessed 16-6-08.
of this is attributable to the UK. However, in 2005 some 448,000 UK residents were considered high net-
worth individuals (HNWI) by the World Wealth Report,\(^{203}\) some 5.1% of the world total. Assuming equal
distribution of HNWI wealth and income then the loss to the UK might be about £6.7 billion a year from
this group alone. This probably seriously understates the loss from this group because London has attracted
a very large population of ultra-HNWIs, being those with considerable wealth plus the means to avoid tax legally.

Both this figure and that for the domicile rule (with which it will partly overlap) suggest that tax avoidance
using offshore imposes a substantial cost for the UK amounting to many billions a year.

Tax evasion imposes a much bigger cost to the UK. The Missing Billions, published by the TUC, suggested the cost of personal tax avoidance in the UK amounted to at least £13 billion a year. Our current estimate of tax evaded is not less than £70 billion a year. Of this a significant part happens through offshore as a result of:

- Hidden investment income, of which the 2007 “tax amnesty” only scratched the surface for a number of reasons.
- Undeclared earnings invoiced from shell companies in tax havens, the value of which is very hard to estimate but is considered substantial.
- Corruption, where bribes and the proceeds of fraud are hidden offshore, often disguised as “consulting income”.
- Tax fraud, such as carousel fraud.
- Transfer pricing abuse and re-invoicing fraud, to which the UK as a major trading nation will undoubtedly be vulnerable.
- Insider dealing and other City based frauds operated through offshore accounts, to whom many in financial institutions have easy access.
- VAT abuse, for example from such activity as yacht registration in tax havens.

The list could be continued. We believe that if the cost of tax evasion is more than five times that of tax avoidance in the UK then it is likely that the cost of offshore tax evasion is likely to exceed £20 billion per annum.

We cannot prove this. What is surprising is that HM Treasury has not sought to do so. We would urge the Select Committee to ask them to do so. An informed basis for this work seems essential if this problem is to be tackled, and resources are to be appropriately allocated to dealing with it.

If it were appropriately tackled then we believe that there could be a substantial change in the direction of UK domestic tax policy, as noted above. It is the pressure to broaden the tax base that has led to accusations of “stealth taxation”, which, whilst not accurately described is indicative of what has happened. It is the consequence of seeking to give apparent tax concessions within a limited palette of opportunity because of the constraint of both being a tax haven and refusing to tackle tax haven abuse that has led to such poor policy choices as introducing and then abolishing the 10p tax rate, and introducing and then abolishing the 0% tax rate for small companies. Both of these measures have spectacularly backfired and given rise to significant additional complication in the tax system.

Only by accepting, and changing the UK’s role as a tax haven, and its policy towards tax havens can a domestic focus be reintroduced to tax policy for the benefit of the people of the UK. That is currently the major challenge for UK tax policy.

14. Are British Overseas Territories and Crown Dependencies well regarded as Offshore Financial Centres, both in comparison to their peers and international standards?

It is apparent from the report of the National Audit Office on the British Overseas Territories in November 2007 that those territories and the Crown Dependencies cannot be treated as a homogenous unit when answering the question.

Anguilla and Montserrat are at the very lowest level of the tax haven hierarchy. They have almost non-
functioning regulation. The quality of the OFCs operating from them is very low. It is the lowest quality of offshore transaction that uses places with high reputational risk. The Turks & Caicos are probably in the same league, being closely associated by many with high risk transactions, as is noted elsewhere in this report. These places are treated in low regard.

The British Virgin Islands are probably treated only a little better. It is true that the quality of the OFC operating from the BVI may be slightly higher than in the first three mentioned places, but that is almost certainly due to volume of demand due to lax regulation. So low is that regulation that when officials in the BVI were interviewed by the author of this report in April 2008 concerning the extraordinary number of private companies that it is claimed are registered in those islands\(^ {204}\) it was admitted that the published

\(^{203}\) http://www.ml.com/media/67216.pdf accessed 17-6-08.
statistic is itself of doubtful quality. It represents the total number of registrations in the last decade. The BVI has no real idea of how many of these are actually really in operation still, giving some indication of the quality of its own administration, and further indication of its limited capacity to regulate anyone else.

What is known, and is recognised by those in the BVI, is that much of their business relates to China and there can be little doubt that much of this is “round tripping”, involving the reinvestment of capital flight funds illegally exported from that country as if it were foreign direct investment. Since this, by definition, involves evasion of regulation there can be little doubt that the quality of regulation and reporting within the BVI is low. This might be part of its attraction, joining it with those territories already mentioned.

Bermuda and the Cayman Islands have higher standards of regulatory compliance than the first four territories mentioned, and the NAO found evidence of this. Both are widely used by the American financial markets to which they primarily sell their services. For this reason their banking compliance is believed by the NAO to be good. Both have lapses elsewhere in their regulatory regimes and it is apparent from other matters reported on by the NAO that the standard of civil administration in Bermuda is very poor, many of its own accounts, for example, being several years out of date. There is little or no chance of a territory unable to keep its own accounts in order being able to regulate a financial market.

The consequence has been graphically shown of late. In May 2008 the EU issued a list of territories deemed to have equivalent regulatory standards to the UK with regard to client identification and other procedures meant to tackle money laundering activities.209 Inclusion on the list meant a territory has been deemed to have satisfactory controls against money-laundering. As the Daily Telegraph noted,208 Jersey, Guernsey and the Isle of Man plus Gibraltar were in effect placed by the EU on an “intermediate” list of financial centres which ‘may’ meet compliance regulations whilst the British Overseas Territories including the Cayman Islands and British Virgin Islands have been excluded altogether, meaning they are effectively blacklisted.

The ranking appears appropriate based on the available evidence, and that supplied by the NAO. The Crown Dependencies do have better apparent compliance with regulation than do Bermuda and Cayman. In part this is because of support provided to them by the UK, including the loan of significant numbers of staff (it is believed at least eight members of staff were loaned by the UK to Jersey in 2007 to deal with money laundering related issues). However, despite the protests of such places it is impossible to believe that their standards are as good as those in the UK and some of the other countries listed, even if that list does include Russia. That is because of the nature of small island life. As the NAO reports, reporting of suspicious activity is at the heart of anti-money laundering arrangements but at least in the smaller financial centres, the number of reports is so low as to indicate that some financial institutions either do not know or monitor their customers sufficiently or are unaware of their obligations to report.207 But this need not necessarily be the explanation in small islands where the civil servant regulator is relatively lowly paid, is regarded as coming from a lower social order than those they regulate, and has much less influence in the local community than the much richer financial services operators who will have the ear of government more readily than the civil servant will. This is true of all the territories being considered here, it is just most exaggerated in places like Montserrat. The reality is that in very small communities elites are virtually ungovernable and all these locations suffer badly from the existence of both financial elites and political elites, many of whom will overlap, at least in social circles. Nowhere has the impact of such elites been more graphically demonstrated in the last year than in Jersey. The latest crisis to hit the Island, during early June caused one opposition senator on the island to say208 that there was an entrenched ruling clique who were “out of control, deficient and undisciplined”. There may be political hyperbole in his claim, but the evidence is on his side, as it is on the side of commentators in Cayman who make the same sort of observation.209

The conclusions reached are clear: some of the locations are little better than out of control. Regulation in Cayman and Bermuda is wholly deficient for the volume of business they handle. Cayman being considered the fifth largest banking centre in the world, a fact that evidence published in the last month suggests plausible.210 Gibraltar is widely perceived as remaining inadequately regulated and liable to attract low end business. Whilst things are perceived as being better in the Crown Dependencies the standards of regulation in these places are low, and the quality of reporting of suspicious transactions is indicative of serious deficiency in both standards and attitudes. This being the case, the NAO was justified in saying in its own report that:

Contingent liabilities [for the UK] are not a hypothetical risk in financial services. Regulators worldwide are open to legal challenge for their actions or inaction, if such actions can be shown to be in bad faith. The victims of a crime or a financial collapse that can, in part, be attributable to weak oversight may seek financial compensation on the grounds that the authorities in the Overseas Territories knew about the weaknesses and failed to address them. The costs of such actions could be high, and would fall directly to the UK in jurisdictions such as Anguilla,
Montserrat and the Turks and Caicos Island, where the Governor retains direct responsibility for regulation of international finance. In the wealthier Territories, responsibility for the financial services sector lies with the Territory government but the UK could still face reputational impacts, and, in a worst-case scenario, be called to provide aid should the sector collapse. To date, no regulator in a UK Overseas Territory has been successfully sued, and currently their regulators express confidence of being able to defend any known disputes with complainants which might reach the courts.

So far short of international standards are all these places that this risk is real, and is likely to grow in an economic downturn. The UK has to accept its responsibility for a situation that it has allowed to develop by taking action to remedy the defects. In most cases this will mean that the financial services activity in these locations will have to stop. Effective regulation is almost impossible in small island communities which are liable to political capture by dominant industries and their local cheerleaders.

Perhaps a word should go to a pro-tax haven commentator. Bob Bauman was once a Republican Congressman in the USA and now writes for the Sovereign Society that staunchly defends tax havens. He said in his blog dated 6 May 2008 that:

Because these islands are under ultimate control of the United Kingdom, they lack the greater privacy and freedom to act that independent tax havens, such as Panama, Singapore, Hong Kong or even Switzerland, enjoy.

Five years ago I wrote: “As long as the British Labour government continues in power, you can expect it will continue its unrelenting efforts to curb tax and asset havens, including those under its colonial domination.”

So this latest announcement from the House of Commons Committee is just another skirmish in a decade-long war against British financial privacy and freedom.

And if you are interested in using these jurisdictions as a base of offshore activity, you may be wise to wait for the outcome of the British parliamentary elections due within the next two years. In the meantime, if you’re shopping for a place to set up your business, or invest globally, I would look outside the United Kingdom’s rule.

All of which suggests that these places are neither one thing or another: neither bad enough to attract rogue business or good enough to compete in a global market where only the highest standards of transparency and regulation will eventually be allowed. It is why they will, almost inevitably, fail in the foreseeable future. But in that case an editorial in the Cayman NetNews of 11 June 2008 is most telling. It said:

Joel Slemrod, a tax economist at the University of Michigan Business School, sees tax havens as “clearly a bad thing”. They enable many small island nations to “commercialise” their sovereignty at the expense of mostly industrial nations, he says. Tax havens have given tiny nations a lucrative job-creating business and, once again, the Cayman Islands is referred to as having 5,400 financial-services employees.

This is an issue that we regularly raise for debate but very few people in either public or private sectors seem to acknowledge that the writing is on the wall (and has been for some time) as to the direction that Cayman’s traditional offshore industry seems to be heading.

One local attorney, Stephen Hall-Jones, did take up the issue recently in a letter to the editor and he made some very valid observations, including the telling point that he used to believe that there was no moral obligation on the part of any country to impose direct taxation of any kind, which largely coincides with the view expressed as recently as this year by the Chairman of the Cayman Islands Monetary Authority, Tim Ridley, that paying tax is not a moral obligation.

However, Mr Hall-Jones now believes that an independent democratic country may owe a moral obligation to the wider international democracy that goes “beyond simply applying its own domestic choice in its internal fiscal philosophy.”

It seems to us that Mr Hall-Jones’ conversion on this issue may reflect a growing global consensus and one that is not especially favourable to our financial sector. He echoed a message long promoted by us that a “head-in-the-sand” approach is not the solution, and expressed the hope that “someone is prepared to give us an honest answer.”

Thus far, that hope remains unfulfilled so far as we are aware and, in our experience of arguing for the same thing, is unlikely to be addressed any time soon in the typically reactive environment of public sector management and administration in the Cayman Islands.

However, it still seems to us that the looming problems in this respect are not going away but getting potentially weightier with each new media report and official or political murmurings in the more highly-taxed jurisdictions.

211 http://baumanblog.sovereignsociety.com/2008/05/the-brit-haven.html accessed 16-6-08.
Ev 92  Treasury Committee: Evidence

It would be nice to think that there might be a contingency plan should our financial services industry suffer a devastating blow, but there is no evidence that one exists. Of course, each financial institution that transacts offshore business of any kind here has its own such contingency plan, but that will involve them bailing out of Cayman rather than sticking around to offer or be part of any solution.

The problems that appear to be looming for the financial sector are just some of the severe economic pressures that the county is facing. We hope that more voices of comprehension and reason will soon be heard in order to stimulate a real and effective national debate on these issues.

When some in the tax havens doubt their own credibility or place in the world, let alone the quality of the regulation they impose there is sign of real change coming. The UK has a duty to participate in that debate.

15. To what extent have Offshore Financial Centres ensured that they cannot be used in Terrorist Financing?

There is only one realistic answer to this question, and that is that no one knows.

There can be no doubt that the world’s tax havens have been doing what has been asked of them by the Financial Action Task Force to put in place legislation that is supposed to assist the tracing of terrorist funds.

There can equally be no doubt that in some cases this implementation has not, at least as yet, resulted in an effective regulatory regime existing on paper. Evidence from the National Audit office report on the British Overseas Territories, noted in the introductory chapters and published in November 2007 shows this to be the case.

That data on weaknesses of the sort they catalogue is widely available meaning that the whereabouts of ineffective regimes is also known means that anyone seriously seeking to launder funds of any sort can easily find locations where this is relatively easy to undertake because of the weakness of effective regulatory regimes.

This fact is facilitated by two further factors. The first is that terrorist financing is probably by far the smallest component of all international money laundering, and so exceptionally difficult to differentiate from any other flows.

The second is that it is believed that the 9/11 attacks cost somewhere between $400,000 and $500,000 to execute. This sum is so small it could have been laundered using credit cards. As has been noted in the introductory chapters, both the major credit card networks (Visa and MasterCard) supply anonymous credit cards from operations based in some of the least regulated tax havens (such as the Turks & Caicos Islands), the ownership of which is almost impossible to track. Whilst commercial organisations of this sort, both quoted on the US stock exchange show such indifference to the risk of money laundering by licensing the use of their products in this way it is very difficult to see how any effective measures against terrorist financing can be launched anywhere.

As a result it can be reasonably concluded that there are no effective mechanisms for dealing with the regulation of terrorist finance in tax havens or amongst the OFCs that operate from them, and that some operating in the latter sector would appear to show indifference to this issue because the mechanisms they supply for their own commercial benefit can easily be exploited for money laundering of the sums required to launch serious terrorist attacks.

16. What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?

Treasury policy is massively influenced by two things. The first is that London is a tax haven and the biggest OFC in the world, which has arisen as a result of deliberate policy decisions taken by the UK. The second is that the UK is responsible for some of the biggest tax havens in the world, and as we have also shown this is also the consequence of UK government policy.

The Treasury is constrained by these two factors when considering (as we have also shown) taxation policy, regulation policy, relationships with the EU, international relations in general and the relationship between the UK taxpayer and their government.

The need for our government to raise funds through tax havens to fund UK trade deficits has created an open economy from which capital can leave as easily as it can arrive.

The problem for the UK now is to resolve the dilemma that this policy has left us with. In particular, we have to decide whether to compete on tax rates, or tax base. If we do not decide on one or the other then we will, inevitably lose tax sovereignty. Anyone who fights on two fronts at once, with a policy of gradual withdrawal on both, inevitably ends up losing. And yet that is the policy we are pursuing. This must change or the principle of sovereignty will be one not worth maintaining: there will be no tax revenue to collect from those with the capacity to remove income from the UK.

The same is true of regulation. It is apparent that there is a current need to re-regulate the financial markets. But being a tax haven the UK has maintained a “light touch” regulation regime. The consequence has been obvious. The sub-prime crisis might be a US phenomenon but the impact is being more heavily felt in London than New York. The US has supposedly lost from its tighter regulation environment introduced after the offshore abuse of Enron, and yet it has proved relatively effective. It is British banks that have the CDOs and SPV on their balance sheets that have led to massive banking losses. These “assets” were created offshore, often in British jurisdictions, and we are paying the price for that.

We pay a similar price for losses in the domestic economy from the abuse of company law; law that allows hundreds of thousands of companies to be struck off the register of companies each year without ever paying tax, without ever filing accounts and in many cease leaving creditors in their wake with no chance of making a claim for the money they are owed. This is the real cost of the race to the bottom in company regulation, in which the UK plays a part, even having a ministry dedicated to the role at present.214 This reflects the impact of tax havens but the cost is borne by each and every person who loses from the abuse of incorporated status that follows from it. We do not promote regulation for its own sake; we do to protect the vulnerable. When companies are deregulated it is always the vulnerable who suffer: limited liability is a privilege that is always open to abuse. The UK has turned this into an art form at a cost to our own population and to the people of the developing world.

This is also the case with regard to our policy on corruption. We have stood by as tax havens are used to facilitate corruption215 and have not taken action to stop the problem at source. Our international standing has suffered as a result. The standing of government has suffered as a result. This is a tax haven issue, and we have not addressed it.

Most of all this is an issue for development. We have shown in this report that tax havens impose massive cost and cause deaths in the developing world. Others have done the same.216 The duality of this approach when we are also strong supporters of development makes the stand even more perverse, and utterly illogical. Facilitating one of the means from which it is accepted that developing countries are suffering badly when lending them support makes no sense.

In fact, none of these policies make sense now, if they ever did. The only welcome thing to note is that the mood of many is now changing, and that the opportunity for change exists. To quote from two commentators hardly noted for their radical positions, both writing in the Financial Times in May:

Financial regulation is only one example of where the mantra of needing to be “internationally competitive” has been invoked too often as a reason to cut back on regulation. There has not been enough serious consideration of the alternative—global co-operation to raise standards.217 and:

regulation will need to be radically reconsidered, unless, as Mr Volker218 points out, we are comfortable with a substantial financial crisis every five years or so. However great the lobbying power of the financial sector, it will surely be unable to preserve a licence to commit havoc on such a scale, particularly when, as he also remarks, “it is hard to argue that the new system has brought exceptional benefits to the economy generally”.219

We believe both these true: we believe as a result that the current incoherent policies of the Treasury arising from the UK’s role as a tax haven need to be reformed. We believe substantial harm could be remedied as a result. We have laid out what we thinks need be done in our recommendations in chapter 19 of this report.

But we also find ourselves in agreement with this comment from Martin Wolf, made on 26 May 2008:

I agree that the present ability of corporations to shift income into tax havens is intolerable. But tax competition among countries must still be allowed. If Ireland wants lower taxes on its residents than the UK does, that is a sovereign choice. If some British residents move to Ireland in response, so be it.220

Sovereign choice must exist in the world of tax. What must end is the choice of sovereign states and related microstates to use that power to undermine the right of other states to exercise their national sovereignty in the area of tax and regulation, which is the only raison d’être lor tax havens.

This the new direction in which the Treasury needs to travel. It means rejection of the tax haven and OFC model it helped create and which it has embraced since 1957, at least. But there has never been a better time for that change to happen, there has never been more evidence of the benefits that will arise from doing so, and there has never been a greater need for it to happen.

We happen to believe it is possible as well, which helps.

214 Department for Business, Enterprise and Regulatory Reform.
217 Larry Summers writing in the FT 5.5.08 http://www.ft.com/cms/s/0/999160e6-1a03-11dd-ba02-0000779fd2ac.html accessed 17-6-08.
219 Martin Wolf writing in the FT 6.5.08 http://www.ft.com/cms/s/0/52bbf0f8-1bb8-11dd-9e58-0000779fd2ac.html accessed 17-6-08.
17. What has been and is the extent and effect of Double Taxation Treaty abuse within Offshore Financial Centres?

It is important to note that most places conventionally thought of as tax havens are not party to Double Tax Treaties (DTAs). This particularly applies to micro-states such as the British Overseas Territories and Crown Dependencies. They have Tax Information Exchange Agreements, at best.

There are, however, some tax havens where the abuse of DTAs forms a major part of their activity. These include some micro-states. For example, the Netherlands Antilles based much of its economic development strategy on its DTA with the USA, for which it acted as a conduit for a number of years until such time as the benefits of this treaty were largely negated as result of changes in US legislation.

The “conduit” role is very important and is a major role of the havens involved, which include:

— The Netherlands
— Switzerland
— Belgium
— The UK
— Cyprus
— Malta
— Luxembourg
— Mauritius
— Netherlands Antilles
— Barbados

This list is meant to be indicative, and is not complete.

The role of the conduit is almost always dependent upon the existence of favourable DTAs and tax arrangements that are very often specially constructed by the tax haven to exploit those treaties.

Some conduits are used to access trading markets. An example from outside the UK might be found in the Canada—Barbados DTA. If a Canadian parent company opens a Barbados company to undertake its global sales operation outside of Canada then the Barbados company only pays 2.5% taxes on profits recorded there and can return 97.5% of its income to Canada as a dividend, tax free. The Canadian company can then pay the resulting income it receives on to its shareholders without incurring any additional tax charge because of the foreign dividend exemption that applies in Canada for “active income” of this sort, so reducing its tax on this profit from this activity to 2.5% in total in Canada for an activity which may well be only very notionally located in Barbados. This sort of abuse is of the type the UK has sought to avoid when considering anti-avoidance measures when planning to exempt foreign dividends from tax in the UK. If it does not do so similar abuses will occur in the UK.

Other conduits are used for the purposes of investment. An example in this case might be the India—Mauritius DTA. This DTA has caused considerable controversy and is currently under renegotiation because Mauritius has been widely used by foreign investors to route their investments into India. Mauritius does not tax capital gains on the resulting investments recorded as arising in that country, while the corporate tax liability does not usually exceed 4%. About 40% of the $45-50 billion Foreign Direct Investment that came into India from 1991 to 2006 was routed through Mauritius. A similar percentage of Foreign Institutional Investment inflows into India are also from Mauritius, but most worrying of all is the incidence of “round tripping” and “treaty shopping” by investors. In round tripping, Indians bring their tax evaded money back into the country via Mauritian shell companies whilst in treaty shopping, foreign investors route their investment into India via Mauritius to save tax. The Indian government had estimated a revenue loss of over Rs50 billion (£600 million) caused by treaty shopping. It has offered Mauritius aid of Rs 5 billion (£60 million) to persuade it to remove clauses in the agreement giving rise to this loss. This gives some indication of the value of these arrangements, and the cost they impose. It also suggests a direct and quite possibly appropriate course of action for ending this abuse.

There are other examples of the impact of tax havens on development. For example, when Global Witness investigated the investment Mittal Steel made in Liberia it found that it had used this structure.

A Netherlands subsidiary of the holding company invested in turn through another holding company in Switzerland which in turn owned a holding company in Cyprus that owned the licence to operate in Liberia but which in turn licenced it to an operating company based in Liberia.

The structure was tax driven. The Liberian company enjoyed considerable tax advantages in that state, including a considerable tax holiday. This meant that it would have normally given rise to a full tax charge in the Netherlands if it had remitted profits straight to that country, because the usual treaty arrangement with the Netherlands which exempts dividends received in that country from tax does not apply if the profits giving rise to the income were not taxed in accordance with the usual tax regime of the country in which they arose, as would have been the case here.

Routing them through Cyprus and Zug overcame this problem even though both were passive and entirely nominal participants in the arrangement. Cyprus would charge all income from Liberia to tax on any dividend received, but at a maximum rate of tax of 10%, the lowest in the EU, which makes it an ideal conduit for receiving income from such locations into the EU environment. Zug might have charged an income stream from Cyprus to tax except for the fact that its tax rate would have been lower, at between 6 and 8%, so it was neutral in this deal, but had a better double tax treaty with the Netherlands for ensuring that the income stream was not tracked back to a source not properly taxed. Because of its own “participation exemption” the Netherlands would then treat the dividend as passive income in that country and so tax it at, at most 5%, except because it had already suffered tax in the EU at 10% in Cyprus even this might be waived. The result was that the tax holiday granted by Liberia was translated by the structure used into an effective overall very low rate of tax for Mittal Steel. The use of these arrangements does, therefore, contribute significantly to the fiscal degradation of developing countries.

That treaty shopping is rampant is obvious from other evidence. UNCTAD’s Inward FDI Performance Index for 2004–06 shows the following:\(^\text{224}\)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Economy</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Luxembourg</td>
<td>17,476</td>
</tr>
<tr>
<td>2</td>
<td>Hong Kong, China</td>
<td>9,630</td>
</tr>
<tr>
<td>3</td>
<td>Suriname</td>
<td>9,454</td>
</tr>
<tr>
<td>4</td>
<td>Iceland</td>
<td>7,715</td>
</tr>
<tr>
<td>5</td>
<td>Singapore</td>
<td>7,622</td>
</tr>
<tr>
<td>6</td>
<td>Malta</td>
<td>7,401</td>
</tr>
<tr>
<td>7</td>
<td>Blgaria</td>
<td>7,000</td>
</tr>
<tr>
<td>8</td>
<td>Jordan</td>
<td>6,357</td>
</tr>
<tr>
<td>9</td>
<td>Estonia</td>
<td>6,288</td>
</tr>
<tr>
<td>10</td>
<td>Belgium</td>
<td>6,122</td>
</tr>
</tbody>
</table>


It is obvious that Luxembourg is not the biggest recipient of FDI in the world. It has only 486,000 people.\textsuperscript{\textcopyright} It is being sued as a conduit. The same is almost certainly also true of Hong Kong, Iceland, Singapore, Malta, Estonia and Belgium in this list. Each offers mechanisms to encourage investment through them, not in them, and tax treaty shopping is part of this.

The evidence from this limited range of case studies is clear: DTA shopping is rampant and has significant impact on the way in which world trade is structured. This imposes real costs on governments, and most especially on those of the developing countries of the world.

18. \textit{To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK Taxation?}

The tax havens that do most business with the UK are, without doubt, those over which it has greatest influence, including in particular those in the Crown Dependencies and the British Overseas Territories.

As is noted in the introductory chapters of this report, the National Audit Office of the UK reported in November 2007 with regard to the British Overseas Territories that:\textsuperscript{\textcopyright}

Progress has been made in developing the Regulation of Offshore Financial Services, though the four larger offshore financial centres are leaving in their wake the weaker regulatory capability of the three smaller centres where the UK retains most direct responsibility. The main challenge across all Territories is to respond adequately to growing pressures to reinforce defences against money laundering and terrorist financing.

As the evidence, also noted in the introductory chapters shows, they are in practice struggling to comply with legislative requirements in most territories, do not have the resources to investigate the suspicious transaction reports they receive, which are pitiful in number, and concentrate solely (as the above paragraph does) on money laundering and terrorist financing. It is very unlikely that any assistance is provided to the UK in tackling either evasion or avoidance from these locations.

The situation in the Crown Dependencies is supposedly a little better. However, this may in no small part be because significant numbers of their investigating officers are on secondment to them from UK authorities. Nonetheless the emphasis remains on drugs money laundering and terrorist financing: awareness that tax evasion is defined as money laundering appears very low either due to ignorance (despite the money laundering manuals of Jersey, for example stating that is the case) or because of a wilful desire to turn a blind eye to the issue: largely because those who should be reporting on tax evasion are largely dependent on fee income from this activity.

The revelation that more than 60,000 people held bank accounts with just the five main UK high street banks in the Crown Dependencies on which they had evaded tax makes this amply clear. These were declared under the term of the “tax amnesty” offered by HM Revenue & Customs in 2007. More than 45,000 of these people made tax settlements and more than £400 million in tax was paid.\textsuperscript{\textcopyright}

The banks in question, all of which are household names claimed that this was not their responsibility. They relied upon the argument, also recently used by the Swiss Bankers Association to defend its actions, that what their customers did with their bank accounts was not the banks concern.

In this case that was not true. Prior to the introduction of the EU Savings Tax Directive in July 2005 the banks in question would have been required to write to every one of these customers to ask them if they wished for tax to be withheld on interest paid to their account of for information exchange to take place. Presumably, and because these account holders had to make declaration under the ‘tax amnesty’ they all opted for tax to be withheld.

The moment the banks in question received a request for the withholding tax option they should have reported their suspicion that the account in question might have contained funds that had been money laundered to the relevant financial services authority in each of the jurisdictions in question. This is because any reasonable person knowing that a person receiving income in the UK on which it was likely that they had a tax liability but who did not wish it to be declared to the UK tax authorities must have had suspicion that this was because tax evasion was taking place. The only requirement for making a report is that there is suspicion that money laundering (in this case in the form of tax evasion) is taking place. There is no duty to report that it is: that is not the banker’s job, they must merely report suspicion.

What we know without doubt is that in 2006 such suspicions were not reported. Tax evasion would be criminal money laundering. Not a single report of criminal money laundering was made to authorities in Jersey in 2006, as noted in the introductory chapters. This means that all these banks ignored their duty to report. They also fought to prevent disclosure of the data they held in the UK.

\textsuperscript{\textcopyright} https://www.cia.gov/library/publications/the-world-factbook/print/lu.html accessed 13-6-08.
\textsuperscript{\textcopyright} http://www.nao.org.uk/publications/nao_reports/07-08/07084.pdf accessed 13-6-08.
\textsuperscript{\textcopyright} http://business.timesonline.co.uk/tol/business/money/tax/article3008168.ece accessed 13-6-08.
The conclusion is simple: tax havens and the OFC operators based in them do not appear to investigate businesses and individuals that appear to be evading UK taxation. Worse, they deny that it is their duty to do so even though it is abundantly clear that under all money laundering regulation the contrary is the case.

There would appear to be willful and deliberate neglect of this obligation in OFCs based on the evidence noted here.

19. Conclusions and Recommendations

“There is a strong economic and social case for strong co-operation and exchange of information between Governments and tax authorities around the globe, and particularly within the EU, in order to meet the challenges being posed by globalisation, not just for economies as a whole, but also specifically for national tax systems.”


This report has sought to achieve four objectives:
1. To explain what tax havens and offshore financial centres are.
2. To explain how these places work, and what their impact is.
3. To relate the findings in these first two sections to the questions raised by the Treasury Committee in its call for evidence dated 30 April 2008.228
4. To offer recommendation on how the UK might tackle the issues that have been referred to.

This chapter deals with the last of these four objectives.

We do not consider tax havens and OFCs to be the same thing. Indeed, whilst it is clear that the two are related one to the other they have entirely different characteristics. Tax havens are places with the capacity to create legislation designed to assist a person to avoid the regulatory obligations imposed upon them in the place where they undertake the substance of their economic transactions. In other words, tax havens deliberately create legal structures, whether they be companies, trusts or other arrangements that have little or no benefit for those resident within their own domains (and might even be denied to those so resident) but which can be exploited by those resident elsewhere, legally or illegally, to avoid obligations placed upon them by the law of the places where they live or undertake their economic activities.

Offshore Financial Centres are the commercial communities hosted by tax havens which exploit the structures that can be created using that tax haven’s legislation for the benefit of those resident elsewhere. In other words, the offshore financial centre is made up of the accountants, lawyers, bankers and their associated trust companies who sell services to those wishing to exploit the mechanisms the tax haven has created.

It is immediately obvious that these are not the same thing. The tax haven is fixed geographically and has loyalty to a place. The OFC community is highly mobile, often works in many tax havens simultaneously, and serves a mobile client base who can relocate globally. As we have shown, the last thing that this community has in a commitment to a geographic space: indeed, developments in its activities over the last decade have shown that its commitment is to securing for its clients the ultimate goal of the tax avoider, which is to be “nowhere” for regulatory purposes and therefore beyond the scope of the law, whether that law relates to tax or other matters.

As we have shown, this is possible. The result is that it is possible to create “secrecy spaces” in which transactions take place that are effectively unregulated by the global financial system. This possibility poses a fundamental threat to the stability of that system. It also challenges the ability of governments to collect the tax due to them. Most seriously, in our opinion, these structures permit the capital flight that is fundamentally undermining development efforts in the poorer nations. This capital flight represents the biggest flow of funds from the poorest people in the world to the richest people in the world and from the poorest nations in the world to the richest nations in the world since time began. This capital flight is estimated to be at least US$600 billion a year at present, and might be as high as US$1 trillion.229 Sixty or more percent of this might arise as the result of commercial exploitation of developing countries and their tax systems by multinational corporations: 30% might relate to criminal activity. As little as 3% might relate to corruption, but in all these areas the impact is pernicious and harmful to universal well being.

None of these activities can take place without the veil of secrecy that tax havens provide, and which the OFC operators exploit. It is wrong to think of tax as the major selling-point of these locations. Secrecy is their major selling-point and the central component of all activity that takes place there. Low or no taxes is best seen as bait that either attracts the business to them or that keeps it within their domains once captured: once the secrecy that the havens supply has been exploited in the course of a commercial transaction it might well be that tax law has been violated in another state. The unwillingness of the tax haven users to admit the tax evasion to which they have been a party keeps their funds locked into the tax haven and the OFC operators who exploit this to provide themselves with a long term income stream.

228 http://www.parliament.uk/parliamentary_committees/treasury_committee/tc0708pn42.cfm accessed 12-6-08.
In assessing this issue the UK has a particular problem to address. As we show, it is a tax haven in its own right. It also hosts what is almost certainly the largest OFC in the world in the City of London. All objective observers agree that this is so. Indeed, many would argue that the UK is at the epicentre of the tax haven phenomenon, having created many of the instruments that tax havens now utilise, and still being in the market for their supply at this time. As we also show, whether this happened by either accident or the circumstance of chance is now irrelevant: the UK’s economic policy and the Treasury’s taxation policy is explicitly based on maintaining the UK’s role as a haven. This might not be advertised, but it is a fact. The evidence is impossible to interpret otherwise, and the impact is being seen in many of the taxation issues that have caused recent embarrassment to the government.

In addition, the UK also has international responsibility for many of the largest tax havens in the world, including Cayman, Jersey, Guernsey, the Isle of Man, Bermuda and the British Virgin Islands, a fact that recent government reports have acknowledged.

This being the case, the UK has a range of issues to address when considering both tax havens and OFCs. In particular it has to:

1. Resolve and make explicit its own polices as a tax haven.
2. Determine how best to regulate its own OFC in the City of London.
3. Consider how it can mitigate the risk arising from the actions of the tax havens for which it is responsible both to itself and others, and how best to regulate the OFCs that operate from those locations.
4. Create a coherent strategic policy for progress on tax haven and OFC issues that addresses all the issues they pose with regard to transparency, taxation, financial stability, corruption criminality and, most importantly, development.

In our opinion this strategy does not exist at present. Its absence has contributed to many recent economic and political concerns in the UK as well as being an issue of major concern to many of our trading partners and international allies, both within and beyond the EU.

In this section we touch on the issues that the UK will need to address if this coherent strategy is to be created and suggest some of the benefits that will result.

1. Extend regulation to OFCs

The entire focus of regulation of the offshore economy has to date focussed on the role of the tax haven. The reason is obvious: in world where regulators come from nation states their mind set has been to use the power of the nation state to regulate activity that they believe is located within it.

As is becomingly increasingly obvious, this does not work in the offshore economy. Some have claimed that the role of that economy is to undermine the power of the nation state to regulate. Whilst there is little evidence, as yet, that this has impacted on the major nation states of the world, there can be no doubt that any power that the micro states that are host to most of the world’s tax havens has been foregone by them as a result of hosting OFCs. The reason is simply stated: those OFCs are dominated by major international banks, firms of accountants and lawyers. As has been increasingly obvious over the last decade, the global and mobile OFC operators of the world can hold any micro-state tax haven to ransom when demanding legislation that they desire to facilitate their trade.

As a result there has been widespread introduction of laws that, for example, facilitate the relocation at will of corporate entities through the process known as redomiciliation: these laws effectively undermine any power the fixed location tax haven might have over entities that are now, at most nominally incorporated using its laws, but which might at any time move elsewhere. Legislatures that have, in effect, sold their right to regulate in this way have little or no power to exercise control over the OFCs that are located within their domains.

The consequence has been plain to see. Whilst enormous effort has been put into creating legislation and regulation to comply with the requirements of organisations such as the Financial Action Task Force, that regulation has been treated with contempt by the OFC operators located within tax havens who have little or no incentive to offer more than token compliance with its requirements for two, very obvious reasons. The first is that those who staff the senior ranks of the companies that make up the OFCs rarely come from the tax havens in which they operate, and as such have no tie with that location bar a temporary commercial one. They therefore know that in the event of problem arising they can usually flee back to the state from whence they came. Second, their clients have even less allegiance to a place which they may never have visited. In that case they are indifferent to its regulation, especially when, as far as they are concerned the entity they have created is not located in that tax haven, but offshore from it, in what we have termed a “secrecy space”.

What this means is that the entire focus of offshore regulation has been focussed at the wrong target. Whilst there can be no doubt that regulation of financial services activity within an economy is essential, to presume that it might be effective in a global economy where much if not most financial activity is at least notionally based in micro-states has been an act of misplaced faith.
Recommendation 1

There is only one alternative option to regulating the tax haven though, and that is to regulate the OFC. There is obvious difficulty in doing so. These are made up of commercial entities, many of which are multinational and some of which have global extent. The Big 4 firms of accountants are in all major and many of the world’s minor tax havens, for example. But it is the OFCs that must be regulated if we are to ensure that the risks that the offshore economy poses to the world at large, now and in the future, is to be minimised.

We recognise the difficulty of regulating commercial organisations who operate multinationally. We also believe that the need to address this issue is one of the consequences of globalisation and that it cannot be avoided. Equally, and obviously, the task requires a different approach to regulation from that adopted to date, which has to a large extent failed. It is for that reason that we next turn to individual issues of regulation, but in all cases set our comments against this background requirement that it is the OFCs that now need regulating before returning later in this chapter to the theme of how that task might be fulfilled based on our other recommendations.

2. Extend transparency

We have already noted that it is secrecy that underpins the offshore economy. Without it most of the other abuses that emanate from there would be curtailed, or be significantly limited in extent. It is therefore apparent that transparency is key to regulation. Without it what happens in OFCs will not be known and regulation of their activities will not be possible.

The UK needs to lead the way in regulatory reform to promote transparency: both as a tax haven and OFC in its own right it has a duty to do so. Its own practices falls far short of the level that might be considered desirable. The UK should ensure that transparent recording of the structure of all entities is available on public record and that the accounts of all material entities are available on public record.

Recommendation 2

The UK government should make clear its own commitment to creating and rigorously enforcing operation of the registers noted here, and lead the call for other countries around the world, and especially those tax havens for which it is responsible, to do the same:

A. Create a public register of companies and to record on it:

(a) A list of all incorporated companies.

(b) Detailed information for each company concerning:

(i) Its registered office at which official contact can be made with it;

(ii) Its constitution;

(iii) Its membership and their identifiable addresses at which they can be contacted, updated at least annually, and if those members are nominees or corporations the names of the persons for whom they ultimately act shall be given;

(iv) The details of the person or persons (whether individuals or a corporation charity trust or other entity) that controls the corporation shall be stated and if there are five or fewer persons the identities of those persons shall be given;

(v) The holders of any debt or other financial instruments that it has issued which does, or might foreseeably, afford control of the company shall be stated and if there are five or fewer such persons the identities of those persons shall be given;

(vi) The holders of any debt or other financial instruments that it has issued which does, or might foreseeably, afford control of the company, including full details of beneficial ownership if nominees are used.

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231 A connected person is generally considered to be a person’s parent, step-parent, sibling, step-sibling, child, step child or greater issue or step-issue, aunt or uncle, first cousin, spouse and former spouses for a period of five years from the time of divorce having taken place and those spouses’ connected persons and all corporations, trusts, charities or other entities owned or controlled by such persons, all business partners and those of connected persons and all trustees, nominees and agents appointed to undertake business on behalf of any such connected party, whether the person in question be a natural person or a corporation, charity, trust or other entity created under legislative powers anywhere in the world.
(c) A list of all companies, charities, trusts or other entities controlled directly or indirectly by the company, in each case with sufficient identification details and an address being given so that the entity can be identified in its country of incorporation or registration.

(d) Its annual financial statements.

B. Create a register of charities containing all that information required of companies, with in this case provisions with regard to directors and other officers extending to trustees and other such officials and with the addition that in this case:

(a) The names of those promoting the charity should be disclosed.

(b) The names and identifiable addresses of any individual, corporation, charity, trust or other entity who, with their connected parties, provides more than 10% of the income of the charity in a year should be disclosed.

(c) The names of the beneficiaries receiving more than 5% of the income of the charity in any year should be disclosed.

(d) The reason why the income of the charity has not been distributed shall be disclosed annually if less than 75% of its income has been applied to its stated charitable purpose.

C. A register of trusts should be created containing all that information required of companies, with in this case provisions with regard to directors and other officers extending to trustees and other such officials and with the addition that in this case:

(a) The name of the settlor or settlors of the trust should be disclosed and all those contributing a sum more than 10% of previously gifted trust property shall likewise be disclosed together with their identifiable addresses, at least annually.

(b) The trust deed should be disclosed as should all side letters, letters of wishes and other communications of any form (including written summaries of verbal instructions or communications issued in non-reproducible electronic format) that give indication to the trustees or those who instruct the trustees as to the way in which the funds under their care should be used.

(c) In the event that the trust is of a discretionary nature then a list of all those who have benefited from more than 5% of the income of the trust in any year in the previous ten years should be supplied with identifiable addresses.

D. A register of other entities created under statute should be created containing all that information required of companies, and with such other information as shall be appropriate to ensure that information of the type required for charities and trusts is also available, if appropriate.

Each of these registers should be available for free public searching, on the internet and at public buildings at any time.

Such a commitment would require an extension of disclosure rules in the UK and for almost every government in the world. The advantages would be:

1. A reduction in secrecy.
2. An increase in the efficiency of identifying assets under the control of any person or other entity.
3. An increase in the tax yield.
4. Greater openness and transparency in commercial transactions leading to benefits for all stakeholder groups including enforcement agencies of all sorts, employees, those with environmental concern, commercial creditors of organisations, banks and other suppliers of capital, consumers, and civil society at large.

It should also be noted that in practice the requirements are not onerous. Under the “know your client rules” that are an integral part of FATF based financial services regulation such information has to be secured as a matter of course by those providing service to these entities. The information must therefore be known, as is the additional information noted as to proof of ultimate beneficial ownership and the means by which such connections can be established. As such the public disclosure of this information would not impose an onerous administrative burden on any business which is in possession of a bank account anywhere in the world since it has to have it available already, no matter where located.

3. An end to banking secrecy

Everyone has the right to reasonable privacy. No one has the right to break the law. Banking secrecy was created by Switzerland to enable foreign person’s using its bank accounts to break the law of their countries of residence, and that has remained the prime purpose of banking secrecy ever since. This has to end, and the UK should lead the way in demanding this change in banking regulation, which is something it could do if the registers noted in the previous section were created in the UK as the law of this country could not then be used to create what the Swiss consider banking secrecy by proxy through the combination of trusts and nominee companies.
Once banking secrecy is abolished the next obvious step is the automatic exchange of information on income earned on capital assets located by a person in one state when their main place of residence is another state. The EU Savings Tax Directive has shown that this is possible.

Recommendation 3
The UK seek that the EU extends the EU Savings Tax Directive to all privately owned entities (whether they be companies, trusts, foundations, partnerships with limited liability or their like).

Recommendation 4
The UK seek that the EU extends the EU Savings Tax Directive to all forms of income derived from capital including all forms of interest, without exception, income from insurance policies and pension funds, dividends of all forms, trust distributions and the payment of royalties, licence income and similar payments derived from the ownership of intellectual property.

Recommendation 5
The UK seek that the EU extend the EU Savings Tax Directive to additional territories to ensure that its effectiveness is extended.

Each of these objectives has been subject to discussion, and all are considered politically achievable.

There is of course the option of using sanctions if cooperation is not obtained: the US are considering this and Presidential candidate Senator Barack Obama has signed the Stop Tax Haven Abuse Act which incorporates that option by threatening tax withholding. The UK also threatened this to Jersey in 2002 when it was refusing to cooperate on implementation of the EU Savings Tax Directive and legislation to achieve this goal is as a result already sitting, unused on the UK statute book.

4. Shattering the secrecy space in corporate accounts

The secrecy space that OFC operators provide when utilising tax haven entities has enabled the world’s largest corporations to significantly reduce their taxation liabilities. This opportunity would be massively reduced if the world’s accounting rules did not greatly assist this process. It does by requiring that the accounts of multinational corporations be presented in what is called a consolidated format. This approach to accounting (and it is no more than an approach) requires that only the transactions between the group of companies that are within the multinational entity and third parties be included in the reported accounts. This means that all transactions within the group of companies are excluded from view. It is as if they simply did not exist.

This, of course, is not true. Multinational groups can include thousands of companies. As is noted in this report, the OECD estimates that 60% of world trade takes place on an intra-group basis ie between companies under common ownership. None of this trade is reflected in the published consolidated accounts of multinational entities and yet it is this same trade that gives rise to the whole problem of transfer pricing abuse that facilitates so much of the capital flight out of developing countries. This means that the accounts, whilst reflecting one aspect of the transactions that a group undertakes do not by any means reflect the whole impact of that company upon the communities with which it engages.

This is of particular benefit to multinational companies seeking to use tax havens. Almost all their use of such locations will arise from intra-group trade, whether it be in physical goods, or more commonly now in services. It is through these transactions that profit is relocated to these places with the aim of saving tax. Because of the current combination of consolidated accounting, tax haven secrecy and failure to place accounting information on public record the vast majority of this abuse stays permanently out of sight in the secrecy space that OFC operators create for their clients using tax haven legislation.

There is a mechanism to break this combination of secrecy that facilitates the biggest flow of capital flight out of the developing world, and a significant loss of taxation revenue to the developed world. This is called country-by-country reporting. Those promoting it suggest that accounts prepared on this basis should be published as part of the accounts of multinational corporations alongside, but not replacing, their consolidated accounts.

232 http://levin.senate.gov/newsroom/release.cfm?id = 269479 accessed 12-6-08.
234 For an example of such a structure see http://www.taxresearch.org.uk/Blog/2008/06/01/tescoes-the-zug-deal-is-tax-avoidance/ accessed 12-6-08.
235 For a broader discussion see http://www.taxjustice.net/cms/upload/pdf/Country-by-country_reporting_080322.pdf accessed 12-6-08.
Country by country reporting means that a multinational corporation would report in its accounts, without exception:

- which countries it operates in;
- what name it trades under in each country;
- its financial performance in the countries where it operates, including:
  - sales, both within the group and outside the group
  - purchases, split the same way;
  - financing costs, split the same way;
  - labour costs and employee numbers;
  - pre-tax profit; and
- tax payments to the government of the location where it is trading.

This information would be required to reconcile with the company’s main published accounts.

It is important to note that Country-by-country reporting would impose little cost burden on MNCs because they already hold all the necessary data that we are asking be disclosed for internal accounting purposes.

The benefit of country-by-country reporting would be that it shows where a group of companies operates, what name it trades under, and what trading it undertakes there, both within its own group and with third party customers and suppliers. This would make new information available to a wide range of stakeholder groups. In particular it would put on record:

- Where a company is registered and operates. This would highlight those operating in politically unstable regimes, tax havens, war zones and other sensitive areas. It would also help citizens of those jurisdictions find out who really owns the companies that are trading in their countries.
- What tax is being paid where, whether that appears reasonable in relation to the tax rates in the country in question, and whether the group appears to be using tax havens for profit-shifting purposes. The use of tax havens will be highlighted both by the country listing and by data showing that intra-group trading in these places is particularly heavy. Heavy use of tax havens should trigger deeper enquiry into whether transfer mispricing is occurring.

Making this information available to a wider range of stakeholders would also strengthen efforts to monitor:

- Corrupt practices, which are often disguised through the use of offshore special purpose vehicles.
- Corporate governance. There has been a remarkable coincidence between major corporate failures and groups of companies making extensive use of offshore arrangements.
- Tax payments to developing countries.
- World trade flows. Data on the 60% of world trade that takes place within MNCs is scarce and hard to understand.
- Corporate responsibility. For example, employment conditions in all the countries where an MNC operates could be monitored.

**Recommendation 6**

The UK should actively promote the use of country-by-country reporting by the International Accounting Standards Board and by individual countries.

5. **Corruption**

The UK has a poor record in tackling corruption, not helped by such incidents as the BAE affair.

The UK signed the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (“the OECD Convention”) in 1997 and ratified it in 1998. The UK’s ratification was extended to the Isle of Man in 2001.\(^{236}\) It has not been extended to any of the other territories for which the UK is responsible including the Channel Islands.

\(^{236}\) http://www.oecd.org/document/1/0,3343,en_2649_37447_36430329_1_1_1_1_37447,00.html accessed 12-6-08.
Recommendation 7

The UK must extend ratification of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions to all territories for which it is internationally responsible and require their active participation in its implementation.

The UK is seen to have been weak on this issue. Its commitment is now essential if the convention is to be supported and the UK is to play its full role in the fight against corruption, much of which takes place in tax havens.

The UK needs to take the initiative in another area of corruption. It must recognize that corruption has two sides: the demand side, which represents the person undertaking the corrupt transaction, and the supply side, which represents the supply side of those supplying the mechanisms to undertake the corrupt transaction.

Recommendation 8

The UK should recognize the role of OFCs in supplying the mechanisms used in many corrupt transactions, and actively promote research into methods of curtailing this supply that do not rely solely upon the actions of tax haven governments who have neither the power, resources or inclination to regulate that supply.

6. Tax policy

The UK has to decide whether it has one tax policy or two: whether its tax policies are established primarily for the benefit of those living in the UK or for the benefit of those living elsewhere.

There can be no doubt that those living in the UK will benefit from the UK making a commitment to the creation of taxation policy that has as its primary goal the creation of stable domestic markets for the UK.

This requires a number of commitments to removing the UK’s status as a tax haven and promoting a level playing field within the UK economy.

Recommendation 9

The UK should scrap the domicile rule entirely. The changes announced in 2007 and implemented from April 2008 have left a massive ring-fence within the UK economy that is harmful when compared with any assessment of tax practices. As the clearest indication that can be given that the UK intends to drop its status as a tax haven this change is essential.

Recommendation 10

The UK currently provides a taxation environment that favours large companies over small ones, quoted companies over unquoted companies and international entities over those operating solely in the UK. This is despite the fact that at least half of all the UK workforce work for companies whose activities are located solely in the UK.

The UK should now commit to a tax strategy that ensures that all companies have equal access to markets, all can enjoy equivalent tax rates (there is now serious risk that smaller companies are paying taxes at higher rates than large ones) and that undue regulatory burden is not placed on companies operating solely in the domestic market as a result of the action of those working multinationally.

Active steps should be taken to promote this objective.

Recommendation 11

The UK should work with the EU to promote adoption of a Common Consolidated Corporate Tax Base that limits the possibility for companies to arbitrage the taxation laws of one country against those used in another, and that allocates profit to country on the basis of a unitary apportionment formula taking into consideration solely where a company’s employees, assets and sales are located, so limiting the possibility of profit being allocated to tax haven activity.

Recommendation 12

The UK is believed to have been an obstacle to implementation of some aspects of the EU Code of Conduct on Business Taxation. The UK should commit to this Code, seek to extend it to personal taxation and require that the Conduct group monitoring its implementation publish reports on its work.

7. The UK’s tax havens

The UK has no clear policy for its tax havens. It does on occasion seem to treat them as a source of embarrassment. It is also aware that they are a source of risk. In the case of the Isle of Man and Montserrat it provides considerable financial assistance that assists their status as tax havens. It persistently fails to ensure that good standards of governance, financial regulation, financial reporting and local accountability are maintained. This inconsistent approach assists those who use the stability that the UK affords its tax havens as the basis for the operation of abusive OFCs.

Recommendation 13

In 1998 the UK undertook the Edward’s Review of its tax havens and then failed to require the proper implementation of the recommendations of the resulting report. The world has changed substantially since 1998 and another review is required, with Royal Commission status, to determine future policy for the tax havens.

Recommendation 14

The UK should require that its tax havens operate systems of accountability and transparency with regard to corporate and other disclosure equivalent to those of the UK.

Recommendation 15

The UK should now as a result of the findings of the National Audit Office published in November 2007:

— Improve the quality of its training for all staff seconded to Overseas Territories and the Crown Dependencies.

— Second such staff as are needed to ensure that the financial services regulation of all territories for which the UK is responsible is operational and effective.

— Ensure that deficiencies in current legislation for regulatory regimes are remedied with immediate effect, if necessary by way of Orders made in Council.

— Require that contingency place be put in place for the demise of the financial services industry in each of these locations.

— Create plans to diversify the economies of these territories so that they might have alternative sources of income available to them.

— Make clear that funds to ensure that this development is possible are dependent upon adopting recommendations on transparency included in this report.

Recommendation 16

The Crown Dependencies are particularly vulnerable to political capture by the financial services industry. The Isle of Man can only operate because of subsidies amounting to more than £200 million a year provided to it by the UK; Jersey and Guernsey are likely to run substantial government deficits as a result of tax changes adopted to comply with the EU Code of Conduct on Business Taxation. Neither gives indication of having contingency plans available to manage those budgets given the current likely down turn in their trade as the world financial crisis develops.

The UK government should:

— Make explicit the terms of its support for the Isle of Man government and make explicit its requirement that the Isle of Man comply with both the spirit as well as the letter of the EU Code of Conduct on Business Taxation in exchange for that support.

— Require that each of the Crown Dependencies prepare contingency plans based on the premise that there will be no growth in their financial services sectors for the next five years.

— Make explicit that support will only be forthcoming for these territories if they are willing to comply with recommendations on transparency included in this report.

— Require that each Crown Dependency develop a plan to break its dependency upon financial services as the main source of its income and demonstrate the viability of doing so.
8. Tax Havens and Development

No one suffers more comprehensively from the existence of tax havens and OFC abuse than the developing countries of the world. For them this is not a question of ensuring the effectiveness of financial regulation or the efficiency of the tax system (although both have significance in developing countries): it is also a matter of life and death, as Christian Aid has shown. This must be recognised in UK development policy, which needs also to urgently consider the lack of coherence between the UK’s role as a tax haven and protector of tax havens dotted across most time zones, and its role as a leading aid donor:

Recommendation 17

The UK needs a policy on tax havens that is integrated into its work on development. This must include commitments to:

— Provide technical support and training to developing countries to ensure they can engage effectively with tax haven abuses, whether relating to corruption, crime or taxation abuse.

— Provide technical support to developing countries to ensure that they can negotiate effective contracts with significant commercial trading partners that provide them with access to adequate information to ensure that appropriate taxes are paid within their domain as required by their law.

— Develop models for development that break the dependence on fiscal degradation that has been the pattern of incentive used to date, so undermining the credibility of developing country tax systems and their prospect of becoming effective, self governing democracies that are not dependent upon aid.

— Support developing countries in creating effective information exchange agreements with other nations and with tax havens to ensure they have access to the information they need to ensure they can collect the taxes due to them.

— Assist developing countries in recovering stolen assets that are their rightful property, including those that have arisen as a result of tax evasion, and to create effective mechanisms for the repatriation of these assets from locations over which the UK has control (including the City of London) to those places that need these assets to fulfill their development objectives.

— Ensuring that international and domestic civil society is represented in the processes recommended here to ensure that governments are held accountable for the actions they take in the name of the people they govern and that where appropriate training is provided to ensure that those groups are empowered to undertake these tasks.

9. Regulating the OFCs

The first recommendation of this report was that the focus of offshore regulation should now shift from the tax haven as such to OFCs. In addition to that recommendation we have made 16 further recommendations. The focus of those has been, in no small part, to break down the veil of secrecy that tax havens supply. Without that secrecy there would be no product for the OFCs of the world to supply. It is only secrecy that allows them to successfully sell products designed to abuse the regulatory obligations a person has in the place in which they normally reside or undertake their trade.

If the recommendations of this report are adopted there will be little for the OFCs to sell. Their regulation will be unnecessary. The harmful trade they purvey will have been undermined.

And there can be no doubt that it is harmful. It has as its intent the creation of secrecy from which some in society (mainly rich people and criminals) can benefit but from which the majority are excluded. The result is inevitable: the gap between rich and poor in society increases. This harms people’s sense of well being. It increases absolute poverty. It increases the likelihood of crime and social discord. The resulting loss of revenue harms educational and health outcomes. The infrastructure needed for trade is not available. Essential resources to tackle some of the biggest issues we face, including global warming, will be denied when they are essential.

And all this is known to be inevitable: the most basic understanding of economic theory of the sort taught in every university in the world suggests that imperfect information results in imperfect markets, the rise of monopoly power and the need for additional regulation. Our suggestions accord perfectly with that theory. All that surprises us is that the massed ranks of the world’s economists do not do so as well.

This happens through the promotion of self interest, most especially by those professions such as lawyers and accountancy that were once seen to have strong ethical motivation. Banking, once also the pillar of society, is now playing a key role in undermining it through its extensive involvement in the offshore world.

All of these sectors obtain substantial benefit from the existence of the democratic states of the world with which they are now in conflict because of their near universal presence in the world’s OFCs. Society needs to present them with a choice; a choice to support society or be sanctioned by it. It would clearly be in the best interests of all that this choice was to comply. As such we come to our final recommendation:
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Recommendation 18

The UK must promote Codes of Conduct for Taxation. The first would be to support the creation of a Code of Conduct for Taxation to be adhered to by governments. Progress is being made on this issue at the United Nations, and we recommend that that the UK support the development of that Code. The second would promote a Code of Conduct for Taxation that would uphold the highest ethical standards of conduct, including a commitment to making full disclosure of all information noted in recommendation 2 above and to desisting from the promotion of all forms of tax avoidance on the part of all engaged in the taxation profession, whether in the UK or offshore. This should be enforced be refusing to extend UK contracts for services to any company or firm that did not commit itself and all its group members and their affiliates trading under similar or associated names to that standard of conduct.

This is possible. OFCs are a commercial response to an opportunity made available by tax haven governments. Those governments that wish to tackle tax haven abuse have the commercial right to withhold trade from those commercial firms who exploit tax havens by operating in OFCs to undermine the revenues of the governments from which those same firms want revenue. Indeed, they have more than this right, they have a duty to do so, and the USA has recently made welcome moves in this direction.

20. Bibliography

This is a limited and selective bibliography of relevant works on this issue. Many more can be accessed through the footnotes contained in this report.


239 As an example, see http://www.taxjustice.net/cms/upload/pdf/AABA-TR-Code_long.pdf accessed 13-6-08.
21. The Language of Tax

Affiliate
A related company or subsidiary of a corporation.

Aggressive tax avoidance
The use of complex schemes of uncertain legality to exploit taxation loopholes for the benefit of taxpayers who can afford the fees charged by professional advisers who create such arrangements.

Arising basis
Treating income earned outside the country of residence as liable to tax in the year in which the income is earned, even if it is not remitted to the country where the tax is payable. Compare with the remittance basis.

Banking secrecy
Banking secrecy laws strengthen the normal contractual obligation of confidentiality between a bank and its customer by providing criminal penalties to prohibit banks from revealing the existence of an account or disclosing account information without the owner’s consent. Can be used to block requests for information from foreign tax authorities.

BIS
Bank for International Settlements http://www.bis.org/

Capital gains tax
A tax on the profits from the sale of capital assets such as stocks and shares, land and buildings, businesses and valuable assets such as works of art.

Capital flight
Capital flight is the deliberate and illicit disguised expatriation of money by those resident or taxable within the country of origin.

Center for Freedom and Prosperity

Charitable trust
A trust established for purposes accepted by law as charitable.

Citizenship basis of taxation
Tax is charged on the worldwide income of all citizens of the state irrespective of whether they are resident or not in the territory during the period for which the taxes are levied. The most obvious example is the USA.

Collateralised debt obligation
Collateralized debt obligations (CDOs) are asset backed securities and structured credit products. CDOs are constructed from a portfolio of fixed-income assets. This “construction” usually takes place offshore and the opacity with which the CDO product is thought to have had significant impact on the credit crisis that emerged in 2007.

Company or corporation
An entity treated as a separate legal person from those who set it up, established under the rules of the country in which it is registered.

Controlled foreign corporation (CFC)
A tax definition to describe a situation in which a company which charges tax on the profits of corporations has a subsidiary registered in a tax haven or other territory where little or no tax is charged on the profit the subsidiary makes. The subsidiary is then called a CFC and its profits can in some cases be subject to tax in the country of residence of the parent company.
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Coordination centres
A special form of company with taxation advantages, often used to attract corporate headquarters to a country. Most notably found in Belgium, the Netherlands and Ireland.

Corporation tax
A tax on the profits made by limited liability companies and other similar entities in some countries, but otherwise usually being similar in application to income tax.

Currency transaction tax
A tax levied by a country that issues a currency on all the trades in that currency worldwide at very low rates eg 0.005%. Considered the most likely form of the Tobin Tax to be effective in practice.

Deferred tax
A fictional tax which only exists in company accounts and is never paid. Deferred tax does not, as such, exist. But the rules of accountancy generally require that income be matched with expenses. If an expense is recognised for tax purposes more quickly than it is for accounting purposes (which is common with much plant and equipment) this means that the tax cost for the years when this happens are understated. Conversely, when all the tax allowances have been used on the assets there might still be accounting charges to make and the tax cost would then be overstated. To balance this equation a notional tax charge called deferred tax is charged to the profit and loss account in the earlier years and put on the company’s balance sheet as a liability. The liability is released as a credit to profit and loss account in the later years and supposedly over the life of the asset all should balance out.

Discretionary trusts
Most offshore trusts permit payments to be made at the discretion of the trustees, which means that the identity of beneficiaries can remain a secret. In practice, trustees normally follow a “letter of wishes”, provided by the settler, instructing them whom they are to pay money to, when and how.

Domicile
The country identified as a person’s natural home, even if that person has not been resident there for extensive periods of time.

Double tax relief
Tax relief given by the country in which the tax payer resides for tax paid in another country on a source of income arising in that other country.

Effective tax rate
The percentage of tax actually paid in relation to the total income of the person paying the tax.

Elsewhere
An unknown place in which it is assumed, but not proven, that a transaction undertaken by an entity registered in a secrecy jurisdiction is regulated.

EU
European Union http://europa.eu/

EU Savings Tax Directive EU STD
The EU Savings Tax Directive was adopted to ensure the proper operation of the internal market and tackle the problem of tax evasion. It was approved in 2003 and came into effect on 1 July 2005. The main method is exchange of information between tax authorities. However, an alternative withholding tax arrangement has been allowed for some countries, which is intended to be provisional.

EU Code of Conduct on Business Taxation
The Code of Conduct for business taxation was set out in the conclusions of the Council of Economics and Finance Ministers (ECOFIN) of 1 December 1997. The Code is not a legally binding instrument but it clearly does have political force. By adopting this Code, the Member States have undertaken to:
— roll back existing tax measures that constitute harmful tax competition and
— refrain from introducing any such measures in the future (“standstill”).

The code covers tax measures (legislative, regulatory and administrative) which have, or may have, a significant impact on the location of business in the Union.
Export processing zones
Artificial enclaves within states where the usual rules relating to taxation and regulation are suspended to create what are, in effect, tax havens within larger countries.

FATF Financial Action Task Force
The Financial Action Task Force (FATF) is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing. The FATF is a “policy-making body” created in 1989 that works to generate the necessary political will to bring about legislative and regulatory reforms in these areas. The FATF has published 40 + 9 Recommendations in order to meet this objective. http://www.fatf-gafi.org/pages/0.2987.en_32250379_32235720_1_1_1_1_1_1_1_1_1_1_1_1.html

FSF Financial Stability Forum
The Financial Stability Forum (FSF) was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. The Forum brings together on a regular basis national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. http://www.fsforum.org/home/home.html

Flags of convenience
The flag of a country with easy or lax maritime regulations and low fees and taxes, flown by ships registered in such countries, even though they have no substantial connection with the country.

Flat tax
A tax system in which as income increases above an agreed tax free sum the amount of tax paid remains constant in proportion to total income. Compare with progressive taxes.

Foreign direct investment FDI
Foreign direct investment is defined as funds from one country being used to create a physical investment into another country. Its definition can be extended to include the purchase of a company in one country by a company located in another country so long as it is the intent to retain that ownership in the long term.

Formula apportionment
A means of allocating taxable profits generated by a multinational group of companies between the jurisdictions in which it operates using a formulaic approach. The so called Massachusetts formula affords equal weight to third party sales, labour cost and fixed tangible capital, and this formula is now commonplace in the USA.

General anti-avoidance principle
A law that seeks to prevent a tax payer from obtaining the taxation benefit arising from any transaction if they undertook it solely or mainly to obtain a tax benefit. It does so by looking at the motivation of the taxpayer at the time of entering into the transaction, for which reason the concept of tax compliance is important. If the person was seeking to be tax compliant then they should probably keep the benefit they obtained from the transaction. If they were taxation non-compliant then they should not. Compare with a general anti-avoidance rule.

General anti-avoidance rule
A general anti-avoidance rule seeks to tackle those who try to break the rules of taxation through the use of further rules. Rather than considering intention, it lays downs ways of interpreting a series of events to determine whether the benefit of tax legislation can be given to the tax payer. Because rules are invariably open to interpretation a general anti-avoidance rule runs the risk of increasing the opportunity for abuse.

Gift tax
Taxes charged on gifts either during life or on death. The charges may be on the donor or on the cumulative value of gifts received by the recipient.

Harmful tax competition
A term synonymous with the OECD’s report of 1998 that launched its attack on tax haven activity, entitled “Harmful Tax Competition: An Emerging Global Issue” http://www.oecd.org/dataoecd/33/0/1904176.pdf. The difficulty with the concept it created was that no explanation was given on how to differentiate harmful tax competition from that which some claimed was benign, and the project was flawed from the outset as a result.
Hedging
A strategy intended to reduce investment risk using call options, put options, short selling or futures contracts. Often refers to taking a futures position that is equal and opposite from a position in the cash market. A hedge can be used to lock in existing profits. It is often claimed that hedging is best done offshore, but there is no evidence to support this assertion and most hedging expertise is onshore.

Heritage Foundation
Sponsor of the Center for Freedom and Prosperity, main opponent of the OECD harmful tax competition initiative.

High net-worth individuals
Otherwise known as HNWIs (pronounced hen-wees). Generally categorized as individuals with more than US$1 million of liquid financial assets available for investment.

Holding companies
A company that either wholly owns or owns more than 50 percent of another company, the latter being called a subsidiary. An intermediate holding company is a holding company which has one or more subsidiaries but is itself owned by another company. The term “ultimate holding company” refers to the one that is finally not controlled by another company.

Income tax
A tax charged upon the income of individuals. It can also be extended to companies. The tax is usually charged upon both earned income from employment and self employment and unearned income eg from investments and property.

Inheritance tax
A form of gift tax charged upon the estates of people upon their death.

International Business Corporations (IBC)
A type of company offered by many offshore finance centres and tax havens, usually one which receives all or most of its income from abroad. IBCs usually pay an annual registration fee but are subject to minimal or zero tax rates.

International Finance Centre
A financial services centre that both provides and executes a full range of such services on behalf of clients located within the jurisdiction in which the service centre is located and, most especially, in other, identified locations to whom information is made available on the nature of the transactions undertaken, and by whom, either automatically or on request, with or without the consent of the parties for whom the transaction was undertaken.

IMF
International Monetary Fund

Inversion
The act of a parent company whose headquarters are located within one jurisdiction switching registration with an offshore subsidiary they own to secure location within that offshore jurisdiction in order to secure a tax advantage. Mainly occurring in the USA.

Land value taxation
A tax on the rental value of a site, assessed as if it were undeveloped and unimproved—in other words, as if it were bare land.

Licence (Licensing)
A contract for the use or property, often intellectual property such as a patent, copyright or trademark. If ownership of the property is transferred to a holding company located in a tax haven, the licence fee income paid to the licensor may be exempt from tax, as well as reducing the taxable profits of the operating company (often a subsidiary) which is the licensee.

Limited liability partnerships (LLP)
A partnership that provides its non-corporate members with limited liability. LLPs are frequently based offshore for tax avoidance purposes.

Loophole
A technicality that allows a person or business to avoid the scope of a law without directly violating that law.

Money-laundering
The process of “cleaning” money from criminal or illicit activities to give it the appearance of originating from a legitimate source. See social security contributions. Often called NIC.

National insurance contributions
Persons, often being members of the legal or accountancy professions, who will lend their names to act as directors, shareholders and company secretaries of companies or as settlors and trustees of trusts with the intention of ensuring that the identity of the beneficiaries of the transactions that they undertake cannot be identified.
Nowhere The part of the offshore economy where by design or chance the combination of unregulated entities used results in those entities and the transactions they undertake being either entirely unregulated, or being very lightly regulated.

OECD Organisation for Economic Development and Cooperation. http://www.oecd.org/home/0,2987,en_2649_201185_1_1_1_1_1,00.html

Off balance sheet The process by which an asset and/or liability is transferred out of the ownership of the company that has beneficial use of it and transferred into the ownership of an orphan company that will usually be a special purpose vehicle owned by a specially established charitable trust. The combined structure means that the accounting profession has agreed that the resulting entities need not be consolidated into the accounts of the company that nonetheless has close control of the structure through contractual or other obligations. These structures are frequently offshore where secrecy assists the companies involved to hide the true identity of the transactions they have undertaken.

Offshore More correctly called the offshore economy in which tax havens and OFCs combine to provide their clients with the opportunity to undertake transactions without the impact of the regulation of the places in which the participants really reside being brought to bear, whether legally or illegally. In common perception the regulation avoided is tax, but in practice a much wider range of regulation is abused in the offshore economy with secrecy being the prime tool for achieving this goal, meaning that the suspicion of illegality is rarely avoided, although it will by no means necessarily occur.

As a result offshore relates to any jurisdiction (regardless of whether they are islands) which provides tax and regulatory privileges or advantages, generally to companies, trusts and bank account holders on condition that they do not conduct active business affairs within that jurisdiction. The term “offshore” is very broad and normally includes “onshore” tax havens such as Andorra, Lichtenstein, etc.

Offshore financial centre OFCs Offshore financial centres are not the same as tax havens. OFCs are the commercial communities hosted by tax havens that exploit the structures that can be created using that tax haven’s legislation for the benefit of those resident elsewhere. In other words, the offshore financial centre is made up of the accountants, lawyers, bankers and their associated trust companies that sell services to those who wish to exploit the mechanisms the tax haven has created.

OFC operator A company providing services from an Offshore Financial Centre. Usually a bank, trust company or firm of lawyers and accountants.

Orphan companies Entities set up as special purpose vehicles and owned by specially established charitable trusts with the sole purpose of disguising the true nature of the transactions undertaken and keeping them off the balance sheets of the companies that promote them. Called “orphans” because their parent has disassociated themselves from them and because the structure adopted, where a charitable trusts has nominal control means that they apparently have no parent or owner.

Partnerships Any arrangement where two or more people agree to work together and share the resulting profits or losses.

Payroll taxes See social security contributions.

Permanent Establishment An office, factory, or branch of a company or other non-resident. Under Double tax treaties business profits are taxable at source if attributable to a Permanent Establishment. May include construction sites or oil platforms in place for over six months.

Poll tax A tax that levies the same sum on each person irrespective of their means to make payment.

Preferential tax treatment A situation in which individuals or companies can negotiate their tax treatment in the state in which they have a tax liability. Pioneered by Switzerland in the 1920s, the arrangement is commonplace in the offshore world.
Private company  A company not quoted on a stock exchange. Shares cannot usually be sold without the consent of the company or its owners; in many countries little or no information need be disclosed on the activities of such companies even though their members enjoy the benefit of limited liability.

Profit laundering  The process of transferring profits from a territory in which they would be taxed to another in which there is either no tax or a lower tax rate. Mechanisms for achieving this include transfer-pricing, re-invoicing, licensing, thin capitalisation, corporate restructurings and inversions.

Progressive taxes  A tax system in which as income rises the amount of tax paid increases in proportion to the income as well as in absolute amount i.e. the percentage tax rate increases as the income rises. Also referred to as Graduation. Compare with flat and regressive taxes.

Public company  A company whose shares are quoted on a recognised stock exchange and are available to be bought and sold by anyone who wishes without consent being required from the company itself. Generally required to be more transparent than private companies.

Quoted company  See public company.

Race to the bottom  The downwards trend of tax rates and regulatory requirements on capital arising from competition between sovereign states to attract and retain investment.

Regressive taxes  A tax system in which as a person’s income from all sources increases the amount of tax they pay reduces in proportion to their income even if it increases in absolute amount i.e. their percentage tax rate falls as their income goes up. Compare with progressive taxes and flat taxes.

Reinsurance  Some large companies decide not to insure their risks with the conventional insurance markets but instead set up their own insurance companies. When insurance companies do this it is called reinsurance. By setting up a captive or reinsurance company offshore, a tax deduction for the premiums paid is available in the country where the risk is and the premium is received offshore where there is little or no tax. This can, therefore, be viewed as another form of transfer-pricing.

Re-invoicing  Re-invoicing involves invoicing a sale to an agent, typically based in a tax haven or OFC, who subsequently sells on to the final purchaser. In practice the agent pays part of their mark up to the original vendor or to the purchaser, usually to an offshore account. This is a widely used process for laundering profits to a tax haven. The process is dependent upon secrecy for its success.

Remittance basis  Concerns income earned outside the country of residence. The remittance basis says that tax is only due in the year when income is remitted to the country in which the tax payer is resident and not when it arises. Enables a person to avoid tax indefinitely in their country of residence provided it is kept and spent abroad. Compare with the arising basis. Both have relevance within the context of the residence basis of taxation.

Residence  For an individual, the person's settled or usual home; for simplicity a presumption may be applied based on a rule-of-thumb, such as presence within the country for six months or 183 days in any tax year. It may be possible to be resident in more than one country at one time (though double tax treaties aim to prevent this). Some individuals may also try to avoid being resident anywhere. For companies, residence is usually based on the place of incorporation but can also be where the central management and control of the company is located, if they are different. Tax haven companies formed for non resident owners are usually defined not to be resident in their country of incorporation.

Residence basis  Taxation of residents of a territory on all their worldwide income wherever it arises, usually with a credit for tax already paid overseas. The aim is to discourage residents from investing abroad in lower tax countries, by ensuring that income is taxed at the residence country rate if it is higher. Compare with source and unitary basis.

Ring-fencing  Different and preferential tax and regulatory treatment given by
tax havens to companies and trusts owned by non-residents as contrasted to companies and trusts owned by residents.

Round tripping
The process by which capital flight funds leave a country only to be reinvested as if foreign direct investment having first been laundered through a tax haven entity to disguise the true ownership of the funds in question.

Sales tax
Taxes on sales can be levied in two ways. Firstly, as a general sales tax (GST) added to the value of all sales with no allowance for claiming a rebate on tax paid. Secondly, as a value added tax (VAT) charged by businesses on sales and services but which allows businesses to claim credit from the government for any tax they are charged by other businesses. The burden of VAT therefore falls almost entirely on the ultimate consumers. GST and VAT are both regressive taxes since lower income households always spend a higher proportion of their income on consumption and therefore invariably spend a greater proportion of their income on this tax than do the better off. VAT is the most widely used form of sales tax.

Secrecy jurisdiction
Another, and potentially more accurate term for a tax haven because secrecy is their primary product.

Secrecy space
The unregulated spaces that are created by OFCs using entities given legitimacy by a tax haven but which are suggested to operate outside their domain and so are treated by them as being “elsewhere” or “nowhere”. Both of these are domains without geographic existence in which regulation does not occur, which is the characteristic that defines the secrecy space.

Social security contributions
Payments made towards a fund maintained by government usually used to pay pension and unemployment benefits. Health benefits are sometimes covered as well. Social security contributions are generally considered to be taxes.

Somewhere
A place other than that in which a regulated entity resides in which it can undertake transactions that are regulated, with transparent interaction and communication between that place and the location in which the regulated entity resides taking place, at least on request.

Source basis
Taxation of income in the territory where it is earned. Compare with residence and unitary bases. Under double tax treaty rules, income attributable to a Permanent Establishment is taxable at source. Some countries tax only on a source basis, and consider income earned outside the country exempt; but some tax on the basis of both source and residence (subject to a foreign tax credit). Compare with residence and unitary bases.

Special purpose vehicles SPV or SPE
A special purpose vehicle (SPV) or special purpose entity (SPE) is a company that is created solely for a particular financial transaction or series of transactions. It may sometimes be something other than a company, such as a trust. SPVs/SPEs are usually located to provide the most favourable tax outcome for the transaction. As a result many are offshore. SPVs are used for transactions including securitisations and the issue of catastrophe bonds. In addition to reducing tax, SPVs can also remove assets or liabilities from balance sheets, transfer risk and (in securitisations) allow the effective sale of future cash flows. Many SPVs will be engineered to ensure that they are “orphan companies” owned by charitable trusts and so not appear to be under the ownership or control of the company that has promoted them. In this way they are taken “off balance sheet”.

Structured investment vehicle SIV
A structured investment vehicle (SIV) is a fund which borrows money by issuing short-term securities at low interest and then lends that money by buying long-term securities at higher interest, making a profit for investors from the difference. SIVs are a type of structured credit product; they are usually from $1bn to $30bn in size and invest in a range of asset-backed securities, as well as some financial corporate bonds. They are frequently located offshore.

Stamp duty
A tax on the value of contracts. Usually charged on contractual dealings on shares and other stocks and securities and on dealings in land and property.

Subsidiary company
A company 50% or more owned by another company which is its...
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Tax arbitrage
The process by which a sophisticated tax payer plays off the tax systems of two different countries to obtain a tax benefit as a result.

Tax avoidance
The term given to the practice of seeking to minimise a tax bill without deliberate deception (which would be tax evasion or fraud).

The term is sometimes used to describe the practice of claiming allowances and reliefs clearly provided for in national tax law. If the law provides that no tax is due on a transaction then no tax can have been avoided by undertaking it. This practice is now generally seen as being tax compliance. So what the term tax avoidance now usually refers to is the practice of seeking to not pay tax contrary to the spirit of the law. This is also called aggressive tax avoidance.

Aggressive tax avoidance is the practice of seeking to minimise a tax bill whilst attempting to comply with the letter of the law while avoiding its purpose or spirit. It usually entails setting up artificial transactions or entities to recharacterise the nature, recipient or timing of payments. Where the entity is located or the transaction routed through another country, it is international avoidance. Special, complex schemes are often created purely for this purpose. Since avoidance often entails concealment of information and it is hard to prove intention or deliberate deception, the dividing line between avoidance and evasion is often unclear, and depends on the standards of responsibility of the professionals and specialist tax advisers. An avoidance scheme which is found to be invalid entails repayment of the taxes due plus penalties for lateness.

Tax base
The range of transactions that a country chooses to tax. A broad base includes a wide range of transactions. A narrow base includes relatively few transactions.

Tax competition
This is the pressure on governments to reduce taxes usually to attract investment, either by way of reduction in declared tax rates, or through the granting of special allowances and reliefs such as tax holidays or the use of export processing zones. Applies mainly to mobile activities or business, but the competition to attract investment may result in an overall decline of corporation tax rates and in the amounts of corporation tax paid, often resulting in an increased burden on individuals.

Tax compliance
A term that is acquiring a new use. It can mean payment of tax due without engaging in tax avoidance or evasion. It is also now being used in contrast to the terms tax avoidance and tax evasion. Tax compliance in this context is used as a test of a person’s intention before they undertake a transaction. It asks whether the person is seeking to comply with the spirit of the legislation concerning the transaction into which they are entering. If they are, then it should be presumed their intent was to be legal. If they are seeking to comply with the letter but not the spirit of the law (and it is usually possible to determine this from the form the transaction takes) then it should be presumed their intent was to break that law, the onus of proof otherwise falling upon them. This test is then used in connection with a general anti avoidance principle to determine whether that principle should be applied to a transaction, or not. A person who has used an appropriate motive is “tax compliant”.

Tax efficiency
A term used by tax professionals to suggest getting away with paying as little tax as possible.

Tax evasion
The illegal non payment or under-payment of taxes, usually by making a false declaration or no declaration to tax authorities; it entails criminal or civil legal penalties.

Tax haven
Tax havens are places that create legislation designed to assist a person—real or legal—to avoid the regulatory obligations imposed upon them in the place where they undertake the substance of their economic transactions. This is not by accident or chance: there is clear evidence that these places, some of them countries, some not, but all with the power to pass legislation, set
out to undermine the impact of legislation passed in other jurisdictions.

The Organisation for Economic Cooperation and Development defines tax havens as jurisdictions where:
- Non-residents undertaking activities pay little or no tax.
- There is no effective exchange of taxation information with other countries.
- A lack of transparency is legally guaranteed to the organisations based there.
- There is no requirement that local corporations owned by non-residents carry out any substantial domestic (local) activity. Indeed, such corporations may be prohibited from doing business in the jurisdiction in which they are incorporated.

Not all of these criteria need to apply for a territory to be a haven, but a majority must. This definition is now considered too limited by many.

**Tax holidays**
A period during which a company investing in a country does not have to pay tax under an agreement with its government.

**Tax mitigation**
A phrase used by tax professionals when describing the desire to pay as little tax as possible.

**Tax non-compliant**
A person who is not seeking to be tax compliant.

**Tax planning**
A term used in two ways. It can be used as another term for tax mitigation. When, however, tax legislation allows more than one possible treatment of a proposed transaction the term might legitimately be used for comparing various means of complying with taxation law.

**Tax shelter**
An arrangement protecting part or all of a person’s income from taxation. May result from pressures on government or a desire to encourage some types of behaviour or activity, or may be a commercial or legal ruse, often artificial in nature, used to assist tax planning.

**Thin capitalisation**
Financing a company with a high proportion of loans rather than shares. Used by Transnational Corporations to reduce the business profits of a subsidiary, since the interest on loans is usually allowed as a deduction, but dividends on shares are paid out of after-tax income. The interest is usually paid to another subsidiary of the transnational corporation located in a tax haven where no tax is paid upon its receipt, resulting in an overall reduction in the tax charge of the group of companies.

**Tobin tax**
The Tobin Tax or Currency Transaction Tax (CTT) is a proposed tax on the foreign exchange market named after the late James Tobin, the Nobel Prize winning economist, who proposed the idea.

**Transfer-pricing**
A transfer pricing arrangement occurs whenever two or more businesses (whether corporations or not) which are owned or controlled directly or indirectly by the same people trade with each other. The term transfer pricing is used because if the entities are owned in common they might not fix prices at a market rate but might instead fix them at a rate which achieves another purpose, such as tax saving. If a transfer price can be shown to be the same as the market price then it is always acceptable for tax. What are not acceptable for tax purposes are transfer prices which increase the cost or reduce the sales value in states which charge higher tax rates and increase the sales value or reduce the costs in states with lower tax rates. The difficulty for many corporations at a time when over 50% of world trade is within rather than between corporations is that there is no market price for many of the goods or services that they trade across national boundaries because they are never sold to third parties in the state in which they are transferred across national boundaries within the corporation. This gives rise to complex models in which attempts are made to allocate value to various stages within the supply chain within a company, which process is open to potential abuse. For this reason it is argued that such firms should be taxed on a unitary basis.
Transnational corporations (TNCs)

A corporation with subsidiaries or divisions in two or more nations. Also known as multinational corporation (MNC).

Trusts

A trust is formed whenever a person (the settlor) gives legal ownership of an asset (the trust property) to another person (the trustee) on condition that they apply the income and gains arising from that asset for the benefit of a third person (the beneficiary). Trusts can be established verbally but typically take written form. Trustees are frequently professional people or firms charging fees. Trusts are usually of one of three types:

- Discretionary trust;
- Charitable trust; and
- Interest in possession trust.

Trustees

The people who hold the legal title to assets held in a trust and administer it.

Trust beneficiary

Anyone who may obtain a benefit from a trust. A person who has the right to a benefit has an “interest in possession”; a discretionary beneficiary can get income or benefits only when and if the trustees decide to pay it to them.

Trust settlor

The person who establishes a trust by gifting assets to it.

Unitary basis

Treating the income of related entities within a single firm or corporate group on a combined or consolidated basis, and applying a formula to apportion it for taxation by the different countries or territories from which it derives. Each may apply the rate of tax it wishes. An alternative to the residence and source bases of taxation. It has been used in federal countries such as the USA, applying an allocation formula based on a ratio of sales, employment costs and assets employed within each state. It has been opposed by tax authorities (and TNCs) because they consider that it would be too difficult to reach international agreement especially on the formula. However, taxation of highly integrated TNCs may in practice entail a formula-based allocation of profits, due to the difficulty of finding appropriate arm’s length transfer prices.

Value Added Tax

Known as VAT. See sales tax.

Wealth tax

A tax on a person’s declared wealth, typically imposed annually at a very low rate. Once commonplace in Europe these are now little used since they are thought to encourage people to hide assets offshore.

Withholding tax

Tax deducted from a payment made to a person outside the country. Generally applied to investment income, such as interest, dividends, royalties and licence fees.

World Bank

http://www.worldbank.org/. Traditionally little involved with the offshore economy, but now engaging with it as a result of its Stolen Asset Recovery (StAR) programme.

22. About the Tax Justice Network

The Tax Justice Network brings together organisations, social movements and individuals working for international tax co-operation and against tax evasion and tax competition. In an era of globalisation, the TJN is committed to a socially just, democratic and progressive system of taxation. TJN campaigns from an internationalist perspective for a tax system which is favourable for poor people in developing and developed countries, and finances public goods and taxes public bads such as pollution and unacceptable inequality. TJN’s objectives are detailed in the TJN declaration (www.taxjustice.net).

TJN is a pluralistic, diversified, non-governmental, non-party and multilingual network. Local, regional and national civil society and social movement organisations as well as tax justice campaigners, researchers, journalists, development specialists, trade unionists, concerned business people, tax professionals, politicians and public servants are members and supporters of the network.

TJN is campaigning for social change through public debate and education. Public understanding of tax matters is the precondition for international tax justice. The network makes information available through mass media as well as through conferences and seminars, the internet, newsletters, publications in print, symbolic actions, demonstrations and advocacy. We base our activities on expertise and sound research.

TJN facilitates co-operation, communication and information sharing between its members. The network organises international exchange and policy debates in order to harmonise the views and concerns of our members. This process forms the basis for powerful global campaigns in international tax policy.
TJN is run by its member organisations as well as individual supporters. The network functions on the principles of participatory democracy, empowerment, transparency, accountability and equal opportunity. TJN encourages and where necessary supports member organisations and individuals to participate in the decision making. The network supports the building of national TJN campaigns in particular in developing countries. An international secretariat coordinates the network’s activities.

23. About the author: Richard Murphy

This report was written by Richard Murphy of Tax Research LLP on behalf of the Tax Justice Network in the UK.

Richard Murphy is a chartered accountant and graduate economist.

He trained with KPMG in London before setting up his own firm in 1985 in London. He and his partners sold the firm in 2000 when it had 800 clients, with a particular focus on media enterprises.

He is a serial entrepreneur, having helped launch or direct more than 10 companies, some of them backed by venture capital. These have included companies in the IT, toy, environmental and arts sectors.

Since 2000 Richard has increasingly been involved in taxation policy, both as an adviser and campaigner. He is director Tax Research LLP and advises the Tax Justice Network, the Publish What You Pay campaign, Christian Aid, the TUC and many other organisations on tax issues. He advises several prominent MPs and members of the Treasury Select Committee on taxation issues. He has also advised the States of Jersey on reform of its taxations systems and has addressed meetings of the UN Committee of Experts on International Cooperation in Tax Matters and of the European Commission Directorate on taxation policy. His current research work is largely funded by the Ford Foundation.

He has been a member of the Association of Chartered Certified Accountants’ Academic Research Committee and is a visiting fellow at the Centre for Global Political Economy at the University of Sussex and at the Tax Research Institute at the University of Nottingham. He was formerly a visiting fellow at the University of Portsmouth Business School.

Richard is a regular radio and TV commentator on tax and corporate accountability. He has participated in the making of television documentaries for Panorama, Dispatches and the Money Programme, including for the latter an analysis of Mohammed al Fayed’s tax affairs. He contributes regularly to File on Four and other BBC Radio 4 documentaries. He has worked with broadcasters in a number of other countries.

His articles have appeared in a wide range of professional journals. He wrote for the Observer on taxation issues for a number of years. He writes a daily blog at www.taxresearch.org.uk/blog.

June 2008

Memorandum from the Cayman Islands Financial Services Association

EXECUTIVE SUMMARY

1. This memorandum has been prepared by the Cayman Islands Financial Services Association in response to a public invitation for written evidence by the Treasury Committee of the House of Commons of the United Kingdom Parliament as part of the Committee’s enquiry into offshore financial centres.

2. The Cayman Islands Financial Services Association (CIFSA) is a not-for-profit organization funded solely by the private sector in the Cayman Islands. Its membership comprises the jurisdiction’s key associations including: the Cayman Islands Society of Professional Accountants (CISPA), the Society of Trust and Estate Practitioners (STEP), the Cayman Islands Fund Administrators Association (CIFAA), the Company Managers Association (CICMA), the Bankers Association (CIBA), the Insurance Managers Association (IMAC) and CFA Society.

3. The Cayman Islands is regarded as an important financial services centre in the global financial markets. This role is partially as a result of its unique position as the only offshore centre in the world which simultaneously has leading market positions in banking, captive insurance, hedge funds and structured products.

4. The role of the Cayman Islands banking centre for example, has been well documented by the Geneva based Bank for International Settlements (BIS) which ranks the jurisdiction highly in terms of its market share, its connectiveness to other banking centres as well as its prestige. The jurisdiction is also home to 90% of the world’s hedge funds and serves as an important operational jurisdiction for most of the world’s leading financial institutions.

5. Independent reviews of the Cayman Islands regulatory framework by the International Monetary Fund and the Caribbean Financial Action Task Force (CFATF) indicates that the jurisdiction is one of the most highly regulated financial centres in the world. The jurisdiction adheres to the Basel Core Principles for Effective Banking Supervision, the IAIS principles for insurance regulation, the IOSCO principles for
regulation of investments business, the FATF Forty Recommendations on anti money laundering and the Nine Special recommendations on terrorist financing as well as best practices in the area of trust and corporate services regulation.

6. As far as we are aware, there has not been any empirical research into the role of OFCs in global financial stability. However based on the regulatory issues identified by the OECD’s Financial Stability Forum (FSF) as potentially contributing to global financial stability, the independent reviews of the jurisdiction indicates that its regulatory regime meets the highest international standards and is therefore functioning under a regulatory framework which supports global financial stability.

7. Generally, there are four main products and services offered across offshore centres which would come under the definition of complex financial instruments. These are a) repackaging, b) securitisation and CDOs (collaterised debt obligations), c) CFOs and d) asset backed loans.

8. The Cayman Islands is the most commonly used jurisdiction for repackaging and is widely held to be a key jurisdiction for many of the other products as well. 2006 data indicates that the Cayman Islands is second only to Ireland in terms of the number of reported Asset Backed, and other structured products and this illustrates the general importance of offshore centres in this market. It is therefore a fair assessment to conclude that offshore centres have played a very important role in the market for complex financial instruments.

9. Generally, the issue of transparency of OFCs with respect to overseas bodies such as the UK’s tax authorities and financial regulators relates to the extent of cross border information sharing where such information is either requested by overseas authorities or shared as a matter of statistical reporting (for example to the Bank for International Settlements) or the availability of information to the general public.

10. Based on an objective test of the availability of information in comparison with international best practices, the Cayman Islands is a highly transparent jurisdiction. It has participated in international statistical initiatives such as its reporting of data to the BIS and the IMF for many years. The Cayman Islands Monetary Authority (CIMA) also provides extensive data on its website on the financial services sector. Viewers can search for all licensed entities by name; can obtain information on the size, nature, geographical origins of the industry’s aggregated transactions and a host of other information from the website.

11. The jurisdiction provides information on a disaggregated basis under terms and conditions of its various information exchange agreements and in accordance with the law. CIMA, as its financial services regulator, has a long history of co-operating with official regulators in other countries including the UK financial services regulator on information relating to individual institutions on regulatory matters.

12. The traditional idea that absence of transparency and tax evasion represents key incentives for investors doing business in OFCs has long been superseded by a number of modern motives behind the attractiveness of such centres and by extension, their success. Such factors include the following:
   — The increasing importance of “tax neutrality” as opposed to tax avoidance as a motive for utilising OFCs.
   — The accumulation of knowledge and skills in OFCs relating to both offshore financial structures as well as in other areas not traditionally regarded as “offshore” (such as securitisation for example).
   — Ease and convenience of doing business associated with the geographical location of some offshore centres.
   — The relatively higher level of regulatory oversight in some areas as compared to onshore centres (for example in the areas of company incorporation and anti-money laundering measures).

13. It is therefore highly unlikely in today’s climate that lack of transparency or tax evasion would be fundamental success factors for any OFCs whether these are new to the financial services market or existing for some time. Countries that seek to rely on these outdated advantages as a matter of strategy are likely to fail due to heightened international scrutiny and cross border cooperation.

14. The international financial markets also clearly regard the Cayman Islands very highly in terms of the jurisdiction’s quality of service and expertise as well as its reputation as a well regulated centre. This is evidenced by the country’s leadership positions in each of the areas of financial services. It is also supported by a significant endorsement of the integrity of the Cayman Islands via the recent ratings of the jurisdiction by Moody’s, one of the world’s leading credit rating agencies. In 2007, Moody’s, raised Cayman’s ceiling for foreign currency bonds and notes from Aa3 or high grade, to Aaa or exceptional.

15. The primary international standard which governs combating terrorist financing is the FATF’s nine Special recommendations on terrorist financing mentioned earlier. An offshore centre’s effectiveness against terrorist financing will depend largely on the extent to which it has met the requirements for full implementation of these recommendations.

16. The Cayman Islands has not only taken extensive and robust steps to prevent its regime from being abused by terrorist financing, but has also received acknowledgement via several independent reviews that its regulatory framework aimed at these activities is of the highest international standards.
17. The potential policy implications for HM Treasury regarding OFCs can be viewed from two angles; a) the impact of taxation and b) any potential reputation implications for the UK as a result of the operations of the OFCs which are Overseas Dependent Territories (such as the Cayman Islands and Bermuda) or Crown dependencies (such as Jersey or the Isle of Man).

18. From a taxation perspective, there is research suggesting that the lower tax regimes of OFCs could potentially benefit the levels of investment in countries which serves as the home base of the multinational parent company.

19. Research also suggests that lower corporate tax rates do not necessarily translate into less tax revenues to the extent that the lower taxes encourage more taxable economic activity and this is a further issue for HM Treasury to consider when considering its domestic tax policies.

20. With respect to HM Treasury’s policies regarding any potential regulatory reputational risk of OFCs, the UK should continue to work with such centres to ensure that they meet high international regulatory standards. To a large extent much of this has been achieved already as is evident from the various independent reviews of some OFCs over the past eight years. In particular, the Cayman Islands has received numerous endorsements of its regime from international standard setting bodies as mentioned earlier and these results should serve as the basis for guiding HM Treasury’s policies.

21. Double taxation treaties are usually only executed between countries where both countries have a direct taxation system. The Cayman Islands does not have a direct taxation regime, and it does not have any double taxation treaties in place.

22. While the abuse of double taxation treaties does not apply in the case of the Cayman Islands, it is worth noting that the Cayman Islands does not have a regime which facilitates or encourages tax evasion. Indeed, the Cayman Islands was excluded from the list of 35 countries which were blacklisted by the OECD as “uncooperative” in terms of having a harmful tax regime and the jurisdiction committed to implementing measures to prevent harmful tax practices. The Cayman Islands’ participation in the European Savings Tax Directive (EUSD) through the implementation of mechanisms for sharing information with European Tax Authorities was just one of such measures.

23. In general, the extent to which offshore centres investigate businesses and individuals that appear to be evading UK taxation will depend on each country’s individual legal framework and international treaties in this regard. However it is unlikely that such frameworks will directly facilitate investigation of UK tax offences as a matter of law and international convention, but instead will more likely facilitate some level of assistance to the UK tax authority in the event of an investigation.

24. In the case of the Cayman Islands, its participation in the European Savings Tax Directive and its Tax Information Exchange Agreement with the United States are both initiatives that operate under terms and conditions which enable information and assistance to EU tax authorities and the US tax authority (the IRS).

25. These two important initiatives provide a level of information and assistance which would help the overseas tax authorities to carry out their own investigations.

26. The Cayman Islands Financial Services Association welcomes any additional opportunities to provide information on the Cayman Islands to the Treasury Committee of the House of Commons of the United Kingdom Parliament as part of the Committee’s enquiry into offshore financial centres.

Introduction

27. This memorandum has been prepared by the Cayman Islands Financial Services Association in response to a public invitation for written evidence by the Treasury Committee of the House of Commons of the United Kingdom Parliament as part of the Committee’s enquiry into offshore financial centres.

28. The Cayman Islands Financial Services Association (CIFSA) was formed in 2003 to represent Cayman’s financial services industry and to promote information about the industry locally and internationally. Since its inception CIFSA has served an important role in providing information to international and local media about the Cayman Islands financial services industry. It has also recently launched an awareness campaign aimed at raising awareness targeted at the resident population of the Cayman Islands on the nature of services and general role of the industry in the Cayman Islands.

29. CIFSA is a not-for-profit organization funded solely by the private sector. Its membership comprises the jurisdiction’s key associations including: the Cayman Islands Society of Professional Accountants (CISPA), the Society of Trust and Estate Practitioners (STEP), the Cayman Islands Fund Administrators Association (CIFAA), the Company Managers Association (CICMA), the Bankers Association (CIBA), the Insurance Managers Association (IMAC) and CFA Society.

30. In this context CIFSA is well placed to provide information to the UK Treasury Committee on the nature and role of offshore centres, with a focus on the Cayman Islands.
A brief summary of the Cayman Islands as an international financial services centre

31. The two main sectors of the economy are financial services and tourism. Other areas such as property development and construction sectors also play an important role in the local economy. There are no property, capital gains or income taxes in the Cayman Islands.

32. The country has enjoyed this tax free status throughout its entire history. The country has established itself as one of the world’s leading international financial centres.

33. The jurisdiction is a sophisticated international financial services centre with a wide array of service providers and high quality professional expertise. Unlike many offshore centres, Cayman has been in a unique position of being one of the leaders simultaneously in the areas of banking, mutual funds, captive insurance and structured finance.

34. Over the past eight years in particular, the Cayman Islands has undergone a number of enhancements to its regulatory framework for financial services. The jurisdiction adheres to the Basel Core Principles for effective Banking Supervision, the IAIS principles for insurance regulation, the IOSCO principles for regulation of investments business, the FATF Forty Recommendations on anti money laundering and the Nine Special recommendations on terrorist financing as well as best practices in the area of trust and corporate services regulation.

35. In the remaining sections of this memorandum CIFSA will address the majority of the questions identified by the UK Treasury Committee as valuable for the purposes of its enquiry. In addressing the questions CIFSA will focus on the Cayman Islands. The questions which will be addressed are listed below:

— To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?
— To what extent does the use of Offshore Financial Centres threaten financial stability?
— How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom’s tax authorities and financial regulators?
— To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?
— How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets?
— Are British Overseas Territories and Crown Dependencies well-regarded as Offshore Financial Centres, both in comparison to their peers and international standards?
— To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?
— What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?
— What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres?
— To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?

To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?

36. In general, Offshore Financial Centres (hereinafter called “OFCs”) have played a key facilitating role in the world financial markets. The key distinction between OFCs and traditional onshore financial centres is that OFCs tend to be financial services centres where support services and mechanisms are provided to facilitate transactions, while a traditional international financial centre such as London or New York would engage in the actual trading or physical execution of such transactions.

37. This section will address the questions with respect to some of the key areas of financial services using primary data or secondary research where available.

The role of offshore banking

38. The prominence of an international banking centre is often reflected by the cross border links with banks in other locations. A recent study by the Bank of International Settlements (BIS) in its Quarterly Review December 2007, aimed to assess the vitality of international banking centres and how well they are placed to play an important role in international banking. It made the point that size is only one indicator of the multi-faceted dimensions.
39. Before looking at the other factors that determine the importance of a banking centre, the BIS Study ranked banking centres by market share. This was done by looking at total international banking liabilities, excluding liabilities to bank residents.

40. To appreciate the extent of involvement of the Cayman Islands, the top ten countries by market share are listed below, showing that the Cayman Islands ranked fourth in terms of the BIS calculation of market share.

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<th>Banking centres by market share (liabilities)—Dec 2007</th>
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<tr>
<td>1. UK</td>
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<td>2. US</td>
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<td>3. France</td>
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<td>4. Cayman</td>
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<td>5. Germany</td>
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<td>6. Switzerland</td>
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<td>7. Ireland</td>
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<td>8. Netherlands</td>
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<td>9. Belgium</td>
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<td>10. Italy</td>
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*Source: Bank for International Settlements, quarterly review, December 2007*

41. In terms of classifying International Banking Centres, the BIS said another important factor other than size is the degree of connectivity to International Banking Centres. The idea is that being connected to many counterparties in the international banking network enables a banking centre to interact readily with other locations around the world. The most connected centres have a presence on both sides of the market (borrowing and lending). Also, the most connected centres take deposit placements from a greater number of locations than they lend to. For example banks in the UK take deposits from 382 locations (90% of all locations) while lending to 79% of locations.

42. Other measures of the importance of a global banking centre were: closeness to rest of the world, ability to bring lenders and borrowers together, financial intermediation and prestige. These variables are further defined below. The table below is an extract of the BIS data which indicates how the Cayman Islands compares to other major banking centres.

<table>
<thead>
<tr>
<th>International banking centres rankings</th>
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<td><strong>Mktshare</strong></td>
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<td>United Kingdom</td>
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<td>Singapore</td>
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<td>Australia</td>
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*Source: BIS Quarterly Review Dec 2007*

43. In the above table the rank of the jurisdiction is given by the number in the brackets. In addition to its rank as 4th in terms of market share, the Cayman Islands as a banking centre also ranks 11th in terms of its “connectiveness” (In-degree) to other international banking centres and as high as 6th in terms of its “prestige”.

**Definition of other key indicators for international banking centres**

— Closeness—how close it is to the rest of the world, in terms of centres having a broad reach to smaller and more remote countries.
— Betweenness—its ability to bring lenders and borrowers together.
— Intermediation—its capacity to channel funds in the financial sector from those who have it available to those that need it.
The role of Captive Insurance

45. With over 765 captive licensed at the end of 2007, the Cayman Islands is second only to Bermuda in the number of captive insurance companies domiciled in the jurisdiction. Developments in the US legal system in the 1970s and the popularity of liability claims for issues of medical malpractice meant that some hospitals and healthcare administrators did not have adequate access to insurance coverage either because the costs were too high or no traditional insurance company was willing to cover the risks.

46. Some forward thinking medical colleges and hospitals started to look at forming captive insurance companies, where a new company is formed specifically to cover the risks—or part of the risks of its parent. As an offshore financial services jurisdiction, which does not impose tax on companies and business structures and is located close to the US, the Cayman Islands was seen as an ideal location for this new breed of insurance companies.

47. While there are many benefits to private companies in forming a captive, there are a number of benefits to the economy of the jurisdiction of the parent company and to the international insurance markets as well.

48. The International Association of Insurance Supervisors (IAIS) has acknowledged the importance of the captive insurance markets in the international financial markets. According to the IAIS, “Throughout the evolution of the captive insurance market, the reinsurance industry has progressively supported the captive concept and significant reinsurance pools were formed to provide extensive capacity at prices that were commercially attractive to major buyers of insurance. Many of the original captive insurance programmes were based on property insurance of well-protected risks that were subject to extensive loss prevention surveys, exposure analysis and active management of the exposures”.

49. Captive insurance is also well known to produce good risk management benefits as the owner of the captive typically enhances its risk management procedures to reduce the risks to its own capital.

50. The IAIS also recognises that captives bring economic benefits to the economy of the parent company as captives enhance the financial strength and also competitiveness to their parents. Owning a captive has brought risk management to higher prominence in many major international companies, focusing the interest and support of company boards on reviewing and managing all risks, including uninsured risks. The placing of group risk within the captive and active management of that insurance risk has provided the opportunity for the captive insurance owner to accept higher deductibles on its primary programme and by insuring them through the captive the owner is able to obtain reinsurance coverage at lower cost (IAIS).

51. The captive insurance industry in the Cayman Islands therefore not only benefits the individual clients but also serves as an important service for the international reinsurance market which benefits from enhanced risk management within the captives. Its position as the second largest captive insurance domicile outside the United States is proof of its importance in this segment of the international financial markets.

Role of Hedge Funds

52. The hedge funds sector is the fastest growing segment of the Cayman Islands financial services industry. The importance of the Cayman Islands as a domicile for hedge funds for the world’s leading international financial centres is evidenced by the fact that while the influential money managers that run the hedge funds are more likely to be found in major cities like New York and London, or financial centres like Hong Kong and Singapore, to attract the capital needed to make investments, the chances are that the hedge fund itself will be registered in the Cayman Islands.

53. In fact around 90% of all new hedge funds are registered in the Cayman Islands. There were 9,413 hedge funds in the Cayman Island as of December 2007, which comprises the lion’s share of a global market.

54. The significance of the Cayman Islands hedge funds sector to global financial markets is evident from a recent report from the Cayman Islands Monetary Authority which indicates that gross assets under management for Cayman Islands funds totalled US$2.316 trillion. This figure is based only on 5,052 funds which participated in CIMA’s first E-reporting exercise for funds at the end of 2006 and not all funds so the gross assets under management is likely to be much higher. Based on this significant sample however, New York was the top investment management location at 28% with the UK (mainly London) being second at 18% of the net assets under management. This illustrates the confidence of two of the world’s major financial markets in the Cayman Islands hedge funds industry.
55. According to CIMA there were 153 fund administrators, some of which are affiliates of the world’s largest fund administration providers in terms of net assets under administration. Ireland and New York represented the two most significant locations outside the Cayman Islands in terms of net assets under administration.

56. These statistics show that the Cayman Islands is not only very connected to the international investment markets, but is also perceived by leading service providers in these markets as a centre of excellence.

57. As far as global financial stability goes, it has been shown that in times of volatile market swings, the sophisticated trading strategies employed by hedge funds actually aid capital flows around the world, preventing more severe losses.

58. Hedge funds have also been acknowledged for their significant contribution to liquidity in capital markets. A 2007 testimony to the US Senate by Mr. Daniel Shapiro, a representative of the Managed Fund Association explained that “hedge funds are an important source of liquidity, not only in the traditional markets for equity securities, but in other markets such as those for distressed debt, convertible debt, and asset backed securities in the US.”

59. Mr Shapiro also underscored a statement made by US under secretary Steel that “United States capital markets are the envy of the world. Our markets are deep, efficient and transparent. Creativity, innovation and entrepreneurship have long been the hallmark of U.S. markets and their benefits to our economy are clear. Private pools of capital—which include venture capital, private equity, and hedge funds—have helped make us the world’s leading financial innovator.”

60. The role of the Cayman Islands is indicative of the general value of OFCs, which serve as key service centres for the global financial markets. When these services are provided in an environment which meets high regulatory standards, offshore centres play an important role in the global financial architecture.

To what extent does the use of Offshore Financial Centres threaten financial stability?

61. As far as we are aware, there has not been any empirical research into the role of OFCs in global financial stability. One of the most high profile discussions as to this role stems from a report by the OECD’s Financial Stability Forum in 2000 which was based on a survey of various institutions and drew a number of high level conclusions. The FSF Report is important as one of its key objectives was to look into the impact of OFCs on global financial stability. The FSF report concluded that “OFCs, to date, do not appear to have been a major causal factor in the creation of systemic financial problems. But OFCs have featured in some crises, and as national financial systems grow more interdependent, future problems in OFCs could have consequences for other financial centres.” The main thrust of the FSF Report was that poor information exchange, weak supervision, inadequate due diligence and lack of cross border cooperation were important areas to be addressed to maximise the effectiveness of regulation of global financial markets, and by extension, to maintain global financial stability.

62. The FSF also warned that the increasing role of OFCs as evidenced by growth and assets and liabilities coupled with weak supervisory systems could have a negative impact on global financial stability.

63. In the absence of any empirical research into the role of OFCs in global financial stability, it may be useful to outline the extent to which the Cayman Islands addresses these potential issues raised by the FSF.

64. With respect to the issue of weak supervision, while the Cayman Islands has areas identified for further improvement, the jurisdiction has received very positive reviews over the past four years on its regulatory framework. These reviews were carried out by independent bodies; namely the IMF and the Caribbean Financial Action Task Force (CFATF), the latter being the Caribbean arm of the OECD’s Financial Action Task Force (FATF) which is the international standard setting body for anti money laundering and combating terrorist financing. Both organisations concluded that the Cayman Islands was largely compliant with all of the relevant international standards governing the regulation of financial services.

65. In summary, the extent of changes introduced within the Cayman Islands regulatory framework over the past eight years in particular means the jurisdiction is presently one of the most compliant regimes in terms of financial regulation.

66. On the issues of cross border cooperation and information exchange, the Cayman Islands official regulatory bodies have been exchanging information and cooperating with its regulatory counterparts such as the SEC in the US and with regulators in other OECD countries for many years.

67. In addition, the Cayman entered into a historic Agreement for the Exchange of Tax Information with the US. The tax information exchange agreement with the US came into effect in 2004 for criminal tax matters and for other civil and administrative tax matters in 2006.

68. The Cayman Islands implemented a Mutual Legal Assistance Treaty with the United States in 1990. The Cayman Islands Government and the United States has successfully prosecuted over 230 cases since the MLAT was introduced and many of these included the forfeiture of the proceeds of crime as well as the repatriation of assets to the United States for restitution to victims of crime.
69. Indeed, the Cayman Islands was the first country in the Caribbean region, and among the first worldwide, to criminalise the laundering of the proceeds of all serious crimes and extending such legislation beyond the ambit of drug-money laundering.

70. Finally, the Cayman Islands signed up to the European Savings Tax Directive (EUSD) in 2005 and implemented the information exchange option to sharing information with European Tax Authorities. Some jurisdictions signed up to the EUSD with a withholding tax option which meant that they would be liable to pay a withholding tax but not required to share information. But the Cayman Islands private sector fully supported the Government in its decision to sign up under the more cooperative option which requires automatic exchange of information with European tax authorities.

71. On the issue of due diligence the Cayman Islands are now well known to be one of the most compliant jurisdictions in terms of anti money laundering regulation. As an example of this, the most recent CFATF report found the Cayman Islands financial services industry to have a strong anti-money laundering and counter terrorist financing (AML/CFT) compliance culture. In the examination, Cayman was recognised to be compliant in 38 out of 49 measures, which was ahead of the UK, Canada, Spain, Italy and Ireland. Only the US and Belgium have achieved a higher third-round FATF style evaluation than the Cayman Islands.

72. In conclusion, in terms of the issues identified by the FSF as potentially contributing to global financial stability, the Cayman Islands regime meets the highest international standards and is therefore functioning under a regulatory framework which supports global financial stability.

To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?

73. Generally, there are four main products and services offered across offshore centres which would come under the definition of complex financial instruments. These are a) repackaging, b) securitisation and CDOs (collateralised debt obligations), c) CFOs and d) asset backed loans.

74. The Cayman Islands is the most commonly used jurisdiction for repackaging and is widely held to be a key jurisdiction for many of the other products as well. Generally, a repackaging describes an issue of Notes by an SPV (special purpose vehicle), where the Notes are secured on assets of the SPV. The underlying assets generate cash flows equal to cash flows due under the Notes, and are thought of as having been repackaged into the Notes issued by the SPV. The Notes are limited recourse obligations—Noteholders must look to the underlying assets only and cannot look to any other assets of the Issuer. Asset-backed Loans are similar to repackaging but rather than issue Notes the SPV borrows under a loan agreement.

75. Securitisation, or structured finance as it is also known, is the process of transforming assets into securities, which can then be marketed, bought and sold. The prime reason for undertaking a securitisation is to raise finance because initially the securities are sold to investors. One of the most popular types of securitisation is that of mortgage backed securities. CDOs on the other hand, refer to securitisation of other type of loans and debts other than mortgages.

76. Finally CFOs are a structured finance product (similar in structure to a CDO) where the underlying assets are interests in a hedge fund, or fund of funds, (managed by an investment manager). Finally, The SPV issues Notes which are linked to the performance of the underlying fund.

77. The best way to understand the role of the Cayman Islands in the growth of such complex financial instruments is to examine the attractiveness of the Cayman Islands to clients wishing to establish these products. The features of the Cayman Islands in this regard are key to the success of this market and other OFCs who attract this business to a certain extent possess at least some of these features.

78. In the Cayman Islands environment there are some general reasons which will apply across the financial services as a whole and some that are more specific to the structured products market. These reasons are:
   — Stable political and economic climate.
   — Absence of direct taxation—in particular, in the context of structured products, no tax on cash flows received by the SPV under the underlying securities or under the Swap and no withholding tax on interest or Swap payments by the SPV or other taxes applicable to the Notes, the Swap or the SPV.
   — Minimal capitalisation of SPV.
   — Cost—many of these deals are fairly “commoditised” so there is often not a lot of scope for movement in fees and other costs associated with the deal. As a jurisdiction the Cayman Islands have been able to keep both government and service costs/fees within acceptable levels which results in continued efficiency for the structured products market.
   — Speed of incorporation of SPV.
   — Non-intrusive regulatory regime—there is no requirement to obtain regulatory consents for an issue of Notes, no restrictions on issues of Notes by the SPV and no requirement to produce financial statements.
— Minimal profit to be made by the SPV on each transaction.
— High quality of service providers.

79. Generally, the offshore jurisdiction of choice on any particular structured product deal will depend on the requirements of that deal. Investor preference is often a major determining factor, and certain structures (eg where double tax treatment is required because of the jurisdiction of the underlying assets) will call other jurisdictions into play.

80. However, the Cayman Islands is widely regarded as one of the leading offshore jurisdictions for structured products. The 2006 data for the structured products market by jurisdiction by country and deal type is given below:

2006 DATA ON PARTICIPATION OF OFCs IN STRUCTURED FINANCE

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Asset Backed</th>
<th>CDO/CBO/CLO</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Ireland</td>
<td>565</td>
<td>463</td>
</tr>
<tr>
<td>2 Cayman Islands</td>
<td>364</td>
<td>330</td>
</tr>
<tr>
<td>3 Netherlands</td>
<td>145</td>
<td>122</td>
</tr>
<tr>
<td>4 Jersey</td>
<td>40</td>
<td>34</td>
</tr>
<tr>
<td>5 Luxembourg</td>
<td>33</td>
<td>16</td>
</tr>
<tr>
<td>6 BVI</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>7 Guernsey</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>8 Bermuda</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

81. The above table indicates that the Cayman Islands is second only to Ireland in terms of the number of reported Asset backed, CDO, CBO products and illustrates the general importance of offshore centres in this market. It is therefore a fair assessment to conclude that offshore centres have played a very important role in the market for complex financial instruments.

How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom’s tax authorities and financial regulators?

82. Generally, the issue of transparency of OFCs with respect to overseas bodies such as the UK’s tax authorities and financial regulators relates to the extent of cross border information sharing where such information is either requested by overseas authorities or shared as a matter of statistical reporting (for example to the Bank for International Settlements) or the availability of information to the general public.

83. The issue of information sharing with the UK’s tax authorities is addressed elsewhere in this memorandum but it is important to note that the Cayman Islands regulator, the Cayman Islands Monetary Authority shares information with its counterparts (such as the SEC in the US or the FSA in the UK for example) in other countries on regulatory matters.

84. Statistical information relating to transactions of financial services institutions is publicly available in aggregate form in the same way that such information is handled in virtually all other countries as a matter of international statistical best practices, whether offshore or onshore centres.

85. For example, the Cayman Islands submits statistical reports with an extensive series of financial statistics to the Geneva based Bank for International Settlements (BIS) on the banking industry. The Cayman Islands Monetary Authority also recently launched the first issue of a new statistical digest on the hedge funds sector which provides useful data in aggregate form on a wide range of areas highlighting the structure and nature of the hedge funds sector in the Cayman Islands. The Cayman Islands is also a participant in the annual Coordinated Portfolio Investment Survey (CPIS) which is coordinated by the IMF. The CPIS collects data from individual countries and jurisdictions on their cross-border holdings of portfolio investment assets as at the end of the year, disaggregated in equities, short-term debt securities and long-term debt securities. The Cayman Islands has been participating in the CPIS since 2001.

86. The Cayman Islands Monetary Authority also provides extensive data on its website on the financial services sector. Viewers can search for all licensed entities by name; can obtain information on the size, nature, geographical origins of the industry’s aggregated transactions and a host of other information from the website.

87. The jurisdiction provides information on a disaggregated basis under terms and conditions of its various information exchange agreements and in accordance with the law. CIMA, as its financial services regulator, has a long history of co-operating with official regulators in other countries including the UK financial services regulator on information relating to individual institutions on regulatory matters.

88. Most of the statistical information mentioned above is available to the general public via CIMA’s website.
89. The Cayman Islands treats the information for privately owned companies with a similar level of confidentiality as in most advanced economies, whether offshore or onshore financial centres. Public companies listed on the Cayman Islands Stock exchange are subjected to the same level of disclosure requirements as in other countries, while there is no requirement for privately owned companies to disclose their information to the general public.

90. It is important to note however, that the level of regulation and oversight of all companies incorporated in the Cayman Islands (including privately owned ones) is generally of a higher standard than that seen in most countries. This is due to the fact that all service providers incorporating companies in the Cayman Islands are themselves subject to strict licensing, ongoing supervision and onsite inspections by the Cayman Islands Monetary Authority, under the Companies Management Law. The incorporation and administration of private companies is not regulated as a matter of practice in most other countries, so this layer of oversight is considered rare.

91. Indeed, the strength of the Cayman Islands regulatory regime in this area has been recently acknowledged by US Senator Carl Levin in his introduction of the “Incorporation Transparency and Law Enforcement Assistance Act” in the United States Senate. Mr Levin observed that “each year the United States allows persons to form nearly two million corporations and limited liability companies in this country without knowing—or even asking—who the beneficial owners are behind those corporations”. He then acknowledged that “Most offshore jurisdictions already request this information as well, including the Bahamas, Cayman Islands, Jersey, and the [Isle] of Man. Our States should be asking for the same ownership information, but they don’t, and there is no indication that they will any time in the near future, unless required to do so.

92. This point is also supported by the OECD’s 2006 report entitled “tax Co-operation: towards a level playing field-2006 assessment by the Global forum on taxation” which points out that certain small jurisdictions such as the Cayman Islands have put in place mechanisms that enhance transparency and the exchange of information for tax purposes, whereas certain onshore jurisdictions (most notably US states such as Delaware, Nevada and Wyoming) have not.

93. The implication of this observation for the issue of transparency is that while the information of private companies may remain confidential in line with the practice in other countries, there is an underlying obligation that sufficient due diligence on the persons behind the companies is carried out as a matter of law in the Cayman Islands and in strict accordance with the country’s anti money laundering and terrorist financing regime.

**How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets?**

94. The traditional idea that absence of transparency and tax evasion represents key incentives for investors doing business in OFCs has long been superseded by a number of modern motives behind the attractiveness of such centres and by extension, their success. Such factors include the following:

- The increasing importance of “tax neutrality” as opposed to tax avoidance as a motive for utilising OFCs.
- The accumulation of knowledge and skills in OFCs relating to both offshore financial structures as well as in other areas not traditionally regarded as “offshore” (such as securitisation for example).
- Ease and convenience of doing business associated with the geographical location of some offshore centres.
- The relatively higher level of regulatory oversight in some areas as compared to onshore centres (for example in the areas of company incorporation and anti-money laundering measures).

95. In the case of the Cayman Islands, transparency is practiced at high levels as mentioned earlier and it is more likely that the relatively higher levels of scrutiny gives investors a level of comfort which may not exist in some other financial centres.

96. It is important to note that investors in Cayman Islands based entities, cannot evade or avoid taxation as a matter of practice in the Cayman Islands. Ultimately each investor whether individual or a corporate entity will be subject to the tax laws of its originating country so that when dividends/income is paid the relevant tax obligations will have to be complied with at that time. While there are some tax benefits to be had legally, “tax neutrality” has become an equally, and in some cases more important, advantage when clients use Cayman Islands based financial services.

97. Being tax neutral means that whatever tax burden the proposed transaction will have in the main operating market of the companies involved (for example in the US or UK), basing the structure in an offshore jurisdiction will ensure that there is no additional tax burden. At the same time, the international investors will have access to a jurisdiction through which to conduct business that is neutral from the perspective of each as often several countries are represented in a group.

98. For example, US Investors that participate in a Cayman Islands-based hedge fund will have to pay tax on their income to the US tax authorities. The fund, however, does not have to pay any additional tax for being set up and operated in the Cayman Islands.
99. Another example is where international joint ventures are structured as companies in an offshore jurisdiction because neither party involved wants to form the company in the other party’s home jurisdiction, while both sides will want to ensure that there are no unwanted tax consequences. This is achieved by the new joint venture company being established in a tax neutral jurisdiction.

100. Another key factor explaining the position of the Cayman Islands as a leading OFC is the level of expertise developed over the past four decades across numerous areas. The jurisdiction attracts some of the world’s best qualified and sought after bankers, accountants, attorneys and investment professionals. These professionals have been attracted by a market which displays two important features; the presence of some the world’s leading financial services firms (which in turn attracts the best employees) and a working environment that is one of the safest anywhere in the world and offers a high quality of living.

101. These professionals, whether brought in from overseas or trained up locally, pass on their expertise within the industry. They also increase their own knowledge significantly as a result of working in a highly sophisticated financial services market. Indeed there are many instances of Cayman based professionals being “poached” by other new or aspiring OFCs (such as Dubai for example) in order to secure the highest levels of expertise in a given area. Then end result is that the jurisdiction increases its expertise exponentially and this has high marketing value to potential clients seeking to use the services of an OFC.

102. Generally, OFCs will differ in the extent to which their success is based on the modern motives described above. New OFCs for example, will face an environment which requires far more regulation than was required thirty or forty years ago, as regulatory standards have improved dramatically in both offshore and onshore centres since then. International cooperation and the increase in tax agreements between onshore and offshore centres have also changed the landscape of transparency and information exchange.

103. It is therefore highly unlikely in today’s climate that lack of transparency or tax evasion would be fundamental success factors for any OFCs whether these are new to the financial services market or existing for some time. Countries that seek to rely on these outdated advantages as a matter of strategy are likely to fail due to heightened international scrutiny and cross border cooperation.

Are British Overseas Territories and Crown Dependencies well-regarded as Offshore Financial Centres, both in comparison to their peers and international standards?

104. As acknowledged by the FSF report in 2000, all OFCs are not the same. The offshore centres differ in both the nature and diversity of their financial services on offer as well as in the quality of their regulatory frameworks.

105. Notwithstanding this diversity, the Cayman Islands is one of the so called “mainstream offshore centres” (other jurisdictions widely held to be part of this group are Bermuda, Bahamas, BVI, Jersey, Dublin and Switzerland). These jurisdictions can therefore be regarded as Cayman’s peers. For the most part these jurisdictions recognise the relatively higher quality of each other in terms of both their commercial success and regulatory standards. As a result there is cooperation at both the official levels between regulators as well as within the private sector as evidenced by many of the leading firms having offices across several of these jurisdictions. In some cases, these jurisdictions also provide complementary services based on their relative strengths. As an example the Cayman Islands is home to over 90% of the world’s hedge funds but a large percentage of these funds are administered in Dublin.

106. With respect to international standards, the various independent regulatory reviews are the most objective indicator of whether offshore centres are well regarded in terms of international regulatory standards. Each individual jurisdiction will differ in terms of the extent to which it complies with these various international standards. As mentioned earlier the Cayman Islands has received very positive reviews of its regulatory framework in this regard.

107. Commercially, the international financial markets also clearly rates the Cayman Islands very highly in terms of the jurisdiction’s quality of service and expertise as well as its reputation as a well regulated centre. This is evidenced by the country’s position as the only offshore centre which can simultaneously holds the position of being among the top jurisdictions across the widest range of services. The Cayman Islands is the number one choice for offshore hedge funds, is regarded as one of the world’s top offshore banking centre, is second only to Bermuda in the number of captive insurance companies and is the leading offshore jurisdiction for structured finance transactions.

108. Another significant endorsement of the integrity of the Cayman Islands generally lies in the ratings of the jurisdiction by Moody’s, one of the world’s leading credit rating agencies. In 2007, Moody’s, raised Cayman’s ceiling for foreign currency bonds and notes from Aa3 or high grade, to Aaa or exceptional. This recent rating puts the Cayman Islands alongside the UK, US, Canada and Bermuda. The country ceiling is the highest rating obtainable for an issuer of long-term foreign currency-dominated bonds. The Moody’s rating is of significance in terms of how highly the Cayman Islands is regarded because Moody’s is an independent provider of economic information that international banking and other lending institutions use as one of their guides on whether they should conduct business with entities within a country, or a government, and to what extent.
109. Moody’s advises that an Aaa country ceiling for foreign currency bonds and notes could be interpreted as “having the best and/or exceptional quality with the smallest of investment risk” so the rating confirms the Cayman Islands status as a quality jurisdiction from the perspective of international investors.

110. The reputation and general quality of the Cayman Islands is also evident from a recent review by the UK’s House of Commons Public Accounts Committee in the seventeenth report of Session 2007–08 entitled “Foreign and Commonwealth Office: Managing Risk in the Overseas Territories. In this report the following observations made by the House of Commons PAC are worth noting:

— The Cayman Islands are regarded as the one of most highly regulated offshore jurisdictions based on the summarised report of compliance presented by the PAC which is based on the IMF assessments. It is also worth clarifying that this table represents data from the 2005 review by the IMF and not the follow up assessment by the IMF in 2007. The significance of this observation is that the 2007 assessment would have captured the improvements made by the Cayman Islands in any areas identified by the 2005 review.

— The PAC report acknowledges the “major improvements in capacity since 2000 (in reference to the Cayman Islands’ ability to adequately regulate its financial services industry).

— The Cayman Islands is the only OFC in a UK Territory or Crown Dependency which reported successful local prosecutions in connection with investigating suspicious financial activity.

— The Cayman Islands met the US$2.5 billion cost of Hurricane Ivan without recourse to UK financial assistance. The PAC also acknowledges that the Cayman Islands has “advanced systems” in terms of its standard of disaster management.

To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?

111. The primary international standard which governs this area is the FATF’s nine Special recommendations on terrorist financing mentioned earlier. An offshore centre’s effectiveness against terrorist financing will depend largely on the extent to which it has met the requirements for full implementation of these recommendations.

112. It is also important to note that in the case of the Cayman Islands, data from the Royal Cayman Islands Police in 2006 indicates that terrorist financing accounts for a mere 1% of the total suspicious activity reports made in the country. While no studies have been conducted as to the reason for this, it is likely owing to the Money Laundering Regulations as well as an extensive suite of measures targeted at terrorism financing starting with the introduction of the terrorism law in 2003. The Terrorism Law addresses various topics that include:

— definition of terrorist activity;
— money laundering;
— forfeiture of terrorist cash; and
— disclosure of information.


114. Finally, the Cayman Islands regularly receives executive orders from the President of the United States specifying suspected terrorists and lists from the UN Security Council and other credible sources and these are immediately circulated to the financial services industry by the Cayman Islands Monetary Authority. This enables checking of client lists and any necessary follow up actions.

115. In 2005 the IMF review of the Cayman Islands regulatory regime concluded that the jurisdiction had “a sound legal basis and robust legal framework for combating money laundering and terrorist financing”. The report also acknowledged that the Cayman Islands has “an intense awareness of anti money laundering and combating of financing of terrorism which is supported by a sound supervisory program.”

116. The Cayman Islands has therefore, not only taken robust steps to prevent its regime from being abused by terrorist financing, but has also received acknowledgement via several independent reviews that its regulatory framework aimed at these activities is of the highest international standards.

What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?

117. The implications for policies of HM Treasury ultimately depend on the research and analysis carried out internally within the UK on the actual impact of OFCs on the UK economy. But the potential policy implications can be viewed from two angles; a) the impact of taxation and b) any potential reputation implications for the UK as a result of the operations of the OFCs that are Overseas Dependent Territories (such as the Cayman Islands and Bermuda) or Crown dependencies (such as Jersey or the Isle of Man).
118. From a taxation perspective, there is research suggesting that the lower tax regimes of OFCs could potentially benefit the levels of investment in countries that serve as the home base of the multinational parent company. Mihir Desai and Fritz Foley of the Harvard Business School and James Hines of the University of Michigan, produced a research paper in 2005 which suggests that “tax haven activity enhances activity in nearby non tax havens”.

119. In a separate paper, Hines concludes that there is empirical evidence suggesting that a 1% greater likelihood of establishing a tax haven is associated with a 2.5% greater investment and sales in nearby non tax haven countries.

120. There are research difficulties in assessing the exact impact of lower tax jurisdictions on higher tax countries, but another way of looking at the question of impact is to view the continuing use of lower tax jurisdictions by companies as proof that it is economically beneficial to their business and global competitiveness and by extension good for the respective economies in which they are domiciled (and also where they tend to employ the most staff members).

121. Research also suggests that lower corporate tax rates do not necessarily translate into less tax revenues to the extent that the lower taxes encourage more taxable economic activity and this is a further issue for HM Treasury to consider when considering its domestic tax policies.

122. HM Treasury’s policies with respect to the potential regulatory reputational risk of OFCs are a relatively easier matter to address. The UK should continue to work with such centres to ensure that they meet high international regulatory standards. To a large extent much of this has been achieved already as is evident from the various independent reviews of some OFCS over the past eight years. In particular the Cayman Islands has received numerous endorsements of its regime from international standard setting bodies as mentioned earlier and these results should serve as the basis for guiding HM Treasury’s policies.

What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres?

123. Double taxation treaties are usually only executed between countries where both countries have a direct taxation system. One of the reasons for this is to prevent abuse of such treaties by companies who can potentially restructure their affairs in such a way as to always affect the minimum level of taxes via the country with the lower tax rate. The abuse occurs because it is felt that this restructuring goes against the spirit of the double tax treaty which was primarily to avoid duplicating tax liabilities for the individual or company, not to reduce the tax liability (or in some cases, completely avoid any tax liability at all). As the Cayman Islands does not have a direct taxation regime, it does not have any double taxation treaties in place.

124. While the abuse of double taxation treaties does not apply in the case of the Cayman Islands, it is worth noting that the Cayman Islands does not have a regime which facilitates or encourages tax evasion. Indeed, the Cayman Islands was excluded from the list of 35 countries which were blacklisted by the OECD as “uncooperative” in terms of having a harmful tax regime and the jurisdiction committed to implementing measures to prevent harmful tax practices. The previously mentioned agreement of the Cayman Islands in participating in the European Savings Tax Directive (EUSD) through the implementation of mechanisms for sharing information with European Tax Authorities was just one of such measures.

To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?

125. In general, the extent to which offshore centres investigate businesses and individuals that appear to be evading UK taxation will depend on each country’s individual legal framework and international treaties in this regard. However it is unlikely that such frameworks will directly facilitate investigation of UK tax offences as a matter of law and international convention, but instead will more likely facilitate some level of assistance to the UK tax authority in the event of an investigation.

126. As mentioned earlier the Cayman Islands have signed up to the European Savings Tax Directive and have in place a Tax Information Exchange Agreement with the United States. Both of these initiatives operate under terms and conditions which enable information and assistance to EU tax authorities and the US tax authority (the IRS).

127. These two important initiatives provide a level of information and assistance which would help the overseas tax authorities to carry out their own investigations.

128. The Cayman Islands does not have a TIEA or any other form of taxation agreement in place directly with the UK. As the Cayman Islands does not have a direct tax system the country’s legislative framework does not address (ie criminalise) tax evasion. However it does provide assistance to other countries under certain agreements (see discussion under section on double taxation treaty abuse).

June 2008
EXECUTIVE SUMMARY

— The Isle of Man is an active, constructive and pragmatic partner in the OECD Global Forum on Taxation and is acknowledged by the OECD as a responsible international financial centre. Over recent years, the Isle of Man has striven to comply with the highest standards of international financial regulation. The Island is a mature small financial centre and has no secrecy laws or practices that protect the identity of bank customers. Whilst it is true to say that both individuals and businesses can conduct their affairs confidentially, the Island should not be bracketed with jurisdictions which have actively introduced laws and practices to promote secrecy. The Island has always been careful to maintain an appropriate balance between the confidentiality of private bank customers and businesses on the one hand, and the need for taxing and regulatory authorities to be privy to certain information on the other.

— In the operation of its legislative, legal and administrative provisions, there is no doubt that the Isle of Man is transparent and operates under the rule of law. Its laws and regulations are clearly set out in both primary and secondary legislation, which is available to all. Interpretation of certain legislative provisions by the authorities is often made the subject of practice notes, which are issued in the public domain. As in most jurisdictions, the authorities (whether tax or otherwise) can be approached on an individual basis for a private ruling, but this represents no more than confirmation of the authority’s interpretation of the Island’s laws as they apply to the facts of a particular case.

— Given their geographical and historical proximity, a strong business culture is shared between the Island and UK business. The Island has established a reputation for being internationally responsible and economically competitive. That the Isle of Man holds Moody’s and Standard & Poor’s AAA accreditation is testimony to this fact. Given the close affinity in business cultures, the Island has succeeded over recent years in becoming a gateway to the City of London in ways highly beneficial both to the Island and the UK.

“Assets worth billions of pounds held by Isle of Man companies are invested in and through the City. The way we see it is that the Isle of Man is a core asset for the City.”

The Lord Mayor of the City of London, Alderman David Lewis, 21 November 2007

CONSTITUTIONAL, POLITICAL AND LEGAL BACKGROUND

1. Located in the middle of the Irish Sea at the centre of the British Isles, the Isle of Man is 33 miles long and 13 miles wide at its broadest point and has a total land area of 227 square miles. The resident population is just over 80,000 (2006 interim census). There are no immigration barriers between the Island and the United Kingdom ("UK") or Ireland, but there is a work permit system that controls the right to take up employment.

2. Constitutionally, the Island is a self-governing British Crown Dependency with its own ancient parliament (Tynwald), government and laws. The UK Government, on behalf of the Crown, is ultimately responsible for the Island’s international relations. As the Head of State, the Queen is represented on the Island by the Lieutenant-Governor. The Isle of Man has never been part of the UK nor the European Union ("EU") and receives no funding from either. It is not represented at Westminster nor in Brussels. The Island has a limited relationship with the EU set out in Protocol 3 to the UK’s Act of Accession annexed to the Treaty of Accession by which the UK acceded to the Treaty of Rome in 1972, allowing for free trade in agricultural and manufactured products between the Isle of Man and EU members. Apart from matters relating to this special relationship, which includes customs, the Island is not bound by EU legislation.

3. The Island has no party political system and the leader of its government, the Chief Minister, is chosen by Tynwald after each general election. The Chief Minister selects nine Ministers to head the major government departments and together they make up the Council of Ministers, the central executive body or Manx “cabinet”, which is accountable to Tynwald.

4. The Island has its own legal system and jurisprudence. English law is not directly of application in general, but the Manx legal system is based on the principles of English common law which are of course shared by many Commonwealth countries. Manx law is accordingly very similar to English law in areas such as crime, contract, tort and family law. However, in certain areas, although modelled on English law, Manx law has adapted to meet the Island’s own special circumstances, particularly with regard to direct taxation, company law and financial supervision. The Island’s High Court judges hold the ancient office of Deemster and have jurisdiction over all criminal and civil matters. The rarely exercised final right of appeal to the Judicial Committee of the Privy Council remains. The Island has fully incorporated into Isle of Man law the basic rights set out in the European Convention on Human Rights through its Human Rights Act 2001. The Island has also embarked on an ambitious legislative programme to ensure compliance with various international anti-crime instruments, including the Council of Europe Criminal Law Convention on Corruption 1999, the Palermo Convention against Transnational Organised Crime 2000 and the United Nations Convention against Corruption 2003.
5. The Isle of Man is committed to delivering effective regulation. It complies fully with international standards. Under the auspices of the Organisation for Economic Co-operation and Development ("OECD"), it is at the forefront of the development by small jurisdictions of a network of Tax Information Exchange Agreements ("TIEAs"), based on mutual economic benefit. It has a transparent tax code, and does not have banking secrecy laws. It has consistently shown itself to be a co-operative jurisdiction in terms of the international fight against criminal activity.

6. The Isle of Man has had one of Europe’s fastest growing economies in recent years, led by the international financial services industry. Business is attracted by the competitive tax regime, professional expertise, supportive government, world-class telecommunications infrastructure and sound financial regulation. New growth areas include e-commerce, the film industry, international shipping, aviation, and space and satellite business, whilst traditional sectors like tourism (including the famous Tourist Trophy motorcycle races) are still important.

7. In 2005–06, the Gross Domestic Product (GDP) was £1.6 billion. Over the past ten years, the Island’s average real annual rate of economic growth has been 7.8%, continuing some quarter of a century of unbroken growth. Economic sectors include: financial services (36% of GDP), construction (9%), manufacturing (7%), professional and scientific services (16%), tourism (6%), and farming/fishing (1%). The Island has a working population of around 43,000 and a current unemployment rate of 1.3%. Annual inflation to April 2008 was 4.9%.

**THE GENERAL ROLE OF “OFFSHORE” FINANCIAL CENTRES WITHIN THE GLOBAL FINANCIAL SYSTEM**

8. Whilst the Isle of Man wishes to assist the Committee with its work, and therefore seeks in this submission to provide answers to the Committee’s questions, nevertheless, the Island’s Government also wishes to point out that there is no commonly agreed definition of the term “offshore” when linked to a financial centre. Without such a definition, those people, organisations and governments that make submissions to the Committee may be making unstated assumptions. In consequence, comparison of the submissions may prove difficult.

9. A concentration of activity in export service sectors in most small economies is not unexpected, given typically an absence of resources and economies of scale in production. That specialisation occurs in an area of comparative advantage, be it tourism or financial services, is then not only understandable (and encouraged by free trade organisations such as the WTO), but also upheld in standard economic analysis of comparative advantage, be it tourism or financial services, is then not only understandable (and encouraged by free trade organisations such as the WTO), but also upheld in standard economic analysis to be beneficial both to the country concerned and to its trading partners. Exporting, whether of goods or services, is a fundamental part of most modern economies.

10. In a similar vein, there is often specialisation within multinational companies leading to their allocating specific functions to different jurisdictions. In the quest for maximum efficiency, large companies are legally and ethically justified (and indeed ought to be encouraged by all parties) in dividing their business operations into different functions and having organisational structures that minimise costs (including tax liabilities), whilst maximising profits and shareholder value.

11. Low tax centres, such as the Isle of Man, are a key part of the global financing system. By facilitating capital movement, often in niche segments of markets, they are able to bring on-stream what might otherwise be dormant, unproductive and ineffective financial resources.

12. As global markets have been liberalised and capital mobility increased so the smaller centres have deployed their capabilities to the mutual benefit of investors and recipient nations. In general, the small international financial centres make global financial markets more liquid, more cost-effective and more efficient in the direction, accumulation and allocation of investment capital, so providing for greater economic growth and increased living standards worldwide. The liberalisation of cross-border capital movement and the role of low tax centres within the global system have beneficially focussed the attention of governments of larger nations on their own tax systems and public finances generally.

13. It is often forgotten in the debate over taxation that there is nothing natural about taxes. Unlike the prices of goods and services, taxes are not determined by market forces. Rather, they are an artificial device to help governments attain various policy objectives. To the extent that governments will have differing policy objectives, the structure of taxation systems, tax levels, and indeed whether taxes exist at all, will naturally differ between nations.

14. Smaller jurisdictions, unlike their larger counterparts, cannot expend vast sums on financial packages to attract inward investment or subsidies to sustain existing production. They simply do not have the funds. Tax is a competitive tool they do have available.

15. It is contended that the liberalisation of cross-border capital movement and the role of low tax centres within the global system has beneficially focussed the attention of governments of larger nations on their own tax systems and public finances generally. Lowering tax rates does not necessarily result in lower tax revenues, a fact not lost on governments of all sizes and for reasons not all connected with the competition for investment. However, tax pressure can contain government spending and accelerate consideration of the need for reform in ensuring the efficient, economic, and effective provision of public services.
THE ISLE OF MAN PERSPECTIVE

16. With specific reference to the UK, the Isle of Man serves a highly important function as a gateway for channelling capital to the UK. Current data indicate that the deposit-taking institutions alone invest some £17 billion more in the UK than is sourced from there, thereby increasing liquidity to the UK financial markets and creating activity and profits for the UK’s financial services industry. In the Isle of Man’s absence, it is certain that much of the outflow of funds from the UK would still occur, but would go further afield and be reinvested in other jurisdictions. From a regulatory perspective, the recipient jurisdiction for such funds might well not be as transparent and well-regulated as the Isle of Man. During a visit to the Isle of Man on 21 November 2007, the Lord Mayor of the City of London, Alderman David Lewis, referring to the synergies between the Isle of Man and the City and citing the Island’s role as the leading offshore jurisdiction for non-UK companies joining the London Stock Exchange’s Alternative Investment Market (AIM), stated:

“We recognise how capable you are in helping companies list on AIM and thereby gain rapid, quality access to the City’s capital investment markets”.

17. The Lord Mayor described the Isle of Man and the City as “boosting each other’s competitive edge in a way which is unmatched by other financial centres given our mutual history, geographical proximity and business culture” and cited with approval “our common understanding of and approach to business”. The latest Hemscott Report (September 2007) ranks the Isle of Man first by market capitalisation in both top 100 non-UK companies listed on AIM, and in the overall list of non-UK companies listed on AIM. The report describes how, during 2007, the Isle of Man fed some £9.04-billion of AIM listings to London.

18. Further evidence of the commonality of interests in the development of the Isle of Man’s economy is provided in labour market data. A large proportion of the employment created in the Isle of Man in recent years has provided jobs for individuals from other parts of the British Isles. There can be little doubt that the growth of the Isle of Man’s economy has created jobs in the UK. If we were to think of the Isle of Man purely as a region of the UK, then it is likely that overall employment would be lower than is currently the case. The majority of jobs on the Island are filled by non-Manx born individuals. Just under half of the total workforce, and just over half of the workforce in the financial services sector, were born in the UK.

19. The Isle of Man Government allocates £10.4 million (2007–08 probable) on support to its farming and fisheries sectors, in schemes providing equivalent assistance to that available in the UK. A sum of £3.5 million (2007–08 probable) is provided to manufacturing.

20. Such finance is discretionary and based on the rigorous examination of business plans to be supplied in support of any application. The sums provided are modest and cannot be said to constitute the subsidisation of ailing concerns or speculative initiatives, of a kind commonly and expensively adopted by larger nations and which are arguably the major distorting influence on decisions affecting the location of economic activity.

21. For any economic action or policy to be “harmful” implies that the aggressor jurisdiction is of a size significant enough to impose meaningful damage on others with which it is competing. In the context of competition for investment, it would have to be the case, on both theoretical and practical grounds, that a jurisdiction was conducting a sufficiently large volume of international business and, moreover, that it was its tax advantage alone that was responsible for the attraction of the investment. On neither count can the Isle of Man be said to constitute a source of harmful competition. The available quantitative data indicate clearly that the Isle of Man attracts and transacts a miniscule fraction of global investment capital flows, something which also makes it unlikely that it could constitute any systemic risk to the global financial system. Furthermore, the relatively low tax rate forms just one part of a package of operating advantages on offer. There is a vast quantity of empirical evidence that confirms that tax is just one, and not necessarily the key, factor that determines geographic and portfolio investment decisions.

22. In the Isle of Man’s case there are equally important factors including the scope, space and commitment to growth, the range and depth of professional skills, the excellent quality of life in terms of recreation, education, travel to work and housing, political stability, the English common law basis to the legal system, cost advantages, extensive communications links, the capacity and security of telecom systems, and the business benefits of the time zone.

23. The Isle of Man Government is fully cognisant of its economic interests being inextricably related to the maintenance, and indeed improvement, of its reciprocal access to overseas markets. Government’s position in matters of international co-operation is therefore one of full and open participation whilst defending its own economic interests. It holds the view that its present role in the international financial and trading system will be sustained only through open engagement with current and prospective trade partners, with standards and requirements set by mutual agreement, be it on a multilateral or bilateral basis.

24. Clearly, anything which significantly damaged the economic interests of the Isle of Man would have negative effects elsewhere, primarily in the UK, but also in the EU. Significant economic damage would consign the Isle of Man to the economic status of a deprived area which, in an EU context, would necessitate financial assistance. On the UK scale, the size of the Isle of Man would rank it only alongside a small local council. The Island’s GDP figures would suggest it is typical of areas within assisted regions throughout the
EU. There are innumerable areas of similar size within EU Member States that will be receiving vast sums of EU finance, whilst also being the target for investment attracted under preferential tax schemes sanctioned by the EU, because of geographical location and low per capita GDP.

25. There is very little evidence that the Isle of Man financial services industry poses a threat to international financial stability. As indicated above, the scale of the flows of funds involving the Island is relatively miniscule seen against global movements (see, for example, the figures quoted in HM Treasury’s paper, “Embracing financial globalisation”, May 2008, Crown Copyright) and the recognisedly advanced level of regulation and law enforcement co-operation and assistance, coupled with the on-going programme of Double Taxation Agreements and TIEAs, serve to negate such threat as there might theoretically be.

26. The Isle of Man is generally not a jurisdiction that engages in complex financial instruments, so this is not an area of financial services that is of much importance in the Island.

**TAXATION**

**Direct Tax**

27. Income Tax and National Insurance (social security) are the two significant direct taxes levied on the Island. National Insurance contributions, classes and rates are structured in a similar way to the UK’s system, as there is a reciprocal agreement on pensions and health care.

28. Resident persons (natural and legal) are taxed on worldwide income while non-resident persons are taxed only on Isle of Man source income.

**Personal Income Tax**

29. The Island’s personal income tax system for individuals is as follows:
   - All sources of income are taxed on a current year basis of assessment.
   - Joint assessment for married couples is available by election.
   - Various personal allowances and other deductions from income are available, such as relief for interest, covenanted payments and approved pension arrangements. The main tax-free personal allowance is £9,200.
   - Taxable income in excess of allowances is then subject to a standard rate of tax of 10% (residents only) on the next £10,500 and thereafter at the higher rate of 18%.
   - A system of deduction of tax at source on earnings called the Income Tax Instalment Payments Scheme (ITIPS) is operated, and there is a similar scheme specifically for persons involved in the building industry.
   - Where a person’s total income is less than their personal allowance, up to £500 is payable directly to them annually as a tax credit.
   - Personal income tax is capped at £100,000 (£200,000 for a jointly assessed married couple).

**Corporate Income Tax**

30. Major changes in the Isle of Man’s corporate income tax system took effect from 6 April 2006:
   - The standard rate of corporate income tax is 0% on all income, except for two defined activities: (a) a licensed banking business; and (b) corporate income from Manx land and property (property development, commercial letting and rents and mineral extraction). Corporate income from these two activities is taxed at 10%.
   - Corporate income from all other regulated activities, eg, insurance, fund management, etc. are taxed at the standard rate of 0%.
   - Special regimes (Non-resident Company Duty, Exempt Companies, Exempt Insurance Companies, Exempt Managed Banks, International Business Companies and other international regimes) were repealed from 6 April 2007. New entrant applications for any of the special regimes ceased to be accepted from 6 April 2006.

**Indirect Taxation—Value Added Tax**

31. The Isle of Man’s indirect taxation system is a mature, advanced system which in short parallels the system in operation in the UK and is in accordance with all EC/EU rules, regulations, directives, etc. Through the Customs and Excise Agreement with the United Kingdom and the Protocol 3 arrangement, the Island is part of the EC customs territory and is treated as if it were part of the fiscal territory of the EC. EC/EU legislation in most customs matters applies directly. Although EC/EU Value Added Tax and excise legislation does not apply in the Isle of Man, the provisions of the relevant directives are given legal effect through Manx legislation. The Isle of Man is almost unique amongst jurisdictions outside the EU in that it
levies such taxes on everyone, including businesses, financial institutions, trusts, etc, in the same manner and at the accepted rates as for any full Member State. This levying of indirect taxes results in a substantial loss of business to many traders in the Isle of Man in that their clients can and do use other jurisdictions which do not enforce or apply such taxes and duties. The taxes imposed in the Isle of Man include VAT at a standard rate of 17½%. Customs duties, agricultural levies, excise, alcohol and tobacco, and air passenger duty. In terms of an agreement between the Isle of Man and the UK, for VAT, customs and most excise duty purposes, the two territories are treated as if one. These indirect taxes and duties are pooled and shared. This negates the need for customs barriers between the two jurisdictions. Most, but not all, excise duties are covered by the agreement. All these are subject to rules and liability similar to what applies in the UK and Europe. These taxes are enforced in the same way as in the UK, and, where the trader has not complied with the rules, penalised in the same way as in the UK. Traders have the same rights as those in the UK, whether by appeal to the UK VAT and Duties Appeals Tribunal, the European Courts or by seeking equity of treatment in the Single European Market.

32. The Island’s customs and excise (although not its direct taxation) administration and collection procedures are subject to annual audit by the UK National Audit Office. The Island’s indirect taxation receipts are included in the European Court of Auditors’ annual checks and the accounts are laid before the UK Parliament annually.

33. The Island has agreements with all member states of the EU in relation to the Directive on the Taxation of Savings Income in the Form of Interest payments, and has operated local legislation equivalent to the Directive effectively and in accordance with all EU requirements since 2005.

Isle of Man’s Position in Respect of Exchange of Information for Tax Purposes

34. The Isle of Man is an active, constructive and pragmatic participating partner in the OECD Global Forum on Taxation and is acknowledged by the OECD as a responsible International Finance Centre.

35. Recognising that exchange of information on request is the appropriate international standard, the Island is negotiating Tax Information Exchange Agreements (TIEAs) which are in the Island’s interest and of mutual economic benefit.

36. A TIEA with the United States was signed on 3 October 2002, was ratified by Tynwald in April 2006 and entered into force on 26 June 2006.

37. A TIEA with the Netherlands was signed on 12 October 2005 and was ratified in May 2006. Discussions for the development of a Double Taxation Agreement (DTA) are under way.

38. TIEAs were concluded with the seven members of the Nordic Council—Denmark, the Faroe Islands, Finland, Greenland, Iceland, Norway and Sweden—in October 2007 and with Ireland in April 2008.

39. TIEA negotiations are at various stages with other countries, and further new negotiations have commenced this year. The Isle of Man expects to sign a number of further TIEAs before the end of the year.

40. In a Press Release dated 12 October 2005, the OECD welcomed the tax information exchange agreement between the Isle of Man and the Netherlands. OECD Secretary-General Donald J. Johnston hailed the agreement as an important step forward in the global effort to detect and deter abuses of the global financial system:

   “I congratulate both parties for having strengthened their bilateral co-operation to counter tax abuses. This agreement confirms the Isle of Man’s commitment to implement high international standards, thereby reinforcing its stature as a responsible international financial centre”.

41. On signature of the tax information exchange agreement between the Isle of Man and Ireland on 25 April 2008, Paolo Ciocca, the Chair of the OECD’s Committee on Fiscal Affairs welcomed such agreements as enhancing the international reputation of the Isle of Man as a legitimate financial centre and thereby strengthening its integration into the international financial system.

42. The veteran District Attorney for New York County, Robert Morgenthau, has expressed his view in writing that the Isle of Man is well-regulated and co-operated in assisting his office in investigations and, in 2003, the following statement was made through the US Embassy in London:

   “US Customs Agents based in the US Embassy in London have confirmed that, contrary to various recent reports, in all their dealings and requests for assistance, the Isle of Man has been fully co-operative and takes an aggressive position in joint investigations involving money laundering and fraud”.

43. In the Financial Times of 21 February 2008, the Secretary-General of the OECD, Angel Gurria, referred to the need to secure a commitment to transparency and the effective exchange of information from the three financial centres which remain on the OECD’s most recent list (August 2007) of unco-operative tax havens: Liechtenstein, Monaco and Andorra. He commented that, in comparison with these financial centres, other “financial centres, such as Jersey and the Isle of Man, have made great strides in strengthening their bilateral tax co-operation and are thriving. I hope Liechtenstein continues down this path of greater co-operation.”
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**Blacklists**

44. The Isle of Man has been labelled in the past either as a “tax haven” or as having “harmful tax practices”, or both. Whilst not accepting the legitimacy of these labels nor the methodology on which they are based, the Isle of Man nevertheless wishes to ensure that its international reputation is that of a well-regulated jurisdiction that is prepared to comply with appropriate worldwide economic and fiscal standards. As a consequence, the Isle of Man has both played an active role in, for example, the OECD Global Forum on Taxation and has rapidly updated its domestic legislation and practices to meet international benchmarks.

45. Certain countries have included so-called “subjective tests” in their fiscal legislation in relation to the OECD “tax haven” list. This list is acknowledged to be out of date. The OECD has posted a covering memorandum to its 2000 Harmful Tax Practices Report that states:

> “The report includes a list of tax havens on page 17. That list should be seen in its historical context and as an evaluation by OECD member countries at a particular point in time of which countries met the criteria set out in the 1998 Report, “Harmful Tax Competition: An Emerging Global Issue”. More than five years have passed since the publication of the OECD list contained in the 2000 Report and positive changes have occurred in individual countries’ transparency and exchange of information laws and practices since that time. The list has not been updated to reflect such changes.

If a country chooses to use a list of countries derived from the OECD list, it should do so based on the relevant current facts. Thus, progress made in the implementation of the principles of transparency and effective exchange of information in tax matters should be taken into account by such countries and their legislatures. This statement does not reflect any judgment on the tax or other policies underlying country lists.”

46. According to Angel Gurra (again writing in the Financial Times of 21 February 2008), “almost all the jurisdictions identified as potential tax havens by the OECD in 1998 have committed to the principles of transparency and effective exchange of information.” As a reflection of the Isle of Man’s commitment to these principles, the Isle of Man has not appeared on the OECD’s list of unco-operative tax havens since 2001. Moreover, since 2001, the Isle of Man has taken a place in its own right at the OECD’s regular Global Forum meetings, where only unlisted jurisdictions have the right to a seat.

47. In relation to blacklisting, Jeffrey Owens, Director of the OECD’s Centre for Tax Policy and Administration, testified in 2007 before the United States Senate Finance Committee:

> “Lack of transparency and lack of effective exchange of information are the key attractions for tax cheats because they can place their assets in a jurisdiction with these features in the knowledge that information on their activities will not be disclosed to the tax authorities back home. They are also the key factors in identifying tax havens.”

48. During his visit to the Isle of Man in November 2007, the Lord Mayor of the City of London, Alderman David Lewis, affirmed that:

> “From the City’s point of view, your brand was immensely strengthened when you committed to work with the OECD on improving transparency and tax information, and then backed it up with a host of Tax Information Exchange Agreements.”

49. The Isle of Man has a transparent tax system, provides prompt and effective co-operation to countries which request assistance in accordance with the Island’s financial crime legislation and is able to provide tax information on the basis of TIEAs.

**Regulation**

50. The Island is a relatively small, but nonetheless mature, international financial services centre. As such, it is acutely aware that it must act responsibly and co-operatively at all times, in order to enjoy the confidence of standard setters and assessment bodies and secure reciprocal access to other markets. The Island’s principal asset as a financial centre is its reputation, and sustaining that reputation is the most important discipline imposed upon it.

51. In regulatory terms, the first priority which this requires is for the Island to adhere to accepted international standards in all areas of financial activity which it regulates. In particular, this refers to the core principles and recommendations of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions (“IOSCO”), the International Association of Insurance Supervisors and the Financial Action Task Force (“FATF”). The Island is committed to adherence to the principles of all the FATF recommendations.

52. The Island’s regulatory arrangements are grouped under the Financial Supervision Commission (“FSC”) which oversees all banking, funds, investment, corporate and trust service providers business, and the Insurance & Pensions Authority (“IPA”) which supervises insurance and pensions business. Both are independent statutory bodies with their own legislation and powers of supervision and intervention. The Companies Registry is also part of the FSC.
53. The FSC’s Annual Report is available on its website (www.fsc.gov.im) and that of the IPA on its website (www.gov.im/ipa). Both go into detail about their regulatory operations.

54. Licensing of institutions and individuals is subject to a comprehensive regime for establishing the fitness and propriety of applicants and their key staff on an initial and ongoing basis. This includes important elements of competence and financial soundness. Supervision is exercised on a consolidated basis, and embraces on-site visits to licenceholders as a core element.

55. The FSC has a pro-active enforcement unit which is responsible for AML/CFT policy for FSC licenceholders. It also investigates and pursues unlicensed regulated activity. It petitions the High Court for the disqualification of directors of companies in deserving cases, and has published a record of successful action (see Appendix A).

56. In 2000, the Financial Stability Forum gave recognition to the Island’s premier position and announced that it was placing the Isle of Man in the Group 1 category of offshore jurisdictions, based on responses from the major centres and their experiences in dealing with the Island.

57. The Island has been assessed under the auspices of the FATF on two occasions in respect of anti-money laundering measures and was judged to be co-operative and significantly in compliance with all key FATF recommendations. At no time has the Island been listed as unco-operative by the FATF. All anti-money laundering initiatives on the Island are co-ordinated through an industry-wide Joint Anti-Money Laundering Advisory Group.

58. In 2002–03, the IMF conducted a full assessment of the Island’s compliance with all of the international standards referred to above. Its report was published and is available on the FSC’s website. The Island was “assessed to have a high level of compliance”. It was commended for the attention given to:

- upgrading the financial regulatory and supervisory system to meet international supervisory and regulation standards in banking, insurance, securities, and anti-money laundering and combating the financing of terrorism”;

59. The IMF’s assessment of the Island’s regulatory arrangements was very important because, apart from reviewing the legislative infrastructure, it focussed on how implementation was being carried out in practice.

60. In common with the other Crown Dependencies, the Island is shortly to be visited again by the IMF as part of its ongoing programme of assessment. The Island is confident that it will be shown to have maintained a high degree of compliance with evolving standards. Meanwhile, staff of the FSC have participated in assessing other jurisdictions as members of IMF and FATF missions.

61. As a jurisdiction in which companies and trusts are administered, it was decided that all service providers in this area should be regulated pro-actively to ensure that high levels of due diligence are applied in all areas of the business. Applicable legislation was introduced in 2000. In particular, this ensured that the legal requirement for intermediaries to know the ultimate beneficial owners of all companies administered though the Island, as well as the identity of all settlors, beneficiaries and other persons involved with trusts, could be enforced pro-actively. When requested, these regulated intermediaries are in a position to provide relevant information to the regulators and law enforcement authorities who use appropriate powers to assist in domestic and cross-border investigations.

62. The regulation of corporate and trust service providers was a clear example of the Island identifying a potential threat to its reputation and introducing pioneering legislation to prevent malpractice. In so doing, and in regulating business which still remains unsupervised in most major jurisdictions, including the UK, the Island has been determined not to see its hospitality abused.

63. On taxation, the FSC’s stance is that individuals have a right to plan their tax affairs efficiency in compliance with the law. However, it does not regard aggressive tax avoidance for clients as a prudent part of any licenceholder’s business strategy. Any suspicion of tax evasion would need to be reported immediately as a suspicious transaction to the Financial Crime Unit of the Isle of Man Constabulary.

64. The ability to penetrate the corporate veil as outlined above has been especially important in the securities arena, where the Island has become a full signatory to the benchmark IOSCO Multilateral Memorandum of Understanding: as such, the Island has been judged by its peers to have the legislative ability to provide full co-operation in dealing with market manipulation and abuse, insider dealing and other securities malpractices. The FSC has established a strong track record of co-operation in this area (see Appendix A).

65. The Island has also exchanged individual memoranda of understanding with a number of international regulators to underpin its co-operation in the cross-border supervision of international financial services groups. Because of the large number of regulated businesses with UK connections, the regulators here have good relations with the FSA. The supervisory regimes in both the UK and Isle of Man complement each other well. The FSC provides copies of its on-site visit reports to the FSA where the latter is lead regulator for the group concerned. There are regular meetings and communication with the FSA, and the FSA has visited the Isle of Man. This dialogue has been especially close, for example, in the context of the current liquidity difficulties in the money markets generally.
66. A number of financial services groups have operations in two or more Crown Dependencies. It is therefore important that these jurisdictions co-ordinate their regulatory policies wherever possible, to try and eliminate unnecessary distinctions and reduce the scope for regulatory arbitrage. Regular meetings take place, and indeed joint papers on certain topics have been published.

67. HM Treasury has granted the Island designated territory status, which provides arrangements for the distribution of the Island’s authorised collective investment schemes in the UK. This status is subject to regular review, normally by the FSA on behalf of HM Treasury.

68. The Island operates compensation schemes for depositors, investors and policyholders, as well as a financial services ombudsman scheme as part of the Office of Fair Trading.

[It is noted that the Treasury Committee wishes to examine how the Island’s regulators “address the issues that concern the UK”. However the FSC and IPA are unaware of any regulatory issues which currently concern the UK.]

**LAW AND RULE ENFORCEMENT: TRANSPARENCY AND CO-OPERATION**

69. Money laundering is criminalised in the Isle of Man. The current statutory basis of that criminalisation is contained in the Drug Trafficking Act 1996 (drug trafficking offences), the Anti-Terrorism and Crime Act 2003 (terrorism) and the Criminal Justice Act 1990 (all other crimes). Draft legislation in the form of the Proceeds of Crime Bill 2008 has been passed by Tynwald’s House of Keys and is currently before the Legislative Council. When enacted later this year, it will consolidate and reform the criminal law in the Island with regard to money laundering, replacing separate drug trafficking and criminal justice legislation with a consolidated and updated set of provisions.

70. The offence of money laundering extends to any type of property, regardless of its value that directly or indirectly represents the proceeds of crime. The provisions of the Drug Trafficking Act 1996, the Criminal Justice Act 1990 and the Anti-Terrorism and Crime Act 2003 relating to money laundering are broadly drafted and, for example, in the Drug Trafficking Act 1996, refer to any property which represents the proceeds of drug trafficking. Similar provisions are found in the other statutes referred to above. No type of property is excluded and there is no minimum or maximum value. Predicate offences for money laundering under the Drug Trafficking Act 1996 and Anti-Terrorism and Crime Act 2003 are specified and self-explanatory, namely drug trafficking (as defined in section 1 of the Drug Trafficking Act) and terrorism as defined in section 1 of the Anti-Terrorism and Crime Act. With regard to “all crimes” involving money laundering, as defined in sections 17A to 17C of the Criminal Justice Act 1990, there is no list of predicate offences. The money laundering offences in the Criminal Justice Act 1990 apply in respect of the proceeds of criminal conduct which is defined to mean conduct which:

(a) constitutes an offence to which this Part (Part 1 of the Criminal Justice Act 1990) applies; or

(b) would constitute such an offence if it had occurred in the Island.

71. Part 1 of the Criminal Justice Act 1990 defines such an offence in the following terms:

“References to an offence to which this part applies are references to an offence which:

(i) is a prescribed offence; or

(ii) if not a prescribed offence, is an offence triable on information (whether or not it is exclusively so triable), other than a drug trafficking offence or an offence under any of sections 7 to 10 of the Anti-Terrorism and Crime Act 2003.” [at section 10(9)(c)]

72. All serious and intermediate offences are therefore caught by this definition as these are triable on information (indictment) and there is a power by subordinate legislation to prescribe less serious offences which would be triable in the summary (lower) courts. To date, no such subordinate legislation has been prepared.

73. The Proceeds of Crime Bill defines money laundering in relation to criminal property which is defined as the benefit from criminal conduct which is itself defined as conduct which constitutes an offence in the Island or would constitute an offence if it occurred there. Criminal conduct will not therefore be restricted to offences which are triable on information, but will encompass all offences.

74. The legislation which contains provisions relating to the financing of terrorism is the Anti-Terrorism and Crime Act 2003. Terrorist financing is criminalised in the Isle of Man by sections 7–10 of the Anti-Terrorism and Crime Act 2003. Section 7 deals with the offence of fund-raising for terrorism, section 8 the offence of use and possession of property for the purposes of terrorism, section 9 the offence of entering into an arrangement for the purposes of financing terrorism and section 10 the offence of money laundering of terrorist property. Each of these sections provides for penalties on summary conviction including custody for a term not exceeding six months or a fine not exceeding £5,000 or to both, or on conviction on information to custody for a term not exceeding 14 years or an unlimited fine or both.

75. Terrorist financing offences extend to any person who willfully provides or collects funds by any means, directly or indirectly, with the unlawful intention that they should be used or in the knowledge that they are to be used in full or in part to carry out a terrorist act, by a terrorist organisation or by an individual terrorist. The offence of fund-raising as defined in section 7 provides that a person commits an offence if he
invites another to provide money or other property and intends that it should be used or has reasonable cause to suspect that it may be used for the purposes of terrorism, if he receives money or other property and intends that it should be used or has reasonable cause to suspect that it may be used for the purposes of terrorism. If he provides money or other property and knows or has reasonable cause to suspect that it may be used for the purposes of terrorism. Terrorism is broadly defined in section 1 to include terrorist acts and action taken for the benefit of proscribed organisations.

76. The terrorist financing offences do not require that the funds are actually used to carry out or attempt a terrorist act or be linked to a specific act. The offences refer to funds being used “for the purposes of terrorism”, which is defined broadly to include the use or threat of terrorist action and the benefitting of a proscribed organisation.

77. There is no specific offence of attempting to commit the offence of terrorist financing, but section 9 of the Criminal Law Act 1981 provides that an attempt to commit an offence shall be an offence punishable as if the offence itself had been committed. Attempts to commit the offences of terrorist financing are therefore criminalised.

78. Whilst there are currently no ancillary offences defined in the legislation specific to the financing of terrorism offences, ancillary offences in general are covered by section 330 of the Criminal Code 1872 which deals with conspiracy and sections 350, 351 and 354 which deal with accessories. Section 330 of the Criminal Code 1872 provides that conspiracy to commit any offence constitutes a misdemeanour with conviction attracting a sentence of a term of imprisonment of up to 10 years. Sections 350, 351 and 352 define the law in relation to accessories to felony (serious crimes which are triable on information) and provide that the accessory before the fact “to any felony shall be guilty of felony and may be indicted or proceeded against by information, tried, convicted and punished in all respects as if he were a principal felon.”

79. Part 7 of the Proceeds of Crime Bill 2008 specifies that the Council of Ministers may by order extend provisions relating to investigations, including production orders, search and seizure warrants, disclosure orders, customer information orders and account monitoring orders, to external investigations. It may also make provision for prohibition on dealing with property which is the subject of an internal request and for the realisation of property for the purpose of giving effect to an external order.

80. The Isle of Man is able to provide a wide range of mutual legal assistance involving the production, search and seizure of information.

81. Sections 24 and 25 of the Island’s Criminal Justice Act 1990 ("the 1990 Act") provide powers to obtain information, search warrants and answers to questions.

82. Section 24 of the 1990 Act provides for investigatory powers exercisable at the discretion of the Attorney General where there is a suspected offence (wherever committed) involving serious or complex fraud. Section 25 of the 1990 Act allows for dissemination of information obtained to certain authorities outside the Isle of Man. Under section 24 of the 1990 Act, a person under investigation or any other person may be required to produce specified documents and if necessary provide an explanation of them. Section 24 goes on to provide for a warrant to be issued to enter and search premises and take possession of documents in certain circumstances, for example, where serving notice might seriously prejudice the investigation.

83. Sections 21 and 22 and Schedule 2 of the Criminal Justice Act 1991 ("the 1991 Act") provide powers to obtain evidence, witness statements and search warrants.

84. Section 21 of the 1991 Act mirrors section 4 of the Criminal Justice (International Co-operation) Act 1990 of England and Wales, providing for evidence to be received by a nominated court. Upon receipt of a request for assistance in obtaining evidence in the Island in connection with a criminal investigation or proceedings in another country, the Attorney General may make an application to the High Bailiff to receive evidence. In doing so, he must be satisfied that there are reasonable grounds to suspect that an offence has been committed and that an investigation or proceedings are in progress.

85. Section 22 of the 1991 Act provides for search and seizure in relation to material relevant to section 21. In order to invoke section 22, an application to a Deemster (i.e. a higher court) is necessary. The Deemster must be satisfied that proceedings have been instituted or an arrest made, that the offence in the requesting country would constitute an arrestable offence if it had occurred in the Island and that there are reasonable grounds for suspecting that there is evidence on premises on the Island which the suspect occupies or controls.

86. Schedule 2 of the 1991 Act provides a framework for the use of section 21 dealing with securing the attendance of witnesses, the power of the High Bailiff to administer oaths, transmission of evidence and costs. Schedule 2 also deals with privilege of witnesses.

87. The Isle of Man courts have over time laid down extensive case law in relation to these provisions.

88. Sections 52 to 54 of the Drug Trafficking Act 1996 and section 173 of the Criminal Justice Act 1990 confer powers on the High Court to grant production orders and search warrants—since it is not stipulated that the drug trafficking, criminal conduct or proceeds of crime must have occurred in the Isle of Man, these provisions are used to provide mutual legal assistance.
89. Sections 11 and 12 and Schedule 1 of the Police Powers and Procedures Act 1998 enable a constable to obtain further production orders and search warrants to seize material on specified premises which is likely to be of substantial value to the investigation and these powers can be invoked in respect of requests for mutual legal assistance.

90. The Isle of Man is able to provide assistance in a timely, constructive and effective manner. Letters of request for assistance are received by the Attorney General’s Chambers and dealt with by two full-time advocates with the title “Legal Officer (Financial Crime).”

91. The most common type of request for mutual legal assistance is for the production of evidence and witness statements for use outside the Isle of Man and this is usually achieved via section 21 of the 1991 Act. As outlined above, this section requires that there are reasonable grounds to suspect that an offence under the law of the requesting country has been committed, not necessarily an offence under the law of the Isle of Man. It is possible to invoke this section either when criminal proceedings have been instituted or a criminal investigation is being carried on.

92. The requirements for proceeding under section 24 of the 1990 Act are similar, there must be grounds to suspect serious or complex fraud (in the ordinary meaning of the word) and it is sufficient that an investigation has commenced.

93. Section 21 (3) of the 1991 Act stipulates:

“Where it appears to the Attorney General that the request relates to a fiscal offence in respect of which proceedings have not yet been instituted he shall not exercise his powers under subsection (2) unless:

(a) the request is from a country or territory which is a member of the Commonwealth or is made pursuant to a treaty to which the United Kingdom is a party and which extends to the Island; or

(b) he is satisfied that the conduct constituting the offence would constitute an offence if it had occurred in the Island."

94. Therefore, a request may be refused on the sole ground that it relates to a fiscal offence only in rare cases and not simply where the offence is considered to involve fiscal matters. Mutual legal assistance can be rendered in the absence of dual criminality with the exception of cases involving a fiscal offence where proceedings have not been instituted and where the request is received from a country or territory which is not a member of the Commonwealth or is not made pursuant to a treaty to which the UK is a party and which extends to the Island. The Isle of Man has the ability to and in practice does take expeditious action in response to requests by foreign countries for mutual legal assistance. Assistance is almost always granted when requests merely require evidence to be obtained. When requests are for restraint, freezing or confiscation, assistance can only be granted if the requesting country or territory is either the UK or a “designated country or territory”, as designated by secondary legislation.

95. To put some flesh onto these rather legalistic bones, one might refer to a case that arose in 2001 from a complex share-pricing fraud perpetrated against an American company. Heeding their statutory obligations under the Criminal Justice Act 1990 to curb money laundering, local banks made a spontaneous suspicious transaction report to the Financial Crimes Unit (FCU) concerning the transfer of some $200-million to the Island from Switzerland. Following close co-operation between the Island’s Attorney General and the United States Securities and Exchange Commission (SEC), a restraint order was eventually granted locally under the Criminal Justice Act 1990, freezing part of the funds in local bank accounts in contemplation of criminal proceedings against the responsible individual in the US which would in turn lead to a forfeiture order enforceable against the Isle of Man funds. Following extensive litigation, including an appeal, the Isle of Man High Court upheld the restraint order and affirmed the Island’s statutory duty to recognise and enforce the external confiscation order made in the US. As a result of this textbook case of co-operation between the law enforcement and judicial authorities of the two jurisdictions, some $175-million was repatriated to the US.

96. The Isle of Man has established an asset forfeiture fund in respect of drug trafficking. Confiscated proceeds of drug trafficking are deposited in the fund and are used for law enforcement, health, education and other appropriate purposes. Confiscated proceeds of other crimes are currently paid to Treasury, but it is envisaged that a similar proceeds of crime fund will be established in respect of the proceeds of non-drug trafficking criminal conduct. There are currently no specific legislative provisions relating to the sharing of confiscated assets with other jurisdictions. Asset sharing is currently negotiated on an individual case by case basis, but the Proceeds of Crime Bill contains provision that: “The Treasury may enter into asset sharing agreements on behalf of the Island.” A draft asset-sharing agreement is therefore currently being negotiated between the Isle of Man and the United States and it is envisaged that further such agreements will be entered into once the Bill becomes law.

97. Appendix B reflects the statistics for international requests for assistance received by HM Attorney General under the relevant mutual legal assistance criminal justice legislation.
Conclusion

98. The Isle of Man is a mature, responsible small financial centre. The Island has striven over recent years to comply with the highest standards of international financial regulation. The Isle of Man has no secrecy laws or practices that protect the identity of bank customers. Whilst it is true to say that both individuals and businesses can conduct their affairs confidentially, the Island should not be bracketed with jurisdictions which have taken positive action to introduce laws and practices to promote secrecy. The Island has always been careful to maintain an appropriate balance between the confidentiality of private individuals and businesses on the one hand and the need for taxing and regulatory authorities to be privy to certain information on the other.

99. In the operation of its legislative, legal and administrative provisions, there is no doubt that the Isle of Man is transparent. Its laws and regulations are clearly set out in both primary and secondary legislation, which is available to all. Interpretation of certain legislative provisions by the authorities is often made the subject of practice notes, which are also issued in the public domain. As in most countries, the authorities (whether tax or otherwise) can be approached on an individual basis for a private ruling, but this represents no more than confirmation of the authority’s interpretation of the Island’s laws as they apply to the facts of a particular case.

100. Given their geographical and historical proximity, a strong business culture is shared between the Island and UK business. Given this close affinity, the Island has succeeded over recent years in becoming a core asset for the City of London in ways highly beneficial both to the Island and the UK.

June 2008

APPENDICES

APPENDIX A

SUCCESSFUL COMPANY DIRECTOR DISQUALIFICATIONS UNDERTAKEN UNDER SECTION 26 OF COMPANIES ACT 1992

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<th>Year</th>
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<td>1</td>
<td>3</td>
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IOSCO REQUESTS SINCE THE ISLE OF MAN SIGNED THE IOSCO MULTILATERAL MEMORANDUM OF UNDERSTANDING (OCT 2005)

<table>
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<tr>
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INSIDER DEALING CASES IN WHICH THE ISLE OF MAN FSC HAS PROVIDED EXTERNAL ASSISTANCE

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<td>Total</td>
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APPENDIX B

ACTION TAKEN IN RELATION TO INTERNATIONAL LETTERS OF REQUEST RECEIVED BY HM ATTORNEY GENERAL

YEAR 2006 TOTAL = 90 REQUESTS

<table>
<thead>
<tr>
<th>Action taken</th>
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<tr>
<td>Section 21 Criminal Justice Act 1991 powers used</td>
<td>42</td>
</tr>
<tr>
<td>Section 24 Criminal Justice Act 1990 powers used</td>
<td>16</td>
</tr>
<tr>
<td>Further information sought from Requesting Authority—none provided</td>
<td>3</td>
</tr>
<tr>
<td>Request withdrawn by Requesting Authority</td>
<td>3</td>
</tr>
<tr>
<td>No information in Isle of Man to assist/unable to assist (unable to serve witness summons)</td>
<td>11</td>
</tr>
<tr>
<td>Criminal Justice Act Restraint Order obtained</td>
<td>0</td>
</tr>
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Further memorandum from the Isle of Man Government

The Select Committee visited the Isle of Man on 9 July 2007. During the discussions that took place the Select Committee requested further details relating to the Customs and Excise Agreement between the United Kingdom and the Isle of Man. The following information is supplied in response to that request.

The Customs and Excise Agreement

The Isle of Man is not subsidised by the United Kingdom; rather the Island contributes to the economy of the United Kingdom, as evidenced by the Lord Mayor referring to the Isle of Man as a “core asset” of the City of London. In addition it shares most of the indirect taxes it collects with the United Kingdom under the terms of the Customs and Excise Agreement.

Arrangements for the sharing of revenues between the Isle of Man and the UK date back to the Revenue Returns Act 1894 of Tynwald which required returns to be made by dealers in tea and tobacco imported into the Island and as a result enabled the Island to receive a fair share of duties on such imports.

The arrangements for the sharing of indirect tax has continued, with many detailed changes since, such as in October 1957 when the “Agreement between the Governments of the United Kingdom and the Isle of Man regarding Customs and other matters” was signed. Commonly referred to as the Common Purse Arrangement this agreement survived until replaced by the current Customs and Excise Agreement in 1979.

One of the taxes dealt with by the Common Purse Arrangement was Purchase Tax. This had been introduced in the Island at the same time as in the UK, and was charged at the same rates. The Common Purse Arrangement provided for HM Customs and Excise to collect the Purchase Tax chargeable in the Island and for the Commissioners of Customs and Excise to periodically pay over to the Isle of Man Government its share of this tax, as well as the other duties and taxes covered by the Arrangement, less expenses connected with collection and audit. When Purchase Tax was abolished and replaced by VAT (and Car Tax) on 1 April 1973, its place under the Arrangement was taken by the new taxes.

Regular Decennial Tests were introduced following the 1957 Arrangement, in order to establish more accurate levels of consumption of the various excise (and other) goods in the Island, so as to be able to adjust the sharing arrangements accordingly and ensure they were as fair as possible. These tests involved surveys of receipts in the Island of the various goods, by both businesses and private individuals and, together with
an adjustment for the calculated “resident population”, enabled the calculation of the proportion of revenue (“common duties”) liable to be paid over to the Island under the terms of section 2(2) of the Isle of Man Act 1979 of the UK Parliament, which provides the legal basis for the sharing arrangement.

In July 1979 Tynwald approved the entering into of a new agreement with the UK, and the Customs and Excise Agreement 1979 was signed on 15 October 1979 and came into operation on 1 April 1980. Under the new Agreement the Island agreed to keep rates of most indirect taxes and duties at the same rates, and subject to the same reliefs, as in the UK and again most revenues were pooled and shared, with Decennial Tests continuing to provide a means of fine tuning the proportions.

Over the years there have been numerous amendments to both the Common Purse Arrangement and the Customs and Excise Agreement such as for providing flexibility in respect of VAT on “non-exportable” services related mainly to the tourist industry and most recently (in 2007) to establish a new basis for sharing the pooled revenues based on the relative changes in national incomes of the two economies.

The 1979 Agreement remains in effect, notwithstanding the merger of HM Customs and Excise into HM Revenue and Customs in 2005, and the common duties remain shared between the two Governments in accord with section 2(2) of the Isle of Man Act.

The current mechanism results from a review and agreed changes made to the Customs and Excise Agreement in 2007 and is based upon the principle that there is correlation between economic activity and consumption generating indirect tax and so follows the spirit of the Isle of Man Act, section 2 of which provides as follows:

“2 Isle of Man share of common duties

(1) Of the moneys standing to the credit of the General Account of the Commissioners an amount ascertained for each financial year in accordance with subsection (2) below shall be paid by the Commissioners, at such times and in such manner as they may determine, to the Treasurer of the Isle of Man.

(2) There shall be calculated in such manner as the Treasury may direct—

(a) the amount of common duties, whether collected in the United Kingdom or the Isle of Man, which is attributable to goods consumed or used in the Island, to services supplied in the Island or (as respects pool betting duty) to bets placed by persons in the Island;

(b) the cost incurred by the Commissioners in collecting the amount so attributable together with the amount of any drawback or repayment referable to that amount;

and the amount arrived at by deducting from the amount calculated under paragraph (a) above the amount calculated under paragraph (b) above shall be known as the net Isle of Man share of common duties; and the amount mentioned in subsection (1) above shall be the excess of the net Isle of Man share of common duties over the common duties collected in the Island.”

This GNP (Gross National Product) Growth model is a principled approach since both the Isle of Man and United Kingdom are treated symmetrically. The model also scores very highly on simplicity and transparency; the data inputs for the calculation are minimal, all that is required are total United Kingdom and Isle of Man net VAT receipts, United Kingdom GNI and Isle of Man GNP, whilst application to other shared duties enhances simplicity and cuts administration costs. It also provides greater stability of future revenue incomes and so aids economic and financial planning.

In brief the GNP Growth model applies the relative growth of the Isle of Man and United Kingdom economies to the Isle of Man’s percentage share in the agreed base year and then applies that revised fraction to the current revenue pools to be shared under the Agreement.

Whilst other Crown Dependencies are free to decide whether to impose indirect taxes and duties and, if so, at what rates, the Isle of Man under the terms of the Customs and Excise Agreement is obliged to follow United Kingdom indirect tax decisions, rates (with some minor variation) and developments, irrespective of how that affects it’s economy and competitiveness.

Summary

The Customs and Excise Agreement between the Isle of Man and the United Kingdom is a long standing agreement, which has both stood the test of time and shown itself to be flexible to amendment, upon joint agreement between the two Governments, to respond to changing economic circumstances.

30 September 2008
Memorandum from Maples and Calder

We refer to the Treasury Committee Press Notice No. 42 dated 30 April 2008 inviting written submissions to assist the Treasury Committee’s enquiry into Offshore Financial Centres.

Maples and Calder is an international law firm with over 200 lawyers and a total staff of approximately 750 worldwide. We have offices in the Cayman Islands, Ireland, London, Hong Kong, Dubai and the British Virgin Islands and have been practising Cayman Islands law in the Cayman Islands for more than 40 years. Consequently, we believe that it might be helpful to the Treasury Committee for us to share our views on the role of the Cayman Islands as an Offshore Financial Centre.

Executive Summary

The role and importance to the international financial community of Offshore Financial Centres is often misunderstood and misstated. It is our submission that rather than being a threat to the world’s financial stability, the Cayman Islands provides the international business community with a stable and neutral jurisdiction through which to facilitate international and cross border business for the benefit of the global economy.

We have sought to confine our comments to the specific questions raised in Press Notice No. 42, but the reader should feel free to contact us with further written questions if required (our contact details are set out at the end of this submission).

Specific Questions

1. To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?

1.1 The Cayman Islands financial industry has grown significantly over the last 30 years directly as a result of the corresponding growth in the worldwide financial markets and in particular the alternative investment fund industry. The development of the global alternative investment fund industry is well-documented in many books and journals and this submission is only designed to provide a very brief overview of this topic.

1.2 The Cayman Islands as an Offshore Financial Centre have been successful in attracting the following types of financial business:

(a) investment funds—principally hedge funds and private equity funds marketed to institutional investors. The Cayman Islands are widely recognised as the leading jurisdiction for hedge fund formation;

(b) capital market transactions—such as securitisations, capital raising corporate finance subsidiaries and note issuing programmes;

(c) structured investment products—note repackagings, credit linked transactions such as credit derivatives and credit linked notes and structured and derivative products;

(d) insurance companies and related products, such as captive insurance companies, catastrophe bonds and other alternative risk transfer products;

(e) commercial aircraft and ship finance;

(f) joint venture companies and corporate subsidiaries for international businesses; and

(g) international commercial banking.

1.3 Many of these transactions are arranged and managed by well-known fund managers, investment banks and companies based around the world and in which sophisticated institutional and high net worth investors (including pension funds, insurance companies, university endowment funds and sovereign funds) invest in order to place a part of their portfolio in a variety of “alternative investment strategies”. Consequently, only a small percentage of Cayman Islands investment funds (probably less than 1%) are marketed to retail investors and substantially all capital markets debt issuance is through the global clearing systems such as DTC and Euroclear/Clearstream. There is a growing trend for big institutional investors, such as pension funds, insurance companies, university endowment funds and sovereign funds, to allocate larger proportions of their investment portfolios to alternative investment funds, many of them established in the Cayman Islands. It is well-documented that almost all the major developed countries have ageing populations and in the medium term it is anticipated that both private and state-run pension plans will struggle to finance their pension fund obligations based on traditional investment strategies. Consequently hedge funds, private equity funds and other investment funds based in Offshore Financial Centres with global investment strategies may play an increasingly important role in generating enhanced returns for pension fund investors.

1.4 The alternative investment fund business, capital markets and commerce generally are becoming increasingly more global. Many large multinational companies have separate and diverse businesses in many different jurisdictions. Most major investment banks and many of the bigger investment fund managers now have global investor client bases and investment management teams in more than one of the main financial
centres, including New York, London, Tokyo and Hong Kong. These investment banks, investment fund managers and multi-national companies must compete globally for capital, investors and customers to build their businesses. To give you some examples:

(a) a fund manager based in London or New York with expertise in investing in European or US equities might seek investors from outside the UK or US, including Europe, the Middle East or Japan, who are looking to invest in European or US equities. The same US or UK based fund manager may also have expertise through branches in other countries to offer investment funds which specialise in investing in investments in countries outside the UK or the US (eg emerging markets);

(b) a multinational corporation may wish to enter into a joint venture with investors from many different jurisdictions to manufacture a power generation plant or other infrastructure project in a developing country;

(c) an entrepreneur in a developing country may wish to start a business with a view to eventually raising capital by way of a public share offering in the UK or the US;

(d) a commercial airline (again perhaps based in a developing country) will need the ability to raise significant capital sums from international lending syndicates to finance its aircraft fleet;

(e) a financial institution based in one jurisdiction may wish to issue notes or bonds to investors in different jurisdictions through the international capital markets allowing it to access new sources of capital whilst at the same time providing international investors with new investment opportunities with diversified risk profiles;

(f) a business may wish to insure against natural disaster risk by way of issuing bonds into the international capital markets; and

(g) an international bank may maintain a branch or subsidiary in the Cayman Islands to provide multi currency accounts for corporate customers in order to facilitate trade financing or to provide sweep facilities and an internal treasury function to the group.

1.5 The challenge for multinational companies, investment banks and fund managers is often how to create an investment fund or business structure which is able to accommodate investors from all over the world within the complex parameters of existing tax and securities laws that apply to the investors, the management team and the business or investment activities, all of which could be based in multiple jurisdictions.

1.6 The global financial system needs, and will continue to need, legal entities which are formed (whether in the Cayman Islands or elsewhere) to facilitate such international transactions. In many cases, investment managers, investment banks and multinational companies will, on advice of their onshore legal counsel, use companies based in the Cayman Islands and other Offshore Financial Centres to build their investment fund structures or other business vehicles. The international business community thus benefits by being able to form such legal entities swiftly and efficiently in a stable jurisdiction and on a tax-neutral basis. This can be of particular benefit to developing countries in Africa and other regions, where the facilitation of inward private investment is critical to their economic development (See also paragraph 1.8 (d) and (e) below).

1.7 It is not the case that it is just offshore jurisdictions such as the Cayman Islands which provide a tax-neutral location for finance transactions: Offshore Financial Centres compete as a business matter with onshore jurisdictions. Certain onshore European jurisdictions, such as Ireland, Luxembourg and the Netherlands have picked up a lot of this business and overcome the structuring difficulty of establishing special purpose vehicles in taxing jurisdictions by adjusting their domestic tax rules to achieve an effective zero tax rate for vehicles participating in such transactions. In Ireland, for example, changes were made to the tax legislation so that structured finance vehicles qualify as “section 110” companies, meaning that their cost of funding and related expenditure will be tax-deductible, as will many other types of payment, with the result that Ireland is, effectively, a tax-neutral jurisdiction for these sort of companies.

1.8 Some of the reasons why the international business community use offshore companies based in the Cayman Islands are as follows:

(a) Political Stability. The Cayman Islands are politically and economically stable. Unemployment is low and the standard of living one of the highest in the Caribbean. The favourable economic situation of the Cayman Islands is reflected in its political stability. This stability is also reflected in Moody’s country ceiling rating of “Aaa”.

(b) Cayman Islands Legal Infrastructure. The laws of the Cayman Islands are substantially based upon English common law and a number of “key” English statutes, although Cayman Islands statutes have been specifically adapted to assist the international business community. This gives Cayman Islands law and legal system a common origin with those of many of the jurisdictions of its users. It also means that the business entities (such as Cayman Islands companies, limited partnerships and unit trusts) and the types of securities which Cayman Islands entities offer are well recognised and accepted around the world, and particularly by Fund managers and investors in New York, London, Tokyo and Hong Kong. Bankruptcy-remote vehicles established in the Cayman Islands are also recognised worldwide and major rating agencies have published specific
criteria for Cayman Islands companies. The final court of appeal is to the Privy Council in London. All the major audit firms have offices in the Cayman Islands and there are several major Cayman Islands law firms to give legal advice to support the financial services industry.

(c) Quality of Service Providers. The quality of the service-providers (attorneys, auditors, mutual fund administrators, trust companies, company managers, etc) in the Cayman Islands is very high. The majority of the Islands’ professionals are recruited from the top law and accountancy firms and financial institutions in London and other major financial centres. In response to client demand, the Cayman Islands have therefore developed an expertise and level of service in the financial service industry which meets the standards set by major onshore financial centres.

(d) Investor requirements. By using a Cayman Islands company to make an investment into foreign jurisdictions, investors are able to better realise their investment by either selling their shares or in an initial public offering (IPO) of shares in the Cayman Islands company. The Cayman Islands legal infrastructure, with which most international investors are familiar, makes it easier to effect such sale or IPO. If the investment was directly into a company in the foreign jurisdiction, the investors would need to understand what rules applied to such investment and a floatation could be more complex and expensive in ensuring that the listing and relevant securities registration rules and local rules are complied with on the IPO. As many Cayman Islands entities have been listed on major stock exchanges such as London, New York and Hong Kong, investors can have confidence that a flotation should, from a legal standpoint, be possible in due course.

(e) Lender requirements. In some cases, an investment fund or a multinational company will need to borrow significant sums of money to leverage its investment activities or finance its business activities. For example, a multinational business might need to borrow to finance a business based in a developing or an emerging market country. Many lending institutions would prefer to organise the lending and related security interest arrangements offshore through a Cayman Islands company rather than in a developing or emerging market country. Such lenders take comfort in having this important element of these transactions facilitated through corporate vehicles based in the Cayman Islands since the Cayman Islands offers (a) a legal regime which recognises security interests (eg created under English or New York law) most commonly utilised in international cross-border financings, (b) a creditor friendly system where lenders can easily enforce security interests, (c) a legal system which has been scrutinised and approved by all major credit rating agencies, and (d) corporate and partnership entities created under legal principles with which lenders are familiar. These transactions can be extremely complex; indeed some would be difficult and in some cases impossible to structure directly under the legal regimes of the relevant developing or emerging markets. It is for this reason that governmental and quasi-governmental agencies such as OPIC, a US governmental agency, and the International Finance Corporation (“IFC”), a division of the World Bank, will support lending to investment fund structures using Cayman Islands companies; and in the context of aircraft finance deals, the export credit agencies, including the ECGD do likewise.

(f) Exchange Control and Cash Flow Neutrality. A Cayman Islands company is not subject to Cayman Islands foreign exchange controls and there are no significant restrictions on the payment of interest or dividends, the repayment of capital or the ability to repurchase shares or redeem or repurchase debt. This is important because some cross-border transactions would be rendered uneconomic if cash flows are interrupted by foreign exchange controls or such payment restrictions.

(g) Tax and Exchange Control Neutrality. Cayman Islands companies provide a tax-neutral platform so that investors from multiple jurisdictions are not subject effectively to double taxation by virtue of the investment fund or offshore company adding extra layers of foreign taxation at different levels of the structure in addition to the investors’ home country tax. This neutrality is important because it provides a level playing field for all investors; in other words it avoids creating a vehicle in a jurisdiction that may provide more benefits to some investors than others. The fact that there are no direct corporate or income taxes levied on a Cayman Islands company in the Cayman Islands and that accordingly transactions can be structured on a “tax-neutral” basis, unfortunately often leads to a misconception that investors in offshore companies are free from all forms of taxation. This is not the case at all. Investors based in onshore jurisdictions are likely to be taxed on dividend and other income received from the offshore company and on any capital gains realised on the sale or redemption of shares in the offshore company. Many onshore jurisdictions have also introduced anti-avoidance tax rules that tax income and gains which are rolled up in the offshore vehicle as if they had been distributed. Additionally, the offshore company may itself be subject to withholding taxes imposed in respect of income or gains on its investments by tax authorities in the onshore jurisdictions in which the offshore company’s businesses or investments are located and such withholding taxes are frequently not creditable against taxes paid by the investor in the offshore vehicle in respect of the same income or gains. Furthermore, a Cayman Islands company may have a branch or a place of business in an onshore jurisdiction or be centrally managed and controlled in an onshore jurisdiction and be subject to the taxing regime in that onshore jurisdiction.
2. **To What Extent Does the Use of Offshore Financial Centres Threaten Financial Stability?**

2.1 The Cayman Islands have been the subject of several major reviews by international bodies such as the International Monetary Fund (“IMF”) and the Financial Action Task Force. We do not believe that the use of Offshore Financial Centres threatens global financial stability. On the contrary, we would argue that the use of Offshore Financial Centres for the financial products developed by onshore financial institutions actually helps spread risk on a wider basis globally.

2.2 In 2005, the IMF conducted a review of the financial sector regulation and supervision in the Cayman Islands with regard to the assessment of the supervision in the Cayman Islands of the offshore banking, insurance and securities sectors on the basis of the Basel Committee’s **Core Principles for Effective Banking Supervision**, the IAIS’s Insurance Core Principles and IOSCO’s Objectives and Principles of Securities Regulation and evaluated the Cayman Islands anti-money laundering and combating of terrorist financing legislation using a common methodology based on the FATF 40 + 9 Recommendations. We enclose a copy of the IMF report on the Cayman Islands.

2.3 In summary, the IMF Report did not conclude that the use of the Cayman Islands companies in world wide financial markets threatens financial stability. On the contrary, whilst the IMF made some useful observations as to how the Cayman Islands government can continue to improve regulations it concluded, amongst other things, that:

(a) The Cayman Islands financial industry and regulators have developed an intense awareness of the measures to combat money laundering and the financing of terrorism;

(b) banking supervision is largely in compliance with Basel Core Principles; and

(c) securities regulations are largely in accordance with the IOSCO principles.

2.4 Although Cayman Islands entities have been connected with some major collapses of corporate enterprises, for example Enron and Parmalat, it should be noted, that the Cayman Islands entities are usually the victims of the fraud, with the fraudulent activity having taken place onshore (in those cases, the
United States and Italy, respectively). In addition, the fact that Cayman entities are in a jurisdiction which is creditor-friendly and have a English law based legal system has, in the case of Enron, enabled the sale of assets in an efficient way that had assisted in increasing the realisation for creditors in that liquidation.

2.5 It is also worth noting that in relation to the recent credit crisis, whilst there have been well-publicised examples of Cayman Islands hedge funds experiencing difficulties, according to recent statistic produced by the Cayman Islands Monetary Authority, only 0.1% of the 9,400 hedge funds registered with CIMA have suffered difficulties which have led to a suspension of trading.

2.6 We would also observe that many frauds that really have threatened the worldwide financial system, such as Barings and more recently Societe Generale, have not in any way been perpetrated through offshore entities.

2.7 Finally, we would refer you to several articles written by The Economist published on 24 February 2007 which give a balanced view of why offshore financial centres are beneficial for the global financial system. We enclose copies of those articles.


3.1 The Cayman Islands have invoked numerous statutory measures to cooperate with and assist foreign authorities, governments and courts with the provision of information held in the Cayman Islands. Such laws override any statutory or common law duties of confidentiality.

3.2 Mutual legal assistance for criminal matters has been covered under the Criminal Justice (International Cooperation) Law from 1997 and, with particular regard to US criminal matters, under the Narcotics Drugs (Evidence (United States of America) Law from 1984 and the Mutual Legal Assistance (United States of America) Law (“MLAT”) from 1986. Extradition between the Cayman Islands and other jurisdictions, including designated Commonwealth countries, is provided for by a variety of Extradition Orders, by extension from Her Majesty’s Government.

3.3 The Misuse of Drugs, Proceeds of Criminal Conduct Law (“PCCL”) and Terrorism Law also contain provisions for the sharing of information with authorities in relevant circumstances. Of 23 requests made to the Cayman Financial Reporting Authority by US authorities since 2003 in relation to money laundering and predicate offenses, 22 have been granted.

3.4 The Cayman Islands are also a party to the Hague Convention 1970 on the taking of evidence abroad, the principles of which are followed in the Evidence (Proceedings in Other Jurisdictions) (Cayman Islands) Order 1978.

3.5 As a regulatory matter, the Cayman Islands Monetary Authority (“CIMA”) is empowered under the Monetary Authority Law to entertain requests for information from any recognised overseas regulatory authority exercising equivalent functions. CIMA does not consider requests from fiscal authorities in relation to tax matters, which are more appropriately dealt with by the Tax Information Authority (see below under 3.6). If certain criteria are met, CIMA will direct a local financial service-provider or connected person to disclose information they hold which is responsive to the overseas regulatory authority’s request.

3.6 In relation to disclosure for tax matters, the Cayman Islands made a commitment to the OECD to cooperate with tax information requests. In 2001 the Cayman Islands signed a Tax Information Exchange Agreement with the United States. This provided for information in relation to criminal tax matters from the 2004 tax year and civil matters from the 2006 tax year and does not require a dual criminality test (ie that the matter constitutes a criminal offence in both the US and the Cayman Islands). When it was signed, the US Treasury Secretary at the time, Hon. Paul O’Neill, commented “We commend the Cayman Islands for emphatically demonstrating that those who seek to engage in tax evasion or other financial crimes are not welcome within its jurisdiction”. The following year, US Treasury officials were reporting to the Senate that the agreement would be “an invaluable source of information to the IRS”. Since then, the Cayman Islands have introduced the Tax Information Authority Law, 2005 which creates and empowers the Tax Information Authority (“TIA”) as the competent authority to deal with requests and responses which schedules the Tax Information Exchange Agreement with the United States. This Tax Information Exchange Agreement conforms to the model developed, with US participation, by the OECD Global Forum on Taxation, and is a form of an agreement which both the G-8 and G-20 countries have endorsed as reflecting “high standards of transparency and exchange of information for tax purposes”.

3.7 In 2005, the Cayman Islands implemented exchange of information measures similar to the EU Savings Directive and has introduced the Reporting of Savings Income Information (European Union) Law, 2007 (and related Regulations) (together, “ROSII”). As with the United Kingdom, the Cayman Islands chose the more transparent automatic reporting of interest payments rather than opting (as did certain onshore EU jurisdictions whose transparency must be questioned) to apply a withholding tax system in which the identities of the persons having bank accounts etc are not revealed. The ROSII also designated the TIA as the competent authority to deal with disclosures under ROSII and to act as the local liaison with the relevant foreign fiscal authority. We understand that the TIA has over the last two reporting periods, passed to the UK HM Revenue and Customs reports of relevant interest payments that are required to be made pursuant to these obligations.
3.8 The Cayman Islands Government and CIMA have had ongoing dialogue with foreign national and international agencies such as the FSA, US Securities and Exchange Commission and International Organization of Securities Commissions ("IOSCO") to ensure that the Cayman Islands is viewed as cooperative and responsive in relation to requests for information on regulatory and criminal matters. The Cayman Islands Monetary Authority has entered into a number of memoranda of understanding ("MoU") with respect to exchange of information (For a full list please go to www.cimoney.com.ky/section/regulatoryframework/default.aspx?id = 150). The most relevant of these for the purposes of this submission, is the recent MoU that CIMA has entered into with the Financial Services Authority in the UK. In addition, the Cayman Islands have applied for membership of IOSCO pursuant to which they have agreed that they would be bound by the IOSCO multilateral MoU. We understand that, at present, several EU regulators (eg Austria, Sweden and Ireland) have not as yet agreed to sign this new initiative to assist in the global co-ordination of exchange of information between regulators.

3.9 Outside of these statutory measures, there is also in practice a large number of transactions that involve Cayman Islands entities which are identifiable onshore due to the fact that either (a) the counterparties to the transaction are regulated onshore (eg a swap counterparty to a Cayman Islands bond issuer) and the relevant transaction is reportable; (b) the securities issued by the Cayman Islands entity are publicly listed on a stock exchange in the EU or elsewhere; (c) the transaction may be reportable under relevant accountancy rules by a party to the transaction; or (d) the transaction may be reportable by a party that has sponsored or originated the transaction under tax structure reporting rules.

4. To What Extent Does the Growth In Complex Financial Instruments Rely on Offshore Financial Centres?

4.1 This is difficult to answer as it is not clear what is meant by “complex financial instruments”.

4.2 If this alludes to the issues that have arisen in connection with the US sub-prime market and the use of complex financial instruments to pass on the risk of those securities into the market, it is absolutely not the case that such growth relied on Offshore Financial Centres. Although a large number of special purpose vehicles (“SPVs”) which contained sub-prime asset backed securities in their portfolios were incorporated in the Cayman Islands, these transactions were arranged by major US investment banks and could have been structured through several other jurisdictions, including EU jurisdictions such as Luxembourg, Ireland and the Netherlands (and indeed a large number of such SPVs were incorporated in those jurisdictions). The growth of these complex financial instruments was driven by market appetite for such instruments and many of the offshore structures, as is evident from the above, can easily be replicated onshore. The major reasons for using offshore structures are often cost and investor preference.

5. How Important Have the Levels of Transparency and Taxation In Offshore Financial Centres Been In Explaining the Current Position In Worldwide Financial Markets?

5.1 Cayman Islands entities are used for a wide range of legitimate business purposes and for a variety of reasons, the respective weighting of which will depend on the circumstances. Secrecy (in the sense of concealing information that would otherwise be available to appropriate parties, such as auditors, investors, lenders, counsel, counterparties and regulatory authorities) is not a driving motivator for reputable business coming to the Cayman Islands. Indeed, press articles which focus on the way in which multinational corporations use group companies in jurisdictions such as the Cayman Islands to conduct their international businesses are usually written based on information which a journalist has been able to obtain by reviewing the publicly-available audited accounts or regulatory filings of those multinational corporations which list their offshore subsidiaries.

5.2 Equally though, people and businesses the world over rightly are entitled to an appropriate level of privacy (which is, after all, enshrined in the United Nations Declaration of Human Rights) with a presumption that this is the starting position and that private information will be protected against disclosure save when there are proper reasons to override such duty of confidentiality through well-ordered gateways and subject to the application of the rule of law and suitable protections against abuse. It should also be borne in mind that many of the transactions that involve in part a Cayman Islands vehicle are either (a) listed on a major stock exchange; (b) consolidated for accounting reasons on the books of the parent entity, which in turn is publicly listed; or (c) been rated by a credit rating agency and information is freely available for the investors party to the transaction (eg in the case of a securitization, the notes trustee or an agent of the notes issuer is required to give financial information on the cash flows to the investors on a monthly or quarterly basis).

5.3 As was noted in paragraph 1.8 above, tax neutrality is only one of the many reasons why international investors and other participants choose to use Cayman Islands vehicles as part of their transaction and such tax-neutrality can often be obtained through the use of onshore vehicles (eg UK residential mortgage backed securitisations).

241 Based upon statistics compiled by Dealogic, 61% of global CDO deals in 2007 used a US domiciled vehicle and a further 15% used a vehicle domiciled in Ireland or the Netherlands.

6.1 As we are not experts on UK tax revenue and policy, this is difficult for us to say other than to note the following points.

6.2 As an initial point, the Cayman Islands have never had, during their 500 year history, any form of direct taxation (ie income tax, capital gains tax or corporation tax) and therefore do not have a “taxation policy” as such which can be changed in order to impact on UK tax revenue.

6.3 Secondly, the use of Cayman Islands vehicles are essentially tax neutral as was stated in our response at paragraph 1.8 with UK investors being required to pay tax on any income or capital that may arise for the transaction (either at the time of receipt if the vehicle is a pass through vehicle or if the payments are held in the vehicle by virtue of the vehicle becoming subject to controlled foreign corporation rules and so the UK investor is often taxed on that basis). Therefore in that sense, there is no impact.

6.4 Thirdly, to the extent that Cayman Islands vehicles are doing business in the UK or are UK managed and controlled, they will be liable to UK tax in the normal way.

6.5 Since the Cayman Islands, like most other offshore financial centres, do not have the infrastructure to support the relocation of the tax domicile of major UK companies, the fact that there is no direct taxation such as income tax or corporation tax is unlikely to lead to the loss of UK companies to the Cayman Islands. Indeed in light of the recent changes to the non-domicile and capital gains regimes, it is interesting to note that Shire’s recent move was to Ireland, not to any offshore centre, and that Switzerland is being mooted as the other major alternative.

6.6 It should also be borne in mind that while the Cayman Islands do not have a direct tax system, there is an indirect tax system collected mainly through stamp duty on real estate and import duty of 20% on most items with higher rates for certain other item. Therefore the idea of Cayman Islands resident individuals and/or businesses having a “tax free” existence is misconceived.

6.7 It should also be noted that one of key factors in identifying and assessing jurisdictions as being a “non co-operative” jurisdiction as set out in the Organisation for Economic Cooperation and Development (“OECD”) 1998 report on “Harmful Tax Competition—an Emerging Global Issue” was so called “ring-fencing” of tax regimes, whereby preferential regimes or policies were applied for taxation of “offshore” companies but taxation was applied domestically. This has never been the case in the Cayman Islands as the no-direct-tax regime applies domestically in the Cayman Islands and there is no distinction for tax purposes between onshore and offshore companies. The Cayman Islands was also one of the first of the Offshore Financial Centres to be placed on the OECD “white list”, ie categorised as being co-operative.

7. Are the British Overseas Territories and Crown Dependencies Well-Regarded As Offshore Financial Centres, Both In Terms of Comparison To their Peers and International Standards?

7.1 For the reasons specified earlier in this submission, in particular the response to Question 1 and Question 3, we are of the view that the Cayman Islands are regarded by investors, rating agencies and service providers in all the major financial centres as a world class jurisdiction for the formation of hedge funds, private equity funds, capital markets and structured finance companies, business and joint venture vehicles and insurance companies.

7.2 Another important area that relates in part to the response to Question 8, is the current Cayman Islands anti-money laundering (“AML”) regime. In that regard, the Cayman Islands underwent an evaluation by the Caribbean Financial Action Task Force (“CFATF”) in June 2007. The Report was published in November 2007 and can be accessed on the CFATF website at http://www.cfatf.org/profiles/media/Cayman%20Islands%20MEV%20-%20Final%20Report%20_2_a.pdf.

The evaluation reported a “strong compliance culture” in the Cayman Islands’ financial services sector. The evaluation rated the Cayman Islands “compliant” or “largely compliant” with 38 out of the 40 Financial Action Task Force AML recommendations and the nine combating of financing of terrorism special recommendations. This compares very favourably with third-round evaluations to date of FATF countries and, using the same ratings, places the Cayman Islands 4th out of the 26 jurisdictions reviewed so far. The Cayman Islands have achieved better results than other FATF members, including Denmark, Finland, Greece, Ireland, Italy, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

7.3 The Cayman Islands have had AML legislation since 1989. The Misuse of Drugs Law criminalised, among other things, dealings with the proceeds of drug trafficking. All crimes AML legislation was introduced in 1996 with the Proceeds of Criminal Conduct Law (“PCCL”), which has been regularly amended and revised to meet international standards. The Cayman Islands were the first Caribbean jurisdiction to introduce such legislation and the PCCL has been used as a legislative model for other regional jurisdictions. The PCCL essentially provides for the criminalisation of various forms of money laundering, a mandatory reporting obligation and tipping off offence, the empowerment of the police and courts to search, freeze and confiscate the proceeds of crime and the ability of the courts and relevant authorities to assist in the enforcement of foreign confiscation judgments.
The Money Laundering Regulations (the “Regulations”) were introduced in 2000 and essentially codified the basic procedural AML requirements which the financial services industry had been applying voluntarily for over a decade. The Regulations require that financial service providers conducting relevant financial business must maintain the following procedures when entering a business relationship or conducting a one-off transaction:

(a) client identification and verification;
(b) record keeping;
(c) internal controls and communication;
(d) suspicious activity reporting; and
(e) training and awareness.

Client identification and verification procedures will normally include obtaining information on the controllers and principal beneficial owners of client entities. In 2001, the Regulations were amended so that the requirement to maintain client identification and verification procedures would apply to all relationships established prior to the introduction of the Regulations (ie an obligation was imposed to perform retrospective due diligence on all relationships pre-2000). To date, the Cayman Islands are the only jurisdiction in the world to have completed the retrospective due diligence exercise across all industries.

The Regulations apply to all licensed trust companies, corporate service providers and company managers, as well as those entities registered and licensed to conduct securities investment business, amongst others. In contrast, the UK and other EU member states have only recently extended their Money Laundering Regulations to trust companies with the introduction of the EU Third Money Laundering Directive. In this regard, the Cayman Islands can be considered to be more regulated than most onshore jurisdictions.

8. To What Extent Have Offshore Financial Centres Ensured That they Cannot Be Used In Terrorist Financing?

Since October 2001, the Cayman Islands have applied the Terrorism (United Nations Measures) (Overseas Territories) Order, which provides for the fundamental offences against dealings with terrorist property and the support of terrorist financing. The Terrorism Law was introduced in 2003, which clarifies and extends the terrorism and terrorist financing offences, in particular providing for the forfeiture of terrorist funding, prohibition of terrorist activity, money laundering, and mandatory disclosure of information to appropriate authorities on the same lines as the anti-money laundering legislation.

As noted above in paragraph 7.3, the Cayman Islands were highly commended by the CFATF report in November 2007 for the steps it had taken in relation to maintaining global standards on money laundering and terrorist financing. The Cayman Islands is currently contemplating the adoption of a new Proceeds of Crime Law, which will replace the current Proceeds of Criminal Conduct Law and will harmonise the offences and reporting requirements under that law, the Misuse of Drugs Law and the Terrorism Law.

9. What Are the Implications for the Policies of HM Treasury Arising From Offshore Financial Centres?

It is not really possible for us to answer this as we are not fully aware of what HM Treasury’s policies are. If the Committee is familiar with them and would care to share them with us, we would be happy to revisit this question.

10. What Has Been and Is the Extent and Effect of Double Tax Treaty Abuse Within Offshore Financial Centres?

None, as the Cayman Islands are not party to any double tax treaties.

11. To What Extent Do Offshore Financial Centres Investigate Business and Individuals That Appear To Be Evading UK Taxation?

In addition to the reporting obligations under the ROSII and Tax Information Exchange Agreements, under the PCCL any person that knows or suspects (in the course of their business, trade etc.) that another person is engaged in money laundering must disclose such information to the Cayman Islands Financial Reporting Authority as soon as reasonably practicable.

“Money laundering” is essentially defined under the PCCL as any act constituting an offence under the PCCL, the Misuse of Drugs Law or the Terrorism Law, or an act done outside the Cayman Islands that would have constituted such an offence if it had been committed within the Cayman Islands. An offence or criminal conduct to which the PCCL applies refers to an indictable offence. As such, a reportable act should be an indictable offence in the Cayman Islands, whether committed in the Cayman Islands or not.
11.3 As the Cayman Islands have no income, capital gains, corporation, estate, gift or inheritance taxes, there are no direct tax offences and foreign tax evasion per se (ie omissions to pay income, capital gains or corporation taxes to the requisite overseas taxing authority) may not form a predicate offence for the purposes of the money laundering legislation in the Cayman islands.

11.4 However, it is likely that the actual conduct (or some part or aspect of it) could constitute an ancillary indictable offence under the Cayman Islands Penal Code or common law. Possible offences under the Penal Code could include, for example, false accounting, forgery, fabricating or destroying evidence, perjury in relation to proceedings or conspiracy to defraud. If the alleged act may include any of these criminal elements, a duty to report may arise.

11.5 As a matter of practice, most financial service providers will enquire, as part of their anti-money laundering procedures, whether the source of funds is legitimate and, in certain circumstances, whether onshore tax advice was obtained. Maples and Calder operates a group policy that where instructions are not received through an onshore law firm, financial institution or accountancy firm, confirmation of compliance with local laws, including tax laws, must be provided.

June 2008

Memorandum from the Society of Trust and Estate Practitioners (STEP)

INTRODUCTION

1. Well run low-tax international financial centres (IFCs) are essential complements to “onshore” economies such as the UK. It is no accident that the world’s leading IFCs are clustered around New York and London.

2. Leading economists have shown how low-tax centres reduce the user cost of capital for companies and individuals, making it cheaper to export goods and services, and to facilitate inward investment into the UK as well as overseas investment. This in turn makes it cheaper to employ people, gives companies easier access to overseas markets—accessing new demand, and allows companies to reinvest profits in the UK.

3. The special affinity of the Crown Dependencies and Overseas Territories towards the UK is a major advantage in directing inbound business for the City and the UK economy as a whole. The global appeal of these territories as intermediaries for structuring insurance, funds and private banking activities means that they facilitate collection and direction of significant investment of global capital into London markets.

4. It may be that other EU member states are conscious of the considerable advantage enjoyed by the City of London from its relationship with the Crown Dependencies and the Overseas Territories. If so, the UK might wish to guard against external efforts to drive a wedge into this symbiotic relationship. The Netherlands defends its territories in Aruba and Netherlands Antilles fiercely by making sure they are on the recent EU white list for example.

5. Is it true that any jurisdiction can succeed in financial services simply by a good governance and high regulatory standards, are key reasons for the success of the Crown Dependencies and many of the Overseas Territories.

6. The reality is that global consumers demand much more from their financial centres than low or no tax and secrecy. Consumers seek well governed centres with market confidence in their regulation, low levels of corruption as well as competent and trustworthy professionals and courts. These elements, particularly good governance and high regulatory standards, are key reasons for the success of the Crown Dependencies and many of the Overseas Territories.

7. What is an international finance centre?

8. The terms “tax haven” and “offshore centre” are often used in a pejorative way to describe the low–tax IFCs. “Offshore” is a concept more appropriately defined not by whether a financial centre is surrounded by coastlines or mountains, but rather by whether the client resides outside the jurisdiction providing the particular financial service.

9. IFCs play a substantial commercial role facilitating tax-neutral transactions (often conceived in London and New York). These are not activities confined to the traditional IFCs; such offerings are also common in the major developed countries. Consider, for example, the Eurobond market based in London which provides a tax-neutral platform for international debt issuers. New York, London and Tokyo control,
between them, nearly 60% of the global market for offshore banking and capital markets services. Taking into account the additional similar activity in other OECD member states such as Switzerland and Luxembourg, OECD jurisdictions already control 80% of the international market for offshore financial services.

10. The “onshore”/”offshore” divide is too simplistic. Many jurisdictions compete for globally mobile capital, individuals and companies by providing tax incentives. Places like the Netherlands, Ireland, the UK, Spain, Germany, and France offer special concessions on tax. Many EU countries can be used as conduits via their holding company regimes and extensive tax treaty networks. Places like New Zealand provide incentives for non-resident trusts to locate themselves there with a special tax regime. Delaware also offers incentives for corporations to headquarter in the state. Clearly so-called “onshore” states can be used in tax planning. These surprising examples show how most jurisdictions already compete for capital and readily facilitate tax planning for both corporate and individual investors from other jurisdictions.

11. What makes a low-tax international finance centre successful?

12. Why do people use offshore centres? They do so because they have a use for them. But this is not enough. Good low-tax IFCs succeed because they focus on:
   - tax neutrality;
   - balancing confidentiality with transparency;
   - financial and legislative innovation;
   - political stability, legal certainty and investment in people and infrastructure; and
   - a focus on a good international reputation.

13. Balancing confidentiality with transparency

14. Confidentiality is important for those clients who are concerned about their own financial privacy and security. This can take the form of wishing to maintain high levels of confidentiality for privacy or commercial reasons to preventing kidnapping of individuals who fear their personal information will be sold or misused by domestic institutions. This is a common concern for clients from Latin America, Africa and the Far East. For example, it is understood that the UK government has suspended information exchange under its tax treaty with Mexico to reflect tax data security concerns there. Middle Eastern and CIS clients are often concerned about political stability.

15. Closer to home in April the Italian Government posted the earnings and taxes for the entire country on a website, causing an outcry: “Before being blacked out at the insistence of data protectors, vast amounts of data were downloaded, posted to other sites or, as eBay found, burned on to disks.”

16. The Financial Times subsequently reported criticism that the initiative would help the mafia find targets for extortion and robbery. It is also of concern to clients that employees with access to private data have sold-on such data and compromised clients. This report from the Strategic Forecasting Terrorism Intelligence Report of January 9, 2007, highlights typical concerns:

17. “In additional to industrial espionage, there have been several well-publicized cases in which Indian workers have stolen information—such as bank account numbers, PIN numbers for automatic teller machines or birthdates and Social Security numbers (from American customers) for criminal purposes. In perhaps the most notable of these cases, a worker at an Indian call center allegedly sold the bank account information of 1,000 British customers to an undercover reporter at $7.68 per account. The call worker boasted that he was able to steal and sell up to 200,000 accounts each month."

18. There are important exceptions to confidentiality. In Cayman, for example, confidentiality is disapplied if certain conditions are met. These include investigations in connection with offences committed or alleged to have committed in Cayman or, if outside Cayman would have been an offence if committed in Cayman.

19. There are legitimate concerns that excessive secrecy can lead to abuse. A point comes when excessive secrecy prevents legitimate tax collection. The balance between confidentiality and risking abuse is maintained by enforcing the rule of law and having effective risk assessment and robust AML rules. The CDs and the OTs have balanced these concerns by regulating corporate and trust service providers and requiring them to beneficial ownership data. This contrasts with many EU Member States and the USA, which generally have not effected regulation to the same standards.

243 Economist, 8 May 2008
20. The importance of reputation and good governance

21. Multinational corporations seek country platforms which stress political and economic stability and have a sound reputation for good governance. Few, if any, truly successful finance centres will have high levels of corruption. Indeed, research by leading economists shows that states in which tax is used to attract foreign capital have significantly higher levels of good governance, as political stability and good governance are foundation stones for attracting capital.\(^{24}\)

22. Political stability, legal certainty and investment in people and infrastructure

23. It is occasionally said that the Crown Dependencies, Bermuda, the BVI and Cayman have benefited from the result of being, and continuing to be, one of the leading groups developing modern financial services legislation. The corollary of this is that, over the years, this group has attracted many of the leading international banks, trust companies, accountancy firms and other such financial service providers and that the local law firms have been able to attract a high numbers of very experienced and qualified international lawyers. It is fair to say that, to a large degree, these jurisdictions now compete with the major onshore financial centres when it comes to the type of international services provided and the quality of the professionals providing such services.

24. They are also remarkably politically stable as it could be counterproductive to establish a trust, for example, in a politically unstable jurisdiction.

25. In Cayman, for example, the corollary of having such an established trust industry is that many of the leading international trust cases have been litigated in Cayman and Cayman’s courts system is an internationally recognized forum for the resolution of such disputes. Indeed, it is not unknown for trusts to be re-domiciled to Cayman precisely because of the possibility of a dispute and the need to settle it as appropriately and efficiently as possible.

26. Like in any major finance centre, there is a need to invest in quality people. This is particularly important when dealing with modern financial services. It is also necessary to ensure, for example, that modern communications are effective.

27. Financial and legislative innovation—non-resident trusts and companies

28. Whilst levels of taxation and confidentiality are important in establishing an IFC they are a necessary but not sufficient cause of success. An offshore trust or company, for example, has many uses beyond tax neutrality.

29. Flexible legal arrangements and corporations are available in IFCs. It is useful therefore to examine in some detail why families and corporates use such structures and these are set out in below.

30. Trust Relationships

31. A trust creates a legally enforceable relationship such that the trustee holds the assets of the trust subject to certain obligations of a fiduciary nature. This provides settlors with the comfort of knowing that the assets of the trust should be utilized in the best interests of the objects of the trust and that, if the trustee does not comply with its obligations, recourse may be had to the courts for a remedy.

32. If it is necessary to seek a remedy from the courts, there is an extensive body of binding and persuasive international case law stretching back many hundreds of years. This provides settlors and those who must apply trust law an invaluable resource in terms of how trust law is likely to be interpreted by the courts and the certainty that goes hand in hand with this.

33. Whilst, in order for a trust to be valid, it must, as a minimum, create an “irreducible core of obligations” and that its provisions, property and objects must be sufficiently certain, a trust is an extremely flexible planning tool. Indeed, this is one of the key reasons they are often chosen over other possible structuring arrangements, such as a company.

34. It is noticeable that the rise in the use of trust has closely mirrored the increasing globalization of families. Such families often have assets in a number of jurisdictions. A trust located in a suitable jurisdiction will often serve as the ideal way of holding such assets, administering them holistically and avoiding, for example, multiple probate applications upon the death of the settlor.

35. Sensibly, a settlor should ensure a smooth transition of family assets through the generations by establishing, and being involved in, succession planning arrangements during the settlor’s lifetime rather than simply leaving all his assets to the next generation under a Will or other such testamentary arrangement. This may be of particular importance in the case of a family business where the avoidance of disruptions in management and control can be a crucial consideration. Trusts facilitate business continuity, particularly family businesses, by minimizing disruption in management control, for example on the death of owner-manager.

36. It is not unreasonable for individuals to wish to have an appropriate level of confidentiality concerning their financial and other such affairs. The motivation may extend to such concerns as the avoidance of media attention and that of potential kidnappers. Indeed, it is not uncommon for offshore trusts to contain specific provisions to deal with kidnap situations.

37. Given all their advantages, trusts are increasingly used in commercial situations. Such uses include (but are certainly not limited to) pension trusts, unit trusts, employee benefit trusts schemes, share voting trusts, trusts for use in corporate/aircraft finance transactions, trusts to hold the voting shares of corporate funds to avoid consolidation and other such issues and trusts. The value of UK trusts used in a commercial context runs into several trillions. Mutual funds in places such as Jersey benefit the UK economy as they bring large sums to the UK.

38. Although trusts are an invention of the common law, trusts are increasingly popular with clients in civil law jurisdictions. Italy has recently adopted trust law, Switzerland has recognised trust law, and France has a similar arrangement, La Fiducie.

39. Why create a trust in Cayman?

40. Cayman imposes stringent legal requirements on trust companies which offer trust services to the public, both in terms of their obtaining the necessary license to do so and in terms of ongoing monitoring. Accordingly, those involved in establishing Cayman trust structures can expect that the trustee will properly carry out its role as such and that, in the unlikely event that any issues arise with the trust company itself, there will be an appropriate regulatory framework in place to deal with this.

41. Again, there is occasionally a misconception amongst the less well informed that it would in some way be beneficial for Cayman to do less than its fair share in implementing measures to combat the laundering of the proceeds of crime and the funding of terrorism. In fact, the reverse is true and Cayman has had robust laws and regulations in place to implement such measures going back at least a decade or so (see Table 1 for breakdown of Cayman CFATF findings). This has done much to enhance Cayman’s reputation and thus to assist it in attracting welcome high quality business (and to dissuade unwelcome business).

42. Cayman has developed innovative offshore trust legislation, usually in response to the needs of international trust advisors and their clients. The equivalents of Cayman’s exempted trusts, STAR trusts, reserved powers trusts are, by and large, unavailable in most onshore jurisdictions.

43. Why create a company in the British Virgin Islands?

44. The British Virgin Islands introduced in 1984 the BVI International Business Companies Act. After twenty years, the legislation was completely reviewed and updated, resulting in the BVI Business Companies Act of 2004 (“BVI BC Act”).

45. The BVI BC Act has been well received by international practitioners, and a leading UK QC has commented that it was reviewed extensively and favourably by those involved in the consultation process leading up to the introduction of the new UK company legislation. The BVI BC Act is at the forefront of modern company law. By way of example, innovations include:

46. the abolishing of old-style capital maintenance provisions, and concepts of authorised capital. Shares in a Business Company represent an entitlement to benefits such as dividend and voting rights and not a fraction of the capital. Accordingly there are no constraints as to the need to maintain capital;

47. A new solvency test for distributions, which can only be made if after the directors have determined that immediately after the distribution, the company will satisfy the statutory solvency test;

48. Statutory footing is given to a variety of directors duties;

49. The provision of modern minority shareholder rights;

50. The new concept of a “reserve director” to avoid succession problems in the event of the death of a sole shareholder/director;

51. Allowing a director of a wholly-owned subsidiary to act in the best interests of its holding company even though the contemplated act may not be in the best interests of the company itself;

52. Financial assistance is permitted in connection with the acquisition of a company’s own shares;

53. All BCs are required to have registered agents in the BVI which are required by law to retain copies of registers of shareholders and directors in their offices in the BVI.

54. Filing with the BVI Registrar of Corporate Affairs is accomplished on-line, 24 hours a day. Insolvency legislation has also been fully brought up to date. Corporate service providers licensed and regulated by the BVI Financial Services Commission for almost 20 years.

55. Existing market reputation as one of the world’s premier provider of competitively priced, flexible, corporate vehicle. The IMF 2004 Report concluded that “the regime for registering and maintaining [BVI companies] meets or exceed most best practices”. 
56. The importance of international reputation

57. A successful IFC seeks to maintain a good international reputation based on objective assessments. That is why the major finance centres in the Crown Dependencies and Overseas Territories are well regulated by comparison to other international finance centres.

58. Major IFCs have focused on international standards and peer comparisons as they relate to anti-money laundering legislation and regulation and have proved highly responsive to any criticism based on objective criterion. The same cannot be said for many EU member states who have not implemented the 2nd Money Laundering Directive let alone the 3rd.

59. Effective international regulation is vital to disrupt cross border crime. If international regulation is weak in any of the major cross border finance centres then there is a strong danger of regulatory arbitrage. STEP therefore believes that effective regulation on the basis of a level playing field is the best way to minimize crime.

60. Comparisons with international regimes

61. Table 1 shows a comparison of some of the latest FATF assessments of key centres. Note that there have been no recent comparable reports on the Crown Dependencies.

62. Table 2 shows a comparison of the latest IMF assessments. The IMF conducts a Financial Sector Assessment Programme (FSAP) to ensure adequacy of supervision and the availability of relevant data. Its recent progress report mentions that “the compliance levels for OFCs are on average better than in other jurisdictions assessed under the FSAP”. Moreover, “on average, OFCs meet supervisory standards superior to those of other jurisdictions” Source: OFCs, The assessment program, A progress report (IMF 25 February 2005), paras 5–6. An up-to-date report on the BVI is imminent.

63. Industry seeks objective assessments from credible sources

64. Industry also seeks credible sources of information on regulation in order to make judgments on how to risk assess jurisdictions for the purposes of anti-money laundering. IMF and FATF are generally considered to be the most credible sources of information on AML country risk. It is also important that where weaknesses have been identified that there is a willingness from government to tackle the problems identified.

65. There is considerable concern amongst industry that some international membership groups are incapable of providing objective analysis of AML risk. The OECD and the EU have recently been criticised for producing reports in these areas which do not appear to take account of inadequacies within their own membership. STEP would recommend that AML regulation is rationalised so that organizations can rely on objective reports on applied international standards from credible sources.

66. Moreover there is concern that the US states which provide competitive services are not only failing to meet core FATF obligations on beneficial ownership but that they are not committed to making such changes in the future. By contrast it is held that the Crown Dependencies and the BVI, Bermuda and Cayman are committed to improving AML regulation and being good global citizens (see case studies on Delaware and Bermuda).

67. “EU” Whitelist—lists which lack credibility confuse industry and increase risk

68. The EU member states have released a contentious list that implies that it creates an objective list of which countries have an equivalent regime to the EU. Unfortunately the list is not objective, there is no single “EU regime” for AML/CTF, and inclusion on the list gives a significant economy benefit. Moreover the simplified due diligence permitted for companies in those third countries on the list offers opportunities to money launderers if jurisdictions on the list do not actually have stringent AML laws. This is of great concern to STEP and members who rely on credible sources to inform their AML risk regimes.

69. An “equivalent country” is a country with legislation that contains comparable anti-money laundering provisions to the EU. Briefly, third country equivalence status affords the following advantages to such countries, in respect of credit and financial institutions:

— Allowing simplified due diligence between firms in the UK and equivalent third countries.
— Allowing reliance on third parties in equivalent third countries.
— Allowing in certain circumstances financial institutions, lawyers and accountants to inform another firm in the third country in their network that a suspicious transaction report has been made.

70. The list is not drawn up according to an objective set of criteria. It would be an obvious starting place to use the FATF and IMF reviews as a methodology for determining equivalence. That has clearly not been used. Of third countries it is noticeable that Russia, Netherlands Antilles and Aruba are on the list as well as the USA while UK Crown Dependencies may, or may not, be considered as equivalent by Member States. The Cayman Islands, the British Virgin Islands, and the Bahamas are not on the list. Russia remains
something of an unknown quantity as it has not been recently reviewed by the FATF/IMF and some US states have recently been censured by the FATF for failing to disclose any corporate beneficial ownership information whatsoever. This failure has caused three Senators, including Senator Barack Obama to introduce a Bill to the Senate compelling beneficial ownership data to be unveiled.

71. According to the Financial Times, one British official who works on anti-money laundering said the decision to include Russia while excluding the Cayman Islands was “outrageous” and seemed to reflect a historic suspicion of the Caribbean territory.

72. It is not useful to those professionals putting together country risk assessments to suggest that regimes can be equivalent with EU standards as there is no single standard. Although the list assumes that all EU member states are equivalent this is clearly not the case. In fact the UK is one of a small number of member states that has implemented the 3rd Money Laundering Directive. The European Commission has decided to pursue infringement procedures against 15 Member States for failure to implement the Third Anti-Money Laundering Directive in national law. The Commission will send formal requests to Belgium, Czech Republic, Germany, Greece, Spain, Finland, France, Ireland, Luxembourg, Malta, the Netherlands, Poland, Portugal, Sweden and Slovakia. These formal requests take the form of “reasoned opinions”, the second stage of the infringement procedure laid down in Article 226 of the EC Treaty. If there is no satisfactory reply within two months, the Commission may refer the matter to the European Court of Justice. The Directive should have been implemented by 15 December 2007.

73. Clearly the EU Whitelist is not only discriminatory against certain jurisdictions that are not included on the list that will suffer economically as a result but also creates space for those seeking to launder money. This should be of great concern to us all.

CASE STUDY—DELAWARE—FATF AND FEDERAL EVALUATIONS OF US STATES’ STANDARDS

74. A key concern in the regulation of the global financial system is the ability to track (ultimate) ownership of companies and similar structures. Following articulation of programmes to ensure this goal by the OECD and the Financial Action Task Force at the turn of the millennium, UK Overseas Territories and Crown dependencies required their corporate company service providers to track beneficial ownership interests in companies established by them for clients.

75. In order to ensure that these obligations would be carried out in practice, the Overseas Territories and Crown Dependencies also adopted laws to regulate their service providers and expanded their financial services commissions to ensure full supervision capability. Many of these regulated service providers are STEP members. Accordingly, in the UK Crown dependencies and overseas territories the public authorities have, and routinely exercise, effective access to information regarding beneficial ownership of companies established for clients by local service providers.

76. The United States has a well-deserved reputation as a large and well-regulated financial services market. The federal government has apparently committed to adherence to international standards for tracking ownership of companies. However, the constitutional split of powers in the United States means that corporate regulation is conducted at state level and the States do not observe international standards agreed (and promoted) by their federal government. In consequence, it is possible to establish anonymously owned tax-free companies in the form of single member LLCs in nearly every state in the United States. As these companies are not taxed unless they conduct “effectively connected” trade or business in the US, they are widely used internationally by foreign clients as they have no US reporting obligations from a tax or corporate point of view.

77. The Financial Action Task Force conducted a peer review of US compliance with their 40 + 9 Recommendations in 2006.245 The July 2006 FATF report on the US noted that State corporate service providers are “actively marketing the States as locations where anonymity [for corporate ownership] can be assured”. Commenting on risks posed by US state reluctance to adopt the new transparency standards the FATF concluded as follows:

78. “In discussions with the state authorities, it was clear that there was a realization of the threats posed by the current “light-touch” incorporation procedures, including the failure to obtain meaningful information on individuals who effectively control the entities. However, the states primarily see this activity as a revenue-raising enterprise, and the company formation agents represent a powerful lobby to protect the status quo. Therefore, any proposals to enhance the disclosure requirements have not progressed.”

79. This FATF view was supported by an April 2006 report by the US government auditor, the General Accountability Office,246 which notes that “most states do not require companies to provide ownership at formation or in periodic reports”.247 That report also notes that law enforcement officials are concerned that the use of shell companies established in the United States enables individuals to conceal their identities and conduct criminal activity.

245 http://www.fatf-gafi.org/document/320.3343_en_32250379_32236982_35128416_1_1_1_1_0.0.html
247 I bid at page 4.
80. An additional US government report published by the US Treasury Department in January 2006\(^{248}\) contains (in chapter 8) a review of US shell companies and trusts, noting that German, Eastern European and Russian law enforcement agencies have expressed concern that regional criminal organisations are abusing Delaware shell companies to promote money laundering.

81. At the time the FATF conducted its evaluation in 2006, these and several other US government reports supported FATF concerns about routine use of anonymously owned US companies by foreign criminals. In the event, the FATF imposed a two year deadline on the United States to address these issues. That period expires in July 2008; no state action has been taken to date.

82. US states have now incorporated more than three million LLCs (http://levin.senate.gov/newsroom/release.cfm?id = 265861). By contrast, the number of international companies established in BVI is approximately 800,000. Of course, a number of US tax-free corporations would be used for ordinary domestic US purposes by individuals who may be taxable in their own right; however, as the States do not track beneficial ownership they are unable to determine the split between domestic and foreign ownership of these structures. It is certainly clear to international practitioners STEP that anonymously owned US companies are ubiquitous in the global financial services industry.

83. Expressing concern about the failure of the US states to make any progress on the FATF deadline for tracking corporate ownership, a bill was introduced in the US Senate at on 1 May 2008 (sponsored by Senator Carl Levin and Senator Norm Coleman and Senator Barack Obama) to require US States to take action on tracking corporate ownership (http://obama.senate.gov/press/080501-obama_joins_leve/). However, no check on state compliance with the requirement is planned under the terms of the bill until 2012. It is also uncertain whether the federal government has the constitutional power to take the action proposed and of course political support for the bill is unclear. Accordingly, effective US action on defaults is uncertain, and not imminent.

84. The British Overseas Territories and Crown Dependencies are concerned that if standards comparable to their own are not also adopted in those countries calling for change then they will continue to suffer from adverse competitive impact as business migrates from these well-regulated smaller centres to OECD countries promoting but ignoring the emerging transparency standards.

85. Substantial gaps in the world regulatory system such as the continuing ability to establish anonymously owned companies in the United States also mean that the regulatory programme designed by the supranationals is destined to be ineffective; business dislodged from one centre simply moves to another country. STEP believes that if these standards are seen as important they must be uniformly adopted to be effective, including particularly in the countries calling for standards in other countries to be upgraded. STEP has promoted adoption of a “level playing field” for the regulation of financial services since 2001 when it published “Towards A Level Playing Field, Regulating Corporate Vehicles in Cross-Border Transactions”.

86. On 29 January 2008 the International Monetary Fund (IMF) published the findings of its assessment of Bermuda under the Offshore Financial Center Assessment Program (OFC). Bermuda received a mixed report, but responded with an impressive array of proposed changes to its AML regime.

**Post-mission changes**

87. June 2007, saw the passing of an amendment to the POCA and amendments have been proposed to the Proceeds of Crime Regulations, along with a new Financial Intelligence Act 2007 to establish an administrative Financial Intelligence Unit (FIU), as well as amendments to the Criminal Justice (International Cooperation) (Bermuda) Act 1994 (CJICBA).

88. Furthermore in May 2008 the Bermuda National Anti-Money Laundering Committee (NAMLC) issued a consultation paper on further changes to the AML regime. These changes include:

89. Draft Anti-Money Laundering and Anti-Terrorist Financing (Supervision and Enforcement) Act 2008 which makes provisions to establish appropriate supervisory authority for the financial institutions and professionals to monitor and ensure compliance with the proposed Proceeds of Crime (Anti-Money laundering and Anti-Terrorist Finance) Regulations 2008.

90. Draft Anti-Terrorism (Financial and other measures) Amendment Act 2008 which primarily expands the definition of terrorism and addresses other identified deficiencies relating to disclosures.

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WHY ARE LOW-TAX IFCs GOOD FOR THE UK ECONOMY?

91. The overwhelming consensus amongst economists who have examined this area is that low-tax finance centres provide significant economic benefits to higher-tax economies like the UK. It is common for newspapers to criticize major firms or “non-doms” for using holding companies or trusts to mitigate their tax liability. Leading economists have shown how low-tax centres reduce the user cost of capital for companies and individuals, making it cheaper to export goods and services, as well as investing abroad. This in turn makes it cheaper to employ people, gives companies easier access to overseas markets, and allows companies to reinvest profits in the UK. Offshore trusts provide a place for non-doms to invest in the UK in a tax neutral way where income and gains are charged to tax when remitted to the UK.

92. There is general understanding among the public that Direct Investment Abroad (DIA) is good for “onshore” economies. As studies of the effect of direct investment abroad show, such investment is coupled with higher economic growth in the parent country (eg. the UK), lowers the cost of employment and creates jobs. Recent economic discussion has focused on DIA through low-tax jurisdictions and whether this is “good” for onshore economies. The simplistic view is that investment in low tax jurisdictions creates a tax revenue loss in onshore countries like the UK and therefore “hurts Britain” and only helps the original investors.

93. According to a major recent study by Professors Hines, Desai and Foley249, there is no evidence that low-tax centres divert activity from high-tax centres within the same region, and, in fact, the opposite appears to be the case. Instrumental variables analysis indicates that low-tax centre and high-tax centre activity within a region are complementary, as the establishment of low-tax centre operations is associated with expansions of activity outside of low-tax centres.

94. Where low-tax jurisdictions help deferral of home-country taxation of income earned elsewhere, or where affiliates in low-tax areas offer valuable intermediate goods and services to affiliates in high-tax areas, investment in high-tax states is encouraged.

95. How does deferral work? Suppose a subsidiary may either reinvest a profit of £100 at a rate of return of 10% after foreign corporation tax or distribute the profit to its parent. If the subsidiary repatriates the profit to its parent the parent pays a tax of say 10% of the dividend to its home state. If the profit is temporarily reinvested abroad and then paid out with the addition of a 10% return after a year, the parent will at that time receive a net income of 110 = 100 x 1.10 = £110. If the profit is immediately repatriated the company would (net of foreign and repatriation taxes) end up with £90. If the parent company was resident in a state which levied no repatriation tax the result would be the same meaning that this tax is neutral towards the subsidiaries investment and distribution policy.

96. The ability of low-tax IFCs to offer a tax neutral platform for investment also serves to attract investment from third countries, offering clear advantages to investors as demonstrated above. The Chartered Institute of Taxation recently estimated that UK resident non-domiciliaries invested between £75 billion and £125 billion in the UK economy through trusts and companies that facilitate the deferral of tax.

97. The economic literature demonstrates that the proximity of low-tax IFCs strengthens this positive relationship, further boosting the UK economy. Tax neutrality attracts investment from other sources for example through mutual funds, unit trusts, and banking services. All of these services take place in low-tax IFCs but invest in the UK and other higher-tax centres. By increasing inward investment to the City of London and other financial services providers in the UK, international investment in these high value added services is made possible by low-tax IFCs. The banking sector is the largest contributor to UK tax revenues and much of the trade on which this tax is paid is attracted to London by adjacent low-tax IFCs.

98. Another major area of debate is about whether low-tax centres speed processes of tax competition—driving our tax rates down. Tax competition between higher taxing countries has not been shown to be accelerated by low-tax IFCs250.


250 There is a widespread assumption that tax competition means that one jurisdiction must follow another in cutting rates and much of the trade on which this tax is paid is attracted to London by adjacent low-tax IFCs.

Firstly, it must be noted that the concept of tax competition is not wholly borne out by the empirical literature or theoretical debate. Theories of tax competition, predicated generally on capital mobility and fixed labor markets, suggest that tax rates on capital should be declining and that more open and integrated economies should have lower capital (corporate) taxes. Hansson and Olofsdotter examine the empirical literature and conclude, “The results of previous studies seem inconsistent, and provide only weak empirical support for the predictions of the tax competition theory.” Slimrod notes, “there is no consensus in the political science literature that openness, liberalisation, or globalization has led to reduced taxation of capital income, including use of the corporate income tax, although lower corporate taxes were sometimes pursued as a policy package with financial liberalization.”
Limits on tax planning—what are the implications of low-tax centres for HM Government’s policy?

99. Non-discriminatory anti-avoidance legislation also has a legitimate role in countering some tax planning. There is a balancing act between promoting economic growth and gathering tax revenues.

100. If low-tax centres, and therefore tax planning, are economically beneficial for the UK, should all anti-avoidance legislation be repealed? Clearly there is a balance to be struck between curbing abuses which involve the creation of wholly artificial arrangements and allowing no tax planning at all. So far, the European Courts of Justice have drawn the line that taxpayers, be they corporates or individuals, have the right to structure their business to pay less than the very maximum amount of tax due but that they are not permitted to set up “structures” that constitute wholly artificial arrangements. As the European Courts of Justice noted in Cadbury Schweppes a tax system may contain provisions to counter abuse of the system but:

101. “...the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.”

More recently, the European Courts of Justice, said in the Halifax ruling on VAT:

“... taxpayers may choose to structure their business so as to limit their tax liability.”

102. This means that individuals and corporations can relocate to other member states within the EU in order to be taxed at a lower rate. However, this principle also means that companies can take advantage of incentives that the Government creates in order to pay less tax. This can have significant economic benefits to the UK economy.

Conclusions

103. Clearly international businesses and people are globally mobile as is their capital. It is important to maintain the UK’s attractiveness as a destination for such globally mobile capital and important to recognize the role that low-tax centres play in making the UK attractive to that capital, those businesses and those individuals. It is crucial to balance fairness with competitiveness.

104. A company setting up a treasury company in a low tax IFC is not creating something that is wholly artificial even if it is doing so with tax in mind. Anti-avoidance legislation such as CFC rules, transfer pricing rules, and anti-treaty shopping measures are limited because it is recognized that some ability to plan makes it more attractive to do business in the UK. Other countries also recognize this by limiting the reach of their anti-avoidance measures. Tax planning and related “anti-avoidance legislation” is part of the competitive advantage of the UK in attracting international citizens and capital. It is important anti-avoidance legislation is framed to maintain UK competitiveness.

105. When HM Treasury examines UK anti-avoidance rules they must continue to in the context of UK competitiveness and the impact on foreign investment and capital formation.

106. The CDs and leading OTs have a critical role to play in establishing and administrating many of the structures which actively support UK business and the City of London.

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251 Cadbury Schweppes plc v. Commissioners of Inland Revenue, C-196/04 para 55.
252 See Point 85, AG’s Opinion, Halifax plc and others v. Customs and Excise Commissioners [2006] 2 W.L.R. 905 Court of Justice of the European Communities 2004 Nov 23; 2005 April 7; 2006 Feb 21
### Table 1

**RECORD OF COMPLIANCE WITH FATF RECOMMENDATIONS ON ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM—OVERVIEW**

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### RECORD OF COMPLIANCE WITH FATF RECOMMENDATIONS ON ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM—BREAKDOWN

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### Table 2

**IMF Assessments of the Supervision and Regulation of Financial Sector**

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June 2008
Bibliography


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The Society of Trust and Estate Practitioners (STEP) is a unique professional body providing members with a local, national and international learning and business network.
STEP provides education, training, representation and networking for its members, who are professionals specialising in trusts and estates, executorship, administration and related taxes. Members advise clients on the broad business of the management of personal finance.
Full members of STEP are the most experienced and senior practitioners in the field of trusts and estates.

Memorandum from Jersey Finance Limited

INTRODUCTION
1. Jersey Finance is a non-profit making organisation jointly funded by Jersey’s finance industry and the States of Jersey whose role is to represent Jersey’s finance industry around the world and to promote the Island as an International Finance Centre.253

JERSEY’S ROLE AS AN INTERNATIONAL FINANCIAL CENTRE
2. Jersey is a leading international finance centre which started as a provider of financial services for non-residents almost fifty years ago. During this period the Island has developed into a global leader in the provision of financial services and more recently has extended its professional expertise beyond the servicing of individual clients. A gradual specialisation in large-scale institutional client business, servicing the equity and debt financial markets in a number of other countries, has been successful due to the Island’s acknowledgement that legislative transparency, appropriate regulation, service innovation and stability is fundamental to supporting financial services.
3. The services provided are complementary to those provided by the City of London with which Island-based financial institutions and professionals work extremely closely. These services are no different from those performed in London, New York, Tokyo or Frankfurt and play an important role in facilitating international investment.

253 A full description of Jersey Finance can be found in Appendix 3.
4. The main areas of business now undertaken in Jersey include:
   — international banking services;
   — global custody and security services;
   — treasury operations;
   — mutual fund management and administration;
   — trustee services and company administration;
   — investment management and advice;
   — bond note and other structured debt issuance;
   — insurance and re-insurance;
   — pensions and employee benefits; and
   — accountancy and legal services.

5. The States of Jersey’s determination to attract high quality business to the Island, and the support offered by the sophisticated and comprehensive infrastructure of laws and regulations, combine to promote investor confidence. Jersey is perceived as a top-tier international financial centre due to its strong expertise and history as a well-regulated and transparent financial jurisdiction254 with a recent study on behalf of the City of London255 ranking Jersey in the top twenty financial centres globally. The Island has never seen the need to enact bank secrecy legislation as other countries have done, and has applied the normal rules of client confidentiality that apply in common law jurisdictions, including the UK.

**EXECUTIVE SUMMARY**

6. There is no theoretical or practical evidence to suggest that Offshore Financial Centres (OFCs) threaten financial stability.

7. Jersey meets or exceeds all of the relevant international financial standards for financial stability and transparency expected from the world’s leading financial centres.

8. International finance cannot be divided meaningfully into offshore and onshore because of the volume of foreign financial capital managed and fiscal regimes offered by the world’s centres whether islands or mainland states. The nature of the financial services business undertaken in Jersey, and many other financial centres both onshore and offshore, is, in certain respects, broadly similar and many of the world’s largest onshore financial centres such as the City of London, Ireland and in Switzerland are located in jurisdictions which offer low tax regimes to non-residents. “Dividing the world into onshore and offshore financial centres is difficult because “it is a matter of degree, not substance,” to quote one European bank regulator”.256

9. Regulatory and legal frameworks vary widely from country to country, and only some financial centres enact banking secrecy laws (Jersey does not). Therefore it is more appropriate to distinguish between well regulated and poorly regulated financial centres rather than between offshore and onshore financial centres. Well-regulated centres co-operate with foreign tax and other authorities and have sound, transparent supervisory controls which still manage to confer appropriate client privacy. Poorly regulated ones hide behind secrecy laws to avoid co-operation with legitimate investigative approaches from foreign authorities.

10. In many cases OFCs have implemented stricter regulatory controls than onshore centres since transparency plays an important role in the way in which OFCs differentiate themselves and attract capital from worldwide investors. A recent IMF study found that, on average, supervisory standards in OFCs were “superior to those of other jurisdictions”.257

11. OFCs act as a conduit helping in the flow of global capital world-wide. There is also evidence that OFCs provide further benefits to worldwide financial markets by increasing economic activity and the competitiveness and efficiency of the banking system in nearby jurisdictions.258

12. Jersey has been consistently recognised as a mature and well regulated jurisdiction by respected international bodies including the IMF and the Financial Stability Forum and the UK Home Office who carried out an extensive analysis of the British Crown Dependencies in 1999. The most recent assessment by the IMF concluded that the Island’s ability to comply with global standards was high.

255 Mark Yeandle, Alexander Knapp, Michael Manelli and Ian Harris of Z/Yen Group “The Global Financial Centres Index” prepared for the City of London. See Appendix 5 for table.
13. Whilst Jersey adheres firmly to the principles of confidentiality for legitimate investors, Jersey has never had banking secrecy laws. Jersey has implemented measures to ensure that it can co-operate when investigations are underway into criminal and fraudulent use of the global financial services system. This system has proven practical and effective in dealing with legitimate information requests in the past.

14. Jersey has legislation in place which complies with anti-money laundering and counter terrorist financing standards consistent with other leading financial centres.

ANSWERS TO SPECIFIC QUESTIONS

To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?

15. OFCs are specialist financial centres which have developed considerable professional expertise in financial services and frequently act as conduits in helping the flow of global capital world-wide. For example, a high proportion of the capital that reaches the City of London, the world’s largest financial centre, through the money markets and the major financial institutions, does so via an offshore jurisdiction such as Jersey. Such funds are borrowed for trading purposes, generating profits which are then taxed domestically in the UK. Much of this inward investment might not reach the UK but for the partnership relationship that has been forged between finance professionals in the City and those in Jersey.

16. Funds that have been directed through Jersey or other OFCs into an onshore jurisdiction are also frequently borrowed by governments and multinational businesses to finance projects, many of which are in developing countries and are supporting their growth and infrastructure.

17. There is evidence to suggest that OFCs complement onshore jurisdictions. Research by economists from Harvard Business School and the University of Michigan found that the presence of OFCs increased economic activity in nearby onshore jurisdictions rather than diverting it. A further paper which studied the banking sectors of 221 countries and territories found that the nearer a country was to an offshore jurisdiction, the more competitive and efficient its banking system appeared to be.

To what extent does the use of Offshore Financial Centres threaten financial stability?

18. Financial stability is most threatened by liquidity shortages, negative investor sentiment, political instability and poor financial regulation/application of law. There is no evidence to suggest that the existence of OFCs threatens financial stability. Recent events have shown the importance of liquidity in markets and the capital from financial centres such as Jersey is used by neighbouring onshore finance centres and assists the flow of liquidity around the world. Jersey is making a positive contribution to many of the major world economies through its role as a leading offshore partner to the major financial centres.

19. Jersey has been recognised for the quality of its regulatory controls and its financial regulator, the Jersey Financial Services Commission, has strict supervisory controls. The most recent assessment by the IMF concluded that the Island’s ability to comply with global standards was high. The British Crown Dependencies including Jersey are described by the IMF as 100% compliant or largely compliant in their supervisory capabilities for anti-money laundering regulations. 97% compliant in banking, 96% observed or largely observed in insurance and 89% implemented and broadly implemented in securities business, consistently ahead of the progress of other similar jurisdictions overseas.

How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom’s tax authorities and financial regulators?

20. As discussed above, we make the distinction between well-regulated centres, both onshore and offshore, which co-operate with foreign tax and other authorities and have sound supervisory controls and poorly regulated centres which hide behind secrecy laws. In many cases OFCs have implemented stricter regulatory controls than onshore centres since transparency plays a more important role in the way in which OFCs differentiate themselves and attract capital from worldwide investors. In a recent study the IMF found that, on average, supervisory standards in OFCs were “superior to those of other jurisdictions”.

21. Furthermore, a study undertaken for the Commonwealth Secretariat in 2007 found that the legal and administrative frameworks available for tax information exchange in OECD countries are not superior to those in OFCs.


262 Compiled by Jersey Finance based upon IMF information.


21. The recent independent study by London Business School into Jersey\textsuperscript{265} found that amongst finance industry professionals from around the world the transparency and stability of the regulatory platform were two of Jersey’s perceived strengths.

22. Jersey has never had banking secrecy laws such as those which restrict meaningful access to the beneficiaries of trusts and funds registered in the jurisdiction. The rules that Jersey applies to protect the confidentiality of client affairs are similar to those applied in many onshore centres where respect of a client’s privacy is naturally of importance and information remains private under legitimate circumstances. However, Jersey has shown its willingness to co-operate with international measures designed to facilitate transparency and is fully committed to the principles of transparency and information exchange promoted by international bodies such as the Organisation for Economic Co-operation and Development (“OECD”), Financial Action Task Force (“FATF”) and International Organisation of Securities Commissions (“IOSCO”). Indeed the Secretary General of the OECD praised Jersey for its efforts in this regard in a recent article in the \textit{Financial Times}.\textsuperscript{266}

23. A double tax arrangement (‘DTA’) has existed between Jersey and the UK since 1952. This DTA contains a provision under which the tax authorities of the UK and Jersey may exchange information in order to prevent fraud or assist in the administration of statutory domestic tax provisions against legal avoidance of income tax.

24. Jersey entered into the Criminal Justice (International Co-operation) (Jersey) Law 2001 which is a gateway through which information can be passed to other jurisdictions in the event of fraud including fiscal fraud.

25. Jersey is one of 35 jurisdictions that have made commitments to transparency and effective exchange of information and are considered co-operative jurisdictions by the OECD’s Committee on Fiscal Affairs (see Appendix 3). These “participating partners” work together under the auspices of the OECD’s Global Forum on Taxation to develop high international standards for transparency and effective exchange of information in tax matters. Furthermore, in his testimony before the Senate Finance Committee on Offshore Tax Evasion,\textsuperscript{267} Jeffrey Owen, Director of the OECD’s Centre for Tax Policy and Administration, singled out Jersey and Guernsey as examples of jurisdictions that have implemented high standards of transparency.

26. The Island has endorsed the concept of the Tax Information Exchange Agreement, a series of agreements between countries designed to facilitate information exchange in appropriate circumstances. However in doing so, Jersey acknowledges that a series of tax agreements between nations will only work successfully if the concept is embraced and implemented wholeheartedly by all competitor jurisdictions, not only those located offshore, but also in many financial centres such as Switzerland, Hong Kong Singapore, Luxembourg and Austria. At present, there is a need to bring pressure to bear on other financial centres to comply.

27. Jersey’s financial regulator has also signed memoranda of understanding or statements of co-operation with fellow regulators in 31 territories including with the United Kingdom’s Financial Services Authority. This sets out the process by which the Jersey authorities work with the regulator in the UK when investigations are underway.

\textit{To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?}

28. The growth in complex financial instruments has been driven by innovations in large international financial centres such as New York and London. Where financial centres like Jersey have been involved in the use or development of complex financial instruments it has been to implement, administer and refine the structures necessary to support the concepts created elsewhere.

\textit{How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets?}

29. If international competition amongst OFCs were confined to fiscal incentives then the jurisdictions with the lowest taxes would lead—this is not the current position. Competition is also driven by the clarity and simplicity of underlying laws, including framework, fiscal and regulatory aspects. Jersey has focused on clear laws which create greater certainty for users.

30. Transparency is important to any jurisdiction in terms of providing comfort to investors about clear, functional and appropriate regulation. Knowledge of a regulator’s processes and robust practices attracts capital.

\textsuperscript{265} London Business School study May 08 “The Jersey Finance Strategy Project—Future of Finance 2015”.

\textsuperscript{266} “A tax haven that needs to clean up its act”: Angel Gurria, \textit{The Financial Times}, 20 February 2008. See Appendix 6.

\textsuperscript{267} Written testimony Jeffrey Owens, Director, OECD Center for Tax Policy and Administration before Senate Finance Committee on Offshore Tax Evasion, 3 May, 2007.

31. While the fiscal regimes of OFCs have certainly had a role to play in the early development and growth of these jurisdictions, including the jurisdiction of Jersey, there are many other factors that play an equally important role in attracting funds from international investors. Business is attracted to Jersey for the following reasons:

— stability—political, economic and fiscal;
— respectability—selection of business, institutions of stature, comprehensive and up-to-date legislative framework, international regulatory standards;
— security—secure relationships with the UK and EU, confidentiality for legitimate business through customary law;
— fiscal—general prevailing income tax rate of 0% for resident and non-resident companies with individual Jersey residents individual tax residents in Jersey taxed at 20%, no capital, transfer or inheritance taxes;
— flexibility—speed of response to market needs, government/industry “partnership”, approachability of government; and
— quality—quality of service reflecting skills/experience of the workforce, the judicial system, high standard of international communication links, proximity to the City of London and other European finance centres.

32. Client confidentiality is essential to any financial centre and it will certainly play a role in attracting investment to financial centres, both onshore and offshore. Jersey, like other financial centres, adheres to strong principles of client confidentiality and the privacy of each person’s financial affairs. However, Jersey is fully committed to the principles of transparency promoted by international bodies and has implemented measures to ensure that it can co-operate when investigations are underway into criminal and fraudulent use of the global financial services system.

How do the taxation policies of Offshore Financial Centres impact on UK tax revenue and policy?

33. Jersey has for many years operated an effective tax rate of 0% for international businesses providing our customers with fiscal neutrality and certainty. Jersey does not seek to tax non-residents as they are not reliant on the public services paid for by tax revenues raised by the States of Jersey and therefore it would be morally unethical to do so.

34. Jersey has recently amended its fiscal policies in order to comply with the principles of “roll-back” and “stand-still” as required under the EU Code of Conduct on Business Taxation, notwithstanding that the Island is not part of the EU and is therefore unable to a large extent to benefit from a single market. During the process of change, Jersey worked closely with the UK Treasury to ensure that its future fiscal policies adhered to all the principals of the Code. We would therefore expect that HM Treasury are conversant with Jersey tax policies and are comfortable that they do not pose an undue burden upon UK tax revenue.

Are British Overseas Territories and Crown Dependencies well-regarded as Offshore Financial Centres, both in comparison to their peers and international standards?

35. Jersey has been consistently recognised as a mature and well regulated jurisdiction by respected international bodies including the IMF and the Financial Stability Forum (“FSF”) as well as the UK Home Office who carried out an extensive analysis of the British Crown Dependencies in 1999. As referenced above, a recent report prepared on behalf of the City of London ranked Jersey comfortably within the top twenty financial centres globally.\(^{268}\)

36. The IMF visited Jersey in 2003 and concluded that “the financial regulatory and supervisory system of Jersey complies well with international standards”.\(^{269}\) The Island’s regulator was commended for its efforts in upgrading standards for banking, insurance, securities and anti money laundering and combating the financing of terrorism. There is an ongoing process of scrutiny with which Jersey is happy to co-operate. For example, the IMF is scheduled to return to assess the Island’s regulatory capabilities again later this year.

37. The Foreign and Commonwealth office in its report “Managing Risk in the Overseas Territories” published last year,\(^{270}\) acknowledged that the British Crown Dependencies, which include Jersey, had introduced measures which meant they had reached the status of “zero non compliance” with international standards.

\(^{268}\) Mark Yeandle, Alexander Knapp, Michael Manelli and Ian Harris of Z/Yen Group “The Global Financial Centres Index” prepared for the City of London. See Appendix 5 for table.


38. Furthermore, the recent study by London Business School\(^{271}\) into Jersey conducted extensive research amongst professionals from a range of backgrounds and concluded that “Jersey is regarded as one of the best players amongst offshore jurisdictions due to its well regulated environment and history in Europe”.

To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?

39. The Financial Action Task Force (FATF), an intergovernmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing, drew up a new international standard in the wake of the terrorist attacks of 11 September 2001 to address money laundering and terrorist financing.

40. In Jersey, legislation is in place which complies with these international regulatory and anti-money laundering and counter terrorist financing standards and this is periodically reviewed by the IMF. The most recent review was in 2003 when the IMF concluded that “the financial regulatory and supervisory system of Jersey complies well with international standards”\(^{272}\).

41. The Terrorism (Jersey) Law 2002 came into effect in September 2003 and updates to tighten the rules have followed. These and other regulations introduced this year, place Jersey on a par with leading financial centres such as London.

42. Jersey has been recognised in its efforts by the FATF. Jersey is not a member of FATF but through its representation on the Offshore Group of Banking Supervisors (OGBS) actively engages with FATF both in terms of policy formation and in the evaluation of anti money laundering standards.

43. Jersey’s joint Financial Crimes Unit is a member of the Egmont Group, the international affiliation of Financial Intelligence Units established to combat the threat of money laundering. Countries have to go through a formal process in order to be recognised on this international body.

44. Jersey was also one of the first jurisdictions to regulate its trust and company service providers to ensure they are fit and proper for their roles. The Society of Trust and Estate Practitioners (STEP) believes this is an important part of the debate over money-laundering regulation. If practitioners are competent they will more easily identify suspicious transactions and they will be better equipped to encourage high standard good practice. In contrast trust and company service providers are currently not regulated in the UK.

What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?

45. Jersey offers, inter alia, a tax neutral platform through which business may be conducted. As detailed in above, Jersey has only one main double tax arrangement (DTA) and that is of limited scope. It therefore does not offer any form of DTA shopping. Jersey has also undergone a major change to its fiscal policies in order to comply with the principles of “roll-back” and “stand-still” as required under the EU Code of Conduct on Business Taxation, notwithstanding that the Island is not part of the EU and is therefore unable to a large extent benefit from a single market. During the process of change, Jersey worked closely with the UK Treasury to ensure that its future fiscal policies adhered to all the principles of the Code.

46. Although Jersey was a major recipient of business that took advantage of the low value consignment relief for VAT purposes, the Island subsequently revised its policies to discourage businesses setting up in the Island to take advantage of this relief, thus ensuring that HM Treasury did not need to take any formal counter-preventative measures against the Island.

What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres?

47. Jersey has two double tax treaties: one with Guernsey the other with the UK; and a very limited treaty with France in relation to shipping and transport.

48. The UK treaty was signed in 1951 and is limited in its operation. In particular, there are no provisions relating to income from immovable property, dividends, interest, royalties or capital gains. Furthermore, there are no tiebreaker, discrimination, or pension clauses.

49. Due to the limited nature of the treaty, there is little scope for wide spread double tax arrangement abuse. It should further be noted that Jersey was not a jurisdiction to locate offshore trading partnerships which was subject to a clamp down in this year’s UK Finance Bill. We do not believe that the treaty is abused otherwise it is likely that HMT and HMRC would have sought to materially renegotiate it since its introduction.

To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?

50. As discussed above, we make the distinction between well-regulated centres, both onshore and offshore, which co-operate with foreign tax and other authorities and have sound supervisory controls and poorly regulated centres which use banking secrecy laws to restrict legitimate enquiries. As a well-regulated centre, Jersey has measures in place to co-operate with investigations into cases of alleged tax evasion and has assisted with many overseas prosecutions.

51. The judicial authorities from overseas Governments can also seek assistance where a tax fraud has been perpetrated, taking advantage of the provisions of the Island’s Investigation of Fraud Law, which allows for assistance including exchange of information in cases of serious or complex fraud including tax fraud. In 2007, Jersey’s Attorney General dealt with some 30 requests.

52. Similarly, the Criminal Justice (International Co-operation) (Jersey) Law allows the Jersey authorities to assist when criminal investigations are underway in other jurisdictions including the UK. The scope of the Law covers tax evasion and other fiscal crimes.

19 June 2008

APPENDICES

APPENDIX 1

TERMINOLOGY

| EU Code of Conduct on Business Taxation | The Code of Conduct requires Member States to refrain from introducing any new harmful tax measures (“standstill”) and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code (“rollback”). The code covers tax measures (legislative, regulatory and administrative) which have, or may have, a significant impact on the location of business in the Union. More details can be found here. |
| FATF | Financial Action Task Force: An inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing. |
| FSF | Financial Stability Forum: Brings together senior representatives of national financial authorities, international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank to promote international financial stability through information exchange and international co-operation. |
| IMF | International Monetary Fund |
| OECD | Organisation for Economic Co-operation and Development |
| OGBS | Offshore Group of Banking Supervisors |
| Privacy | Information remains private under legitimate circumstances |
| Secrecy law | Legal principle under which institutions are allowed to protect personal information about their customers |
| STEP | Society of Trust and Estate Practitioners |
| Tax neutrality | A tax system which does not impose an additional liability over and above existing tax obligations on the investor. |

APPENDIX 2

INFORMATION ON TYPES OF BUSINESS DONE IN JERSEY AND THEIR SCALE

— Jersey has 48 banks drawn from the 500 leading banks in the world, 1311 investment funds and 187 trust company businesses as at 31 December 2007.
— Bank deposits: GBP212.3 billion as at 31 December 2007.
— Net Asset Value of funds under administration: GBP246.1 billion, as at 31 December 2007.
— The total value of funds under Investment Management: GBP78.8 billion, as at 31 December 2007.
— Financial sector accounts for over half of all tax revenues.
— Jersey has more than 13,000 people employed in the finance sector.
### JERSEY FUNDS ASSOCIATION—STATISTICS, PUBLISHED JUNE 2008

#### Classification by Fund Type

<table>
<thead>
<tr>
<th>Classification by Fund Type</th>
<th>Number of Funds</th>
<th>Number of Separate Pools</th>
<th>NAV £ Millions</th>
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<tr>
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<td><strong>COBO Funds</strong></td>
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<td><strong>Total</strong></td>
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<td><em>3,076</em></td>
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</table>

### APPENDIX 3

**INTRODUCTION TO JERSEY FINANCE**

Formed in 2001, Jersey Finance is a non-profit making organisation jointly funded by Jersey’s finance industry and the States of Jersey. Jersey Finance's role is to represent Jersey’s finance industry around the world and to promote the Island as an International Finance Centre. It acts as a central communications point, offering journalists and anyone connected with the Finance Industry, both locally and internationally, with up-to-the-minute information on issues affecting Jersey’s Finance Industry.

Jersey Finance is the gateway for the Industry, Government and the Financial Services Commission in the handling of all technical matters. Through its technical division, Jersey Finance co-ordinates the consultation process and review by the Industry of proposed legislation and regulation. The trade associations continue to play a key role in the process. The organisation also performs a role in market intelligence and feedback on the changing requirements of the world’s financial centres.

### APPENDIX 4

**LIST OF OECD “PARTICIPATING PARTNERS”**

35 Jurisdictions committed to improving transparency and establishing effective exchange of information in tax matters

The 35 committed jurisdictions are:

- Anguilla
- Antigua and Barbuda
- Aruba
- Bahamas
- Bermuda
- Belize
- British Virgin Islands
- Cayman Islands
- Cook Islands
- Cyprus
- Dominica
- Gibraltar
- Grenada
- Guernsey
- Isle of Man
- Jersey
- Liberia
- Malta
- Marshall Islands
- Mauritius
- Montserrat
- Nauru
- Netherlands Antilles
- Niue
- Panama (Spanish), (English)
- Panama
- Palestinian Authority
- Palau
- Portugal
- Portuguese Indian Ocean Territory
- Quito
- Saint Kitts & Nevis
- Saint Lucia
- Saint Vincent and the Grenadines
- San Marino
- Seychelles
- St. Lucia
- St. Kitts & Nevis
- St. Vincent and the Grenadines
- St. Pierre and Miquelon
- Tuvalu
- Turks & Caicos Islands
- US Virgin Islands
- Vanuatu
- Vanuatu
- Vatican City
- Wallis and Futuna Islands
- Western Sahara

Letter from the OECD’s Secretary General, Donald J. Johnston, to the Minister of Finance of Aruba, Dr. Robertico R. Croes.

1. Overseas Territory of the United Kingdom.
2. Aruba, the Netherlands Antilles and the Netherlands are the three countries of the Kingdom of the Netherlands.
3. Fully self-governing country in free association with New Zealand.
5. External Territory of the United States.
APPENDIX 5

THE GLOBAL FINANCIAL CENTRES INDEX RATINGS

<table>
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<tr>
<th>The GFCI Centre Ratings</th>
<th>GFCI 3 Rank</th>
<th>Change in Rank since GFCI 2</th>
<th>GFCI 3 Rating</th>
<th>Change in Rating since GFCI 2</th>
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<td>— 7</td>
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<td>In GFCI 2 Jersey and Guernsey were grouped together as the Channel Islands</td>
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<td>Osaka</td>
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<td>— 18</td>
<td>469</td>
<td>33</td>
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Note: Scores have been rounded to the nearest whole number, so where there is an apparent tie, centres have been placed according to their underlying scores.

APPENDIX 6

“A tax haven that needs to clean up its act”: Angel Gurria, The Financial Times, 20 February 2008

A TAX HAVEN THAT NEEDS TO CLEAN UP ITS ACT

By Angel Gurria

Freer, more open and better integrated financial markets have benefited people and companies around the world. They have lowered the cost of capital and encouraged greater competition in the provision of financial services. But they have also facilitated distortions such as money laundering and tax evasion.

Financial cases such as Enron, WorldCom, Parmalat, Siemens, the investigations into BAE Systems and now the German tax evasion inquiry have revealed serious weaknesses in governance and market functions. Some of the issues are for companies to address. But governments must also play their role in setting the rules and enforcing standards.

As new technologies shrink geography, opportunities have opened up for dishonest taxpayers to use tax havens to evade their tax obligations. Jurisdictions characterised by strict bank secrecy and a policy or practice of non-co-operation with law enforcement in other countries prosper by attracting brass plate...
banks, anonymous financial companies and asset protection trusts. But they do so to the detriment of the integrity of the world financial system and such behaviour is no longer acceptable. Money laundering and the misuse of corporate vehicles for tax evasion and other ways of exploiting financial markets for personal gain have expanded to the point where they threaten the political and economic interests of sovereign states. It is time for the governments of countries where such practices are prevalent to accept their responsibilities and crack down on them—or face the consequences.

Most Organisation for Economic Co-operation and Development governments have responded to the threats posed by financial crimes by enacting legislation to detect and deter such practices and by strengthening their law enforcement and tax enforcement capacity. Money laundering has been criminalised and financial institutions are required to report suspicious transactions. Stricter regulatory and supervisory measures have been put in place and access to beneficial ownership information and trust formation rules has been strengthened in most OECD countries and in many offshore financial centres. Almost all the jurisdictions identified as potential tax havens by the OECD in 1991 have committed to the principles of transparency and effective exchange of information. Only three still remain on the OECD’s list of unco-operative tax havens: Liechtenstein, Monaco and Andorra.

Now the cat is out of the bag. The disclosure of tax evasion schemes running through Liechtenstein’s oldest bank has confirmed what tax authorities suspected. The affair has tarnished Liechtenstein’s attractiveness as a financial centre, not just for legitimate investors but also for tax evaders, who know their affairs will now come under increased scrutiny by all countries. Liechtenstein’s next moves are critical. It can continue to ignore the trend towards greater co-operation in combating tax evasion in the hope of recapturing the business of tax evaders. Or it can work to restore its reputation in the international community by establishing a network of bilateral tax agreements to improve co-operation.

At present, Liechtenstein’s system of foundations and other entities that hold private wealth facilitate a culture of secrecy. But things are already changing. As a result of the campaign by the Financial Action Task Force, an international anti-money-laundering group, Liechtenstein now obtains information on the beneficial owners behind these foundations. For the moment, it is still not making that information available to other countries for tax enforcement purposes. But a decision to change tack is within the government’s reach.

In Wednesday’s FT, Otmar Hasler, the Liechtenstein prime minister, announced further steps, in the context of its negotiations with the European Union, that may lead to more co-operation in matters involving fraud, including tax fraud. This would be a step in the right direction. Other financial centres, such as Jersey and the Isle of Man, have made great strides in strengthening their bilateral tax co-operation and are thriving. I hope Liechtenstein continues down this path of greater co-operation. By implementing high standards of transparency and tax co-operation, Liechtenstein will not only rebuild faith in its financial services sector but may also gain benefits for the remaining 70 per cent of its economy. So why wait and pay a high price in terms of reputation and standing in the international community?

The writer is secretary-general of the Organisation for Economic Co-operation and Development.

Memorandum from Christian Aid

EXECUTIVE SUMMARY

Christian Aid works in nearly 50 developing countries worldwide, supporting local organisations to deliver urgently needed services directly to poor communities, and to scrutinise and hold their own governments and the international community to account.

Finance is fundamental to development, since without sustainable revenue for governments there is no prospect for sustained, independent development. Poorer countries typically have revenues around 10–15% of GDP, compared to more than 40% in the UK. Taxation is also at the heart of citizen-state relations, and has been shown to significantly strengthen channels of political representation.

There are many different obstacles to effective taxation systems, and Christian Aid is increasingly working with partners to address these domestically where possible. Even absolute success domestically would not come close to a solution, however—because the international financial system as it stands represents an insurmountable barrier to effective taxation in developing countries. The role of offshore financial centres (OFCs) is central to this, and therefore we welcome both the fact that the committee is to examine OFCs, and also the opportunity to make this submission.

Our submission will focus on the role that OFCs play in preventing the international transparency that developing countries need in order to prevent corruption and to ensure their taxation systems are effective, and on measures that the Treasury could take to reduce the damage done by OFCs. OFCs provide opacity to international flows of capital, which prevents developing countries from taxing wealthy individuals and businesses where appropriate, and from taking steps to prevent grand corruption.
Christian Aid has estimated that one form of corporate tax evasion alone (via trade mis-pricing) is responsible for a revenue loss to developing countries of around $160 billion a year—more than one and a half times total aid flows. The World Bank quotes estimates of illicit capital outflows from developing countries of $500–$800 billion annually, of which 3% relates to corruption and bribery and 60–65% to commercial tax evasion.

Since the UK has a substantial role in, and historic responsibility for, the system of OFCs, this means that the UK is responsible for taking with one hand (via facilitating corruption and tax evasion) what it gives with the other hand (as aid). Estimates of the scale of the former strongly imply that developing countries are net losers from this arrangement. It also follows that the money of the UK taxpayer is not being spent effectively for development.

**OUR RECOMMENDATIONS FOR THE UK GOVERNMENT ARE AS FOLLOWS**

We welcome DFID’s existing support for the capacity of tax authorities and of civil society groups to hold governments to account on taxation issues, and hope that the latter in particular can be scaled up and given greater priority.

We also welcome Treasury’s recent statements about the need for “strong co-operation and exchange of information between Governments and tax authorities around the world”, and look forward to concrete actions. We make the following recommendations.

First, the UK government must lead multilateral efforts to ensure automatic exchange of information between jurisdictions—since exchange of information on request only is manifestly insufficient to address the problem.

Second, the UK government should call on the International Accounting Standards Board to prepare an accounting standard on country-by-country financial reporting—which would provide the other element of transparency necessary.

**INTRODUCTION**

1. Christian Aid’s mission is to challenge and change the structures that keep poor men and women marginalised, and this motivates our deep concern with the role of offshore financial centres. From a development perspective, offshore financial centres (OFCs) represent a significant obstacle to effective taxation.273

2. There are many legitimate concerns about the impact of OFCs beyond that on developing countries. The members of the Tax Justice Network (a Christian Aid partner) have recognised international expertise in this area, and their submission sets out a broader range of concerns. We do not duplicate here their technical analysis of the functioning of OFCs, but instead highlight key areas in which OFCs undermine development specifically.

3. Leading academics, such as Prof E.V.K. FitzGerald (Director of the Department of International Development at the University of Oxford) have also made submissions highlighting important development concerns.

4. From Christian Aid’s perspective, and given our emphasis on the structures that maintain global poverty, the role of OFCs is most important in relation to two particular areas: the international nature of corruption, and—which is not unrelated—the ability of developing countries to create effective taxation systems.

**THE INTERNATIONAL NATURE OF CORRUPTION**

5. Corruption is a global phenomenon, and one that hinders development at many levels. Petty corruption can require poor people to pay bribes out of incomes that are already insufficient to meet their basic needs, and can also undermine their ability to obtain goods and services—or political representation—from the state.

6. Grand corruption is decidedly international in its character. The World Bank cites estimates that corruption and the bribery of public officials is responsible for illicit capital outflows from developing countries of $15–24 billion a year.274

7. These outflows, that deprive developing countries of much needed funds for development, do not occur in a vacuum. Often, the money reflects illicit payments by companies involved in bidding for large public contracts. Whatever its origin, as it leaves developing countries it is channelled through banks and other financial institutions, with the assistance of a range of finance professionals from accountants to lawyers.

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273 This analysis draws extensively on our May, 2008 report, *Death and Taxes: The true toll of tax dodging*, which is available via our website: http://www.christian-aid.org.uk/.
8. Corruption is not therefore a problem of developing countries alone—the responsibility for facilitating corruption, for handling the proceeds of illegal actions, also rests firmly in certain industries in rich countries.

9. The secrecy provided by OFCs (or secrecy jurisdictions) is important to the process, since it is typically this that prevents greater visibility to those in the countries which suffer the corrupt outflows. The World Bank’s Stolen Asset Recovery Initiative, which we commend, is aimed at addressing this problem, by tracking down the proceeds of corruption, through complex layers of financial transactions that occur not in poorer countries but in the financial systems of rich countries and in OFCs in particular.

10. However, the share of illicit capital outflows from developing countries is dwarfed by the estimated value due to commercial tax evasion—which Christian Aid also sees as fundamentally corrupt, since it is illegal and directly undermines the functioning of the state. The same analysis that finds corruption and bribery of public officials to be responsible for $15–24 billion of outflows a year, indicates that commercial tax evasion results in outflows of $300–$500 billion a year.

THE IMPORTANCE OF TAXATION

11. The importance of effective taxation for developing countries is increasingly widely recognised. Taxation contributes to development through the “four Rs”: 275

12. Revenues. Most obviously, tax is necessary to provide developing country governments with sufficient revenues to deliver basic services to their citizens. In low-income countries, and even in many middle-income countries, tax revenues are often less than or close to 10% of GDP, compared to around 40% in the richest like the UK. One definition of a fragile state—ie one that cannot or will not meet its citizens’ needs—is simply of having revenue below 15% of GDP. 276 The alternative to states with the revenue capacity to deliver development is the vacuum of power (and of development opportunities for citizens) that is seen in conflict countries.

13. To meet the Millennium Development Goals by the target date of 2015, the World Bank has estimated that an extra $40–$60 billion a year of development finance would be necessary. Given the lack of progress in many countries thus far, and the failure of the international community to deliver on aid commitments, this now seems to substantially under-estimate the problem. Ultimately, the only sustainable source of development finance is domestic tax revenues (as emphasised in the Monterrey Consensus)—and this is also the only exit strategy from aid. It is vital then that development efforts by donors, including the UK, are geared towards building effective taxation systems.

14. Redistribution. Taxation is also the tool by which states can address inequalities that exist, or that arise from eg the liberalisation of trade or of financial markets. Market incomes in much of Latin America, for example, are characterised by similar inequality to that seen in the richer OECD countries. The difference is that post-tax inequality in the latter is much lower, because tax systems are capable of delivering redistribution. It is estimated that the poorest people in Brazil spend more than a quarter of their income on VAT, compared to less than 10% for the richest. 277 Only recently has the government been able to mobilise sufficient revenue to start a programme of targeted cash transfers to help the poorest—and most developing countries are poorer than Brazil and simply lack that capacity.

15. Re-pricing. Tax systems also play the role of ensuring that the private costs and benefits of production and consumption decisions are aligned with the social costs and benefits. For example, the UK places a high tax burden on tobacco and on petrol, because of the health and environmental damage, respectively, that these cause. This can lead—for example—to a competitive race to the bottom in which polluting industries are concentrated in poor countries with weak tax systems, since the social costs of their production may not be effectively costed there.

16. A broader international concern should be the ability of developing countries to deliver on commitments that are likely to be required under the UN Framework on Climate Change Convention negotiations. If the agreement due to be reached in 2010 is to be effective in cutting global emissions, then governments in every country must be able to pass on appropriate incentives to their households and businesses—and that will only happen through taxation.

17. Representation. Finally, and perhaps most importantly, taxation is the fundamental link between states and citizens. Research shows that effective, non-coercive taxation is what drives citizens to hold governments to account for their expenditures and thereby improves governance and promotes political

representation. Analysis of historical data for many countries shows that the share of tax revenues on government expenditure is systematically associated with democratization, and direct taxation (tax on income and profits) is most important.

18. DFID has taken positive steps to help build the capacity of developing countries’ tax revenue authorities, and we welcome this where it reflects the demands of those countries. In particular, this must move beyond the “tax consensus” which has dominated the thinking of aid donors for more than two decades, but consistently failed to yield benefits in terms of the four Rs. More recently, DFID have shown interest in building civil society capacity to hold their governments to account for taxation decisions, and we strongly welcome this.

The Development Damage done by OFCs

19. Improvements in developing countries, however, are completely insufficient to deliver effective taxation. This is because of the large scale of tax evasion that occurs through the international system, over which developing countries have little control. At the heart of the problem is a lack of transparency. This prevents developing countries from raising the appropriate level of revenues, since taxable income streams that arise within their jurisdiction are hidden in OFCs and beyond.

20. This creates a fundamental inconsistency in UK government policy. On the one hand, UK taxpayers provide substantial sums to be used as aid. Much of this is provided as budgetary support to developing country governments. On the other hand, the international structure of OFCs is responsible for directly undermining the revenues of those governments.

21. Since the UK has a substantial role in, and historic responsibility for, the system of OFCs, this means that the UK is responsible for taking with one hand (via facilitation) and giving with the other hand (as aid). Estimates of the scale of the former strongly imply that developing countries are net losers from this arrangement.

22. It also follows that the money of the UK taxpayer is not being effectively spent to support development, since this incoherence of broader policy on OFCs and international financial regulation undermines the value of the aid given.

23. Transparency is required in two main areas—first, in the financial accounts of multinational companies, which are able to shift profits out of developing countries and hence reduce their tax liabilities there. Christian Aid has estimated that one form of tax evasion alone—that which occurs through the mis-pricing of trade, including abusive transfer pricing by multinational companies—is responsible for $160 billion a year in lost revenues to developing countries. This value far exceeds the total flow of aid, and could not be provided to support development without the action of the international community.

24. The other key area in which transparency is lacking is through the offshore financial centres. As the revelations from Liechtenstein earlier this year showed, EU countries like the UK have been unable to effectively tax their citizens because of the secrecy provided by such jurisdictions. Even a revenue authority as well resourced as HMRC is relatively powerless against the barrier of secrecy. Last month, a Treasury official made just this point:

25. “There is a strong economic and social case for strong co-operation and exchange of information between governments and tax authorities around the globe, and particularly within the EU, in order to meet the challenges being posed by globalisation, not just for economies as a whole, but also specifically for national tax systems.”

26. In effect, the statement highlights the problems of retaining national tax sovereignty in light of the ease of international financial flows and the secrecy provided by some jurisdictions. This analysis applies much more deeply to poorer countries, where the capacity to trace the income streams of individuals or businesses, especially international ones, is much more limited. The need for additional revenues—to provide basic services to citizens and to invest in infrastructure to support growth and broader development aims—is also much clearer in the poorest countries.

27. Information exchange between jurisdictions on request has not been effective—since it has not been possible generally for the revenue authority of poorer countries to provide sufficient information to OFCs for the latter to deliver the corresponding data.

28. Only automatic (and comprehensive) exchange of information between all jurisdictions can ultimately enable developing countries to levy the appropriate amount of tax on the income and profits earned there. There are certainly capacity constraints to how that information could be used if it were provided tomorrow—but without any prospect of receiving that information, there is of course no incentive for countries to invest in the relevant capacity. The first step is to ensure that the information is available.

**OUR RECOMMENDATIONS TO THE UK GOVERNMENT**

29. The secrecy provided by OFCs is a fundamental obstacle to effective taxation, and to the prevention of grand corruption, in developing countries. As such, OFCs play an important role in the international structure that restricts the opportunities for development and escape from poverty of poor men and women in those countries. The UK government must confirm its commitment to development, and the coherence of its policies, by ensuring that it acts to address the damage done by OFCs.

30. We welcome DFID’s existing support for the capacity of tax authorities and of civil society groups to hold governments to account on taxation issues, and hope that the latter in particular can be scaled up and given greater priority.

31. We also welcome Treasury’s recent statements about the need for “strong co-operation and exchange of information between Governments and tax authorities around the world”. We now look forward to concrete steps to support this sentiment and to ensure policy coherence with DFID. We make the following recommendations to ensure the tax transparency that will benefit developing and developed countries alike.

32. The UK government must lend its support to multilateral efforts to ensure automatic exchange of information between jurisdictions—since exchange of information on request only is manifestly insufficient to address the problem. The UK is uniquely well placed to lead on this, because of its historic responsibility and great influence over the Crown Dependencies and Overseas Territories which are such important OFCs, and because of the importance of the City of London as a global financial market.

33. Finally, the UK government should address the other main aspect of international financial opacity that undermines development by allowing multinational companies to avoid and sometimes evade taxation in poorer countries. The first step is to call on the International Accounting Standards Board to prepare an accounting standard on country-by-country financial reporting.

June 2008

Memorandum from the Isle of Man Chamber of Commerce

1. INTRODUCTION

1.1 The Isle of Man Chamber of Commerce is pleased to make this submission to the House of Commons Treasury Committee in respect of its inquiry into Offshore Financial Centres. We welcome the opportunity to respond to the Committee’s inquiries in respect of the Isle of Man. We will be pleased to address any questions that might arise; contact details are given below.

2. THE ISLE OF MAN CHAMBER OF COMMERCE

2.1 The Isle of Man Chamber of Commerce has a diverse membership, representing all sectors of the Isle of Man’s economy, including finance, manufacturing, information technology, hospitality and leisure, transport, construction and retail.

2.2 The chamber was established in 1956 and currently has 360 members.

2.3 The Isle of Man Chamber of Commerce is affiliated to the British Chambers of Commerce (“BCC”).

3. DEFINITION OF “OFFSHORE FINANCIAL CENTRE” AND RELEVANCE TO ISLE OF MAN

3.1 It would be helpful to understand the mandate and scope of this inquiry, particularly in the context of other reviews of the Island such as the Edwards Report (1998), reviews undertaken by OECD and the Financial Stability Forum, the most recent IMF visit in 2003 and the forthcoming visit of the IMF in September 2008.

3.2 It would also be helpful to know whether the inquiry relates only to the British centres (ie the Crown Dependencies and the Overseas Territories) or more widely.
3.3 We suggest it is important to define the expression “offshore financial centre” (“OFC”), so that it
might be better understood in the context of the global economy. We are aware that the Committee has used
the definition proposed by Zoromé (IMF Working Paper 07/87—“Concept of Offshore Financial Centers:
In Search of an Operational Definition”). We consider this succinct, useful and serviceable, but the
Committee should be aware that other definitions are in circulation.

3.4 It should also be recognised that an OFC need not necessarily be physically “offshore”. Indeed, the
Financial Stability Forum in their April 2000 report (cited above) commented that “while OFCs are
commonly perceived to be small island states, a number of advanced countries have succeeded in attracting
very large concentrations of non-resident business by offering economic incentives either throughout their
jurisdiction or in special economic zones”.

3.5 Some reports include the UK within the list of countries which are defined as OFCs. These include

3.6 Thus the defining characteristics of an OFC are not necessarily restricted to relatively small island
territories. Major Nation states such as the USA, UK, Switzerland, Ireland, Dubai and Luxembourg have
all been considered by various commentators to fall within this categorisation.

4. An OVERVIEW OF THE ISLE OF MAN

4.1 The Isle of Man is located in the Irish Sea at the heart of the British Isles. The Island is 33 miles long
by 13 miles wide, with a land mass of 227 square miles. The population is approximately 81,000.

4.2 The Island is a self-governing Crown Dependency with its own government and laws. The Island is
not and has never been part of the United Kingdom and has no representation in Parliament. The Island’s
parliament, Tynwald, was founded over 1,000 years ago and is the oldest continuous parliament in the
world.

4.3 The people of the Isle of Man, and things pertaining to the Island, are referred to as Manx.

4.4 The Isle of Man is not part of the European Union, but it has a limited relationship under Protocol
3 to the United Kingdom’s Act of Accession in 1972. This allows for the free trade of agricultural and
manufactured products across the EU, but not for services. The Island does not receive any funding or
support from the EU. The Isle of Man is part of the European Common Customs Area and has a revenue
sharing customs agreement with the UK.

4.5 Whilst the Isle of Man is a separate and distinct legal jurisdiction, it is not a secret one. The Island’s
legal system follows UK common law, and explicitly does not have any bank secrecy legislation. As
explained elsewhere in this document, a number of independent external assessments of the Island’s
regulatory regime have validated that the Island co-operates fully in the international fight against terrorism
financing and financial crimes.

4.6 These assessments include the Home Office commissioned Edwards’ Report, the Financial Action
Task Force (“FATF”), the OECD, the IMF and the Financial Stability Forum. Without exception, such
reviews have found the Island to have very high levels of compliance with relevant international standards
and supervisory practices, and levels of international co-operation that place it in the first division of OFCs.

4.7 The Island’s positive image is further reinforced by Moody’s and Standard and Poor’s AAA
accreditation. Accolades for the Island have included being awarded “Best International Financial Centre”
at the International Investment Fund and Product Awards for seven out of the past eight years, and
European winner of “Financial Centres of the Future 2005” from The Banker magazine.

5. ECONOMIC DIVERSITY OF THE ISLAND

5.1 The Isle of Man is an economically diverse economy, of which the Finance Sector directly accounts
only for 36% of gross national income. The Island’s proposition is one of an international business centre,
not merely a finance sector; one where real business is encouraged rather than “brass plate” operations.

5.2 Included within this diversity of activity within the financial community are:

E-business

Over the past 10 years, the Island’s ebusiness activities have blossomed. From an IT infrastructure
perspective, the Island’s proposition is compelling. It offers a world-class telecoms solution, with two
separate high capacity self-healing fibre optic rings currently utilised under 1% of capacity; advanced mobile
technology, being the first country in Europe to introduce a 3G service, and the first in the world to adopt
3.5G; near 100% broadband available across the Island; and a highly IT-literate workforce, with over 90%

of school leavers holding a recognised IT qualification. These technical advantages, coupled with a highly
cOMPETITIVE corporate tax environment and a good quality of life for employees, have helped position the
Iseland as a leading ebusiness jurisdiction. From the e-gaming perspective, Microgaming and BetInternet are
key participants. The Isle of Man was one of only two countries identified by the UK Department of Culture,
Media and Sport to be white-listed in relation to the Gambling Act 2006. But the e-business sector is wider
than gaming; other companies provide a mix of specialist software solutions, web hosting, online money
transmission, IP telephony, security, data storage and associated services.

Ship Register

As a maritime nation, it is only to be expected that shipping is within our lifeblood. In fact, the first entry
on the Island’s shipping register dates back to 1786, and the Island became an international register in 1984.
Nowadays, there are different registers for merchant shipping, commercial yachts, and leisure craft. The Ship
Registry is a world recognised Category One Red Ensign Group register, and maintains a high position on
the Paris MOU “White List” for Port State Control. In addition the Isle of Man was placed No 1 on the
Flag State Performance table issued by a Round Table of shipping associations making it the “Best Register
in the World”. The Isle of Man Shipping register adds significant value to the shipping sector in the City
of London.

Aircraft Register

Adding to the success of the Ship Register, the Island launched an Aircraft Register in 2007. Linked to
the UK CAA register, but with the aim of providing a fast and user-friendly service, the register has already
seen great success particularly in the new “light jet” market.

Film/Media

Over recent years, The Isle of Man has built a worldwide reputation for co-financing and co-producing
feature film and television dramas. The Island has become one of the busiest areas of film production in the
British Isles, having produced over 80 feature films and TV dramas since 1995. Films such as Stormbreake
r and Miss Potter were shot on locations both in the UK and the Isle of Man, demonstrating the symbiotic
relationship that exists between the two jurisdictions. To support the film sector, a local industry has
developed in areas such as construction, medical assistance, locations, production, post-production and
wardrobe. To further assist in the development of career paths, Isle of Man Film is working with the Isle of
Man College in enhancing the industry based courses already available on the Island. In addition to this Isle
of Man Film ensures that at least four local trainees are employed per production as part of the Island’s
commitment to fostering a new generation of skilled and experienced local production crew.

Satellite/Space

The Island’s Space business has developed strongly since the millennium. The Island is now home to active
subsidiaries of the world’s leading space and satellite companies such as SES Global, Inmarsat, Sea Launch,
Lorel and Boeing. The Island is also home to other less well-known, but equally impressive, enterprises in the
space sector. For example, Genesys Consulting Limited won top prize in the prestigious European Satellite
Navigation Competition 2006 for innovative applications of satellite navigation technology, beating over
200 other companies from across Europe. Genesys Consulting’s winning project married satellite navigation
technology and geological science to create an application that can be used for surveying for natural
resources and helping to predict earthquakes and volcanic eruptions. Working closely with ManSat Limited,
Isle of Man satellite companies are able to access orbital positions and radio frequencies via the
International Telecommunications Union in Geneva. ManSat can make such filings with a speed and
efficiency that many jurisdictions cannot match.

Insurance

The Isle of Man has developed into one of the world’s largest offshore life assurance jurisdictions. The
Island’s combination of highly skilled staff, innovative product design and strong but appropriate regulation
has led to strong sustained growth in the market. The Island is home to international life assurance arms of
many of the world’s leading financial services groups. An indication of how successful the Island has been
at attracting new life business is given by the total funds under management for the sector. For the year ended
31 December 2006 these totalled in excess of GBP32 billion, representing a compound annual growth rate
of 17% over the last five years. Indicative figures for December 2007 confirm that this strong growth has
continued. A significant portion of these assets are invested through the City of London.
Captive Insurance

The Isle of Man is recognised as being one of the leading centres for captive insurance and has a strong reputation for attracting high quality captive business. The Island offers a broad range of captive management services, ranging from small local operations to representatives of the world’s leading captive management groups, such as Willis and Marsh, whilst the Global head office for AON Group’s captive management is also based on the Island.

International Pensions

Since the introduction of the Retirement Benefits (International Schemes) Regulations 2001, the Island has become established as a major centre for the administration of international pension schemes. The legislation establishes a sound governance template for international schemes, with the objective of encouraging international businesses with globally mobile employees to base their schemes in the Isle of Man. The Island provides a solid foundation for international retirement planning by ensuring that schemes are operated by appropriately licensed professionals, that the latter adopt strong internal governance, and that certain member rights are enshrined in law. In terms of the transfer of pension rights from the UK, the Isle of Man’s Pensions legislation is fully recognised by HMRC, and Isle of Man schemes are capable of being registered as Qualifying Recognised Overseas Pension Schemes (QROPS).

AIM listings

As described in detail in section 7.4 below, the Isle of Man plays a key role in assisting international companies to achieve listings on AIM. India is now the second largest investor into City of London, and 75% by market capitalisation of Indian business listed on AIM is structured through companies domiciled in the Isle of Man.

Professional support services

The various financial services provided from the Isle of Man are supported and complemented by a strong body of professional legal and accounting advisers offering a deep understanding of international personal and corporate business and the ability to advise on complex financial structures, thus developing business through a value added proposition rather than solely through a competitive tax environment.

5.3 The Island is not resting on its laurels, and constantly seeks to re-engineer and extend its proposition. The Island sees a key component of its future role as working in close partnership with the City of London on a “hub and spoke” basis, providing value and profits to both centres.

6. Responses to Committee Questions

6.1 We are pleased to respond to the Committee’s questions as follows:

7. To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?

7.1 It has been suggested that OFCs have two implications for global economies:

7.2 First, such centres reduce the effective marginal tax rate on capital, and as a result, create more incentives to save and invest. Because the cost of doing business in or through OFCs is lower, businesses operating in or through these countries can undertake investments with lower expected returns or higher risks than those in high tax jurisdictions. With these new investment opportunities, individuals and corporates will most likely consume less (or keep a smaller share of their wealth in non-income generating assets) and save and invest more.

7.3 Secondly, by providing a lower tax alternative for mobile taxable resources, OFCs can serve to moderate public sector spending, improve efficiencies in public service delivery, and keep higher spending jurisdictions in check. Hines notes that since the 1980s, effective corporate income tax rates across the industrialized world have fallen by nearly 15% and statutory tax rates have dropped by almost 20%. During the same period, activities in OFCs as a share of world economic output increased eightfold.

7.4 The geographic proximity and time zone of the Isle of Man and other Crown Dependencies has been important factors in the development of the City of London over the past two decades, to its current position as the World’s pre-eminent finance centre. As outlined above, the growth in AIM listings for non-UK

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sourced business has been achieved in partnership with these three territories. It could be argued that without OFCs and the opportunities offered by the Crown Dependencies, AIM would not have achieved its current success. In the context of the Isle of Man, research from Hemscott Group Limited\(^280\) dated March 2008 notes that:

521 AIM companies were incorporated outside the UK

The top three jurisdictions for the registration of non-UK AIM companies were Guernsey (61 companies), Isle of Man (59 companies) and Jersey (51 companies). In total, the three Crown Dependencies represented 171 listings, or 33% of the total non-UK incorporated companies. The combined market capitalization of these companies was nearly £17 billion, or which £7.2 billion alone related to Manx incorporated entities.

Of the 15 countries outside the UK that are the registered homes of AIM 100 companies, 12 of these are incorporated in the Isle of Man, with a market capitalisation of £4.6 billion.

This demonstrates the Isle of Man’s growing reputation as the preferred jurisdiction for overseas companies listing in London.

7.5 The Isle of Man’s contribution towards the City of London’s international trade has been acknowledged by the current Lord Mayor, Alderman David Lewis, who is quoted as saying\(^280\) that “assets worth billions of pounds held by Isle of Man companies are invested in and through the City. The way we see it is that the Isle of Man is a core asset for the City.” adding that “from the City’s point of view, your brand was immensely strengthened when you committed to work with the OECD on improving transparency and tax information, and then backed it up with a host of Tax Information Exchange Agreements”.

8. To what extent does the use of Offshore Financial Centres threaten financial stability?

8.1 We submit that the Isle of Man poses no threat to financial stability, indeed the centre enhances it.

8.2 In the first instance, it should be recognised that not all OFCs are the same. The Financial Stability Forum in their April 2000 report noted that the term “offshore” carries with it in some quarters “a perception of dubious or nefarious activities”. The report continues to note that “there are, however, highly reputable OFCs that actively aspire to and apply internationally accepted practices, and there are some legitimate uses of OFCs. OFCs are not homogeneous and there is a wide variety of practices found in them. Hence, there is a strong aversion by some jurisdictions to being listed as an offshore centre given the risk of guilt by association”.

8.3 Following on from this work, in May 2000 the Financial Stability Forum published a press release\(^291\) which placed the Isle of Man into Group I of OFCs, albeit with the imperative for the Island and the other British Isles centres to continue to improve their quality of supervision. Jurisdictions in this category “are generally perceived as having legal infrastructures and supervisory practices, and/or a level of resources devoted to supervision and co-operation relative to the size of their financial activities, and/or a level of co-operation that are largely of a good quality and better than in other OFCs”.

8.4 We consider that the Isle of Man has engaged constructively with the international debate and developments in international supervision over the past 10 years.

8.5 The work done by the Isle of Man has been recognised by the House of Commons. In May 2008 the Committee of Public Accounts published its Seventeenth Report of Session 2007–08\(^292\) entitled “Foreign and Commonwealth Office: Managing Risk in the Overseas Territories”. Whilst the report is directed towards the Overseas Territories rather than the Crown Dependencies, a key conclusion was that “overall regulatory standards in most Territories, particularly those with smaller financial centres, are poor compared to standards achieved in the Crown Dependencies”.

8.6 The Isle of Man has long-standing and comprehensive anti-money laundering legislation. Indeed, the Isle of Man led the way in the concept of “know your customer” and has long been regarded as setting the gold standard in this area.

8.7 It has been claimed that there are more company administrators within the London area than in all the British OFCs. Whatever the respective numbers, unlike the Isle of Man, these UK based businesses are not subject to regulation, although they have recently been brought into the UK’s anti money laundering regime. In contrast to this unregulated corporate management activity in the UK, the Isle of Man’s Corporate and Trust Service Providers have been subject to the Island’s anti-money laundering regime since 1999, and have been regulated by the FSC since 2000 in the case of the provision of corporate services and since 2005 in relation to trustee services. It should be noted that the legislation to regulate fiduciary activities was introduced on the Island’s own initiative, and not in response to any external pressures.

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\(^280\) http://www.cains.co.im/library/briefings/Overseas/%20AIM%20Report%202014-03-08.pdf


\(^291\) http://www.fisforum.org/publications/PR_OFCC00.pdf

\(^292\) http://www.publications.parliament.uk/pa/cm200708/cmselect/cmpubacc/176/176.pdf
9. How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom’s tax authorities and financial regulators?

9.1 The Isle of Man, unlike some other jurisdictions, does not have any bank secrecy legislation. The position in the Isle of Man in terms of the practice of normal commercial confidentiality is identical to that in the UK. UK case law on the subject is followed, as represented by the case of Tournier v National Provincial and Union Bank of England [1924] 1 K.B. 461.

9.2 The Island’s stance has been to engage constructively with international bodies such as OECD and to position itself to be both internationally responsible and compliant, where possible.

9.3 Arising from this engagement, the Island has entered into a number of OECD model Tax and Information Exchange Agreements (“TIEAs”) over recent years. In 2002, a TIEA with the USA was signed, and in 2005 one with Netherlands was executed; both of these came into effect in 2006. In 2007, the Island entered into TIEAs with Denmark, Faroe Islands, Finland, Greenland, Iceland, Norway and Sweden. More recently, the Island executed a TIEA with Ireland.

9.4 The Isle of Man currently has the largest network in the world of TIEAs based on the OECD model agreement on exchange of information on tax matters. Of the 25 TIEAs currently executed between OECD member states and OFCs, 10 of these have been entered into by the Isle of Man, demonstrating both the Island’s commitment to transparency and international assistance, and its leading stance in this area.

9.5 We understand that the Isle of Man Government is in negotiations to execute TIEAs with a number of other OECD member countries, including Australia, Belgium, Canada, France, Germany, India, Italy, New Zealand, Spain and the United Kingdom.

9.6 The Chamber of Commerce endorses the stance of the Isle of Man Government, being the principle of entering into OECD-model TIEAs with other jurisdictions on the basis of mutual economic benefit, for example allowing market access or the removal of the Isle of Man from any black-lists maintained by the counterpart country.

9.7 In relation to the UK, the current Double Taxation Treaty between the two nations dates back to 1955. This agreement provides for the disclosure of relevant information held by our revenue authorities, on request.

9.8 As set out below, this Chamber would support the entering into of negotiations leading to an updated OECD-type DTA with the UK, subject to constructive support from the UK as outlined in our proposal.

9.9 The Isle of Man is a participant within the EU Savings Directive network of Third Countries and has adopted a default position of retention tax, along with the other Crown Dependencies and some other European countries. As this Directive evolves, the Chamber of Commerce is confident that the Isle of Man will continue to be an active contributor to the debate.

9.10 The FSC, which is the principal regulatory body in the Isle of Man, has committed to compliance with the Basel Core Principles in prudential regulation of banking institutions and with FATF Recommendations on the prevention of money laundering and the countering of the financing of terrorism.

9.11 The FSC is a member of the International Organisation of Securities Commissions (“IOSCO”) and has been accepted as a signatory to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information. The FSC is committed to compliance with IOSCO’s Objectives and Principles of Securities Regulation.

9.12 The FSC is also a member of the Offshore Group of Banking Supervisors. The Financial Crime Unit (“FCU”) is the Island’s financial intelligence unit. The FCU is a member of the EGMONT Group of Financial Intelligence Units, and the EGMONT secure channels of communication are available to other members of this grouping when contacting the FCU.

9.13 The Isle of Man has a wide number of gateways for the provision of information and evidence to foreign regulators, prosecutors and Courts. These are summarised in Appendix One at Section 19.

9.14 In summary, we consider the levels of transparency to be reasonable and balanced. The UK Tax Authorities have recourse to action that can be taken in the event of tax evasion, should this occur. Equally we are a well regulated jurisdiction and should the UK FSA identify a situation regarding regulated activity which gives it concern, it has recourse through the Isle of Man regulators to take appropriate action.

10. To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?

10.1 If focus of the Committee is on the smaller nations, it should be recognised that these centres are not generally involved in the creation and distribution of complex financial instruments, other perhaps than being used as a booking centre for the transaction.

10.2 The sixth report of the Committee refers (paragraph 32 on page 14) to Granite, the Jersey-based SPV of Northern Rock. There are two aspects to the use of an SPV in this manner: firstly, the design and planning for such a structure took place in the UK, by a UK regulated banking institution. We suggest that control might better be focussed on the planning stage, particularly when such is undertaken by a regulated entity in the UK, rather than the implementation offshore of an agreed strategy. The second aspect is that the use
of Granite and similar vehicles to package financial products and to move them off balance sheet into a separate structure is an important component of the international financial services environment which has facilitated the development of the finance sector over the past decade. We suggest that although Granite is a facet of the Northern Rock problem, it was the broad strategic failings of the UK bank’s management which brought about the company’s difficulties, rather than any activities emanating from OFC.

10.3 Most complex financial derivatives tend to be created in the major financial centres such as London and New York, and it is in these centres that the majority of the financial planning and engineering are undertaken.

11. How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets?

11.1 The success of the Isle of Man is due to a dynamic and legitimate approach to business. The Island’s levels of transparency are reasonable and balanced. Whilst it is recognised that the Island’s competitive taxes are one component of its success, each country in the world has its own particular advantages and the Island competes honestly and legitimately on the international stage, with a high level of transparency and an aggressive willingness to assist nations in their fight against financial crime and terrorism.

11.2 As stated above, the Isle of Man is not a closed jurisdiction, and it has no bank secrecy laws. Over the past decade, the Island has been assessed by a number of international agencies and reviews. These have all confirmed that the Island is proactive in its co-operation with other territories in the pursuit of international financial crime and that its defences against money laundering comply with the highest global standards.

11.3 Our Government’s policy is to be both internationally responsible and economically competitive: complying with changing international standards on information exchange and ‘harmful practices’ whilst lowering the standard rate of income tax for businesses. Unlike others, the Island has pursued a strategy of engagement with international bodies. For example, the Island is, through the UK, a member of OECD and is an active participating partner in the OECD Global Forum on Taxation.

12. How do the taxation policies of Offshore Financial Centres impact on UK tax revenue and policy?

12.1 Although it might be assumed that an adjacent OFC would be detrimental to the tax base of the UK, we suggest that this is a simplistic and inaccurate interpretation of the relationship which exists.

12.2 The UK has introduced significant anti-avoidance legislation which has reduced the attractiveness of OFCs to UK resident and domiciled individual clients, and to most UK corporate taxpayers. In order to ensure that the Isle of Man reduces the risk from the wrong types of business the Island has introduced KYC and source of funds enquiries for new customers. In addition the FSC regulate corporate service providers to ensure that take-on procedures are adhered to; otherwise regulatory consequences will follow from a breach, which can include but is not necessarily limited to the revocation of the company’s license to provide corporate administration services.

12.3 From the corporate tax perspective, recent press reports would suggest that mainstream EU partners such as Ireland are benefiting much more from tax arbitrage than are the smaller nation OFCs.

12.4. A paper by Desai, Heinz and Fritz Foley11 (“Do Tax Havens Divert Economic Activity?” 2005) concludes that “contrary to many policy concerns and the assumptions of much of the tax competition literature, reduced costs of using tax havens do not appear to divert activity from non-havens”.

12.5 The authors suggest that “the empirical evidence indicates that firms facing reduced costs of establishing tax haven operations respond in part by expanding their foreign activities in nearby high-tax countries. Hence it appears that careful use of tax haven affiliates permits foreign investors to avoid some of the tax burdens imposed by domestic and foreign authorities, thereby maintaining foreign investment at levels exceeding those that would persist if tax havens were more costly”.

12.6 They conclude that “the available macroeconomic evidence indicates that countries have not reduced their taxation of foreign investment, or of capital income, to anything approximating the degree implied by many models of capital tax competition. The use of tax havens by foreign investors may help to explain this empirical pattern, as high-tax countries are able to maintain high-tax rates while continuing to draw significant levels of foreign investment. It is not even necessary that high-tax countries are aware of the importance of tax havens in preserving their ability to attract foreign investment”.

12.7 The many billions of pounds collected by Manx investment and insurance businesses from expatriates around the world mainly find their way to the United Kingdom and in particular, the City of London. The profits earned by the various City institutions on this business contribute notably to the UK’s tax take. Furthermore, from the resources of the IOM government, generated in large part by the success of the various IOM financial institutions, very significant sums have been spent of improving our infrastructure. The companies employed to complete this work are invariably UK companies, thus again enhancing the UK tax take, together with benefits for UK employment.
Are British Overseas Territories and Crown Dependencies well-regarded as Offshore Financial Centres, both in comparison to their peers and international standards?

13.1 We submit that the answer to this question in respect of the Isle of Man is a resounding yes.

13.2 In 2000, FATF conducted a review into “non cooperative countries/territories”. The findings of this review were that the Isle of Man passed the tests applied to it, and so did not meet the criteria for a “non co-operative country”. In reaching this conclusion FATF commented that “the Isle of Man has a robust arsenal of legislation, regulation and administrative practices to counter money laundering. Perhaps more importantly, the authorities clearly demonstrate the political will to ensure that their offshore financial institutions and the associated professionals maximise their defences against money laundering and co-operate effectively in international investigations into criminal funds”. The report added that “the standards set in the Isle of Man are close to complete adherence with FATF’s 40 recommendations”.

13.3 The Financial Stability Forum undertook a review in 2000 to consider the implications of OFCs on global financial stability. The Isle of Man was one of only eight offshore jurisdictions that were given the highest rating.

13.4 In 2003, the IMF’s assessment of the supervision and regulation of the finance sector concluded that “the financial regulatory and supervisory system of the Isle of Man complies well with the assessed international standards”.

13.5 Commenting on the execution of the TIEA between the Isle of Man and the Netherlands, the Secretary-General of the OECD commented that “this agreement confirms the Isle of Man’s commitment to implement high international standards, thereby reinforcing its stature as a responsible international financial centre”.

13.6 More recently, the execution of the Isle of Man TIEA with Ireland led the OECD to “welcome these agreements as enhancing the international reputations of . . . the Isle of Man as legitimate financial centres and thereby strengthening their integration into the international financial system” adding that “the trend towards greater transparency and tax cooperation continues as more and more countries and jurisdictions implement the OECD standards,” and that “recent events have put international tax evasion in the spotlight, demonstrating the pressing need for action to tackle tax compliance issues in an increasingly borderless world. These agreements will better equip their signatories to address all forms of tax abuses.”

13.7. From an investor protection perspective, the Isle of Man has led the way, with the introduction of a number of initiatives:

**Banking Depositors**

The Depositors’ Compensation Scheme protects up to 75% of deposits, to a maximum of £20,000. Whilst this is now lower than the recently revised UK scheme, it is broadly in line with schemes in other EU member states, and covers both individual and corporate depositors, wherever located, and for deposits in all currencies.

**Life Assurance Policyholders**

The Life Assurance (Compensation of Policyholders) Regulations 1991 ensure that, in the event of a life assurance company being unable to meet its liabilities to its policyholders, up to 90% of the liability to the protected policyholder will be met. Unlike many other policyholder protection schemes, the Island’s scheme operates globally, providing protection to policyholders no matter where they reside.

**Investors in Authorised Collective Investment Schemes**

The Scheme compensates investors in Authorised schemes for 100% of the first £30,000 of claim, and 90% of the remainder, up to a maximum compensation of £48,000.

**Financial Services Ombudsman Scheme**

The Island operates a free, independent dispute resolution service for customers worldwide with a complaint against an Isle of Man financial firm such as a bank, insurance company or financial adviser.

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295 http://www.oecd.org/document/3/0,2340,de 2649 33745_2649 35483395_1_1_1_1,00.html
296 http://www.oecd.org/document/19/0,3343,en_2649_13745_40518675_1_1_1_00.html
14. **To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?**

14.1 Given the proximity of the Isle of Man to Northern Ireland and to the Republic of Ireland, in an historical context the Isle of Man has long understood the risks of it being used for terrorism financing and its original anti-terrorism legislation—the Prevention of Terrorism Act 1990—predates more recent global initiatives and concerns.

14.2 In the modern-day context, the Isle of Man strives towards full compliance with international standards. In their November 2003 report, the International Monetary Fund commented\(^\text{297}\) that “the financial regulatory and supervisory system of the Isle of Man complies well with the assessed international standards. The authorities are to be commended for the attention they have given to upgrading the financial regulatory and supervisory system to meet international supervisory and regulation standards in banking, insurance, securities and anti-money laundering and combating the financing of terrorism (AML/CFT), and the introduction of a comprehensive regime for the licensing of corporate service providers (CSPs)”.

14.3 The report also concluded that “The jurisdiction has been assessed to have a high level of compliance with the four key standards. Moreover, the legal framework for company and trust service providers (TSPs) is fully consistent with the Offshore Group of Banking Supervisors (OGBS) Statement on Best Practices.” The report did identify a number of shortcomings but noted that these “have not been a major concern to date”.

14.4 Please also refer to the positive external endorsements of the Island’s stance on Anti-Money Laundering initiatives, as set out in section 13.

15. **What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?**

15.1 The Isle of Man is a key contributor of deposits and business referrals to the City of London. The Island (along with the other Crown Dependencies) is a significant component of the UK’s proposition as the world’s leading financial centre. We propose that it would be to the benefit of both the UK exchequer, and to the Island, for the Isle of Man to be promoted and endorsed internationally by the UK Government as a key contributor to the success of the City of London.

15.2 Looking to the future, the Isle of Man Chamber of Commerce would support the commencement of negotiations between the UK and the Isle of Man leading towards the execution of an OECD-model TIEA between the two nations.

15.3 However, given the disappointment and frustration that is felt within the Island that initiatives taken by the Island in good faith to meet agreed international standards over the past decade has not been fully acknowledged, we propose that the entering into of such an agreement would represent an ideal opportunity for the UK to support further its Crown Dependency on the international stage. Such support might include:

- public recognition by the UK, and communication in all relevant forums, of the stance and position of the Isle of Man in terms of its commitment to international transparency and stability; and
- the UK, working in partnership with the Isle of Man, communicating to and educating its European partners on the constructive position and stance adopted by the Isle of Man, in stark contrast to some other European centres.

16. **What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres?**

16.1 This is a difficult question to answer. A double taxation treaty is an agreement entered into by two nations. Almost invariably, where an individual or corporation has a presence in both jurisdictions, tax experts will endeavour to construct their clients’ affairs in a legitimate manner in order to minimize taxation. If the tax planning is open and as is regularly the case prior consents from HMRC are sought this would seem to be symbiotic for both parties.

16.2 Research by academics such as Desai et al (cited above) suggest that without this relationship in the first place the group may choose another jurisdiction (ie not the UK) that offers this opportunity. This would clearly not benefit the UK.

17. **To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?**

17.1 The Isle of Man certainly does not encourage this type of business.

17.2 If the UK authorities become aware of tax evasion they have avenues open to them which should result in the tax being settled, together with penal rates of interest, potential fines and in some cases, custodial sentences.

17.3 A schedule of the gateways available to foreign authorities is set out in Appendix one. In particular, the Island’s Criminal Justice Acts, which date back to the early 1990s, facilitate the assistance of any country where the conduct constituting a taxation offence under the law of that country would also constitute the same or a similar offence under Isle of Man law or where the conduct constitutes serious or complex fraud.

17.4 The Island’s Money Laundering legislation is extensive and is broadly equivalent to the third EU Money Laundering Directive. Given the nature of the Island’s financial services proposition, any money laundering discovered is likely to have a cross-border element and there is, therefore, provision for legal assistance. In particular, disclosure of any suspected money laundering is made to the Financial Crime Unit (“FCU”) of the Fraud Squad of the Isle of Man. The FCU liaises with the Serious Organised Crime Agency in London.

18. Summary

18.1 In summary, we submit to the Committee that the Isle of Man:

- Is in the upper tier of OFCs;
- Has demonstrated its stated commitment to international engagement and co-operation with a series of positive initiatives over many years; and
- Is a responsible member of the international community, a stance that has resulted in the Island being consistently well-regarded by international bodies undertaking reviews of the Island’s activities.

18.2 Consequently, we believe that the Island poses no threat to international stability.

June 2008

APPENDIX ONE

19. Information Gateways Available to the Isle of Man Authorities to Assist in International Investigations and Enquiries

19.1 The Isle of Man has the following gateways for the provision of information and evidence to foreign regulators, prosecutors and Courts:

19.2 Sections 24 and 25 Criminal Justice Act 1990

Section 24 grants considerable powers of investigation to the Attorney General (“AG”), which can be exercised where it appears to him that there are reasonable grounds for suspecting serious or complex fraud, where ever committed, and whether inside our outside the Island.

Under Section 25 the AG can disclose the information that he obtains for the purposes of investigation of an offence or a prosecution in the Isle of Man or elsewhere—see Section 25 (4)(c). Further, the AG can disclose this information to any person or body having, under the law of any country or territory outside the Isle of Man, functions which correspond to the Manx functions of an Inspector under the Companies Act or the functions of a regulatory body in any area of commercial activity. The AG does not have the power to disclose information that he has obtained under these powers to a private plaintiff for use elsewhere (see Section 25(5)).

19.3 Section 21 and 22 Criminal Justice Act 1991

Section 21 gives the AG the authority, upon receiving a request from a foreign jurisdiction, to appoint the High Bailiff to receive evidence for use in criminal proceedings abroad.

Section 22 grants the AG the authority to search for evidence within the Island.

19.4 Tax Information Exchange Agreements

The Manx Government has entered into TIEA’s with Denmark, Faroe Islands, Finland, Greenland, Iceland, Ireland, Norway, Netherlands, Sweden and the United States. The Island is currently negotiating TIEA’s with a number of other jurisdictions, including Australia, Belgium, Canada, Estonia, France, Germany, India, Italy, New Zealand, Spain and the United Kingdom.

By way of an example as to modus, the TIEA with the US has been incorporated into Manx domestic law through the Income Tax (USA) Order 2006 (SD169/06), which permits the US to approach the Chief Financial Officer in the Isle of Man, to seek information in relation to federal tax matters. It should be noted that under Article 5 of the 2006 Order, “such information shall be exchanged without regard to whether the conduct being investigated would constitute a crime under laws of the requested party if such conduct
occurred in the territory of the requested party”. In other words, there is no need for dual criminality of offences, whereby the criminal offence being investigated in the US would also be an offence under the law of the Isle of Man.

19.5 Section 17 Investment Business Act 1991

Section 17 allows the Financial Supervision Commission (“FSC”) to enter into mutual assistance agreements with recognised regulators in countries or territories outside the Isle of Man, which exercise functions corresponding to those of the FSC. It is understood that the FSC has entered into a mutual assistance agreement with IoSCO in the US, but in our experience this section is used infrequently, because the FSC is bound by the provisions of Section 24(6) Financial Supervision Act 1988, which places restrictions upon the disclosure of information relating to the affairs of an individual customer of a financial institution, and can make disclosure quite cumbersome.

19.6 Section 24(1) Financial Supervision Act 1988

Section 24(1) permits the FSC to disclose certain restricted information (as defined at Section 23 of the Act) to other authorities, regulators and prosecutors through the various gateways listed in Section 24(1). The gateways are too numerous and complex to discuss in this note, but it should be noted that Section 24(1)(a) permits the disclosure of information by the FSC “with a view to the institution of or otherwise for purposes of criminal proceedings whether in the Island or elsewhere”.

19.7 Section 14 and Schedule 3 Insider Dealing Act 1988

Under Schedule 3, if it appears to the Treasury that there are circumstances suggesting, amongst other things, “that there may have been a contravention of the laws of another country or territory relating to insider dealing and that a person in the Island, (i) may have been concerned (directly or indirectly) in any such contravention; or (ii) may have information or documents which may be of assistance in the investigation of any such contravention”, it may appoint one or more inspectors to carry out an investigation.

19.8 Evidence (Proceedings in Other Jurisdictions) Act 1975

The 1975 Act is an Act of Parliament which was applied to the Isle of Man by Order in Council (SI 1979/1711). This act only applies to civil proceedings, and not to criminal investigations, and under Section 2 the Manx Courts are given power to obtain evidence in any way that the Court feels appropriate for the purpose of giving effect to the request of any Court outside the jurisdiction of the Manx Court, provided the Manx Court is in empowered to obtain evidence in that way for Manx proceedings.

Section 2 (2) of the Act sets out the type of assistance that may be requested in civil proceedings, which includes the examination of witnesses, either orally or in writing, the production of documents and the preservation of property.

The UK has issued a Declaration under Article 23 of the Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters 1970, stating that it would not execute letters of request for the purpose of obtaining pre-trial discovery of documents, and the Declaration extends to the Isle of Man.

Whilst the 1975 Act only applies to civil proceedings, some foreign authorities (such as the US SEC) can obtain penalties in civil proceedings brought in the US, which mean that it could seek to obtain evidence in the Isle of Man under the 1975 Act. Normally, however, the SEC will use Section 24 CJA 1990 or Section 21 CJA 1991 to obtain evidence in the Island.

19.9 Section 1 Bankruptcy Act 1988

Section 1 allows the Manx Court to grant an Order in Aid pursuant to a request made to it by a Court in any relevant country or territory.

Section 1(4) defines “relevant country or territory” as the UK or any part thereof, and any country or territory designated for the purposes of the Section by an Order made by the Council of Ministers. To date, no such Order has been made but it is anticipated that Orders will be made in the near future.
19.10 **Foreign Trustees in Bankruptcy and Foreign Liquidators**

The Manx High Court will also recognise a foreign trustee in bankruptcy, or the liquidator of a company appointed by a foreign Court, on the principles of international comity, thus enabling the trustee/liquidator to investigate the activities of the individual/company in the Island.

In the case of re: Regatta Trading Limited (21st July 1998) (unreported) Deemster Corrin CBE applied rules 167(2) and 169 in Dicey and Morris—"Conflict of Laws" (11th Edition) and recognised a trustee in bankruptcy appointed by a Finnish Court. This judgment was upheld on appeal by the Staff of Government Division, and is generally regarded as authority for the power of the Manx High Court to recognise a foreign trustee in bankruptcy or a foreign liquidator under the principles of international comity.

19.11 **Mutual Legal Assistance Treaties ("MLAT’s")**

On 6 January 1994 the UK entered into a Treaty on Mutual Legal Assistance in Criminal Matters with the US, and that Treaty was extended to the Isle of Man on 5 June 2003.

Under the Treaty, the Central Authority for the Isle of Man is the AG, and he will normally use his powers under Section 24 CJA 1990 and Section 21 CJA 1991 to assist the US pursuant to the Treaty.

It is anticipated that the Island will enter into MLAT’s with other jurisdictions, in similar terms, either directly or through the UK.

*June 2008*

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**Memorandum from Professor Ronen Palan and Dr Anastasia Nesvetailova**

**Executive Summary**

There is a link between offshore finance and financial stability. We believe that this connection lies in the financial cycle and more specifically in the maintenance of illusion of liquidity. The secrecy and opacity provided by the offshore financial centres, and most crucially, the manipulation of ownership which had developed due to non-existent, or in most cases, *de facto* loose regulation of new financial entities and their functions, facilitated the construction and maintenance of liquidity illusions in the markets. In “good times” financial actors seem prepared to take risks with such ambiguity, assuming that tax evasion schemes are part of the rules of the game. But the moment the mood in the market turns sour, as happened in August 2007, this creates an added dimension of fear as no one can be sure who will honour debts of what are legally speaking, separate entities. This was an important contributing factor in the current crisis that began in August 2007. We believe, therefore, that OFCs are an important element in the link between the illusion of liquidity that preceded the current crisis, and the puzzling disappearance of this liquidity, virtually overnight.

Thank you for this opportunity to share our thoughts on some of the lessons of the current financial turmoil with you.

1. In each and every financial crisis or scandal over the past twenty years, the names of offshore jurisdictions pop up. This is true for the crises in East Asia, Russia, Argentina, firms like LTCM, Parmalat, Refco, Enron and most recently, Northern Rock. Yet the link between the type of offshore financial centres (OFCs) commonly known as tax havens and financial instability has not been widely researched and is not well understood.

2. A minority of economists take the view that OFCs have a positive impact because they increase competition among financial centre and hence, the argument holds, increase efficiency and innovation. This opinion, however, is never supported by empirical evidence and remains by and large, a theoretical proposition. The consensus nowadays is that tax havens are certainly not enhancing financial stability; nor are they improving in any ways the system of financial governance, but instead, are contributing factors to instability and crisis. This view is represented by, among others, the ad hoc Committee on OFC seconded to the Financial Stability Forum (FSF). On the basis of research into the causes of the East Asian crisis of the late 1990s, the FSF concluded, for instance, that OFCs were not the major cause of the crisis, but a contributing factor.

3. In this brief, we would like to draw the attention of the Committee to an important, though scarcely discussed, link between offshore finance and financial stability (though this point has been raised by Tax Justice Network’s submission as well). We believe that this connection lies in the role OFCs play in the cycle of financial liquidity. More precisely, we believe that OFCs are an important element in the link between the illusion of liquidity that preceded the current crisis, and the puzzling disappearance of this liquidity, virtually overnight.
4. As members of the Committee may recall, just a few months before August 2007, the mainstream view in financial commentary maintained that the world economy was, in the words of the Chairman of the Fed, Ben Bernanke, “flush with liquidity.” 298 The IMF also has warned about inflationary dangers of the global liquidity glut in a small minority of heterodox economists never shared the sense that the world was experiencing a liquidity boom, or what Hyman Minsky301 called “Ponzi,” or pyramid finance, is what has really been at the epicentre of the boom of securitised finance.

5. How come the illusion of liquidity had been sustained for such a long period of time?302 We now believe that the answer to this question may to an extent, lie—and again we emphasise that OFC played a contributing, not a principle factor—in the grey area of financial innovation, which today encompasses offshore financial facilities, regulatory avoidance, speculation and outright fraud.

6. We suspect that the secrecy and opacity provided by the offshore financial centres, and most crucially, the manipulation of ownership which had developed due to non-existent, or in most cases, de facto loose regulation of new financial entities and their functions, facilitated the construction and maintenance of such liquidity illusions in the markets. Financial actors are perfectly aware of these manipulations, which includes and may host, say, an export processing zone, they can also develop an OFC sector—yet, tax haven and evasion schemes are part of the rules of the game. But the moment the mood in the market turns sour, as happened in August 2007, this creates an added dimension of fear as no one can be sure who will honour debts of what are legally speaking, separate entities. To put it simply, no one knows for sure if, for instance, Northern Rock will take the responsibility for the estimated £50 billion debts of what was assumed to be its offshore SPV, Granite, because legally, Granite is a separate entity. Since this particular relationship is replicated through the thousands and thousands of SPVs set up in offshore world-wide, the problem is of systemic proportions.

7. In “good times” financial actors seem prepared to take risks with such ambiguity, assuming that tax evasion schemes are part of the rules of the game. But the moment the mood in the market turns sour, as happened in August 2007, this creates an added dimension of fear as no one can be sure who will honour debts of what are legally speaking, separate entities. To put it simply, no one knows for sure if, for instance, Northern Rock will take the responsibility for the estimated £50 billion debts of what was assumed to be its offshore SPV, Granite, because legally, Granite is a separate entity. Since this particular relationship is replicated through the thousands and thousands of SPVs set up in offshore world-wide, the problem is of systemic proportions.

8. To begin to understand the full scale of the problem therefore, we would like to draw your attention to the great ambiguities of language and terminology, often perpetrated by those who benefit from this ambiguity. In this brief we will be talking about three aspects of this ambiguity: The grey zone between what is an “offshore financial centre” and a “tax haven”; b) what does “financial innovation” really mean; c) ambiguity about the meaning of “liquidity”. All three, as we show below, have been at the epicentre of the current malaise on financial markets and specifically, of the fiasco of UK’s Northern Rock.

DEFINITION PROBLEMS: THE CONFUSION BETWEEN TAX HAVENS AND OFCS

9. Due to the highly politicized debate, and the association of tax havens with evasion, money laundering, criminality and embezzlement, few tax havens carry the tag “tax haven” with pride. In fact, most if not all deny any association to tax, or tax havens, and seek to present their policies as benign forms of Preferential Trade Regimes (PTRs). At best, or worst, some tax havens are prepared to accept the less pejorative designation, “offshore financial centers” (OFCs). Some of them may indeed advertise their offshore business sector in their official websites. As a result the term tax haven is no longer popular and is increasingly replaced by the term OFC, particularly by international economic organizations such as the International Monetary Fund (IMF), the Financial Action Task Force (FATF), the Financial Stability Forum (FSF) and so on. We believe this to be a mistake. Tax havens and OFCs are two distinct phenomena. They evolved for different purposes and in different historical periods. Just as tax havens can serve also as flag of convenience and may host, say, an export processing zone, they can also develop an OFC sector—yet, tax haven and OFC should not be confused one from the other.


302 The boom lasted for at least four consecutive years: 2003–07.
10. The term “tax havens” gained currency since the beginning of the 20th century. Tax havens were used primarily, but not exclusively, for the purpose of tax evasion and avoidance, including inheritance tax. They served, of course, other purposes as well, including money laundering, capital flight, and offered stringent secrecy provisions which proved attractive, for instance, to less enamored couples seeking to avoid punitive divorce settlements. OFCs began life as financial centers specializing in non-resident wholesale financial transactions, otherwise known as Euromarket transactions. The original OFC developed in September 1957 in London. The market became known popularly as “offshore” because it escaped nearly all forms of financial supervision and regulations. As an unregulated market, the market is global in reach and trading take place among many such OFCs spread around the entire planet. The world’s most important OFCs are London, New York’s International Banking Facilities (IBFs) and Tokyo’s Japanese Offshore Market (JOM).

11. An OFC strategy, in fact, is a logical extension of the tax haven strategy as both are the product of, and benefit from, avoidance. Furthermore, the lack of regulation or light supervision that characterizes of tax havens can easily be used (or abused) for reasons for tax avoidance and money laundering purposes as well. British banks and corporations, for instance, realized early on the advantages of tax havens for Euromarket operations and began to establish subsidiaries in Crown Colonies as booking offices already in the early 1960s. They were followed soon by North American banks that preferred the Caribbean havens. The result is a confusion between different type of OFCs. Booking centers or what the IMF calls OFCs are “more lightly regulated centers that provide services that are almost entirely tax driven, and have very limited resources to support financial intermediation. While many of the financial institutions registered in such OFCs have little or no physical presence, that is by no means the case for all institutions”.303 This submission is concerned primarily with the last two categories of OFCs, tax havens and “regional” centers, both of whom, we believe, thrive effectively as tax havens and secrecy spaces.

12. Having commenced operation in this way in the 1950s and especially during the 1960s, the attraction of this model became obvious. It was necessary that tax havens attracted particular expertise to service the market they had attracted for non-resident wholesale financial transactions. The expertise required was that of accountants, lawyers and bankers. Once established in these places these persons, almost all of them expatriate with regard to the taxation looked for other markets to exploit using similar “offshore” techniques, incorporating the absence of nearly all forms of financial supervision and regulation. The consequence was the expansion of the tax on points and evasion market using the trusts, foundations and international business corporations that they could sell based on the legislation that they advised their tax haven posts to adopt. As such over time, the OFC became something more than a Euromarket facilitator, it became the combination of professional firms that supplied the clients with the structures for regulatory avoidance in other jurisdictions that the tax haven had created.

13. These type of “OFCs” benefited enormously from the emergence of the Euromarket. BIS statistics of international assets and liabilities of banks show that some tax havens are among the world’s premier’s financial centers. The Cayman Islands in ranked sixth largest financial centre in the world in terms of assets (sometimes fifth or even fourth by some other measures), Jersey 16th and the Bahamas 17th. In fact, if we add the onshore/offshore types of centers such as Switzerland (7th), the Netherlands (8th) and Luxembourg (9th), then the list of OFCs is dominated by tax havens. About 20% of all international banking assets and liabilities are located in such centers. Although presenting themselves as financial centers, they are not.

**Financial Innovation**

14. Financial innovation is a tricky term. On the one hand, much like in any other sphere of activity—technology, science, trade- innovation is a healthy component of economic progress. It thrives at the juncture of competitive entrepreneurial spirit, desire to minimise costs, raise efficiency and ultimately, enhances social welfare. Credit cards, or internet banking, for instance, have made our daily life both dynamic and conformable. On the other hand however, innovation in finance, unlike in other sectors of the economy, spurs from the financiers’ constant drive to escape regulation. Unlike in other spheres of economic activity, the nature of finance, with its reliance on financial engineering and globalisation of IT technology, has not only facilitated the process of inventing new products and investment techniques - such as securitisation or subprime loans—but transformed it into a lucrative line of business. Increasingly, the spread of this process has made regulatory avoidance (or “regulatory arbitrage”, as the literature calls it), the key channel of innovation in finance.

15. This aspect of financial globalisation is not new at all, although as a subject of study, it has escaped the lens of mainstream economics ad political science. Some 20 years ago, the few students of financial innovation pointed out that in financial markets, a great impetus to innovate comes from “regulatory arbitrage”—“a desire to circumvent existing regulations in taxation and accounting, without necessarily breaking the law”.304 In his case study, Shah found that with the great help of investment bankers and lawyers, companies are able to design sophisticated schemes of regulatory avoidance. The regulators, the

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media and analysts were unable to expose these practices publicly and restrain such creativity. He writes: “overall … practicing creative accounting is not that difficult, owing to the significant grey area that exists between compliance with the rules and non-compliance or evasion…. The collusion between management, bankers, lawyers and auditors suggests that there is an avoidance industry out there which is capable of undermining the spirit behind accounting regulations.” Shah also noted that the self-regulatory nature of UK accounting standard setting, and lack of explicit legal status of financial supervision are fertile grounds for the practice of “creative accounting”.

16. The nexus between the two elements—the self-regulation of the financial industry, and the ambiguity that exists at the juncture between law and new financial practices, created a grey zone for competitive financial innovation, or, more accurately, regulatory avoidance. Thriving in this grey area, innovation has produced a skewed structure of the financial system itself. When interest rates are low, financiers are looking for other ways of making money: through commission fees, tax evasion, “creative accounting”, and outright fraud.

17. Among the many factors supporting this skewed structure of finance, in this brief, we focus on the role of regulatory avoidance in the shape of offshore finance or tax evasion, and the role of liquidity illusions in sustaining the bouts of financial speculation. These elements have been at the epicenter of the Northern Rock fiasco in the UK in late 2007, and are representative of more general trends in the financial industry today.

NORTHERN ROCK AND ITS SPV, GRANITE

18. Many recent financial crises including that in East Asia as well as scandals associated with dot com bubble, Enron, World Com, Parmalat and to some degree, Northern Rock and the 2007–08 subprime crisis have been blamed, at least in part on the opacity of current accounting practices and the use of tax haven affiliate entities for either fraudulent or opaque purposes. Opacity is benefiting those who are, as one of the directors of Enron is reputedly quipped: “the smarter man in the room”. The small investor, by definition if not the stupidest in the room, at least the one least equipped to handle complex and rapidly changing information. Opacity is used and abused in effect to shift risk from big financial institutions to society at large. Of course, scandals and frauds not only cheat investors, they leave many workers without pensions and jobs, and have contagious effects on the entire economy that ultimately bears the resulting risk without enjoying the risk premium that created it.

19. The offshore entities that seem to have caused most of the problems are the special purposes vehicles or entities (SPVs, or as they are called sometimes SPEs). SPVs raise severe prudential problems. SPV's hit the headlines following the collapse of Enron. A congressional committee investigating the Enron affairs emphasized that Enron’s fraud was organized through 3,000 SPVs. Enron set up over 800 registered in well known offshore jurisdictions, including about 120 in the Turks and Caicos, and about 600 using the same post office box in the Cayman Islands’ (Congressional 23). It appears that Enron’s offshore SPVs were set up primarily for tax avoidance purposes, although they served to hide debts as well. To be fair, despite headlines reports, neither the Powers report, nor the congressional hearings have demonstrated that conclusively offshore structures were palpably more poisonous that the onshore ones in the Enron case.

20. SPVs are often described as asset holding vehicles, they are used to park and isolate high-risk assets. These entities are subsidiaries of large companies normally established to serve as a risk management tool, such as when financing large projects. They are used primarily, or so it is argued, to reduce the cost of bankruptcy, but due to weaknesses and ambiguity in accounting they are used for other purposes as well. Financial institutions also make use of SPVs to take advantage of less restrictive regulations on their activities. Banks, in particular, use them to raise Tier I capital in the lower tax environments of OFCs. SPVs are also set up by non-bank financial institutions to take advantage of more liberal netting rules than faced in home countries, reducing their capital requirements.

21. Tax havens have made it exceedingly easy to set up offshore SPVs but crucially they do not have the resources, especially in terms of people, to perform appropriate due diligence on what are very sophisticated financial vehicles. For example, the Cayman banking system holds assets of over 500 times its GDP. Jersey holds resources of over 80 times its GDP. It seems obvious to ask whether such small jurisdictions can allocate sufficient resources to monitor and regulate such colossal sums of money. A recent report by the UK’s National Audit office has clearly suggested that they do not.105 As we all know now, after its demutualization Northern Rock became a bank and commenced an aggressive expansion path which resulted in its 2006 audited accounts showing that it raised just 22% of its funds from retail depositors, and at least 46% came from bonds.

22. For the following we are grateful for research conducted a tax expert, Richard Murphy. Murphy demonstrates that those bonds were not issued by Northern Rock itself, but by what became known as its “shadow company”. This was Granite Master Issuer plc and its associates, which was an entity owned by a charitable trust established by Northern Rock. After the failure of the company it became clear that this

charitable trust had never paid anything to charity and that the charity meant to benefit from it was not even aware of its existence. Its sole purpose was, in fact, to form a part of Northern Rock’s financial engineering that guaranteed that Northern Rock was legally independent of Granite, and that the latter was, therefore, solely responsible for the debt it issued.

23. This was, of course, a masquerade, and one that was helped by the fact that the trustees of the Granite structure were, at least in part, based in St Helier in Jersey. When journalists tried to talk to Granite employees they found there were no such employees in Jersey, of course. In fact, an investigation of Granite’s accounts showed it had no employees at all, despite having nearly £50 billion of debt. The entire structure was acknowledged to be managed by Northern Rock, and therefore (and unusually) was treated as being “on balance sheet” by that entity and was therefore included in its consolidated accounts.

24. This is by no means unusual. We include here an abridged version of a table drawn by the Irish economist, Jim Stewart who studied the Irish Financial Service Centre (IFSC). The table shows very clearly that many of these financial affiliates in the Irish “financial centre” are “brass plate” type companies used most probably for tax avoidance purposes. In fact, although the IFSC has assets about six times Irish GDP, it employs directly only 4,500 people! Such information is valuable and rare. Due to opacity and intentional secrecy we are unable to provide similar data with regards to say, Luxembourg or Singapore, let alone Bahrain, Cayman or Jersey.

<table>
<thead>
<tr>
<th>Name of ultimate parent company</th>
<th>Name of Affiliate</th>
<th>Pre-tax Profits million</th>
<th>Gross Assets Millions</th>
<th>Number of employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>3Com, U.S.</td>
<td>3Com, (Cayman)</td>
<td>$4.6</td>
<td>$153</td>
<td>0</td>
</tr>
<tr>
<td>Albany Inter. U.S.</td>
<td>A1 fin. service (Switzerland)</td>
<td>3.0 euro</td>
<td>117 euro</td>
<td>0</td>
</tr>
<tr>
<td>Airbus, France</td>
<td>Airbus, fin. ser (Netherlands)</td>
<td>0</td>
<td>E 2</td>
<td>0</td>
</tr>
<tr>
<td>Analog Development, U.S.</td>
<td>An analog Development</td>
<td>$11.6</td>
<td>$592</td>
<td>6</td>
</tr>
<tr>
<td>BBA, UK</td>
<td>BBA finance (Luxembourg)</td>
<td>0</td>
<td>$433</td>
<td>0</td>
</tr>
<tr>
<td>Boston Scientific, U.S.</td>
<td>Bost. S. Int. Fin (Netherlands)</td>
<td>$2.8</td>
<td>$312</td>
<td>0</td>
</tr>
<tr>
<td>Tyco Inter. Bermuda</td>
<td>Brangate (Lux)</td>
<td>$26.6</td>
<td>$907</td>
<td>6</td>
</tr>
<tr>
<td>Bristol-Meyers Squibb, U.S.</td>
<td>BR. Mey, Sq. Int. (Switzerland)</td>
<td>E 15.1</td>
<td>E947</td>
<td>4</td>
</tr>
<tr>
<td>Cisco Systems, U.S.</td>
<td>Cisco Fin Int. (Bermuda)</td>
<td>5 – 109.0</td>
<td>$235</td>
<td>27</td>
</tr>
<tr>
<td>Coca-Cola, Greece</td>
<td>Coca-Cola holding (Cyprus)</td>
<td>3.7 euro</td>
<td>2,179 euro</td>
<td>0</td>
</tr>
<tr>
<td>CNH, Netherlands</td>
<td>CNH, Capital (Netherlands)</td>
<td>– 6.3 euro</td>
<td>94 Euro</td>
<td>49</td>
</tr>
<tr>
<td>IBM, U.S.</td>
<td>IBM, Int. fin. holding (Netherlands)</td>
<td>$50.2</td>
<td>$2,653</td>
<td>4</td>
</tr>
<tr>
<td>Eli Lilly, U.S.</td>
<td>Kinsale Fin. (Switzerland)</td>
<td>$32.9</td>
<td>$1,409</td>
<td>1</td>
</tr>
<tr>
<td>Pfizer, U.S.</td>
<td>Prizer, Services (Isle of Man)</td>
<td>$33.6</td>
<td>$6,501</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>Pfizer int bank, Europe (Isle of Man)</td>
<td>$23.6</td>
<td>$485</td>
<td>0</td>
</tr>
<tr>
<td>Vivendi, France</td>
<td>Polygram int. (Luxembourg)</td>
<td>$22.0</td>
<td>$3,919</td>
<td>0</td>
</tr>
<tr>
<td>Sea Container, Bermuda</td>
<td>See Container, fin. (Bermuda)</td>
<td>0.5 euro</td>
<td>26 Euro</td>
<td>0</td>
</tr>
<tr>
<td>Black &amp; Decker, U.S.</td>
<td>Black &amp; Decker, int. (Netherlands)</td>
<td>$5.9</td>
<td>$888</td>
<td>7</td>
</tr>
<tr>
<td>Volkswagen, Germany</td>
<td>Volkswagen, inv. (Cayman)</td>
<td>15.9 euro</td>
<td>566 Euro</td>
<td>7</td>
</tr>
<tr>
<td>Xerox, U.S.</td>
<td>Xerox leasing (Jersey)</td>
<td>29.7 euro</td>
<td>645 Euro</td>
<td>0</td>
</tr>
<tr>
<td>General Motors, U.S.</td>
<td>RFC (Ireland)</td>
<td>$2.1</td>
<td>$108</td>
<td>0</td>
</tr>
<tr>
<td>Sigma-Aldrich, U.S.</td>
<td>Sigma-Ald. serv (UK)</td>
<td>£1.2</td>
<td>£645</td>
<td>0</td>
</tr>
<tr>
<td>INGKA, Holdings,</td>
<td>IKEA, Invest. (Netherlands)</td>
<td>SEK 53.7</td>
<td>2,052 SEK</td>
<td>1</td>
</tr>
</tbody>
</table>

The dilemma this created for Northern Rock was apparent. Granite was used to securitize parcels of mortgages on the money market through bond issues. When the money market lost its appetite for that debt in August 2007 Northern Rock’s business model failed: it could no longer refinance the debt and as a result had to support Granite in meeting the obligations it had entered into with its bondholders, even though the company was notionally independent.

25. The same confusion arose as to whether the company was onshore or offshore. In practice it included elements of both. And, when Northern Rock was nationalised the House of Commons held late night debates on whether this meant that Granite was also nationalised. The issue was never resolved. No one seemed to know whether a company wholly managed by a state-owned enterprise but notionally owned by a charitable trust registered in a tax haven was under state control, or not. Despite that, the government had little choice but extend its guarantee to the Granite bond holders.

306 http://www.parliament.the-stationery-office.co.uk/pa/cm200708/cmhansrd/cm080219/debtext/80219-0022.htm
26. The Northern Rock/Granite fiasco is an embarrassment. More significant is the confusion created by structures about ownership and risk. SPVs are often “orphaned” from their parent (through the artificial use of charitable trusts in the case of the UK) to break nominal control. This structure is however commonplace throughout the offshore world and has been widely used with regard to the securitisation of sub-prime mortgages. Northern Rock was, in fact, a relatively clean case compared to many, and yet when it failed it exposed uncertainty on how to deal with the resulting situation on the part of almost every regulator who approached the scene, and the ambiguity remains even after Northern Rock has been nationalised by the UK government.

27. What is clear is that the uncertainty this created significantly contributed to the problems that the failure of this bank caused. Moreover, what is also clear is that if the bank had been unable to issue debt in this way it was highly likely it would not have failed. The opaqueness of the arrangement, partly offshore for that very purpose, guaranteed that the risk within it was hidden from regulators and others for a considerable period. The result was serious financial, political and economic instability.

MAKING BAD DEBTS LIQUID

28. It is amazing how quickly a widely shared belief in new and better ways of managing risk can unravel as a grandiose scheme of exuberance, greed and fraud. In winter 2007, Northern Rock was valued at £5 billion; in February 2006, its shares dropped to 90p per share, pulling the value of the company down to £380 million. On 19 February 2008, the UK government announced the decision to nationalise the bank. Northern Rock, along with other high-profile victims of the financial crisis, was exposed as an element in a convoluted chain of securitisation techniques, centred on the sub-prime mortgage industry in the US, and spread globally. At heart, Northern Rock suffered from a crisis of liquidity. As the global crisis unfolded, it became apparent that the very idea of a sub-prime mortgage market was nothing but a grandiose Ponzi scheme, while the process of securitisation in fact concealed a myriad of risky, bad loans, packaged and distributed in sophisticated ways. As the securitisation boom came to a halt in the summer of 2007, observers left and right started to argue that securitisation practices had never really discovered new ways to manage or optimise risks; they merely hid them. If the real foundations of financial health were never there, why and how so many dubious debts were made liquid?

29. Some eight years ago, just as the securitisation bubble was beginning to be inflated, one of the big investors warned about specific liquidity risks faced by his own firm. Although the firm’s securitisation strategy had been based on the assumption that CMOs will be more liquid than their underlying collateral, the properties, he forewarned that this assumption is far too short-sighted, and over-relied on the market’s shared sentiments: as a guide to market discipline, we like the expression, “sure they’re liquid, unless you actually have to sell them!”

30. How come then, that against the warnings of history and even some market players, the bubble of dubious quality debt, packaged and offloaded to obscure third parties, was widely perceived as a liquidity glut? The answer, we believe, lies in the interplay of three elements: First, it was the notorious moral hazard factor and the idea that big banks are the public frontier of global finance and they will never be allowed to go bust. Second, it was the collective belief in the tradability of securitisation products shared by market players and therefore, a certain state of mind regarding the liquidity of the markets and products. And third, it was the legitimisation of these debt instruments offered to the markets by the credit rating agencies. Each of the above contains a complex set of problems, the second and third, however, are also linked to the question of OFC.

HERD INSTINCT: LIQUIDITY AS A “STATE OF MIND”

31. During periods of economic optimism, much like the periods of stress, it seems that it is the herd instinct of investors, each of whom is keen not to lag behind the competitive regulatory arbitrage of others, that sustains the market liquidity. Typically in this game, it is not the rationale of cost minimisation or efficiency that informs the decisions and actions of securitisation officers, but commission fees, the spirit of the herd, and sheer exuberance. In this herd-driven process of financial innovation, the usual trends of a bubble, or Ponzi pyramid, prevail: the under-valuation of risks, especially the liquidity risk; the aggressive expansion of new borrowings; and in many cases, the use of quasi-legal investment techniques and outright swindling.

32. Crucially, two elements in the current regulatory paradigm have aggravated the latest bout of liquidity illusion and risks inherent in it. First—associated primarily with financial deregulation—has been the sophistication of new products, for instance synthetic structures, which have eroded the transparency of the markets, both in relation to supervisory bodies, but also, importantly, at the level of counterparties. The prevalence in the securitisation spiral of obscure institutions such as hedge funds, private equity firms, the secretive sovereign wealth funds and offshore accounts suggests that anyone who is attempting to find out what precisely is held on which books, and how much is owed and to whom, belongs to an old and forgotten age of narrow banking and is hopelessly obsolete.

33. Second, the overall mode of financial governance has contributed to a great homogenisation of investment techniques. Here, the collective reliance on value-at-risk (VAR) models of valuing risks, investment practices based on the “originate and distribute” principle, and the exercise of supervision and monitoring based on the “bottom-up”, soft-touch principle of financial regulation of the 1990s and 2000s, have only exacerbated the crisis potential of the illusions of liquidity in the markets. The “originate and distribute” model of lending has reduced incentives for banks to screen and monitor the potential borrowers, and the credit risk has been under-priced. The models do not differentiate between onshore and offshore entities or products. At the same time, the CDO market (whose value exceeds $10 trillion) proved to be opaque and inefficient. It seems to have been used to “transform old accurately priced debt instruments into new ones that are overvalued”.

34. The fiasco of Northern Rock shows that dispersing the risk off the books and onto third and fourth parties does not eliminate it; in most cases, it actually aggravates it. When the “good times” end, the illusion of liquidity sustained by markets’ shared belief in continued prosperity, reinforced by benign endorsement of financial experimentation by public authorities quickly turns into a systemic crisis of unpayable debts. Which is what happened in August 2007, and continues to unravel at this time. All this, it appears, is the outcome of a long-running problem of “artificial liquidity”, or liquidity illusions that had underpinned the boom of structured finance and have become a product of financial innovation.

LEGITIMATING BAD DEBTS

35. But however exuberant, canny or short-sighted financial engineering might be, illusions of prosperity, including the liquidity illusion, can only be sustained over periods of time if there is some credibility given to new instruments. In other words, something was needed in the markets to sustain the collective belief in the liquidity of bad debts and make the complex structures of IOUs “worth—or seem to be worth—more than the sum of its parts”. That something was the credit rating agencies. Here, two processes have been at play: the so-called “vehicle finance”, driven by regulatory avoidance, manipulation of legal ownership of assets, and creative accounting mentioned above; and secondly, the engineering technique of layering securitization structures. Credit ratings agencies have been pivotal to both.

36. First, from the very beginning of the securitization boom, a central concern to ensure the marketability of securitized debt (or as most people mistook for liquidity) is to enable the rating agencies to analyse and grade the credit risk of the assets in isolation from the credit risk of the entity that originated the assets. In other words, credit rating agencies required legal confirmation that the securitized assets represented a so-called “true sale” and were outside the estate of the originator in the event the originator went bankrupt. According to Baron’s such a removal of legal “home” of assets it was absolutely essential for the approval stamp that the risk was redistributed and taken away from the originators’ books. The primary purpose of such a transfer of ownership is to prevent the seller and its creditors from obtaining control or asserting a claim over the assets following the seller’s insolvency.

37. That is where are infamous special-purpose vehicle (SPVs) come into the story—Granite. From the point of view of financial prudence and stability, such a transfer means, for example from Northern Rock to Granite, that once the assets have been isolated from the insolvency risk of the originator, there is no additional credit risk analysis required on the purchaser. In other words, the purchaser of Granite’s structured finance product should not care about the state of Northern Rock, and hence Granite’s product can be analyzed and approved in isolation. This was, of course, a sham and it is reasonable to assume that the credit agencies knew full well that such separation of ownership is most probably apparent and not real. Yet, they went “with the flow” as long as, strictly speaking, the arrangement could operate to suit their models and requirements.

38. We would like to stress that there was nothing to prevent Northern Rock from creating its own structured risk and selling it directly to third party. In this scenario, the rating for such risk would have been lower and Northern Rock inevitably would not have been able to get into such high leverage debt. We think that most of us would agree that this would have been the prudent thing to do. We can entertain another prudent scenario, namely, that Northern Rock still uses its SPV, Granite, but that the rating agencies do not accept the proposition that Granite is in fact an independent entity. But while Northern Rock acknowledged its close relationship with Granite, in principle such an approach is futile because of the great ease creating opacity and secrecy in offshore jurisdictions. A third prudent scenario would demand a certain premium of risk on offshore entities, so, for instance, they can never obtain a full AAA rating. Again, a prudential measure that anyone who has ever looked carefully into the practice of the offshore world is likely to agree with. Each of the three prudential measures discussed above would have certainly slowed down the flow of artificial liquidity and would have made things better in this financial crisis.

311 Including an insolvency official of the seller.
312 We suspect for tax avoidance, shifting profitable part of the business to low tax jurisdiction such as Jersey.
CONCLUDING REMARKS

39. Today’s financial system seems to be less about intermediating between savers and borrowers, and much more about the ability to trade risks. In such a system thriving on product and institutional innovation, risk analysis is required by credit ratings agencies, and it is in this task that according to most observers, credit agencies have failed most scandalously. Relying again, on new ways to float a series of bonds and putting less risky ones on top of the tranche, ratings agencies found a way to reward AAA ratings to obscure pyramids of dubious quality loans. According to the existing paradigm of financial regulation, risk analysis is also the task of the bankers and financiers themselves, and this is where they failed quite miserably. But now the liquidity glut the Bernanke was so worried about disappeared so quickly that central banks around the world collectively intervened by injecting US $3.5 trillion (!), of which net estimated at about $1 trillion.

40. It is difficult to legislate against such negligence or regulate it out of the system (whether the regulators have done their job, or even tried to do their job is a different matter—we believe they did not). What is clear, however, that OFCs are not making the task of easier to either. To the tax regulators they claim to be highly regulated financial centres’ to the financial regulators they claim to be merely legitimate form of low tax countries. Frankly, we see not advantage whatsoever in the continuing existence of these type of financial centres.

19 June 2008

Memorandum from Deloitte

1. About Deloitte

1.1 Deloitte is one of the largest professional services organisations in the world, and one of the Big Four auditors. Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. As of 2007, Deloitte member firms employed approximately 150,000 professionals in over 140 countries, of whom around 10,000 are in the United Kingdom (Deloitte & Touche LLP) delivering audit, tax, consulting, risk management and financial advisory services.

1.2 Deloitte professionals advise Governments and others on the creation and development of competitive financial centres, as well as a range of clients on location and other business decisions.

1.3 Among the British Crown Dependencies and British Overseas Territories Deloitte member firms have offices employing a total of around 650 people in Guernsey, Isle of Man, Jersey, Bermuda, British Virgin Islands, Cayman Islands and Gibraltar.

1.4 Deloitte do not have offices in Anguilla, Falkland Islands, Pitcairn Islands, South Georgia and South Sandwich Islands, Turks and Caicos Islands, Antarctic Territory, British Indian Ocean Territory, Montserrat, Saint Helena and Ascension Island, Tristan da Cunha, or the military bases in Cyprus (although the Deloitte Cyprus member firm employs around 350 people in the main jurisdiction of Cyprus).

2. Executive Summary

2.1 There is continuous competition, much of it healthy, between financial centres, and “onshore” and “offshore” are very much relative terms in categorising different centres and the way they compete.

2.2 Although many Financial Centres considered to be “offshore” originally developed with a culture of secrecy and by facilitating structures which helped to minimise tax, these factors have more recently played an increasingly smaller role in their success.

2.3 Many Offshore Financial Centres have already voluntarily taken steps to adopt more rigorous regulatory regimes and remove perceived harmful tax practices. There are a number of reasons underlying these actions but the three, which are probably most worthy of note are:
   — the need to respond to initiatives by the European Union (EU) and Organisation for Economic Cooperation and Development (OECD) to remove harmful practices;
   — the need to retain their competitive position (which in our experience requires adequate regulation); and
   — recognition of the fact that the failure of an inadequately regulated financial business could have a catastrophic economic effect on the Centre itself as well as the wider global economy.
3. To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?

3.1 Financial Centres arise because most financial activities develop best in “clusters”—financial businesses successfully access more—and more diverse sources of skilled labour, finance, suppliers, customers, trading partners and counterparties by locating their activities closer to other financial businesses, both in the same and in complementary sectors.

3.2 What makes a Financial Centre “offshore”? There is no single clear definition. The term suggests a financial jurisdiction where legal, regulatory, tax or similar restraints are lower than in “onshore” centres. But this description may hold true of any one Centre in some respects, but not in others. Increasingly, for example, many are seeking to adopt more rigorous regulatory regimes—as weak regulation is increasingly viewed as a competitive disadvantage.

3.3 So “offshore” and “onshore” are relative terms but all Centres have some legal requirements, however minimal and escaping onerous or uncertain legal, tax and regulatory constraints in other countries has been a major factor in London’s rise to dominance, notwithstanding that the UK has extensive requirements of its own.

3.4 If one had to choose a single criterion, we might define an offshore centre as one that is part of a jurisdiction that has few or no Double Tax Agreements (“DTA”) with other countries. This would characterise as “offshore” the territories traditionally viewed as such, but as the UK has a very extensive network of DTAs, would make London very much “onshore”. However, this is an oversimplification. Some Centres which might be considered “offshore” have attempted more recently to broaden their network of DTAs, while countries which are generally regarded as “onshore” jurisdictions with established DTA networks sometimes compete by introducing financial centre regimes in their territories with “offshore” characteristics.

3.5 From a public policy perspective, the motivation to “go offshore”, and the competition between jurisdictions which it creates, can have both healthy and unhealthy aspects. To deal with the healthy aspect first, such competition creates an impetus to reduce the “collateral damage” that any legal, regulatory and tax systems impose—prohibitions, compliance costs, uncertainties, impediments to innovation, delays for approvals or clearances, tax costs and penalties. All those create costs and/or uncertainties, reducing levels of economic activity and the benefits to which that gives rise. For example, there is competition between legal systems and very many international commercial contracts are drawn up under English or New York law, which are common law systems offering relative certainty of outcome. They are not the only legal systems which have this characteristic but they have become known and trusted for it and developed a lead in the market—a “cluster effect” again. The consequence is greater legal certainty for the whole global financial economy than if diverse national systems were followed more passively. London and the UK have also benefited from a reputation for less costly but still effective regulation as compared to, say, Frankfurt and New York, and again this competition is to the benefit of the global economy.

3.6 A very particular example of the importance of offshore centres is in the field of securitisation. For commercial reasons securitisation companies typically have very large volumes of interest income and expense, making no material profit. (Their primary function is not to make profit in their own right but to repackgate cashflows to have different risk and security profiles to appeal to different categories of investors). Notwithstanding the current impact of the credit crunch, on balance such activity has been of great economic benefit, for example in reducing mortgage costs faced by homeowners—as the increase in costs as a result of recent market conditions shows. If the expenditure incurred by such companies is not fully tax deductible against the income, an unfunded tax charge will arise, making the transaction prohibitively expensive. There is no public policy reason to impose such tax (which would in any event raise no revenue, as such transactions would then not occur). However, the complexities of many national tax regimes create a risk of it that can be expensive to address. Jersey in particular historically became an accepted location for many securitisation companies which have benefited from exempt company status there—not to shelter profits, for no material profits arise—but to achieve certainty of treatment. (Jersey gained a position ahead of other offshore centres in this respect largely because of the “cluster effect”.) Many “onshore” tax regimes, including Ireland, Luxembourg and more recently the UK have now legislated to give such companies the certainty they need, onshore. This seems a sensible, considered and positive policy (and certainly not a knee-jerk reaction to the position of Jersey) which has accommodated financial innovation without in any sense compromising national tax revenues.

3.7 The unhealthy aspect of jurisdictional competition is the threat that the desirable and necessary public policy objectives behind jurisdictional rules are frustrated—most obviously in the raising of tax revenues and in combating money laundering. We revert to this below.
3.8 As well as competing, Financial Centres may perform complementary roles, particularly where one or more of them are “niche players” which specialise in particular fields. For example, Bermuda is very strong in the area of wholesale insurance which can provide an important service to other Centres. Many Centres are locations for funds—much of whose investment management supporting activity may be performed elsewhere (“onshore”). For example, there is a great deal of investment advisory and management activity in London supporting funds located in the Channel Islands or Isle of Man.

4. To what extent does the use of Offshore Financial Centres threaten financial stability?

4.1 In general, not much, though there are inherent risks which must be kept under constant review.

4.2 As a broad statement, it is the activities of large financial businesses, especially those operating globally, which threaten the financial stability of particular jurisdictions rather than vice versa. This is not to be negative about financial businesses, which generally produce great economic benefit—but like any business they entail risks. In the case of many financial businesses, these can, if unregulated, be significant enough to threaten the stability of economic systems of individual countries or areas of the world. This is precisely why such businesses are typically subject to some level of regulation in most jurisdictions, even “offshore centres”.

4.3 On this view, the major risk to an offshore centre of operating an insufficient regulatory oversight of financial businesses is a risk to the offshore centre itself—such a centre will be excessively exposed to risks of financial instability. This is one reason why insufficient regulation is no longer viewed as a competitive advantage for a financial jurisdiction. (Other reasons are that typically an offshore regime will want its regulators to be treated as “equivalent” to onshore regulators in the way onshore regimes are applied to institutions based in that offshore jurisdiction but operating onshore; and will also want to offer a lower level of perceived uncertainty and risk to business counterparties of institutions which it regulates.) In fact, strong regulation in our experience a competitive advantage—large financial businesses place a large premium on the stability, transparency and effectiveness of a country’s regulatory systems and the extent to which it co-operates with other regulators.

4.4 This analysis leaves open the risk that financial businesses by locating activities in relatively unregulated centres will (even if the lack of regulation in such centres is not in their own best interests) undermine the effectiveness of regulation in more mainstream centres. In general we think this risk is successfully contained in practice by increasing collaboration between regulatory regimes (including, to varying degrees, those of centres characterised as “offshore”), as demonstrated by the increasing number of Memorandums of Understanding signed between national regulators, and the widespread adoption of the Basel Committee’s Core Principles for Effective Banking Supervision and increasing sophistication by national regulators in identifying the risks to their economies from the financial activities to which they play host, for example the UK Financial Services Authority’s (“FSA’s”) Financial Risk Outlook. http://www.fsa.gov.uk/Pages/Library/corporate/Outlook/fro_2008.shtml

4.5 Of course, such containment cannot be guaranteed by general statements: it requires a “Forth Bridge job” of reviewing the risks, implementing the steps necessary to contain it and collaborating with other regulators in doing so. International co-ordination bodies such as Basle and the International Organisation of Securities Commissions (IOSCO) have been effective in identifying risks, harmonising international standards, and continually “raising the bar”. However, this need for continuous review and remedial action does not fundamentally arise from the existence of offshore centres, but from the innovative nature of much financial activity. The credit crunch was triggered, for example, by a crisis in sub-prime debt in the United States, rather than (say) the Cayman Islands.

5. How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom’s tax authorities and financial regulators?

5.1 This is increasingly the case.

5.2 As far as regulation is concerned, there is an increasing tendency for national regulators, including those based in “offshore centres” as we have defined them, to enter into bilateral “Memorandums of Understanding” between each other enabling them to co-ordinate their approaches. (Clearly this involves a judgment by each regulator that it is appropriate to enter this level of co-operation with the other: where there is insufficient confidence to form this judgment, this may be viewed by the market as a signal that the regulatory environment in the “shunned” offshore centre is not all that it should be and this in turn would be a competitive disadvantage). More widely, our clients have seen examples of co-operation between home and host regulators and co-ordination of their visits. For example a client recently hosted a visit by the United States “Fed”, the State Regulator and the UK FSA to discuss their response to the credit crunch. The UK’s Financial Services Authority (FSA) is active in entering such bilateral arrangements and in debating with the EC and United States how international regulatory co-operation can be best achieved. National Regulators and their host jurisdictions are also subject to review by international bodies which publish clear reports on compliance with international norms. For example, The International Monetary Fund and the World Bank launched the Financial Sector Assessment Programme (FSAP) in 1999 with the intention of helping countries identify vulnerabilities in their financial systems and determine needed
reforms (http://www1.worldbank.org/finance/html/fsap.html). Home regulators from onshore centres will typically take an interest in the activities of any of their overseas branches or subsidiaries, capturing their financial exposures in consolidated returns. Finally, national regulators can impose requirements which in practice are effective extraterritorially—this is particularly so of United States regulators.

5.3 As stated earlier (paragraph 3.2), many Offshore Financial Centres are adopting more rigorous regulatory regimes as an absence of accepted regulation is increasingly viewed as a competitive disadvantage. In some recent jurisdictions we have seen the adoption of international regulatory norms used as a competitive advantage. For example the regulation of the Dubai International Financial Centre (“DIFC”) has a similar feel to the UK system. Its website proudly states “Created by statute and entirely independent of the DIFC, the DFSA (“Dubai Financial Services Authority”) is unique. While many regulatory bodies have been formed in response to financial crises, the DFSA has been established as a world-class regulator from the outset.” And later, “We are responsible for ensuring that the DIFC is one of the best regulated financial centres in the world.” (http://www.dfsa.ae/dfsa/about—who—we—are/)

5.4 As far as tax is concerned, Her Majesty’s Revenue & Customs (HMRC) have been increasingly effective in using domestic UK information powers to identify depositors in offshore savings institutions and where necessary improve the effective enforcement of tax laws. In general we believe information powers are a sensible way to proceed (as compared to, say, attempting to withhold tax at source) because they offer a way of identifying and combatting illegal evasion and are increasingly accepted in principle as a reasonable imposition by the markets, whereas withholding tax is a blunt instrument retaining a standard amount irrespective of taxpayers’ circumstances, and can affect and distort the market pricing of financial instruments, and can be avoided in favour of instruments which pay a gross return.

5.5 The most systematic multinational tax disclosure regime to which the UK is a party is the European Union Savings Directive (“EUSD”) which establishes reporting requirements on paying agents in respect of payments of interest to private investors. Certain countries as a transitional measure are allowed to withhold tax instead of report the information to the relevant tax authorities.

5.6 The UK has entered into agreements effectively extending the provisions of the EUSD either on a reciprocal or non-reciprocal basis with the following countries:
- Anguilla
- Aruba
- British Virgin Islands
- Cayman Islands
- Gibraltar
- Guernsey
- Isle of Man
- Jersey
- Montserrat
- Netherlands Antilles
- Turks and Caicos Islands

5.7 There has been some criticism that the EUSD is too narrowly focussed on interest payments, allowing other forms of investment returns to go unreported. The United States operates extraterritorially and with some success a reporting regime on financial institutions (known as “qualifying intermediaries” or “QIs”) holding US securities on behalf of clients. This is generally credited with an increase in the US tax take in respect of such securities.

6. To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?

6.1 Comparatively little. The reasons why some (not all) financial instruments are complex are varied, but generally speaking all complex structuring is intensive of skilled labour and is developed in the typically larger onshore “clusters” of financial activity such as London and New York. For example, London is the largest centre for derivative instruments such as swaps. An activity, or a role in an activity (whether involving simple or complex instruments) is more likely to be attracted to an offshore centre if the market needs to, or seeks to, avoid specific constraints inherent in onshore legal, tax or regulatory restrictions.

6.2 As described in section 3 above, this may be a reaction to unintended compliance costs, uncertainties or rigidities entailed in these restrictions, as much as from a desire to frustrate the intention of policy behind them. Unintended consequences are particularly prone to occur in innovative areas of financial markets because the precise products and the issues to which they give rise are harder for policy-makers to foresee. A good example of this historically was the struggle that the UK tax system (which historically divided cashflows somewhat artificially into “capital” and “revenue” items) had in dealing with the explosion of foreign exchange transactions and derivative instruments from the 1980s onwards. The uncertainties and irrationalities of tax treatment of these items led to the creation (often with official acquiescence) of offshore treasury companies (although normally in jurisdictions such as Netherlands or Luxembourg rather than
“offshore financial centres” as we have defined them). A more sensible and lasting response has been a slow and sometimes erratic, but nevertheless real, programme of reform of the traditional tax treatment to tax these activities more closely in line with their commercial profit.

7. How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets

7.1 Although many Offshore Financial Centres originally developed with a culture of secrecy and by facilitating structures which helped to minimise tax, this has more recently played an increasingly smaller role in their success. This is in part due to the fact that the increasing sophistication of onshore tax rules has meant that there is sometimes little tax benefit to moving offshore. Also, it must be remembered that Offshore Financial Centres are not the only jurisdictions with traditional banking secrecy laws.

7.2 In addition, it is possible to form an exaggerated view of the benefits of tax haven status by focussing exclusively on the relative ease of moving passive/mobile income flows away from a “host country” which attempts to tax them. This is a factor, but one which is balanced by others. Firstly, such mobile flows can potentially be taxed in the country of residence of the owner of the income, if it effectively charges tax on worldwide income and moves referred to earlier to increase disclosure of such income flows are tending to make this more effective. We accept that this balancing factor will not operate to the extent that people are able and willing to take up residence in low or zero tax countries, and this will be of concern from the standpoint of the perceived fairness of the tax system, but the numbers of people who can really take up residence in the relatively small territories concerned is inevitably limited. A second, and often ignored balancing factor is that the migration of an active financial business is far more difficult—counter-intuitively perhaps more difficult than migrating a typical “heavy industry” activity, because it may well be more labour (and skilled-labour) intensive. For such a move to be economically viable, such a business may require a considerable physical presence in the offshore location, which may not be possible for a variety of reasons (for example, the absence of other financial institutions, housing restrictions, or a lack of infrastructure, schools and other amenities, all of which deter immigration).

7.3 As in the example in paragraph 3.6 above, the key relevant benefit of a low tax rate can often be the relative certainty that it affords as distinct from any saving in tax. Transparency works both ways. A complex tax system, especially if subject to repeated unexpected change, combined with a relatively high tax rate, can be a competitive disadvantage. Correcting that disadvantage is an opportunity to pull people and activity back to the home country, such as the UK, without adversely affecting its tax base.

7.4 Another benefit afforded by some Offshore Financial Centres is their more flexible company law, which sometimes has been adapted more quickly to changing commercial requirements than in the UK. This has allowed such jurisdictions to keep apace with commercial advances (for example, products that involve a capital repayment which would not be permissible under UK company law), which in turn has increased their international attractiveness.

8. How do the taxation policies of Offshore Financial Centres impact on UK tax revenue and policy?

8.1 We would suggest that UK tax policy should continue to:

(i) strive to improve the competitiveness of the UK tax system, to the extent that this reduces the unintended costs and uncertainties, and to the extent that this does not entail “beggar-your-neighbour” policies that become self-cancelling once everyone adopts them;

(ii) adopt proportionate domestic measures to protect the revenue; and

(iii) engage in international co-operative activity through the OECD, EU and other bodies in order to counteract harmful tax competition.

These are considered in turn below. As a preliminary general point, the second and third of these recommended lines of action are of course intended to contain the risk inherent in competition between Financial Centres noted in section 3 above that such competition can frustrate the fundamental public policy objective of the collection of tax. In pursuing protection measures one must not lose sight of the fact that ultimately the capacity for extracting tax revenues from individuals and businesses derives from the fact that the UK is an attractive place to live, work and do business (and deeply, rather than superficially so). The more we reinforce this (which has implications for a range of policies from infrastructural improvements, to educational and cultural policies, and receptiveness to positive migration) the greater our capacity to levy taxes successfully and competitively will be. Specific measures of revenue protection, whether domestic or international, need to work with the grain of this underlying truth and not be pursued in “Maginot line” fashion.

8.2 As far as the competitiveness of the UK tax system is concerned, we applaud many current directions of UK tax policy toward large (including financial) businesses, including:

— attempting to measure compliance costs and using the information as a framework for assessing proposals for change and progress against these objectives;
— introducing wider use of clearances to give business greater practical certainty over tax outcome;
— seeking to align enforcement action with a transparent assessment shared with the taxpayer of the real risks to the revenue;
— specific policy changes such as the “Substantial Shareholdings Exemption” introduced in 2002 to facilitate corporate disposals, and the proposed “foreign dividend” exemption; and
— limited steps undertaken to align taxable profits with a commercial measure of profit and reduce tax distortions to decision-making.

8.3 The key areas in which much greater progress is required on this front are:
— renewed efforts to simplify the tax system which is over-engineered (even allowing for the range of purposes which it serves). For example, both existing rules and proposals on the table for taxing the foreign profits of UK based companies and banks (whether operating through subsidiaries or branches) impose high compliance burdens, and sometimes irrational tax burdens, with the whole structure of rules being completely disproportionate to the real need which is to protect the UK tax base rather than seeking systematically to tax profits arising elsewhere;
— much greater consistency in consulting about change rather than announcing significant changes every six months or so (in the course of Budgets and Pre Budget Reports) without prior warning. Again, transparency works both ways; and
— specific measures to encourage activities to be brought onshore. For example, attractive tax regimes could be devised which:
   — target the catastrophe insurance activities that, to a large extent, are currently undertaken in Bermuda and Switzerland; and
   — encourage companies to hold intangible assets in the UK.

8.4 As far as domestic measures to protect the revenue are concerned, the picture is mixed:
— On the one hand we welcome the focus from HMRC in recent times on enforcement of legal liabilities through greater use of information powers.
— In similar vein, we think that certain areas of anti-avoidance legislation traditionally deployed, such as transfer pricing, are inevitable protections that almost any developed tax system is likely to require.
— However, we think that certain areas of traditional anti-avoidance policy risk becoming counter-productive. For example, over-extensive “controlled foreign company” rules can serve to deter multinational businesses from being based in the UK in the first place. And excessive reliance on withholding tax applied to payments abroad can simply undermine the ability of UK businesses to access the international capital markets. The best protection for the revenue is to base the rules as to the application, or otherwise, of tax on real commercial criteria; to apply tax at a reasonable rate to a broad base of activities, so that it is accepted as part of the cost of living and of doing business; and to exploit the increasing willingness of the capital markets to accept and respond to the use of information and reporting powers (as the success of the United States “qualifying intermediary regime”—see paragraph 5.7 above—shows) to enforce reasonable liabilities legally due.

8.5 In the formulation of certain taxation policies and legislation, the UK may need to consider the wider international framework—for example, the need for EU compliance or the incorporation of OECD recommendations and standards. The OECD can, and has had, an influential effect on the taxation policies/legislation of Offshore Financial Centre jurisdictions (for an example see paragraph 9.2 below. In addition, both Guernsey and the Isle of Man have introduced new tax regimes to remove tax practices categorised as harmful by the OECD; and Jersey will do so from 1 January 2009). Consequently, the UK Treasury and HMRC need to continue to closely work with such organisations to ensure that, where possible, the UK position is taken into account in their output. If this can be achieved, there could be direct benefits for the UK (for example, where there is a consensus view that an offshore tax system contains harmful characteristics, this could be tackled at the root rather than the UK having to introduce complex anti-avoidance legislation which may have unwelcome side-effects such as compliance costs and may be less than fully effective in an attempt to counter its impact).

9. Are British Overseas Territories and Crown Dependencies well regarded as Offshore Financial Centres, both in comparison to their peers and international standards?

9.1 Many of these Territories/Dependancies have taken active steps to maintain their reputation and international standing through, for example, the adoption of anti-money laundering provisions and the entering into of information exchange agreements. For example, Jersey and Guernsey have entered into Tax Information Exchange Agreements with the United States and the Netherlands. These jurisdictions are also in advanced discussions with a number of other territories including Australia, New Zealand and various Nordic countries.
9.2 Partly in response to international initiatives, and partly in a defensive move to protect their reputations, many offshore financial centres now apply fairly rigorous anti-money laundering regulations to offshore business. This is evidenced by the fact that many of these Territories/Dependencies are members of the Offshore Group of Banking Supervisors, which is an observer member of the Financial Action Task Force. In addition, although many appeared on the OECD’s original list of “Unco-operative tax havens”, they all committed to improving transparency and establishing effective exchange of information in tax matters. Consequently, they no longer feature on this list which is now comprised of only three jurisdictions: Andorra, the Principality of Liechtenstein and the Principality of Monaco. More recently, the EU’s draft list of approved countries was published on the Treasury website (http://www.hm-treasury.gov.uk/documents/financial_services/money/fin_crime_equivalence.cfm). This will allow companies operating in EU countries the option of waiving some of the checks they would normally carry out on financial transactions carried out with companies abroad to ensure they did not involve the proceeds of crime. Compiled by the EU committee on the prevention of money laundering and terrorist financing, the list comprises 13 countries considered to have money-laundering legislation equivalent to that of EU countries. The list states that the Crown Dependencies, which are not part of the EU, may be considered to have equivalent standards to those of Member States, without specifically approving them. British overseas territories have been excluded altogether. The draft list has been heavily criticised by the Channel Islands, and, for example, Guernsey have put forward the view that they have been unfairly penalised due to their tax policies. We cannot attest to the validity of this specific statement but are of the strong belief that the taxation policies of a jurisdiction should not have a bearing on a review of any its other unrelated policies such as its measures to control money-laundering. Otherwise offshore centres will not be incentivised to take such measures as strongly as they should be. Moreover, if aspects of their tax policies are considered harmful, this can be addressed in other ways as described earlier in this and in the previous section.

9.3 In order to maintain their competitiveness the British Overseas Territories and Crown Dependencies need to be well regarded as Financial Centres. As demonstrated by the example in paragraph 9.2, where there is an international consensus as to any perceived weaknesses, and there is clarity surrounding the issue, these jurisdictions have shown their willingness to voluntarily rectify the position.

10. To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?

10.1 No international active financial system will be able to ensure it cannot ever be used for Terrorist Financing. A more practical objective would be to limit the use of financial systems and make it increasingly difficult to pass funds to terrorists. However, we have seen the fight against terrorist financing receive a tremendous focus by most financial institutions and by most Financial Centres, partly due to the use of the extra-territorial provisions within the US Sanctions Regime.

In summary, most offshore centres (Channel Islands, Cayman etc.) have done a great deal, some others have passed laws but done little by way of implementation, and a small minority have done even less.

In the countries we have recently worked in, this is an area of considerable focus, large financial institutions are implementing global standards and ensuring that these are enforced, laws are being introduced and enforcement regimes strengthened.

11. What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?

11.1 As far as taxation is concerned our comments are in section 8 above.

11.2 The UK has been highly successful in promoting London as an international centre in the last two decades. We have seen a weight of comment by other countries on the effectiveness of the UK regime. For example, in its recent paper the US “THE FINANCIAL SERVICES ROUNDTABLE” compares the UK system to that of the US and is highly complimentary of the UK system. It comments (pages 42 and 43) “Unless these regulatory perceptions are changed, more and more businesses and jobs likely will migrate to other regulatory venues—most notably London—that are viewed as more conducive to doing business while maintaining high, principles-based regulatory standards”.

11.3 In short, it is important that we maintain and develop the ”more principles-based regulation” approach of the FSA. It has served the UK well and we should be careful not to lose this in reaction to the Northern Rock episode.

11.4 The UK Government and the Treasury are also undertaking initiatives which attract business from offshore centres. An example of this is HM Treasury including as one of its objective for Islamic finance the desire to enhance the UK’s competitiveness in financial services by establishing London as a gateway for international Islamic finance.
12. What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres

12.1 As noted in section 3.4 above, Financial Centres that are considered “offshore” have typically been characterised by being part of jurisdictions which have no, or few, Double Tax Agreements (DTAs). Consequently, they cannot significantly benefit from such agreements, abusively or otherwise.

12.2 Jersey, Guernsey and the Isle of Man do have DTAs with the UK, which is very much an exception to the general rule. However, the provisions of these Treaties are significantly less comprehensive than the more “standard” DTA which the UK typically negotiates, which we believe militates effectively against the possibility of widespread abuse.

12.3 The position might in theory change as offshore centres become more assiduous in developing networks of DTAs or countries with such networks develop financial regimes with offshore characteristics, as noted in paragraph 3.4 above. However, the UK tax authorities are in practice alert to the possibilities of abuse of DTAs and are increasingly negotiating caveats and protections in such Agreements.

13. To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation

13.1 Traditionally as a general rule no jurisdiction, onshore or offshore, would enforce others’ tax laws. The principal exception used to be that under bilateral Double Taxation Agreements, information which had been collected for the purposes of one country’s tax system might be shared with the authorities of the other country. Professional rules of advisers which would not countenance assisting clients illegally to evade tax did not concern themselves with such a client’s position under the laws of other countries. This position has changed beyond recognition, principally in the EU because of anti-money laundering rules, whereby (for example) an adviser who suspects that a client had evaded foreign tax would be required to report his or her suspicions to the authorities without “tipping off” the client. A key determinant of how much assistance the UK will get from offshore centres in enforcing its laws against illegal evasion is the extent to which these centres have adopted anti-money laundering rules to EU standards. This is currently a live and disputed issue (see paragraph 9.2 above).

13.2 As set out in section 5 above, one of the key ways in which the UK Government can determine whether businesses or individuals are evading UK taxation is the sharing of information. It is therefore worth considering some of the enabling measures that have been introduced in the UK, and which could potentially be of benefit if they were to be replicated by the British Crown Dependencies and British Overseas Territories. These measures include:

— Exchange of information articles in bilateral Double Tax Agreements (“DTAs”)—this is covered elsewhere in this memorandum but it is worth pointing out that the DTAs between the UK, Jersey, Guernsey and the Isle of Man (referred to at paragraph 12.2 above), although limited in scope compared to other DTAs, do contain exchange of information articles. We are aware of cases where substantive information has passed between these jurisdictions and the UK under this article in the DTAs.

— The enactment of the EU Savings Directive (Statutory Instrument 2003/3297)—see paragraph 5.5 above.

— Section 125, Finance Act 1990 extended the powers in section 20, Taxes Management Act 1970 to allow the issue of a notice to provide documents and information necessary to determine a liability to tax on income or capital in a Member State other than the UK.

— The enactment of the EU Mutual Assistance in the Recovery of Debt (“MARD”) in section 135 and Schedule 39, Finance Act 2002. MARD is a reciprocal arrangement which allows one EU Member State to ask another Member State to assist in:

— obtaining information;
— serving legal documents; or
— recovering a tax or duty debt;
where the defaulting taxpayer is living in that other member state.

— Section 173, Finance Act 2006 which allowed the UK to bring into effect the OECD 1988 Convention on Mutual Administrative Assistance in Tax Matters. Previously, the UK did not enforce the collection of taxes raised by other jurisdictions outside the EU. Section 173 changed the position by providing a single power to make arrangements with another territory for the exchange of information, service of documents and assistance in tax collection in respect of both direct and indirect taxes. New agreements are brought into effect by Order in Council.

13.5 In our own business we have, as Deloitte, extensive “client take on” procedures, which reflect among other things our obligations under anti-money laundering legislation and which, we believe, are indicative of such systems put in place by many other organisations. These procedures cover the UK, Jersey, Guernsey and Isle of Man. A centralised, computerised system is used for collating and recording information to ensure that Deloitte meets its “Know Your Client” and client identification requirements. The output of the
systems is reviewed by a number of parties within Deloitte, generally ascending based on seniority, to ensure that both our external and internal requirements are met. This system complements our other activities in this area which include, for example, the requirement for all of our client handling staff to be fully aware of the Anti-Money Laundering rules. This is achieved through training and online assessment, which differs between the UK and Jersey, Guernsey and the Isle of Man to reflect the difference in the underlying laws and regulations.

June 2008

Supplementary memorandum from Deloitte

Please find below our written response to the two questions we agreed to come back to the Treasury Select Committee on.

We consider that we should also bring to your attention the fact that the audit of US Qualified Intermediaries forms part of our service line offering, and we may therefore be perceived as having a financial interest. However, as set out in the attached paper, we have recommended that any change to the UK tax information gathering powers be subject to full and open consultation, and we would expect this to include consideration of the compliance costs and appropriate enforcement mechanisms.

Question 51: Which offshore centres haven’t done enough to combat terrorist financing, and why?

Some years ago the Financial Action Task Force (FATF)\(^\text{313}\) drew up a “blacklist” of jurisdictions it considered to be non-cooperative in the fight against money-laundering and terrorist financing. In 2000 this had 15 names on it: by 2006, following changes in legislation and supervisory practices, all of these had been removed. Although this signals a big improvement in compliance, there remain some detailed improvements that are still judged necessary.

The FATF set out Nine Special Recommendations (SR) on Terrorist Financing providing the basic framework to detect, prevent and suppress the financing of terrorism and terrorist acts. FATF monitors the implementation of the SRs and assesses the effectiveness of counter-terrorist financing systems in FATF member jurisdictions through the mutual evaluation process. So far, 20 detailed country reports have been issued as part of the third round of mutual evaluations, which commenced in 2005. Overall, the results point out that more work needs to be done on the part of FATF member countries in combating terrorist financing. A summary of the third round evaluation reports are set out in Table 1 at the end of this document. As will be noted from the table, in the main, this evaluation did not focus on those jurisdictions which would traditionally be viewed as Offshore Financial Centres (OFCs). Indeed, the findings demonstrate that it is not just these traditional OFCs which need to take further action in this respect.

The biggest problem areas for countries with respect to FATF assessments seem to be SR VII on wire transfer rules\(^\text{314}\) and SR IX on cross-border activities, with nine and five countries respectively scoring Non-Compliant on these SRs.

It is not just FATF member countries who have less than perfect records of compliance with SRs. IMF’s Detailed Assessment Reports on Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT) [http://www.imf.org/external/ns/cs.aspx?id=175] also point out some problems, particularly regarding SR VII and SR IX.

Concerns about the potential risks posed by OFCs in aiding terrorism financing have been frequently raised and have in recent years been addressed by several international organisations.

Liechtenstein was the latest country to be reviewed by the IMF in relation to compliance with Combating Terrorist Financing (http://www.imf.org/external/pubs/ft/sec/2008/cr0887.pdf). While the report was on the whole quite positive, and praised Liechtenstein for its quick response to any concerns raised by the IMF, the terrorist financing regime does not appear to have been put to much use to date. For example, since 2001

\(^{313}\) The Financial Action Task Force is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing.

\(^{314}\) VII. Wire transfers—Countries should take measures to require financial institutions, including money remitters, to include accurate and meaningful originator information (name, address and account number) on funds transfers and related messages that are sent, and the information should remain with the transfer or related message through the payment chain. Countries should take measures to ensure that financial institutions, including money remitters, conduct enhanced scrutiny of and monitor for suspicious activity funds transfers which do not contain complete originator information (name, address and account number).

\(^{315}\) IX. Cash couriers—Countries should have measures in place to detect the physical cross-border transportation of currency and bearer negotiable instruments, including a declaration system or other disclosure obligation. Countries should ensure that their competent authorities have the legal authority to stop or restrain currency or bearer negotiable instruments that are suspected to be related to terrorist financing or money laundering, or that are falsely declared or disclosed. Countries should ensure that effective, proportionate and dissuasive sanctions are available to deal with persons who make false declaration(s) or disclosure(s). In cases where the currency or bearer negotiable instruments are related to terrorist financing or money laundering, countries should also adopt measures, including legislative ones consistent with Recommendation 3 and Special Recommendation III, which would enable the confiscation of such currency or instruments.
a total of five reports have been submitted to the government in relation to the monitoring of terrorism-related assets.\textsuperscript{316} To place this in context however, FATF had some similar conclusions in its recent report on Russia. As stated earlier, this issue is one that faces both “onshore” and “offshore” centres. In addition, the IMF has evaluated Liechtenstein’s compliance with SR VII on wire transfers\textsuperscript{317} and SR IX on cross-border cash movements\textsuperscript{318} as inadequate, with not even minimum requirements in these areas being met.

In its recent assessment report by the International Monetary Fund (IMF) Bermuda was marked as Non Compliant with two SRs, namely SR VII and SR IX.\textsuperscript{319} The IMF was particularly critical of Bermuda’s lenient policy towards cross-border declaration and disclosure procedures. It was noted that although seizures of cash by customs officers occur on a limited basis, currently no disclosure or declaration system for either incoming or outgoing transportation of currency is in place. However, it should be noted that around 50\% of travellers to Bermuda travel to the US and need to clear US customs in Bermuda. Therefore, effectively 50\% of Bermudan travellers are subject to border controls on cash. In addition, legislation was put in place in March 2008 enabling Bermuda Customs to put border controls over cash in place, and regulations giving effect to that legislation are currently being developed.

The scale of civil and criminal money fines was also reported as not sufficiently dissuasive. The March legislation, referred to above, increased the scale of civil and criminal penalties.

Finally in relation to Bermuda, the authorities were said not to have undertaken a review of laws and regulations related to non-profit organisations to ensure that they cannot be misused for financing terrorism.

The Cayman Islands are generally seen to have been making good progress in relation to terrorist financing, with their compliance with all nine FATF SRs assessed as either Partially Compliant or Largely Compliant.\textsuperscript{320} The following is taken from the 2007 Caribbean Financial Task Force (CFATF)\textsuperscript{321} assessment:

“In terms of the overall Anti-Money Laundering (AML)/Combating the Financing of Terrorism (CFT) compliance culture prevailing in the Cayman Islands, it was evident to the assessors that the country in general and the financial service providers in particular all have a keen sense of awareness of AML/CFT issues. Additionally the financial service providers displayed a healthy compliance culture based on an appreciation of the reputation risk of AML/CFT for the jurisdiction. The strong compliance culture was also demonstrated by the financial service providers’ proactive co-operation with the authorities in implementing AML/CFT measures”.

However, doubts have been expressed by CFATF regarding the successful implementation and use of enacted terrorist financing laws. For example, CFATF noted that the effective implementation of recently enacted regulations in relation to SR IX could be in doubt due to inadequate human and financial resources of Cayman’s Customs.

Gibraltar has also been evaluated positively by the IMF (http://www.imf.org/external/pubs/ft/scr/2007/cr07157.pdf) and was found to be Non Compliant with only one SR.\textsuperscript{322} However, a remark was made by the IMF regarding Gibraltar’s application of its provision governing freezing and confiscating terrorist assets. It was noted that despite broad legal authorities that have been successfully applied by the law enforcement community in two cases, there is a “disconnection in the financial community concerning their affirmative obligations under the UNSCR 1267 and EU regulations”.\textsuperscript{323}

Despite the good progress made by Bermuda, Cayman Islands, Liechtenstein and Gibraltar, it is important to point out that the Cayman Islands\textsuperscript{320} and Liechtenstein\textsuperscript{324} were not assessed as fully compliant with any of the nine SRs, while the other two OFCs (Bermuda\textsuperscript{322} and Gibraltar\textsuperscript{324}) have been assessed as fully compliant with only one SR. In some cases, countries have not had any practical experience in putting a system in place, even though it has been positively evaluated based on how effective it seems “on paper”.

\section*{Conclusion}

Due to the wide range of measures that are being used to assess compliance in this area, there is no simple reason why some jurisdictions have made better progress than others. However, in general terms, many countries both “off” and “on” shore do need to devote more time and attention to the combating of terrorist financing.

\textsuperscript{316} See paragraph 236, page 70 of IMF report.
\textsuperscript{317} See section 3.5.2 onwards, page 129 of IMF report.
\textsuperscript{318} See section 2.7, page 86 of IMF report.
\textsuperscript{321} See section 9, page 12 of IMF report.
\textsuperscript{322} See paragraph 9, page 12 of IMF report.
\textsuperscript{323} See page 230 of IMF report.
\textsuperscript{324} See page 121, Comments on SR IIII, of IMF report.
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NC—Non Compliant  
PC—Partially Compliant  
LC—Largely Compliant  
C—Compliant
Question 43: What is the US Qualified Intermediary regime, and how does it compare with UK section 20 notices?

Answer: The US Qualified Intermediary (QI) Regime is a regime whereby non-US financial intermediaries (including US branches of non-US entities) who generally hold US assets on behalf of investors are required to obtain documentation from the beneficial owners in order to apply the correct level of withholding tax on income (and in certain circumstances capital gains) generated by the assets. At the end of the US tax year (1 January to 31 December), all income received by the beneficial owners must be reported to the Internal Revenue Service (IRS). If the financial intermediary chooses to enter into a QI agreement with the IRS and become a QI, these reporting obligations become less onerous: only US persons are reported separately to the IRS (detailing each person’s name, taxpayer identification number and income), non-US persons are collectively reported meaning that person’s individual details are not sent to the IRS. Non-US persons for these purposes include overseas corporations that are owned by US persons, and this has been identified as a potential limitation on the effectiveness of the QI regime.

The QI regime started in 2002 when about $2bn of tax was withheld on US sourced income moving offshore. In 2003, this figure had increased to about $5 billion.

Reportable income broadly includes both dividends and interest income (unlike, for example, the European Savings Directive (EUSD) which only includes interest income) and includes corporates and individuals (again unlike the EUSD which excludes corporates). In summary, an “offshore” (to the US) QI entity whose client is a US person would be required to report annually to the IRS on the amount of income and, in certain circumstances capital, that the US person had received during the past tax year which therefore enables the IRS to police their tax return.

Thus, through the constant obligations of documentation, withholding and reporting, the IRS uses overseas intermediaries to identify and report US persons back to it on an ongoing basis.


The GAO made four main recommendations to the IRS:

1. measure U.S. withholding agents’ reliance on self-certification documentation and use that data in its compliance efforts;
2. determine why withholding agents report billions flowing to undisclosed jurisdictions and unidentified recipients;
3. enhance external reviews to include reporting of indications of fraud or illegal acts; and
4. require electronic filing in QI contracts whenever possible.

Regarding the third recommendation, the IRS recently held a conference call with six leading accounting firms, including Deloitte, to ask for their help in identifying foreign banks that fail to report US taxpayers’ identities and earnings held in non-US bank accounts.

We have not commented fully on these recommendations but included them to illustrate the fact that any regime is capable of improvement. As set out below, we would strongly recommend that if consideration were to be given to changing the tax information reporting regime in the UK, this should commence with full and open consultation. This process should allow for issues to be discussed and agreed in advance. Thereby, providing certainty and ensuring appropriate systems are developed to provide the requisite information from the outset.

In contrast, section 20, TMA 1970 notices are a request for information under primary legislation giving the power to do so (under s20(8a), TMA 1970 as the recent notices were) following approval by the special commissioners where they are satisfied that the taxpayer’s identity is not known to HMRC, there is reasonable grounds for believing there has been failure to comply with tax legislation, that the failure is likely to have led to serious prejudice in the collection of tax and that the information likely to be contained in the documents to which the notice relates is not readily available from another source.

In short, the QI regime is an ongoing compliance and reporting regime where an institution has contractually agreed with the IRS to meet certain obligations. In contrast, section 20 is a tool which has to be deemed appropriate to use to gather documentation regarding potential tax evasion, and as such is a “one off” investigative tool rather than a compliance regime per se.

Accordingly QI-type regimes would not appear to be alternatives to section 20 as they are trying to do a somewhat different job.

In considering the possible application of the lessons of the US QI regime to the UK, policy-makers would need to take into account:

— administrative costs to financial institutions;
— differences between the UK and US tax regimes (especially in the extent to which they seek to impose withholding tax in the first place); and
— the practical ability of the US to drive market practice.
However, these issues could, to some extent, be addressed in the design of any proposals for change. We would strongly suggest an open consultative approach to any consideration of such a proposal as being more likely to produce an effective result.

18 July 2008

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**Memorandum from the States Of Jersey**

**Executive Summary**

1. Jersey is well known to the Treasury Committee as a Crown Dependency with a well regulated Finance Industry on which the local economy is dependent for its economic wellbeing.

2. Where possible Jersey participates actively in international fora and has sought to establish itself among the top tier of international finance centres in terms of scale, substance and its commitment to international standards of regulation, with citations from numerous leading independent, international organisations.

3. It is Jersey’s view that:
   a. the title Offshore Financial Centres (OFCs) can be misleading. Attempts to arrive at a universally accepted definition have not been successful;
   b. OFCs form an extremely diverse group forming a spectrum of jurisdictions which overlap in terms of most relevant criteria (regulation, transparency, tax rates) with many onshore jurisdictions;
   c. all jurisdictions should be considered in terms of their levels of compliance with international standards of regulation, transparency and harmful taxation; and
   d. lower tax regimes exist in both onshore and offshore jurisdictions and promote effective tax competition.

4. Today, Jersey’s financial services industry is based on a high level of expertise and responsiveness as well as a commitment to international standards of regulation, competitive tax rates and targeted tax certainty including fiscal neutrality.

5. Jersey’s commitment to international standards of regulation means that its regulation is in the top quartile and ahead of many OECD nations. Further it has removed all elements of harmful tax competition identified by the OECD Harmful Tax Practices initiative and the EU Code of Conduct.

6. In respect of Financial Stability and Transparency:
   a. OFCs form only one part of the totality of financial “linkages” with UK financial institutions;
   b. credible threats to financial stability require scale problems typically found only in onshore economies;
   c. there is no evidence of which we are aware to suggest that OFCs in general or Jersey in particular have been or are a potential future cause of systemic financial instability;
   d. Jersey acts primarily as a liquidity centre with intra group loans to parent companies accounting for 75% of banks’ total assets. It has therefore been able to assist financial stability and act more as a solution than a problem during the recent crises;
   e. there are no grounds for suggesting that SPVs are a potential source of financial instability;
   f. many SPVs are located in OFCs because of the fiscal neutrality offered, not because of any lighter touch regulatory environment;
   g. financial stability is a global issue and international standard setters should focus on creating the clearest possible picture of linkages, identifying risks or gaps wherever they arise, not just in OFCs; and
   h. Jersey meets international standards and is ready to meet further international standards introduced as part of a level playing field.

7. In respect of tax rates and impact on the UK:
   a. lower taxes increase the return on investment and thereby increase overall levels of investment encouraging economic growth;
   b. Jersey uses tax neutrality and targeted tax certainty to attract international financial services business; and the growth in the bank deposits and other financial business in the island during the last 10 years suggests that these factors have been successful in attracting new business despite the introduction of additional regulatory, formal anti-money laundering and information exchange regimes during that period;
   c. the UK benefits directly from the circulation of significant offshore investment funds attracted to Jersey from around the world and invested through UK markets—funds that might otherwise flow to the Caribbean and US markets or Hong Kong/Singapore and Asian markets;
d. tax competition and targeted financial services allow small otherwise economically challenged jurisdictions to share in the world’s economic success; and

e. independent studies have shown that the presence of OFCs has resulted in an increase in inward investment in nearby onshore economies.

8. HM Treasury has publicly listed Jersey as a third country it considers as having equivalent anti-money laundering and countering the financing of terrorism (AML/CFT) systems to the EU standards.

9. Jersey is also extremely active in providing international cooperation on a number of fronts in terms of both international regulation as well as working with other international authorities in the fight against financial crime.

10. Responses in this submission are in reference to Jersey’s particular circumstances and should not be construed as a response on behalf of OFCs generally unless stated.

INTRODUCTION

11. Jersey will be well known to the Treasury Committee as a self governing possession of the British Crown, one of the Channel Islands. The States of Jersey, the island’s parliament, have autonomous capacity in domestic affairs.

12. Jersey has a population of c. 90,000, a working population of c. 55,000 of whom c. 13,000 work in the finance industry.

13. Jersey has a high quality finance industry with banking licenses only for banks that are in the world’s top 500 banks. It has operations belonging to the top four accountancy firms and leading offshore multi-jurisdictional legal practices who work effectively with city of London based magic circle and other legal firms.

14. The close working relationship with the City of London, means that a very significant proportion of financial flows received in Jersey will end up in, or flow through the UK with all the multiplier benefits that accrue.

15. Jersey shares a Channel Island stock exchange with Guernsey. It is recognised by the London and New York Stock Exchanges.

16. Third-party endorsements of the Island’s compliance with international standards of financial regulation, anti-money laundering and combating financing of terrorism are set out in the response to question 7.

Question 1: To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?

17. Today, OFCs account for a material element of worldwide financial assets and flows of funds.

18. Almost all funds placed in OFCs will ultimately flow through and be invested in onshore economies.

19. A significant majority of funds that are placed in Jersey are channelled through the City of London with all the multiplier benefits that will accrue to the UK economy. Those funds placed in Caribbean OFCs are most likely to benefit US markets and those in Singapore the Asian markets. In the absence of local OFCs there is no doubt that the UK economy would suffer a material loss of market share of worldwide financial flows. This has been most aptly demonstrated by the recent removal of some of the typically offshore attractions offered by the UK to the non-domiciled community in London which is now moving to alternative locations.

20. In particular, Jersey’s offer of political stability, a sound legal system and fiscal neutrality, acts as an attractive investment conduit to the UK for the significant liquidity emanating from GCC countries in the Middle East.

21. In arriving at this position as major players in worldwide financial markets, OFCs have acted as a spur to competition lowering the cost of taxation and increasing the rate of return on capital thereby encouraging additional investment which typically benefits those onshore jurisdictions that work most effectively in conjunction with the OFCs. Today OFCs have to compete in a globalised world where tax competition is universal.

22. OFCs also highlight the importance of appropriate regulation and certainty of tax regimes. As more nimble and responsive economies OFCs are often able to be more targeted with their regulation or taxation, avoiding the one size fits all approach that may operate in larger economies with the resultant additional costs. The example of the negative impact of the Sarbanes-Oxley regulation in the US has been widely debated. Separately a greater share of SPV activity would be onshore if the tax regime was more certain.

23. Jersey in particular has developed an economy based on a high degree of transparency and compliance with international standards but is able to generate significant business by offering more targeted or market focussed legislation, regulation and taxation certainty.
24. OFCs have also played a major role in dispersing risk throughout the worldwide economic system by facilitating the establishment of SPVs. Although SPVs have received negative publicity recently due to a lack of understanding in the media (discussed further in the response to next question), they do operate to disperse risk which has reduced concentration risk in major institutions. This has operated to free up funding and capital for further investment thereby expanding the overall economy.

Question 2: To what extent does the use of Offshore Financial Centres threaten financial stability?

25. Jersey, like most OFCs is more dependent on its financial services industry than onshore centres. It therefore has an active interest in all initiatives to ensure global financial stability.

26. Jersey considers that it offers no systemic or material threat to global financial stability and indeed the Financial Stability forum (FSF) has found no evidence that OFCs generally operate to provide a systemic or material threat to global financial stability.

27. Critically, in order to create serious threats to financial stability there needs to be a scale problem or the potential to create a scale problem that will typically only be found in onshore economies. The recent study by the House of Commons Treasury Committee in its Sixth Report of Session 2007-08 entitled “Financial Stability and Transparency” (The Study) refers to “global imbalances” and “a crisis of emerging market economies or failed macro-economic policies in the rest of the world” and also that “the current period of instability has its origins firmly in the most developed markets” being the failure to adequately assess the risks inherent in the US sub prime mortgage market.

28. Further The Study notes that “despite strong growth in recent years, the total size of the market of asset backed securities and sub-prime residential mortgage backed securities is small when compared to other securities markets such as those for corporate equities and corporate debt”.

29. Jersey only provides licenses to the world’s top 500 banks which on average have world leading Tier I banking ratios.

30. Further, Jersey acts primarily as a liquidity centre with intra group loans to parent companies accounting for 75% of banks’ total assets. It has therefore been able to assist financial stability and act more as a solution than a problem during the recent crises.

31. The circumstances under which the use of OFCs might threaten financial stability are therefore unclear.

32. The Study did not identify any areas of particular concern other than that “the links between offshore financial centres, the institutions and entities registered in OFCs, and the financial institutions regulated by UK authorities means that there is the potential for a further opacity to be added to the financial system, as the lines of sight to where economic risk actually lies may be obscured by the link with an offshore financial centre.”

33. The Study appeared to identify SPVs as an example of potential opacity. The Study focussed on the Granite structure, an SPV structure established by Northern Rock (NR) which has received an unfair amount of negative publicity in the media. The line of argument appears to have been that Northern Rock has had to be rescued; that Northern Rock used SPVs; that the SPVs couldn’t be refinanced causing a liquidity problem; that SPVs are a potential risk to financial stability; that most SPVs are located in OFCs; and hence do OFCs cause a threat to financial stability? We do not believe this to be the case as set out below.

34. The problems giving rise to the need to mount a rescue for NR did not originate with the Granite structure.

35. A number of facts are clear. The main problem at NR was its over-dependence on wholesale funding. Despite concerns over the business model having already been raised by onshore regulators NR continued with 75% wholesale funding (compared to a typical 20–30% for most building societies). Stress testing models did not anticipate that such funding would dry up completely. Once the default rates on sub prime mortgages shot up in August 2007 the market sentiment turned against mortgage backed securities generally and it was clear that it was going to become more difficult to refinance shorter term wholesale funding. Most banks were aware of the scale of committed liquidity lines funding mortgage assets generally and in anticipation of calls on these lines there was an expectation that overall inter-bank liquidity would be affected. In response many banks started to hoard cash thereby exacerbating the problem. Wholesale funding stopped. NR had significant on balance sheet funding that could not be replaced and they had to go to the Bank of England for support. Word of NR’s problems spread causing a run on the bank.

36. Around 50% of NR’s mortgage assets were funded through SPV structures.

37. It is fair to say that many SPVs are located in OFCs.

38. It is not fair to say that their location in OFCs added any opacity to the system as typically full information on the underlying structures is publicly available.

39. Neither in NR’s case was the problem caused by the complexity in the underlying assets which were high quality assets.
40. The problems at NR were caused by the inability to refinance certain on balance sheet wholesale funding. Arguably, if NR had securitised more of its assets this would have reduced its on balance sheet maturity mismatch and avoided or reduced the problem. It is worth noting that the maturity dates for the September 2007 note issue for the Granite structure are either 2032 or 2054.

41. The opacity is derived from the complexity of the market risks faced. In NR’s case it was the speed at which credit issues arising on sub-prime mortgages in the US were transformed into problems of funding high quality mortgages in the UK, and liquidity issues in the UK wholesale and inter-bank markets in particular.

42. SPVs can easily be located in onshore markets (indeed within the Granite Structure there are three SPV vehicles only one of which, the Mortgages Trustee, is located in Jersey and it holds the mortgages under a trust created under English law).

43. SPVs are often located in OFCs not only to obtain the benefit of regulatory regimes designed with SPVs in mind but also to obtain taxation certainty that is unavailable in onshore markets. Despite recent changes in UK taxation this remains the case in the UK.

44. If the UK tax regime were more attractive in this respect many SPVs could be located in the UK but the consequences would not have been different. In relation to Northern Rock, for example, the jurisdiction of incorporation of the Mortgages Trustee had no influence upon the events.

45. There have also been a number of other charges targeted at SPVs or the Granite Structure in particular and it is worth addressing those here.

46. The first of these is the media perception that the Granite Structure had an unfair allocation of higher quality mortgages. This suggests that there is some degree of choice about which mortgages are sold to the Mortgages Trustee in the Granite Structure. Clearly once (SPV) investors have invested on agreed terms then it would clearly be unreasonable that repaid low risk mortgages be replaced by higher risk assets. Indeed FSA regulations prohibit cherry picking of assets in this regard. The initial choice of mortgages would have been selected to meet the requirements of the investors (typically AAA notes). Critically, any mortgage assets passed to the Mortgages Trustee in the Granite Structure will be purchased with a zero risk asset, namely cash, and so it is hard to see how this treats onshore investors/depositors unfairly.

47. The second of these is that SPVs have reduced capital requirements compared to onshore banks. This view fails to understand the role of capital on a bank balance sheet where it acts as protection for those investors/providers of funds (especially retail depositors) who are exposed to risks that they have not knowingly accepted (retail depositors do not assess a bank’s range of assets prior to depositing their cash) and therefore prudential regulations require that an element of capital is required to fund those assets which would shoulder initial losses and create the security for those retail investors seeking a safe deposit. In an SPV, on the contrary the professional investors will assess the risks of their investment without the presence of a capital “buffer” and choose to invest on that basis so there is no requirement for capital. Each investor has invested in their chosen asset based on the terms offered including any credit enhancements already mentioned that are available to their tranche of investment or class of loan note issued. The credit rating of the higher rated tranches will reflect amongst other matters the credit enhancement mechanisms in place in respect of them. These commonly include provisions for the replacement of any key element of the structure (for example the liquidity facility provider) whose own credit rating is downgraded.

48. It also needs to be highlighted that in such cases (eg the Granite Structure) full public data is typically available and, in particular, all investing organisations will have had full access to complete information on the underlying investments.

49. Finally there have been suggestions that the formalities of incorporation are minimal in OFCs. In fact, incorporation of a company in Jersey has been and remains a much more complex process than incorporating a company in other parts of the world, including the United Kingdom—see further the response to the next question. By way of example, Jersey currently requires the production to the authorities of the identity of the proposed beneficial owner of the company before incorporation is allowed to proceed, and indeed this requirement has existed for over 35 years.

50. In the first instance it is therefore hard to see where financial stability issues arise from SPVs being offshore. Credit losses arising from investment in SPVs should be similar to onshore losses in similar assets, SPVs do not typically incorporate any additional gearing and onshore institutions that have established “bankruptcy remote” SPVs and have sold assets to them should have no continuing beneficial exposure (exposure to defaults, arrears and interest flows) to the assets and no continuing obligations to the loan note investors.

51. What has confused perceptions over the NR circumstances is the extent to which in other circumstances (eg as in the case with certain European banks) onshore institutions have retained continuing actual or perceived obligations to SPVs that have resulted in decisions to bring assets back on balance sheet and or the obligation to provide additional liquidity or other support to the vehicle.

52. Mention is also made in The Study of the complexity in the underlying products in some circumstances whereas in the case of the Granite Structure, whilst the structure may appear complex (primarily to separate beneficial and legal ownership and add some credit enhancement), it only involved vanilla, high quality mortgage assets and problems have not arisen as a result of product complexity.
53. Where these circumstances do apply the problem lies not with the OFCs but with disclosure or transparency within the onshore jurisdiction. Transparency in ensuring that onshore organisations adequately disclose their continuing risks to SPVs or other structures and transparency in terms of the monitoring and disclosure of investment risks arising from any product complexity.

54. Whilst The Study notes this is not an easy task as “many of the new financial instruments are ludicrously complex” and that “where such information exists, it is, as the Association of British Insurers stated often indigestible”, this appears to be a matter for international standards to ensure that such obligations are properly captured and disclosed.

55. Further information on SPVs is included at Appendix 1.

Question 3: How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom’s tax authorities and financial regulators?

56. Jersey is at least as transparent as (and in most cases more transparent than) all other offshore jurisdictions.

57. Jersey is also as transparent as most onshore jurisdictions and more transparent than some, including several OECD countries or States (political sub-divisions) of the USA.

58. All matters that are regulated in the UK are regulated in Jersey by the Jersey Financial Commission which has 33 regulatory memoranda of understanding with regulators in other jurisdictions, including four with the UK.

59. Jersey can reasonably claim to be a world leader in the regulation of Trust and Company Service Providers (including company formation agents) which are not regulated in most onshore jurisdictions including the UK and the US.

60. Jersey requires banking confidentiality, like the UK, but it does not have any banking secrecy or domestic interest test laws.

61. Bearer shares are prohibited in Jersey.

62. Jersey has only recently introduced pre-incorporated companies available on demand. This practice has been commonplace for some time in other jurisdictions including the UK. It has now been permitted in Jersey because those who incorporate companies are themselves required to be regulated persons and have to provide details of beneficial ownership and satisfy the requirements of the Control of Borrowing (Jersey) Order 1958, which allows the JFSC to request details of the ownership of, or interests held in companies, limited partnerships, and unit trusts at the time that they are established.

63. As in most onshore jurisdictions Jersey retains no register of trusts but the proposed activities of all companies incorporated are required to be disclosed to the regulatory authorities prior to incorporation. SPVs established as plcs are also obliged to file accounts with the public registry.

64. Jersey requires that beneficial ownership for all corporate vehicles (companies, trusts and partnerships) is available.

65. Jersey has been an active participant in the EU Taxation of Savings Directive, signing bilateral arrangements with each of the EU member states.

66. Jersey has a track record in respect of providing information concerning criminal matters arising in other jurisdictions.

67. Jersey is one of 35 jurisdictions that has made a commitment to improving transparency and the effective exchange of tax information for civil matters and is working actively with the OECD Sub-Group on Level Playing Field Issues as a Participating Partner with the aim of speeding up progress towards a level playing field.

68. Jersey has signed Tax information exchange agreements with the US and the Netherlands and expects to sign up to nine further TIEAs during 2008 assuming that benefits sufficient to compensate for proceeding ahead of the level playing field can be agreed. Jersey has a track record of dealing effectively with every request received under such TIEAs.

69. Jersey has responded fully on all TIEA requests received to date other than the three that continue to be worked on.

70. Additionally, Jersey receives monthly requests from Her Majesty’s Revenue and Customs for information requested under its Double Taxation Agreement (DTA) with the UK. Jersey provides regular assistance on such requests.

71. Jersey stands ready to explore the introduction of any additional internationally agreed measures of transparency that are introduced as part of a level playing field.
Question 4: To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?

72. Product innovation of this nature is typically developed onshore and within major investment banks in major financial centres in particular.

73. Jersey’s business model typically relies on onshore innovation being adapted for the offshore market. The reason why complex funds may be based offshore are for the same reason as simple or straightforward funds are based offshore and that is the fiscal certainty offered and the market related regulation imposed.

74. Therefore as far as we are aware, the growth in complex financial instruments do not rely on OFCs.

Question 5: How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets?

75. Jersey has for some time, realised that a commitment to transparency is an integral part of its proposition as a premier OFC and as a leading international finance centre, committed to international standards.

76. This positioning has served Jersey well for many years and it is increasingly clear that this is the only viable long term strategy.

77. Overall regulation in Jersey is now market leading, best illustrated by the many international citations set out elsewhere in this submission.

78. Jersey’s commitment to high levels of compliance with international standards and international cooperation has established itself both as a premier brand within OFCs but also as an international finance centre that competes directly with onshore jurisdictions for quality business from across the globe.

79. Today, Jersey’s economy depends on providing a quality range of financial services that meet international standards. Whilst lower taxation and greater taxation certainty is a part of the overall proposition, Jersey is able to compete with all jurisdictions offering the following proposition:

- top level experience across a range of products and services;
- banking services only from top 500 banks from around the world;
- substantial operations for each of the top four and other leading accountancy practices;
- leading multi-jurisdictional legal practices that work closely with London’s magic circle lawyers;
- the leading centre for regulated trust services;
- political and economic stability and democracy;
- an established and well understood legal system;
- English;
- a 40 year track record; and
- a flexible time zone with excellent transport links to and proximity to the UK and the City of London.

80. However, Jersey has not always been in this position. Small jurisdictions face many challenges in becoming self sufficient and avoiding the need for financial support. Driven by a lack of natural resources or physical capacity to attract substantive physical or labour intensive activity, OFCs were initially encouraged to establish simple primarily deposit based financial services businesses but more recently have developed the capabilities to develop high quality financial services businesses and compete with the more established financial centres.

81. Initially, the main driver of this growth was tax competition and lighter regulation.

82. OFCs have provided and continue to provide lower tax for residents and local businesses and zero taxation or fiscal neutrality for non resident owned businesses.

83. Jersey’s has shared this success with the City of London and the wider UK economy as funds have typically been invested in or have flowed through the City of London and have circulated there or have been used to boost investment.

84. In response to this competition, onshore jurisdictions have been lowering their corporation tax rates and some such as Ireland have introduced similar corporate tax regimes eg at 12.5% and the UAE have used their 0% environment as the basis for a comprehensive drive to build financial services businesses.

85. Further, the so designated “harmful” elements of differentiated tax rates in Jersey for local and non resident owned businesses have been removed in line with the recommendations by the OECD Harmful Tax initiative and the EU Code of Conduct.

86. The tax advantage offered by OFCs is therefore being steadily eroded and captured by major nations.

87. Tax competition and tax certainty have therefore been pillars of Jersey’s past success and are likely to play a critical part of Jersey’s continuing strategy. Recent competitive responses however have confirmed that a commitment to transparency and quality business is the only long term credible strategy.
Question 6: How do the taxation policies of Offshore Financial Centres impact on UK tax revenue and policy?

88. Tax competition typically leads to a headline loss of tax as do tax incentives, allowances etc. as with the remittance basis offered to UK non domiciled individuals. However, it is clear that the purpose for providing such incentives the world over is the belief in there being a net economic benefit from the additional activity thereby encouraged.

89. Tax competition within the EU and from jurisdictions across the globe have a direct impact on UK tax revenue.

90. Similarly it can be assumed that as OFCs compete with the UK for taxable income the immediate impact on UK tax revenue is negative.

91. However, as already stated, and in contrast to the impact of competition from elsewhere, much of the benefit obtained by Jersey is then duplicated as financial flows are reinvested in onshore markets either directly or via the city of London.

92. Appropriate structuring also allows onshore and offshore jurisdictions to work effectively together to lower the cost of taxation and thereby capture a greater market share of worldwide mobile investment and to boost inward investment.

93. A number of studies (see response to question 9) have shown that onshore markets that are geographically close to OFCs and work effectively with them have succeeded in boosting inward investment.

94. OFCs compete actively between themselves and with most onshore jurisdictions for the provision of financial services and to secure market share in financial assets.

95. Those financial assets are then typically invested in or circulated through the leading financial centres.

96. Jersey and the other CDs probably account for over a £1 trillion of financial assets, a significant proportion of which will be invested in the City of London, at the same time consuming closely related financial services such as banking, foreign exchange, money transfer, insurance, accounting and legal services etc.

97. Business lost to competing OFCs or onshore jurisdictions in the Caribbean or in Asia will end up supporting other financial centres such as New York, Hong Kong, Tokyo, Zurich.

Question 7: Are British Overseas Territories and Crown Dependencies well-regarded as Offshore Financial Centres, both in comparison to their peers and international standards?

98. Jersey is well regarded as an OFC and has obtained numerous citations for its commitment to international standards:

— The review of the Island’s financial regulation undertaken in 1998 set out in the Edwards Review which confirmed that the arrangements in place at that time conformed in large measure to the internationally accepted standards of financial regulation.

— The FATF style mutual evaluation undertaken in 1999 by a team drawn from the United States, France and Malta which concluded that Jersey was close “to complete adherence” with the then FATF Forty Recommendations.

— The FATF decision in 2000 to exclude Jersey from its list of non-cooperative countries and territories.

— The Financial Stability Forum’s (“FSF”) decision in 2000 to place Jersey in Group 1 of the Offshore Financial Centres (“OFCs”) reviewed. This group included jurisdictions which were described as cooperative, with a high quality of supervision which largely adhere to international standards.

— The International Monetary Fund (“IMF”) report in 2003 when the Island was assessed as part of the OFC assessment programme which concluded that the Island’s financial regulatory and supervisory system complies well with all the main international standards.

— Following their May report entitled “Managing Risk in the Overseas Territories, the chairman of the Commons Public Accounts Committee, Edward Leigh, stated: “In most of the territories, the standards of regulation across areas such as banking, money laundering, insurance and securities are not as good as those in the crown dependencies”.

— In his testimony before the Senate Finance Committee on Offshore Tax Evasion in May 2007, Jeffrey Owen, Director of the OECD’s Centre for Tax Policy and Administration singled out Jersey and Guernsey as examples of jurisdictions thatr have implemented high standards of transparency.

99. Jersey is therefore seen as one of the leading, if not the leading offshore jurisdiction in terms of its commitment to international standards and its role as an international good neighbour.

100. In the context of international cooperation in criminal matters, the island has never been treaty based, but as a study of the Attorney General’s reviews will show, the Law Officers do receive requests annually from other countries including the UK, all but a very few of which are processed on a timely and
constructive basis with relevant information supplied to the enquiring jurisdiction as a result. Jersey Law Officers have participated regularly in the European Judicial Network’s activities and are pleased to operate actively within it. The Attorney General gave a presentation on the subject of trust law in the common law jurisdictions to the EJN meeting hosted by the UK during its presidency of the EU, held in Edinburgh in December 2005. In addition, though the island is not within Eurojust, the Law Officers have had useful dialogue with Eurojust in individual cases and worked proactively and collaboratively with other EU countries in particular investigations. The island also participates in the Mutual Legal Assistance Forum, chaired by the Judicial Cooperation Unit of the Home Office, in London, and in the Channel Islands—French Law Enforcement Liaison Group, established to ensure practical and close cooperation between those responsible for this area of international business. Further afield, the Law Officers have had for many years a very good working relationship with the Department of Justice in Washington and are hopeful of developing equally good relations with their colleagues in leading EU Member states.

101. Further, Jersey is often regarded more favourably than many offshore and several OECD nations in terms of international compliance.

102. The International Trade and Investment Organisation (ITIO) commissioned a report on Assessing the Playing Field—International Co-operation in Tax Information Exchange. A study was undertaken by Camille Stoll-Davey of Oxford University as a basis for the report, which was published recently by the Commonwealth Secretariat. The report disproves the contention that offshore centres have inferior regulation or standards to onshore ones. It is based on an analysis of objective data compiled by the Organisation for Economic Cooperation and Development. It finds that in key areas such as a willingness to exchange tax information or to identify who is behind companies or trusts, OECD member countries do not operate to a higher standard than OFCs and in some cases they operate to a lower standard.

103. Jersey is also co-sponsoring a study on the taxation and regulatory arbitrage of OFCs in Europe by the independent think tank, the Centre for European Policy Studies (CEPS). The project will be led by Rym Ayadi, Head of Research of the Financial Institutions and Prudential Policy Unit at CEPS. Jersey is confident that this independent study will further confirm its commitment to international standards.

104. Jersey legislation does not require bi-lateral agreements to be in place in order to cooperate internationally. Nevertheless, the JFSC has concluded 33 bilateral memoranda of understanding with overseas financial services regulators. The purpose of each memorandum is to establish an agreed mechanism under which both signatories commit to using their statutory powers of cooperation.

105. In addition, the JFSC has concluded a letter of intent with the Hong Kong Securities and Futures Commission and Statement of Cooperation with the China Banking Regulatory Commission.

106. In March 2003, Jersey was also amongst the first jurisdictions to become a signatory to IOSCO’s multilateral memorandum of understanding. The memorandum sets a benchmark for cooperation on combating securities and derivatives violations, and commits the Island to sharing a wide range of information about the illegal use of the securities and derivatives markets with securities regulators in other countries. Before signing the memorandum, the JFSC had to satisfy IOSCO that it has the necessary laws, powers and practices to cooperate effectively in investigations.

107. The JFSC also works closely with the Wolfsberg Group, an association of eleven global banks, which develops industry standards for “Know Your Customer and AML/CFT policies.

108. The JFSC is also committed to engaging with the international regulatory community and is a member of IOSCO, the IAIS, and the Offshore Group of Insurance Supervisors (“OGIS”).

109. Officers of the JFSC sit on IOSCO Standing Committee 5 (investment management) and also the Implementation Task Force, which developed the Methodology used to assess compliance with IOSCO’s Objectives and Principles. An officer of the JFSC also sits on the IAIS’s pensions committee and OGIS’s management committee.

110. The JFSC has been a member of the OGBS since its creation in 1989, and has played a leading role in the OGBS’s anti-money laundering programme; particularly through the OGBS Chairman Colin Powell, who is also Chairman of the JFSC.

111. Through its membership of the OGBS, the JFSC works with the FATF and Basel Committee. The JFSC’s Chairman attends FATF meetings. Most recently, the Chairman co-led the typologies project on the misuse of corporate vehicles, the report on which was published in October 2006. The JFSC’s Chairman also co-chaired the Basel Committee Working Group on Cross-Border Banking, which has issued a number of papers including a paper on “Cross-Border Banking Supervision” and in 2001 a paper on “Customer Due Diligence for Banks”. The OGBS is also involved in Interpol’s Working Group on Anti-Money Laundering and Terrorist Financing.

112. As part of the OGBS, the JFSC has also participated in the development by the OGBS of a statement of best practice for trust and company service providers.

113. Jersey’s Companies Registry is a member of the European Business Register—which provides easy access to reliable information on companies all over Europe.
114. The Companies Registry is also a member of the European Commerce Registries’ Forum (“ECRF”) and has actively taken a lead in two projects: provision for a standard certificate for companies that continue in other jurisdictions; and provision for a multi-lateral memorandum of understanding between registries. The Companies Registry is also responsible for the management and modernisation of the ECRF website.

115. The Companies Registry also supports the Business Registries Interoperability through Europe project (“BRITE”), which is funded by the EU and intended to improve communication between European registries.

116. The JFCU is a member of the Egmont Group, an international affiliation of FIUs which was established in 1995 to combat the threat of money laundering. It is also a member of the Camden Asset Recovery Inter-Agency Network (“CARIN”) and sits on CARIN’s steering group. The JFCU actively participate in developing the role of CARIN to identify best practice and promote cooperation in tracing assets that are the proceeds of crime, drug trafficking and funds used to promote acts of terrorism. CARIN coordinates an informal network of recognised experts in the field of asset tracing with one law enforcement and one prosecution representative from each jurisdiction. The representatives act as a focal point to issue advice and guidance to CARIN members seeking to identify methods, best practice and legislation to trace and restrain assets in another jurisdiction.

117. The Island is effectively a member of the OECD through the UK’s membership and an official declaration of the Island’s association in 1990, whereby decisions and recommendations adopted by the OECD are extended to the Island, such as the Codes of Liberalisation on Current Invisible Operations and on Capital Movements.

Question 8: To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?

118. In a “Common Understanding” published in May 2008, the EU’s Committee on the Prevention of Money Laundering and Terrorist Financing stated that “the UK Crown Dependencies may be considered as equivalent by Member States”

119. Subsequently, HMT has publicly listed Jersey as a third country it considers as having equivalent AML/CFT systems to the EU. The list is relevant to assessing whether a jurisdiction is equivalent for the purposes of simplified due diligence and this applies to both AML and CFT.

120. Jersey has a good record of suspicious activity reporting (SARs) and dealing with requests from other jurisdictions. Volumes are currently c.1,500 per annum (3,571 from regulated businesses during 2005–07) and c 500 per annum respectively and details have been published for several years now on the Jersey police website.

121. Prosecutions tend to be concluded in other jurisdictions but Jersey concluded seven in 2007 and 25 during the period 2004–07 and provides active support to other jurisdictions throughout their processes where required.

122. Jersey has introduced The Terrorism (United Nations Measures) (Channel Islands) Order 2001 in order to make it an offence to collect for, or make funds available to, terrorist organisations, and to enable it to comply with UN Security Council Resolutions. In addition, the island passed the Terrorism (Jersey) Law 2002, which is modelled upon the UK Act, with some exceptions in respect of matters thought unlikely to be of practical relevance locally, and consideration is being given to updating that legislation in the light of amendments which have more recently been adopted in the UK.

123. The Island requested the UK in 2003 to extend to Jersey its ratification of the International Convention for the Suppression of the Financing of Terrorism, and has subsequently renewed that request on several occasions. Unfortunately that extension of the ratification has not yet happened, but it is hoped that the matter is being addressed imminently. Jersey’s request for that extension is evidence of the island’s commitment to the standards set by that Convention.

124. More detailed information on Jersey’s approach to Anti-Money Laundering and Countering the Financing of Terrorism is set out in Appendix 2.

Question 9: What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?

125. HM Treasury policy will undoubtedly consider tax competition across the globe. Tax competition is brought about not just by OFCs but by many countries including, Ireland, Switzerland, new EU member states as well as Gulf states and elsewhere.

126. By way of illustration, a study by the recently formed UK government Department for Innovation, Universities and Skills (DIUS) reported that large British Companies pay more in corporate taxes (12%) than their competitors in Germany (6%), France and Switzerland (8% each).
127. Also the recent selection of Ireland as the tax residence for Shire Pharmaceuticals and United Business Media has demonstrated that an inability to offer a competitive corporation tax environment is likely to result in a steady erosion of the number of large companies, content to remain tax resident in the UK.

128. On the other hand, a study published in 2006 by Mr Hines of the University of Michigan and Mr Desai and Fritz Foley of Harvard Business School entitled “Do tax havens divert economic activity?” found that OFCs boosted economic activity in nearby onshore markets rather than diverting it.

129. The Economist report dated 24 February 2007 concluded that the interaction (between onshore and offshore jurisdictions) increased total economic activity in the world and thereby both offshore and onshore jurisdictions benefit.

130. In a paper by Andrew Rose and Mark Spiegel in October 2007 for the National Bureau for Economic Research entitled “OFCs—Parasites or Symbionts?”, it was found that of the banking sectors of the 221 countries studied that the nearer a country or territory was to an OFC the more competitive and efficient its banking system appeared to be.

131. In reviewing potential responses to tax competition from EU member states and further afield, perhaps HM Treasury might consider exploring what opportunities exist to work more closely with local OFCs to mutual benefit.

Question 10: What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres?

132. Jersey has two full double tax agreements: one with Guernsey the other with the UK; and a very limited treaty with France in relation to shipping and transport.

133. The UK DTA was signed in 1951 and is limited in its operation. In particular, there are no provisions relating to income from immovable property, dividends, interest, royalties or capital gains. Furthermore, there are no tie-breaker, discrimination, or pension clauses.

134. Due to the limited nature of the agreement, there is little scope for wide spread double tax arrangement abuse. It should further be noted that Jersey was not a jurisdiction in which to locate offshore trading partnerships which was subject to a clamp down in this year’s UK finance bill.

135. On the other hand, many less transparent OECD nations have wide double tax treaty arrangements eg Luxembourg and Switzerland, well as Singapore and UAE despite the latter being a zero tax regime.

Question 11: To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?

136. Legislation allows the Jersey Authorities to investigate all kinds of fraud, money laundering and tax evasion. By and large, the Authorities do not investigate tax evasion in the United Kingdom, because that is not an offence within the jurisdiction of Jersey which one could prosecute here. It is also the case that Island Authorities do not have the basic information which would be required, in most cases, to carry out those investigations themselves. The Island’s policy is entirely consistent with ordinary principles of exercising an independent criminal jurisdiction that the investigating authorities concentrate their efforts in relation to offences which they are able to prosecute before their domestic courts.

137. Accordingly, Jersey approaches these matters in exactly the same way as the United Kingdom would approach the question of an investigation of businesses or individuals that appear to be evading taxation in some other jurisdiction—which might include evading the tax laws of Jersey.

138. This is not to say however that the Authorities in Jersey turn a blind eye to the evasion of UK taxation, nor do they act in any sense unco-operatively in this connection. First of all, the money laundering offences contained in the Proceeds of Crime (Jersey) Law, 1999, include the money laundering of the proceeds of tax evasion, wherever that tax evasion takes place, including tax evasion in the United Kingdom. Accordingly, among the suspicious activity reports filed by Jersey financial services businesses with the States of Jersey Police are included suspicious activity reports in relation to suspected UK tax evasion, and intelligence is shared appropriately.

139. Furthermore the Jersey Financial Services Commission regard it as part of their regulatory function to crack down on businesses which do not have sufficient anti-money laundering controls and defences, and therefore are alert to any problems which arise from businesses assisting illegal activity such as tax evasion, wherever that evasion might have taken place. As Jersey’s regulatory regime extends beyond that which exists in the United Kingdom and includes regulation of the provision of trustee services and company administration, the defences against Jersey businesses being used for the purposes of encouraging tax evasion elsewhere are robust.
140. None of this is to say that taxpayers in the UK do not abuse the services of financial services businesses established in Jersey to evade their tax liabilities. If the positions were reversed, the Jersey Authorities would suspect that there may be English practitioners in the financial services industries which assist Jersey taxpayers in evading their Jersey taxation liabilities. The issues which arise are:

(a) Does government encourage such activities?

(b) Assuming such activities are discouraged, what steps are taken when evidence arises of the activity taking place?

141. For the reasons given above, the Jersey Authorities are clear that financial services businesses in Jersey are actively discouraged from taking steps which would assist taxpayers in other jurisdictions from evading their taxation liabilities. This is a statement of general application, but of course it applies particularly to the United Kingdom.

142. Our experience shows that the Island Authorities have in fact assisted United Kingdom Authorities considerably in relation to criminal tax enquiries. Since 1999, the Attorney General has received annually from other jurisdictions including the United Kingdom between 74 and 120 new requests. In 2007, there were 77 new requests. In addition to those, the Attorney General received 67 supplementary requests seeking more information in relation either to the requests made in 2007 or those made in earlier years. Of the 77 new requests received in 2007, 31 were from the United Kingdom. These concern a range of criminal offending, but they certainly include tax evasion and benefit fraud. All of the United Kingdom requests made in 2007 resulted in mutual legal assistance being given fully and speedily. By contrast with some other jurisdictions, which are much slower in handling such requests, Jersey turns round the requests for assistance on average within two to three months.

143. As an example of the proactive and co-operative stance which exists in practice in this area of governmental business, reference is made to the case involving a Mr. Peter Michel, an accountant running his own business in Jersey under the name and style of Michel & Co. It became apparent in or about 2001 that Mr. Michel’s business included a number of money laundering operations the purpose of which was to assist UK taxpayers in evading their liabilities. The taxpayers themselves were the subject of Inland Revenue enquiries in the United Kingdom. In Jersey, an investigation was commenced by the Attorney General using his powers under the Investigation of Fraud (Jersey) Law, 1991. In the course of that investigation, all the business records, including the computer hard drive, were seized. A copy of the hard drive was provided to the Inland Revenue under certain conditions, the most important of which was that the information so disclosed could only be used for the purposes of criminal tax investigations or prosecutions. This was necessary because the Attorney General’s statutory powers in Jersey to obtain the information were similarly circumscribed. However, the sharing of that information is a clear illustration of the type of co-operation which the Jersey Authorities do in practice give to UK Authorities with the responsibilities of investigating criminal UK tax evasion.

144. Furthermore, the investigation of Mr. Michel resulted in money laundering charges being brought against Mr. Michel in the Royal Court of Jersey. He was convicted of 10 counts of money laundering and was sentenced to six years imprisonment. In addition, there were confiscation orders and orders for costs.

145. The Jersey Authorities are in no doubt that they do not only require extensive amounts of information to be retained by financial services businesses; that such businesses are required to demonstrate high levels of probity in order to obtain the appropriate registrations enabling them to be in business at all; and that when requests are received either for mutual legal assistance or for regulatory assistance, the Island Authorities deal with such requests co-operatively, promptly and fully.

146. Mention should also be made of the Civil Asset Recovery (International Cooperation) (Jersey) Law 2007, the purpose of which is to confer on the island’s competent authorities the power to serve summonses on residents of external civil asset recovery process from countries outside Jersey, to collect evidence and transmit it to the requesting authority, to make property restraint orders in support of external civil asset recovery orders and to register and enforce such orders in the Royal Court. The enactment of this legislation fills a gap in the ability to assist other countries in cases where there is no criminal forfeiture process but a civil asset recovery system in lieu.

19 June 2008

APPENDIX 1

THE ORIGINS OF SPVS AND THEIR OPERATION

1. The recent study by the House of Commons Treasury Committee entitled Financial Stability and Transparency (The Study) notes the shift from an “originate and hold” to an “originate and distribute” banking model has become well established in response to surplus global liquidity “in search of yield”.

2. SPVs are therefore established to meet the dual needs of the investor and the loan originator, being the appetite for higher yield that SPVs offer and the need to free up capital and funding to expand the origination business respectively.
3. At one level the process is not dissimilar to the more traditional business of the sale of loan portfolios between banks. In each case there is a willing professional buyer who is seeking a specific type of asset and a seller who is trying to free up capital and funding for further business.

4. The difference in the case of an SPV is that there typically exists a variety of investors with different risk reward appetites but none of which are interested in buying the whole portfolio. The portfolio is therefore “securitised” ie it is turned into securities.

5. As The Study notes the “search for yield” has resulted in a significant appetite for higher yield AAA assets. The underlying portfolio is not of AAA standard and so an SPV is used to structure the investment options some of which will have much lower risk than the overall portfolio including AAA assets and some of which will face risk that is much higher than the overall portfolio. The higher is the quality of the underlying portfolio, the easier this is to do and the greater will be the proportion of AAA investment created.

6. Creating the AAA investment is often achieved by providing other benefits to the SPV to reduce the risk to an investor eg by providing credit enhancement by in the form of insurance, or additional collateral such as by providing guarantees or undertakings from the previous owner of the portfolio being securitised.

7. In the case of the Granite structure it is understood that NR had made the decision to securitise its higher quality assets to limit the levels of credit enhancement that would have need to have been provided (at an additional cost to NR) if lower quality assets had been used as has been the case in the US with the greater levels of origination of sub-prime or higher risk mortgages.

8. The result whichever route is selected is that a number of independent professional investors operate to buy the whole portfolio of assets by each buying their preferred loan note that matches their risk reward profile.

9. The bank has therefore sold the assets to a third party and has received cash in return and should have no further exposure to the assets and therefore does not need to hold capital against those assets.

10. This situation is often assisted by creating an orphan (bankruptcy remote) asset via the use of a charitable trust (the charity being used simply to provide a beneficiary to ensure that the trust does not fail, not because it imparts any tax benefit). In this way the onshore institution does not own the SPV thereby removing any obligations to hold capital against the sold assets or any parental responsibility to make good losses in the SPV.

11. This is fairly standard practice whether such structuring operates onshore or offshore. As the SPV is simply repackaging interest flows (so that interest expense exactly equals interest income) there should not be any profit or taxation consequences. Locating offshore in a fiscally neutral environment confirms and avoids any unintended taxation arising.

APPENDIX 2

DETAILED INFORMATION ON JERSEY’S APPROACH TO ANTI-MONEY LAUNDERING AND COUNTERING THE FINANCE OF TERRORISM (AML/CFT)

1. Legislation criminalising money laundering and terrorist financing has evolved over time, initially recognising drug trafficking and some terrorist funding as predicate offences, and now covering all predicate offences for which a person is liable on conviction to imprisonment for a term of one or more years (including more specific terrorist financing offences) (referred to as “serious offences”). In common with other jurisdictions, Jersey’s framework continues to develop, and the Island is in the process of revising and updating its legislation in line with the revised 40 Recommendations and 9 Special Recommendations of the Financial Action Task Force (the “FATF”)—which Jersey has formally endorsed.

2. All natural and legal persons are covered by Jersey’s AML/CFT framework. In addition, certain obligations are imposed on persons that conduct financial services business—as defined in Schedule 2 of the Proceeds of Crime (Jersey) Law 1999 (“Proceeds of Crime Law”) (and hereafter referred to as “financial services businesses”). These obligations are set out in the Money Laundering (Jersey) Order 2008 (“Money Laundering Order”).

3. The most important statutes are the Proceeds of Crime Law, the Drug Trafficking Offences (Jersey) Law 1988 (the “Drug Trafficking Offences Law”), the Terrorism (Jersey) Law 2002 (the “Terrorism Law”), and the Money Laundering Order. Together with the Guidance Notes and Handbook, these are referred to hereafter as “AML/CFT legislation”.

4. The Handbook sets out regulatory requirements—which are considered to be “enforceable means issued by a competent authority”—in areas that the FATF does not require Recommendations to be set through law or regulation. Currently, these requirements are enforceable on registered persons and on the approval of new law by the Privy Council and the law coming into force, non registered persons, eg lawyers, accountants, estate agents, and high value goods dealers. Oversight is and will be conducted by the JFSC.

5. Other laws have been introduced in response to measures taken by the United Nations. The Terrorism (United Nations Measures) (Channel Islands) Order 2001 makes it an offence to collect for, or make funds available to, terrorist organisations, and the Al-Qa’ida and Taliban (United Nations Measures) (Channel
6. Other laws allow the Island to cooperate fully where financial crime has been committed outside Jersey.

7. In addition, legislation also provides for an ongoing assessment of the “fitness and properness” of registered persons under the following laws: the Collective Investment Funds (Jersey) Law 1988 (the “Funds Law”), the Banking Business (Jersey) Law 1991 (the “Banking Business Law”), the Insurance Business (Jersey) Law 1996 (the “Insurance Business Law”), and the Financial Services (Jersey) Law 1998 (the “Financial Services Law”) (hereafter referred to as “regulatory laws”). The Financial Services Law covers investment business, trust company business, and general insurance mediation business, and an amendment to the law recently extended its scope to include money service business—bureaux de change, money transmission, and cheque cashing activities.

8. Also relevant, and peculiar to Jersey (and also Guernsey), is the Control of Borrowing (Jersey) Order 1958, which allows the JFSC to request details of the ownership of, or interests held in companies, limited partnerships, and unit trusts at the time that they are established. This power has provided a useful deterrent to money launderers and was commented on favourably by the Organisation for Economic Co-operation and Development (the “OECD”) in its report on the misuse of corporate vehicles. The Island has also enacted the Corruption (Jersey) Law 2006, which will permit in due course the ratification of the UN Convention against Corruption, the OECD Convention against the Bribery of Foreign Public Officials and the Council of Europe Criminal Law Convention on Corruption.

9. The main features of Jersey’s AML/CFT legislation are summarised below.

10. Money laundering offences. Under the Proceeds of Crime Law and Drug Trafficking Offences Law it is an offence to: (a) assist another to retain the benefit of the proceeds of serious offences; (b) acquire, possess or use, the proceeds of serious offences, and (c) conceal, disguise, convert, transfer or remove from the jurisdiction the proceeds of serious offences, knowing or suspecting them to be so. This is consistent with the definitions set out in the Vienna Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (the “Vienna Convention”) and the United Nations Convention against Transnational Organized Crime, 2000 (the “Palermo Convention”).

11. Under the Terrorism Law, it is an offence to become concerned in an arrangement which facilitates the retention or control by or on behalf of another person of terrorist property by concealment, by removal from the Island, by transfer to nominees, or in any other way.

12. Money laundering offences cover laundering one’s own proceeds, and can be applied to bodies corporate. The maximum penalty is 14 years imprisonment and/ or an unlimited fine.

13. Overseas offences are covered where, had the equivalent conduct occurred in Jersey, it would have been a predicate offence. There is no exemption for fiscal offences.

14. Terrorist financing offence. The Terrorism Law makes it an offence to (a) fund-raise for the purposes of terrorism, (b) use and possess property that is used or may be used for the purposes of terrorism, and (c) enter into or become concerned in an arrangement as a result of which property is made available or is to be made available to another, where than individual knows or has reasonable cause to suspect that it will or may be used for the purposes of terrorism. This is consistent with the definition set out in the Convention for the Suppression of the Financing of Terrorism.

15. Financing offences can be applied to bodies corporate. The maximum penalty is 14 years imprisonment and/ or an unlimited fine.

16. Overseas offences are covered where, had the equivalent conduct occurred in Jersey, it would have been a predicate offence.

17. Reporting obligations. The Proceeds of Crime Law creates an obligation on all citizens to report their involvement in money laundering in order to provide an absolute defence to the commission of a money laundering offence. In practice this is treated as a firm legal reporting obligation. In addition to this reporting obligation, the Drug Trafficking Offences Law and the Terrorism Law make it an offence for a person not to report knowledge or suspicion that another person has committed a money laundering or terrorist financing offence, where that knowledge or suspicion arises in the course of a trade, profession, business or employment. Under the Terrorism Law, where knowledge or suspicion arises in the course of a financial services business, then it is also an offence to fail to make a report where there are reasonable grounds for suspicion. Under the Drug Trafficking Offences Law and Terrorism Law there is a maximum sentence of five years imprisonment for failing to report. Amendments to the statutory provisions of the Proceeds of Crime Law and Drug Trafficking Offences Law are under way to mirror the broader reporting offence of the Terrorism Law.

18. Where a SAR is made to the JFCU before a transaction is executed, it becomes an offence to execute the transaction without the consent of the JFCU. The JFCU is not obligated to provide consent.

19. Broad immunities from criminal and civil claims for breach of confidentiality exist. Provision is also made for legal professional privilege.
20. Under the Money Laundering Order, financial services businesses are also obliged to maintain procedures which require knowledge or suspicion to be reported internally and, in turn, to the JFCU, and failure to maintain such procedures constitutes an offence.

21. In addition, the Money Laundering Order requires the JFSC to report knowledge or suspicion of money laundering or terrorist financing to the JFCU—which is discovered in the course of examinations of registered persons.

22. Tipping off. Subject to provision for circumstances where legal professional privilege applies, it is an offence, with a maximum sentence of five years imprisonment, to prejudice an investigation by tipping off a suspect or third party.

23. Additional obligations. Schedule 2 of the Proceeds of Crime Law defines a wide range of financial services business activities that must adopt and maintain systems in order to deter money laundering and terrorist financing.

24. These additional obligations are set out in the Money Laundering Order. The Order requires financial services businesses to establish and maintain procedures for the purpose of forestalling money laundering and terrorist financing, covering verification of identity, record keeping, the recognition and reporting of suspicious transactions, and also to provide staff with training and to raise awareness so that employees are aware of AML/CFT legislation and helped to recognise operations that may relate to money laundering or terrorist financing. The Money Laundering Order also requires financial services businesses to “take such other procedures of internal control and communication as may be appropriate for the purposes of forestalling and preventing money laundering”. Failure to establish and maintain such procedures, and to train and raise awareness of employees on AML/CFT matters, is an offence punishable by up to two years' imprisonment or an unlimited fine, or both, irrespective of whether money laundering has taken place.

25. Financial services businesses are required to seek satisfactory evidence of identity of a prospective customer (a person seeking to form a business relationship or to carry out a one-off transaction)—except where exceptions apply (as set out in Article 6 of the Money Laundering Order, in line with those permitted by the EU First and Second Money Laundering Directives). Unless satisfactory evidence of identity is obtained “as soon as is reasonably practicable, then a business relationship or one-off transaction must not proceed. Where a customer acts on the instructions of a third party, then the Money Laundering Order also requires that reasonable measures be taken to establish and verify the identity of that third party. Irrespective of exemptions, identification procedures are required where there is suspicion of money laundering or terrorist financing.

26. Currently provisions covering verification of identity apply only to new accounts, and not to accounts already in existence when the Order came into effect on 1 July 1999. However, financial services businesses remain responsible for having appropriate systems and controls to manage the risk arising from both new and existing customers. The Island is, however, to directly apply FATF Recommendation 5 to existing customers.

27. Record-keeping procedures maintained by a financial services business are in accordance with the Money Laundering Order if they require evidence of a person’s identity to be held throughout the relationship and for a further period of five years after the relationship is terminated or one-off transaction completed, and also a record containing details of all transactions carried out, to be held for at least five years following execution of each transaction.

28. The Money Laundering Order requires a financial services business to identify a person to whom a SAR is to be made (a “money laundering reporting officer” or “MLRO”). That person must consider the information provided to determine whether or not to report to the JFCU. The Money Laundering Order provides for the MLRO to have access to necessary information so that he may investigate the SAR.

29. In 2006, the Court of Appeal upheld a decision by the Royal Court to convict persons for failing to comply with the Money Laundering Order. The Court of Appeal agreed that the obligation to establish and maintain procedures for the purposes prescribed in the Money Laundering Order is an absolute one and the ruling makes it clear that even a single breach is enough to constitute an offence. The defendants in the case were fined £100,000.

30. Investigation. Provisions allow information and evidence to be obtained for the purposes of criminal investigations. The police may, for the purposes of an investigation into whether any person has benefited from criminal conduct or into the extent or whereabouts of the proceeds of criminal conduct, apply to the Bailiff (Jersey’s chief judge) for a production order compelling a person who appears to be in possession of material likely to be of substantial value to the investigation to produce such material (for example bank statements, correspondence etc). In addition, in certain circumstances, the police may apply for a search warrant in relation to specified premises. The Terrorism Law also includes a specific provision relating to financial services businesses, requiring such businesses to provide customer information to the police for an account to be monitored for up to 90 days.

31. Freezing and confiscation. In circumstances where proceedings have been instituted in Jersey, or the Royal Court is satisfied that proceedings are to be instituted in Jersey, the Royal Court is able to freeze assets.
32. Once convicted of any criminal conduct committed in Jersey, the Royal Court, if satisfied to the civil standard that the defendant has benefited from any relevant criminal conduct, may make a confiscation order requiring the defendant to pay an amount considered to be the proceeds from such conduct.

33. An application to vary or discharge a freezing order may be made to the Bailiff by any person affected by it. Compensation may also be paid where property is frozen and where a defendant is not subsequently convicted. Affected parties also have the right to be heard prior to the confiscation of property.

34. Under the Drug Trafficking Offences Law and Terrorism Law, cash can be seized at the border if it is suspected to be associated with drug trafficking or terrorist financing—and it is intended to extend these powers to cover inland seizure and also serious offences under the Proceeds of Crime Law.

35. Sanctions for non-compliance with AML/CFT legislation can be criminal, civil, or administrative. The basis for enforcing compliance with regulatory requirements—which may attract civil or administrative sanctions—is considered below.

Memorandum from the Offshore Group of Banking Supervisors (OGBS)326

EXECUTIVE SUMMARY

— OGBS welcomes this opportunity to have an informed, balanced and objective debate on the role of OFCs in, and their commitment to, enhancing financial stability and transparency;
— OFCs through OGBS and otherwise have been and continue to be active participants in international action concerned to foster financial stability and transparency;
— OFCs through OGBS have played a particularly active role in the work of the Basel Committee on Banking Supervision and the Financial Action Task Force on Money Laundering and Terrorist Financing (FATF);
— for the majority of OFCs their subsidiaries and branches of international banks are deposit gatherers and the major part of the funds so gathered are up-streamed to their parent bank or other group entity, the loss of which could have a significant impact on the liquidity of the parent;
— of particular relevance to the issue of financial stability and transparency is information on the beneficial ownership and control of corporate vehicles (both legal persons and legal arrangements). OGBS proposed to the FATF, and led, a typologies project on the misuse of corporate vehicles, the report on which was published in October 2006;
— the Financial Stability Forum (FSF) has found no evidence that OFCs have been a major causal factor in the creation of systemic financial problems or are material to global financial stability;
— no evidence has been produced by the IMF or the international standard setters to suggest that the OFCs present different or greater issues than non-OFCs. Their focus, rightly, is on any jurisdiction that fails to meet the international standards of financial regulation and AML/CFT;
— international assessments of compliance with international standards show that the results for OFCs and non-OFCs are similar with good and some not so good performers in each group;
— OFCs play a significant role in the global financial market place. They are important contributors to global capital movements and it can be argued help to oil the market mechanisms;
— OGBS believe it is of particular importance that there should be a level playing field in the implementation of international standards of financial regulation, AML/CFT and measures against harmful tax competition;
— OFCs have played a key role in new market developments because as “niche” market operators they have the ability to be “fleet of foot” and better able to take advantage of new market opportunities as they arise;
— OFCs are complementary to and supportive of neighbouring finance centres such as the City of London which benefit greatly from the OFCs within their sphere of influence;

326 OGBS is a body set up in 1980 at the instigation of the Basel Committee on Banking Supervision. It has the following membership—Aruba, Bahamas, Barbados, Bermuda, British Virgin Islands, Cayman, Guernsey, Isle of Man, Jersey, Labuan, Macau China, Mauritius, Netherlands Antilles, Samoa, Panama, and Vanuatu. Further information on OGBS can be obtained from its website—www.ogbs.net. What is an OFC? The IMF in its progress report on the OFC assessment programme dated 8 February 2006, which is on the IMF website, included a list of 52 jurisdictions described as “offshore and international financial centres” which include Ireland, Luxembourg, Hong Kong China, Singapore and Switzerland. If the focus is on “offshore” meaning the providing of financial/corporate services to non-residents the list should include the USA and the UK. To narrow the definition, the IMF in working papers has sought to focus on those jurisdictions where financial services for non-residents predominate over domestic business, but this has the defect of excluding significant centres of “offshore” activity and by focusing on financial services fails to give sufficient weight to trust and company service activity because the authors do not consider the latter as financial services.
OFCs have responded to the concerns expressed by the FSF and other bodies and have recognised
the importance of increased transparency for effective financial regulation, for AML/CFT, for the
fight against corruption and for dealing with harmful tax practices but in every respect consider it
is a global approach that is required;

there has been a significant increase in transparency of OFCs in recent years, and to the extent that
gaps remain they are as if not more often to be found in non-OFCs as in OFCs;

OGBS members recognise that international acceptance depends on their reputation for
compliance with international standards and that there is no better position than to be so
recognised by a third party such as the IMF;

OFCs have been at the leading edge in regulating trust and company service providers who are key
players in financial markets;

the distinction between OFCs and non-OFCs is no longer seen by the international standard setters
as being important in addressing the issues of financial stability and transparency. The IMF also
has recently decided to integrate the OFC assessment programme into the global Financial Sector
Assessment Programme (FSAP);

all significant financial centres are important for world wide financial markets stability and all
should be subject to the same international standards and should offer the same degree of
transparency;

the recent market disturbances have not originated in the OFCs but the OFCs share in recognising
the need to address the key requirements for enhanced transparency;

that new financial products are to be found in OFCs is not because the OFCs are more lightly
regulated. Reasons for the OFC location are the tax neutrality enjoyed, the low rates of personal
and corporate taxation, and the level of professional expertise in associated areas of financial
service activity;

OFCs have taken positive action to improve transparency not least because they have more to lose
through a failure to address the issues involved as their economies are heavily dependent on
businesses serving financial markets;

the main challenges to be addressed on issues of financial stability and transparency are the same
for OFCs as for non-OFCs. They include protecting legitimate confidentiality, protecting
competitiveness, ensuring a greater understanding of how information can be obtained, improving
the gateways for information exchange, and resourcing; and

there is a need for a global approach to tackle what are global issues on a level playing field basis.
Financial stability issues and risks are global in nature, and they call for a global response. The
focus should be on the risks and the gaps in transparency wherever those risks and gaps arise. The
overall message that this submission has sought to convey is that in relation to financial stability
and transparency, both for the extent of the existing commitment and the need for further action,
OFCs ought not to be separately distinguished but should be considered with jurisdictions
generally.

INTRODUCTION

1. The House of Commons Treasury Select Committee in its Sixth Report of Session 2007–08 entitled
“Financial Stability and Transparency” referred to the potential uses of offshore centres and concluded that
“they remain relevant in any discussion of financial stability”. The Committee as a result concluded “we will
undertake further work on offshore financial centres in the context of our ongoing scrutiny of financial
stability and transparency to seek to ascertain what risks, if any, such entities pose to financial stability in
the United Kingdom.” OGBS welcomes this opportunity to have an informed, balanced and objective
debate on the role of OFCs in, and their commitment to, enhancing financial stability and transparency on
a global basis.

2. An interest in OFCs in connection with financial stability and transparency is not something new. In
1980 the Basel Committee on Banking Supervision instigated the formation of OGBS because of a concern
for the unknown threat to the stability of international banks arising from the business placed with their
offshore subsidiaries about which little was known. At the time a very significant proportion of international
loans to South American and other jurisdictions were being booked through foreign subsidiaries in OFCs
because of a lower tax liability, and more accommodating regulatory requirements. There was concern that
the OFCs were not applying adequate supervisory standards, and that the lack of transparency surrounding
the loan business, and the position on actual or potential loan loss provisions, represented a hidden threat
to the solvency of the international banks concerned.

3. The OGBS for their part—and with some foresight having regard to recent experience—were happy
to work with the Basel Committee on these and other cross-border issues because they were concerned that
the failure of a parent bank would have an obvious impact on subsidiaries and branches in their jurisdictions
which in turn would have a serious impact on their economies which were increasingly dependent on
financial services activity.
4. The OGBS consequently joined with the Basel Committee—for many years jointly chairing the Basel Cross Border Banking Working Group—in producing the following reports:
   - A Supplement to the Basel Concordat on practical aspects of international collaboration between
     banking supervisory authorities (1990).
   - Customer Due Diligence for Banks (2001).
   - Shell banks and booking offices (2003).
   - Parallel-owned banking structures (2003).

5. The OGBS is currently represented on the Basel Committee’s AML Expert Group which reports to
   the Committee’s International Liaison Group. OGBS is also represented on the Basel Committee’s Cross-
   Border Bank Resolution Group.

6. OGBS members are fully committed to the Basel Core Principles, and are actively engaged in
   implementing the Basel II Capital Adequacy Requirements. OGBS members also recognise the significance
   of their activities for the liquidity of international banks. For the majority of OFCs their subsidiaries and
   branches of international banks are deposit gatherers, and have limited loan activity. The funds gathered
   are normally up-streamed to the parent and their loss to the parent either through market events, or through
   attempts by the host regulator to ring fence the subsidiaries to protect the depositors’ interests, can have a
   significant effect on the liquidity of the parent bank.

7. OGBS members have also long recognised the importance for their activities of AML/CFT, and in the
   mid-1990’s sought and obtained observer status at meetings of the Financial Action Task Force on Money
   Laundering (FATF). Since then OGBS has been an active participant in FATF meetings, and shared in the
   work on the review of the FATF 40 Recommendations on money laundering and the nine Special
   Recommendations on terrorist financing. OGBS members have provided the FATF with letters confirming
   their political commitment to compliance with the 40 + 9 Recommendations and OGBS is treated by the
   FATF as a body equivalent to the FATF Style Regional Bodies (FSRBs).

8. OGBS is a member of an Interpol Working Group on Money Laundering and Terrorist Financing.
   OGBS also has observer status, and has participated in, UN Conferences of State Parties on the Convention
   on Corruption and the Convention on Transnational Organised Crime.

9. Of particular relevance to the issue of financial stability and transparency is information on the
   beneficial ownership and control of corporate vehicles (both legal persons and legal arrangements). OGBS
   proposed to the FATF, and led, a typologies project on the misuse of corporate vehicles the report on which
   was published in October 2006. Many OGBS members lead international practice in this field by insisting
   on the divulgence and maintenance of information on the ultimate beneficial owners of such vehicles.

10. OGBS is a member of the FATF/Asia Pacific Group on AML project group on the links between anti-
    corruption and AML/CFT issues. OGBS also was invited to participate as an expert member of a
    Commonwealth Working Group on Asset Repatriation which published its report in 2005. OGBS was
    represented at the UN Intergovernmental Working Group on Asset Recovery meeting held in Vienna in
    August 2007. Individual OGBS members have put the principles of asset recovery and repatriation into
    practice through their seizure and return of the proceeds of corruption (e.g Jersey in respect of Nigeria and
    Abacha).

11. The foregoing should provide sufficient evidence to show that OGBS members and other OFCs have
    been and continue to be active participants in international action that is concerned to foster greater
    financial stability and transparency.

What evidence is there that OFCs pose a greater threat to financial stability than non-OFCs?

12. The Financial Stability Forum (FSF) in 2000 received a report of a Working Group on Offshore
    Centres. That report concluded that:

   “3. OFCs, to-date, do not appear to have been a major causal factor in the creation of systemic
   financial problems. But OFCs have featured in some crises, and as national financial systems grow
   more interdependent, future problems in OFCs could have consequences for other financial
   centres. The significant growth in assets and liabilities of institutions based in OFCs and the inter-
   bank nature of the offshore market, together with suspected growth in the off-balance sheet
   activities of OFC based institutions (about which inadequate data exist), increase the risk of
   contagion.”

13. The report also noted that, “5. Not all OFCs are the same. Some are well supervised and prepared to
    share information with other centres, and cooperate with international initiatives to improve supervisory
    practices. But the survey carried out by the Working Group indicated that there are serious concerns by
    onshore supervisors about the quality of supervision in, and degree of cooperation provided by, some
    OFCs.”
14. In the report of the OFC Review Group of the Financial Stability Forum, in which Group the OGBS has observer status, entitled “Review of the FSF Initiative on Offshore Financial Centres” (October 2007), it is stated:

“1. Since 2000, when the FSF OFC initiative began, significant progress has been made by offshore financial centres (OFCs) in enhancing their compliance with international standards regarding cross-border cooperation and information exchange and supervision and regulation more generally.”

15. The FSF noted that “1. As regards compliance with international standards and codes, concerns remain with respect to cooperation, prudential practices and market integrity, although the various efforts underway have not to-date produced clear evidence of remaining or new risks posed by OFCs that, in the judgement of the majority of Review Group members, are material to global financial stability”.

16. OGBS and other OFCs also have been active participants in the work of the IMF in implementing the FSF’s recommendations. This is evidenced by:

— their voluntary participation in the IMF OFC assessment programme—in its report in 2005 on the first phase assessment results the IMF stated that “Compliance with standards in OFCs, on average, are better than in other countries assessed under the Financial Sector Assessment Programme (FSAP)”;
— the publication of their assessment reports in full; and
— their participation in the IMF information framework initiative.

17. In January 2008 OGBS participated in the Fifth IMF Roundtable for Offshore and Onshore Supervisors and Standard Setters which focussed largely on transparency and its implications for OFCs, the implications and lessons learned from the recent financial crisis and the proposed integration of the IMF’s OFC assessment programme with FSAP. To quote from the Aide-Memoire issued by the IMF, “Some speakers noted that, as transactions and financial institutions became increasingly globalised, the distinction between offshore and onshore was becoming less relevant, especially since incentives (and the scope) for regulatory arbitrage have narrowed as a result of the action of the IMF and the standard-setters. Rather, OFC representatives argued jurisdictions should be distinguished by their level of compliance with international standards. Other participants pointed out that the transactions in OFCs still raise legitimate concerns for onshore supervisory authorities, and that the publication of detailed IMF assessments helped address these concerns.”

18. Some discussants at the Roundtable observed that transparency among OFCs had increased with the demands of the global market place, but also stressed that gaps remain. The panellist representing the OFCs stressed that OFCs had as much at stake in promoting transparency and preventing global financial instability as other jurisdictions, since any instability caused by a lack of transparency or failure in an OFC would have significant reputational impact on the OFC with very considerable risks/costs for its economy.

19. Information on OFCs continues to be collected by the IMF and by the Bank for International Settlements. Of the 46 OFCs invited to participate in the IMF’s information framework initiative, 28 are submitting data, six have committed to participate but not yet submitted data and 12 have not yet agreed or declined to participate. However it should be noted that eight of those declining already provide the IMF with, or alternatively publish, their data, or have declined not because they were non-cooperative jurisdictions but because they judged the OFC label inappropriate.

20. Although OGBS is not involved with matters of taxation it is worth pointing out that information of value as much to the international standard setters and financial regulators as to the tax authorities also has been gathered and published in tables included in the 2007 assessment by the OECD Global Forum on Taxation. This provides a comprehensive source of information on the domestic laws that permit information exchange, the access to bank information and the availability of ownership information. What this information shows is that the gaps that remain to be filled are as present in non-OFCs as in OFCs, and in some cases more so.

21. It is noteworthy that the Financial Stability Forum has now stated that its 2000 list of OFCs has served its purpose and is no longer operative. The FATF had an NCCT (Non-Cooperative Countries and Territories) list which initially included a number of OFCs but it is notable that the five jurisdictions that were the last to be removed from the NCCT list did not include any OFCs. The FATF’s International Cooperation Review Group has taken over the role of identifying jurisdictions that do not engage in international cooperation or practice effective exchange of information. In January 2007 the ICRG identified a total of 30 jurisdictions that it was suggested might need to be further addressed of which only two were in the IMF list of jurisdictions included in the OFC assessment programme. Of the seven jurisdictions that were identified by the FATF at its Plenary meeting in February 2008, which called for particular attention in respect of their deficiencies in AML/CFT, none were included in the IMF list of OFCs.

22. Attached as an annex to this submission is a table which shows the results of assessments of compliance with the FATF 40 + 9 Recommendations covering a number of OFCs and a number of FATF member jurisdictions. These show that there are good and not so good performers among non-OFCs as well as OFCs, and many of the latter compare favourably against some major non-OFCs. The same picture emerges whether the focus is on money laundering or on terrorist financing. This reinforces the view firmly
The Importance of OFCs to Global Financial Markets

23. Notwithstanding the foregoing it is to be expected that there will continue to be some focus on the major OFCs. This is because they play a significant role in the global financial market place. They are important contributors to global capital movements and it can be argued help to oil the market mechanisms. OFCs also often facilitate investment decisions that have consequential employment and trade benefits in other jurisdictions.

24. Globalisation has involved multi-national companies seeking out opportunities to minimise their global tax liabilities and OFCs as low tax jurisdictions have often been attractive business locations. More and more countries are recognising that low taxation can and does encourage investment and job creation, and OFCs are now under increasing pressure from the reduction in corporate tax rates taking place in many non-OFC jurisdictions.

25. The review of financial regulation in the Crown Dependencies carried out by Her Majesty’s Government in 1998 (the Edwards Report) referred to the case in favour of offshore financial centres from a global perspective. The report on the review referred to a number of elements as follows:

- the right to supply services. There are many quality services for customers that well regulated offshore centres are well able to supply and have a perfect right to supply like anyone else. Examples are offshore funds, captive insurance, trust services and services to expatriates, and in recent years specialist funds or other corporate vehicles in structured finance transactions;
- stability. Political and fiscal stability is an advantage that many offshore centres are better able to offer which is attractive to residents of less politically stable jurisdictions;
- risk spreading. International clients wishing to spread their risks may find it helpful to spread their assets between different jurisdictions including offshore centres, particularly those centres that have established a level of expertise (eg in trust administration, captive insurance etc);
- convenience and simplicity. Especially in an electronic age, the offshore centres are well placed to facilitate business or coordinate transactions involving many different jurisdictions through the provision of a base free from the tax and other complications of the larger jurisdictions. In this way they may help to lubricate the world’s financial markets. Examples are international custody or treasury operations in banking services;
- innovation and flexibility. Offshore centres are sometimes better able than the larger centres to test out innovative financial products such as new insurance or investment vehicles. They can respond flexibly and quickly to the changing needs of international customers and markets. In the larger centres, the ramifications of change are typically wider;
- regulation. The offshore centres may also be able to lead the way in certain areas of regulation which can be attractive to some market participants in providing legal certainty and a reputation for quality. Examples are the regulation of trust and company service providers; and
- fiscal elements. A degree of competition in tax rates may be helpful, not least in giving the large countries an added incentive to avoid penal rates of tax. Low rates of taxation and tax neutrality come together to encourage the use of offshore financial centres, and the resultant lowering of business costs is frequently supportive of investment in business activity in other jurisdictions which investment would otherwise not have occurred.

26. There is keen competition in the market place and OGBS believe it is of particular importance that there should be a level playing field in the implementation of international standards of financial regulation, AML/CFT, and measures against harmful tax competition. While it can be argued that good business should not be concerned about transparency there is a natural desire on the part of many in the financial market place to protect their privacy not because they are engaged in financial crime but because of the natural desire to hold to themselves the details of their financial circumstances and activities. The absence of a level playing field is a matter of concern for OFCs. Jurisdictions or political sub-divisions that are “onshore”, through their professionals if not through their authorities, are marketing themselves as centres for what they describe as “offshore” activities. A number of these centres are far less transparent than the OFCs, particularly in the area of company formation and administration.

27. Competition has encouraged new market development. OFCs have played a key role in this respect because they are “niche” market operators. They succeed on their ability to be “fleet of foot” and being better able to take advantage of new market opportunities as they arise. They are able to pass legislation more quickly, and their legislation is likely to be more user friendly as far as non-resident business is concerned—not with a view to lowering standards but just to be quicker in responding to market needs. Not surprisingly many innovators in the financial market place find OFCs a favourable location in which to base their activities or pilot particular projects and activities. OFCs therefore have a key role to play in improving the general understanding of new market developments. It is accepted that more information on and a
greater understanding of new financial market activities is required. What is important however is that
efforts in this respect are coordinated recognising that this is a global issue. All the major players need to be
involved in understanding and monitoring market/product new initiatives. OFCs are willing to play their
part but they will be discouraged from doing so if they find they are being discriminated against simply
because they are categorised as OFCs.

28. As noted in para 6 above, the OFCs are significant fund gatherers with a high proportion of the funds
held as bank deposits being upstreamed to a parent bank. Those wishing to place their funds in an OFC to
take advantage of the tax neutrality and political stability, and the investment opportunities available (e.g.
offshore funds), will be clients of financial institutions/intermediaries that will use the financial services
available in centres such as London and New York. In this way the OFCs are both complementary to and
supportive of these centres, and the latter derive considerable business through this relationship. It can be
argued therefore that the City of London and the European capital markets benefit greatly from having
OFCs within their sphere of influence.

Transparency and OFCs

29. OGBS recognises the importance of transparency for effective financial regulation, for AML/CFT,
for the fight against corruption and for dealing with harmful tax practices but in every respect consider it is
a global approach that is required.

30. The desirable characteristics of transparency can be listed as access, timeliness, relevance and quality.
To achieve effective transparency it is necessary therefore:
— for quality information to be obtained and held by those practicing in the market place;
— for the information that is obtained and held to be accessible in a timely manner to those who need
it for the effective operation and regulation of the financial market place; and
— for the information to be able to be shared between all relevant parties.

31. There is a need to avoid “black holes”. The “credit crunch” has shown that the scale and nature of
off balance sheet activity was not recognised by all regulatory authorities. It was said to be something that
was not on their radar screens. Information obtained through effective banking supervision was lost through
a plethora of hedge funds, SIVs, and CDOs—colloquially referred to as “the shadow banking sector”.

32. Understanding what is going on in the market place—particularly for law enforcement purposes—
also calls for increased knowledge of the beneficial ownership of companies and other corporate vehicles.

33. There has been a significant increase in transparency of OFCs in recent years, and to the extent that
gaps remain to be filled they are as if not more often to be found in non-OFCs as in OFCs.

34. OGBS members and other OFCs are:
— publishing their IMF OFC assessment reports;
— publishing AML/CFT assessments carried out by the FATF style regional bodies of which they are a member;
— participating in the IMF information framework initiative;
— supplying data to the Bank for International Settlements;
— involving themselves with international fora including the Basel Committee on Banking Supervision, FATF, IOSCO, IAIS, the Egmont Group, the Financial Stability Forum, the United Nations Counter Terrorism Committee and the UNODC;
— providing information to the OECD Global Forum on Taxation;
— signatories in many cases to the IOSCO Multilateral Memorandum of Understanding—a significant number of OFCs were among the first to sign up;
— sharing information with other jurisdictions through memoranda of understanding between regulators, MLATs, and tax information exchange agreements;
— joining in supervisory colleges (recognising that for many host supervisory authorities the subsidiaries and branches of foreign banks can have a systemic impact greater than the parent bank will have in its home jurisdiction);
— ensuring through both on-site and off-site supervision that regulated institutions comply with international standards of financial regulation and AML/CFT, and adopt the principles of transparency necessary not least to enable independent assessors of compliance such as the IMF to test the effectiveness of the regimes in place; and
— matching non-OFCs in the establishment of FIUs, in the making of STRs and the sharing of information with correspondent bodies. The latter is particularly important because OFCs are usually part of a trail in the pursuit of those engaged in financial crime the prosecution of whom will take place in another jurisdiction (for example, a number of successful prosecutions in the USA have depended on information provided by an OFC).
35. The OGBS also produces annually summary statements whereby individual members set out what action has been taken in the past year to further ensure compliance with the Basel Committee Core Principles, and the FATF 40 + 9 Recommendations. These summary statements are made available to the FATF, the IMF, the FSF, the Basel Committee on Banking Supervision, the UNCTC and other interested parties.

36. OGBS members recognise that international acceptance depends on their reputation for compliance with international standards. There is no better position for an OFC than to be recognised by a third party such as the IMF that it is compliant with the international standards set by the Basel Committee on Banking Supervision, IOSCO, IAIS and the FATF. It should come as no surprise therefore that OGBS members have been keen to participate in the IMF OFC assessment programme.

37. Some G7 jurisdictions are of the view that the OFCs have only moved in the direction of greater transparency and compliance with international standards because they have been under threat. However, to counter this view it is worth remembering that the OFCs have been at the leading edge in regulating trust and company service providers which the FATF include in the definition of non financial businesses and professions but which are key players in financial markets. As recent events have shown, the traditional focus on banking regulation has not been sufficient to deal with the increasing complex financial markets and those engaged in business within those markets. The OGBS has recognised the importance of non financial businesses and professions, and has sought to promote as an international standard a Statement of Best Practice for trust and company service providers (TCSPs) which was supported by the publication in 2004 of a report on seeking effective exchange of information and supervision in respect of TCSPs. The OGBS also promoted and led a FATF typology into the misuse of corporate vehicles. To-date the G7 countries have been reluctant to progress the idea of an international standard for TCSPs but the OGBS has recently written to those who took part in the working group—including representatives of the IMF, FATF and OECD—that produced the best practice statement to see whether there is any appetite for meeting to consider what further progress could be made in this area.

38. The report on the FATF typology into the misuse of corporate vehicles, published in October 2006, identified a number of next steps which it was recommended the FATF should take, which included what more could be done to ensure that adequate, accurate information on the beneficial ownership and control of legal persons/legal arrangements might be obtained or accessed in a timely fashion by competent authorities. The need for action in this respect—hopefully through the adoption by non-OFCs of the regulation of TCSPs that features prominently amongst OFCs—is evident from the assessment of compliance with the FATF Recommendations. At the time of writing this submission, of 19 FATF member jurisdictions assessed for compliance with Recommendation 33 (legal persons—beneficial owners) only three had a compliant/largely compliant rating, whereas of 12 OFCs assessed seven had that rating. Similarly of the 10 FATF members assessed for compliance with Recommendation 34 (legal arrangements such as trusts—beneficial “owners”) none had a compliant/largely compliant rating, whereas of 12 OFCs assessed seven had that rating.

39. This message has been reinforced by the introduction into the US Senate by Senators Levin, Coleman and Obama of the “Incorporation Transparency and Law Enforcement Assistance Act”. To quote from Senator Levin’s statement “Federal legislation is needed to level the playing field among the States, set minimum standards for obtaining ownership information, put an end to the practice of States forming millions of legal entities each year without knowing who is behind them, and bring the United States into compliance with its international commitments.” It is noteworthy that Senator Levin in proposing a tightening of the incorporation rules in the USA, so that information on the beneficial ownership of companies is available, has made specific reference to the fact that most offshore jurisdictions already request this information.

40. The general message OGBS would wish to leave with the Treasury Select Committee is that all significant financial centres are important for world wide financial markets stability and all should be subject to the same international standards and the same degree of transparency.

The need for a Global Approach

41. There is therefore a need for a global approach. In this respect drawing a distinction between OFCs and non-OFCs is increasingly artificial, and runs the risk of diverting attention from the real issues. The IMF have recognised this in their recent decision to integrate the OFC assessment programme into the IMF financial sector assessment programme (FSAP). As a result of this integration the IMF will no longer maintain an OFC list. This action on the part of the IMF reflects the priority being attached to issues of financial stability. The OFC’s assessments undertaken to-date have focussed mainly on compliance with the international standards set by FATF, the Basel Committee on Banking Supervision, IOSCO and IAIS. The emphasis of the FSAP is on financial stability and financial sector development with the assessment of standards and codes playing a supporting role.

42. The FSAP provides an explicit mandate to assess micro-financial vulnerabilities, both nationally and internationally. Applying this broader view to OFCs will enable more comprehensive risk assessments. It is recognised that given the large volumes of financial transactions conducted using the major OFCs, failures of OFC domiciled institutions or systems could have broader systematic implications—although recent
experience suggests that these failures are more likely to arise from situations developing in non-OFCs than from within the OFCs themselves. Assessments under the FSAP will involve specific attention to such vulnerabilities and the adequacy of contingency mechanisms. OFCs are also important links in the vertical chain of financial transactions, and play a key role in global risk transfer mechanisms. Consideration of these linkages in the context of the FSAP will enhance the effectiveness of the IMF’s multilateral surveillance mandate.

43. The need for a global approach is also evident from the fact that the troubles in recent times have not come from the offshore world. The sub-prime mortgage crisis in the USA was not an OFC phenomenon. The liquidity crisis is also a problem arising from the credit policies of the parent banks, not from the excesses of OFCs subsidiaries or branches. Indeed quite the contrary, for the latter are a source of up-streamed funds upon which parent banks are heavily dependent (for example, for Jersey based subsidiaries and branches group loans comprise 75% of total assets). The problem facing the banking community in raising new capital, rolling over long term borrowings, maintaining a stable retail deposit base, maintaining committed funding lines, are the problems of the parent bank not of the OFCs making. However, the major OFCs have a significant involvement in the world financial market place. They therefore accept that they need to join in measures designed to enhance financial stability, particularly through greater transparency. Particularly is this so where securitisation and new financial products are involved. To quote the Chairman of the Treasury Select Committee, “the best and brightest at our top investment banks have expended great energy designing ludicrously complex financial products, which you need a Nobel Prize in physics to understand. Whilst financial innovation and securitisation have brought real benefits and allow for risk dispersion through the system, it has come at a cost. Product complexity has introduced increased opacity into our financial system, making it almost impossible to determine where risk lies and making it much more difficult to achieve financial stability.”

44. The fact that a number of the new financial products are to be found in OFCs is not because the OFCs are more lightly regulated, as some might believe. For the most part off-balance sheet securitisation, hedge funds and private equity have not been subject to on-going regulatory oversight in on-shore as well as offshore jurisdictions. Also, because many OFCs have tighter controls on company incorporation and trust company administration than the non-OFCs, what regulation has applied at authorisation stage has been tougher in the former than the latter. Reasons for an OFC location are the tax neutrality enjoyed, the low rates of personal and corporate tax, and the level of professional expertise in associated areas of financial service activity. It is also the case that OFCs as niche market operators are quicker to enact legislation and produce a business environment favourable to new business.

45. The leveraging that has taken place off balance sheet was not sufficiently appreciated by regulators world-wide. A full picture calls for action by regulators collectively and there is a need for greater transparency among all the parties involved so that a proper risk assessment process can be applied effectively. OGBS members are committed to playing a full part in this.

46. OFCs recognise the need for this greater transparency. What should be clear to all is that this is not something which can be laid at the door of OFCs alone. While the OFCs as host supervisors accept that they have a part to play in providing for greater transparency in monitoring the spreading of risks by international banks through securitisation and new financial products, for a total picture to be obtained it is as if not more important for the home supervisors to implement measures that require appropriate disclosure by the parent banks. These are issues that have to be tackled on a global level playing field basis. OFCs are accustomed to being blamed for the ills of the financial market place. Politically it is understandable that there is an obvious attraction in being able to suggest that problems arise because of the activities of OFCs. However, the necessary joining of the key OFCs in a global approach to tackling what are global issues will be more likely to be achieved if they are treated as equals with non-OFC jurisdictions rather than as pariahs. As the Governor of the Bank of England in December 2007 told the Treasury Committee, “I think the problems we are facing are international in nature…… it has been a very salutary lesson, because this crisis has become international in nature. It is not a crisis of emerging market economies or failed macro-economic policies in the rest of the world, this crisis goes right to the heart of the financial centres of the three big developed parts of the world”. Because OFCs are so heavily dependent for their economic well-being on their financial service activity they are as enthusiastic about the current crisis being tackled by the major international finance centres as those centres themselves.

47. Financial stability and transparency will be further enhanced, embracing both OFCs and non-OFCs, by:

- a global approach;
- the dropping of the OFC/non-OFC distinction and embracing OFCs in the IMF FSAP;
- ensuring that processes/procedures are capable of responding quickly to the fact that financial markets are constantly developing new vehicles;
- ensuring good information is available rather than focussing simply on information exchange mechanisms—particularly in respect of beneficial ownership;
- extending the regulatory approach to TCSPs and the creation of an international standard in this respect;
— ensuring greater understanding and enhancing the relationships between all relevant authorities; and
— recognising the importance of cross-border collaboration in dealing with banks in difficulties.

48. As far as the final bullet point is concerned it is important that proper regard is had for cross-border issues where international banks are involved. Issues that OGBS has suggested the Basel Cross-Border Bank Resolution Group should address include:

— how to define a systemic bank with cross-border operations—there is the issue here of the bank that is not systemic in its home country but through its foreign operations is systemic in a host country;
— how far can or should a host regulator allow a branch or subsidiary to be dependent on the parent bank and/or the home regulator;
— how far can and should home country deposit protection/rescue packages extend to foreign branches and subsidiaries;
— how far can the laws/legal judgements of the home country extend to the country in which foreign branches and subsidiaries are located;
— how to enhance communication flows from home to host, from host to home, and in some cases where there are regional centres (eg for treasury operations) from host to host both as a routine and when there are problems;
— how to deal with situations where a foreign subsidiary has minority shareholders and independent non-executive directors;
— how to ensure that a foreign subsidiary, prompted by its regulator or by its Board of Directors, does not act in a way (eg through clawing back up-streamed funds placed with the parent) that is detrimental to the health of the parent; and
— how to deal with a situation where the foreign subsidiary is a subsidiary of a holding company and not of the parent bank.

49. Financial stability is of key importance to OFCs. Their economies are heavily dependent on serving financial markets. They are therefore keenly interested in the Financial Stability Forum’s work on market and institutional resilience and will take whatever action is necessary to ensure that they play a full part in following the actions set out by the FSF which have a relevance for all financial centres both OFCs and non-OFCs.

**Main Challenges Facing OFCs (and Non-OFCs)**

50. The main challenges facing OFCs when addressing transparency are common to those facing non-OFCs. They can be said to be:

i. protecting legitimate confidentiality:
   Legitimate reasons for protecting confidentiality include:
   — the protection of commercially confidential information of financial service businesses for competitive reasons;
   — the protection of individuals from improper harassment by the State (or by a Foreign State);
   — the protection of the right of the individual to due process and civil rights;
   — the protection of the source of information.
   Particular difficulties often arise also in complying with the requirements of data protection legislation;

ii. protecting competitiveness
   The absence of a global level playing field continues to encourage the retention of barriers to transparency in the interests of safeguarding a jurisdiction’s economic interests.

iii. ensuring that there is a greater understanding of how information can be obtained. Accusations of a lack of transparency often arise from a failure of a requesting authority to understand how best to approach the authority from whom information is required;

iv. improving the gateways particularly in response to the problems faced in exchanging information between different regulators (eg between banking and securities regulators) and between regulators and enforcement agencies;

v. resourcing
   Data collection and information sharing are accepted as important but for many authorities are not considered to have as high a priority as engaging in the onsite and offsite examinations required to ensure compliance with international standards.
51. However, while there are challenges to be faced, the major OFCs have a firm commitment to the principles of transparency as embodied in the international codes and standards. OGBS members and other OFCs have come a long way since the FSF report in 2000 in which reference was made to the lack of comprehensive and up-to-date data on OFCs financial activity impeding effective monitoring and analysis of capital movements.

52. OFCs face the challenge of a far greater exposure to reputational risk than most if not all non-OFCs should money laundering or terrorist financing be identified. There is also a much greater threat that they will be put on “black lists”, or face restrictions on financial transactions. This is notwithstanding the fact that the scale of money laundering/terrorist financing may be much smaller than in many non-OFCs. There is also the ever present attitude that where problem cases do arise in the case of the OFC it is frequently portrayed as a bad apple in an otherwise good barrel.

Conclusions

53. In conclusion it can be stated that:

— the international standard setters are not focussing on OFCs per se. The FATF priority list of jurisdictions identified by the International Cooperation Review Group does not include any OFCs. IOSCO has indicated that in seeking to identify non-cooperative jurisdictions it is not focussing on OFCs per se. The Basel Committee does not focus separately on the OFCs and neither does the IAIS;

— all OFCs have been or will be subject to an assessment of compliance with international standards of financial regulation and AML/CFT by the IMF, or for AML/CFT by the FATF FSRBs;

— OFC assessments are published in full on the relevant websites. Information is thereby available to other regulatory authorities, and to financial institutions to assist in their risk assessment processes. The OFCs performance compares well with that of many non-OFCs. The IMF in its progress reports has evidenced the progress being made. The gaps that remain to be filled are those that the assessments show are also to be found amongst many if not all non-OFCs;

— the IMF has decided to drop its OFC list and integrate the present OFC assessment programme into its global Financial Sector Assessment Programme;

— the OFCs have shown that they are very much alive to the relevance of compliance with international standards for their own reputation. They have recognised that a failure to comply with the international standards, and not to be viewed as equivalent with non-OFC jurisdictions in their application, can have a detrimental impact on the success of their finance centre activities upon which their economies largely depend. To this extent the market influences on OFCs to comply with international standards can be far greater than the market influences on non-OFCs;

— the international concern for the current lack of transparency on beneficial ownership is not one that is peculiar to OFCs. Indeed the OFCs through their regulation of trust and company service providers are in a better position to meet the requirements through the availability and accessibility of information on beneficial ownership;

— the OFCs through OGBS have been active in both the setting and application of international standards. There are no grounds for suggesting that the cooperation of the OFCs has only been obtained because of their separate identification by the Financial Stability Forum as an area of special concern;

— the FSF initiative, and the consequential IMF assessment programme, are not concerned with taxation issues. At the same time the view taken of OFCs by FSF members on occasion appears to be greatly and often predominantly influenced by taxation concerns. However, it should be noted, in respect of the OECD harmful tax initiative, that most OFCs are now described as “participating partners” and, with a few exceptions which include two OECD Member States, OFCs are fully committed to the OECD principles of transparency and information exchange;

— OFCs can be expected to maintain and enhance their compliance with the international standards on financial regulation and AML/CFT because it is in their best interests to do so;

— there is no case for maintaining an OFC/non-OFC distinction when focussing on compliance with international standards. The better focus should be on activities and issues, and on whether a jurisdiction is compliant/non-compliant or cooperative/non-cooperative;

— OGBS believes that the monitoring of compliance with international standards of financial regulation and of AML/CFT can and should be left to the international standard setters. The latter through their own formal processes can identify those jurisdictions that are not compliant, and in particular those that are not compliant with the standards of international cooperation and effective information exchange. The FSF with its concern for global financial stability should receive reports from the international standard setters on which jurisdictions are failing to comply with the international standards, their significance for world financial markets, and the collective action that might need to be taken to bring those jurisdictions into compliance; and
— financial stability issues and risks are global in nature, and they call for a global response. The focus should be on the risks and the gaps in transparency wherever those risks and gaps arise. The overall message that this submission has sought to convey is that in relation to financial stability and transparency, both for the extent of the existing commitment and the need for further action, OFCs ought not to be separately distinguished but should be considered with jurisdictions generally.

June 2008

Summary of Ratings of Compliance with the FATF Recommendations

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**Note:**

C = Compliant

RC = Largely Compliant

PC = Partially Compliant

NC = Non-Compliant

N/A = Not applicable

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327 Recommendations 1, 5, 10, 13, 23, 35, 36, 40; SR I, II, IV, V
Memorandum from the Association of Investment Companies (AIC)

EXECUTIVE SUMMARY

1. Offshore financial centres provide important opportunities for investment companies and their shareholders. They facilitate the delivery of investment strategies that meet evolving UK and international consumer demands but which cannot be delivered with a UK-domicile. Historically, the UK regime has supported the principle of collective investment through investment companies (as this delivers valuable consumer benefits) but it has not yet responded to recent market developments. This has prevented UK-domiciled investment companies from gaining exposure to emerging asset classes without suffering double-taxation and encouraged the sector to look offshore.

2. At the same time, increasingly high standards in offshore financial centres have boosted investor confidence. Offshore financial centres also offer greater commercial and administrative flexibility and certainty than the UK— which has also encouraged moves offshore.

3. The shares of AIC member investment companies, wherever they choose to be domiciled, are overwhelmingly traded through UK markets. This provides an additional layer of reassurance for those investors who want to maintain exposure to domestic standards.

4. Where investment companies are concerned, old-fashioned suspicion of the reasons for “going offshore” is increasingly inappropriate. These domiciles facilitate legitimate commercial opportunities within an appropriate regulatory framework. Many investors are UK residents. Accordingly they pay tax on the returns they receive, as appropriate. The availability of offshore investment companies to UK investors provides no grounds for regulatory or public policy concern. On the contrary, they have served investor needs and enhanced the position of the UK financial services sector.

BACKGROUND

5. The AIC represents closed-ended investment companies whose shares are traded through an investment exchange. These companies invest in a diversified portfolio of assets and seek to provide their shareholders with capital growth (when the value of the underlying assets rise this will be reflected in the share price). They can also offer income to investors (where dividends, interest, rent etc. received by the company are paid out to shareholders).

6. The AIC has 349 members, including UK-based Investment Trusts, Venture Capital Trusts and 53 offshore investment companies. Most of these are located in UK Crown Dependencies (Guernsey, 39, Jersey, 9). The others are domiciled in UK overseas territories (Bermuda, 2, Cayman, 2) except two (one in Luxembourg and another in the Netherlands). Our offshore members manage just over £14.5 billion in assets in a range of asset classes including equities, property, bonds, private equity and unlisted hedge funds.

7. Each offshore investment company is governed by a board of directors (elected by the shareholders), which provides strategic oversight of the company. It ensures, for example, that the portfolio is invested in line with the investment policy agreed by the shareholders. The board also monitors the performance of the external fund manager. (The day-to-day management of the portfolio is sub-contracted to an expert fund manager, who may be replaced if performance is unsatisfactory.)

8. Investment companies (onshore and offshore) are a mainstream part of the UK’s investment environment. Their shareholders include large institutions (pension funds, insurance companies, unit trusts etc), wealth managers and retail investors. All are attracted by the opportunity to gain diversified exposure to assets at low cost.

9. Institutions seeking access to new or specialist asset classes are currently the predominant investors in offshore investment companies. However, the investor profile of the sector may broaden over time to include more retail investors as the investment practices pioneered offshore become more established. The Association of Private Client Investment Managers now suggests that a “balanced” investment portfolio might include 5% in hedge funds and 5% in commercial property (alongside more traditional asset classes). As these can be accessed through offshore investment companies (by buying shares on the stock market) they are increasingly likely to be considered by a wider range of investors in the future.

10. The AIC’s mission is to help its Members add value for shareholders over the longer term. This includes understanding the needs of boards and working to help them deliver their obligations to shareholders more effectively.

The growth of the offshore investment company sector

11. The offshore investment company sector has seen significant growth over the last 10 years—at the same time new UK launches have declined.

12. Overall the sector remains overwhelmingly UK based, but Figure 1 (below) illustrates how new investment companies are increasingly favouring offshore jurisdictions. A UK domicile was the primary choice for new investment companies before 2001. Since then, domicile choices have increasingly been
offshore. Figure 1 shows Channel Island investment companies with a London listing (the majority of the AIC’s offshore members). It omits those not listed in London—which might have selected alternatives such as Euronext or chosen to quote on AIM—and those domiciled in other jurisdictions such as the Cayman Islands or Bermuda. Nevertheless, even this partial picture shows that the UK has been less attractive than alternative financial centres and that, in the current environment at least, UK launches have largely become a thing of the past.328

![Fig 1. New investment company launches 1999 - 2007](image)

13. Offshore centres, particularly the Channel Islands, have won this business by being more responsive to investor and commercial needs.

Meeting consumer demand for broader asset allocation

14. The underlying philosophy of taxing collective investment funds is that investors in those funds should receive, in tax terms, the same return as if they had invested directly in the underlying assets. Without this, the attraction of collective investment is substantially reduced. Investors would face double taxation—once inside the fund and then again when they received dividends or sold their investment. The ability to invest without suffering such tax leakage is particularly important for tax-exempt institutions (such as pension funds) and retail investors, who are the main purchasers of investment company shares.

15. Many shareholders in offshore investment companies represented by the AIC are UK-resident for tax purposes and pay the appropriate rate of tax on their investment returns. Where they are exempt institutions they do not pay any tax. Where they are taxpayers they will pay at their marginal rate (many retail investors will be higher-rate taxpayers).

16. Of course, where investors are not UK resident for tax purposes, they would not pay tax in any event. However, offshore investment companies also extend the reach of the UK’s fund management sector so that it covers assets which might otherwise be managed elsewhere. In turn their fees enhance their profit levels and enhance tax revenues in the UK.

17. Investment companies are genuine investment propositions seeking to deliver a tax-neutral outcome for savers seeking exposure to certain asset classes. They are not financial vehicles created for other purposes, for example, by companies seeking to move assets off-balance sheet or to facilitate securitisations.

18. The UK government recognises the desirability of encouraging tax-neutral collective investment and offers a variety of tax regimes to support this model. These include closed-ended (ie investment company) regimes such as Investment Trusts, Venture Capital Trusts and Real Estate Investment Trusts and open-ended alternatives, Authorised Unit Trusts and Open-Ended Investment Companies. Despite the UK’s historic recognition of collective investment, the tax system has not kept up with market developments and evolving demand. This is illustrated by the investment company experience.

19. UK-domiciled Investment Trusts can invest without exposing the shareholders to double-taxation in UK equities, which were traditionally the key component of asset allocation for UK investors. By and large, the Investment Trust rules reflect this historical position. They do not allow for investment in new assets demanded by investors. On the other hand, offshore investment companies have been able to offer a much broader range of assets in a tax-neutral manner.

328 The figures exclude VCT launches and secondary issues.
20. As shown by Figure 2, the main assets of offshore investment companies have included private equity, property and unquoted hedge funds. These assets cannot generally be held in Investment Trusts because of their tax position. UK dividend income is currently exempt from tax within an Investment Trust. All other forms of income, including overseas dividends, bond interest and rental income are subject to tax within the company. Where exposure to assets producing these income streams is relatively small, and therefore income levels are low, then the tax burden for the Trust may be negated by offsetting allowable expenses (and double tax relief in the case of overseas dividends). However, this is less possible where investment companies are seeking higher levels of income from those sources. In these circumstances, the best outcome for investors may be achieved where the fund is domiciled in a more attractive regime. This responsiveness to investor needs is the primary reason that jurisdictions such as Guernsey and Jersey have been able to compete successfully for investment company business.

21. Even where investment companies are exposed to equities (the traditional Investment Trust asset class) there is still a commercial and consumer incentive to locate in an offshore financial centre. The investment companies described (above) as “equity” funds are in receipt of high levels of foreign dividends—around two thirds have remits to invest entirely outside the UK. As foreign dividends may be subject to tax within an Investment Trust these remits can be difficult to deliver with a UK domicile.

22. Indeed, the inflexibility of the Investment Trust rules, particularly the unfavourable treatment of income, has even seen existing Investment Trusts (who pay no tax at present) move offshore during the past 12 months. Various reasons account for this. Key among them is likely to be a desire to increase their exposure to securities which provide income, but which cannot be purchased without the shareholders suffering double-taxation onshore.

23. Future investment company launches will continue to be offshore where they deliver asset allocations which cannot be provided effectively by Investment Trusts. For example, recent launches have included exposure to debt or infrastructure which the UK-domiciled Investment Trust structure cannot accommodate effectively.

**Commercial advantages offered by offshore domicile**

24. There are certain areas where offshore investment companies do compete with UK-based alternatives. The offshore property sector provides a good example of this. It competes with UK-domiciled Property Investment Funds (PIFs) and Real Estate Investment Trusts (REITs).

25. Offshore investment companies (and other closed-ended vehicles) are able to compete with PIFs because of their structural advantages. PIFs are open-ended. This structure is not ideally suited to investing in illiquid assets such as property, as high levels of redemptions (where consumers sell their units in the fund
back to the scheme manager for cash) could create a need to sell the fund’s underlying assets to meet this demand. As property sales cannot be undertaken quickly the fund may find itself without the cash required to repay its investors. This would be a particular risk when confidence in the underlying assets is falling. Problems of this nature emerged recently in the property fund market and a number of vehicles were temporarily closed to redemptions (which was contrary to consumer expectations, and may have only postponed the problem). This situation also creates issues for investors which remain within the fund if assets are sold quickly (and cheaply) because of liquidity demands rather than the manager’s view of their fundamental investment attractions.

26. Closed-ended funds, where the shares are traded on a market (not via the scheme manager) avoid these problems. Both UK and offshore investment companies might therefore be favoured by investors with reservations about open-ended alternatives. However, offshore investment companies can still compete on commercial grounds. In comparison with a REIT, the tax position of an offshore domiciled company may be marginally more attractive depending on the investor’s own position. It will also have greater commercial flexibility (for example, it will not suffer from the same gearing restrictions as a REIT). The complexity of tax-compliance (and the impact it has on commercial decisions) is also likely to be far greater for a REIT than for an offshore domiciled company.

27. The difficulties in achieving compliance with the UK’s tax rules should not be underestimated. Some investment strategies involving derivatives, which could theoretically be deployed by Investment Trusts, are avoided solely because of uncertainty on how they would be treated by the UK tax authorities. The likelihood is that they would not create any tax issues—but the company cannot take that risk. A number of companies wishing to use derivatives for investment purposes have therefore taken a prudent view that an offshore domicile will deliver a more tax-neutral outcome and that they can place more reliance on the approach taken in those jurisdictions. The high levels of certainty available offshore is a very important factor (alongside flexibility and simplicity) which have also helped attract investment companies to these jurisdictions.

Standards applying to offshore investment companies

28. The term “offshore financial centres” is not clearly defined. One problem with much of the debate about offshore regimes is that they are judged together and little consideration is given to the differences between them.

29. The most significant offshore domiciles for investment companies trading on UK markets are the Crown Dependencies (Guernsey, Jersey and the Isle of Man). A recent International Monetary Fund assessment329 found that their level of compliance with global standards is extremely high. Where securities are concerned, they have fully complied with 81% of global standards, and “broadly” or “partly” implemented the remainder. The same report found similar high standards applying where money laundering is concerned. No areas were un-addressed. Standards are continuing to evolve and the next iteration of the IMF assessment is likely to see further positive developments.

30. Other offshore jurisdictions hosting AIC members have also been rated positively (although they have some way to go to catch up with The Crown Dependencies). However, they have also seen significant improvements in recent years, and we would hope to see further developments over time as the regimes become more established.

31. As far as securities regulation is concerned, the record of these financial centres rebuts the myth that they offer no regulatory controls. The increasing quality of regulation has helped encourage interest by investors who would not have considered purchasing an offshore investment company ten years ago. This in turn has led many UK fund promoters to consider offshore options when previously they would have favoured the Investment Trust route.

32. The value of offshore regulators was demonstrated in the run up to problems in the Split-Capital Investment Trust market (which emerged in 2000) where a number of offshore and onshore investment companies failed and some retail investors lost money on what they thought were safe investments. It was representatives of an offshore regulatory authority—the Guernsey Financial Services Commission—who were among the first to raise concerns with the UK regulators about potential problems. Clearly, offshore centres do try and balance their commercial position with appropriate regulation (as the UK does). However, where regulatory standards differ from those in the UK, they are not necessarily inferior and they should be assessed on their merits.

33. Of course, the offshore Investment Companies represented by the AIC also allow investors to rely on various UK-originated standards because their shares are traded on domestic markets. Most of our members are UK-listed. They therefore apply the rules set by the UKLA (which in part flow from European directives). These cover issues such as transparency, liquidity, independence of directors etc. They include requirements to disclose their governance arrangements in comparison with the standards set out in the

UK’s Combined Code on Corporate Governance. Other of our members are traded on AIM, the UK’s leading alternative securities market with standards reflecting the needs of its investor base—primarily institutions.330

34. We would also note that many offshore AIC members use the AIC Code of Corporate Governance. This has been developed as a means of reporting against the Combined Code, but it also provides value for investors by addressing unique investment company issues. For example, it examines issues boards might consider when dealing with their external fund manager.

Impact on the UK of offshore domiciled investment companies

35. Offshore investment companies customarily employ offshore administrators (indeed, it is a requirement of domicile in a number of jurisdictions). However, as discussed above, their shares often list or trade on UK exchanges. They therefore support the UK’s financial services infrastructure.

36. Arguably most importantly from a UK financial services perspective, they also tend to employ UK-based fund managers as investment advisers (which are UK regulated). This is a useful source of revenue for these firms. Where investment companies have an international shareholder base (some recent launches have raised their capital substantially overseas) they enable managers to extend their market—with knock-on effects for their profits, which are taxed in the UK. Offshore investment companies also help develop experience within the UK’s fund management community where they increase opportunities to gain exposure to alternative asset classes.

37. The offshore investment company sector benefits investors and managers as well as developing the overall position of the City. It does not undermine the UK’s tax-take or its position as a financial centre. In fact, it can help enhance them. The relationship is mutually beneficial and, while we envisage it will evolve over time, should be welcomed by those interested in the potential of financial services to provide ongoing economic benefits for the UK.

19 June 2008

Memorandum from the British Bankers’ Association

1. The BBA is the leading association for the UK banking and financial services sector, speaking for 223 banking members from 60 countries on the full range of UK or international banking issues and engaging with 37 associated professional firms. Collectively providing the full range of services, our member banks make up the world’s largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy. Financial services companies pay £12 billion directly in tax and their employees a further £15 billion in income tax. The sector contributes annually over £100 billion to UK economic growth and a trade surplus of £25 billion to the balance of payments.

EXECUTIVE SUMMARY

2. The Inquiry’s terms of reference contain no clear definition as to what constitutes an Offshore Financial Centre (OFC). The categorisation of “offshore”, however, is becoming increasingly less meaningful, given the diversity of the financial services centres covered by this term. The Inquiry should be wary of the generic connotations encapsulated by the term “offshore”. The public perception of OFCs as havens for tax evaders etc is somewhat out of date and, particularly in the case of the Channel Islands and the Isle of Man, is quite at odds with the reality.

3. The BBA has sought to limit its focus to the territories in which its members operate in the main and with which it has experienced the most amount of contact: ie Jersey, Guernsey and the Isle of Man.

4. OFCs are complementary to the services provided by the City of London. They provide further benefits to worldwide financial markets by increasing economic activity and the competitiveness and efficiency of the banking system in nearby jurisdictions. The development of niche and specialized sectors in certain OFCs can be beneficial in general to worldwide financial markets.

5. OFCs which accept and implement international standards of regulation, supervision, disclosure and information sharing, do not constitute a major causal factor in the creation of systemic financial problems. Recent events have shown that a range of factors can interplay to threaten the financial stability of the world economies, including the credit crunch, bad debt, liquidity issues etc. The capital from OFCs, such as the Channel Islands and Isle of Man, may in fact be used by neighbouring onshore finance centres to assist the flow of liquidity around the world, thereby assisting financial stability.

330 The one exception among AIC members is a company trading on Euronext, which applies European listing standards, but it intends to take a dual-listing in the UK and will then also apply UK listing standards.
6. The sustained interest in, and monitoring of, OFC activities has already gone some considerable way towards tackling concerns relating to the transparency of such jurisdictions. Jersey, Guernsey and the Isle of Man have all received positive assessments on their regulatory regimes from the IMF. They are also included in the OECD’s list of 35 jurisdictions committed to improving transparency and establishing effective exchange of information in tax matters, resulting in their designation as co-operative jurisdictions.

7. Financial instrument innovation is not restricted to a particular type of jurisdiction or locality. The growth of financial instruments cannot be deemed to be “reliant” on OFCs.

8. Many factors play a significant role in market positioning, including the level of taxation, governance arrangements, corporate regimes and the availability of expertise.

9. Tax policies, and in particular rates of tax, are indeed a factor influencing companies’ choices of where to conduct financial services, so inevitably the greater the relative attractions of other financial centres around the world, the less business will be conducted in the UK with resultant implications for UK tax revenue.

10. There is sufficient evidence to believe that the Jersey, Guernsey and the Isle of Man are well-regarded.

11. There are numerous reasons why financial institutions, in whichever jurisdiction they operate, would not wish to foster links to customers engaged with illegal and nefarious activities. Jersey, Guernsey and the Isle of Man have comprehensive legal frameworks for countering money laundering and the financing of terrorism.

12. The use of an OFC does not signify a propensity towards tax evasion, nor are financial institutions in a position to know what information their clients divulge to tax authorities.

**General Comments**

13. We would note that the terms of reference contain no clear definition as to what constitutes an OFC for these purposes and indeed arguably, the categorisation of “offshore” is becoming increasingly less meaningful, given the diversity of the financial services centres covered by this term. The difference between those financial markets which are well-developed with mature infrastructures, such as Hong Kong and Singapore, and those that are considerably smaller and more modestly positioned, such as Labuan, is significant for the purpose of this inquiry.

14. In recognition of this, the BBA has sought to limit its focus to the territories in which its members operate in the main and with which it has experienced the most amount of contact: ie Jersey, Guernsey and the Isle of Man.

15. Additionally, the BBA is wary of the generic connotations encapsulated by the term “offshore”.

16. The public perception of OFCs as havens for tax evaders etc is somewhat out of date and, particularly in the case of the Channel Islands and the Isle of Man, is quite at odds with the reality. They have not enacted banking secrecy legislation, their compliance with international regulatory and supervisory standards is judged by organisations such as the International Monetary Fund (IMF) to be high, and their engagement with other jurisdictions on tax information exchange is creditable.

*To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?*

![Chart](Source: Bank for International Settlements)
17. The statistics captured by the Bank for International Settlements (BIS),\(^{331}\) and illustrated in the chart above, show that in comparison with a collection of onshore jurisdictions, the Channel Islands and Isle of Man take a relatively modest proportion of bank and non-bank deposits.

18. For the UK, the services provided by OFCs are complementary to those provided by the City of London. OFCs administer funds which are then frequently re-invested in onshore economies and therefore act as a conduit helping in the flow of global capital world-wide. They provide further benefits to worldwide financial markets by increasing economic activity and the competitiveness and efficiency of the banking system in nearby jurisdictions.\(^{332}\)

19. The development of niche and specialized sectors in certain OFCs can be beneficial in general to worldwide financial markets. OFCs contribute to economic liberalization by providing tax-efficient platforms for global commerce, enabling investors and entrepreneurs to allocate capital in ways that boost economic growth.

To what extent does the use of Offshore Financial Centres threat financial stability?

20. The BBA considers that OFCs which accept and implement international standards of regulation, supervision, disclosure and information sharing, do not constitute a major causal factor in the creation of systemic financial problems. There is sufficient evidence to suggest that many OFCs compliance levels, from a prudential and market integrity perspective, are of a standard that makes them no more likely to threaten financial stability than their onshore counterparts. Indeed, in 2007 a study\(^{333}\) undertaken by Camille Stoll-Davey of Oxford University, for the Commonwealth Secretariat, disproved the contention that offshore centres have inferior regulation or standards to onshore ones. Based on an analysis of objective data compiled by the OECD, it was found that in key areas such as a willingness to exchange tax information or to identify who is behind companies or trusts, OECD member countries do not operate to a higher standard than OFCs and in some cases they operate to a lower standard.

21. Recent events have shown that a range of factors can interplay to threaten the financial stability of the world economies, including the credit crunch, bad debt, liquidity issues etc. The capital from OFCs, such as the Channel Islands and Isle of Man, may in fact be used by neighbouring onshore finance centres to assist the flow of liquidity around the world, thereby assisting financial stability.

How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom’s tax authorities and financial regulators?

22. The sustained interest in, and monitoring of, OFC activities has already gone some considerable way towards tackling concerns relating to the transparency of such jurisdictions. The International Monetary Fund (IMF), the Financial Stability Forum (FSF), the OECD, the European Union (EU), the Financial Action Task Force (“FATF”) and the International Organisation of Securities Commissions (“IOSCO”) have all undertaken work to promote effective cross-border cooperation and information exchange and adequacy of supervisory resources. The OFCs have also engaged bilaterally with numerous countries.

23. Jersey, Guernsey and the Isle of Man have all received positive assessments on their regulatory regimes from the IMF. They are also included in the OECD’s list of 35 jurisdictions committed to improving transparency and establishing effective exchange of information in tax matters, resulting in their designation as co-operative jurisdictions.

24. All three jurisdictions have signed up to the provisions of the EU Tax Package, including two business tax related measures, the Code of Conduct and the European Directive on Interest and Royalties, and one related to the taxation of private individuals, the European Savings Tax Directive (EUSD). Whilst the legal scope of the EUSD doesn’t extend outside of the EU, these jurisdictions voluntarily agreed to apply the same measures to Member States in the EU and implement local legislation to support the Directive. They have also all endorsed the concept of the Tax Information Exchange Agreement (TIEA), signing up to a series of agreements between their jurisdictions and other countries designed to facilitate information exchange in appropriate circumstances.

25. The Channel Islands and Isle of Man have not enacted banking secrecy legislation. Like most jurisdictions, including the UK, banks in these jurisdictions take the confidentiality of their customers seriously, but there are appropriate procedures in place for law enforcement agencies to obtain information regarding suspicious bank accounts. We note, for instance, that HM Revenue and Customs has successfully used its information powers to obtain details of offshore bank accounts in these jurisdictions, related to UK-domestic individuals who have not declared income on money kept in offshore centres.

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To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?

26. Financial instrument innovation is not restricted to a particular type of jurisdiction or locality. In our view OFCs play no material role in the development of such instruments and hence the growth of financial instruments cannot be deemed to be “reliant” on OFCs. However, as the tax treatment of such complex financial instruments remains uncertain particularly in the early stages, some, but not all, organisations may be motivated to go offshore for a period of time, to obtain certainty of treatment.

How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets?

27. As previously stated, concerns in relation to the level of transparency of OFCs seems increasingly groundless, particularly in the case of the Channel Islands and Isle of Man. The level of taxation in these jurisdictions has been a significant factor contributing to the attractiveness of the locations, as it has equally for some onshore jurisdictions. Nevertheless, other factors play a significant role in market positioning, including their governance arrangements, corporate regimes and the availability of expertise. Offshore jurisdictions have proved to be innovative in establishing a niche, such as in trust and fiduciary services, where professional expertise and quality of service are as high as onshore but at a lower cost.

How do the taxation policies of Offshore Financial Centres impact on UK tax revenue and policy?

28. Tax policies, and in particular rates of tax, are indeed a factor influencing companies’ choices of where to conduct financial services, so inevitably the greater the relative attractions of other financial centres around the world, the less business will be conducted in the UK with resultant implications for UK tax revenue. HM Treasury and HM Revenue and Customs will, understandably, be better equipped to respond in detail to this question.

Are British Overseas Territories and Crown Dependencies well-regarded as Offshore Financial Centres, both in comparison to their peers and international standards?

29. There is sufficient evidence to believe that the Jersey, Guernsey and the Isle of Man are well-regarded. They have all received positive assessments on their regulatory regimes from the IMF. They are also included in the OECD’s list of 35 jurisdictions committed to improving transparency and establishing effective exchange of information in tax matters, resulting in their designation as co-operative jurisdictions. Additionally, all three Islands are members of IOSCO, holding positions in IOSCO’s European Regional Committee. In addition, the Director General of the Guernsey Financial Services Commission is a member of the Executive Committee (the governing body) of the International Association of Insurance Supervisors—the insurance equivalent of IOSCO, taking an active role in setting international standards for insurance regulation and supervision.

30. In 1998, the Home Office undertook the Review of Financial Regulation in the Crown Dependencies that was published in November 1998. This review, referred to as “The Edwards Report” (after Andrew Edwards, the Treasury official who undertook its preparation), generally praised the level of service and regulation that then prevailed. A number of recommendations were made that have since been broadly put into effect by the local financial authorities.

To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?

31. There are numerous reasons why financial institutions, in whichever jurisdiction they operate, would not wish to foster links to customers engaged with illegal and nefarious activities. Firstly, a financial institution’s reputation and integrity can be irreversibly harmed through involvement in laundering money or financing terrorism. The long-term detrimental effect of loss or reputation on business from its usual clients combined with regulatory sanctions can bring the institution to effective closure, as happened with Riggs in the United States. Furthermore, a financial institution that would accept illegal funds cannot rely on those funds as a stable deposit base. Large amounts of laundered funds are likely to be suddenly wired out to other financial markets as part of the laundering process, threatening the institution’s liquidity and solvency.

32. The 2008 International Narcotics Control Strategy Report[334] (INCSR) is an annual report by the US Department of State prepared in accordance with the Foreign Assistance Act. It describes the efforts of key countries to attack all aspects of the international drug trade, money laundering and financial crimes. The report details in some depth the credentials of various OFCs, and notes that in the case of Jersey, Guernsey

and the Isle of Man, they have comprehensive legal frameworks for countering money laundering and the financing of terrorism. The United States Inland Revenue Service ("IRS") have also approved these jurisdictions’ “know your customer” provisions for the purpose of its rules on withholding tax.

33. The Channel Islands and the Isle of Man are not FATF members, however, as Crown Dependencies of the United Kingdom (which is an FATF member) and members of the Offshore Group of Banking Supervisors (OGBS), a body that is an observer to the FATF, they have fully endorsed the FATF 40 Recommendations and Nine Special Recommendations, and contribute to the deliberations of the body, for instance the Isle of Man’s experts are assisting the FATF working group that considers matters relating to customer identification and companies’ issues. The OGBS also conducts evaluations of its members’ anti-money laundering systems. OGBS members are committed to publishing their assessment reports in full. These reports appear on the websites of the IMF, or the relevant FSRB with whom OGBS has joined in undertaking an assessment of a member jurisdiction. All the reports are also available on the OGBS website. The IMF OFC assessment programme also includes assessment of compliance with the international standards set by the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors.

To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?

34. The use of an OFC does not signify a propensity towards tax evasion, nor are financial institutions in a position to know what information their clients divulge to tax authorities. Financial institutions adhere to due diligence and “Know Your Customer” procedures in order to gain certain assurances about the probity and the integrity of their clients. However, they are not privy to the tax reporting that the client actually makes. A bank cannot be in a position to know that a customer is evading tax until such time as they are notified of such behaviour.

35. Jersey, Guernsey and the Isle of Man all have Double Taxation Agreements with the UK, and are currently in the process of negotiating Tax Information Exchange Agreements with the UK. Additionally the criminal justice legislation in each jurisdiction allows them to assist when criminal investigations are underway in other jurisdictions including the UK.

June 2008

Memorandum from the Finance Ministry, Government of Bermuda

“BERMUDA’S ROLE IN THE PROVISION OF INTERNATIONAL FINANCIAL SERVICES”

SUBMITTER


EXECUTIVE SUMMARY

2. Bermuda’s modern economy is based primarily on international business and tourism. International insurance and reinsurance is the dominant component of international business. The volume of premium flows (US$116 billion) and the size of total assets (US$440 billion) in 2006 position Bermuda as one of the top insurance markets in the world.

3. As a world market for insurance and reinsurance, Bermuda bolsters global financial stability through the efficient spread and diversification of insurance risk and provides market-driven solutions at the pace of modern business.

4. Bermuda’s long-established consumption-based tax model assists in the efficient accumulation and deployment of capital on a global basis and results in greater competitive pricing for insurance premiums.

5. Bermuda has not adjusted its tax base to attract mobile capital from other jurisdictions.

6. Bermuda has a strong tradition of KYC in its business culture. Its institutional and legal framework for the supervision and oversight of financial services is based upon recognised international standards established by standard-setting bodies for the purpose of enhancing transparency and financial stability.

7. Bermuda embraces international cooperation and is regarded as a cooperative, transparent and responsible jurisdiction.
**Economic Background**

8. Bermuda is a small island nation in the mid-Atlantic with a land mass of 53 square kilometers and a population of 62,000. From the very early days of settlement in the 17th Century, Bermuda has been engaged in some form of international business. From whaling, ship-building and salt-raking (in the Turks Islands) during the 17th Century to export of spring vegetables to the eastern United States in the 19th Century, international commerce has been an enduring feature of Bermuda’s economic history. Its modern economy is based primarily on tourism and international business. The Ministry of Finance has estimated Bermuda’s GDP for 2007 at $5.8 billion.335

9. As Bermuda’s economy developed during the 20th Century, tourism was the principal source of jobs—especially for those segments of the population not employed in managerial, professional, and technical occupations. But, during the last half of the 1990s, employment in hotels, restaurants, and other travel-related sectors declined appreciably. In contrast, employment levels in the expanding financial services and international business sectors were on a rising trend.

10. As the first decade of the 21st Century draws to a close, international business activity and the provision of business services have strengthened their positions as the leading sectors of Bermuda’s economy, together accounting for some 45% of GDP.336 These leading sectors helped to sustain an average annual growth rate of 4% during the period 2000–06.337

11. For a small island nation situated 600 miles offshore from the North American continent, Bermuda—mainly through its international businesses and financial institutions—has leveraged the economic advantages of the Country’s geographic position at the crossroads between North America, Europe and the Caribbean to provide market-driven solutions at the pace of modern business.

**Bermuda’s Comparative Advantage**

12. The development of international business in Bermuda, particularly financial services, was both serendipitous and fortuitous. There was no marketing campaign, no re-writing of laws, no specially created income or corporate tax codes designed to lure onshore companies to Bermuda’s international marketplace. Rather, the business developed first. Once it had taken root, the government sought—over a 60-year period beginning in 1947— to ensure there was a suitable regulatory framework to govern operations in the emerging sector. Among the factors that have attracted international companies to Bermuda are (1) an effective legal framework; (2) a well-developed infrastructure; (3) high quality professionals and business services; (4) close geographic proximity to major markets in the United States and Canada; and (5) political stability.

13. At the end of 2007, there were 15,358 international companies and international partnerships on Bermuda’s business registry compared to 13,509 in 2003.339 The majority of the international entities registered in Bermuda are owned and controlled by “Fortune 1000” companies.

14. In Bermuda, the emphasis has always been on quality over quantity. This emphatic focus by the Ministry of Finance has established Bermuda in the top tier of premier international financial centres and distinguishes Bermuda from many other jurisdictions that compete in the arena of offshore financial services. Not all centres provide the same services or the same quality of service. Business leaders choose Bermuda for its high quality, its probity and its speed to market.

15. In Bermuda, international insurance is the primary component of the international business sector. Captive insurance, life insurance and catastrophe reinsurance companies have a significant presence. With gross annual premiums of US$116 billion, capital and surplus of US$158 billion, and total assets of US$440 billion recorded in 2006, Bermuda is a dominant player in the global insurance and reinsurance market.340 In establishing this position, Bermuda joins with other major centres such as London and New York—in a complementary rather than a purely competitive paradigm—to spread and diversify insurance risk around the world. This role is important to worldwide financial markets as it averts the concentration of risk and thereby bolsters financial stability in the wake of an event that triggers a claim.

16. Bermuda’s insurance market has significant depth and sophistication in terms of product offerings. There is a fully developed mezzanine layer and the product lines extend well beyond excess liability coverage and property catastrophe protection. More recent lines include integrated occurrence coverage, punitive damages, secondary products recall and many other lines. Consequently, the Bermuda market has become a focal point for insurance managers, brokers, and underwriters with a global footprint. Further, the stability provided to the global financial system through well distributed catastrophe risk has been underscored by the reinsurance industry in the aftermath of Hurricanes Katrina and Rita.

335 Bermuda dollar is pegged at par with US dollar.
337 Ibid, Table 2, page 16.
338 American International was the first international insurance company incorporated in Bermuda in 1947.
340 Bermuda Monetary Authority Report and Accounts 2007, page 42.
17. Had US insurers been restricted to buying reinsurance in the US market, the burden of reinsurance claims arising from an event such as Hurricane Katrina could have led to the collapse of the US reinsurance industry and the primary market in 2005.

18. From the Ministry of Finance’s perspective, Bermuda has demonstrated a comparative advantage in the development and provision of financial services to the global community. Moreover, this economic achievement has been recognised by leading businesses and financial organizations worldwide.

19. The wide array of financial service entities doing business in Bermuda include:

— asset management;
— commercial banks;
— corporate services;
— fund administration;
— investment providers;
— insurance and reinsurance;
— mutual funds; and
— trust companies.

20. Bermuda has achieved a significant degree of development in insurance and reinsurance. While the Country is not an international banking centre—there are only four banks in Bermuda—it has made considerable progress also in providing services for trust business, mutual funds and asset managers. At the end of 2007, there were some 1,300 funds domiciled in Bermuda with a combined net asset value of $249 billion.341

21. Bermuda’s financial services sector is complemented by the dynamic and well-regulated Bermuda Stock Exchange. This international exchange provides regulated securities trading on one of the most technologically-advanced and secure electronic trading platforms in the world. The Bermuda Stock Exchange (BSX) is a member of the America’s Central Securities Depositories Association (ACSDA). The BSX was successful in attaining this membership because of its modern clearing, settlement and depository service; it was assessed as a mainstream exchange, rather than a listings exchange service provider. In early 2006, the BSX was granted Designated Investment Exchange status by the UK Financial Services Authority. The BSX has also been approved by the US Securities and Exchange Commission (SEC) as a designated offshore exchange. The BSX was accepted as a full member of the World Federation of Exchanges (WFE). It is also recognised by the Australian Tax Authority under the Foreign Investment Fund Taxation Rules.

BERMUDA’S CONSUMPTION-BASED TAX MODEL

22. Bermuda has a long-established and highly efficient consumption-based tax system that has been in place since the 19th Century. One of the first legislated taxes, the Revenue Act 1898 that made provision for the collection of customs duty, remains in effect today.342 For the greater part of the 20th Century, customs duty accounted for more than 50% of government revenue. Stamp duties accounted for the next largest share of tax revenue. In the latter part of the 20th Century, other forms of indirect taxes were introduced, including payroll tax, passenger taxes, and property tax. For the fiscal year 2007–08 (April–March), these five tax sources together with annual fees for international companies generated $745 million or 80% of the revised estimate of $929 million in total revenue for the year.343

23. In a broader sense, it should be noted that the scale of taxes imposed by the Government of Bermuda is in line with those prevailing in several other countries with which it conducts the bulk of its foreign trade. In Bermuda, the ratio of total Government receipts in relation to GDP was approximately 17.8% of GDP in 2007.344 For the United States and Canada the same ratio was in the range of 19.5 to 20.5% of GDP in 2007.344

24. In making the comparison, it is important also to take account of the fact that as a British Overseas Territory, Bermuda does not bear the costs of an external affairs department, external defence, foreign embassies and membership in international organizations. In 2005, such costs were estimated in the range of $10 million to $15 million345, equivalent to about 0.3% of GDP.

25. Bermuda does not have, nor has it ever had, any form of direct tax on income. Further, the absence of direct tax does not provide a necessary and sufficient condition for labeling a jurisdiction as a “tax haven”.

26. In this regard, it is important to note that Bermuda’s consumption-based tax system has not been targeted by the Organization for Economic Cooperation and Development (OECD) as unfair or designed for the purpose of attracting mobile capital. OECD has not recommended any changes to Bermuda’s tax

342 Revenue Act 1898, Revised Bermuda Laws, Volume 5.
344 Total receipts includes $929 million in taxes, licences and fees booked to the Government Consolidated Fund plus about $98 million of social insurance contributions that goes into the Contributory Pension Fund for payment of pensions and allowances to senior citizens.
structure. In a sense, this can be seen as an important victory for Bermuda, because it means that OECD has recognised Bermuda’s system of taxation as legitimate, fair and principled in the context of the global economy.

27. The tax structure is an element of Bermuda’s success and should be evaluated in objective economic terms. The tax system was shaped for efficiency and fairness to Bermudian taxpayers. It was not designed to attract mobile capital from offshore jurisdictions. Further, Bermuda authorities do not condone tax evasion. There are treaties in place to exchange tax information with other jurisdictions including for instance the United Kingdom and the United States of America.

28. The Government of Bermuda rejects absolutely any reference to Bermuda as a “tax haven”. Bermuda’s tax regime applies equally to local and international companies and other entities. Businesses, in particular international companies, pay a significant share of total taxes in Bermuda.

29. The comparative tax differences that exist in the international arena are due to the nature of the tax model that is adopted by different jurisdictions. In Bermuda’s case, the consumption-based model has proven to be quite compatible with the operation of an economy based primarily on the provision financial service activities. Further, it has been shown that the scale of taxes levied in Bermuda is not out of line with that of developed countries.

30. As there are no taxes on capital, firms domiciled in Bermuda are able to allocate capital efficiently. Subsidiaries or branches that operate in various other countries of the world pay all taxes that are applicable in the country where the business activity occurs. The remaining profits can be re-invested in that country or distributed to the company’s head office. If that head office is in a country that charges income tax against a firm’s foreign income, then the firm is in effect suffering from double taxation on its profits. If the distributed profits are accumulated in Bermuda, or a jurisdiction with a similar tax structure, then the capital pool remains intact and is available to be reinvested anywhere in the world where the firm has the greatest opportunities.

31. Thus, Bermuda’s tax structure allows a greater proportion of the capital pool to remain in the private sector thereby permitting a higher level of corporate investment worldwide. This may be viewed as one of Bermuda’s major contributions to the global economy. In the case of the insurance sector, which is the largest segment of Bermuda’s international business, the ability of reinsurance companies to accumulate loan loss reserves without paying tax on interest earned actually facilitates competitive pricing for insurance premiums that ultimately benefits purchasers of insurance products worldwide.

32. Bermuda’s connection to the US insurance market is instructive in this respect. In 2005, US insurance companies reinsured some 45% of their risks with Bermuda companies compared to some 41% for companies based in the United Kingdom, Germany and Switzerland combined. Based upon the research by Professor J. David Cummins, it is likely that, in 2008, Bermuda will again provide the largest share of property and catastrophe reinsurance coverage for the United States of America. Further, it has now been affirmed that Bermuda reinsurers will cover more than 30% of the losses of Hurricane Katrina and pay out more than $22 billion to rebuild Florida and the Gulf coast.

MAINTAINING INTERNATIONAL STANDARDS

33. The development of Bermuda’s local and international business environment is based on three key principles:

— transparency and know your customer;
— responsible but appropriate regulation; and
— international cooperation.

34. Transparency: Bermuda has a long standing practice of know your customer or KYC. Further, Bermuda does not have bank secrecy legislation. Rather Bermuda relies on the common law principles of privacy of information which may be disclosed provided there is express power under law. Any entity seeking to register and carry on business in and from Bermuda is vetted fully by the public authorities. This approach to vetting includes a review of the owners as well as the proposed business. Further, the Bermuda Monetary Authority vets all shareholder controllers and directors of licensed entities. In addition to these vetting procedures, Bermuda law expressly prohibits companies from certain specific activities, including gambling and dealing in arms. Such a review process for registration of businesses in Bermuda has served the jurisdiction very well, especially in our efforts to identify risks.

35. Regulation: The independent regulator of financial services is the Bermuda Monetary Authority which has the mandate for overseeing the financial services sector. The regulator is independent and has responsibility for reviewing the operations and controls of financial institutions operating in and from Bermuda. In addition, the Bermuda Monetary Authority is an active representative in standard-setting bodies such as the International Association of Insurance Supervisors (IAIS), International Organization of Securities Commissions (IOSCO) and participates in the deliberations of the Offshore Group of Banking Supervisors (OGBS).

36. Financial services operating in and from Bermuda are subject to international standards that have been incorporated into our domestic laws and related supervisory practices. Key standards include:
   - Basle I and Basle II capital standards for banking.
   - IAIS standards for insurance (Bermuda is presently finalizing a multilateral mutual agreement with IAIS).
   - IOSCO core principles for investment business (Bermuda recently signed a multilateral mutual agreement with IOSCO).
   - Financial Action Task Force (FATF) recommendations for anti-money laundering and combating terrorist financing.

37. Bermuda’s regime for oversight of its financial services and systems for prevention of money laundering has been assessed by the International Monetary Fund in 2003 and 2007. As well the jurisdiction’s regime was reviewed by the Financial Stability Forum in 2000 and KPMG on behalf of the Foreign and Commonwealth Office in 2000. Bermuda has been a full member of the Caribbean Financial Action Task Force (CFATF) since 1995. The CFATF was the first regional body of the FATF.

38. In 1997, Bermuda adopted legislation to make money laundering an offence subject to criminal prosecution. Presently the Bermuda Monetary Authority, as the independent regulator, carries out supervisory reviews of the AML systems and controls of all financial service providers. Bermuda authorities are implementing a national action plan to enhance Bermuda’s AML/CFT regimes. The enhancements will ensure that the jurisdiction complies with the most recent recommendations of the FATF.

39. As Bermuda has strictly practiced KYC, the IMF assessors have recognised that the risk of money laundering within Bermuda’s financial services sector has been minimal.

40. Bermuda’s well developed regime for monitoring closely those businesses which set up in Bermuda has served Bermuda well not only to know customers, but also to identify business trends. As financial structures become more complex and involve cross border transactions, cooperation and appropriate regulatory structures are key. For example, as Special Purpose Vehicles (SPV’s) and transformers became popular, Bermuda authorities reviewed such structures closely with both industry and the regulator to determine the nature of the risk. SPV’s related to insurance are fully regulated. Where such vehicles are owned by an overseas financial institution, Bermuda adopted the practice of coordinating approval of any structure with that institution’s relevant regulator. As these structures have developed, Bermuda has undertaken to implement appropriate regulatory regimes and oversight.

41. At the same time, standards and regimes must be developed to check abusive use of structures. This is not a simple task but Bermuda is a strong advocate of the basic fundamentals. First, Bermuda does not condone abuse of business structures. Second, Bermuda does cooperate internationally in all areas including tax. Third, Bermuda continues to commit more resources for development of highly skilled professionals and an effective regulatory regime.

42. Terrorist financing is not seen as a high risk in Bermuda. This is mainly due to the nature and high quality of business that the jurisdiction has supported and the long-standing policy of turning away dubious business. There is domestic legislation dealing with anti-terrorist financing and for enforcing international sanctions. In addition, there is a MOU which deals with the enforcement of UN sanctions extended to Bermuda. There is a requirement for companies to seek consent to carry on business in designated areas which is managed by the Minister of Finance. Where there have been breaches the Minister has exercised his power to investigate and is presently winding up one company for dealings in oil contrary to UN sanction on Iraq. Again Bermuda has had an occasion to deal with suspect financing and dealt with it accordingly.

43. We note for the record that the current President of the Financial Action Task Force visited Bermuda in April 2008. He was greatly encouraged by the robust nature of Bermuda’s AML/CFT regimes and the enhancements that Bermuda authorities are in the process of implementing in the wake of the International Monetary Fund’s most recent assessment of same.

44. International Cooperation: Bermuda embraces international cooperation and is regarded as a cooperative jurisdiction. The Country has entered into a number of international agreements to assist other jurisdictions by sharing information with overseas regulators, tax authorities, and policing services.

45. As a case in point, collaboration between authorities in Bermuda and authorities in the British Virgin Islands (BVI) led to the conviction in the BVI of a group of companies known as IPOC, and a wind-up Order issued by the Supreme Court of Bermuda against the same group of companies in May 2008. As a result of the conviction in the BVI, $45 million of assets held by IPOC was confiscated as proceeds of crime and is to be shared between the two jurisdictions.

46. The action against the IPOC group was initiated in Bermuda in 2004 and took four years to conclude. Bermuda authorities remained steadfast throughout and committed significant resources and public funds to the process. This case and its outcome represent clear and substantial evidence of Bermuda’s commitment to financial stability and transparency in the global arena.
47. The Bermuda Monetary Authority has the capacity to assist a foreign regulator of financial services by sharing information in its possession and has entered into MOUs for this purpose. The Authority also has the capacity to assist in matters which are not under review by the Authority, provided it is satisfied that it is a legitimate regulatory review being conducted in the overseas jurisdiction. The scope of assistance extends to seeking information from both regulated and non-regulated persons.

48. With regard to criminal investigations, there is express power to cooperate under the Criminal Justice (International Cooperation) (Bermuda) Act 1994 (CJIC). The Bermuda Financial Intelligence Unit (FIU) has been a member of the Egmont Group since 1999. The Egmont Group consists of country representatives of financial investigation units and now represents over 100 countries. It was set up to facilitate effective international cooperation between FIUs to combat money laundering. At the annual plenary meeting held in Bermuda in 2007, the Bermuda Charter was signed by all members. This Charter formalised the Egmont Group and established a permanent secretariat. Further, Bermuda’s law enforcement authorities have access to Interpol via Her Majesty’s Government.

49. With respect to tax matters, under CJIC the Attorney General may assist overseas authorities in tax fraud cases. Bermuda has entered into international agreements to exchange information on tax—in both civil and criminal matters—with other tax authorities. The first agreement was entered into with the United States more than 20 years ago. Recently, agreements were concluded with Australia and the United Kingdom.

50. Bermuda’s cooperative stance in the fight to counter and prevent tax evasion has been publicly recognised by the OECD, the United States of America, Australia and the United Kingdom. On December 4, 2007, on the occasion of signing the TIEA between Bermuda and the United Kingdom, the Financial Secretary to Her Majesty’s Treasury, the Right Honourable Jane Kennedy, MP, hailed the new arrangement, and stated: “…I commend the Government of Bermuda for its willingness to implement the high standards of transparency and exchange of information to which it is committed and for its continuing leadership in this important global tax policy area.”

51. Bermuda is presently in negotiation with a number of other countries (including EU members) and with the European Commission. Under these agreements Bermuda has upheld the OECD standards for transparency and has adopted wide parameters for sharing information. Also, Bermuda has been an active participant in the OECD working group on tax information exchange.

52. Accounting and Auditing Principles: The auditing profession is overseen by the Institute of Chartered Accountants of Bermuda (ICAB). ICAB is an affiliate of the Canadian Institute of Chartered Accountants (CICA). An agreement originally signed in August 1973, and restated in July 1998, formalises the relationship between CICA and ICAB.

53. The Minister of Finance has the power to mandate generally accepted accounting and auditing principles in Bermuda under the Companies Act 1981. The following accounting and auditing principles are permitted in Bermuda:

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54. Ratings: The External Validation

Country credit ratings are valuable tools for assessing risk and for determining the cost of debt, but they provide benefits on a number of other levels as well:

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55. Since its first rating in 1994 by Moody’s Investors Service—a sovereign credit rating of Aa1—Bermuda consistently has maintained high investment grade ratings by Moody’s, Standard and Poor’s, and Fitch Ratings.

CONCLUSION

56. Bermuda has matured as a market and a developed service centre for financial services with a global platform. It is a jurisdiction of choice for the insurance sector and has developed a strong market in the investment field. Bermuda is politically stable and has a track record of superior economic performance.

57. To be successful in the competitive global arena, an international financial centre must be efficient, flexible, and ready to adapt to international developments and opportunities. At the same time, it must commit the resources to provide good governance, proper regulation and effective oversight. Together these
factors characterise a sound financial centre. Businesses seek to do business in a jurisdiction that is sound and credible, and known internationally for probity, endurance, and market-driven solutions. Bermuda signifies this brand.

58. As the global market becomes more interdependent, there is no question that jurisdictions must cooperate and inter-act. The challenge is how jurisdictions may work together to ensure that businesses are properly regulated and minimise risks. Bermuda’s strategy has been to adopt international standards and practices using the prism of a risk-based approach and to monitor business trends and practices.

59. Bermuda authorities have entered into MOUs for the purpose of information sharing. This underscores the jurisdiction's approach towards transparency and international cooperation.

60. The breadth of “blue chip” companies that have chosen to do business through Bermuda, including those with strong links to Lloyds of London, is testament to that reputation. Bermuda neither has ignored nor shirked its international responsibilities.

61. In summary, the Government of Bermuda is proud that the jurisdiction has made a positive contribution to transparency. This was done through strengthening international cooperation with overseas regulators, tax authorities and law enforcement officials. In addition, global financial stability has been enhanced by Bermuda’s international role as an effective reinsurance market for the spread and diversification of insurance risk and the efficient allocation of capital.

18 June 2008

Memorandum from Sol Picciotto, Emeritus Professor of the Lancaster University Law School

SUMMARY

OFCs are an endemic source of risk, by their very nature as providers of services to non-residents. They have become designer jurisdictions, whose laws and regulations are crafted to facilitate avoidance and evasion of the laws and regulations of other countries. Policy towards them has been fatally compromised by attempting to distinguish between legitimate and illegitimate uses of offshore. Attempts have been made especially since 1998 to develop a more coordinated international approach towards improved regulation of the offshore system, but these have several limitations and flaws. In practice, the procedure for monitoring of compliance with financial supervision standards is enabling OFCs which are found largely compliant with such standards to represent the process as conferring on them a general seal of approval. It was also mistaken for the campaign against tax havens to be led by the OECD and directed at small OFCs, since OECD countries are themselves divided on the issue, and many of them (including the UK and US) are deeply involved with the offshore system. Hence, they have been rightly portrayed as hypocritical bullies. It is clearly time for a new approach to phase out the offshore system, based on concerted action between all relevant regulatory authorities, nationally and multilaterally. The UK is in a key position to take the lead.

1. This submission is by Sol Picciotto, Emeritus Professor of the Lancaster University Law School. Over the past 20 years, I have researched and written extensively on tax havens and offshore financial centres (OFCs), including a book International Business Taxation (1992). I recently conducted a three-year research programme supported by the Economic and Social Research Council (ESRC) into Regulatory Networks and Global Governance, one of the topics in which was the regulation of OFCs and tax havens. In the course of my research, I have conducted interviews with both regulators and private sector professionals involved with this issue, and visited a number of OFCs, including the Isle of Man, the Cayman Islands, Dubai, Liechtenstein and Vanuatu.

2. In my view, OFCs are an endemic source of risk and instability for the financial system. It is their very reason for existence which creates these risks. The definition of “offshore” is the provision of services for non-residents. Hence, OFCs offer the cloak of their laws and regulations to persons who are not resident in their territory. The central purpose of this is to make it possible for such persons to avoid or evade the laws or regulations of other countries, usually those in which they are resident. Hence, OFCs by their nature are engaged in a continual war of attrition on the laws and regulations of other countries. This has now become a refined and continuous process since these jurisdictions, which have in effect become captured by elements of the financial services industry, regularly introduce new legislation or amendments to their laws, often at the behest of, or designed by, industry advisers. In effect, OFCs offer a haven for pin-stripped pirates.

3. OFCs are quite open about this, and indeed are mistakenly supported by some academics and commentators, on the grounds that they provide “regulatory competition”. Even if a case can be made for competition between countries of the same or a similar type to attract genuine activities, this does not apply to OFCs, for two main reasons:
(i) they are generally small countries, so that financial services and related activities can be a relatively very large proportion of their GDP; their government revenues from even very low fees (eg for company registrations) can enable them to maintain a zero or low direct tax regime, which would not be possible for countries with larger populations and a more balanced economy; and

(ii) they offer the cover of their laws to activities which generally have little or no connection with them.

4. OFCs have acted as a corrosive factor on other countries’ fiscal and financial laws and regulations. Their laws and regulations which effectively make them participants in the offshore system. The result has been serious distortion of the international allocation of investment, the undermining of national tax systems, and the creation of such a high degree of opacity as to create serious risks for the international financial and monetary system.

5. There has long been a fatal ambivalence in public policy towards OFCs, due to lack of clear understanding of their nature. This has resulted in a compromise policy, which has condoned, allowed, or encouraged “acceptable” types of offshore activities, while attempting to prevent the “harmful” aspects, through regulation. There are two major flaws in this approach:

(i) it is often difficult or impossible to distinguish legitimate from illegitimate activities and transactions; and

(ii) the same features facilitate and protect both the purportedly legitimate and the clearly illegitimate activities.

6. The view that some offshore services are legitimate rests on the assumption that it is acceptable to try to find ways of avoiding the law. This argument is made especially in relation to tax avoidance, and has been strongly made in the UK, where the view took hold that “every man is entitled if he can to order his affairs so that the tax attaching … is less than it otherwise would be” (Lord Tomlin, in IRC v. Duke of Westminster, 1936). Especially since the 1970s, this attitude spawned a massive tax avoidance industry, which has poured enormous resources into the entirely unproductive activity of devising complex avoidance schemes. Many of these turn out to be invalid under existing law, others require legislative changes to shore up the basic principles which they try to undermine. The UK has now introduced some specific anti-avoidance rules in its tax legislation, as well as a notification procedure, and there is considerable support for the enactment of a general anti-avoidance rule, such as is available in a number of other OECD countries. However, the cat-and-mouse game of tax avoidance is made much more complex by the existence of tax havens. They offer the facilities to form artificial corporate, trust or other entities, which can be used to manage assets and international transactions, to avoid other countries’ taxes. This greatly exacerbates the problems of the Revenue. First, the difficulty of finding out about schemes and arrangements, due to the secrecy rules and lack of information agreements with havens, makes it very hard to take effective enforcement action. Secondly, international tax avoidance schemes can take advantage of loopholes or ambiguities in tax treaties, which it is difficult and time-consuming to renegotiate.

7. Avoidance is inevitably linked to evasion, due mainly to the secrecy offered by havens. While all countries accept commercial, banking and professional confidentiality, most place limits on this, both for the protection of the public, and especially for the purposes of law enforcement, including tax laws. Havens create an opaque smokescreen by:

(i) allowing formation of entities such as “international” companies, with no or minimal information required about directors, shareholders or beneficial owners;

(ii) reinforcing confidentiality rules by special laws criminalising information disclosure eg by bank employees; and

(iii) offering no or very limited provisions to obtain information for the purposes of enforcing other countries’ laws.

8. Tax havens and OFCs are virtually synonymous, for several reasons:

(i) tax liability has a direct and significant impact on competitiveness, so that arrangements to avoid other types of regulation are usually combined with tax avoidance;

(ii) financial engineering is central to tax avoidance, since it is very easy to create notional and essentially fictitious entities and transactions to organise and route financial flows; and

(iii) it is difficult to counteract avoidance techniques based on financial engineering using standard methods such as taxation of Controlled Foreign Corporations (CFCs), since it is hard to distinguish between “active” and “passive” income from financial services.

Consequently, all OFCs are also tax havens, and most tax havens are or have ambitions to become some type of OFC.

9. It is by now well-known that the secrecy offered by the offshore system facilitates money-laundering. This runs the whole gamut of concealment of illicit funds, ranging from tax avoidance through bribery and corruption to terrorist financing. I am sure that the Committee will receive ample evidence detailing the
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extent of these funds. I will therefore limit myself here to stressing once again the point that it is in practice impossible to distinguish the clearly criminal from potentially legitimate flows, and that in practice all funds using OFCs should be regarded as tainted. Practitioners in and defenders of OFCs like to give examples of legitimate uses, such as enabling confidential family estate planning. However, such activities can easily be done without resorting to OFCs. As already stated, all jurisdictions protect legitimate financial confidentiality. There is no good reason why legitimately confidential transactions should not be done in jurisdictions which accept a high level of financial transparency for regulatory purposes.

10. Some steps have been taken to try to establish such transparency. OFCs have been put under considerable pressure to implement the Recommendations of the Financial Action Task Force (FATF) on anti-money-laundering and countering the financing of terrorism (AML-CFT). Since 1998 also, the Financial Stability Forum (FSF) has established a Compendium of Standards and Codes for all financial centres, including the FATF Recommendations. Compliance with these standards is monitored by the International Monetary Fund (IMF), in conjunction with the World Bank and the FATF, under the Financial Sector Assessment Programme, which operates a rolling programme of Review of Standards and Codes (RoSCs). Although this is a laudable effort, it suffers from several major flaws, in particular:

(i) it requires considerable resources to conduct Reviews even every four to five years;

(ii) it relies, especially for the AML-CFT component, essentially on a “peer-review” process, which tries to use poachers as gamekeepers, and tends to reinforce views from within the existing system;

(iii) the IMF has rejected the use of “black-listing” which proved a very effective means of improving compliance when applied by the FATF; although this is admittedly a crude method, no alternative such as a compliance scoresheet or ranking has been introduced; and

(iv) finally, it does not include compliance with international tax enforcement standards.

This means that jurisdictions which have been found to be compliant or largely compliant in a RoSC can in effect use it as a seal of approval.

11. The campaign against tax havens has been led by the Committee on Fiscal Affairs of the Organisation for Economic Cooperation and Development (OECD-CFA), working in tandem with the EU’s Code of Conduct group. This has also been flawed in several key respects. The main problem is that the OECD is the wrong forum, even though the OECD-CFA has considerable resources and expertise. The OECD countries have themselves been divided, especially as they include the leading financial centres, several of which are lynch-pins of the offshore system. Thus, Switzerland and Luxembourg continue to offer minimal levels of transparency in tax matters. However, other OECD financial centres are also significantly deficient. In particular, both the UK and the US allow payment of interest gross to non-residents without requiring any notification of payee details, so that they are not able to supply such information even to treaty partner countries.\textsuperscript{348} Proposals to introduce notification of such details were shelved, apparently due to fears of a large outflow of portfolio capital and bank deposits. Thus, the OECD campaign was easily and to some extent validly portrayed as a form of bullying of small countries. This led to the establishment of a Global Forum, which has attempted to develop “level playing field” standards. This effort is greatly hampered by the refusal of some key countries to participate, such as Singapore and Dubai. Overall, little progress has been made. Although many havens made “commitments” to introduce some transparency, few tax information exchange agreements (TIEAs) have actually been negotiated. This confirms that it was a mistake to abandon the initial intention to establish a multilateral framework for cooperation, since the pursuit of an adequate network of bilateral TIEAs would be a never-ending task.

12. It is clear that a new approach is needed. It must begin with a firm policy commitment to tackle all aspects of the offshore system. This must be done in a fully joined-up manner between all relevant authorities and agencies, both at the national level and multilaterally. Much can be done by authorities in the OECD countries themselves, using their own powers and resources, especially as they are the hosts for the leading financial centres. In particular, they could obtain more extensive reports from banks on international financial transactions with an offshore component, and make such available to all relevant regulators, including the tax authorities. Some have begun to do this. Notably, Australia has established the AUSTRAC (Australian Transaction Reports and Analysis Centre) database, including data collected under AML legislation, which is more extensive than in most other countries. Importantly, officials of the Australian Tax Office (ATO) have direct access to this database, which is exceptional, perhaps unique, even among OECD countries. This enables the ATO to make systematic analyses of currency flows, to identify possible suspicious transactions. The UK is in a key position, both because of the importance of the City of London as a centre of global finance, and because very many OFCs are British Crown Dependencies.

\textsuperscript{348} However, the UK has introduced regulations in compliance with the EU Savings Directive, for individuals (not companies) who are resident in EU or other “fully reportable” countries: Reporting of Savings Income Information Regulations 2003 (Statutory Instrument 2003/3297, as amended) which came into force on 1 July 2005.
Overseas Territories, or Commonwealth countries. In fact, the initial emergence of OFCs took place with the connivance and even encouragement of some parts of the UK Government, especially the Foreign and Commonwealth Office (FCO), despite concerns voiced by the Inland Revenue. The FCO’s proved a very short-sighted policy, which we should now do everything we can to reverse. We can and should take the lead in a renewed drive to end the offshore system.

I would be happy to amplify or provide further details on any points made in this submission, and to give oral evidence if this would assist the Committee.

19 June 2008

Memorandum from the Association of Bermuda Insurers and Reinsurers (ABIR)

1. To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?

2. International Financial Centres like Bermuda provide an essential service to developed economies. Bermuda, Switzerland, Dubai, Hong Kong, and Singapore, amongst others, provide essential financial services to meet a demand that can not be met in the major economies.

3. Bermuda particularly provides an unparalleled ability to deploy capital quickly to meet insurance market capacity needs. Without this “speed to market” businesses—and consumers—would find it more difficult to meet some of their critical insurance needs. The inability to manage this risk would damage the underlying economy.

4. Bermuda’s insurers have been formed largely to fill market gaps created when other insurers were unable to provide coverage. Thus Bermuda’s insurers have played a key role in providing critical capacity and creating competition in markets which were constrained.

5. Equally important as competition is diversification. Bermuda’s reinsurers afford insurers the opportunity to diversify their counterparty credit risk by being able to utilize additional reinsurers. Without the Bermuda reinsurers, more risk would flow to a handful of larger players putting insurers at a greater risk of default in the event of financial calamity with these few, larger reinsurers.

6. To what extent does the use of Offshore Financial Centres threaten financial stability?

7. Well regulated International Financial Centres like Bermuda make a positive contribution to the global economy and strengthen the insurance market and the global economy— Bermuda contributes stability—not instability—to global financial markets.

8. Sophisticated business consumers and insurers do business with Bermuda insurers because they have confidence in the financial standing of the insurers domiciled here and the government that regulates them. This point has been attested to by independent observers. In 2006 a private, not for profit, international body composed of senior representatives from the public and private sectors and academia—called the Group of 30—published its report on reinsurance regulation and financial markets, its Executive Secretary Geoffrey Bell noted the following: “Worries about regulatory standards in offshore centres don’t apply to Bermuda, the world’s largest offshore reinsurance centre and the top source of non-US reinsurance for the US.... Regulatory standards are high in Bermuda.”

9. Policy makers look to the International Monetary Fund (IMF) to conduct the Financial Sector Assessment Program (FSAP) to evaluate the performance of regulators against international standards. A revised IMF FSAP of Bermuda’s insurance regulatory system is expected to be released in late June. It is expected to show compliance in Bermuda with the insurance solvency regulatory standards set by the International Association of Insurance Supervisors (IAIS).

10. How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom’s tax authorities and financial regulators?

11. Bermuda has a tax information exchange agreement in effect with both the United States and the United Kingdom. The agreement between Bermuda and the United Kingdom was signed in December 2007. The OECD noted this at “marking another step forward in international efforts to implement the principles of transparency and exchange of information for tax purposes developed by the OECD’s Global Forum on Taxation.”

12. Furthermore the OECD added: “This arrangement confirms Bermuda’s commitment to high international standards and its stature as a responsible international financial centre. Bermuda was an early participant in the OECD’s initiative to improve transparency and exchange of information in tax matters. OECD warmly welcomes this move by Bermuda.”
13. In a companion press release issued by HM Revenue & Customs, the Financial Secretary to the Treasury, the Rt. Hon Jane Kennedy MP welcomed the arrangement, saying: “these new arrangements represent a significant step in our efforts to counter and prevent tax evasion and avoidance. I commend the Government of Bermuda for its willingness to implement the high standards of transparency and exchange of information to which it is committed and for its continuing leadership in this important global tax policy area.”

14. Further to this point, in May 2007, the US Treasury Acting International Tax Counsel John Harrington, in testimony to the US Senate Finance Committee, lauded two examples of Bermuda’s cooperation with the US in enforcement of tax compliance matters—cooperation made possible by the US/Bermuda Tax Information Exchange Agreement.

15. The financial services regulator in Bermuda (the Bermuda Monetary Authority—BMA) also has in place memorandums of understanding that allow information sharing with insurance regulators in other jurisdictions. Bermuda’s government has been recognized by both the Organization for Economic Cooperation and Development (OECD) and the US Treasury as a “cooperative” jurisdiction. Bermuda is in the midst of implementing substantial improvements in its anti-money laundering laws, regulations and oversight as recommended recently by the IMF in an FSAP dealing with those issues.

16. To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?

17. International Financial Centers like Bermuda have played a key role in product innovation allowing capital markets to more directly assume insurance risk. Positive examples of specific products include catastrophe bonds, weather derivatives and index triggered reinsurance products. New products are more easily developed and sold in a regulatory environment with a principal based approach to regulation, such as is found in Bermuda. Marketing of these products, then proceeds to more established financial centres where the sophisticated buyer is also subject to regulation (such as the US Securities and Exchange Commission—SEC). Consumers worldwide have benefited from the development of such risk transfer products, as have been developed in Bermuda.

18. The current “credit crisis”, which at the very least was exacerbated by the complex financial instruments such as mortgage backed securities, had nothing to do with international financial centres; in fact the calamity seems to be centered in the large, well established financial centres in Europe and the United States.

19. It is interesting to note that international insurance regulators have recognized that insurance companies carry neither undue insurance nor investment risk in respect of these products.

20. How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets?

21. Bermuda has thrived as an international financial centre with the full light of disclosure and transparency as requested by our trading partners. Bermuda’s solid reputation, cooperative stance, and transparent regime have allowed this jurisdiction to flourish. Transparency is very important to establishing credibility with international financial centres. Without a commitment to transparency a jurisdiction can not succeed as an international financial centre because our customers demand the same transparency that regulators seek in order to build confidence in the market.

22. How do the taxation policies of Offshore Financial Centres impact on UK tax revenue and policy?

23. Taxation policies of International Financial Centres may have an impact on tax policy in the UK but it is unlikely to be the most significant, factor. We are aware that there is on ongoing debate on how UK headline tax rates compare with others in the European Economic Area and with Switzerland and we understand that the UK government is focusing on this issue.

24. The tax regimes of Ireland and Switzerland have sometimes been considered by businesses to be better aligned with the needs of international business and we are aware that work has been done that suggests that the UK headline tax rate and the complexity of the UK tax law creates an incentive for UK businesses to relocate elsewhere.

complex and too changeable to provide the right environment for British Businesses.” Further the Executive Summary of that report notes: “An uncompetitive tax system not only erodes the competitiveness of those businesses under its jurisdiction, it also risks driving economic activity offshore.” Bermuda, of course, lacks an international treaty network, has a limited infrastructure and is far removed from Europe. It does not offer the tax competition (nor does it seek to do so) that Ireland and Switzerland, amongst others, may present to the UK.

26. It must also be remembered that ABIR members are substantial employers in London with, in addition to 1,700 employees in Bermuda, some 2,300 employees in the UK. They are for the most part employed in UK subsidiary operations (regulated by the FSA) with all the staffing requirements and tax obligations that apply to any UK business.

27. Are British Overseas Territories and Crown Dependencies well-regarded as Offshore Financial Centres, both in comparison to their peers and international standards?

28. Bermuda is well respected by the international insurance sector and the regulatory community. Bermuda’s peers with regard to insurance are not other “offshore” financial centres, but the United States and the United Kingdom. These three jurisdictions are the world’s three largest commercial specialty insurance and reinsurance centres.

29. Of course international standards are regularly revised and the bar continues to be raised. There may be a time lag in adoption of those standards and there is also a time lag between the time the jurisdiction is evaluated and when a report is published.

30. However, Bermuda has consistently been applauded by international bodies, including the US Department of Treasury and the OECD, as a “cooperative” jurisdiction with regard to international financial transactions and is not considered a domicile where money laundering is a problem.

31. To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?

32. Many “Offshore” Financial Centres (OFCs) have made significant progress in addressing both the issues of combating anti-money laundering (AML) and countering terrorist financing (CTF).

33. The IMF OFC Assessment program includes a detailed assessment of the AML/CFT regimes. In addition, the Financial Action Task Force (FAFT) is assessing and promoting AML/CFT measures. At its March 2005 meeting the Financial Stability Forum (FSF), in acknowledging the progress in the assessments of OFCs conducted by the IMF, withdrew its 2000 listing of OFCs.

34. By the end of 2003, 41 of the 44 contacted OFC jurisdictions had completed some form of an IMF assessment and in addition, at least 19 jurisdictions had received technical assistance as it relates to their AML/CFT regimes. OFC jurisdictions continue to be monitored as part of the ongoing IMF OFC assessment program which for the large part makes its findings public. As FAFT adopted its 40 recommendations with respect to AML in 2003 and additional special recommendations with respect to terrorist financing in 2004, OFCs had moved to enact legislation and implement regimes that meet international best practices.

35. Bermuda is an International Financial Centre, distinguishable from OFC’s and is in the midst of a comprehensive review and update of its AML/CFT program.

36. What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?

37. International Financial Centres like Bermuda’s insurance market are complementary to the longer established UK insurance market. Each market works with each other to meet global market needs, each market has its own strengths.

38. The Lloyd’s of London market particularly has made substantial improvements in efficiency and regulation that has improved its competitive position. It’s global licensing network is unique and makes it well positioned to serve global insurance market needs. Bermuda owned companies now provide an estimated 25% of Lloyd’s insurance capacity (2007 data). The Lloyd’s model affords capital efficiency that is unique in the world. This capital efficiency (ability to operate with reduced capital because of an ability to rely on the Central Fund for financial support) makes it the most efficient insurance capital platform in the world, as cited by Professor Tim Congdon in his July 2007 research entitled “How Profitable is Lloyd’s Underwriting?”
39. The regulatory reforms of the UK Financial Services Authority have also been recognized by insurance markets. The regulatory reforms have put the UK in the leadership again within the EU in the development of harmonized insurance regulatory standards that can be applied on a global basis thus creating certain regulatory efficiencies for global insurance groups.

40. As for tax policy, as previously noted, we refer to the recommendations of the Confederation of British Industry (UK Business Tax: a Compelling Case for Change, March 2008). Further the Executive Summary of that report notes: “An uncompetitive tax system not only erodes the competitiveness of those businesses under its jurisdiction, it also risks driving economic activity offshore.”

41. What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres?

42. Bermuda does not have a tax treaty with the United Kingdom, other than the tax information exchange agreement. Therefore there are no double taxation treaty problems with Bermuda.

43. To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?

44. Evading income taxes is illegal. Tax information exchange agreements are intended to assist tax authorities in overseeing compliance with tax law. Since Bermuda is a cooperative jurisdiction, and a British Overseas Territory, we believe there is an effective spirit of cooperation between the UK and Bermuda governments.

18 June 2008

Memorandum from the States of Guernsey and the Guernsey Financial Services Commission

1. EXECUTIVE SUMMARY

1.1 Guernsey is a well-regulated financial centre committed to maintaining international financial stability and transparency. Guernsey has consistently demonstrated this commitment through international co-operation and information exchange. Recent examples include its constructive partnership with United Kingdom (UK) authorities on the resolution of issues such as those around split-capital investment trusts (see 4.14), and those around Northern Rock (see 4.15).

1.2 The classification of financial centres as “off shore” or “on shore” does not fairly distinguish between those jurisdictions which are well regulated and transparent and those which are not. Each jurisdiction should be considered on its own merits on the basis of objective criteria. By a number of objective measures, reports and assessments Guernsey is a well regulated, transparent and co-operative jurisdiction committed to maintaining international financial stability and preventing financial crime (see in particular 4.11 to 4.15 and 6).

1.3 Guernsey’s reputation as a premier provider of international financial services has been built on a number of foundations, including:

- an effective regulatory regime that meets or exceeds all international standards on financial regulation, anti-money laundering and combating the financing of terrorism;
- international co-operation on regulation and the investigation of financial crime;
- competitive taxation and certainty in its taxation system;
- regular, external, and independent reviews—in the majority of cases at Guernsey’s express invitation and in all cases with Guernsey’s full co-operation and assistance;
- a highly skilled and educated workforce; and
- proximity to the UK and Europe.

1.4 The authorities in Guernsey have substantial investigative powers. They work closely with their counterparts in other jurisdictions (and in particular those in the UK such as HM Revenue and Customs and the Serious Organised Crime Agency) in investigating regulatory, taxation, and criminal matters and assisting in freezing and recovering the proceeds of crime.
2. INTRODUCTION: GUERNSEY’S STATUS AND INTERNATIONAL RELATIONSHIPS

The government of Guernsey

2.1 Guernsey has its own elected legislature called the States of Guernsey (“the States”). The administration of the 10 government departments is overseen by a Chief Minister and 10 Ministers which form the Policy Council. The 10 Departments are each led by a Minister and four peoples’ deputies who are members of the States.

Guernsey’s relationship with the UK

2.2 Guernsey is a Crown Dependency. The Sovereign in Council exercises supreme legislative and judicial powers in Guernsey and has ultimate responsibility for the good government of the Island. The Crown acts through the Privy Council on the recommendations of the Ministers of Her Majesty’s Government in their capacity as Privy Counsellors. The Ministry of Justice acts as the point of contact between the States and the Crown but is not otherwise involved in the Island’s internal affairs. The Ministry of Justice is responsible for ensuring that legislation approved by the States is placed before the Privy Council for Royal Sanction. The UK Parliament does not legislate on behalf of Guernsey without first obtaining the consent of the insular authorities. The extension of an Act of Parliament to Guernsey is exceptional. Where uniform legislation is required the ordinary practice is for the States of Guernsey to enact its own “mirror” legislation.

2.3 Guernsey is not, and has never been, represented in the UK parliament. The States of Guernsey, and always has been, legislatively independent from the UK with the full capacity to legislate for the Island’s insular affairs. Guernsey’s right to raise its own taxes is a long recognised constitutional principle. The government of the UK does not provide any direct financial assistance to Guernsey.

2.4 The UK is responsible for Guernsey’s international relations and for its defence. In recent years the UK has recognised the appropriateness of Guernsey having greater independence with respect to international relations, particularly where those affairs relate to matters within the competence of the States. Guernsey has never been an overseas territory or a colony and the constitutional relationship is distinctly different from that of the British Overseas Territories.

Guernsey’s relationship with the European Union

2.5 Under Protocol 3 to the Treaty of Accession, Guernsey has a special relationship with the European Union and the majority of EU Directives do not automatically apply in Guernsey. As far as financial services are concerned Guernsey is a third country under EU law. Nonetheless Guernsey implements EU laws when it considers it appropriate to do so and meets the international standards on which they are based.

3. THE FINANCE INDUSTRY IN GUERNSEY

Development of the finance sector

3.1 Guernsey’s financial services sector began to grow in the 1960s with the establishment of operations in Guernsey by UK merchant banks and of the collective investment schemes which they sponsored. By 1987 the banking, insurance and collective investment scheme sectors had developed to such an extent that the States of Guernsey took the decision that it should establish an independent regulatory body staffed by dedicated professionals. This was in accordance with internationally accepted best practice at the time. The Guernsey Financial Services Commission (“the Commission”) was established in 1988. During the 1990s Guernsey became one of the world’s largest captive insurance centres, and today Guernsey is Europe’s largest, and the world’s fifth largest, captive insurance centre. The Channel Islands Stock Exchange (CISX), which is based in Guernsey and is the only stock exchange in the Channel Islands, commenced operations in 1998. The CISX has been recognised by the United States Securities and Exchange Commission, the Financial Services Authority (the FSA) and Her Majesty’s Revenue and Customs (HMRC). As the sector

349 This section is drawn from Ogier, D, The Government and the Law of Guernsey, 2005. Further information on Guernsey is available at: www.gov.gg/aboutguernsey
350 The Bailiwick of Guernsey includes the separate jurisdictions Guernsey, Alderney and Sark. Sark is a separate jurisdiction for taxation purposes and levies no tax on income or company profits. There is no companies’ law in Sark. All three jurisdictions are subject to identical regulation of financial services. For ease of reference the term “Guernsey” will be used unless it is necessary to distinguish between the jurisdictions for any reason.
351 Departments may appoint up to two non-States members as non-voting members of each Department.
354 For example Guernsey has entered into a number of tax co-operation and information exchange agreements with other sovereign States in its own right.
continues to develop, so an increasing number of professional firms exist to service the finance industry, particularly in the accounting, legal and actuarial professions. As at 31 March 2008 there were 7,893 people employed in the finance industry.

3.2 Guernsey has developed considerable expertise in administering collective investment schemes, captive insurers and trust and company structures. In addition to expertise in niche areas, the size and diversity of the finance sector enables a great diversity and sophistication in the products and services available. These factors—along with a robust regulatory framework that marries compliance with international standards and an effective handling of risk—attract financial services business to Guernsey.

**The banking sector in Guernsey**

3.3 At 31 March 2008 there were 47 licensed banks from 17 jurisdictions based in Guernsey. Deposits as at 31 March 2008 were £129.6 billion. All are part of wider banking or building society groups operating elsewhere and there are no indigenous Guernsey banks. The types of business carried out by banks include:

- community banking carried out by branches or subsidiaries of Jersey, Isle of Man or UK clearing banks;
- banks and building societies operating subsidiary banks in Guernsey offering a range of services, including deposit-gathering from expatriates and deposit-gathering from local and foreign depositors;
- international private banking, which can involve discretionary asset management. The principal products offered to private clients are call and term deposits, and structured products which have a guaranteed minimum value but may also participate in the growth of securities or commodities markets;
- custodial and sub-custodial services for the funds administration sector; and
- standby letters of credit for the insurance industry.

**Investment business in Guernsey**

3.4 The types of investment business carried out in Guernsey include the management, administration and custody of open and closed-ended collective investment funds; discretionary and non-discretionary asset management; stock-broking; and the provision of investment advice. The total value of assets held by collective investment funds under management or administration (including non-Guernsey collective investment schemes administered within Guernsey) at 31 March 2008 was £203.8 billion. At that date, there were 290 authorised open-ended schemes with 1,901 pools of assets and 582 closed-ended funds with 645 pools of assets. These schemes/funds were sponsored by institutions based in 50 countries. Of these, 121 schemes/funds were listed on a stock exchange in the UK.

**Insurance business in Guernsey**

3.5 Insurance business in Guernsey can be divided into three distinct sectors:

- domestic insurance business. As at 31 March 2008 there were 25 insurers engaged in domestic business, including five local insurers writing domestic insurance business in the Guernsey and 20 other domestic insurers who have a physical presence in Guernsey which are incorporated and authorised to write business within a Member State of the European Union;
- international insurance business which can be categorised as captive insurance, commercial insurance or international life and employee benefits. As at 31 March 2008 there were 368 licensed international insurers. The majority of these international insurance companies have been established by UK based groups but 135 were established by non-UK based groups from a wide range of jurisdictions. Specialist insurance management companies manage most of the international insurers. There were 25 licensed management companies on 31 March 2008; and
- insurance intermediaries, comprising both insurance brokers and insurance agents. At 31 March 2008 there were 44 registered intermediaries.

**Fiduciary services in Guernsey**

3.6 Fiduciary services principally relate to trust management and administration, company management and administration and, to a lesser degree, the provision of executorship services. The firms providing fiduciary services in Guernsey are varied and range from the bank owned trust companies to a number of independently owned private trust companies. There were 196 licensed full and personal fiduciaries at 31 March 2008. The most common form of Guernsey trust is the private discretionary trust. Besides their private use in family situations, trusts are used as investment vehicles (collective investment funds) and for company pension schemes and employee benefit schemes. The different forms of companies operating or

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355 This represents approximately 25% of Guernsey's workforce. On 31 March 2006 Guernsey's estimated population was 61,000 and its estimated workforce was 31,930.
registered in Guernsey are companies limited by shares, companies limited by guarantee, companies limited by shares and guarantee, protected cell companies and incorporated cell companies. As at 28 May 2008 there were 19,341 companies on the Guernsey register of companies.

4. Regulation of the Financial Services Industry in Guernsey

The powers of the Guernsey Financial Services Commission

4.1 The Commission was one of the world’s first unitary regulatory bodies, and is responsible for the regulation of banks, insurers and insurance intermediaries, investment firms, trust companies, company administrators and professional company directors providing directorship services by way of business in Guernsey. It has been given wide-ranging powers to supervise and investigate regulated entities under a variety of regulatory laws. It also takes appropriate enforcement action when necessary. The Commission considers that the prevention of financial instability is one of the key functions of effective regulation.

4.2 Guernsey is one of the few jurisdictions in the world to regulate trust and company service providers in a manner consistent with the prudential regulation of banks, investment firms and insurance companies. It has regulated trust and company service providers in this way since 2001. Unlike supervisors in other jurisdictions the Commission also has the role—under Guernsey’s Control of Borrowing legislation—of scrutinising the establishment of closed-ended collective investment funds.

Meeting international regulatory standards

4.3 In performing its regulatory and supervisory work the international standards adopted by the Commission are those established by:

— The Basel Committee on Banking Supervision.
— The International Association of Insurance Supervisors.
— The International Organization of Securities Commissions.
— The Offshore Group of Banking Supervisors.

4.4 The Commission, along with the States of Guernsey, has invited the International Monetary Fund (IMF) to provide an independent and external review of Guernsey’s compliance with those international standards. This review is presently scheduled for January 2009.

4.5 The Commission is actively involved with international regulatory and supervisory organisations. Guernsey was a founder member of the International Association of Insurance Supervisors (IAIS), of the Offshore Group of Insurance Supervisors, and of the Offshore Group of Banking Supervisors. The Director General of the Commission sits on the Executive Committee of the IAIS and officers of the Commission are actively involved with many of the IAIS’s committees and working groups, especially in those areas where Guernsey has particular expertise such as the supervision of captive insurance. The Commission is also a full member of the International Organisation of Securities Commissions (IOSCO) and a member of the enlarged contact group on the Supervision of Collective Investment Funds.

The Guernsey Financial Services Commission’s licensing and supervision regime

4.6 Since its establishment, the Commission has pursued a policy of selectivity when vetting new entrants to the finance sector. As a result, the Commission has been able to reduce the risk of poor quality businesses being established in Guernsey. The laws under which the Commission regulates financial services businesses contain minimum criteria for licensing. An applicant must continue to meet these requirements in order to maintain a licence. The requirements include:

— integrity and skill—the business must be carried on with prudence, integrity, professional skill and in a manner which will not bring Guernsey into disrepute;
— fit and proper—the business and its owners and directors must be fit and proper, ie honest, competent and solvent;
— “four-eyes”—the business is to be directed by at least two independent individuals of appropriate standing and experience;
— composition of the board of directors—the board shall include an appropriate mix of executive and non-executive directors; and
— business to be conducted in prudent manner—the business should maintain an appropriate mix of business base, insurance cover, adequate liquidity and provision for depreciation of assets, liabilities or losses and should maintain adequate records and systems of control.

4.7 To ensure that licensees continue to meet these requirements the Commission uses a combination of off-site and on-site supervision. Off-site supervision consists of evaluating whether or not licensees meet the requirements of the regulatory laws and the Commission’s rules, codes, guidance and policies by analysis of
information (such as annual reports, business plans, or notifications of specific events) provided by regulated entities. On-site supervision comprises inspections by Commission staff of licensees’ activities by visiting their premises (often for several days). The Commission has issued rules, codes and guidance to licensees on operational requirements. These cover, for example, corporate governance, capital adequacy and anti-money laundering (AML) and combating the financing of terrorism (CFT).

**Transparency and Information Exchange**

4.8 The Commission has the legal authority to disclose information to other supervisory authorities. It can also disclose information to other authorities for the purposes of preventing, detecting, investigating and prosecuting financial crime. In addition, the Commission may obtain information from licensees on behalf of foreign supervisory bodies. The Commission shares information with supervisory authorities and other bodies spontaneously as well as on request. Although it has 13 Memoranda of Understanding (MoUs) with international partners (including the FSA), an MoU is not required to allow information exchange. In light of the links between UK financial services businesses and Guernsey, it is common for the Commission to co-operate and exchange information with the FSA. The Commission has applied to become a signatory to the IOSCO multilateral memorandum of understanding.

4.9 Regarding transparency of transactions, the AML and CFT legislation and rules made by the Commission require financial services businesses to undertake customer due diligence on their potential customers and to look through legal persons such as companies and legal arrangements such as trusts to undertake customer due diligence on beneficial owners, settlors, beneficiaries and other underlying principals and to maintain both customer due diligence and transaction records. In addition, rules made under the Protection of Investors Law require investor transaction records to be maintained (for example, contract notes). HM Procureur (the Attorney General) and the Commission have powers under the legislation they administer to obtain that information on behalf of foreign authorities and to disclose it to those authorities.

4.10 Guernsey is also one of the few jurisdictions which, when the Companies Law 2008 comes into force on 1 July 2008, will require local companies to appoint a resident agent who must take steps to ascertain the identity of the persons who are the beneficial owners of members’ interests.

**Financial Stability**

4.11 Financial stability is a priority for the Commission, both in terms of reducing the potential domestic effect of a crisis and in reducing the potential export of instability. Banking in Guernsey is essentially traditional. It is liability driven with banks seeking low risk outlets for their deposit balances. The aggregate balance sheet assets and liabilities of Guernsey banks were £146.1 billion. At the same date off balance sheet liabilities represented credit guarantees, undrawn committed credit lines, and foreign exchange and interest rate hedging contracts. These contracts exist to manage the risk in the balance sheet and not for speculative purposes. Banks in Guernsey are either branches or subsidiaries of Banks elsewhere and they do not take own account trading positions; positions taken are only minimal intraday foreign exchange positions. Proprietary positions are taken by parent banks with extensive dealing rooms in the major trading centres such as London or New York, where dealers can be close to fast moving market activity. In that context, there is no opportunity for rogue traders in Guernsey to have an effect in destabilising markets elsewhere.

4.12 The size of the collective investment fund sector is not significant with regard to global financial stability. In addition, the sector is diverse in terms of its investments—global equities, global bonds, private equity, venture capital, debt, funds of hedge funds and, to a more limited extent, hedge funds. Due to this diversity, potential problems in any one category of fund will have a limited effect on the sector as a whole both within and outside Guernsey. Only five funds, established by different groups, have gearing of greater than three times net assets. In the insurance area, stability is enhanced as the majority of Guernsey insurers are captive vehicles, a significant proportion of the risk of which is reinsured across the global reinsurance market.

4.13 In recent years, contrary to the widespread perception that off-shore financial centres are a risk to global financial stability, the Commission has had to deal with instability imported into Guernsey by institutions in an “onshore” jurisdiction—principally the UK. This is perhaps inevitable in light of the size of the UK financial sector and of the size and global reach of individual institutions within the sector.

4.14 In 2001 the Commission became concerned about split capital investment trusts and their levels of gearing and, in light of the possibility of systemic risk, stepped up required risk warnings in prospectuses. As indicated in the Treasury Select Committee’s report to Parliament on split capital investment trusts, the Commission publicly identified risk issues before the FSA and wrote to the FSA about its concerns.

4.15 More recently, the Commission has had to deal with the effect of the Northern Rock crisis in Guernsey. Northern Rock’s business model was unsustainable during the credit crunch and led the need for financial assistance from the UK government. Northern Rock had (and still has) a subsidiary in Guernsey which remained solvent throughout the crisis, its principal vulnerability being its exposure to its UK parent. The Northern Rock crisis was therefore exported to Guernsey from the UK. The Director General of the
Commission has, in response to invitations, made presentations to the IMF, the IAIS and the EU Committee of European Insurance and Occupational Pensions Supervisors on the cross-border implications and handling of the Northern Rock (Guernsey) case, with particular reference to cross-border supervisory co-operation.

5. TAXATION

Guernsey’s taxation system

5.1 Guernsey has a well developed taxation system. Taxes in Guernsey are set on the basis of the need to fund public services and the need to ensure that Guernsey’s economy remains strong. Taxation in Guernsey is managed by the Administrator of Income Tax who is responsible for administering legislation relating to Income Tax, Dwellings Profits Tax, and Foreign Tax in support of the EU Directive on the Taxation of Savings Income (2003/48/EC). Apart from dwellings profits tax there is no tax on capital gains or any other taxes on capital in Guernsey. Guernsey’s personal income tax is set at 20%, a rate which has remained unchanged for over 40 years. Guernsey does not have a Value Added Tax but does have a range of indirect taxes and duties.

Company Tax and the EU Code of Conduct on Business Taxation

5.2 As part of its commitment to eliminating harmful tax competition Guernsey has complied fully with the EU Code of Conduct on Business Taxation, and has fulfilled its commitment on rollback/standstill under the Code. From 1 January 2008, the standard rate of company tax is 0% for most company profits. For certain company profits arising out of licensed institutions that conduct “banking business” tax is set at 10%. The flat 20% tax rate which existed before 1 January 2008 remains for the company profits of utilities and on any income that arises from land or buildings situated in Guernsey. Guernsey’s tax system is relatively uncomplicated and effective which minimises the compliance costs on business. Globally there is downward pressure on company tax rates.

Double Tax Agreements

5.3 Guernsey currently has two double tax arrangements: with the UK, signed in 1952; and with Jersey, signed in 1955. The agreements provide for the exchange of information in order to prevent fiscal evasion or avoidance. For many years Guernsey has been able to provide information from its tax files to the UK tax authorities, and has done so on a regular basis, both spontaneously and as requested by the UK. Exchange of information under the double tax arrangement with the UK has led to the opening of investigations or advancement of existing investigations by HMRC.

5.4 Guernsey has implemented measures that are the same as those contained in the EU Directive on the Taxation of Savings Income, has entered into bilateral agreements with each EU Member State, and has introduced legislation to give effect to those agreements. Those agreements provide for the retention of tax by Guernsey paying agents in respect of interest and similar payments made to residents of EU Member States or, where the investor elects, for exchange of information in respect of the interest to their Member State of residence. This tax and information is collected and exchanged on an annual basis, in support of the Directive.

Tax Information Exchange Agreements (TIEAs)

5.5 For many years Guernsey had been providing information to other jurisdictions in respect of criminal tax investigations. Guernsey does not have any banking secrecy legislation. A person’s banking affairs are confidential in much the same way as they are in the UK. The authorities in Guernsey can access banking information when necessary.

5.6 In February 2002 Guernsey publicly announced its commitment to co-operate with the Organisation for Economic Co-operation and Development (OECD)’s initiative on transparency and exchange of information, and is a participating partner in the OECD Global Forum on Taxation. One of the main objectives of this project was to encourage the implementation of TIEAs between OECD Members, and between OECD and non-OECD Members. In return for this public commitment, the OECD agreed to establish a level playing field between all jurisdictions (OECD members and non-members) to enable fair competition on tax.

356 Dwellings Profits Tax is an anti-speculation tax designed to prevent speculation in the property market.


358 See for example a lecture given by the Secretary General of the OECD on 22 April 2008, available at: http://www.oecd.org/document/23/0,3343,en_2649_201185_40499607_1_1_1_1_1_00.html. In that lecture the Secretary General argues that company taxes discourage entrepreneurship and slow economic growth.
5.7 Guernsey signed its first TIEA with the United States of America in September 2002. Since 2002 negotiations have been in progress with a number of other jurisdictions, notwithstanding that the OECD has yet to ensure that a level playing field is in fact in place. In April 2008, Guernsey signed a second TIEA (with the Netherlands\textsuperscript{359}), and is currently in varying stages of negotiations with several jurisdictions both OECD and non-OEC.

6. ANTI-MONEY LAUNDERING (AML)/COMBATING THE FINANCE OF TERRORISM (CFT) FRAMEWORK

6.1 The Guernsey authorities are committed to ensuring that money launderers, terrorists, those financing terrorism and other criminals—including those seeking to evade tax—cannot launder those proceeds of crime through Guernsey, or otherwise abuse Guernsey’s finance sector. The AML/CFT authorities in Guernsey endorse the Financial Action Task Force (FATF)’s 40 Recommendations on Money Laundering and the Nine Special Recommendations on Terrorist Financing. The States has introduced new legislation, amended existing legislation, and the Commission has introduced rules and guidance in order to meet the FATF’s developing standards. Since 1999, the Commission has undertaken a programme of on-site inspections to financial services businesses (which includes trust and company service providers) in order to assess their compliance with the AML/CFT framework.

6.2 All businesses and individuals are required by the AML/CFT legislation to report suspicion of money laundering when they suspect or have reasonable grounds to suspect that funds are the proceeds of criminal activity (which includes tax evasion). The same obligation to report suspicion applies to assets where there are reasonable grounds to suspect or they are suspected to be linked or related to, or to be used for terrorism, terrorist acts or by terrorist organisations or those who finance terrorism. Businesses and individuals reporting suspicion are protected by law from any breach of confidentiality.

6.3 Extensive AML/CFT countermeasures apply to all financial services businesses operating in Guernsey, plus trust and company service providers. The international standards set by the FATF did not apply to trust and company service providers until June 2003. However, the revised AML/CFT framework that came into force in Guernsey on 1 January 2000 subjected trust and company service providers to the full remit of AML/CFT regulation. As a result, since 2000 trust and company service providers have been required by regulations to ascertain the identity of the beneficial owners of companies, the identity of settlors and beneficiaries of trusts and the identity of any other underlying principals.

7. FINANCIAL INTELLIGENCE AND INVESTIGATION

Guernsey’s Financial Intelligence Service

7.1 The Financial Intelligence Service (FIS) is responsible for the collation and dissemination of intelligence relating to financial crime in Guernsey. Formed in 2001, the FIS\textsuperscript{360} is operationally independent although staffed and funded by the law enforcement agencies of the Guernsey Police and the Customs and Excise, Immigration and Nationality Service (“Customs”). The strategic aims of the FIS are:

— the provision of quality intelligence with regard to all financial crime, with a special emphasis on combating money laundering and countering the financing of terrorism;

— the provision of full international co-operation, within the law, to competent and relevant overseas authorities; and

— the provision of services to enhance the co-ordination and the development of criminal intelligence to combat financial crime.

7.2 The staff of law enforcement (the FIS, the Fraud and International Team, and the Commercial Fraud and International Affairs Team) are highly skilled specialists and experienced in the investigation of financial crime. The FIS also is the point of contact for those seeking assistance in relation to financial crime and receives requests for assistance from both local law enforcement and overseas agencies. Since 1997, law enforcement in Guernsey has been a member of the Egmont Group of Financial Intelligence Units. Where the FIS receives intelligence enquiries of a criminal nature that are proportionate and justified the the FIS does not require a Memorandum of Understanding (MoU) in order to exchange information. However where an authority in another jurisdiction does require an MoU to allow information exchange the FIS will enter into such an agreement if there is an operational need. At present the FIS is party to 13 MoUs with international partners, including the UK Serious Organised Crime Agency (SOCA).

\textsuperscript{359} See: http://www.oecd.org/document/19/0,3343,en_2649_34897_40518675_1_1_1_1,00.html

\textsuperscript{360} See the FIS website available at: http://www.guernseyfis.org, also available at that website are the FIS annual reports which provide data on the FIS’ activities in each year.
Suspicous Transaction Reports

7.3 The FIS is the designated authority to receive suspicious transaction reports (STRs) in Guernsey. The FIS investigates all STRs with most being disseminated to relevant local and overseas agencies. Over the past five years the average number of STRs referred to the FIS has been more than 600 per annum. STRs largely relate to suspicions of tax evasion, large cash transactions, and unexplained lifestyles. STRs relating to suspected terrorism are relatively rare and comprise only a small portion of reports received. The high number of reports demonstrates the high level of awareness of AML/CFT obligations in the finance industry in Guernsey. Over 75% of STRs do not relate to local Guernsey residents. Where there is evidence of tax evasion it is Guernsey policy to disseminate all STRs to the appropriate jurisdiction as it would any other STR relating to any other criminal activity. Recent legislation allows intelligence to be disseminated to the SOCA to assist civil investigations in the UK (and elsewhere). The FIS also regularly provides STRs to EU member states and OECD countries.

Co-operation with HM Revenue and Customs

7.4 The Customs Service has very close ties with HM Revenue and Customs (HMRC). The training of Guernsey Customs officers is delivered by HMRC and most procedures and standards used on the Island are equivalent to those used by HMRC. Guernsey Customs officers meet regularly with representatives of HMRC and there is a history of co-operation between the two agencies. Historically HMRC has sought assistance in investigating suspected VAT evasion, money laundering, income tax evasion, duty evasion and smuggling. The sums involved in those investigations are significant. The Commercial Fraud and External Affairs Department of the Guernsey Police have also dealt with letters of request from HMRC where appropriate. Guernsey’s Police and Customs are trained to the same standard as their UK counterparts and work closely with officers of SOCA.

Co-operation with international jurisdictions

7.5 To counter the significant threat posed by sophisticated international money laundering Guernsey has introduced new legislation to give law enforcement greater powers to freeze and recover the proceeds of crime through both criminal and civil action. The laws also make it easier for law enforcement to prosecute money laundering offences. Guernsey regularly assists other jurisdictions who request assistance in obtaining evidence, tracing and freezing assets, and recovering assets related to criminal proceedings. Guernsey has had considerable success in freezing and recovering assets on behalf of many other jurisdictions including the UK, other EU member States and the United States of America. In many cases substantial sums were involved and in several cases substantial sums were repatriated to the requesting State. A significant portion of matters in which Guernsey provides assistance relate to taxation.

8. International Reviews

Independent reviews and assessments since 1998

8.1 Guernsey’s long-standing commitment to meeting international regulatory and criminal justice standards has been demonstrated in a range of independent reviews and assessments undertaken since 1998 on financial regulation, AML/CFT, financial stability, and harmful tax co-operation. Guernsey has invited external reviews from the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), and other bodies. The reviews include:

— 2000—the FATF’s review to identify non-co-operative countries and territories.
— 2000—the Financial Stability Forum (FSF) assessment of off-shore finance centres and whether their regimes could adversely affect global financial stability.
— 2000—the Offshore Group of Banking Supervisors’ mutual evaluation of the anti-money laundering system in Guernsey.
— 2002—the IMF’s assessment of compliance with international regulatory and supervisory standards, and compliance with international AML/CFT standards.364

8.2 In 1998 the Edwards Report concluded that: “[The Crown Dependencies] have developed reputations for stability, integrity, professionalism, competence, and good regulation . . . . I have no doubt that the [Crown Dependencies] are in the top division of offshore centres. Many of the professional people I consulted commended their standards of regulation, the absence of corruption, and their co-operation with other Jurisdictions, especially in the pursuit of drug-trafficking”.

363 The number of requests from the UK amount to 49% of the total number requests for assistance.
364 The number of requests from other EU Member States amount to 30% of the total number of requests for assistance.
365 See note 5 above.
366 The full text of the IMF report is available at: http://www.imf.org/external/np/ofca/ofca.asp#G
8.3 The other inspections carried out since 1998 have confirmed that Guernsey has a well regulated finance industry and a high level of compliance with all international standards including AML/CFT standards. In 2000 the FSF assessed Guernsey as being a jurisdiction which was co-operative and had a high quality of supervision adhering to international standards. Guernsey was considered by the FSF to be a Group 1 jurisdiction, ie the best group alongside Luxembourg, Switzerland, Dublin and Hong Kong. The FSF concluded that offshore financial centres were not a threat to financial stability.

International Monetary Fund Report

8.4 In the report issued by the IMF in 2003 Guernsey was assessed as having “a high level of compliance” for each of the international standards against which the Bailiwick was judged—the Basel Core principles for Effective Banking Supervision; the Insurance Core Principles of the International Association of Insurance Supervisors (IAIS); the Objectives and Principles of Securities Regulation of the International Organization of Securities Commissions (IOSCO); and the FATF 40 + 8 Recommendations (as they then were—it is now 40 + 9, see 6.1). Guernsey’s legal framework for company and trust service providers was also found by the IMF to be “fully consistent with the Offshore Group of Banking Supervisors (OGBS) Statement of Best Practice”. The IMF’s report also commended the Guernsey authorities for the attention they had given to upgrading the financial regulatory and supervisory system and stated: “The mission noted in particular: the comprehensive regulatory framework; the proactive approach of the regulators to achieve high standards in the financial services sector; and an off- and on-site supervisory process that has been addressing the key types of reputational risk to the Bailiwick”.

8.5 Guernsey has invited the IMF to re-assess the Island’s financial, regulatory and criminal justice structure and that assessment is scheduled for January 2009. The assessment will also include financial stability elements in the banking and insurance sectors. Guernsey looks forward to the results of the IMF’s assessment and believes that it will confirm Guernsey’s continuing commitment to meeting international standards.

Guernsey and European Union Directives

8.6 In 2004, in the context of agreements on the EU Directive on the Taxation of Savings, Guernsey satisfied the European Commission that its AML/CFT framework is equivalent to the Second EU Money Laundering Directive. With reference to the Third EU Money Laundering Directive, in May 2008, the EU Committee on the Prevention of Money Laundering and Terrorist Financing agreed a list of equivalent third countries, ie countries that are considered as having equivalent AML/CFT systems to the EU. The Committee confirmed that the UK Crown Dependencies may also be considered as equivalent by Member States. HM Treasury recently confirmed that it considers the UK Crown Dependencies to have an AML/CFT regimes equivalent to the Third EU Money Laundering Directive.365

June 2008

Memorandum from Professor E. FitzGerald, University of Oxford

GREY ASSETS AND BLACK TRANSACTIONS: A GLOBAL SECURITY PROBLEM

SUMMARY

International security in general, and that of the EU in particular, is threatened by the routing of criminal/terrorist “black” funds through offshore financial centres and unregulated cash transfer systems. Research now starting at Oxford University will investigate the extent to which this problem is made intractable by tax avoidance by wealth holders and lack of low cost banking for immigrant remittances, both of which generate large volumes of unregistered “grey” flows and assets that provide cover for black transactions. The findings will have important policy implications.

NEED FOR FURTHER RESEARCH

The key attraction of in offshore financial centres is secrecy (to avoid paying tax elsewhere), not low tax rates as such—and it is this secrecy which generates the security problem.366 Tax evaders require havens with strong property rights (often associated with major powers through treaties, dependency or regulatory agreements) combined with secrecy, precisely because they are not in a good position to claim asset ownership in domestic courts.

365 See HM Treasury’s press release available at:
http://www.hm-treasury.gov.uk/documents/financial_services/money/fin_crime_equivalence.cfm
This liquidity provides a “grey” cover for “black” criminal (narcotics, theft, arms, bribery etc) and terrorist transactions. In the case of migrant remittances, these are mostly transferred through informal nonbank cash transfer systems in order to avoid high bank costs on small transactions, and bureaucratic formalities in the home country. The enormous volume of these grey flows also provides ideal cover for black transactions related to criminal and terrorist activity.367

Current reporting systems do not work well, and even when the target is known tracking payments is a slow and costly process.368 There is need of further research from a strictly economic and financial viewpoint in order to understand the logic of these transactions, and thus design better methods detecting and preventing them.

Apart from the clear benefits in terms of global security, reduction or elimination of tax evasion through offshore financial centres would have clear benefits in terms of increased fiscal revenue, which could either be used to improve welfare services (particularly underfunded pension schemes) or to reduce the burden of taxation on lower income groups. Further, it would provide further fiscal resources to developing countries still burdened by debt problems and pressing infrastructure investment needs.369

STATE OF THE ART AND ADVANCES PROPOSED

Although these are widely recognized problems, most research work on them is from the legal370 and political disciplines371 on the one hand, or by intergovernmental agencies on the other.372 Despite the strong modern tradition of the application of economic logic to crime373 and more recent interest extensions to fields such as information security, this approach seems to be lacking in this field as exemplified by the contents of such leading journals as Journal of Money Laundering Control. International tax research also has potential for economic analysis of users’ motivations, but this too is mainly legal in nature.374

We are concerned with the decisions as to which channels are used to move and hold related assets, rather than the nature of the illegal, quasi-legal or unregulated activities themselves. The advance proposed in this project is to apply financial and economic models of investment decision making to available empirical data, in order to evaluate the factors which generate the “grey” transactions, and assess their propensity to provide an effective camouflage for “black” transactions.

EUSECON

As part of a large research programme funded by the European Community under the Seventh Framework Programme (Theme 10: Security) I am engaged as a key partner in the EUSECON (New Agenda for European Security Economics). The EUSECON is coordinated by the German Institute for Economic Research DIW Germany; and includes in addition to the University of Oxford, the Universities of Hamburg, Prague, Patras, Bilbao, Jerusalem, Thessaly, Linz and The Hague.

The objectives of our component of this programme are as follows:

— Establish empirically the extent to which offshore financial centres and informal money transfer systems provide an effective cover for criminal and/or terrorist funding transactions.

— Explain these observations analytically by reference to modern investment models, taking into account factors such as risk, returns and diversification on the one hand, and costs of information, transactions and agency on the other.

— Test the extent to which more effective tax information exchange and lower bank transfer costs could reduce grey flows and thus the cover given to black transactions.

Work started in May 2008 and will continue until September 2010.

The first stage will be to gather data and documentation from key international agencies, including the US and UK Treasuries, the OECD Centre for Tax Policy and Administration, the Financial Action Task Force, the UN/DESA Tax Cooperation Committee and the Bank of International Settlements. Contact has already been made with these agencies in previous research projects, and access to available information should not be problematic.

The second stage will be to analysis this data (both qualitatively and qualitatively) in the context a simple yet robust financial model of asset choice where the returns, risk and transactions costs are determined by the institutional characteristics of the channel and/or location chosen.


368 FitzGerald (2002) op. cit.


The third stage will be to derive the implications for the design of policy instruments. Of particular interest will be (a) the application of withholding taxes with offshore centres along the lines of exiting EU initiatives; and (b) the provision of free banking services for migrant remittances, connected with micro-credit institutions.

June 2008

Memorandum from the Investment Management Association (IMA)

I. EXECUTIVE SUMMARY

1. The Investment Management Association (IMA) represents the UK-based investment management industry. Our members include independent fund managers and the investment arms of retail banks, life insurers and investment banks. They are responsible for the management of £3.4 trillion of funds (based in the UK and elsewhere), including authorised investment funds, institutional funds, and a wide range of investment management services for private and institutional investors. In particular, our members represent 99% of funds under management in authorised investment funds.

2. These clients are both sizeable and international. Some £500 billion is managed within “UCITS” and other authorised funds, and a little under £1 trillion is managed for each of pension schemes and insurers. Other institutional funds, including sovereign wealth fund clients, provide almost all the remaining balance. To put this in context, the UK-based investment managers represented by the IMA manage investments which are larger than the world’s hedge funds and sovereign wealth funds put together.

3. This submission focuses on the use of pooled investment vehicles, where those vehicles are located in offshore centres. The investment management industry makes significant use of offshore locations as domiciles for their pooled vehicles, which commonly means somewhere as un-exotic as Luxembourg, Ireland, the Channel Islands or the Isle of Man. This submission explains why this is the case, and how Government policy, notably in the tax area, can contribute to it.

4. When determining where to domicile a pooled investment vehicle, the principal concern is what is optimal for the investors, bearing in mind that the returns earned belong to them—whether they are pension funds, other institutional funds or retail investors. The investment managers represented by the IMA do not invest on their own account but act solely on behalf of their clients whose assets are being invested. They do not wish to be party to or vulnerable to any form of tax evasion or terrorist financing.

5. In selecting a domicile for pooled investment vehicles (“funds”), a manager will take into account a number of factors, but the broad objective will be to deliver the best outcome for the client and in the most operationally efficient manner. Given the multinational nature of many investment management businesses—investing in many different jurisdictions for clients from many different countries—it is clearly efficient to concentrate operations in a small number of fund ranges globally rather than to maintain different ranges in every jurisdiction in which they operate. Thus, many investors worldwide will see their money invested in funds outside their own country.

6. A number of factors will affect these decisions: the extent and cost of expertise in the domicile; how it fits in with other parts of the manager’s business; and the likely impact of regulatory and tax factors on investors’ returns.

7. Recent years have seen significant growth of offshore funds, notably in Dublin and Luxembourg, but also in other centres such as the Channel Islands and Cayman Islands, at the expense of UK-domiciled funds. A study by KPMG for the IMA, “Taxation and the competitiveness of UK funds”, identified tax factors as key drivers of this trend.

8. This submission sets out the taxation aspects for this industry, for funds and for investors. There are, in certain circumstances, key fiscal uncertainties or clear disadvantages with using a UK fund as opposed to its offshore counterpart, especially where the same vehicle is intended to be sold to UK and non-UK investors alike. The simple fact is that the best location will tend to be selected. It is not the case that the UK is the default location—the UK must compete with other territories as a fund domicile. In many cases, the balance has been tipping away from the UK for some years and based on recent trends the UK could in the foreseeable future become a net importer of funds.

9. This has an impact on UK tax receipts and the current account, because of the professional and administrative activities which are carried out in the fund domicile rather than in the UK. Further work by KPMG for the IMA estimated that for every £1 billion of funds which were in an offshore location rather than the UK, the cost to the Exchequer was £0.7 million in terms of lost direct tax revenues. Overall EU growth in retail funds has run at 1.5 times that of the UK in the last 10 years, but Ireland and Luxembourg have achieved growth rates of 10.7 and 2.6 times that of the UK.

375 “The Value to the UK Economy of Authorised Investment Funds”, KPMG/IMA, 30 November 2007
10. If the UK were home to those funds domiciled in Luxembourg and Ireland with a UK investment manager, the UK direct tax receipts are estimated by the IMA to be equivalent to £286 million a year.

11. It should be emphasised that this is not a call for lower taxes on UK funds (save in one very narrow respect, where we have pointed to the impact of Schedule 19 Stamp Duty Reserve Tax, which in total raises only £90 million) and certainly not on investment management companies. Instead it concerns the perverse impact of tax policies designed without funds specifically in mind. A good example is the unclear distinction between trading and investing for tax purposes, where the uncertainty that investors could face a penal and difficult to justify tax charge is an incentive to locate funds in a jurisdiction where the risk does not exist.

12. The IMA is in dialogue with HM Treasury about these matters. But we have been given no assurance from Ministers that they will be solved, while, of course, the UK’s competitors do not stand still. Locations such as Luxembourg and Ireland have made very impressive progress in attracting funds, especially aimed at the European retail market. Likewise, the Channel Islands and Isle of Man are able to offer attractive domiciles to certain types of institutional funds.

13. In conclusion, the key points that the IMA would wish to make to the Committee are:

- There are good business reasons, which benefit both investment management companies and end investors, for locating certain activities offshore.
- Some of those factors are the unintended consequences of regulatory or, in particular, tax policies introduced for entirely different reasons.
- The IMA believes the Government should pay greater attention to the impact on the competitiveness of the UK as a place to do business when taking decisions on tax matters.

II. COLLECTIVE INVESTMENT VEHICLES, INVESTMENT MANAGEMENT AND “OFFSHORE FINANCIAL CENTRES”

Background

14. This submission comments on the reasons why investment managers may choose to operate “offshore” and on the taxation implications for the Exchequer. The term “offshore” is a widely-used one, and it is important to explain what is meant by its use in the context of investment management.

15. The majority of the assets of institutional investors (pension funds, life companies, sovereigns, etc) are held under segregated mandates, where one investor’s money is held and invested separately from and not pooled with other investors’ money. The investor may be in one country, the investment manager in the UK and the assets located worldwide. It is common for global investment management houses to operate in a number of jurisdictions. It is obvious that a business needs to have staff and offices on the ground in order to handle marketing and client-facing aspects (ie “distribution”). However, it is also common for the contracted investment manager to delegate parts of mandates to group or third party managers who specialise in eg geographical sectors or certain asset classes. Equally, a UK investor may chose to contract with a non-UK investment manager.

16. However, this is about an international business model and is not about the use of offshore financial centres as such. Of more relevance to the Committee’s deliberations, and therefore the area that this submission focuses on, is the use of pooled investment vehicles, where those vehicles are located in offshore centres.

17. To understand why investment managers may chose to locate collective investment vehicles offshore, it is necessary to separate the components of the business, being the industry, the product and the investor, each of which, separately, may be tax payers.

Components of the industry

18. The industry comprises those participants involved in “manufacturing” and distributing the product. The product for these purposes is a collective investment vehicle (hereafter referred to as a “fund”), into which investors may put their money. Many of these funds (though not all) will fall into a definition contained in statute, the “Collective Investment Scheme”377. A fund is an arrangement whereby investors may put their money and have it managed on their behalf on a discretionary basis by an investment manager, ie the assets being managed are not under the day-to-day control of the investors.

19. Funds may be structured as trusts, corporate vehicles, partnerships or contractual vehicles. They may be “UCITS” (undertakings for collective investment in transferable securities), which are the only EU regulated financial product and may be marketed across Europe to retail investors. The Financial Service Authority (the FSA) authorises UK funds (both UCITS and non-UCITS) and recognises EU UCITS and certain other offshore regulated funds (eg Channel Islands and Isle of Man funds) for sale to UK retail investors.

376 Luxembourg €224.5 billion + Ireland €311.1 billion (source—local trade associations) x 0.2% average local expenses generated by funds x 36% estimated direct tax rate (CT and employment taxes) x 0.743 €/£ exchange rate.

377 As defined in s235 of the Financial Services and Markets Act 2000.
20. In the business of collective investment management, use of “offshore financial centres” means making use of a fund that is legally domiciled offshore. The investors remain resident in their home territory. The industry comprises components of activity which could be based in the location of the fund, the location of the investors, the location of the underlying asset into which the fund is investing or, indeed, simply where it is most beneficial to carry out the activity, independent of all these other factors.

21. A fund will have an operator. This operator will often be connected to the investment manager, who may, in turn, delegate part or all of the investment function to investment managers in other jurisdictions. In addition, fund administration is typically delegated to specialist third party providers.

22. In particular, UK funds authorised by the FSA for sale to retail investors—authorised unit trusts (AUTs) and open-ended investment companies (OEICs)—will have a fund operator who is specifically authorised by the FSA for that purpose. There is, also, an independent party who is responsible for exercising a supervisory role over the fund operator. This party is either the Depositary (for OEICs) or the Trustee (for AUTs). It is a company with specific authorisation by the FSA and its two major roles are custody of the underlying investments and oversight of the fund operator (a quasi-regulatory role).

23. Beyond these integral components of the industry, there are the various distribution channels which are used to bring the product (the fund) to the customer (the investor).

Collective investment and investor motivation

24. Every investor has different objectives, but common motivations that cause an investor to use a fund rather than invest directly in the underlying assets are:

- access to professional investment management;
- cost-effective access to asset diversification;
- cost-effective access to geographical sector;
- access to a wider range of asset classes; and
- liquidity (ie open-ended funds enable investors to redeem on request at a price based on the net asset value of the fund).

25. It is not only individuals who use funds. The assets of institutional investors are often partly or fully invested in funds. For example, pension schemes are particularly significant users. Smaller institutional portfolios may make segregated management uneconomic or, even, unviable; specialised funds are convenient for those with similar investment goals; market exposure through index tracking or geographical/asset class diversification may be more efficiently achieved by pooling, and so on.

III. WHY MIGHT USE OF OFFSHORE FUNDS BE ATTRACTIVE FOR THE INVESTMENT MANAGEMENT INDUSTRY?

26. In the past, the UK regulatory regime has been viewed as unnecessarily restrictive for funds designed for institutional investors. Also, during the 1990s, after the first EU UCITS Directive had been adopted, the regulatory regimes for UCITS in Luxembourg and Dublin were, too, less restrictive. However, the FSA’s fundamental review of its CIS rules in 2003 (which led to the new and widely-welcomed “COLL Sourcebook”), coupled with increasing scrutiny by and discussion in CESR of discrepancies between Member States’ transpositions and interpretations of EU legislation, have significantly closed this regulatory gap between EU fund domiciles.

27. Unfortunately, though, the UK’s fund tax regime is viewed as unattractive by non-UK and certain UK investors. This continues to drive managers to locate new funds offshore and, when consolidating fund ranges, to move existing UK funds offshore.

28. UK authorised funds are subject to a regime of taxation at fund level. For most UK investors and for most funds, this system works relatively efficiently, since the tax at fund level effectively operates as a payment on account system for investor tax (although see the reference to Stamp Duty Reserve Tax below). For some investors (generally, UK tax exempt investors such as pension funds and charities), though, UK funds with a significant tax charge at fund level are not efficient.

29. In addition, non-UK investors may be deterred by the fact that UK funds suffer tax at the fund level. Generally, most tax systems apply tax on most types of investment income based on the residence of the investor rather than the origin of the income (although some withholding tax may be levied by the source country). For foreign investors in UK funds, the fact that there is a 20% tax charge at the fund level is often a deterrent to investing in a UK fund, even though in practice most funds actually pay little if any tax given tax exemption for UK dividends, tax deduction for interest distributions and the general ability to offset foreign tax and expenses when computing tax. Nevertheless, the 20% headline tax rate gives rise to a negative perception.
30. Consequently, UK investment managers who wish to market fund ranges to non-UK customers tend to make use of offshore fund ranges (typically in Luxembourg or Ireland), where there is no tax at fund level. In the interests of economies of scale, once the decision to establish an offshore range has been taken, these funds may be marketed within the UK to avoid the cost of running a second product range purely for UK investors.

31. Another issue which managers must consider in deciding whether to domicile a fund outside the UK is that of “trading versus investing”. UK authorised funds, although they pay tax on income, do not pay tax on capital gains. This is essential to prevent a double layer of taxation for investors.

32. If a manager thinks that there is any risk that the fund might be subject to a challenge by HMRC that it is engaged in a financial trading activity (rather than investing, an activity giving rise to “passive” income and gains), then any gains treated as capital for accounting purposes would potentially be subject to tax at fund level as the profits of a financial trade (ie taxable as income). The risk of a challenge is generally thought to be small, but the cost of such a challenge being successful would be commercially ruinous. For this reason, too, a manager may prefer to domicile a fund outside the UK.

33. It should be noted that where a fund is distributed into the UK, the manager will wish it to distribute sufficient income to obtain “distributing fund” status under the Offshore Fund Regime. Such status, which is in practice essential if the fund is to be commercially viable in the UK, avoids what would otherwise be a penal rate of tax for investors on disposal (ie that UK investors pay 18% CGT on disposal rather than income tax at up to 40%). However, this is a consideration only for UK investors, and offshore funds that do not have to distribute income are more attractive for many non-UK investors.

34. As well as paying stamp duty reserve tax (SDRT) on its acquisitions of UK equities, a UK authorised fund has to pay an additional amount of SDRT based on units purchased and redeemed in two-week rolling periods. This raises little tax for the Exchequer (£90 million), but is complex to administer and audit, is dependent on information provided by third parties and, with a headline rate of 0.5%, supports non-UK investors’ negative perception of the tax status of UK funds.

35. For these reasons, much institutional investment is undertaken via offshore funds. Moreover, these offshore funds are often “transparent” to some degree, for example contractual funds in Luxembourg or Ireland, or Property Unit Trusts in Jersey or Guernsey (“J-PUT/G-PUT”). The term transparent is used to describe an entity that is not itself subject to tax, but instead tax is levied at the level of its participants. Investors in transparent funds are effectively treated for tax purposes as if the underlying assets of the fund were held directly. Transparency enables an institutional investor to claim Double Tax Treaty benefits (such as reduced foreign withholding tax on income) based on the treaty in place between his own home state and the state in which the asset of the fund is located. A tax-exempt, but non-transparent fund would generally preclude such a claim by the investor, and the fund itself, being tax-exempt, would not be able to claim treaty benefits on its own behalf.

36. Likewise, a UK investor investing in UK real estate via a J-PUT/G-PUT would be outwith the Non-Resident Landlord Scheme for UK withholding tax, since the UK investor would be regarded as investing directly. In addition, for real estate investment outside the UK, offshore funds may assist in minimising transfer taxes similar to UK Stamp Duty Land Tax, their flexible regulatory regime may allow the use of holding companies to minimise foreign withholding taxes on income, and so forth.

37. Where the investment manager is resident in the UK, normal corporate (or potentially income) tax rules apply, and where the investor is resident in the UK, normal investment income (or corporation) tax rules apply, including (possibly) the Offshore Funds regime. In other words, as for “mainstream” offshore funds, the expected application of tax rules to the investment manager and UK investors is not usurped by the fund’s domicile.

38. It is worth mentioning hedge funds for completeness. The main reason that these are not domiciled in the UK is that they would, it is widely believed, be regarded as engaged in a financial trade.

39. While many of these vehicles would be eligible for authorisation by the FSA as “Qualified Investor Schemes” (which cannot be marketed to retail investors), the UK fund tax regime is such that a UK authorised hedge fund would be tax-disadvantaged. So, the UK is not a hedge fund domicile in spite of the presence here of many investment managers of hedge funds. Instead, hedge funds tend to be located in those places where both the regulatory and tax regimes give the most flexibility, such as Bermuda or the Cayman Islands.

IV. TAXATION IMPLICATIONS: ONSHORE VERSUS OFFSHORE

40. In looking at the various participants, the following comments may be made on the respective tax positions:

    Industry: investment managers are subject to corporate profit taxes and employ staff who are subject to payroll taxes. These taxes are levied generally where the activity occurs (often the same location as corporate residence). The activity of investment management (ie asset allocation and stock selection), even for offshore funds, can quite easily take place in the UK, so is not directly linked to the location of the fund. However, a number of activities (for example, fund
administration, depositary/trustee services and the services of professional advisers) tend to occur where the fund is located, and these activities are generally taxed, as for other businesses, in the local environment.

Product: UK funds are taxable; Irish and Luxembourg funds are not. However, since the UK fund tax is creditable for most UK investors, this is not of itself independent tax revenue, so does not represent an overall saving of tax by any UK investors. As regards institutional funds, if transparent, the fund would not itself be a taxable vehicle, whether onshore or offshore, since the investor would be taxed as if investing directly.

Investor: UK authorised funds pay out all their income and UK investors are taxed on this income. Offshore funds must basically pay out all or a very high proportion of their income to UK investors or the investors will pay a penal tax rate on disposal of their investment. Therefore, either way, the use of tax-exempt offshore funds does not actually represent a tax saving for retail investors. As noted above, for institutional investors in transparent funds, the investor is taxed as if owning the assets directly, so there is no tax differential. Importantly, UK exempt investors such as pension funds and charities are therefore left in the correct position if invested in offshore funds, whereas they may inappropriately pay tax if invested in a UK fund.

V. Conclusion

41. For the investment management industry, an “offshore fund centre” commonly means somewhere as un-exotic as Luxembourg or the Republic of Ireland. Even for non-EU locations such as the Channel Island or the Isle of Man, offshore funds may well be used simply for regulatory reasons (eg to facilitate investment in certain asset classes) or simply for economies of scale (ie to enable the pooling of assets of different types of investor in the one vehicle without compromising their appropriate tax positions).

42. While the tax position for the fund itself will vary according to location, the investor is generally taxed similarly regardless of the location of the fund. This is not the case for some UK investors in UK funds, which makes offshore funds more attractive. The industry (the investment manager and other key service providers) will be taxed where the economic activity of the business is actually conducted. Therefore, the issue for the UK Government is not abusive tax behaviour using offshore centres, but the loss of business and employment tax revenues to the UK due to funds, and hence a number of associated business functions, being domiciled offshore.

43. A report by IMA/KPMG found that for every £1 billion of funds domiciled offshore (which could have been domiciled in the UK), nearly £1 million a year has been lost to the UK Exchequer. Funds domiciled in Luxembourg and Ireland with UK investment managers already total twice the size of UK funds, and the size of the UK funds market continues to decline relative to these offshore centres. The loss to the UK Exchequer is therefore mounting.

June 2008

Memorandum from ActionAid UK

EXECUTIVE SUMMARY

1. ActionAid International is an international NGO working in 50 countries worldwide, and our positions and recommendations reflect the experiences of our staff and partners in Africa, Asia, the Americas and Europe.

2. We welcome the Treasury Committee’s decision to conduct an inquiry into Offshore Financial Centres (OFCs), commonly known as “tax havens”. We believe that under-regulated OFCs have very harmful impacts on developing countries, largely through their role facilitating tax evasion and aggressive tax avoidance, which seriously undermine the ability of the poorest countries to raise the finance necessary to combat poverty. This lack of finance is one key reason behind Africa being off track to meet the Millennium Development Goals (MDGs) which are a cornerstone of the UK’s international policies.

3. The problem is twofold. Firstly, the secrecy and special legal entities and company structures provided by OFCs allow tax evasion by multinationals to go undetected on a massive scale, and greatly increase the resources needed for authorities to actively prevent this evasion. Secondly, OFCs allow multinationals to aggressively exploit grey areas in tax regulations, and the differences between different jurisdictions in order to avoid tax. As a result multinationals can effectively choose when and where to pay taxes. Taxation no longer occurs at the point of economic activity but at the point most beneficial to the company.

4. The UK is at the heart of this problem for two reasons. Firstly, many OFCs are UK supported, including Overseas Territories such as the Cayman Islands, and Crown Dependencies such as Jersey. Secondly, the City of London is at the centre of the global financial system, and much OFC business is undertaken or facilitated by people working there. Therefore the UK can and should lead the way in pushing for solutions to these global problems by:

— Supporting the adoption of the principle of automatic exchange of information between all tax jurisdictions for all kinds of actor.
— Signalling its intent to take these issues seriously by joining the UN taskforce on illicit financial flows, and pushing UK-supported OFCs to adopt automatic information exchange.

5. Undertaking these vital reforms would, we believe, mark a sea change in global efforts to tackle tax evasion and aggressive tax avoidance. They would result in huge benefits to the world’s poorest countries who could begin to “plug the leaks” that cost billions of dollars of urgently needed finance in the fight against poverty.

6. In this submission, we focus on four areas:

(a) The impact of OFCs on Developing Countries.
(b) How OFCs facilitate harmful practices.
(c) Solutions and recommendations.
(d) Key questions for the UK government.

7. Whilst our focus is on the benefits of tackling this issue for the developing world and the global fight against poverty, we believe that there would also be commensurate benefits to governments and citizens in the developed world.

A: The Impact of OFCs on Developing Countries

8. Each year, hundreds of billions of dollars flow out of developing countries, much of which passes through OFCs. The best available figures, used by the World Bank and the UN are provided by Raymond Baker of the Center for International Policy, who estimates that £500–$800 billion is lost annually. This is made up of:

— Capital flight, not least from proceeds of corruption (3% of the total) and crime (30%).
— Tax evasion and aggressive tax avoidance by multinationals (60%).

9. It is unsurprising that tax evasion and avoidance is by far the largest share of this total, as the OECD estimates that 60% of world trade takes place within multinationals. It is because of the scale of this problem and the fact that multinationals often use OFCs to avoid or evade tax that we have decided to focus our submission on this critical issue.

10. The impacts for developing countries are severe. First, and most obviously, this represents a massive loss of urgently needed finance for development. The estimated $160 billion of taxes lost each year is more than one and a half times global aid. Secondly, because developing countries are unable to raise as much as they should through corporate taxation, they often have to increase other taxes, such as VAT, which hit the poorest hardest. In South Africa, research shows that households from the lowest income quintile pay 10% of their annual income in VAT, while those in the highest income quintile only pay 7% of their annual income in VAT. In effect, developing countries cease to be able to choose their own tax policies, and have to resort to taxing those who can least afford to pay.

B: How OFCs Facilitate Harmful Practices

How should an OFC be defined?

11. The Committee’s inquiry focuses on Offshore Financial Centres, which are more commonly known as “tax havens”. There are no universally accepted definitions of either term, but in common practice they are often used interchangeably.

12. The Tax Justice Network defines a tax haven as “any country or territory whose laws may be used to avoid or evade taxes which may be due in another country under that country’s laws.” Two problems arise. Firstly, the lawyers, accountants, bankers and others who provide the services for any particular tax haven are highly mobile and may not even reside there. In this sense the “offshore financial centre” is more than just the particular tax haven jurisdiction and its geographic location. Secondly, not all jurisdictions that set themselves up as tax havens are successful in attracting customers and may therefore be tax havens in name only.

381 Not all OFCs are “offshore” in the literal sense—Liechtenstein, Switzerland etc
13. To avoid confusion, we therefore adopt a broader understanding of the term OFC, which encompasses both (a) “successful” tax havens—those that not only have the requisite lax regulatory environment and low taxes but also successful financial sectors—and (b) and the people who work in the tax haven’s financial sector, regardless of whether they actually reside there or not. In practice, because of its pre-eminent position in international finance, many are based in London.385

Harmful services provided by OFCs

14. There are two main kinds of harmful OFC services that are attractive for companies and individuals seeking to aggressively avoid or evade tax:

15. Secrecy: The laws of OFCs are designed to provide clients with the maximum amount of secrecy in their business dealings. Many OFCs, such as Switzerland have laws that enshrine banking secrecy. Secrecy also extends in many cases to the ownership and accounts of companies, trusts or other special legal entities such as protected cell companies. For example, the British Virgin Islands registers 60,000 new companies a year, but does not place requirements on them to file their accounts, or disclose ownership details.384

16. Legal structures that facilitate evasion and aggressive tax avoidance: the creation of special purpose vehicles such as trusts, Protected Cell Companies and International Business Corporations allow multinationals to maintain a fiction that subsidiaries are in fact separate legal entities. This allows multinationals:

— To create incredibly complex structures that are very difficult for tax authorities to investigate—for example, BP has over 3,000 subsidiaries.385
— To hide company transactions, facilitating transfer pricing abuse. The most egregious examples of abuse in this area are often in the realm of ownership of intangible assets such as brands, patents, trade marks and logos.

17. There are two principle detrimental impacts of these services for developing countries. Firstly, they facilitate illegal tax evasion. They make it extremely difficult for authorities to investigate companies to ensure that they have paid the correct amount of tax. This is particularly problematic for developing countries whose tax authorities are unlikely to have the capacity to investigate the complex web of financial arrangements facilitated by OFCs. The scale of the problems that arise is shown by the fact that the UK Treasury has a large team devoted to investigating instances of transfer pricing abuse by multinationals. Such capacity is simply not available to developing countries, who suffer disproportionately from this damaging practice. For example, in 2004, Chile asked 34 tax havens for cooperation on exchange of tax information on the same (limited) basis as with the tax havens have with the OECD. Only 10 replied, and only five agreed.386

18. Secondly, they facilitate aggressive tax avoidance—where multinationals and rich individuals use tax haven services to structure their companies to minimise their tax burden, breaking the spirit, if not the letter of tax laws in the other countries in which they operate. This means that real economic activity is delinked from paper activity, and, in effect, companies can “choose” where they are taxed, rather than paying taxes on the basis of their actual economic activities. This is a widespread, global problem, as shown by the recent decision by Shire, previously the UK’s third biggest pharmaceutical company, to move its tax base to Ireland, which offers a lower corporate tax rate, even though it admitted it had not changed its actual economic activity in any way.387

19. This means that, in reality, tax “competition” is often not about countries competing to provide the most favourable environment to attract business investment, but instead competing to attract companies to nominally declare themselves resident in one country, regardless of what their real economic activity is. In the case of many African countries, where low employment extractive companies are often the main multinational investors, this means that countries may be left with many disbenefits such as environmental degradation, without the benefits of gaining tax revenues. Zambia offers the lowest royalty tax rate in the region at just 0.6% of the total production value. As a result the World Bank estimates mining companies contribute only around 12 percent of all corporate tax revenues, despite accounting for nearly 70% of export revenues.388

383 See Closing the Floodgates, Tax Justice Network, commissioned by the Norwegian Ministry for Foreign Affairs, 2007, P136–137
384 http://www.offshorebvi.com/bvi-offshore-companies.php Accessed 13-6-08 at 17:32
385 Closing the Floodgates, Tax Justice Network, commissioned by the Norwegian Ministry for Foreign Affairs, 2007, p43
386 Concept Paper on Tax Havens—A contribution prepared by the GT-7/ Chile for the Technical Group Gt-7 Meeting, 10–11 January 2007, Santiago, Chile
387 http://www.guardian.co.uk/business/2008/apr/15/shire.pharmaceuticals Accessed 13-6-08 at 17:59
C. SOLUTIONS AND RECOMMENDATIONS

19. Tax evasion and aggressive tax avoidance are a global problem, but UK can take specific actions to support solutions, and use its influence to push for global or European action.

20. Firstly they can push for reform at European and international level to:
   — Establish a principle of automatic information exchange between all tax jurisdictions. This should be applicable to all actors, including trusts, and to all jurisdictions. This would force tax havens to collect and share information that would allow tax authorities to investigate effectively.
   — Expand the European Savings Directive to include companies as well as individuals. As the ESD already operates on the principle of automatic information exchange, this would set an important precedent which could be followed at international level.
   — Improve International Accounting Standards to make the operations of multinationals transparent, particularly their operations in OFCs. This could be done by adopting country-by-country accounting standards through the IASB. This would provide tax authorities in developing countries with invaluable information that can be used to tackle illicit flows and capital flight.

21. The above will require international action in the medium term, which ActionAid believes the UK should press for. In the short term, the UK government should take the following steps to show that they want to put an end to OFC practices which undermine development:
   — Join the UN taskforce on illicit flows, chaired by the Norwegian government, which will report to this UN Conference on Financing for Development this November.
   — Work with others to improve the data on the scale of the global problem, and the impacts on developing countries.
   — Push OFCs directly linked to the UK to adopt the principle of automatic exchange of information.

D. KEY QUESTIONS FOR HMG

22. — Does the UK support the principle that taxes should be levied according to the real economic activity conducted in each country?
   — What does the government estimate to be the scale of resources lost to developing countries through practices facilitated by UK-sponsored OFCs, including Overseas Territories and Crown Dependencies?
   — Will the government join the Norwegian-led UN taskforce on illicit financial flows as a first step towards an international solution to this problem?
   — Will the government push for the upcoming review of the EU Savings Directive to include companies as well as individuals?
   — Will the government support the principle of automatic information exchange between jurisdictions and push the UN and OECD to support such a principle?

June 2008

Memorandum from the Montserrat Financial Services Commission

EXECUTIVE SUMMARY

In June 2000 the International Money Fund published a paper “Offshore Financial Centres—IMF Background Paper”. The publication listed countries, territories and jurisdictions which are regarded as Offshore Financial Centres and Montserrat is included on the list. As a consequence, it is important that Montserrat provides evidence to this inquiry.

Although Montserrat does not tick all the boxes that define an offshore financial centre, in that it does not have relatively large numbers of financial institutions engaged primarily in business with non-residents; nor moderate or light financial regulation, nor banking secrecy and anonymity, it is important Montserrat supports the existence of Offshore Financial Centres as they facilitate the movement of capital markets and the growth of investment.

The benefits and services can be measured by the increase use of offshore financial centres by multinational companies and governments and the growth of gross domestic products in successful Offshore Financial Centres’ jurisdictions.

Since the year 2000 when the Financial Stability Forum published its findings the offshore centres have been under scrutiny and to date that there has been no evidence that the centres are a threat to financial stability.
Most Offshore Financial Centres, including Montserrat have adopted international standards in their regulatory framework and Montserrat has welcomed the assessment carried out in its jurisdictions by the International Monetary Fund in 2002. The assessment provided confirmation and/or made recommendations concerning the state of compliance to international standards and provided an impetus for implementing international standards and building up capacity.

Montserrat’s Offshore Financial Centre is transparent in that it has enacted legislation and entered into agreements to provide gateways for international co-operation and the exchange of information. This includes entering into agreements with all EU Member States for automatic exchange of information under the EU Savings Directive.

In the matter of deterring the financing of terrorism Montserrat has enacted relevant legislation for combating terrorist financing and implemented reporting procedures for entities regulated by the Financial Services Commission.

UK TREASURY COMMITTEE INQUIRY INTO OFFSHORE FINANCIAL CENTRES

INTRODUCTION

Montserrat’s financial services industry is regulated by the Financial Services Commission. The Commission was established by the Financial Services Commission Act which came into force in 2001.

The functions of the Commission are legislated in the Act and include duties to:

— administer the financial services legislation, including the granting and revoking of licences;
— supervise financial institutions in accordance with internationally accepted standards;
— monitor compliance by financial institutions with the Anti-Money Laundering Regulations 2000 and such other legislation or guidelines relating to money laundering as may be prescribed;
— monitor financial services business carried on, in or from Montserrat and to take action against persons carrying unlicensed financial services business, in respect of which licences are required to be obtained;
— take such regulatory measures as it considers appropriate to protect the financial services industry in Montserrat;
— monitor the effectiveness of the financial services legislation in providing for the supervision and regulation of financial services business in Montserrat to internationally accepted standards;
— advise the Governor on matters relating to financial services business;
— make recommendations to the Government of Montserrat on such amendments to the financial services legislation or such new legislation relating to financial services business as the Commission may consider necessary or appropriate;
— maintain contact and develop relations with persons engaged in financial services business in or from within Montserrat with a view to encouraging the development of high professional standards within the financial services industry, and promoting industry codes of conduct; and
— maintain contact and relations with foreign regulatory authorities and international associations of regulatory authorities and to provide regulatory assistance to foreign regulators authorities.

With regard the request for evidence the Financial Services Commission as the regulatory body provides the following responses to the questions raised by the Treasury Committee in its invitation of 30 April 2008.

1. In response to what extent, and why are Offshore Financial Centres (OFCs) important to worldwide markets:

Montserrat regards the existence of OFCs important to worldwide financial markets in that benefits are derived from corporate entities who achieve higher growth rate in jurisdiction where their fiscal obligations are not subject to annual changes. The benefits include higher income yields which are reinvested creating jobs and investment opportunities where the capital is employed. The effect is that financial markets do not remain immobile and OFCs contribute to the economic growth of the home jurisdiction where the capital is employed and growth of the gross national product of OFCS.

2. In response to the question to what extent does the use of OFCs threaten financial stability:

There is no evidence to support this assertion. In fact, the Financial Stability Forum in April 2000 report stated that OFCs do not appear to have been a major causal factor in the creation of system financial problems.

At the request of the Financial Stability Forum the IMF carried out assessments of OFCs and observed non-compliance of international standards in some of the jurisdictions, including Montserrat and, as a result of their recommendations Montserrat has enhanced its compliance with internationals standards by strengthening its legislative framework and increasing capacity in the regulatory regime.

3. 1. In response to the question how transparent are OFCs:
   Montserrat’s OFC is transparent in that the jurisdiction has enacted legislation that introduced gateways for providing international co-operation and exchange of information. These include the following:
   ii. Exchange of Information Act.
   iii. The Financial Services Commission Act.
   v. Criminal Justice (International (Co-operation) Act).
   vi. The Company Management Act.

2. With regard the question how transparent are the transactions that pass through its financial institutions:
   In Montserrat, under the EU Directive has adopted the automatic exchange of information policy and as a consequence regulated entities are obliged to report to the relevant EU authorities transactions which subject to be declared under the EU Savings Directive.

   It should be noted that Montserrat was not listed on the Financial Action Task Force (FATF) list of “Non-cooperative Countries and Territories”.

4. In response to the question as to what extent does the growth in complex financial instruments rely on OFCs:
   There is no evidence that the growth in complex financial instruments rely on OFCs. For example, the growth in U.S. sub-prime market did not depend on the use of OFCs to reach a stage where it caused financial markets worldwide to become unstable.

5. In response to the question how important the levels of transparency and taxation in OFCs been in explaining their current position in worldwide financial markets:
   Montserrat OFC is very small; however, it is subject to the obligations in the EU Savings Directive and the individual agreements signed with EU Member Countries which ensures that in relation to the EU Tax Authorities its current position is reported.

6. In response to the question how do taxation policies of OFCs impact on UK tax revenue and policy:
   The position in Montserrat is that under EU Savings Directive and the agreement reached with the United Kingdom residents of the U.K. whose income subject to EU Savings Directive is reported to the relevant reporting authority in the U.K.

7. In response to the question, are British Overseas Territories and Crown Dependencies well-regarded as OFCs, both in comparison to their peers and international standards:
   The U.K. has recently published the House of Commons Committee of Public Accounts 17th Report on Foreign and Commonwealth Office: Managing Risk in the Overseas Territories and the National Audit Office Report—Managing Risk in the Overseas Territories and this regard the reports provide evidence of how the U.K. regard its territories.
   The reports informed public opinion and in respect of Montserrat they do not reflect the current position in relation to its legislative framework and the regulatory regime. Unfortunately the reports, though published in 2008 were based on information gathered by a third party, the IMF in their assessment of the jurisdiction in 2002 and its report which was published in 2003. In this regard a copy of the Montserrat’s response to the House of Commons Committee Report is attached for reference.

8. In response to the question to what extent have OFCs ensured that they cannot be used in terrorist financing?
   In implementing measures to ensure its jurisdiction, Montserrat has complied with international standards and introduced legislation to combat financing of terrorism. In this regard the following legislation have been introduced:
   i. The Anti-Terrorism (Financial and Other Measures) (Overseas Territories) Order.

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390 FATF Report on Non-Cooperative Countries and Territories—February 2000
391 IMF Assessment of the Supervision and Regulation of the Financial Sector: Volume II: Detailed Assessment of Observance of Standards and Codes—Montserrat—October 2003
ii. The Al-Qa’ida and Taliban (United Nations Measures) Order.
iv. The Terrorism (United Nations Measures) (Overseas Territories) Order 2001

In addition, the regulatory body in Montserrat, the Financial Services Commission, periodically circulate to relevant regulated entities the United Nations revised list of persons and entities listed pursuant to UNSCR 1390 (2002).

Further, all regulated entities are mandatorily obliged under the Proceeds of Crime Act to submit Suspicious Transaction Reports to the Reporting Authority and, under Anti-Terrorism (Financial and Other Measures) (Overseas Territories) Order, to disclose information where there is suspicion that an offence has been committed.

9. In response to the question what are the implications for the policies of HM Treasury arising from OFCs:

In our opinion, the implications for the policies of HM Treasury arising from OFCs should reflect and recognise the co-operation received from Offshore Financial Centres in responding to matters concerning transparency, the legislative framework OFCs established to international co-operation, the value of interdependence and the conclusion of the Financial Stability Forum that well regulated offshore financial centres do not destabilise financial markets.

10. In response to the question, what has been and is the extent and effect of double taxation treaty abuse within OFCs:

Montserrat recently entered into Double Taxation Agreement with the U.K. However, its economy is small and therefore it would not be in position to disregard its obligations under the agreement.

11. In response to question as to what extent do OFCs investigate businesses and individuals that appear to be evading UK taxation:

It should be noted that the Government of Montserrat is committed to co-operating in any investigation or complaints from the U.K. Inland Revenue that individuals or businesses domiciled in Montserrat are evading UK Taxation.

June 2008

Memorandum from Global Witness

Executive Summary

1. The Treasury Select Committee is soliciting submissions on various transparency issues in relation to offshore financial centres. However, these questions do not mention the crucial role of offshore financial centres in facilitating corruption and mismanagement of public revenues in developing countries rich in natural resources, and consequently their negative impact on development objectives and poverty reduction.

2. Global Witness believes this is a serious oversight, given that the UK has made a strong commitment to address transparent and accountable management of public revenues from natural resources in its foreign and development policies, and we hope our submission will encourage the Committee to include the facilitation of corruption in its survey of the impacts of offshore financial centres.

3. Our submission outlines one specific country study illustrating the crucial role of offshore mechanisms, including UK offshore centres—but also UK onshore entities—in providing the means for mismanagement and looting of state oil revenues in the Republic of Congo (Congo).

4. This case study details three aspects of how such offshore structures were used, namely:

— How oil-backed loans were contracted in contravention of agreements with the IMF and disbursed through untransparent offshore structures, in several cases with the assistance of Western banks and international oil companies.

— How senior Congolese officials diverted oil revenues using discounted sales through offshore shell companies in a complex structure that at one point involved a UK registered company (Sphynx UK), and the role played in this structure by French bank BNP Paribas and international oil traders.

— How state oil revenues channelled through these offshore structures appear to have been transferred to shell companies owned by the President’s son and subsequently used to pay his personal credit card bills.
5. We suggest that the UK government’s commitments to development and poverty reduction are meaningless, and the money being spent on development wasted, if in practice offshore financial centres are being used to structure transactions that permit public officials in countries such as Congo to hide lending from international financial institutions, disguise ownership of assets, evade creditor judgments, and divert public revenues into private hands.

6. Finally, we suggest some specific steps the UK government could take to improve the transparency of offshore transactions and hence begin to address the abuse of such structures by irresponsible or corrupt officials.

INTRODUCTION

7. Global Witness investigates the link between natural resources and the funding of conflict and corruption (see www.globalwitness.org). We aim to promote improved governance and transparency in the natural resource sector to ensure that revenues accruing from resources such as oil, gas, mineral and forests are used to promote peaceful and sustainable development. Our work was a driving force behind the Kimberley Process, which aims to curb the trade in conflict diamonds, and the Extractive Industries Transparency Initiative, which sets a global standard for greater transparency in the extractive sector by encouraging companies to publish revenue flows to governments and governments to disclose what they receive.

8. Global Witness was co-nominated for the 2003 Nobel Peace Prize for its leading work on conflict diamonds, and awarded the 2007 Commitment to Development Ideas in Action Award, sponsored by Washington DC-based Center for Global Development and Foreign Policy magazine.

9. For many of the poorest countries in Africa, South America, and Asia, the biggest inflow of wealth for the foreseeable future will be payments for oil, minerals, and other natural resources. In 2006, according to the World Trade Organisation exports of oil and minerals from Africa were worth roughly $249 billion, nearly eight times the value of exported farm products ($32 billion) and nearly six times the value of inflows of international aid ($43 billion), according to the UNDP. With the price of oil and many other minerals reaching record highs, this gap will only widen over the next decade.

10. This huge transfer of wealth could be one of the best chances to lift many of the world’s poorest and most dispossessed citizens out of poverty. Yet in the countries where Global Witness has worked—such as Angola, Sierra Leone, Liberia, Republic of Congo, DR Congo, Cambodia, Kazakhstan and Turkmenistan—natural resources have led to impoverishment, rent seeking and greater institutional corruption, authoritarian government, and in some cases, conflict.

11. What unites all these resource-rich countries is the emergence of a “shadow state”: one where public office becomes the means to personal self-enrichment and where state institutions are subverted to maintain the power of a corrupt elite. Behind the façade of laws and government institutions lies a parallel system of rule by patronage and crony capitalism. Through the wholesale subversion of civic institutions and the use of coercion, the leaders of such states divert state wealth for personal gain or use it to fund a bloated military and security apparatus.

12. Kleptocratic elites generate much of their illicit wealth by the expropriation of the natural resource wealth which belongs to the country’s population, with catastrophic long term impacts on the country’s economy. Asset stripping at this level is thus not just a criminal activity but a violation of the basic human rights of the population, as social and economic breakdown inevitably follow when vast amounts of capital are siphoned off by unaccountable officials into overseas private bank accounts. Mismanagement and outright looting of natural resources fundamentally undermines the ability of the state to provide basic services for its people, diverts funds that should go towards economic and social development, and destablises whole societies. In the worst cases, it leads to conflict and failed states.

13. In its 2006 report The Other Side of the Coin, the Africa All-Party Parliamentary Group recognised the role of developed country economies and financial systems in contributing to corruption in the developing world. Private sector banks play a role but an equal part is played by offshore financial centres, which provide a crucial “veil of secrecy” behind which corruption can flourish.

14. The submission to this inquiry from our colleagues at the Tax Justice Network (TJN) sets out in detail the various mechanisms by which offshore financial centres contribute to corruption and poverty. Our submission should be read in conjunction with TJN’s, providing analysis of a specific example of how use of offshore mechanisms lies at the heart of oil sector mismanagement in one African resource rich country. The Republic of Congo is a clear example of the way mismanagement of oil wealth not only leads to lack of economic and social development, but can encourage corruption, lack of democratisation and instability.

15. Finally, we suggest some steps the UK government could take to ensure that its Overseas Territories do not provide safe haven to looters of public assets.
The role of offshore financial centres in facilitating mismanagement and diversion of Congo’s oil revenues

16. Congo is Sub-Saharan Africa’s fourth largest oil producer, with estimated earnings from oil of around $3.6 billion dollars in 2006. It is a classic petro-dictatorship whose current leader, President Denis Sassou Nguesso, who first came to power 1979 and, after a brief period of democracy from 1997, was returned to government after a brutal civil war in 1997.

17. Corruption and mismanagement in Congo’s oil sector is well documented. Despite decades of oil production, it remains one of the poorest and most indebted countries in the world, and the struggle to control its oil wealth has been a major factor in the country’s several bloody civil wars. It is also one of the countries most associated with the “

Vultures” exposure corruption” Sunday Times, June 15, 2008.

18. In March 2006, the country was controversially granted access to debt relief through the Heavily Indebted Poor Countries (HIPC) programme. This was despite what the IMF and World Bank called “serious concerns about governance and financial transparency” focused on mismanagement of its national oil company, Société Nationale des Pétroles du Congo (SNPC).

19. Ironically, SNPC was created in 1998 to market oil on behalf of the state and to represent Congo’s interests with the private operators more effectively. However, lack of transparency and accountability at SNPC has led to little improved management of the country’s but to strong suspicions that public wealth is being transferred to private hands.

20. Global Witness and Congolese anti-corruption activists have long campaigned for reform of SNPC, because its opacity raises the risk of Congo’s oil wealth being mismanaged and misappropriated. In return for debt relief, reform of the oil sector was put at the top of Congo’s development agenda. The country explicitly committed to “

bringing the internal controls and accounting system of [SNPC] up to internationally recognized standards; preventing conflicts of interests in the marketing of oil; requiring officials of SNPC to publicly declare and divest any interests in companies having a business relationship with SNPC”.

21. In fact, since 2003, there have been some improvements in transparency. SNPC has, under pressure from the IMF and civil society, published a large amount of data describing its management of the country’s oil wealth. However, issues of the accuracy and completeness of data provided to independent auditors remain. What the increased scrutiny has revealed, in fact, is huge amounts of state revenue unaccounted for. It is telling that auditors KPMG, while finding improvements in SNPC’s accounting standards, will still not sign off on SNPC’s accounts, despite several years of audits. For the last year of published accounts, 2005, auditors still had no access to the books of Cotrade, SNPC’s marketing arm. Cotrade is cited as having a lack of internal controls, lack of documentation for most commercial operations, lack of supervision, governance and reporting structures, with a subsequent risk of fraud. Overall, the auditors found it “impossible” to understand the revenue flows to the state.

http://www.imf.org/external/pubs/cat/longres.cfm?sk = 21199.0, Table 2, p 20. A recent Sunday Times article estimates that at today’s prices, with a production of 250,000 barrels a day, Congo must be earning around £5.8 billion annually. See www.sundaytimes.co.uk/sundaytimes/2007/june/15/sundaytimes/150615.shtml.


540 SNPC website includes a history of the company at www.snpc-group.com. See also November 2005 Kensington judgment, paras 44–49 and section on “Société Nationale des Pétroles du Congo”, Congo Chapter in Global Witness, Time for Transparency, March 2004, pp18–24. SNPC's accounts, despite several years of audits. For the last year of published accounts, 2005, auditors still had no access to the books of Cotrade, SNPC’s marketing arm. Cotrade is cited as having a lack of internal controls, lack of documentation for most commercial operations, lack of supervision, governance and reporting structures, with a subsequent risk of fraud. Overall, the auditors found it “impossible” to understand the revenue flows to the state.

541 In 2005 the Publish What You Pay campaign highlighted its concerns to the IMF, in particular the apparent US$300 million shortfall in oil revenue for 2004 received by the Treasury compared to the income SNPC reported which ought to have transferred according to KPMG’s audits. In short, around one third of Congo’s 2004 oil income appeared to be unaccounted for in the budget. “Has the IMF dropped the ball on transparency reforms in the Republic of Congo?” and “Republic of Congo Transparency Scorecard”, 15 August 2005 available at http://www.globalwitness.org/press_releases/display.php?sid = 303;
22. Congo’s record on oil sector governance remains poor: the country has failed to meet the targets of the HIPC programme and still has not performed well enough to get back on track with an IMF programme. Much of the poor performance relates to the country’s failure to implement agreed transparency reforms in oil sector and public revenue management, including huge budgetary overruns and the racking up of hundreds of millions of dollars in new debt.\(^{401}\)

23. In fact, many of the discrepancies and questions concern the black hole of Cotrade, and the poor performance of SNPC in marketing the state’s oil, which has been sold consistently at a large discount to the market price. Moreover, both the government data and evidence from court cases taken by litigating creditors suggest that Congolese officials use offshore centres to structure—or obscure—oil sales and associated lending. This not only prejudices the public purse but also reveals officials reaping personal benefit, aided and abetted by commercial actors in the North.

24. Such were the concerns raised when Congo was due to receive debt relief that the international financial institutions insisted on an independent diagnostic of SNPC’s method of marketing oil, as one of their key conditions. In June 2008, the IMF summarized the findings thus: “As for SNPC, a diagnostic of its marketing operations shows institutional and procedural deficiencies that have led to substantially lower oil revenue over the recent past, and raises serious governance concerns”.\(^{402}\) The analysis confirmed that for the period 2003–05 Congo’s oil was sold at an exceptionally low price and estimated the use of pre-payments or short term advances on cargos from buyers with very high rates of interest and fees to have cost Congo 13.1% of its net oil revenues, just over US$533 million (225.8 billion FCFA).

25. This case study details the use of such offshore structures, namely:

- How oil-backed loans were contracted in contravention of agreements with the IMF and disbursed through untransparent offshore structures.
- How senior Congolese officials diverted oil revenues using discounted sales through offshore shell companies in a complex structure that at one point involved a UK registered company (Sphynx UK), and the role played in this structure by French bank BNP Paribas and international oil traders.
- How state oil revenues channelled through these offshore structures appear to have been transferred to shell companies owned by the President’s son, Denis Christel Sassou Nguesso and another top official, and were subsequently used to pay credit card bills used to purchase designer goods.

**Disbursement of oil-backed loans through untransparent offshore structures**

26. A major factor in Congo’s huge indebtedness is its use of oil-backed loans. These are loans given by commercial banks to governments or parastatals (such as state oil companies) that are repaid from the revenues from future oil production. The IMF and World Bank have condemned such lending, since it contributes to the opacity of the government’s fiscal management, usually has high associated costs and fees, and because fluctuations in oil prices can render oil-backed loans a very bad deal for the country concerned.\(^{403}\)

27. Oil-backed lending was first instigated in Congo under the Elf system (see para 17) in order to create conditions of deliberate indebtedness that increased the company’s leverage over political leaders. Ultimately such lending destabilized the country’s fiscal management and even financed civil conflict.\(^{404}\) The main lender to Congo more recently has been the French bank BNP Paribas: between 1999 and 2003 it has been estimated that loan agreements with BNP Paribas totaled $650 million, costing Congo $1.4 billion in repayments.\(^{405}\)


\(^{402}\) Country Report on Republic of Congo, June 2008, http://www.imf.org/external/pubs/ft/scr/2008/cr08173.pdf; p. 15, para 24. Overall, the diagnostic found serious lack of controls over marketing operations: for 12 transactions chosen at random for the period 2002-05, there was an almost complete absence of documentation, leading to “a context of risk in terms of internal operational controls and commercial documentation and indeed of highly risk in terms of governance”. Most sales are in fact, done over the phone, 2:3:8, p 22.

\(^{403}\) For instance, 2005 IMF Congo Country Report.

\(^{404}\) An unpublished IMF report concluded that: “rather than contributing to the welfare of the Congolese population, the proceeds from oil-collateralised borrowing may have been used to finance combat operations during the civil war”. See International Monetary Fund (IMF). 2001. Report on the Republic of Congo. IMF, Washington, DC, p 39.

\(^{405}\) According to a 27 May 2005 RICO complaint filed by Kensington International Ltd against SNPC, BNP Paribas and Bruno Itoua, former head of SNPC in the United States District Court Southern District of New York (05 CV 5101); according to the CONGO authorities, no loans of over 1 year have been taken out since October 2002, see Republic of Congo: First Review Under the Poverty Reduction and Growth Facility, and Requests for Waiver of Performance Criteria and Modification of Performance Criterion—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Congo, 25 August, 2005, p 74.
28. Offshore tax havens appear to be integral to oil-backed loans given that the revenues usually flow into an offshore account outside the borrower country. One reason may be the tax planning requirements of the lender, but this offshore structure also means that such loans are inherently open to abuse by borrower countries because of their opaque nature, falling outside any public oversight afforded by the normal budgetary process.

29. Under numerous IMF programmes, Congo repeatedly promised not to contract any new oil-backed loans (with “loans” being defined in this case as any debt that is contracted but not repaid within the same calendar year).406 Congo also claimed to have ceased short-term pre-financing of oil sales (“prepayments”) in July 2004.407 However, according to analysis by KPMG, such prepayments continue unabated despite Congo’s promises.408

30. The inclusion of prepayments is important because such short-term loans have extremely high associated costs in interest and commissions, as successive audits and the marketing diagnostic found. In 2004 alone, for instance, comparing data published by the Congolese Ministry of Finance with loan data analyzed by the independent auditor (KPMG), Global Witness estimated that the annualized cost of such short-term advances to Congo was 40%. In 2003, the cost was even steeper, a staggering 170%, with an average loan term for both years of approximately 27 days.

31. Analysis by GW has also revealed a pattern of increasing secrecy and complexity in the structures through which both long and short-term oil-backed loans are routed, with funds often being channelled through shell companies or Special Purpose Vehicles (SPVs) registered in offshore financial centres. This complexity appears partly to have been an attempt to avoid Congo’s assets being seized by aggressive private creditors (pejoratively termed “vulture funds”) who bought discounted sovereign debt and then pursued their claims through the UK, US and French courts.409 Most of these creditors have now settled with Congo but the litigation they initiated has brought into the public domain an additional wealth of information about mismanagement of Congo’s oil wealth.

32. Indeed, apart from their high costs, such inherently opaque lending arrangements greatly increase the risk of public revenues being mismanaged and misappropriated. Pre-paid oil sales, as will be seen below, are being routed through offshore shell companies controlled by Congolese officials, with evidence of personal enrichment by the officials in question. Thus in terms of both cost and governance risks, there appears little commercial justification for such long or short term loan structures.

33. Congo’s oil marketing practices will be discussed further in the next section. This section raises questions regarding the use of offshore structures for long-term oil-backed lending—instigated when Congo had on paper committed to ceasing such borrowing—and whose negative impacts on Congo’s public finances are still being felt today.

The Likouala deal: use of offshore structures to shift assets off-balance sheet and hide oil-backed lending from public scrutiny?

34. In 2003, Congo reached a global settlement with French oil company Total over a longstanding dispute (the “Accord Général Transactionnel” or AGT in its French acronym). Part of the settlement involved transfer of Total’s 65% interest in the Likouala oilfield, valued at $160 million, to Congo. However, the interest was then immediately transferred on to a shell company, Likouala SA, registered in Congo, which paid the government $80 million with the option of a further $80 million for the asset. These funds


407 KPMG audit of SNPC’s 2002 accounts, discussing the differences between traders (Chapter 5, p. 12) and the high level of expenses (Chapter 5, p 10). They cite “exceptionally large differences” in the sales prices obtained from different traders and frequent recourse to oil-collateralized borrowing, the costs of which are extremely high and where there is inadequate information about terms of interest, commissions and other expenses.

408 See http://www.merb-cg.org/petrole/certification_concordance.htm. Under HIPC, any new borrowing by the country has to be sustainable. According to the latest IMF reports, by end 2006 Congo had already done new debt deals worth $829 million that “could jeopardize debt sustainability.” $32 million of this new debt, contracted with the Chinese authorities, went to buy three airplanes on non-concessional terms—not an obvious priority in terms of poverty reduction. In the light of this, the IMF “called on the authorities to adheres strictly to their commitment to control future borrowing”. See IMF Executive Board Concludes 2007 Article IV Consultation with the Republic of Congo Public Information Notice (PIN) No 07/47 26 April 2007; http://www.imf.org/external/np/sec/pn/2007/pn0747.htm.

409 Global Witness report Time for Transparency March 2004, discusses a leaked memo prepared by SNPC’s Parisian lawyers Cleary Gottlieb on 23 May 2003 to Bruno Houa (ex-Head of SNPC) in relation to a proposed US$210 million loan to be routed via a Special Purpose Vehicle (SPV) in the Caiman Islands: “The choice of legal structure was made as a result of the following considerations. In order to protect their rights to the petrol, whose sales revenues by SNPC will be used to repay the loan, the lenders have suggested to place between them and SNPC, an independent legal entity that would be the owner of these rights, the SPV. The creditors of the Republic of Congo and/or SNPC would thus in principal be prevented from seizing this petrol from the hands of SNPC . . .”. See Time for Transparency March 2004, Chapter on Congo.
were provided to Congo via an oil-backed loan taken out by Likouala SA. At the time, the Congo had committed to the IMF to abstain from contracting any new long-term oil-collateralized debt. It is clear that if Congo were the owner of Likouala S.A., then this deal would have directly contravened the country’s commitments to the IMF not to seek any further oil-backed loans.

35. However, the lack of transparency and public information about the deal raised governance concerns. Firstly, it still remains to be determined whether the original valuation of the oilfield share at $160 million was correct. Secondly, there is also no public information about what revenue flows are being used to service the loan taken out by Likouala SA, nor what the total value of all the revenues from the Likouala shareholding are, and finally there are questions over the destination(s) of this revenue stream, given the fact that the ownership of Likouala SA is unclear.

36. According to a Congo government press statement, Likouala SA was not a standalone company but belonged to either to Congo, SNPC or Total. If this is correct, it would not be an independent private company and this deal cannot have been an arms-length transaction. For its part, Total stated that it had “assigned its 65.0% interest in the Likouala concession” its 2003 Annual Report and in its submission to the US Securities and Exchange Commission for the year ending 2005 stated that “[u]nder an agreement signed in 2003 with the Republic of Congo, Total sold its 65% interest in the Likouala concession”. The company later confirmed by letter to Global Witness that it “holds no interest in Likouala SA”.

37. At the time, Global Witness believed that these statements by the Congolese government and Total suggested that the Congolese government must be the owner. Additional support for the hypothesis that the loan to Likouala SA was really a loan to the Congo government comes from a draft of the agreement between Total, Congo and Likouala SA obtained by Global Witness. This draft states that Congo’s share of excess oil has been assigned to Likouala SA for the purposes of repaying this loan.

38. Nevertheless, the deal was done with the knowledge of Total, the original shareholder. Indeed, Total continued to be operator of the field, and a Total employee, Andre Bahoumina, was appointed Sole Managing Director of Likouala SA.

39. Further investigation by Global Witness leads us to believe that the Likouala transaction was structured through companies based in offshore financial centres, including the UK offshore centres Jersey and the BVI. Given that the questions about the Likouala deal which Global Witness identified in 2004 have still not been resolved, including who the beneficial owner of Likouala SA is, we believe it is imperative to find out what exactly these offshore structures were, and what role they played in the deal.

**Using offshore structures to market the state’s oil**

40. In 28 November 2005 in the “Nordic Hawk” case, the UK High Court issued a judgment in favour of a US creditor of Congo, Kensington, which was attempting to seize proceeds of an oil cargo in payment of their debt.

41. The case revealed that senior Congolese officials, including the head of SNPC, Denis Gokana, and the President’s son, Denis Christel Sassou Nguesso (head of Cotrade, the marketing branch of SNPC) were involved in selling the state’s oil through an elaborate web of offshore trading companies. According to the judgment, at least US$472 million of Congo’s oil revenues had passed through two shell companies, Sphynx Bermuda and Africa Oil and Gas Corporation (AOGC).

42. The sales were under market price and according to the judgment, the profits ended up in the bank accounts of AOGC. This system of front companies was single-handedly controlled by Denis Gokana, both while he was a special adviser to the Congolese President and in his current position as CEO of SNPC, a blatant conflict of interests that is prohibited by SNPC’s byelaws.

43. The judgement stated that:

“Mr Gokana orchestrated the chain of transactions between Sphynx Bermuda and SNPC. He had control over all the entities concerned and directed what should take place, including the creation of contractual documents and invoices which were intended to present the appearance of commercial transactions between independently operated companies. This was a fiction”.

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44. The judgment found that the primary aim of this structure was to keep oil revenues out of the hands of creditors. However, it also highlighted that “the assets of AOGC, and particularly its cash assets, remained shrouded in mystery”.

Who is benefiting from this “fiction”?  
45. However, Global Witness believes there are two important pieces of evidence that mean that it cannot be discounted that monies reverting to AOGC from sales through offshore structures could have been siphoned off for personal enrichment.

46. Firstly, if the only reason for using offshore companies was to conceal the sale of oil sales by the Congolese state from its creditors, then why would it be necessary to sell that oil to such companies at heavily discounted prices, which is detrimental to the Congolese state? Why did SNPC not take the much simpler route of selling the oil to front companies at a market price? During 2003, Global Witness estimated that Sphynx paid on average 9.6% below the official Congolese tax price (resulting in lost revenue of around US$15 million compared with sales at market price).

47. Indeed, to do so would simply complicate the return of the funds to the SNPC, which is now audited and would need to account for the source of this money to its auditors. As previously stated, the judgment notes the anomalies in price between the sales contracts produced during the case and the figures reported to the auditors. Indeed, it is our view that selling the oil to the shell company at a market price would be an easier and more effective way to avoid creditors seizing the monies, whilst ensuring that SNPC got full value for the oil.

48. On the basis of extrapolation from the profit made on one cargo sold by the SNPC to a Gokana vehicle which then sold it on to an independent trading company in June 2005, Global Witness estimates some US$30–40 million in value at least may have been transferred to these companies. In addition, Gokana-controlled companies made short term loans to the SNPC at very high costs, further draining the state’s resources.

49. Indeed, Gokana himself admitted in his testimony to personally profiting from the sales, despite his companies adding no value to the transactions and running no commercial risks. For instance, in 2003 AOGC generated net earnings of around $2 million and in 2004, Gokana obtained a return of around 157,800% on his initial capital investment. Indeed, it was necessary for Gokana to admit that he personally benefited from these deals in order to make the argument that the “façade” was not a state-sponsored mechanism, as was being claimed by the litigating creditor.

50. Secondly, according to press reports, AOGC has been awarded a 10% interest in Marine Block XI, an offshore oil concession in the Republic of Congo. Essentially, Gokana, head of the national oil company, awarded AOGC, his own private company, part of a state asset, a blatant conflict of interest. There is no public information about the terms on which AOGC participates in the block, which is to be operated by consortium led by the UK-AIM registered trading company SOCO International. SOCO has a 75% interest in the block and SNPC the remaining 15%. If the aim of creating a convoluted series of shell companies is simply to avoid seizure of oil by creditors, it is unclear why AOGC would be awarded an interest in an oil concession.

51. SOCO will in fact own only 85% of its 75% share in the block through its subsidiary SOCO Exploration and Production Congo (SOCO EPC). There is no public information about the beneficial owners of the other 15% of SOCO EPC. In addition, SOCO’s press release states that “The Group is in discussions with various parties to farm-out a portion of its interests in Marine XI”: according to press reports, this portion could be transferred to Vitol and the Swedish Lundin group.

419 GW report The Riddle of the Sphynx: where has Congo’s oil money gone?, December 2005.
420 For full details of how this scheme worked, please see GW’s report The Riddle of the Sphynx: where has Congo’s oil money gone?, December 2005.
424 “Qui seront les partenaires de SOCO sur le permis Marine XI au Congo?”, Lettre du Continent, N° 480, 20/10/05.
52. The Chairman of SOCO International was the now deceased Patrick Maugain and one of its Directors is Rui de Sousa. According to SOCO’s 2004 annual report, de Sousa is a director of Quantic Limited (Quantic), registered in the Bahamas. Maugain and de Sousa each held a 25% shareholding in Quantic, which is also listed in KPMG’s analysis of sales as buying cargoes at under market price from the SNPC. 426

53. An audit of the Marine XI concession and Congo’s awarding of concessions in general was subsequently carried out under the IMF programme. In 2007, the audit report found a lack of clear regulatory framework, controls and potential conflicts of interest among SNPC officials. 427 Gokana claims to have subsequently divested himself of his interest in AOGC and was never sanctioned by the Congolese government.

Sphynx UK: what is the role in the scheme of a UK-registered company?

54. A third shell company, this time registered in the UK, Sphynx UK, also appears to be related the Gokana scheme, although it appears no transactions actually passed through this company. Sphynx UK, according to the November 2005 Kensington judgement, has “earned no revenues since its establishment but plainly exists for no other purpose than to act as a contact/service company for Sphynx Bermuda” (para 98). However, “Sphynx UK never made any charges to Sphynx Bermuda for its services and its accounts showed loans from Mr Gokana and Sphynx Bermuda” (para 96).

55. According to its articles of incorporation listed in Companies House, Sphynx UK Ltd is a UK-registered company, formed in 2002. Its beneficial owner as listed in its 2004 Annual Return is Litchfield Development, a Bermudan company. It was not possible, because of the offshore ownership structure, for Global Witness to determine who the beneficial owner of Sphynx is.

56. Sphynx UK’s annual returns indicate no signs of meaningful business activity. Its annual filing at Companies House indicates that Sphynx UK reported no revenues and costs of £83,480 in the year to January 2004. The financial picture in the preceding year was similar, although costs were higher at £108,627. Because of this, the company has no liability for UK taxation.

57. Global Witness has documentation (a Bill of Lading, which certifies that the cargo described has been shipped) for a 16 June 2004 cargo sold by SNPC to Sphynx UK. 428 Comparison with the quarterly certifications of oil sales shows that shipment to have been sold at a significant discount to the official oil price, or “prix fiscal”, demonstrating that below-market value transactions with Sphynx continued into 2004. Following the pattern of other cargos sold by Sphynx, according to the certifications for the second quarter of 2004, SNPC reported to KPMG that it sold the cargo for $23.770/bbl, a huge discount of $6/bbl below the official tax price of $29.706. 430

58. Furthermore, although the bill of lading first cites Sphynx UK as the consignee of the oil it describes French bank BNP Paribas as the consignee. 431 The same person, Simon Chaffey is listed as the contact for both Sphynx UK and BNP Paribas. Chaffey is described in High Court judgment Kensington as having first worked for SNPC UK, SNPC’s London trading arm then for Sphynx UK.

59. Sphynx UK according to the November 2005 judgment, has “earned no revenues since its establishment but plainly exists for no other purpose than to act as a contact/service company for Sphynx Bermuda”. However, “Sphynx UK never made any charges to Sphynx Bermuda for its services and its accounts showed loans from Mr Gokana and Sphynx Bermuda”.

60. Global Witness believes the UK authorities should investigate the role of Sphynx UK as an apparent front company doing no legitimate business in the UK. Although it appears that transactions did not pass through Sphynx UK, its connection to the wider sales scheme should be investigated.

61. In addition, Africa Oil and Gas, the Gokana vehicle which received the profits from the under-selling of state oil through this scheme, is involved in a joint venture with a UK-AIM registered company, SOCO International.

62. On subsequent cross examination in September 2006, Ike Nwobodo, a Nigerian oil trader at the centre of the operation, gave evidence to the effect that sales of oil through intermediary offshore companies under the control of Gokana, and the receipt of monies upfront in the form of extremely expensive pre-payments, continued despite the finding against Congo in November 2005. All that changed were the names of the shell companies used. 432

427 KPMG’s “Rapport SNPC 2003—Annexe 4 Mandat de gestion” describes the sale of four cargoes of Djeno oil to Quantic and one to Elidovo. Average prices were below Prix Fiscal prices for both.
429 http://www.companies-house.gov.uk/
431 See http://www.meib-cg.org/petrole/dpf/3sur4-Congo%20Attest%20T%202004-Annee%201Id.pdf
432 Testimony of Ike Nwobodo before the UK High Court, Mr Justice Gross, 12 and 13 September 2006.
63. Moreover, in further court actions taken by Kensington, Congo’s main creditor, Kensington alleged that oil traders were aiding the Congolese to evade the judgment, principally by setting up their own offshore structures to buy the oil from the sham Gokana offshore vehicles.

“Our internal deal-churning factory”: active complicity in the offshore marketing scheme by a UK-registered international oil trader?

64. According to estimates by Kensington, a creditor of Congo, since 2002, international oil trader Vitol has purchased nearly US$3 billion of oil from Congo. Evidence and testimony from the Nordic Hawk case and subsequent cross-examination of Ike Nwobodo, the trader at the centre of the Sphynx marketing scheme, suggest that Vitol companies registered in the UK, and top Vitol employees based in London actively assisted Congo, post the November 2005 judgment, to maintain its opaque offshore marketing scam by creating two purpose-built shell vehicles (Vitol Bahrain and Global Oil Trading Mauritius) to buy oil.

65. Kensington took out several court actions against Vitol in Geneva and London in 2006–07 on the basis that it was helping Congo to avoid paying its creditors. On 26 May 2006, a UK High Court judgment found in Kensington’s favour: “there is evidence that Vitol Group (that is, Vitol Broking, Vitol Services, Vitol SA and other companies in the Vitol Group) [. . .] has played a role and a significant role in the dishonest judgment-proofing scheme”.432 The judgment refers to documentary evidence including emails between Vitol employees and Ike Nwobodo referring to the setting up of shell companies by the Vitol Group to buy from a new Gokana offshore vehicle, Phenicia: “[Vitol] agreed to deal with Phenicia without question and promptly changed its own practice by creating a new vehicle through which to buy the Congo’s oil, Global Oil Trader Mauritius (‘GOTM’).”

66. In one particular email of 21 February 2006 to Nwobodo, a Vitol employee, Giles Chautard, refers to routing offshore sales through “our internal deal churning factory here”. The judge finds that “structuring the oil sales with the use of new companies to replace earlier entities, Mr Chautard [a Vitol oil trader] and his colleague Mr Lambrosa [Chief financial officer of the Vitol Group], and thus the Vitol UK Companies and the Vitol Group, must have appreciated that the purpose of using these vehicles was in order to prevent detection by the Congo’s judgment creditors of the oil sales”.

Payments made by Vitol to Congolese officials via offshore vehicles?

67. What is of even greater concern to Global Witness are allegations made by Kensington against Vitol that corrupt payments were made via a Vitol-owned offshore vehicle called Peakville into the Hong Kong bank account of Long Beach Limited, the Anguilla shell company belonging to the President of Congo’s son and head of the Congo branch of SNPC, Denis Christel Sassou Nguesso.

68. On 15 January 2007, Don Schwarzkopf, a consultant for Kensington, alleged in an affidavit that:

“[T]here appear to be only two credible alternative explanations for the payments by Peakville and Vitol SA into the Long Beach account. Either these constitute monies paid to and held by Congo for its own convenience, to be hidden from creditors . . .; or, put candidly, they are corrupt kickbacks or rake-offs in return for the placing of valuable business with Vitol . . .”

69. If Kensington’s allegations are correct—this accusation was not finally resolved due to Kensington settling its dispute with Congo—then it raises further disturbing questions regarding the use of offshore sales structures.

70. On 7 November 07 three appeals by Vitol were dismissed in the UK High Court arising out of various proceedings brought by Kensington. Two of the appeals related to restraining orders on oil purchases from Congo or orders to disclose information about specific sales, while the third related to a court order for the UK Vitol companies and Vitol employees “to disclose certain information relating to payments said to have been made in Hong Kong by or on behalf of Vitol S.A. to employees or representatives of the Congo by way of bribes”.435 The Vitol companies and employees had resisted disclosure of information related to these payments by claiming privilege against self-incrimination under the Fraud Act, which applies when “there are real grounds for thinking that the information [the person] is being asked to provide, or the documents he is being asked to disclose, are such as would tend to incriminate him”.436

71. The Appeal hearing thus upheld the findings of Justice Gross in July 2007, who characterized Vitol’s case as follows:

“Faced with such accusations, an obvious response of a reputable trader might well involve an ignignant root and branch factual refutation of the allegations in question, perhaps coupled with an expressed willingness to assist the judgment creditor so far as it was able to do so. That, however, is not the stance adopted by the Third Parties [Vitol]. To the contrary, while resolutely making no admissions to any of the allegations made by Mr. Schwarzkopf, the entire thrust of the

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432 Mr Justice Cresswell, approved judgment of Friday 26 May 2006, Kensington International vs Republic of Congo.
434 Ibid.
Third Parties’ case is that those allegations could, if proved, amount to criminal conduct under the laws of this country. They go on to assert the privilege against self-incrimination pursuant to section 14 of the Civil Evidence Act 1968.”

72. Kensington has now reached a settlement of its debts with Congo, so the Vitol case has effectively been shelved. However, given the UK courts found that Vitol’s UK-registered and headquartered companies, and UK employees, had aided Congo to evade a UK court judgement and move money offshore to avoid seizure by creditors, and given Kensington’s allegations of corrupt kickbacks combined with the fact that Vitol and its employees resisted testifying by claiming privilege against self-incrimination on the grounds that “those allegations could, if proved, amount to criminal conduct under the laws of this country”, Global Witness believes that this case should be investigated further by the UK authorities.

73. This case again reveals evidence of public officials, with the aid of UK-registered companies, making use of offshore structures to deliberately obscure transactions of state oil, thus evading judgments by UK courts and possibly facilitating the diversion public revenues into private hands.

The President’s son uses offshore structures to pay for lavish personal spending from funds derived from Congo’s oil money

74. In March 2003, Denis Christel Sassou Nguesso, son of the President of Congo and the official with overall responsibility for marketing Congo’s oil, set up an offshore company in Anguilla, a UK Overseas Territory, which was then able to open an account in Hong Kong at Bank of East Asia. This bank account received funds, via other shell companies, that appear to be derived from state oil revenues. Mr Sassou Nguesso’s monthly personal credit card expenses, which ran into hundreds of thousands of dollars over a two year period, were paid off from this account. In one month alone, August 2006, Mr Sassou Nguesso spent US$335,000 on designer shopping.

75. Long Beach was incorporated in Anguilla in March 2003, although its business address is stated as being in Hong Kong, the same address as a company services provider called ICS. According to ICS documents, Long Beach’s shareholders and directors are Orient Investments Ltd and Pacific Investments Ltd, which are both Anguilla-based companies in the ICS group that provide nominee services. However, a Declaration of Trust document shows that Orient and Pacific were actually holding the shares in trust for Mr Sassou Nguesso, who was the ultimate beneficial owner.

76. An identical offshore structure was set up by ICS in Anguilla on 4 June 2002 for Blaise Elenga, formerly general counsel for SNPC and now deputy head of Cottrade, Elenga Investment Limited (EIL). EIL was also used to pay his personal credit card bills.

Proceeds of Congolese oil cargoes paid into the Long Beach and EIL shell accounts

77. Long Beach opened a bank account at Bank of East Asia in Hong Kong in November 2003, account number 015-514-25-10518-6. Orient Investments, based in Anguilla, acted as the sole signatory on the account. EIL also had an account at the same bank.

78. Two specific cargos of Congolese oil are referenced in transfers to Long Beach’s account at Bank of East Asia. A $150,000 payment on 12 April 2005 from Antoine Jadakat, a name unknown to Global Witness, references the Genmar Spartiate cargo, sold by Congo on 17 January 2005, and another cargo shipped on the Tanabe on 21 March 2005 is referenced in a payment of just over $322,000.

79. Bank of East Asia records also show payments into Long Beach and EIL from the offshore companies used to sell Congo’s oil opaquely and at a discount, Sphynx Bermuda and Africa Oil and Gas Corporation (AOGC). Long Beach received a payment of $299,967 from AOGC on 10 November 2004 while EIL used to pay his personal credit card bills.

80. As in the Kensington case, third parties, with the aid of UK registered companies, were paid US$50,000 from AOGC via Banque Belgolaise in Paris.

81. The President’s son and other top officials set up offshore vehicles in Anguilla

82. Kensington has now reached a settlement of its debts with Congo, so the Vitol case has effectively been shelved. However, given the UK courts found that Vitol’s UK-registered and headquartered companies, and UK employees, had aided Congo to evade a UK court judgement and move money offshore to avoid seizure by creditors, and given Kensington’s allegations of corrupt kickbacks combined with the fact that Vitol and its employees resisted testifying by claiming privilege against self-incrimination on the grounds that “those allegations could, if proved, amount to criminal conduct under the laws of this country”, Global Witness believes that this case should be investigated further by the UK authorities.

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The President’s son uses offshore structures to pay for lavish personal spending from funds derived from Congo’s oil money

84. In March 2003, Denis Christel Sassou Nguesso, son of the President of Congo and the official with overall responsibility for marketing Congo’s oil, set up an offshore company in Anguilla, a UK Overseas Territory, which was then able to open an account in Hong Kong at Bank of East Asia. This bank account received funds, via other shell companies, that appear to be derived from state oil revenues. Mr Sassou Nguesso’s monthly personal credit card expenses, which ran into hundreds of thousands of dollars over a two year period, were paid off from this account. In one month alone, August 2006, Mr Sassou Nguesso spent US$335,000 on designer shopping.

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89. As in the Kensington case, third parties, with the aid of UK registered companies, were paid US$50,000 from AOGC via Banque Belgolaise in Paris.
80. EIL also received payments from a company called Pan Africa during 2002 and 2003. Pan Africa is yet another offshore corporate vehicle operated by the same secretarial services company in Hong Kong that set up EIL and Long Beach. According to an affidavit by its owner, Jean Yves Ollivier, who describes himself as “a friend of President Sassou-Nguesso”, Pan Africa “has been involved in organised [sic] oil-collateralised loans for SNPC” since 2002, and has received payments from SNPC as “success fees”. In 2003, for instance, Pan Africa received a payment of $1 million into its account at Standard Chartered Bank in Hong Kong.

81. In a first affidavit, Ollivier states that “there are no business transactions involving Long Beach, EIL [. . .] and Pan Africa” and denies ever having heard of EIL or Long Beach. In subsequent testimony, after evidence of payments into EIL accounts emerged, he says his previous affidavit may be “technically incorrect” and affirms that a payment of $185,000 in 2002 plus “further funds” were a personal loan to Elenga.442

**Payments from the Long Beach and EIL accounts to settle personal credit card bills**

82. Four letters on Long Beach letterhead, between May 2004 and September 2006, request that Bank of East Asia arrange for payment, from the Long Beach Limited account, of Mr Sassou Nguesso’s monthly credit card bill.443 The letters are signed by Orient Investments on behalf of Long Beach.

83. The credit card bills themselves, seen by Global Witness, account numbers 5430 9600 6810 1330 and 5411 2340 4010 1039, are in Mr Sassou Nguesso’s name and are addressed to the Hong Kong address of ICS Trust (Asia) Ltd, one of the ICS group companies.

**Responsibility of the bank**

84. There are questions remaining unanswered relating to the Hong Kong bank, Bank of East Asia, and its policy of “know your customer” due diligence and account monitoring. In order to comply with “know your customer” requirements, the bank should have found out who was behind Long Beach, established whether the beneficial owner was a politically exposed person, and if so, should have performed heightened due diligence. This should have included monitoring ongoing activity on the account including oil-related payments from companies controlled by public officials. Global Witness wrote to Bank of East Asia to ask about its due diligence in this case, but it declined to answer our questions.

**Responsibility of the trust and company service providers: how was the President’s son, with control over the key source of state revenues, able to set up a shell company no questions asked?**

85. However, the purpose of this story for this submission is to illustrate the role of trust and company service providers in a UK Overseas Territory in setting up a company for a politically exposed person, opening a bank account for him that received Congolese oil revenues, and providing instructions to the bank to arrange for payment of his personal credit cards from this account.

86. Global Witness wrote to ask Orient Investments what due diligence it had done on its customer Denis Christel Sassou Nguesso, whether it had established if he was a politically exposed person, and to request copies of its customer due diligence policies, but it did not reply.

87. Orient Investments signed, on behalf of Long Beach, a customer information sheet for Long Beach, which was held by the Bank of East Asia as part of its customer records. It describes Long Beach’s main business activities as “Trading crude oil, gas and products (mogas, jet, gasoil, kerosene) in Congo”.444 From this it is reasonable to infer that Orient Investments knew that its client’s source of revenue was Congolese oil.

88. Global Witness notes that Republic of Congo was placed 113 out of 133 countries in Transparency International’s Corruption Perception Index in 2003, the year in which Long Beach was incorporated and the bank account was opened.445 As we have outlined earlier in this submission, international financial institutions and many other observers, including Global Witness, had raised in the public domain ongoing and serious concerns regarding the management of public funds and in particular the transparency of oil sector transactions in Congo.

89. Global Witness wrote to ask Orient Investments (as well as Pacific Investments, which held the other share in trust for Mr Sassou Nguesso) if, against the background of Congo’s standing with the World Bank, and Congo’s public reputation for corruption, enhanced due diligence was warranted on their relationship with Mr Sassou Nguesso and Long Beach Ltd. They did not reply.

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442 See affidavits on www.globalwitness.org; see also
444 Mr Justice Carlson, Judgment of 31 May 2007 in the High Court of the Hong Kong Special Administrative Region, between Kensington International Ltd and ICS Secretaries Limited, p 26, para 4 (this annex referred to in main judgment at p 7, para 11 and p 13, para 18).
90. In December 2005 Global Witness published information alleging that the head of the Congolese state oil company, Denis Gokana, had sold government oil to his own companies at prices below the market rate in order to profit from subsequent sales to independent traders, and that these deals had been overseen by Denis Christel Sassou Nguesso. This information was reported in the media, including by Dow Jones on 13 December 2005. Information was therefore in the public domain raising questions over Mr Sassou Nguesso’s role in the dubious sales of Congolese oil.

91. Yet Orient Investments, an Anguilla company, was willing to:
   - take Mr Sassou Nguesso on as a customer;
   - hold shares in his company;
   - open a bank account and act as the signatory;
   - declare to the bank that the company traded Congolese oil; and
   - arrange for payment of his credit card bills out of the account.

92. Pacific Investments, another Anguilla company that is part of the same group, was willing to:
   - take Mr Sassou Nguesso on as a customer; and
   - hold shares in his company.

93. The instructions for payment of the credit card, sent on Long Beach letterhead by Orient Investments to Bank of East Asia, mention Mr Sassou Nguesso by name as the owner of the credit card. Therefore Orient Investments clearly knew the name of the person it was dealing with. A quick Google search would have been enough to establish that this was the son of the President of Congo, and head of Cotrade, marketing arm of the state oil company, and therefore potentially a politically exposed person.

94. Global Witness asked Orient Investments if its own due diligence had revealed that some of Mr Sassou Nguesso’s transactions from the Long Beach account appeared to be in payment of personal expenditure by Mr Sassou Nguesso himself, and that this personal expenditure appeared to involve extensive and regular purchases of luxury goods; and whether this due diligence, against the backdrop of their knowledge that Long Beach’s source of income was Congolese oil, prompted any further investigation into the apparent payment, by a company set up to trade oil and gas products, in respect of luxury personal expenditure by its beneficial owner. It did not reply.

95. Global Witness has written to the Anguillian regulator, the Financial Services Commission, to alert it to these transactions. However, the reason that these offshore structures were revealed in the first place was not because of regulatory action, but only because documentation came into the public domain in mid 2007 through litigation by Kensington over assets in Hong Kong. Global Witness obtained and published the documents because they appeared to show a whole circuit of diversion of public funds all the way from sales of state oil cargoes via shell companies through transfers of part of the proceeds to an offshore vehicle beneficiarily owned by the President’s son, Sassou Nguesso and subsequently to pay for his personal expenditure.

96. In June 2007, Mr Sassou Nguesso attempted to seek an injunction forcing Global Witness to remove this evidence of apparent misappropriation of public funds from its website. A UK High Court judgment in August 2007 dismissed his attempt, saying that “it is an obvious possible inference that [Sassou Nguesso’s] expenditure has been financed by secret personal profits made out of dealings in oil sold by Cotrade”. Mr Justice Stanley Burnton continued that the documents, “unless explained, frankly suggest” that Mr Sassou Nguesso and his company were “unsavoury and corrupt”, and stated that where “there is good reason to doubt the propriety of the financial affairs of a public official, there is a public interest in those affairs being open to public scrutiny.” He concluded that “the profits of Cotrade’s oil sales should go to the people of the Congo, not to those who rule it or their families”.

97. What are offshore financial centres such as Anguilla—and the others discussed in the rest of this case study—doing to ensure that they are not used to divert public revenues from the public purse, as this case so graphically illustrates, and what is the UK doing to ensure that one of its Overseas Territories is not facilitating corrupt activity? Regulation of the Anguillian financial services industry is the direct responsibility of the UK-appointed Governor, and thus is also the responsibility of the UK. As the Committee will be aware, last year’s National Audit Office report, Managing risk in the Overseas Territories, noted significant concerns about Anguilla’s regulatory capacity, along with that of other Overseas Territories.

98. By failing to ensure that Anguilla is enforcing appropriate anti-money laundering regulations, the UK bears some responsibility for Mr Sassou Nguesso’s spending of Congo’s oil money on designer shopping sprees.

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447 Dow Jones International News, 13 December 2005, also reported in Factiva Public Figures and Associates newsletter, January 2006, under the heading “Top PEPs stories. Take the Factiva challenge: How many of these PEPs would your current system find?”
448 High Court Approved Judgment, Mr Justice Stanley Burnton, between Long Beach Limited and Denis Christel Sassou Nguesso and Global Witness Limited, 15 August 2007. Case no HQ07X02371.
99. Internationally, company service providers have been covered by the Financial Action Task Force (FATF) regulations since 2003. This means that they should be required to do due diligence on their customers, and apply enhanced measures if they are Politically Exposed Persons—which Denis Christel Sassou Nguesso clearly is. However, implementation varies considerably in practice. One international money laundering expert told Global Witness, “outside the EU, there is considerable ambivalence about their inclusion”. This seems to be an extraordinary gap, and one which the UK should tackle.

100. This case study has also shown that there are third parties, companies and individuals, operating in the UK itself (not even the UK Overseas Territories), as in the case of Sphynx UK and the Vitol case outlined above, who appear to be actively complicit with Congolese officials’ use of offshore structures to obscure transactions involving public funds, at best depriving the Congolese Treasury of desperately needed funds for development through mismanagement, and at worst facilitating their misappropriation.

RECOMMENDATIONS TO THE UK GOVERNMENT

101. The UK has made strong commitments to ending corruption by signing the UN Convention on Corruption and the OECD Anti-Bribery Convention. It has also signalled its commitment to strengthening the global anti-money laundering framework through its membership and, this year, chairing, of the Financial Action Task Force (FATF), which sets the global standard. Most crucially, it is committed to ending poverty, with the UK spending £7,487 million a year on development assistance.450

102. But these commitments are meaningless, and the money being spent on development wasted, if the reality in practice is that offshore financial centres can be used to structure financial arrangements that permit countries such as Congo to hide lending from international financial institutions, disguise ownership of assets, evade creditor judgments, and divert public revenues into private hands.

103. The UK government should:
— Conduct its own examinations to ensure that its Overseas Territories are both fully compliant with FATF recommendations, and are implementing and enforcing them effectively. If Overseas Territories persist in failing to meet the regulatory standards and enforce them, they should not be allowed to function as financial centres.
— Ensure that the UK itself is fully compliant with all FATF recommendations (the 2007 FATF mutual evaluation found the UK to be less than fully compliant on a number of issues), so that when putting pressure on its Overseas Territories, it cannot be accused of double standards.
— Use its influence within FATF to push for the following to be added to anti-money laundering framework: if a government cannot account transparently for its receipt and disbursement of natural resource revenues, and be independently audited as doing so, then financial service providers should be required to exercise extreme caution in doing any business with that government, its state owned companies, or its officials in their private capacity, and should be required to explain exactly how their due diligence has ensured that the money that they are taking, or loaning, is not coming from, or going to, corruption.

104. The appropriate UK authorities should take immediate action to investigate the activities of these corporate actors and individuals registered and/or operating in the UK who may be complicit with facilitating the mismanagement and misappropriation of public revenues through offshore structures.

105. We would like to thank the Treasury Select Committee for this opportunity to make this submission, which we would be happy to discuss further with you.

June 2008

Memorandum from the British Virgin Islands Financial Services Commission (FSC)

EXECUTIVE SUMMARY

I. On 30 April 2008, the United Kingdom Parliament Treasury Committee issued Press Notice No. 42 inviting written evidence on offshore financial centres (OFCs), and outlining 11 questions of particular interest to the Treasury Committee.

II. The British Virgin Islands Financial Services Commission (FSC), responsible for the regulation, supervision and inspection of financial services business operating in and from within the Territory, responds to the invitation for written evidence, outlining the following positions on a general level and in relation to the specific questions posed:

III. Generally, the view is taken that the Treasury Committee’s inquiry into offshore finance centres must not be seen as centering on the longstanding debate between onshore and offshore jurisdictions. Rather, it should be focused on the pertinent issue of the standard of regulation and supervision of financial centres.

whether onshore or offshore, and a demonstrated willingness to cooperate on matters of exchange and sharing of information. It should be noted that generally sophisticated criminals look to jurisdictions with well-established financial structures and reputation, whether onshore or offshore, to abuse and misuse the financial system. Thus regulatory and law-enforcement authorities across the globe have individually and collectively responsibility to prevent the abuse of legitimate financial systems through adequate regulation and supervision and the maintaining of robust regimes of cross-border mutual legal assistance.

1) Offshore finance centres contribute to global financial development and stability by encouraging healthy competition. They act as stimulants to economic growth in other parts of the world by encouraging foreign direct investment, while at the same time serving as catalysts to good government. It is no doubt that OFCs are generally recognized as major players in the global economy as they provide a medium for efficiency and speed in promoting international commerce and reducing costs associated with red tape in a highly competitive global market.

2) The use of well-regulated financial centres is good for financial stability. Offshore financial centres are not inimical to global financial stability. Emphasis, in investigations and evaluations of OFCs undertaken by the International Monetary Fund (IMF) and other international bodies, has been properly placed on ensuring adequate regulation and supervision, a willingness to exchange and share information and foster closer cooperation in rendering mutual legal assistance.

3) Regarding the general question of transparency, OFCs subscribe to international standards for the regulation and supervision of financial sectors, and have been found to operate regimes to standards that are equivalent to, and in some instances, exceed those onshore jurisdictions. Both onshore and offshore jurisdictions are obligated to put in place legislative and administrative measures to monitor their regulatory, supervisory and international cooperation regimes.

4) Complex financial instruments, including collateralised debt obligations (CDOs), have recently come under increased scrutiny, as financial analysts have found that their complexity may have played a role in the subprime mortgage and ensuing credit and liquidity crises and overall market turmoil. CDOs are as much a product of offshore finance centres as they are of onshore centres and the International Organisation for Securities Commissions (IOSCO) is currently in the process of developing guidance for credit rating agencies in rating complex financial instruments, in order to better guide and protect the financial market. The Virgin Islands, as a key player in global financial services, will continue to discharge its obligations by continuing its active participation in the IOSCO and other international initiatives to develop acceptable standards of regulation to ensure greater transparency and stability within the global financial market.

5) The notion that OFCs have been successful because of low or zero levels of taxation is a flawed argument. Those jurisdictions that had the same belief and ventured into financial services realized sooner to their shock that they had had to close down. The more successful United Kingdom Overseas Territories like the Virgin Islands have had to develop efficient systems that ensure good governance and strong legal systems, coupled with low levels of corruption, to ensure success. Operating transparent systems have always assured market confidence which attracts investors. The FSC strongly believes that good business is built on honesty and integrity, and that proper, appropriate regulation attracts, rather than deters, good business.

6) The United Kingdom has always been supportive of the Overseas Territories actively engaging in the business of financial services. It emphasizes the importance of transparency, proper and adequate regulation and supervision and putting in place a regime of international cooperation. The FSC has had no indication from the Government of the United Kingdom or any of its agencies that the policies of the Virgin Islands (whether tax-related or otherwise) are inimical to or have any negative impact on the tax revenue and policy of the United Kingdom.

7) Given that the Virgin Islands (as one of the Overseas Territories) has inherited much of the British legal system (and received support from the United Kingdom for charting a legitimate independent source of revenue—financial services—to fund its budget) and has excelled in developing efficient systems of financial management, good governance, strong legal systems with adequate checks and balances in government, it is internationally recognized for the soundness of its financial services industry. No effort has been spared in ensuring compliance with internationally established standards of regulation and compliance, fully cognizant of the fact that good reputation is cardinal to success.

8) The United Kingdom has taken a leading role in combating terrorist financing in relation to its Overseas Territories through the enactment of two relevant Orders in Council—The Terrorism (United Nations Measures) (Overseas Territories) Order 2001 and The Anti-terrorism (Financial and Other Measures) (Overseas Territories) Order 2001. In addition, the Virgin Islands has taken its own initiative in buttressing its anti-money laundering and terrorist financing regime by enacting the Anti-money Laundering Regulations, 2008 and the Anti-money Laundering and Terrorist Financing Code of Practice, 2008 (effectively revoking previous enactments on the subject). Through the legislative and administrative framework that the FSC has established, in cooperation with the Government of the Virgin Islands, for financial regulation, enforcement, countering money laundering and terrorist financing activities, promoting and fostering
international cooperation, it continues along the tireless path of protecting its service industry and the reputation of the jurisdiction, while at the same time lending maximum support to the international efforts to ensure continued global financial stability.

9) The FSC (as a regulatory body) recognizes and values the relationship with the relevant government ministries and departments in the United Kingdom and counts on their continued support as it continues to operate a transparent, efficient and well-managed financial services industry for the good of the people of the Virgin Islands.

10) Prior to 1984, the Virgin Islands concluded a series of double taxation agreements as a way of steering its economy, in addition to receiving limited aid from the United Kingdom. Such agreements were concluded with Canada, Denmark, Japan, New Zealand, Norway, Sweden, Switzerland, United Kingdom and United States of America. These agreements were given the force of law in the Virgin Islands through a series of Orders made under the Income Tax Act (Cap. 206). The agreement with the United Kingdom was terminated in the 1960s. The agreement with the USA was the one most utilised, but this was terminated by the USA in January, 1983. Following the USA termination, the remaining countries effectively pulled back from their agreements as well. The Virgin Islands does not operate a double taxation treaty arrangement with any country.

11) The Virgin Islands has a binding agreement with the United Kingdom and other EU countries in the context of the EU Directive on the Taxation of Savings Income which requires the Government of the Virgin Islands to collect and transmit, under a withholding tax arrangement, a specified percentage of the interest income of United Kingdom and other EU citizens domiciled in Virgin Islands’ banks. In addition, the Government of the Virgin Islands (with FSC participation) is currently negotiating tax information exchange agreements with other EU and non-EU countries which will facilitate requests of inquiries into tax-related matters.

12) The FSC operates systems and policies that are independent and transparent. It encourages and participates fully in matters of international cooperation, while at the same time ensuring proper and adequate regulation and supervision of all the business entities that fall within its jurisdiction. The FSC has had its regulatory, supervisory and international cooperation regimes independently evaluated by international bodies such as the CFATF, FATF, IMF and IOSCO and has in each case found to be compliant with established standards. Where recommendations had been made, these had been effected in cooperation with the Government of the Virgin Islands. The FSC continues to welcome evaluations of its financial services and related regimes.

IV. As the leading international financial institutions have shown in their studies, the existence of offshore financial centres is not inimical to global financial stability. These centres provide legal and legitimate services recognized and accepted under the WTO Rules, and have also been shown to be good for the stability of the financial system. The FSC believes in a continual review and updating of appropriate legislative and administrative regimes to ensure continued compliance with internationally established standards and to provide full cooperation to requests for mutual legal assistance. This way it will continue to be a part of the international efforts to assure global financial stability.

V. The FSC urges the Treasury Committee not to support large jurisdictions in any anti-competitive attempts to limit policymakers’ inquiries and investigations to small financial centres, especially those like the Virgin Islands that have been shown to comply with and apply internationally established standards of regulation, supervision and cooperation.

VI. In addition, the FSC looks forward to the continued support by and collaboration with HMG and the relevant governmental agencies as the Virgin Islands continues to strengthen its systems and policies to aid the laudable efforts at ensuring global financial stability.

VII. Finally, the FSC calls on the Treasury Committee to take into full account the submissions contained in this summary and in the following report and to appropriately reflect those submissions in any report the Committee generates arising from its inquiry.

INTRODUCTION

1. On 30 April, 2008 the Treasury Committee of the United Kingdom House of Commons issued Press Notice No. 42 announcing a new inquiry it was undertaking into offshore financial centres. This followed on the hills of an inquiry in July 2007, by the Foreign Affairs Committee of the House of Commons into the FCO’s responsibilities as they related to the security and good governance of the UK Overseas Territories (of which the Virgin Islands is one). That inquiry was designed to focus, amongst other things, on issues of transparency and accountability and the regulation of the financial sector. The Financial Services Commission of the Virgin Islands (FSC) responded to that inquiry in so far as it related to the financial services sector of the Virgin Islands by submitting a report in that regard (a copy of which is attached herewith as Appendix 1).

2. The FSC recognizes that it is one of several institutions around the developing world that is characterized as part of jurisdictions that are labeled (rightly or wrongly) as “offshore financial centres” or “offshore centres”. This characterization does not affect institutions that belong to the developed world,
generally referred to as “onshore” and which in the main do not suffer from the negatives associated with the characterization of “offshore”, even though in reality they engage in the same types of business administered by the so-called offshore centres.

3. The irony, however, is that financial institutions and regulatory bodies in both the onshore and offshore worlds deal in the same areas of financial services and as a consequence are in material competition with each other. Thus the potential for abuse of the legitimate structures of the financial services sector is as real in the onshore world as it is in the offshore world.\(^{451}\) Persons with the intent and inertia to promote and perpetrate their designs to launder money, finance terrorist activities, disguise ill-gotten gains for profit, evade payment of taxes, rob public treasuries to ship their loot to the onshore and offshore worlds and engage in other types of financial crimes look to jurisdictions they generally consider “safe” to house the products of their criminal activities. However, the more sophisticated criminals with large products of criminal activity look not only to “safe” jurisdictions; they also look to jurisdictions with well-established financial structures and reputation. The case of the then old and well-established Riggs Bank in the USA (otherwise known as the bank for diplomats and heads of state) is a good example in point. Indeed the aftermath of the terrorist attacks on the USA in September, 2001 had demonstrated the vital and major links for the funding of terrorist activities to have taken place in the onshore world rather than in the offshore world.

4. The global economy (founded largely on the principles of free market economics) as it stands today is inter-twined; it is truly globalized and inter-dependent with resulting benefits.\(^{452}\) The free flow of capital and investment has long been a norm and is a principal driver in the stimulation of economic development. In that context, investors look to different available financial structures, both in the onshore world and in the offshore world, that would secure them appropriate returns and stimulate further investment. This has led to numerous innovations of legitimate structures geared towards facilitating business and economic growth. In some instances these innovations relate only to improvements in the existing structures, such as in the areas of company incorporations (where international companies play a crucial role in facilitating business world-wide) and insurance (where the use of captive insurance enables the coverage of certain activities that otherwise would not receive coverage through the traditional insurance system).

5. However, the FSC recognizes that the more sophisticated financial services structures become, the more the likelihood of criminals engaging in complex and unusual transactions that tend to mar the legitimate basis of those structures. It is precisely for this reason that the FSC subscribes unreservedly to the global effort in developing standards of effective regulation and monitoring, and fostering international cooperation to assist foreign regulators and law enforcement agencies (foreign and domestic) to verify the identities of persons and track down offenders. As the principal driver of the economy of the Virgin Islands, the financial services sector is conscientiously guarded against abuse and misuse through the enactment and continual review of relevant financial and enforcement legislation and the ongoing enhancement of the investigative agencies.

6. The FSC, as the sole regulatory authority for financial services matters in the Virgin Islands, plays a key role in sustaining the development of the Territory’s economy and ensuring maximum compliance with the regulatory laws. This is generally carried out through a system of regular and effective supervision with the primary aim of preventing any abuse of the legitimate financial structures and maintaining vigilance, integrity and professionalism in the financial services industry. In this regard, the FSC engages on a continual building of the capacity and expertise of its employees, sensitizing them both to the requirements of their assignments and the FSC’s international obligations to ensure adequate and proper regulation to established standards and to be fully engaged in the process of providing efficient and effective mutual legal assistance to foreign regulators and law enforcement agencies within the terms of the established laws.

7. By providing a separate response to the Treasury Committee in addition to that made by the Virgin Islands Government, the FSC in no way intends to detract from the Government’s submission, particularly as there are broad areas that are within the sole competence of the Government. However, the FSC hopes that it can provide greater insight into its activities and outline in broad perspectives its role and obligations in promoting competitive financial services and lending credence to the global effort in fighting against activities that are incompatible with the establishment and promotion of legitimate business structures, while at the same time recognizing the legitimacy of financial services as a fundamental component of globalization. In addition, the FSC will seek to provide answers to the questions raised by the Treasury Committee that fall within its area of responsibility.

8. The FSC’s response is in two Parts. The first Part makes general remarks about the development of the financial services sector in the Virgin Islands; the FSC’s involvement in developing regional and international standards of regulation and compliance; the FSC’s international cooperation, regulatory and supervisory regimes; and offshore finance centres and global financial stability and transparency. The

\(^{451}\) In January, 2007, for example, a US Treasury-led Government Money Laundering Threat Assessment highlighted that Eastern European and Russian criminal organizations were abusing US shell companies for money laundering purposes.

\(^{452}\) Writing in *The Economist* on 23 February 2007, Joanne Ramos notes that “What is clear is that globalization has changed the rules of the game. It has produced many benefits for rich countries... OFCs, for their part, have by and large done well out of globalization, the best of them... have become sophisticated, well-run financial centres in their own right, with expertise in certain niches such as insurance or structured finance”.
second Part deals briefly with the specific questions posed by the Treasury Committee. The FSC, however, draws attention to the fact that the provisions of the first Part are essential and very closely linked to the answers provided in the second Part.

PART I: GENERAL

DEVELOPMENT OF THE FINANCIAL SERVICES SECTOR IN THE VIRGIN ISLANDS

9. As with many other so-called offshore centres, the Virgin Islands’ entry into the field of financial services has been a gradual process, propelled in some respects by circumstances (as noted below). The International Monetary Fund, Commonwealth Secretariat and other international agencies had in the early years (late seventies and early eighties and indeed into the early nineties) encouraged and had been supportive of smaller jurisdictions developing and finding niches in financial services453 and, in the case of the United Kingdom dependencies, one commentator has noted that this “suited Britain, because it meant its protectorates could become self-sufficient”454 and in many ways reduce the burden of budgetary aid. Financial services as a medium of economic development was not only seen as legitimate, but it was also encouraged. Over time the small jurisdictions that ventured into this field reaped enormous benefits through prudent management processes, coupled with stability, good governance and strong legal systems. In most cases, a large number of these jurisdictions already had their tax systems in place (high, low or non-existent) and therefore the motivation for investor gravitation towards them was in reality not tax-based.

10. Prior to 1984, the Virgin Islands had concluded a series of double taxation agreements as a means of helping to steer its economy, in addition to receiving limited aid from the United Kingdom. Such agreements were concluded with Canada, Denmark, Japan, New Zealand, Norway, Sweden, Switzerland, United Kingdom and United States of America. These agreements were given the force of law in the Virgin Islands through a series of Orders made under the Income Tax Act (Cap. 206). The agreement with the United Kingdom was terminated in the 1960s, whilst that with the USA was terminated in January, 1983. By far the most important treaty and virtually the only one that was utilized was the one with the USA. Following the USA termination of the agreement with the Virgin Islands in 1983, the remaining countries effectively pulled back from their agreements as well, leaving the Virgin Islands without another efficient and effective medium (save tourism) with which it could continue to steer its economy.

11. Then in 1984, the Virgin Islands developed and enacted new legislation for the registration of international business companies. This enactment became the precursor to the emergence of a financial services industry in the Virgin Islands. Through hard work, prudential management and supervision, regular legislative reviews and the enhancement and strengthening of its legal and judicial systems, the Virgin Islands was able to develop a niche market in financial services through the domiciliation of international business companies. That impetus led to an expansion of the offerings within the financial services sector—insurance, fiduciary services, investment business455—and a greater adherence to emerging international business companies. This enactment became the precursor to the emergence of a financial seaside and financial services industry. The financial services industry is an important contributor to the economy and is an important part of the Virgin Islands’ economy. There are currently only five commercial banks and four offshore banks which are supervised by the FSC’s Banking and Fiduciary Services Division.

12. Until December, 2001, the regulation of the financial services sector of the Virgin Islands fell to the then Government Financial Services Department. However, in accordance with the prevailing views of the late 1990s that required the establishment456 of independent/autonomous financial services regulatory institutions that would properly and effectively administer the operation of financial services outside the purview of any undue governmental or industry influence or pressure, the FSC was established through the enactment of the Financial Services Commission Act (FSCA) in December, 2001 and became operational as such in January 2002.

13. Since that period the FSC has been operating in an independent capacity, but at the same time liaising with the Government on key policy matters with broad financial and social implications for the Territory. The FSCA enables the FSC to retain from 7 to 15% of the total annual revenues it collects on behalf of the Government as a means of buttressing its operational independence. The FSC, in the execution of its duties, is answerable to its Board of Commissioners and the House of Assembly; the Board holds annual formal dialogues with the Cabinet (the Executive Council before 2007) to discuss matters pertaining to the performance of the FSC, initiatives and future direction of the FSC. Government policy with respect to financial services and developments in the international financial markets as these relate to the Virgin Islands.

453 Barbados received assistance from the IMF in establishing its financial services industry in the 1970s.
455 While the Virgin Islands has in place relevant legislation governing the establishment and supervision of banks, the FSC has deliberately steered away from encouraging any large scale establishment of banks. There are currently only five commercial banks and four offshore banks which are supervised by the FSC’s Banking and Fiduciary Services Division.
456 In its Progress Report on Offshore Financial Centers released in February, 2005, the IMF reported at page 20 in respect of the Virgin Islands that “Primary legislation Provides the Financial Services Commission with adequate independence and authority to license and supervise covered financial services, which include banking, insurance, securities, trust, and company service providers”.
14. The FSC recognizes that the growth in financial services within the Virgin Islands brings with it certain risks, including exposure to criminals and others looking for weaknesses within the legal, regulatory and law enforcement systems to use the established financial services structures for illegitimate purposes. In effect, such criminals and other persons use jurisdictions with weak systems to enable them to enter the global financial services markets where they continue to carry on their nefarious activities. It is precisely this realization that had led the Virgin Islands since the early nineties to review and amend its financial services legislative regime to introduce prudential regulation and a mechanism for information disclosure and the rendering of mutual legal assistance.457

15. These defences were strengthened by the enactment of relevant anti-money laundering and mutual legal assistance legislation;458 this includes the establishment in March, 2004 of the Financial Investigation Agency (following the enactment of the Financial Investigation Agency Act in December, 2003).

16. The regular review of these and other related legislation in the context of domestic policies and emerging international standards of regulation and international cooperation remains a vital feature of the work of the FSC in collaboration with the Government of the Virgin Islands.

The FSC’s Involvement in Developing Regional and International Standards

17. The FSC has long recognized the important roles international financial institutions play in ensuring global financial stability through a prudential process of engagement and the establishment of appropriate standards in regulatory, supervisory, enforcement and cooperation matters. In this vein, the FSC continues to participate in regional and international discussions geared towards establishing and enhancing proper and adequate regulation and supervision of the financial services industry, from service providers to the type of business that is conducted.

18. Such participation is not limited to organizations of which the FSC is a member; it extends to those where it enjoys associate or observer status. The FSC also takes account of the developments in those organizations of which it is not a member and in which it holds no other status (such as the OECD and European Union). The FSC pursues active membership of international standard setting institutions primarily as a means of keeping up-to-date with emerging developments and assisting to inform vital decisions that relate to or affect the so-called offshore jurisdictions in the global economy and help develop effective mechanisms for international cooperation.

19. The FSC is currently a member of the International Association of Insurance Supervisors (IAIS) and actively participates in its working groups that develop standards in specific interest areas. In March, 2007, it became the first institution to be admitted to the membership of the International Organization of Securities Commissions (IOSCO) on the basis of the organization’s Multilateral Memorandum of Understanding on Consultation and Cooperation and the Exchange of Information; this followed an extensive review by the organization’s Standing Committee 4 of the Virgin Islands’ legislative and institutional regimes on international cooperation which were accepted as meeting IOSCO’s established standards.

20. In October, 2007, the FSC was admitted as a member of the Offshore Group of Banking Supervisors (OGBS), after having previously served in the capacity of observer within the organization. It served as a member of the OGBS’s Working Group that developed the Statement of Best Practice on Trust and Corporate Service Providers. The FSC is a founding member of the Offshore Group of Insurance Supervisors (OGIS), Offshore Group of Collective Investment Scheme Supervisors (OGCISs) and International Trade and Investment Organization (ITIO) and (save for the ITIO in relation to which the Government now has full responsibility) actively participates in their work.

21. Furthermore, the Virgin Islands’ membership of the regional Caribbean Financial Action Task Force (CFATF) (of which it is a founding member) enables the FSC to regularly participate in the organization’s deliberations in monitoring anti-money laundering initiatives amongst member countries and territories and devising policies for implementation. The FSC was admitted as an associate member of Fin-Net in 2007. The FSC also participated in the OECD-Commonwealth Working Group on Tax Competition and recently served on the Working Group set up to review the FATF’s 40 + 9 Recommendations on combating money laundering and terrorist financing. The FSC played a key role in assisting the Government’s process of reviewing the OECD’s principles of transparency and effective exchange of information in tax matters which led to the Government’s formal commitment to the principles in 2002.

457 The Banks and Trust Companies Act, 1990 and Company Management Act, 1990 were amended in 1995 to provide a mechanism for the disclosure of information to both domestic and foreign regulators and law enforcement agencies. In 2000 the Financial Services (International Cooperation) Act was enacted, but subsequently repealed and amalgamated in the FSCA in 2006.

22. The active involvement of the FSC at such regional and international levels affords it the opportunity to network with a broad section of institutions that seek to continually develop standards of regulation and encourage and foster cooperation at the global level, especially in relation to matters of cross-border trade and services. It is in this context that the FSC, with the full support of the Virgin Islands Government, readily accepts and promotes the idea of subjecting the jurisdiction to regular reviews of its financial services industry and law enforcement and international cooperation regimes.

23. Both the IMF and the CFATF have conducted such reviews; the CFATF is currently finalizing its third review of the jurisdiction, while the IMF is expected to undertake its second review sometime later in the year. Recommendations arising from these periodic reviews are fully considered and given effect to. The FSC considers these reviews as essential to providing an objective assessment of the systems and practices of the jurisdiction, especially as they relate to financial services regulation and supervision. They also provide the FSC the opportunity to further develop and enhance its service industry, while at the same time effectively countering the new innovations developed and engaged in by criminals and organized crime generally.

The Centre Stage of International Cooperation

24. It is an indisputable fact that international finance has taken on a solid centre stage in economic liberalization in an increasingly globalized world. The mobility of capital, new technology and the need to efficiently facilitate business endeavours and protect investments has led over the last several years to the enactment of legitimate business structures and related enforcement mechanisms. Concomitantly, the international community has recognized the importance of adopting necessary measures not only to protect those legitimate structures and strengthen the enforcement mechanisms, but also to keep at bay persons who would be bent on abusing those structures for criminal purposes and make a mockery of the law. With increasing cross-border trade and investment opportunities beyond national borders, coupled with migrant labour, the need for international capital flow has become inevitable.

25. Financial services is a truly lucrative market which is also highly globalized as a service industry that attracts enormous competition. It is an industry that is active both in the onshore and offshore worlds and all jurisdictions engaged therein are generally in material competition with each other. As a commentator notes, “[g]lobalisation has vastly increased the opportunities for such business. As companies become even more multinational, they find it easier to shift their activities and profits across borders and into OFCs…Financial liberalization—the elimination of capital controls and the like—has made all of this easier. So has the internet, which allows money to be shifted around the world quickly, cheaply and anonymously”.

26. Whatever the arguments may be between offshore and onshore jurisdictions in matters concerning international finance and the offering of services in that regard (which the FSC views as a distraction), it should be noted that all such jurisdictions face the same or similar threats or potential threats of abuse of their legitimate business structures from criminals and organized crime, whether in the form of money laundering (including the banking of the proceeds of corruption), terrorist financing or other financial crimes. The FSC strongly believes that the issue really is not between offshore and onshore; rather, it is whether the concerned jurisdictions have in place appropriate legislative mechanisms and administrative resources and capacities to police their financial services perimeters against abuse for unlawful purposes and render effective assistance to other jurisdictions to identify customers and apprehend criminals, including those who criminally evade their tax obligations. It is the recognition of this fact that has led, in recent years, to a greater focus on international cooperation—the development of standards of regulation, enforcement and mutual legal assistance.

27. The leading global standard setters in the field of international finance such as the FATF, OECD, OGBS, IAIS and IOSCO, supported by key agencies such as the World Bank and the International Monetary Fund and regional institutions, recognize the deficiency that will inevitably be gained in not promoting dialogue and cooperation between jurisdictions to apply meaningful standards that will keep criminals and organized crime at bay.

460 “Financial services are lucrative and provide a much more stable income than crops and fickle tourists”. Joanne Ramos, The Economist, 23 February 2007.


462 Indeed Mihir Desai of Harvard Business School contends that even “if today’s OFCs were somehow stamped out, something like them would pop up to take their place”, thus making the point that none will be the wiser in the continuing debate between offshore and onshore, instead of concentrating on the real issues of proper supervision and promoting efficient and effective international cooperation.
28. The FSC considers sacrosanct a jurisdiction’s right to engage in lawful and legitimate business by employing appropriate legal structures and mechanisms. However, such structures and mechanisms must not operate at a level whereby they facilitate criminals and the abuse of the financial system; they must operate to protect such structures and mechanisms against abuse and promote international cooperation to lead a joint and cohesive fight against organized crime, market manipulation and fraud, money laundering, terrorist financing and other types of financial crime. In as much as it believes in the relevance of the principle of confidentiality in business relationships, the FSC does not subscribe to the institutionalization of secrecy laws. The Virgin Islands indeed has no secrecy legislation, even though from time to time assertions to the contrary appear in the international media which we might hope were better informed.

29. A fundamental aspect of the FSCA is its provisions on international cooperation. Section 33D fully empowers the FSC to provide assistance to a foreign regulatory authority and in so doing it may exercise any of the powers granted to it under the relevant sections of the FSCA—these essentially relate to the FSC’s powers to request information and documents from any entity, appoint examiners to conduct investigations in relation to requests, apply for search warrants, examine or apply for persons to be examined under oath and disclose information. Such assistance extends to persons and authorities with “functions in relation to the prevention or detection of financial crime, including money laundering, financing of terrorism, misconduct in, or misuse of information relating to, financial markets and offences involving fraud or dishonesty”. The relevant sections of the FSCA are attached herewith as Appendix 2. It should be noted as well that in other areas of international cooperation, notably law enforcement and tax information exchange, the Virgin Islands has developed and long implemented appropriate legislation.

30. The FSC’s international cooperation regime is considered to be second to none. Between 2003 and 2007, the FSC went through a very rigorous evaluation process of its international cooperation regime by the International Organization of Securities Commissions (IOSCO) and at the end of it the FSC was admitted to membership of the organization. The FSC became the first institution to be admitted into IOSCO ordinary membership on the basis of the organization’s Multilateral Memorandum of Understanding.

31. In addition, the FSC has developed and published, in association with the Government of the Virgin Islands, a handbook on international cooperation which details the procedures for preparing and submitting requests for mutual legal assistance in the areas of financial services (generally on a regulator-to-regulator basis), law enforcement, enforcement of foreign civil judgments and service of process and tax information exchange. A copy of the handbook is attached herewith as Appendix 3.

32. The FSC operates a robust system in the implementation of its international cooperation regime. Appendix 4 shows the number of requests received for the years 2004–08 (May), the requesting foreign institutions and the time frame within which they were disposed of. The FSC is fully cognizant of the importance of timely response to requests for information and has over the years been striving to improve on its record as the 2007–08 statistics in Appendix 4 show. The FSC remains committed to a continual review of the regime to ensure continued improvement.

THE VIRGIN ISLANDS’ REGULATORY REGIME—DUE DILIGENCE AND EFFECTIVE SUPERVISION

33. Prior to January, 2002, the regulation of financial services in the Virgin Islands vested in the Financial Services Department of the Government. Thus as a department of Government, the institution was governed by the rules of the public service, including the hiring and discipline of employees and the allocation of financial resources to regulate the financial services industry. In December 2001, the FSCA was enacted by the then Legislative Council (now succeeded by the House of Assembly) which effectively established the Financial Services Commission as a separate autonomous regulatory authority. The Financial Services Department was thus transformed into an operational FSC in January 2002. The structure of the FSC and its key areas of discipline for regulatory purposes are outlined in Appendix 1 hereof.

34. In essence, the FSC regulates and supervises business in the Virgin Islands in the areas of banking and fiduciary services (which includes trust and company service providers), insurance (which includes captive insurance/reinsurance), investment business (which includes public, private and professional mutual funds), insolvency practice and company incorporation and administration. Its supervisory role is expected to be enlarged to cover non-financial businesses with the imminent enactment of the Financing and Money Services Bill, 2008. The FSC also has responsibility for registering trademarks and patents within the portfolio of the Registry of Corporate Affairs.

462 Section 33C (1) (b) of the FSCA.
464 Sometimes delays in processing requests for mutual legal assistance are occasioned by inappropriate or inadequate submissions by the requesting authority, including the need to verify information and obtain necessary clarifications.
35. Apart from the FSCA, the FSC takes its mandate from several other pieces of financial services legislation. While the FSCA generally provides the powers and functions of the FSC, the enactments relating to banking, insurance, trust business, insolvency and investment business detail the requirements for the respective licensing regimes. Efforts are made on a consistent basis to benchmark these enactments against internationally established standards of regulation and to review them from time to time to effect necessary improvements.

36. The FSC is currently developing subsidiary legislation that would codify relevant standards of prudential regulation relating to insurance and banking. These draw from the Basel Core Principles as well as the IAIS Core Principles. A similar exercise is to be undertaken with respect to investment business and the other regulatory sectors under the supervision of the FSC.

**Due Diligence Responsibilities**

37. As the regulator of financial services business in the Virgin Islands, the FSC is required under the FSCA and other sector-specific legislation to carry out due diligence exercises in respect of all regulated entities. This entails conducting necessary background checks on persons (legal and individual) who relate or are connected to regulated persons. From a prudential standpoint, due diligence generally takes into account the fitness and propriety of a regulated person. This requires the FSC to exercise judgment and discretion with respect to the honesty, integrity, reputation, competence, capability and financial soundness of an applicant regulated person and the persons connected to it.

38. The laws relating to anti-money laundering and terrorist financing require all regulated persons in the Virgin Islands to provide information on persons with whom they establish business relationships or for whom they perform one-off business transactions. The required information includes the identity of the persons concerned, the beneficial owners of the person (in the case of legal persons), the nature and intended purpose of the business relationship or transaction and, in the case of trusts, details of the structure of the trust and classes of beneficiaries and charitable objects and all related matters.

39. The essence of these requirements is to forestall money laundering, terrorist financing and other forms of financial crime. However, the requirements are also considered essential to the Virgin Islands’ international cooperation regime by ensuring that requests for mutual legal assistance are properly and effectively dealt with. Indeed one of the accusations leveled against offshore jurisdictions relates to the non-availability of timely information on beneficial ownership of corporate vehicles and the absence of proper and effective due diligence. These elements are considered relevant to effective cross-border cooperation, especially as they relate to information exchange.

**Effective Supervision**

40. The supervisory powers of the FSC are broadly outlined in the FSCA. The licensing and supervisory matters are vested in the Licensing and Supervisory Committee comprising the Managing Director, his two deputies and the heads of the various divisions of the FSC. Matters pertaining to enforcement are vested in the Enforcement Committee comprising the Managing Director, his two deputies and the heads of the Legal and Enforcement Division and Policy Research and Statistics Division. Between them, these committees oversee the FSC’s responsibilities in ensuring effective supervision and enforcement.

41. The FSC conducts both on-site and off-site supervision of the regulated entities to ensure full compliance with established laws and policies. Where deficiencies are discovered, these are required to be corrected, failing which appropriate enforcement action is taken against the defaulting regulated entity. The FSC has and exercises enormous compliance and enforcement powers pursuant to Part V of the FSCA. Essentially, these require the FSC to conduct compliance inspections; appoint examiners to conduct investigations on behalf of the FSC; require the appointment of qualified and competent persons by licensees; take enforcement action which includes the imposition of administrative penalties; issue public statements where enforcement action is contemplated; revoke or suspend licences and certificates issued to regulated entities; make applications to the Court for protection orders; and issue directives. This process enables the FSC, in addition to ensuring compliance, to effectively respond to issues of international cooperation.

42. Effective supervision requires adequate provision of resources, both financial and human. As noted earlier, the FSC retains annually between 7 and 15% of total revenue collected and since its establishment

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the FSC has been retaining from 9 to 11% of collected revenue. The staff of the FSC have increased steadily over the years according to the demands of the role of the FSC and training is a fundamental feature of the institution.  

OFCS AND GLOBAL FINANCIAL STABILITY AND TRANSPARENCY

43. The focus of the Treasury Committee’s inquiry relates to the relationship between offshore financial centres and global financial stability and transparency. This subject is not new and has been increasingly discussed, especially since the OECD process on transparency and fair competition in tax matters emerged in the late nineties. Offshore jurisdictions have particularly come under closer scrutiny, not least by countries or association of countries with which they are in material competition in the field of financial services.

44. This subject is driven more by concerns held by some countries in the developed world over the loss of tax dollars which are increasingly viewed as finding host in the offshore jurisdictions. The pro- and anti-offshore debaters continue to discuss the subject in varying fashions, but what is clear is that both onshore and offshore jurisdictions were guilty of administering lax rules in the past thus paving the way for illicit money to find its way into their jurisdictions.

45. The emphasis nowadays is on the establishment of appropriate legislative and enforcement regimes that are efficiently and effectively supervised to keep criminals and organized criminal groups from making use of the legitimate structures of international finance. If deficiencies are allowed to creep into the financial system, the resulting effect could be unwarranted distortions and instability in the global market. The subject therefore becomes one of collective responsibility in which every jurisdiction plays its part by putting in place systems and mechanisms that will not only prevent the abuse of the financial system, but that will also facilitate the tracking down of criminals to bring them to justice.

46. Transparency requires openness and eschews secrecy that is deliberately designed to shelter the criminal. The FSC strongly believes that good business is built on honesty and integrity and that the greater number of investors, in both the onshore and offshore jurisdictions, are genuine persons who are taking advantage of legitimate services that the laws offer; they are not crooks. This is confirmed by a straight forward comparison of the number of business entities that are domiciled or licensed in a jurisdiction and the number of requests for mutual legal assistance that is received on a year to year basis to realize this. However, this is no reason for complacency as there will always be those that will domicile or seek licensing in a jurisdiction for nefarious purposes and it is those few that the world needs to gang up against.

47. Globalization embodies trade in goods and services and that includes financial services; its launching pad is trade liberalization. In this context, when the offshore financial centres open up their markets to investment through the enactment of appropriate and lawful legislation, they are acting legally and legitimately. The story only begins there. They must at the same time put in place appropriate and effective structures to prevent criminals from abusing the established financial systems. They must recognize that global financial stability is in everyone’s interest. They must move on further to ensure an efficient and effective regime of international cooperation which enables the tracking down of perpetrators of crime and fosters information exchange.

48. It should be understood and appreciated that not all jurisdictions that are engaged in the provision of regimes of financial services accept and implement less-than-satisfactory rules of business establishment and conduct. Rather, those jurisdictions that recognize the central function of financial services in the growth of their economies, engage actively in ensuring efficiency and transparency to safeguard the niches they have been able to develop.

49. Professor Hines and Dhammika Dharmapala of the University of Michigan undertook a study in 2006 to find out the reason for the attractiveness of the so-called tax havens. The study looked at over 200 jurisdictions and concluded that the so-called tax havens were, as one commentator puts it, “overwhelmingly small, wealthy and, especially, well governed, with sound legal institutions, low levels of corruption and checks and balances on government”. The study found that the lowering of taxes by itself does not bring about a high level of prosperity and the argument that offshore financial centres rely on low or no taxes to attract foreign business emanates from a flawed premise.

466 The OFC's 2007 Annual Report.  
467 The UK National Audit Office, in its report “Foreign and Commonwealth Office: Managing risk in the Overseas Territories” (16 November 2007), recognized at page 21: “Regulators in key centres of Bermuda and the Cayman and British Virgin Islands have, thanks to fees levied on their flourishing financial sectors, achieved major improvements in customer service” since 2000.”

468 The likes of President Obiang Nguema of Equatorial Guinea, Ferdinand Marcos of the Philippines, Sani Abacha of Nigeria and Augusto Pinochet of Chile had largely been able to cause great damage to their national treasuries because of the financial facilities that were afforded to them by both onshore and offshore jurisdictions.


50. It has been stated time and time again that offshore financial centres play a crucial and legitimate role in creating discipline in the financial markets by affording tangible and viable alternatives to consumers. They enable citizens to legally structure their businesses in order to limit their tax liabilities.470 This by itself provides healthy tax competition and encourages the establishment of tax-efficient platforms for the promotion and growth of global commerce. In a fiercely competitive world, offshore financial centres provide speed and efficiency in the operation of modern-day commerce without the traditional intricacies that cause inordinate delays and loss of business and profit.

51. It is the unfortunate case that quite often the offshore finance centres are lumped into one basket and stigmatized as parasitic, havens for criminals and poorly regulated. Nothing could be further from the truth. It should be noted that these so-called offshore finance centres differ from jurisdiction to jurisdiction in terms of the financial services offered and the standard of financial regulation and supervision present.

52. Estimates from the OECD, BIS and IMF show that offshore holdings are in the range of $5 to $7 trillion and account for between 6 and 8% of world-wide wealth under management.473 These estimates derive from the fact that the greater number of offshore finance centres, though small in geographic size, are efficiently and effectively well-governed, exhibit low levels of corruption, adhere to democratic governance and are politically stable. The most successful of the offshore finance centres adhere to internationally established standards as a viable means of maintaining their edge in the specific niches they have been able to map out for themselves. A jurisdiction that operates a badly run finance centre can hardly expect to attract good business.

53. It is therefore clear that lumping offshore finance centres into a single negative basket without an evaluation and appreciation of their standards of regulation and compliance is unfair and unfortunate.472 It is this arbitrariness that continues to engulf the debate between offshore and onshore. It is accepted in a great many quarters that jurisdictions should be recognized as being well-regulated or poorly regulated. Well-regulated jurisdictions, whether onshore or offshore, are good for the global system as they promote financial stability.

54. Most offshore finance centres (including the Virgin Islands) apply risk-based supervision regimes which they find manageable. In the Virgin Islands, the FSC regularly consults with the private sector industry to establish and evaluate current risk issues and take appropriate measures to remedy them or put viable plans in place to address them.

55. The efforts and progress made by offshore jurisdictions continue to be recognized and acknowledged by the world’s leading standard setters. In September, 2007, the Financial Stability Forum (FSF) recognized that the IMF and IOSCO had noted significant progress among the offshore finance centres with respect to compliance with international standards.475 In 2000 the FSF, in reviewing the report of its Working Group on Offshore Financial Centres, noted that “some OFCs are highly regarded” and offshore financial activities are not inimical to global financial stability provided they are well supervised and supervisory authorities co-operate. The report acknowledged that “There are … highly reputable OFCs that actively aspire to and apply internationally accepted practices, and there are some legitimate uses of OFCs” and “it is recognized that there may be jurisdictions not formally thought of as OFCs that are more problematic in terms of global financial stability than some OFCs”.474 The same report notes further that while offshore finance centres are perceived as small jurisdictions there are a number of assessments in the developed world that have effectively succeeded in attracting large concentrations of non-resident business by offering economic incentives either throughout their jurisdiction or in special economic zones. The emphasis is thus on proper and adequate regulation and supervision, rather than on whether or not offshore centres have a place in the global market.

56. In its 2005 Progress Report on Offshore Financial Centres, the IMF noted that “Compliance with standards in the OFCs is, on average, better than in other jurisdictions assessed under the Financial Sector Assessment Programme (FSAP), reflecting in part the higher average income levels of the OFCs. Results on cooperation and information sharing principles, which play a key role in cross-border supervision, show a similar pattern”.475 The reference to “other jurisdictions” relates to non-OFC jurisdictions, meaning jurisdictions in the onshore world. The report went on further to indicate that “The results for cooperation and information sharing principles in the first round of assessments are consistent with the general finding that, on average, OFCs meet supervisory standards superior to those of other jurisdictions though with deficiencies in lower income jurisdictions”.476 The IMF noted that 50% of offshore centres comply with “every principle and recommendation directly concerned with cooperation and information exchange as opposed to 47% of other assessed jurisdictions”.477 The IMF’s assessments under its Module 2 essentially

470 This position has been confirmed by the European Court of Justice in Point 85, AG’s Opinion, Halifax plc and others v. Customs and Excise Commissioners [2006] 2 W.L.R. 905.
472 This is a tendency that well-regulated jurisdictions in the Caribbean (notably the most successful UK Overseas Territories and independent countries) suffer from without any acknowledgement of the strides achieved by them in incorporating international standards into their legislative and supervision regimes. The Virgin Islands and Cayman Islands took the lead in developing policies and regimes for immobilizing bearer shares.
475 This is a tendency that well-regulated jurisdictions in the Caribbean (notably the most successful UK Overseas Territories and independent countries) suffer from without any acknowledgement of the strides achieved by them in incorporating international standards into their legislative and supervision regimes. The Virgin Islands and Cayman Islands took the lead in developing policies and regimes for immobilizing bearer shares.
476 Ibid at p. 4
477 Ibid, footnote 5 on p. 6
evaluate a jurisdiction’s supervisory and regulatory compliance regime with international standards in the areas of banking, securities, insurance and anti-money laundering and terrorist financing. These assessments are benchmarked against the standards established by the Basel Committee on Banking Supervision, IOSCO, IAIS and the FATF. In addition, assessments under the FSAP “consider risks to macroeconomic stability stemming from the financial sector and the capacity of the sector to absorb macroeconomic shocks”.

57. The fact cannot be denied that even in the well-regulated and supervised offshore and onshore finance centres there is always room for improvement and the continuing need for vigilance, as the threats for abuse by criminals is forever present. Hence the emphasis by international standard setting institutions on proper, adequate and sufficiently resourced regulatory and supervisory regimes to ensure transparency, creating an effective check against criminal and other unlawful activity and demonstrating a willingness to engage in information exchange and sharing to foster international cooperation.

Constant Regulatory Improvement in the Virgin Islands

58. As noted above, the FSC and the Government of the Virgin Islands always welcome objective evaluations of the Territory’s financial industry. The FSC sees the outcomes as an opportunity to re-evaluate its systems and processes (in addition to its own regular reviews and reforms) in order to effect necessary improvements and develop new strategies. Following the Virgin Islands’ formal commitment to the OECD principles of transparency and effective exchange of information in 2002 (in which the FSC played a significant role), the Territory moved to review and revise its companies regime to make it more transparent by removing the ring fencing of certain companies as against others. The new regime—established by the BVI Business Companies Act, 2004—carried out additional reforms which required the maintaining of information on directors and beneficial owners.

59. In 2000 a joint UK-Overseas Territories project on the Review of Financial Regulations in the Caribbean Overseas Territories and Bermuda was undertaken by KPMG. This project was designed to identify the strengths and weaknesses in the regulatory and supervisory regimes of the Overseas Territories and make recommendations for improvement. In the Virgin Islands report, the KPMG noted in relation to the then Financial Services Department (succeeded in 2002 by the FSC), that the institution “appears to be a well-run regulator with a strong commitment to achieving international standards. However, we do not consider the current regulatory structure to be fully in accordance with international standards. This is because the current position by which the Governor in Council (or Minister of Finance) is responsible for licensing and enforcement action relating to financial service activity means that the regulator is not operationally independent. We, therefore, recommend that the FSD should become an independent regulatory body and that the current powers exercised by the Governor in Council, Minister of Finance and the individual regulators are transferred to that body.”

The report made two further recommendations to ensure full compliance with international standards: that there should be an increase in staffing resources and that the marketing role of the FSD should be transferred to another body. Following the publication of the KPMG report, the Virgin Islands undertook a comprehensive review of its regulatory regime and enacted the FSCA granting regulatory independence to the FSC and divorcing the marketing role to a newly established Government department called the International Finance Centre. The FSC then undertook a complete review of its human resource requirements and provided necessary adequate staff; it also institutionalized a training programme to properly equip its staff to efficiently and effectively carry out the functions of the FSC.

60. Following its review of the Virgin Islands in 2002, the IMF wrote of the FSC as having “adequate independence and authority to licence and supervise covered financial services, which include banking, insurance, securities (mutual funds, their management, and investors), and trust and company service providers, whether onshore or offshore…In particular, the professionals who staff the FSC, led by senior management and directors, are dedicated and experienced professionals with a clearly articulated goal of maintaining and, where possible, improving the framework and implementation of financial services supervision in the BVI.” Some weaknesses were identified in the IMF report in relation to which recommendations were made for corrective action. These have effectively been carried out through the review and enactment over the last few years of relevant legislation. As regards the practical aspects, the FSC has increased its level of on-site inspection and off-site supervision of regulated entities and instituted a regular dialogue with service providers in the financial services industry through a Meet the Regulator Forum and the establishment of public-private sector committees to work on specific relevant initiatives.

478 Ibid, footnote 1 on p. 4
481 Some of those committees are the Financial Services Legislation Advisory Committee, Company Law Advisory Committee, Joint Anti-money Laundering and Terrorist Financing Advisory Committee.
61. As already noted, the FSC underwent a rigorous assessment of its international cooperation regime before it was admitted to membership of IOSCO. Prior to that the IMF had reported that “Cross-border information exchange and cooperation has been excellent in all areas”. The Virgin Islands has undergone three periodic reviews and evaluations by the CFATF and is looking forward to its second round of evaluation by the IMF later this year. This is a helpful process the FSC hopes to continue to engage in as a means of independently testing its systems and processes for continued compliance with international standards.

PART II: TREASURY COMMITTEE SPECIFIC QUESTIONS

GENERAL COMMENTS

62. Turning now to the specific questions raised by the Treasury Committee, the FSC invites attention to the submissions that have already been made in paragraphs 1 to 61 above which essentially address the issues relevant to the questions raised. There are many facets to the questions and it is the view of the FSC that they must not be considered in isolation. The FSC has not dealt in detail in this submission with tax-related questions which fall within the separate remit of the Virgin Islands Government.

63. The FSC would again urge the Treasury Committee to consider that—as has been recognized by international monitoring and standard setting bodies like the IMF, FSF, IOSCO, IAIS, OGBS and FATF—the real issue is not whether the OFCs have a role to play in the global market vis-à-vis the onshore jurisdictions or that they should be treated differently; the real issue is whether onshore and offshore jurisdictions that engage in financial services are properly and effectively regulated and supervised and demonstrate a willingness to exchange and share information to foster international cooperation, thereby reducing (or eliminating) the incidences of criminal and other unlawful activities through established legitimate financial structures.

THE QUESTIONS

1. To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?

64. The point has already been made that OFCs are not inimical to global financial stability; rather they contribute to global financial development and stability by encouraging healthy competition. They act as stimulants to economic growth in other parts of the world by encouraging foreign direct investment, while at the same time serving as catalysts to good government. There is no doubt that OFCs are generally recognized as major players in the global economy as they increase the efficiency and speed of international commerce and reduce the costs associated with red tape in a highly competitive global market.

65. The offering of financial services by onshore and offshore jurisdictions around the world is recognized under the WTO rules on trade in goods and services. Just as numerous other industries and business sectors add value to modern day economies, so does the financial services sector. The growth of financial services in the last thirty years has demonstrated mankind’s resilience and continuing ability to innovate to expand economic growth through the use of legal structures. Economic growth in one particular sector propels growth in another.

2. To what extent does the use of Offshore Financial Centres threaten financial stability?

66. As has been discussed above under the heading of OFCs and Global Financial Stability and Transparency, OFCs are not inimical to global financial stability. This assessment has been made by the FSF which is a grouping of industrialized countries. The IMF has expressed itself similarly. Indeed no international standard setting institution has said that the use of OFCs threatens financial stability.

67. The emphasis, even in the wake of the debate on fair tax competition, has been on proper and adequate regulation and supervision, a willingness to exchange and share information and foster closer cooperation in rendering mutual legal assistance. The FSC believes that any reduction in the emphasis on regulation and supervision and effective international cooperation would itself threaten global financial stability and it is what the detractors of offshore in favour of onshore would achieve should they be allowed to succeed in their quest.

3. How transparent are Offshore Financial Centres and the transactions that pass through them [to the United Kingdom’s tax authorities and financial regulators]?

68. In addressing the general question of transparency, it has already been noted that OFCs operate regimes to standards that are equivalent and, in some instances, higher than those in the onshore jurisdictions. Full compliance with the FATF 40 + 9 Recommendations would leave no room that could compromise transparency.

69. Both onshore and offshore jurisdictions are obligated to put in place appropriate legislative and administrative measures that would identify applicants for business relationships and other customers (including beneficial owners of legal persons and, in the case of trusts, the beneficiaries thereof), verify their identities, keep appropriate records for specified minimum periods and engage actively in the reporting of transactions that are suspicious. The Virgin Islands subscribes to the FATF Recommendations and has appropriate legislative and administrative systems in place to monitor the activities of persons to ensure compliance with the requirements of the Recommendations.

70. It has also been noted earlier that the Virgin Islands had since 2004 abolished ring fencing in its business companies regime that was considered by the OECD to pose difficulty with transparency. With a strong international cooperation regime (as acknowledged by the IMF and IOSCO), the Virgin Islands has left no room for doubt concerning its ability and willingness to exchange and share information for regulatory, law enforcement and tax purposes. Indeed in 2005 the Virgin Islands voluntarily adopted and legislated in the Territory the EU Directive on the Taxation of Savings Income.464

4. To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?

71. Recently, with the sub-prime mortgage crisis in the USA and international market turmoil, much scrutiny has been given to complex financial instruments, including collateralized debt obligations (CDOs). Many economic analysts believe that due to the difficulty present in providing risk ratings for these complex financial instruments, they were inaccurately rated, thus leading to liquidity and credit crises in international markets.

72. Market analysts agree that these complex financial instruments, including the CDOs, are as much a product of onshore finance centres as they are of offshore finance centres, given that the fund industry has historically been subject to lighter-touch regulation across the globe, since its investors tend to be more sophisticated. IOSCO had since acknowledged the problems and is working towards establishing guidance for credit rating agencies in order to protect and guide the financial markets better.

73. As regulators across the globe learn ever more about complex financial instruments to establish comprehensively the constituent elements of adequate regulation for these products and their administrators, the FSC continues to play its role in participating in the IOSCO initiatives to develop acceptable standards of regulation to ensure greater stability within the global financial market.

5. How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets?

74. The importance of transparency in all aspects of the conduct of financial services, including taxation, continues to be emphasized by international standard setting institutions. These institutions have from time to time investigated relevant business vehicles in both onshore and offshore jurisdictions that may raise questions of transparency and have come up with standards of compliance to ensure systems that are transparent and fair.

75. The OECD’s principles of transparency and effective exchange of information and the EU’s Directive on the Taxation of Savings Income were designed to achieve greater transparency in the operation of financial services both in specific onshore and offshore jurisdictions that were considered to be key players in financial services. The Overseas Territories have been a part of these processes and the Virgin Islands, in particular, has not only accepted and subscribed to the requirements established by these initiatives, it has also gone ahead to put appropriate legislation in place to assist in achieving the objectives of the initiatives. These actions have been taken even though some of the Virgin Islands’ key competitors in the area of financial services (such as Barbados, Singapore and China) had been left out of the initiatives.

76. As already noted, the notion that OFCs have been successful because of low or zero levels of taxation is a flawed argument. Those jurisdictions that had the same belief and ventured into financial services realized sooner to their shock that they had had to close down. The more successful OFCs like the Virgin Islands have had to develop efficient systems that ensured good governance and strong legal systems, coupled with low levels of corruption, to ensure success. Operating transparent systems have always assured market confidence which attracts investors.

6. How do the taxation policies of Offshore Financial Centres impact on UK tax revenue and policy?

77. The FSC does not consider itself best placed to provide guidance on this subject and would direct the Treasury Committee’s attention to the submissions of the Government of the Virgin Islands. However, as noted elsewhere in this paper, the United Kingdom has always been supportive of the Overseas Territories actively engaging in the business of financial services and using this new, legitimate and independent source of revenue to fund their budgets. The United Kingdom United Kingdom rightly emphasizes the importance of transparency, proper and adequate regulation and supervision and putting in place a regime of international cooperation.483 The FSC has had no indication from Her Majesty’s Government or any of its agencies that the policies of the Virgin Islands (whether tax-related or otherwise) are inimical to or have any negative impact on the tax revenue and policy of the United Kingdom.

7. Are British Overseas Territories and Crown Dependencies well-regarded as Offshore Financial Centres, both in comparison to their peers and international standards

78. The standing of the Virgin Islands as a reputable offshore finance centre has already been articulated with supporting endorsements from the IMF. Equally the recognitions accorded to the Territory through its membership of such reputable institutions like IOSCO, OGBS and IAIS is testimony of its important role in the global financial market in charting a collective course of global financial stability. The FATF, during its assessments on the Non-cooperating Countries and Territories (NCCT) in 2000, found the Virgin Islands to be compliant with the established standards of compliance and cooperation and accordingly the Virgin Islands was never included on the NCCT list that was eventually published by the FATF. Furthermore, in its 2008 publication, the Global Financial Centres Index (GFCI) published by the City of London ranked the Virgin Islands amongst the top 30 leading financial services jurisdictions around the globe with London and New York ranking first and second respectively.486

79. The Virgin Islands (as one of the Overseas Territories) has inherited much of the British legal system (and received support from the United Kingdom for charting a legitimate independent source of revenue—financial services—to fund its budget) and has excelled in developing efficient systems of financial management, good governance and strong legal systems with adequate checks and balances in government. Today it is internationally recognized for the soundness of its financial services industry. No effort has been spared in ensuring compliance with internationally established standards of regulation and compliance, fully cognizant of the fact that good reputation is cardinal to success.

80. Research conducted by Alexa Rosdam and published last year under the heading “Are OFCs Leading the Fight Against Money Laundering?” finds that the standard of financial regulation, enforcement, AML/CFT and international cooperation in the so-called offshore financial centres of the British Overseas Territories and Crown Dependencies in many cases exceeds that of the onshore jurisdictions like the United Kingdom and the USA. However, notwithstanding the weight of evidence, the offshore jurisdictions continue to bear the onslaught of inquiries, investigations and reviews of their legislative and administrative frameworks which largely continue to demonstrate high levels of compliance.487

81. It is not widely recognized that more than fifteen years ago, the Virgin Islands (along with Gibraltar) was the first jurisdiction to regulate trust and corporate service providers in the financial services world and continues to fully participate in new endeavours designed to strengthen the global standards of regulation, supervision and compliance. The vast majority of EU Member States are only now introducing regulation of trust and corporate service providers as a result of the Third Money Laundering Directive.

82. The IMF’s estimate of the offshore holdings of 5 to 7% of worldwide wealth under management (referred to earlier) attests to the investment confidence and high regard reposed in the offshore centres.

8. To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?

83. The United Kingdom has itself taken a leading role in this in relation to its Overseas Territories through the enactment of two relevant Orders in Council—The Terrorism (United Nations Measures) (Overseas Territories) Order 2001 and The Anti-terrorism (Financial and Other Measures) (Overseas Territories) Order 2001. In addition, the Virgin Islands has taken its own initiative in buttressing its anti-money laundering and terrorist financing regime by enacting the Anti-money Laundering Regulations, 2008 and the Anti-money Laundering and Terrorist Financing Code of Practice, 2009 (replacing previous enactments). Through these measures, both the Virgin Islands Cabinet and the FSC, acting in accordance with delegated authority under the Proceeds of Criminal Conduct Act, 1997, seek to ensure full compliance with the AML/CFT obligations under the FATF 40 + 9 Recommendations.

483 In an oral evidence presentation before the Committee of the House of Commons on 10 December 2007 to deal with the “Report by the Comptroller and Auditor General, FCO: Managing Risk in the Overseas Territories (IICA)”, Sir Peter Ricketts KCMG, Permanent Secretary, FCO, emphasized the importance of the Overseas Territories having in place “regulatory arrangements so that they can be safe and effective financial centres” and that the FCO “are encouraging them to be proper, world-class, international financial centres”.


84. In addition, the Virgin Islands’ law enforcement institutions have been strengthened through increased staffing and the establishment in 2004 of the Financial Investigation Agency (FIA) which has responsibility for investigating both money laundering and terrorist financing activities and related matters in the Territory. The FIA also executes requests for mutual legal assistance and participates in cross-border investigations relating to money laundering and terrorist financing. As has been widely reported in the international press, the FIA recently concluded, in association with counterpart authorities in Bermuda, an extensive financial fraud investigation which eventually led to the successful confiscation of US$40 million.488

85. The FSC has established, in cooperation with the Government of the Virgin Islands, a powerful legislative and administrative arsenal not just to combat terrorist financing, but also to prevent money laundering and other types of financial crime, ensure effective financial regulation and enforcement, and foster international cooperation. Only in this way can its service industry and the reputation of the jurisdiction be protected and enhanced.

9. What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?

86. The FSC considers this to be a matter that is best addressed by the relevant authorities in the United Kingdom. However, it worth noting that the FSC (as a regulatory body in one of the Overseas Territories) recognizes and values the relationship with the relevant government ministries and departments in the United Kingdom and counts on their continued support as it continues to operate a transparent, efficient and well-managed financial services industry for the good of the people of the Virgin Islands.

10. What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres?

87. As already noted above, the Virgin Islands no longer operates a double taxation treaty arrangement with any country.

11. To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?

88. This is not a specific area of responsibility of the FSC. However, it should be noted that the Virgin Islands does have a binding agreement with the United Kingdom in the context of the EU Directive on the Taxation of Savings Income which requires the Government of the Virgin Islands to collect and transmit, under a withholding tax arrangement, a specified percentage of the interest income of United Kingdom citizens domiciled in Virgin Islands’ banks. In addition, the Government of the Virgin Islands (with FSC participation) is currently negotiating tax information exchange agreements with EU countries (including the United Kingdom) and non-EU countries, which will facilitate requests of inquiries into tax-related matters.

CONCLUSION AND RECOMMENDATIONS

89. The FSC continues to be a part of, and lend support to, continuing international efforts to initiate and implement standards of regulation and compliance in order to prevent criminals from abusing and misusing the financial system and thereby causing global financial instability. The FSC respectfully submits that the Treasury Committee should not view “offshore” in isolation and as something different from “onshore”. To ensure that the international financial system is dealt with as a whole, the focus should be on encouraging greater international cooperation and on ensuring that all countries build the capacity to ensure adequate regulation and supervision. All onshore and offshore jurisdictions must be encouraged to exchange and share information in all areas of financial services. Furthermore, the FSC submits that large jurisdictions should not be supported in any anti-competitive attempts to limit policymakers’ inquiries and investigations to small financial services centres.

90. As numerous studies by the leading international financial institutions and academics show, the existence of offshore financial centres is not inimical to global financial stability. These centres provide legal and legitimate services which are recognized and accepted under the WTO rules, and have also been shown to be good for the stability of the financial system. As has been rightly observed, “although international initiatives aimed at reducing financial crime are welcome, the broader concern over OFCs is overblown. Well-run jurisdictions of all sorts, whether nominally on- or offshore, are good for the global financial system.”469

469 The UK’s National Audit Office noted in 2007: “Since 2004 in the British Virgin Islands an independent Financial Intelligence Agency, funded jointly by the regulator and the Territory government, has been sufficiently resourced to investigate well-founded suspicious transactions and take several to the point of prosecution. The Agency is hopeful that successful prosecution in the USA will yield a share of proceeds from sequestered assets or fines levied there”. National Audit Office report, “Managing Risk in the Overseas Territories”, 16 November 2007, p. 24.

469 The Economist, 23 February 2007.
91. The FSC is proud to play its part in ensuring the Virgin Islands’ place as a leading, reputable global finance centre and in ensuring new economic opportunities and enhanced employment prospects for the Territory’s citizens. The FSC believes in a continual review and updating of appropriate legislative and administrative regimes which it will, in cooperation with the Government of the Virgin Islands, continue to foster by ensuring continued compliance with internationally established standards and providing full cooperation to the execution of requests for mutual legal assistance.

92. The FSC calls on the Treasury Committee to take into full account all of the submissions made in this report and to appropriately reflect those submissions in any report it generates arising from this exercise.

93. Furthermore, the FSC looks forward to the continued support by and collaboration with HMG and the various relevant governmental agencies as the FSC endeavours to strengthen its systems and policies to ensure continued compliance with internationally established standards of regulation, supervision and cooperation.

June 2008

Memorandum from the Government of the British Virgin Islands (BVI)

EXECUTIVE SUMMARY

— The BVI Government understands that the focus of the Inquiry is Offshore Financial Centres (OFCs) and the role these countries play in the international financial system. One of the questions specifically references Britain’s overseas territories. In light of this the BVI Government hereby submits written evidence to the Committee.

— In financial services, the BVI is widely regarded as operating a robust regulatory and supervisory regime, in addition to its well-established international cooperation regime. This is a fact recognized by international organisations including the Financial Action Task Force (FATF) and the International Monetary Fund (IMF).

— The financial services sector grew out of the 1984 passage of the International Business Company (IBC) Act. However, since then it has broadened in scope to include insurance, mutual funds, fiduciary and wider corporate services. There are also a small number of banks.

— The Government of the BVI follows the principle that good governance of the jurisdiction combined with sound regulation enhances our reputation and in turn brings high quality business into the financial services sector.

— On the foundation of good governance, the BVI has established a strong regulatory reputation. Indeed, the BVI was one of the first jurisdictions to establish a fully independent financial regulator, the Financial Services Commission (FSC), which has been critical to ensuring the effectiveness of the regulatory system and therefore of our reputation.

— While their roles are very separate, the BVI Government works closely with the FSC to ensure that legislation is consistently updated so that the jurisdiction operates to international standards. In 2003 the Financial Investigation Agency Act established the Financial Investigations Agency (FIA).

— The BVI is now of major importance in the global financial system and as with any major financial centre activity to deter the criminal element can never be static. The recent NAO report on “Managing Risk in the Overseas Territories” specifically drew attention to the FIA and commended the BVI for its establishment.

— The FIA is a member of the Egmont Group of 108 Financial Intelligence Units and participates in all aspects of the work of the Group. The Agency shares information relating to Suspicious Transaction Reports (SARs) with local law enforcement, regulatory and prosecutorial authorities and foreign law enforcement agencies including foreign Financial Intelligence Units.

— The recently concluded IPOC International Growth Fund case is a prime example of the importance of international cooperation in the fight against money laundering, terrorist financing and other financial crime. In this particular case authorities in the Virgin Islands and Bermuda conducted the probe for 17 months.

— It is important to note that the BVI’s policies and legislation have been developed in close consultation with the private sector to ensure that they meet the needs of the financial community.

— Many law firms, accounting firms, trust companies and fund administrators that have a presence in the BVI also have offices in other parts of the world. This applies equally to the handful of banks with a presence in the BVI. Where such organisations apply a “group standard” typically they use the highest level of standards applicable to any member of the group.
— One of the key factors to the success of the BVI is the importance of the competency requirements of the individual professions within the BVI financial services sector, which is essential to maintaining the BVI's position as a leading financial centre.

— It is currently estimated that there are at least 110 lawyers who are admitted to practice law in the BVI and who are in private practice.

— Accountants are the second largest professional group in the BVI financial services sector. The major accountancy firms including KPMG, PWC, Deloitte, Ernst and Young have all established a presence in the BVI, in addition to some of the smaller international firms and boutique specialist firms.

— The BVI has deliberately chosen not to be a banking jurisdiction and we have only nine banks. However, all these have suitably qualified senior officers, a number of whom are accredited by and are members of the Association of Executives in Finance, Credit and International Business.

— The BVI has been regulating trust service providers long before there was thought of an international requirement to do so. As a result among those working in the BVI financial services sector are a number of highly qualified trust and estate practitioners, some of whom are internationally recognised for their expertise in this field.

— The BVI Government and the FSC recognise the pivotal role transparency and exchange of information plays in combating crime and the misuse of the financial system. Both are committed to policies which foster greater international co-operation to render assistance where necessary.

— The BVI does not have, and has never had, secrecy laws for financial services. It has no legislation which institutionalizes secrecy in any part of the regulatory process. The BVI subscribes to the common law principle of confidentiality while having in place avenues for accessing information for regulatory and law enforcement purposes including rendering assistance to foreign regulatory and law enforcement authorities.

— Contrary to many policy concerns, the ability of investors to use OFC operations does not appear to divert activity from other jurisdictions. The empirical evidence indicates that firms facing reduced costs of establishing OFC operations respond in part by expanding their foreign activities in high-tax countries. Hence it appears that careful use of OFC affiliates permits foreign investors to avoid financing costs they would otherwise incur, and some of the tax burdens imposed by domestic and foreign authorities, thereby maintaining foreign investment at levels exceeding those that would persist if the use of OFCs were more costly.

— The BVI has always been amenable to entering into and concluding treaties with foreign jurisdictions, including law enforcement and tax authorities, to exchange and share information on a variety of matters.

— In 2002 the BVI formally and unequivocally committed to the OECD principles of transparency and effective exchange of information.

— The new legislative regime for tax information exchange enables the Financial Secretary, as the competent authority on tax matters, to receive and fully investigate requests for mutual legal assistance in relation to persons.

— Finally, it should be noted that the BVI voluntarily adopted and implemented the EU Directive on the Taxation of Savings Income through the enactment of the Mutual Legal Assistance (Tax Matters) (Amendment) Act, 2005. By virtue of this enactment, the BVI is able to cooperate with and render assistance to all the EU Member States, including the UK.

INTRODUCTION

The BVI Government understands that the focus of the Inquiry is Offshore Financial Centres (OFCs) and the role these countries play in the international financial system. One of the questions specifically references Britain’s overseas territories. In light of this the BVI Government hereby submits written evidence to the Committee.

In the preparation for this submission the BVI Government has consulted widely with the BVI financial services private sector and with academics who have looked at this issue in detail, particularly over the last ten years. In particular we have drawn on material provided by Professor James R. Hines Jr., University of Michigan and the National Bureau of Economic Research (NBER) (U.S.) who has specialised in this area of academic research. The insights of both sources are included together with details on the structure of the financial services sector in the BVI.

It should be noted that the regulatory function of the BVI financial services sector is entirely separate from the Government. The detail on the operation of the regulatory regime of the jurisdiction is therefore contained in a separate submission from the BVI Regulator, which is the Financial Services Commission (FSC), and it is to this body that specific questions about the regulation of financial services in the BVI should be addressed.
The Committee has asked a number of questions pertaining to the role OFCs play in the global financial system and fortunately, there is extensive recent research that offers important insights into these questions. This evidence indicates that OFCs contribute to financial development and stability in neighbouring countries, encourage foreign direct investment in high-tax countries, have salutary effects on tax competition, promote good government, and enhance economic growth elsewhere.

**About the BVI**

1. The British Virgin Islands is located in the Caribbean, 60 miles east of Puerto Rico. The principal islands of Tortola and Virgin Gorda are where most of the Territory’s 25,000 inhabitants live with the rest scattered around a number of smaller islands. Road Town is the administrative and economic capital.

2. Politically stable and internally self-governing the BVI maintains a fully democratic system. The Territory recently adopted a new Constitution which has allowed for significant constitutional advancement and, among other developments, clearly defines the role of the Governor and ensures a role for the locally elected BVI Government in all issues which might directly impact upon the Territory or its population. This includes the establishment of a National Security Council to advise on internal security and a degree of enabling power for the BVI Government to undertake external affairs on its own behalf. BVI Law is based on the English Legal System and English Common Law. The court system is made up of a Magistrate’s Court, a High Court and an itinerant Court of Appeal of the Eastern Caribbean Supreme Court with final appeal to the Privy Council in England.

3. The BVI has a thriving economy with negligible unemployment. This stems from the successful management of the twin pillars of its economy: tourism and financial services. Because of traditionally close links with the US Virgin Islands, the British Virgin Islands uses the US dollar as its official currency.

4. In financial services, the BVI is widely regarded as operating a robust regulatory and supervisory regime, in addition to its well-established international cooperation regime. This is a fact recognized by international organisations including the Financial Action Task Force (FATF) and the International Monetary Fund (IMF). The UK has ratified on behalf of and, as necessary, extended to the BVI relevant international conventions germane to the Territory’s regulatory and law enforcement regimes, such as the 1988 UN Convention on the Illicit Traffic in Narcotic Drugs and Psychotropic Substances (Vienna Convention) and the 1993 UN Convention against Corruption. The BVI now hopes that the UK will ratify on its behalf the UN Convention against Transnational Organised Crime (Palermo Convention) and the UN International Convention for the Suppression of the Financing of Terrorism, considering that the Territory has enacted the obligations enshrined in these Conventions in domestic law.

5. The financial services sector grew out of the 1984 passage of the International Business Companies (IBC) Act (1984). However, since then it has broadened in scope to include insurance, mutual funds, fiduciary and wider corporate services and some banking services with the establishment of appropriate legal and administrative structures to properly and effectively regulate and supervise such service industries.

**BVI Financial Services Sector**

**Governance**

6. The Government of the BVI follows the principle that good governance of the jurisdiction combined with sound regulation enhances our reputation and in turn brings high quality business into the financial services sector. Several jurisdictions have benchmarked their own offerings against ours. BVI financial services continue to be compliant with and even exceed the relevant international requirements. Indeed, new evidence (Dharmapala and Hines, 2006) shows that OFCs score very well on the World Bank’s cross-country measures of governance quality that include measures of accountability, political stability, government effectiveness, rule of law, and control of corruption. In a statistical analysis that controls for other observable variables, the impact of good governance on the likelihood of becoming an OFC is both statistically significant and quantitatively very large.

7. The simple reason for this is that higher foreign investment flows, and the economic benefits that accompany them, are more likely to materialise for well-governed OFCs than they would for poorly-governed countries that attempt to set themselves up as financial centres. Evidence from the behaviour of American firms is consistent with this explanation, in that, among poorly governed countries, low tax rates do not prompt very much additional U.S. investment, whereas among well governed countries there is a significant investment impact of lower tax rates (Dharmapala and Hines, 2006).

**Financial Services Commission**

8. On the foundation of good governance, the BVI has established a strong regulatory reputation. Indeed, the BVI was one of the first jurisdictions to establish a fully independent financial regulator, the Financial Services Commission (FSC), which has been critical to ensuring the effectiveness of the regulatory system and therefore of our reputation.
9. The FSC is an autonomous institution established under the Financial Services Commission Act 2001. It is answerable to Cabinet and the House of Assembly through the Minister of Finance. The highest body of the Commission is a Board of Commissioners which comprises a Chairman and six other Commissioners, including the Managing Director. One of the Board Members is required to be selected from outside the BVI and has to be a person with a strong financial services background.

10. While their roles are very separate, the BVI Government works closely with the FSC to ensure that legislation is consistently updated so that the jurisdiction operates to international standards. In 1997 the BVI enacted the Proceeds of Criminal Conduct Act designed to formally counter money laundering activities. The legislation introduced a new reporting regime for all suspicious activities relating to financial transactions and established a Reporting Authority. In 2003 the Financial Investigation Agency Act transformed this Authority into the Financial Investigations Agency (FIA). Virtually every year amendments and new legislation are passed to enhance efficiency in regulation and enforcement. In 2007 the BVI Government and FSC published the Handbook on International Cooperation which details the procedures for submitting requests for mutual legal assistance in the area of financial services.

11. The BVI is now of major importance in the global financial system and as with any major financial centre, activity to deter the criminal element can never be static. The recent NAO report on “Managing Risk in the Overseas Territories” specifically drew attention to the FIA and commended the BVI for its establishment.

Financial Investigations Agency

12. The FIA is funded jointly by the FSC and the BVI Government, and inter-alia, investigates well-founded suspicious transactions. It is the therefore the body responsible for receiving, obtaining, investigating, analyzing and disseminating information relating to money laundering, the financing of terrorist activities and other financial crime. The agency is a member of the Egmont Group of 108 Financial Intelligence Units around the world, formed in 1995 to foster cooperation in combating money laundering, the financing of terrorism and other financial crime. The BVI FIA participates in all aspects of the work of the Group and is an active member of both the Outreach Working Group and the Training Working Group. The Agency shares information relating to Suspicious Transaction Reports with local law enforcement, regulatory and prosecutorial authorities and foreign law enforcement agencies including foreign Financial Intelligence Units.

13. The recently concluded IPOC International Growth Fund case is a prime example of the importance of international cooperation in the fight against money laundering, terrorist financing and other financial crime. In this particular case authorities in the Virgin Islands and Bermuda conducted the probe for 17 months. In April 2008, IPOC International pleaded guilty to providing false information and perverting the course of justice.

14. The Bermudan and British Virgin Islands Governments spent a total of US$2.3 million investigating the IPOC fraud case and the evidence in the case totalled over half a million in pages of documents. The case resulted in the confiscation of over US $40 million, the largest seizure of its kind in the Commonwealth.

FIA Statistics

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BVI Private Sector

15. It is also important to note that the BVI’s policies and legislation have been developed in close consultation with the private sector to ensure that they meet the needs of the financial community. Through this, the BVI Government has established a sophisticated and efficient supervision and regulatory regime to safeguard the integrity of the jurisdiction while creating an operating environment that is attractive to business.

16. In addition it is worth noting that as well as the high and exacting standards required under BVI’s own regulatory regime, some service providers are now obliged to apply group standards as a result of being part of a wider global organisation.
17. Many law firms, accounting firms, trust companies and fund administrators that have a presence in the BVI also have offices in other parts of the world. This applies equally to the handful of banks with a presence in the BVI. Where such organisations apply a “group standard” typically they use the highest level of standards applicable to any member of the group.

18. Furthermore a BVI service provider that operates a foreign branch is required to ensure that it operates to the standards established by or at least equivalent to those established under domestic BVI legislation. Ordinarily the foreign jurisdiction of operation will have standards consistent with and reflective of those established by the FATF. In circumstances where the established standards differ, the entity’s foreign branch is required to adopt the higher standards applicable in its jurisdiction of operation.

19. Where global due diligence policies are in place these are very often applied through the use of a group due diligence database. This allows an office within the group to establish whether a client that is perhaps new to that particular office has already been subject to a due diligence exercise within the group and access details of the information and documentation gathered.

20. In addition to group standards, BVI service providers are also required to consider the standards of foreign jurisdictions in the context of relying on an introduction from a source in a foreign jurisdiction. The BVI service provider is obliged to ensure that the jurisdiction in which the introducer is based meets FATF obligations as regards anti-money laundering and countering the financing of terrorism and that supervisory agencies are in place there to monitor and regulate the activities of such introducers.

21. Within this framework, one of the key factors to the success of the BVI is the importance of the competency requirements of the individual professions within the BVI financial services sector, which is essential to maintaining the BVI’s position as a leading financial centre.

Law

22. Lawyers qualified to practise BVI law comprise the largest group of professionals in the BVI financial services sector. It is currently estimated that there are at least 110 lawyers who are admitted to practice law in the BVI and who are in private practice (at least three of whom are Queens Counsel). There are also a number of qualified lawyers working at the various trust companies resident in the BVI who are not necessarily admitted to practice BVI law but rather are qualified in other jurisdictions, including lawyers qualified to practice in non-common law jurisdictions (current estimations suggest there are at least 35 lawyers that fall into this category).

23. The BVI continues to attract lawyers of the highest calibre and experience. These standards are maintained through statutory admission and professional conduct requirements, initiatives of the BVI Bar Association and internal policies of those law firms resident in the BVI.

24. The legal community of the BVI is regulated by the BVI High Court and the requirements for admission are laid down in the Eastern Caribbean Supreme Court (Virgin Islands) Act. This Act also establishes the rules of professional conduct for solicitors by stipulating that the law and practice relating to solicitors in force in England shall extend to and be in force in the BVI and shall apply to all persons lawfully practising as solicitors of the High Court. Consequently, those rules of professional conduct for solicitors in England and Wales apply equally to those solicitors admitted in the BVI.

25. The BVI Bar Association was founded in 1976 to regulate the legal profession in the BVI. It is a voluntary organisation; however, legal practitioners are not eligible to join until they have been resident in the BVI for at least one year (unless they hold Belonger status). It is accepted that the Bar Association speaks for the profession as a whole within the jurisdiction and often addresses the Legislature on that basis. The Bar Association also takes an active role in informing its members as to key developments and initiatives involving the legal profession. Currently, there are 94 members of the BVI Bar Association that are resident in the BVI.

26. In June 2006, the BVI Government introduced the Legal Profession Bill, which makes provision for the fusion of the barrister and solicitor branches of the legal profession, regulates admission requirements and promotes legal education and the discipline of legal practitioners. Although the Bill was not passed before the holding of the BVI general election in 2007, the current Government is likely to review the position and present a similar Bill to the Legislature. The Bill in its current form models legislation that onshore jurisdictions have used to regulate their legal professions and is yet another example of the BVI’s focus on providing unparalleled legal services.

27. A further recent development is that progress is being made in connection with the establishment of a specialist Commercial Court, which will be a division of the Eastern Caribbean Supreme Court. The Commercial Court will be headquartered in the BVI and will further improve the BVI’s standing as one of the leading jurisdictions for the settlement of contentious commercial matters.

28. The BVI also regularly hosts visiting Queens Counsel and senior barristers for those hearings and appeals before the High Court and Court of Appeal. It is a requirement that these visiting barristers are also admitted to practice BVI law.
29. In recognition of the fact that the BVI is a leading Financial Centre with an ability to attract the highest calibre lawyers, each of the leading international offshore law firms now have substantial presence in the BVI. These larger law firms are full service firms, with an ability to advise on all aspects of BVI law, often through specialist departments advising on corporate and commercial law, banking and finance, capital markets, investment funds, private equity, litigation, insolvency, trusts, wills and estates.

30. The law firms resident in the BVI, through their internal policies and initiatives, ensure that the competency levels of those lawyers practising in the BVI are maintained at the highest standard. Examples of such policies and initiatives are as follows:

(a) international offshore law firms resident in BVI typically have policies governing lawyer recruitment and consequently, have very high recruitment standards. It is common for international offshore law firms to hire only those lawyers that have been admitted in England and Wales and have at least three years post-qualification experience and who have been trained by leading City law firms (or equivalent);

(b) many of the international law firms have comprehensive training programmes (equivalent to Articles in England) for those BVI attorneys who have qualified through the Certificate of Legal Education from the Council of Legal Education of the West Indies;

(c) many of the law firms provide continuing legal education and training for their lawyers on an ongoing basis. Some also provide regular advisory services in order to assist their lawyers in keeping abreast of international legal and economic developments, news and market trends; and

(d) in response to the increasing trend for firms to become multi-jurisdictional, many of the international offshore law firms are hiring lawyers who are qualified in multiple jurisdictions (including other onshore and offshore jurisdictions) thereby enabling such firms to provide advice on a number of different laws (often to the same client). In addition, such multi-jurisdictional firms are also able to call on the expertise of colleagues in offices in other jurisdictions, as and when the need arises.

Accountancy

31. Accountants are the second largest professional group in the BVI financial services sector. The major accountancy firms including KPMG, PWC, Deloitte, Ernst and Young have all established a presence in the BVI, in addition to some of the smaller international firms and boutique specialist firms.

32. It is currently estimated that at least 100 qualified accountants practising in the BVI and that 40% are employed by an accountancy firm and the remaining 60% are working in-house for a trust company, bank, law firm or investment fund administrator.

33. Like the international offshore law firms, the accountancy firms resident in the BVI attract the highest calibre of accountants with well-recognised qualifications such as ACA, ACCA and CPA.

34. The growth of the BVI investment funds industry over recent years has attracted a number of internationally recognised investment fund administrators, such as Fortis Prime Funds Solutions (BVI) Limited, BISYS Hedge Fund Services (BVI) Limited, Citigroup Fund Services (BVI) Ltd and Conifer Fund Services Ltd. These organisations, in keeping with their international standards, employ highly trained and qualified staff, many of whom have formal accountancy qualifications. It is also important to note that such organisations have had to satisfy the stringent regulatory requirements in order to be granted a licence by the BVI Financial Services Commission.

Banking

35. The BVI has deliberately chosen not to be a banking jurisdiction and we have only nine banks. However, all these have suitably qualified senior officers, a number of whom are accredited by and are members of the Association of Executives in Finance, Credit and International Business.

36. Unlike the BVI, a number of other financial centres are substantial banking centres. It is therefore worth noting that primary due diligence is undertaken in those centres where the financial transactions take place, normally a banking centre. Therefore these centres will always file a far higher number of Suspicious Transaction Reports (SARs) as a matter of course even if some of them then relate to the BVI companies as part of the transaction.

Trust and Estate Practitioners

37. The BVI has been regulating trust service providers long before there was thought of an international requirement to do so. As a result among those working in the BVI financial services sector are a number of highly qualified trust and estate practitioners, some of whom are internationally recognised for their expertise in this field. These practitioners are particularly active in the Society of Trust and Estate Practitioners (STEP), the professional body for the trust and estate profession worldwide. STEP members
come from the legal, accountancy, corporate, trust, banking, insurance and related professions, and are involved at all levels in the planning, creation and management of, and accounting for, trusts and estates, executorship, administration and related taxes.

38. The BVI has an active branch of STEP which has 68 full members. To gain admission to STEP it is necessary to submit three theses (if the applicant is a lawyer or an accountant) or to sit the STEP Diploma course. Local STEP records show that at present there are 36 Diploma students and 24 Foundation students. The BVI branch of STEP regularly provides educational seminars on topics of interest to the financial services sector, which is available to both members and non-members alike, thereby contributing to the continuing education of those in the BVI financial services sector.

Fiduciary Services

39. Many of those working in the BVI financial services sector, particularly in the area of fiduciary services, have attained or are working towards attaining an ICSA qualification from the UK-based Institute of Chartered Secretaries and Administrators (ICSA). It is currently estimated that there are ten fully qualified chartered secretaries in the BVI (five holding the FCIS qualification and five holding the ACIS qualification). It is also estimated that there are up to 200 students involved in undertaking modules of the various ICSA certificates and diplomas. The H. Lavity Stout Community College in the BVI offers the ICSA course as part of the college curriculum.

Compliance

40. Under the provisions of the Financial Services Commission Act, 2001, a regulated person (not otherwise exempt) must appoint a Compliance Officer who shall be subject to the approval of the FSC. Accordingly, those appointed as Compliance Officers in the BVI are appropriately qualified and have met the requirements of the Commission’s “fit and proper” test.

41. It is currently estimated that there are three fellows of the International Compliance Association resident in the BVI together with eight members of the International Compliance Association and 13 associate members of the International Compliance Association (many of whom are working towards full membership).

ADDRESSING THE COMMITTEE’S SPECIFIC QUESTIONS

To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?

42. Offshore financial centres play increasingly important roles in global financial markets and the world economy. There are at least five ways in which OFCs contribute to the operation of economies worldwide. The first is that OFCs discipline financial markets in other parts of the world, limiting the degree to which banks and other large institutions can exploit local monopolies to the disadvantage of individuals and businesses. The ability of investors to channel financial transactions through OFCs reduces interest rate spreads, arbitrary credit allocation, and other problems associated with excessive market power on the part of local financial intermediaries. As a result, OFCs enhance the stability of the world financial architecture.

43. The second important role of OFCs is their place in stimulating foreign direct investment in high-tax parts of the world. Investors are often better able to structure their capital commitments to high-tax countries by using OFCs, and it appears that levels of foreign direct investment in high-tax countries are sensitive to the availability of financing structures that use OFCs. Evidence of foreign direct investment patterns indicates that firms that are more likely to establish finance affiliates in OFCs exhibit more rapid growth rates of investment and sales in nearby high-tax countries.

44. The third role of OFCs is their impact on tax collections and tax competition among large countries. The evidence of the last 30 years is that there has been relatively little tax competition among OECD countries, as tax bases have broadened at the same time, and to the same degree, that statutory tax rates have fallen. Recent economic research suggests that the availability of targeted low-tax opportunities, such as financing structures that use OFCs, permits governments to maintain healthy domestic tax bases. Hence far from ushering an era of unbridled tax competition, there is good reason to believe that OFCs permit governments of large countries to implement the domestic tax policies they want and need in the face of international economic pressures.

45. The fourth role of OFCs is to promote good governance and the benefits that flow from democratic accountability. Countries and territories without good governance institutions are much less likely to become OFCs than are otherwise similar countries and territories without high quality governance institutions. As a result, OFCs display the economic benefits available from democratic reforms, hopefully indirectly encouraging such reforms. Moreover, the unwillingness of market actors to devote extensive resources to OFCs without high quality governance institutions means that the OFC market is dominated by countries and territories with institutions established by transparent and accountable governments.
46. The fifth role of OFCs is their place in the world economy. OFCs as a group have enjoyed rapid economic growth in the last 25 years, reflecting in part the growing importance of financial sectors of modern economies, and in part the special roles played by OFCs. Greater influence in this part of the world contributes to economic performance elsewhere, as part of the usual process of economic spill over. Far from drawing down or somehow reducing economic activity elsewhere in the world, the ability of OFCs to contribute to finance and other sectors adds value to economic activity everywhere.

To what extent does the use of Offshore Financial Centres threaten financial stability?

47. This question pre-supposes a clear distinction between OFCs and other types of financial centre. For example, most OFCs tend to be low tax countries, but not all. France offers certain special concessions on tax and can be used as a channel for tax planning through its tax treaty networks. Yet few would claim that France is a low tax country. Furthermore, some so-called OFCs are not even offshore or even individual countries. The US states of Delaware and Nevada which have passed legislation in the area of trusts and compete with OFCs in a number of other areas are good examples.

48. It is therefore not so simple to extract a group of jurisdictions and suggest that as a group they threaten financial stability anymore than major centres such as New York or London could. Indeed, as a key player in the financial services world, the BVI recognises the obligations that relate to such a role in ensuring global financial stability. Thus all of the Territory’s financial services legislation is benchmarked against internationally established standards of prudential regulation as enunciated from time to time by standard setting institutions such as the Financial Action Task Force (FATF), the Caribbean Financial Action Task Force (CFATF), the International Organisation of Securities Commissions (IOSCO), the Offshore Group of Banking Supervisors (OGBS) and the International Association of Insurance Supervisors (IAIS). Current legislation is constantly reviewed and new legislation enacted as becomes necessary to ensure that the Territory is attuned to emerging standards of regulation.

49. An important function of OFCs is to discipline financial markets elsewhere in the world. The financial sectors of economies in much of the world are tightly controlled by small numbers of firms and by governments, either through monopolies that are sanctioned by regulation or, most commonly, through state ownership of banks (La Porta et al., 2002). This is particularly true in low-income countries and countries that lack strong democratic institutions, where government ownership of the banking sector is the norm, and where there is pervasive cronyism in the allocation of credit. The resulting absence of competition in credit markets raises interest rates charged to consumers and businesses, and encourages credit rationing in which certain borrowers are effectively unable to obtain credit at any feasible price. To make matters worse, absence of competition in banking appears to influence the whole financial sector, which is underdeveloped as a result.

50. In modern economies there is a considerable cost associated with financial underdevelopment, whatever its underlying causes. As La Porta et al. (2002) document, the financial sectors of economies with uncompetitive banking sectors are less active than are the financial sectors of other economies and countries with monopolized and therefore underdeveloped financial sectors exhibit slower rates of productivity growth and lower levels of per capita income.

51. OFCs have the potential to address some of the problems associated with uncompetitive financial sectors, in essence by providing a needed source of competition for banks and other financial intermediaries.

52. OFCs also contribute to financial sector depth in nearby countries, and it is logical that they should do so, since international finance facilitates domestic finance. Do countries benefit from greater financial sector development? The evidence is that economies with more competitive financial sectors have higher per capita income levels and display faster rates of GDP growth than do other economies, which is not surprising, given the importance of financial arrangements to modern economies. Another way to express this question is to ask what the alternative is to competition in financial markets. The alternative is a monopolized or quasi-monopolized sector that charges above-market prices to consumers and businesses, that rations capital on the basis of personal relationships, and that serves as a drag on local economies.

53. By acting as a counterpoint to this, OFCs enhance the stability of the global financial architecture.

How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom’s tax authorities and financial regulators?

54. The Government of the British Virgin Islands and the Financial Services Commission recognise the pivotal role transparency and exchange of information play in combating crime and the misuse of the financial system. Both are committed to policies which foster greater international co-operation to render assistance where necessary.

55. The BVI does not have, and has never had, secrecy laws for financial services. It has no legislation which institutionalizes secrecy in any part of the regulatory process. The BVI subscribes to the common law principle of confidentiality while having in place avenues for accessing information for regulatory and law enforcement purposes including rendering assistance to foreign regulatory and law enforcement authorities.
56. The Financial Services Act 2001 vests the Commission with broad powers of enforcement which include the exercise of powers to respond to requests for mutual assistance. Section 33(d) of the Act specifically provides the mechanism for giving assistance to foreign regulatory authorities. The Commission operates a transparent system of regulation of licensed entities engaged in business within, and from within, the British Virgin Islands.

57. In terms of enforcement, the Criminal Justice (International Co-operation) Act 1993 is used to render assistance in criminal law matters including fiscal matters such as tax evasion. The BVI also has a Mutual Legal Assistance Treaty with the United States which includes criminal taxation matters.

58. The BVI is a participating partner in the OECD’s Global Forum on Taxation and Co-Chaired the Joint Ad Hoc Group on Accounts. In April 2002, the BVI committed to the OECD’s principles for effective exchange of information and transparency. Following this commitment, the BVI concluded a Tax Information Exchange Agreement (TIEA) with the United States on 3 April 2002. The BVI has a number of on-going negotiations on TIEAs with OECD Member States, including the United Kingdom.

59. The Mutual Legal Assistance (Tax Matters) Act 2003 provides the legal framework for the British Virgin Islands to render exchange of information with regard to tax matters through Tax Information Exchange Agreements.

60. The Act provides mutual legal assistance through the exchange of information relating to the administration and enforcement of the domestic laws of the parties concerning the tax matters covered by an Agreement signed with a specified country, including information that may be relevant to the determination, assessment, verification, enforcement or collection of tax claims with respect to persons subject to such taxes, or to the investigation or prosecution of criminal tax evasion in relation to such persons.

61. The Mutual Legal Assistance (Tax Matters) Act 2003 was amended in 2005 to embody the requirements of the EU Savings Directive on the Taxation of Savings Income and thus implement the bilateral agreements entered into between the BVI and the EU Member States.

How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets and how do the taxation policies of Offshore Financial Centres impact on UK tax revenue and policy?

62. As stated previously confidentiality is always important for those requiring financial services it is worth noting that this can be for any number of reasons including personal security and data protection.

63. The BVI Government recognises the difference between confidentiality and secrecy designed to evade taxes and engage in other nefarious activity. As a result while our practitioners provide their clients with the confidentiality they require, they do so within a robust regulatory framework which is designed to ensure that those intending to abuse the services of the BVI financial services sector are discovered and dealt with appropriately.

64. In addition to the issue of transparency the BVI Government is aware that it has been claimed that low-tax jurisdictions, either OFCs or other countries where investment is facilitated by OFCs, impose fiscal costs on other countries in attracting investment that would otherwise locate in high-tax areas. These concerns persist despite the absence of any reliable estimates of the magnitude or even the sign of such diversion from any Treasury, including the UK.

65. Recent quantitative evidence (Desai, Foley and Hines, 2006a, b) implies that, in fact, the opposite process takes place ie the availability of OFCs that reduce the costs of using of low-tax jurisdictionsFacilitates foreign investment and economic activity in high-tax jurisdictions. There are multiple channels through which OFCs have this effect, all of them stemming ultimately from the ability of investors to use OFC financing structures to rationalize their finances and their tax situations. Tax-efficient financing structures in OFCs permit taxpayers to avoid costly tax situations in high-tax areas, thereby increasing rates of return and making investment in high-tax places more attractive. For investors located in countries that tax active business income earned elsewhere, the use of OFCs can facilitate deferral of home-country taxation of foreign income, which increases returns to foreign investments in countries with tax rates below home country rates. Finally, financial services and other intermediate goods and services obtained at low after-tax cost in OFCs increase the productivity and competitiveness of economic operations in high-tax countries, thereby increasing demand for production in those locations.

66. Desai, Foley and Hines (2006b) offer evidence of the use of OFCs by American multinational firms. Large multinationals, and those that are most active abroad, are the most likely to have affiliates in OFCs, suggesting that the benefits offered by OFCs increase with the scale of financial operations. Additionally, multinational parent companies in industries in which firms typically face low foreign tax rates, those that are technology-intensive, and those in industries characterized by extensive intrafirm trade are more likely than others to have operations in OFCs. This evidence is inconsistent with the common view that multinational firms use OFCs solely to reallocate taxable income from high-tax to low-tax jurisdictions through intrafirm trade and transfers of intangible property, since if that were the case then one would expect investors with OFC operations to be those with the highest tax rates. The fact that multinationals in industries with low foreign tax rates are more likely to operate in tax OFCs indicates that OFC affiliates do not merely serve to relocate profits away from high-tax locations.
67. Evidence for American multinational firms, reported by Desai, Foley and Hines (2006b), indicates that greater activity outside of OFCs is associated with greater demand for OFC affiliates. Firms whose initial investments were concentrated in economies that subsequently grew rapidly are the most likely to establish new OFC affiliates. Economic theory (Desai, Foley and Hines, 2006a) implies that the reverse must, therefore, also hold: firms that establish operations in OFCs are likely than others to expand their economic activities in high-tax countries.

68. Contrary to many policy concerns, the ability of investors to use OFC operations does not appear to divert activity from other jurisdictions. The empirical evidence indicates that firms facing reduced costs of establishing OFC operations respond in part by expanding their foreign activities in high-tax countries. Hence it appears that careful use of OFC affiliates permits foreign investors to avoid financing costs they would otherwise incur, and some of the tax burdens imposed by domestic and foreign authorities, thereby maintaining foreign investment at levels exceeding those that would persist if the use of OFCs were more costly.

69. There is an entirely separate question about the impact of foreign direct investment on economic activity in home countries. If OFCs encourage foreign direct investment in even high-tax foreign countries, might that not deplete economic resources that would otherwise be devoted to producing jobs and activity at home? Put differently, how should the government of a capital exporting country view institutions that contribute to international investment?

70. Both capital exporting countries and capital importing countries have at times expressed concern over the consequences of international capital flows. Capital exporting countries worry that too much of their capital goes abroad while capital importing countries fear foreign control of domestic assets and the possible macroeconomic instability associated with rapid changes in foreign investment levels.

71. The concerns of capital exporting countries, while diffuse, often are based on conceptions of outbound foreign direct investment as diverting economic activity.

72. In fact, it is far from clear that greater levels of outbound foreign direct investment come at the cost of economic activity at home. There are, instead, two possibilities. The first possibility is that a multinational firm’s total worldwide production level is approximately fixed, being determined by resource limits, capacity constraints or market competition. Given that output can be produced either at home or abroad, any additional foreign production then necessarily reduces domestic production, and foreign investment comes at the cost of domestic investment. The second, and more likely, possibility is that the level of total production is not fixed, but it is instead responsive to profit opportunities. If this is the case, then increases in foreign investment have the potential to raise the return to domestic production, stimulating demand for domestic activity and domestic output. Firms might, for example, find that foreign operations provide valuable intermediate inputs at low cost, or that foreign affiliates serve as ready buyers of tangible and intangible property produced at home.

73. The most recent evidence from the United States indicates that greater levels of foreign investment by American multinational firms are associated with expansions in domestic production activities by the same firms. Desai, Foley and Hines (2005a) analyse annual evidence for American firms since the early 1980s, finding that an additional dollar of foreign investment is associated with $3.5 of greater domestic investment. More detailed firm-level evidence tells a similar story. Exploiting differences in foreign economic growth rates to predict foreign activity levels, Desai, Foley and Hines (2005b) find that 10% greater foreign investment is associated with 2.6% greater domestic investment, and that 10% greater foreign employment is associated with 3.7% greater domestic employment. Hence this evidence offers no support for the simple, and common, perception that foreign investment diverts resources from domestic investment.

74. It has been natural to assume that foreign investment comes at the expense of domestic investment. New evidence from analyses of American multinational firms suggests instead that greater foreign investment is associated with higher levels of domestic investment. This estimated relationship implies that firms combine home production with foreign production to generate final output at lower cost than would be possible with production in just one country, making each stage of the production process more profitable, and therefore, in a market economy, more abundant. It is clear that the simple story, in which the world has a fixed stock of investment capital that can either go to one place or another, cannot quite be right. As a result, OFCs that facilitate foreign investment thereby indirectly also stimulate economic activity in capital exporting countries.

75. It stands to reason that countries eager to attract foreign investment might compete with each other by reducing tax rates, as a result of which taxes, and therefore government expenditures, are driven to inefficiently low levels. To the extent that OFCs contribute to this tax competition, either by offering investors low tax rates themselves, or by facilitating investment in other low-tax countries, then OFCs might be responsible for some of the problems associated with excessive tax competition. The likelihood of such an outcome depends on the tax policies available to governments and the nature of the competitive environment. In order to evaluate this prospect it is helpful to consider the incentives that countries face.
76. Modern analysis of the corporate tax rate implications of international capital mobility dates to Diamond and Mirrlees (1971), who demonstrated that efficient taxation in a small open economy, entails zero taxation of income earned by foreign investors. The explanation for their result is that any positive taxation distorts the economy more than would other tax alternatives, without shifting any of the tax burden to foreign investors (Gordon and Hines, 2002). If international capital flows are increasingly sensitive to tax rate differences, then incentives to reduce tax rates are presumably rising as well. The analysis also implies that countries that nevertheless persist in heavily taxing income earned by foreign investors will have lower incomes than those that do not.

77. It is noteworthy that international tax competition may also produce outcomes in which capital taxes are higher than they would be in the absence of competition. This can happen when there is foreign ownership of productive factors, when competing countries differ greatly in size, or when multiple governments attempt to tax the same income sources (Hines, 2006).

78. OFCs figure prominently in debates over the scope and consequences of tax competition. OFCs are widely believed to accelerate the process of tax competition between governments. A separate, and more likely, possibility, however, is that the tax management opportunities presented by OFCs allow other countries to maintain high capital tax rates without suffering dramatic reductions in foreign direct investment. Hence the widespread use of OFCs may retard what would otherwise be aggressive competition between other countries to reduce taxes in order to attract and maintain investment. It is not even necessary that high-tax countries are aware of the importance of OFCs in preserving their ability to attract foreign investment. In effect, what OFCs do is to permit governments to distinguish investments, subjecting relatively immobile domestic investment to higher tax rates than the highly mobile international investment. Keen (2001) identifies the wide set of conditions in which countries benefit from differentiating tax systems in this way, and its impact in improving the outcomes of tax competition.

79. The evidence is that, despite whatever incentives there may be to compete over tax rates, the tax burden on corporate income in OECD countries has fallen little, if at all, over the past 25 years (see Griffith and Klemm, 2004, and Hines, 2006). Corporate tax rates have fallen, but these declines have been at least matched by expansions in corporate tax bases. Corporate tax collections are the product of tax rates and tax bases; governments choose tax rates, and governments also choose definitions of tax bases. The rules determining depreciation allowances, inventory valuation, the taxation of capital gains, the deductibility of interest payments, pension and option compensation, and a host of other considerations all affect the tax burden on corporations just as strongly as do statutory corporate tax rates. Over the same period that statutory corporate tax rates have fallen, governments have broadened tax bases, so that the ratio of national corporate tax revenues to GDP among OECD countries has not declined since 1990. The ratio of corporate tax revenues to total tax collections offers a separate measure of the extent to which governments rely on corporate taxes, and here too it is clear that corporate tax revenue as a share of total taxes among OECD countries has not fallen over time, and in fact, reached new highs in 2003 and 2004. The use of OFCs by foreign investors helps to explain this evidence, as high-tax countries are able to maintain high tax rates on domestic investment while continuing to draw significant levels of foreign investment (Hines, 2006).

80. The analysis of tax competition addresses in large part the concerns that the use of financing structures in OFCs may erode tax bases in high-tax countries. The point of the analysis is that it is important to think about the alternatives, since it is a mistake to contemplate a world in which all tax provisions are unchanged but OFCs are somehow no longer available to taxpayers. If OFCs were unavailable, then tax competition elsewhere in the world would take on a very different character, most likely resulting in an outcome in which tax rates on business income were significantly reduced relative to what they are today. In addition, there is the separate issue that any foreign tax savings attributable to activities in OFCs ultimately enhance tax collections in countries such as the United Kingdom, the United States and Japan that tax foreign incomes while providing credits for foreign taxes paid (Hines and Rice, 1994).

81. In evaluating the evidence, it is important to recognize the significance of something that has not happened: corporate taxes have not disappeared. To the contrary, corporate tax systems are raising revenue now at roughly the same clip that they have for the past 30 years. If the reality were different, if corporate tax collections had instead fallen rapidly over the past 30 years, then it would be natural to point to such a development as confirmation of the impact of tax competition, fuelled in part by the presence of OFCs, and forecast continued declines in corporate tax revenue. The persistence of corporate tax collections does not imply that there is no tax competition, but instead that, in the modern financial world, competition takes a form that does not entail reduced corporate taxation.

82. The BVI Government can only speak on its own behalf in this case. As a key player in the global financial services sector, the BVI recognises the importance and value of associating with regional and international standard-setting institutions for regulatory, enforcement and international cooperation purposes. The lead role in this regard is played by the Financial Services Commission, the BVI’s independent regulator.
83. The BVI is an active member of the bodies in which it participates. It is a member of the Caribbean Financial Action Task Force (CFATF) and Egmont, both respectively dealing with matters relating to money laundering and terrorist financing and intelligence gathering and dissemination. In March 2007 the BVI was admitted to IOSCO after scrutiny of its international cooperation regime. The Commission is a member of IAIS and OGBS. The BVI participated in the OECD/ Commonwealth Working Group on Tax Competition and recently served on the Working Group set up to review the FATF’s 40+9 recommendations on combating money laundering and terrorist financing. It was also a member of the OGBS Working Group which developed the Statement of Best Practice on Trust and Corporate Service Providers.

84. As a member of the CFATF, the BVI has been undergoing periodic reviews to establish the Territory’s compliance, with internationally established standards in the areas of financial regulation, legislative reform, law enforcement and international cooperation, including compliance with current Anti-Money Laundering/Counter-Terrorism Financing standards and recommendations of the CFATF. The BVI has recently undergone its third round of CFAT mutual evaluation (first quarter of 2008) and later in 2008; the IMF will undertake its second assessment of the territory. These assessments seek to determine the level of compliance with standards established by various standard setting bodies like the OGBS, IAIS, FATF and CFAT.

To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?

85. The existence of a robust regulatory and compliance regime is critical to ensuring that any financial centres, from the largest to the smallest, are limited as much as possible in the extent to which they can be used for illicit means, including terrorist financing. As stated previously the BVI’s establishment of a Financial Intelligence Agency was commended by the UK National Audit Office. The FIA is a member of the Egmont Group which is responsible for following the money trail, to counter money laundering and terrorism financing. The May 2008 meeting was attended by the incoming President of the FATF who committed to closer cooperation between the Egmont Group, the FATF and the regional bodies to better address the issues of money laundering and terrorist financing.

86. In addition, the original Financial Services Commission Act 2001 vests the FSC with broad powers of enforcement which include the exercise of powers to respond to requests for mutual assistance. The Act empowers the Commission to take appropriate steps to cooperate with foreign regulatory authorities and other persons or organisations which have functions relative to the prevention or detection of financial crime, including money laundering, terrorist financing, misconduct in or misuse of information relating to financial markets as well as offences involving fraud or dishonesty.

87. The Territory’s CFT regime is essentially comprised in the Terrorism (United Nations Measures) (Overseas Territories) Order 2001 and the Anti-Terrorism (Financial and Other Measures) (Overseas Territories) Order 2002. Both enactments are Orders in Council. The FSC adheres to the compliance and prohibition measures outlined in both enactments. The FSC also takes notice of the UN and EU lists of persons suspected of having links with terrorism or terrorist organisations to ensure that they or the groups they are associated with are not licensed in the BVI.

What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?

88. It is perhaps for the UK Government to comment on this issue rather than the BVI but we would take this opportunity to note that while individual country experiences differ, OFCs as a group have enjoyed very rapid economic growth in the past two decades. Evidence reported by Hines (2005) indicates that the real per capita incomes of OFCs grew by 3.3% a year since 1982, whereas the comparable figure for the world as a whole is 1.4%. As a result, by 1999 the largest OFCs held 0.8% of world population (not counting the United States), whereas their economies contributed 2.3% of total world product (again excluding that of the United States), so per capita economic product in OFCs is more than double the world average.

89. This sometimes leads to the question of whether the affluence of some OFCs comes at the expense of the rest of the world. There is no reason to think it does. Indeed, standard economic theory suggests the opposite: greater income earned by one part of the economy redounds ultimately to the benefit of all other parts of the economy (Bhagwati, Panagariya and Srinivasan, 2004). Financial and other contributions of OFC economies add value to the world in the same way that industries in other countries do, and individuals and businesses who earn returns in OFCs ultimately spend and distribute their returns in ways that stimulate demand for output everywhere. Consequently, the high rates of OFC economic growth have the effect of buoying the world economy just as slow growth elsewhere tends to depress rates of economic activity in OFC economies.
What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres?

90. The BVI maintains no double taxation agreements.

To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?

91. The BVI has always been amenable to entering into and concluding treaties with foreign jurisdictions, including law enforcement and tax authorities, to exchange and share information on a variety of matters. Indeed the BVI entered into a mutual legal assistance treaty with the USA in 1989 to render assistance to each other on matters pertaining to criminal matters, including criminal tax evasion. This treaty is given domestic legal force by the Mutual Legal Assistance Treaty (USA) Act, 1990.

92. In 2002 the BVI formally and unequivocally committed to the OECD principles of transparency and effective exchange of information. Pursuant to that commitment, the BVI entered into and concluded in the same year a tax information exchange agreement which led to the enactment of the Mutual Legal Assistance (Tax Matters) Act 2003. This enactment provides the legislative framework for the exchange of information on tax matters with the USA and other countries which conclude a bi-lateral agreement with the BVI on tax information exchange. Currently the BVI is negotiating with several EU (including the UK) and one non-EU country to conclude tax information exchange agreements.

93. The new legislative regime for tax information exchange enables the Financial Secretary, as the competent authority on tax matters, to receive and fully investigate requests for mutual legal assistance in relation to persons. He has the aid of officials of the Inland Revenue Department and the Financial Investigation Agency, in addition to fully collaborating with the Attorney General’s Chambers to facilitate the processing of requests for mutual legal assistance in tax matters.

94. By virtue of the Criminal Justice (International Cooperation) Act, 1993, the BVI has the authority to provide assistance in relation to requests pertaining to fiscal offences, including tax evasion (section 5 (3)).

95. Finally, it should be noted that the BVI voluntarily adopted and implemented the EU Directive on the Taxation of Savings Income through the enactment of the Mutual Legal Assistance (Tax Matters) (Amendment) Act, 2005. By virtue of this enactment, the BVI is able to cooperate with render assistance to all the EU Member States, including the UK.

Conclusion

The BVI is a well regulated jurisdiction, a fact recognised by the relevant international standard setting institutions. More generally, the ability of investors to use OFC operations does not appear to divert activity from other jurisdictions. In addition, as the Financial Stability Forum (FSF) Working Group on Offshore Centres reported in 2000, OFCs do not appear to contribute to systemic financial problems.

In terms of transparency the right channels are in place in the BVI for effective co-operation with international regulatory and law enforcement authorities. We therefore believe that while continuing efforts, such as the joint BVIFSC Handbook on International Cooperation which details the procedures for submitting requests for mutual legal assistance in the area of financial services, must be made to ensure the jurisdiction’s services are not abused or mis-used, we have the systems in place to ensure that this is the case.

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Memorandum from the Government of the Cayman Islands

INTRODUCTION

1. This submission is made by the Government of the Cayman Islands further to an announcement dated 30 April 2008 by the Treasury Committee (the Committee). This announced an Inquiry into offshore financial centres (OFCs) as part of the Committee’s ongoing work on financial stability and transparency (the Inquiry).

2. The written evidence responds to each of the stated questions posed by the Inquiry and it is hoped that the evidence will assist the Committee in its deliberations by providing an understanding of the nature of the participation of OFCs, including the Cayman Islands, in global financial markets as it relates to financial stability and transparency.

3. The written evidence is provided under the authority of the Cabinet of the Cayman Islands via the office of the Financial Secretary.

4. The Cayman Islands appreciates the opportunity to make this submission and would like to reserve our position in respect of the ability to provide additional or supplementary written and/or oral evidence on the subject of the Inquiry.

EXECUTIVE SUMMARY

5. The Cayman Islands’ submission is presented in eleven sections and covers each of the questions raised by the Inquiry. A summary of key points is provided below.

Question One—To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?

6. There is no universally accepted definition of “Offshore Financial Centre” and no single metric of their importance. However, the evidence is that the use of financial centres by non-residents is both significant and offers advantages.

7. It has been estimated that some 80% of global financial activity conducted by non-residents is conducted in OECD member countries. Other OFCs, including the Cayman Islands, collectively represent the balance. Three inter-related features of financial centres appear particularly important: economic efficiency, the development of “knowledge clusters” and incubation of innovative financial instruments.

8. The Cayman Islands’ contribution to global financial markets is consistent with these general features. Cayman has developed a particular financial services expertise in institutional business over the past 40-plus years. This is reflected in our market position as host to a significant proportion of the world’s internationally active banks, and in sophisticated investment and capital markets products and captive insurance. Centres such as the Cayman Islands have a high degree of visible, commercial integration with large OFCs which generates and supports employment, income and material and efficient global flows of investment.
Question Two—To what extent does the use of Offshore Financial Centres threaten financial stability?

9. There is no credible evidence that the use of financial centres by non-residents has created any disproportionate risk to financial stability.

10. IMF and FSF analyses of the sources of recent systemic financial instability pointed to inadequate risk management, risk assessment and transparency by a variety of market actors and disclosure and valuation gaps in accounting (IASB) and regulatory (IOSCO and Basel) frameworks. There is no suggestion in either analysis that OFCs pose an inherent threat to financial stability. All countries whether OFCs or not have a responsibility to implement the prevailing international regulatory standards as they relate to the activity regulated by their respective domestic supervisors.

11. Far from being dysfunctional threats, small tax havens/OFCs score very well on measures of governance quality. As a corollary, one would reasonably expect such jurisdictions to be inherently pre-disposed to supporting global financial stability.

12. As concluded by The Economist, “well-run jurisdictions of all sorts, whether nominally on- or offshore, are good for the global financial system”.

Question Three—How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom’s tax authorities and financial regulators?

13. As a general proposition, the requisite level of regulatory transparency is secured through adherence to international regulatory standards as promulgated by Basel, IOSCO and IAIS. Jurisdictions that comply with the relevant international standards are inherently transparent. In relation to tax transparency and as a fundamental proposition, the disclosure obligations of foreign parties under home country tax laws are not displaced by any OFC rules or practices.

14. It is frequently the case that transactions structured in OFCs generate “onshore” reporting obligations, for example by the involvement of onshore participants that are subject to regulatory and tax requirements in their home jurisdictions, by the operation of accounting standards, or by dint of the listing of issued securities on stock exchanges.

15. In the case of the Cayman Islands, the Cayman Islands Monetary Authority (CIMA) has a statutory obligation and wide associated powers under the Monetary Authority Law to cooperate with international counterparts. In the tax area, Cayman has implemented the EU Savings Directive via bilateral agreements with all 27 EU Member States on an exchange of information basis and is engaged in bilateral discussions on tax cooperation matters with a number of OECD member states under the general auspices of the OECD Global Forum on Tax Matters.

Question Four—To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?

16. The IMF has credited financial innovation with diversification of risk and the enhancement of liquidity. The products falling within the cohort of innovative financial structures would likely be regarded as including “complex financial instruments” to which the question refers, eg, hedge funds, structured finance, securitisations.

17. There is evidence that financial innovation is stimulated by environments that allow the mitigation or elimination of dead weight cost. Complex financial instruments intended for institutional or sophisticated investors are also most likely to grow outside of a “one size fits all” retail investor-oriented regulatory environment. In this regard, a number of jurisdictions including small OFCs, offer such an environment, either as a general feature of their regimes or via regulatory and/or tax segmentation.

Question Five—How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets?

18. The level of taxation, which in the present context must be understood as including not only headline rates of tax but also the cost of compliance with taxation regimes of ever-increasing complexity, is undoubtedly an element in explaining the position of financial centres/OFCs in worldwide financial markets.

19. The commercial sensitivity to/impact of transparency is a function of the type of financial services business being conducted. Institutional business, that is, business conducted by and for regulated financial services entities, is generally transparent. Private client business may have greater (and not illegitimate) privacy concerns.

20. Cayman has never had direct taxation; and as a specialist in institutional business, does not market based on non-transparency or indeed solely on absence of taxation.
Question Six—How do the taxation policies of Offshore Financial Centres impact on UK tax revenue and policy?

21. An extensive review of tax competition academic literature offers no clear guidance as to the level of impact of specific taxation policies on other jurisdictions. However, it is reasonable to conclude that the tax policies of all countries with significant cross-border financial services activity influence each other.

Question Seven—Are British Overseas Territories and Crown Dependencies well-regarded as Offshore Financial Centres, both in comparison to their peers and international standards?

22. The Cayman Islands has established itself as a stable, sophisticated international financial services centre, providing institutionally-focused, specialised services to a global client base. The government fully associates itself with the statement in the 1999 FCO White Paper that “[i]n the long run, it is the quality jurisdictions that will prosper best. There must be no weak links which can help to undermine the international financial system”.

23. The most recent external AML/CFT evaluation (CFATF, 2007) rated Cayman as “compliant” (the highest rating) or “largely compliant” (C/LC) on 38 of the FATF 40+9 standards, “partially compliant” on 10 and “non-compliant” on one. Eighty per cent of the 19 FATF countries evaluated as at February 2008 under the same standards round had combined C/LC scores lower than those of the Cayman Islands, which puts the territory in the top five, along with the US, UK, Singapore and Belgium.

24. The most current evaluation of Cayman regulatory standards was that by the IMF, published in 2005, in which Cayman fared well, except in relation to aspects of IAIS compliance for which ratings were downgraded primarily due to lack of documentation of rules and practices and staffing vacancies in CIMA’s insurance division.

Question Eight—To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?

25. The Cayman Islands has criminalised terrorist financing in accordance with the 1999 UN International Convention on the Suppression of the Financing of Terrorism, via the Terrorism Law, 2003. In addition, various prior Orders in Council promulgated by the UK on behalf of its OTs, pursuant to UN S/RES 1373 and S/RES 1267, apply.

26. The most comprehensive external evaluation to date of Cayman’s compliance with international CFT standards (the FATF 9 Special Recommendations) was undertaken via the 2007 CFATF evaluation. Cayman received six “largely compliant” and three “partially compliant” ratings; Cayman received zero “Non-compliant” ratings.

Question Nine—What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?

27. We respectfully submit that in relation to transparency and financial stability the subject of the Inquiry there is no reason for the policy resources of HM Treasury to be consumed by OFCs that comply with international standards, except insofar as may be necessary to ensure that corresponding fair treatment for such compliance follows.

Question Ten—What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres?

28. The abuse of double taxation treaties tends not to occur within financial centres per se, but rather within corporate taxation units within capital exporting countries, including those units within the UK. Most of the smaller OFCs either do not have double taxation agreements with other countries, or have treaties which contain anti-abuse provisions and/or do not apply to their “offshore” sectors.

Question Eleven—To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?

29. An OECD study clearly shows that the expenditure of resources on the investigation of non-compliance with foreign taxation regimes, in the absence of a domestic tax interest, occurs on the basis of treaty obligations.
30. As a preliminary point of significance, and as stated in a 2007 IMF Working Paper, there is no universally accepted definition of “Offshore Financial Centre” (OFC) and “an empirical framework for uniform classification [of financial centres] does not exist”. 490 A recent attempt at identifying a relatively objective metric based on exports of financial services produced an OFC population that includes Hong Kong, Luxembourg, Malta, Singapore, Switzerland and the UK. 491 The lack of a consistently applied objective definition will necessarily affect any interpretation of evidence regarding OFCs.

31. There is more concord in relation to the origin of OFCs: as summarised by the Financial Stability Forum (FSF)—

The main contributing factor identified for the historical growth of offshore banking and OFCs was the imposition of increased regulation (reserve requirements, interest rate ceilings, restrictions on the range of financial products, capital controls, financial disclosure requirements, high effective tax rates) in the financial sectors of industrial countries during the 1960s and 1970s. 492 The FSF report goes on to cite as an example the growth of London as the largest offshore banking centre as being directly linked to regulations imposed on the US banking sector over the period 1964–79.

32. There is no single metric of the importance of OFCs. However, the evidence is that the use of financial centres by non-residents is both significant and offers advantages. The IMF has reported that some 60% of global financial activity conducted by non-residents passes through London, New York and Tokyo. 493 Biswas has noted that some 80% of global financial activity conducted by non-residents is conducted in OECD member countries. 494 In relation to London itself, the then UK Chancellor observed in 2006:

The capital is already home to 20% of all cross-border lending, 30% of world foreign exchange turn-over, 40% of over-the-counter derivatives trades and 70% of the global secondary bond market. 495

Other OFCs (21 by Zorome’s estimation, and up to 70 by that of others496), including the Cayman Islands, collectively represent the balance. In fact, there is a significant degree of integration, as typically the large centres are “wholesalers” to the smaller ones and frequently transactions and activity involve multiple jurisdictions. For instance, a Cayman law firm might receive instructions from a US law firm to set up a fund to invest in mid-cap Indian and Asian companies, sponsored by a US investment manager; or instructions from a European law firm to set up an aircraft financing structure for the purchase by an Asian airline of aircraft from a European seller, financed by a European bank.

33. In terms of advantages, three inter-related features of financial centres appear particularly important. The first feature relates to economic efficiency. Efficiency in relation to financial centres is significantly influenced by cost. The minimization of “dead weight cost” allows for capital to be mobilised and applied in an economically efficient manner which increases returns to investors. Successful financial centres tend to have specialised regulatory regimes or carve-outs that limit such dead weight cost in relation to cross-border economic activity. 497 Thus, in the 1950s the UK exempted non-sterling transactions conducted through the City involving non-residents from the administrative burdens associated with exchange controls applied in relation to cross-border sterling transactions. 498 This carve-out in association with contemporaneous increasing dead weight cost in other jurisdictions provided a significant stimulus to the development of the Eurobond market in the UK. 499 It also created the opportunity for UK-based financial institutions to gain synergies from the establishment and use of facilities in other offshore centres, including the UK’s Caribbean colonies and the Crown Dependencies, for financial structuring. The operations in these other centres functioned as collectors and conduits to facilitate the flow of money back to London. Such conduits provided, inter alia, access to hard-currency linked investments in the UK. 500

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491 Ibid, p 19.
493 Biswas, R, “Introduction: Globalisation, Tax Competition and Economic Development” in R Biswas (ed.) International Tax Competition Globalisation and Fiscal Sovereignty (Commonwealth Secretariat, London, 2002). Indeed The City of London has long self-identified as a major supplier of cross-border financial services, as have centres such as New York and Tokyo.
496 Tax Justice Network, “Tax us if you can”; briefing paper, September 2005. The TJN includes the UK in its list.
499 Similarly, the removal of exchange control in the Cayman Islands in 1966 combined with the introduction of a regulatory regime for banks and trust companies stimulated the development of Cayman as an international banking centre.
34. In a 2005 Institute of Economic Affairs paper Teather observes, *inter alia*, “a highly imperfect international system for the prevention of double taxation” and points out that “tax haven jurisdictions” (by which he refers to the geographically small OFCs targeted by the OECD’s “ Harmful Tax Competition Initiative”), by providing a tax neutral platform [and thereby minimising dead weight cost]-

“... make international capital markets more efficient and in many cases make international pooling of capital possible when it would otherwise be prevented by lack of coordination of cross-border tax and investment regulations. By doing this they increase the amount of available international investment capital, and enable it to be invested in the most profitable companies, whatever country they are in, without the distortions caused by the need to avoid double taxation.”

35. Second, successful financial centres develop a concentration of financial expertise, so-called “knowledge clusters”. The expertise found in knowledge clusters increases commercial certainty and creates economies of scale beneficial to the smooth functioning of financial markets. Thus, the City of London now accounts for some 80% of European hedge fund management activity. Similarly, the Cayman Islands provides the domicile for more than one-third of global hedge funds. Such concentrations of activity would not occur unless the expertise present in these jurisdictions delivered significant value-added.

36. The role of financial centres as incubators for innovative financial instruments is a third important feature, as discussed in the response to Question Four.

37. The extent and importance of the Cayman Islands’ contribution to global financial markets is consistent with these general features. Cayman has developed a particular financial services expertise in institutional business over the past 40-plus years. This is reflected in our market position as host to a significant proportion of the world’s internationally active banks, and in sophisticated investment and capital markets products and captive insurance. Some further contextual information may be useful—

— In relation to the banking sector, Cayman’s banks are global and most notably deal virtually exclusively with institutional vs. individual deposits (see charts 1 and 2 [p. ii in the Appendices]). In addition, according to BIS statistics, Cayman consistently ranks within the top 10 global banking centres and Cayman banks participate in a significant proportion of the 17% of global bank liabilities attributed to BIS-designated “offshore centres” (see charts 3a and 3b and chart 4 [pp iii–iv]). Chart 5 (p v) illustrates the interconnected character of banking centers within the global financial system.

— In relation to the investment funds sector, CIMA statistics as of December 2006 indicate that the 81% of reporting funds had a collective assets under management of US$2.3 trillion (without filtering for inter-investment activity to exclude double-counting), with North American fund managers managing the majority of the funds (see chart 6) and 49% having a minimum initial subscription of US$1 million or more (see chart 7 [pp vii]).

— In relation to captive insurance, Cayman ties with the US state of Vermont as the second-largest domicile, with North America as the dominant risk location (see charts 8 and 9 [pp viii]).

— In relation to international debt securities, BIS statistics indicate that Cayman issuers account for the majority of the 7% “offshore” share (the “developed country” share being by far the largest, at 86%) as shown in chart 10 [p viii]).

38. Our client-base is global and spans major international companies, financial institutions and governments.

— Typical transactions include the formation of: investment funds for US, UK, Latin American and Asian fund managers; holding companies for listed multinationals; aircraft financing structures; note re-packagings, securitisation and structured finance vehicles; capital-raising vehicles for major banks; joint ventures, mergers and restructurings for major multinationals; and catastrophe bonds.

39. In addition to a tax neutral platform and depth of professional expertise, specific reasons for the use of the Cayman Islands include—:

(a) Recognised, politically neutral legal system, with final appeal to the Privy Council in London;

(b) Treasur...
Ev 318  Treasury Committee: Evidence

(b) Commercially responsive and responsible regulatory framework that complies with international standards;
(c) Flexible and sound business statutes that produce robust and recognised vehicles for ease of international, multi-jurisdictional transactions;
(d) Strong legal protections for investors and creditors; and
(e) Absence of exchange control.

40. All of the “Big Four” audit firms have sizeable offices in Cayman as well as most of the other firms within the top 10 hedge fund audit firms, and most of the top 10 fund administrators have offices in Cayman as well; and two Cayman law firms rank within the top five firms for hedge fund counsel by number of funds. The majority of the world’s top 50 banks have branches or subsidiaries in the Cayman Islands.

41. It should be evident from the foregoing as well as our responses to the other questions below that the reasons for, use, and corresponding success, of Cayman’s financial services sector do not reside in secrecy or non-transparency or substandard regulation. Centres such as the Cayman Islands have a high degree of visible, commercial integration with large OFCs such as London and New York which generates and supports employment, income and material and efficient global flows of investment, to the benefit of all the economies involved.

Question Two—To what extent does the use of Offshore Financial Centres threaten financial stability?

42. There is no credible evidence that the use of financial centres by non-residents has created any disproportionate risk to financial stability. This conclusion in relation to the smaller financial centres is supported not only by the finding of the Financial Stability Forum in 2000 that the small-jurisdiction OFCs it focused on “do not appear to be a major causal factor in the creation of systemic financial problems”, but also by the more recent findings of the IMF on regulatory performance of OFCs from its OFC assessment programme launched in 2000–01 that, “[c]ompliance levels for OFCs are, on average, more favourable than those for other jurisdictions assessed by the Fund in its financial sector work.”

43. The period of financial instability that began in late July 2007 is a valuable source of empirical evidence: according to the IMF, this instability constitutes an important test of complex structured finance products, which are often domiciled in OFCs. The IMF analysis does not attribute to the legal form or domicile of structured finance and securitisation products or indeed of hedge funds any contributing role. Rather, it identifies the systemic financial stability concerns as arising from inadequate risk management, risk assessment and transparency by a variety of market actors and disclosure and valuation gaps in international accounting and regulatory frameworks.

44. The FSF has also assessed the factors underlying the same market turmoil and concluded that a long period of benign economic and financial conditions vastly expanded the appetite for, and consumption of, risk and leverage but outpaced the capacity of borrowers, intermediaries and investors to manage the associated liquidity and concentration risks posed by a general macroeconomic downturn. The corrective action to achieve resilience recommended by the FSF includes the strengthening of international regulatory standards by the relevant standard-setters (primarily the Basel Committee on Banking Supervision and IOSCO), the development by the IASB of improved accounting and disclosure standards for off-balance sheet vehicles, the improvement by credit rating agencies of the quality of the rating process and improvements in internal risk management and disclosure by market participants.

45. Similar conclusions were reached in a prior test of the financial system. According to the Chairman of the US Federal Reserve, “the collapse of Long-Term Capital Management (LTCM) in 1998 precipitated the first in-depth assessment by policymakers of the potential systemic risk [specifically in relation to leverage] posed by the burgeoning hedge fund industry”. LTCM was domiciled in the Cayman Islands and managed out of the US. Certain commentators have alleged that the LTCM near-collapse was due to tax haven lack of regulation and secrecy. The analysis and conclusions of the US Federal Reserve Chairman differ strikingly.

508 Hedge Fund service provider ranking are per the Lipper Hedgeworld Service Provider League Tables, 2007 Edition.
509 Ibid n.3, p 1. It is not disputed, as the FSF goes on to point, that were OFCs to exhibit serious deficiencies in the implementation of international regulatory standards, that they could in certain circumstances cause contagion. However, the same would undoubtedly hold true for any countries with significant cross-border financial activity. In relation to the Cayman Islands’ performance against the regulatory standards, see response under Question Seven.
512 Ibid, executive summary and ch 2.
514 The IMF report (ibid, n.22, p 82) states that “[f]urther refinement and careful implementation of Basel II would substantially reduce the current gaps”. The Cayman Islands Monetary Authority already has a Basel II implementation project in place to phase in the standards, as permitted, by 2010 and 2012.
46. In reviewing the responses to and lessons learned from the LTCM event, Chairman Bernanke stated—

The primary mechanism for regulating excessive leverage and other aspects of risk-taking in a market economy is the discipline provided by creditors, counterparties, and investors. In the LTCM episode, unfortunately, market discipline broke down... Together with the admittedly extraordinary market conditions of 1998, [broker-dealer, bank and investor] risk management lapses were an important source of the LTCM crisis.517

While noting (with some prescience) that some concerns about counterparty risk management remained relating to the measurement of counterparty exposure in the context of an increasing volume of complex transactions, he went on to confirm the effectiveness of the policy responses implemented. Such responses included measures by US banking and securities regulators (including issuance of guidelines and enhanced monitoring) to ensure that banks and broker-dealers implemented systems and procedures to strengthen market discipline; and the industry-led development of counterparty risk management guidelines.518

47. As in the case of the review of the 2007 instability by the IMF and the FSF, informed and authoritative analysis did not point to domicile offshore or alleged “offshore secrecy and lax regulation” as a source of systemic risk. Chairman Bernanke’s concluding remarks, which are also worth citing, were: “In the final analysis, authorities cannot entirely eliminate systemic risk. To do so would likely stifle innovation without achieving the intended goal”.

48. It should be noted that the relevant standards and practices are neither set nor thwarted by small OFCs.520 Clearly, all countries whether deemed to be OFCs or not have a responsibility to implement the prevailing international regulatory standards as they relate to the activity regulated by their respective domestic supervisors.521 The Cayman Islands’ performance in the implementation of regulatory standards is detailed in our answer to Question Seven below.

49. In addition to the superior regulatory performance of OFCs reported by the IMF as referred to in paragraph 42 above,522 the evidence from a recent academic study by Dharmapala and Hines523 is that far from being dysfunctional threats, small tax havens/OFCs score very well on measures of governance quality (voice and accountability, political stability, government effectiveness, rule of law, and control of corruption). The overall conclusion of the study, which covered 209 countries inclusive of the Cayman Islands and 32 other “tax havens” is that, “there are almost no poorly governed tax havens”.523 This is a function of the reality that state success and state derangement are an unlikely combination. As a corollary, one would reasonably expect jurisdictions with high governance quality to be inherently pre-disposed to supporting global financial stability.

50. As concluded by The Economist, “well-run jurisdictions of all sorts, whether nominally on- or offshore, are good for the global financial system”.524

Question Three—How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom’s tax authorities and financial regulators?

51. As a general proposition, the requisite level of regulatory transparency is secured through adherence to international regulatory standards as promulgated by Basel, IOSCO and IAIS. These sets of standards (as well as the FATF AML/CFT standards) all have components that treat with requirements for supervisory information and records, regulator’s access to same and international cooperation. The transparency standards relating to international cooperation in the provision of supervisory information are implemented via bilateral or multilateral memoranda of understanding, by unilateral measures, or a combination thereof. Jurisdictions, whether deemed to be OFCs or not, that comply with the relevant international standards are inherently transparent. In the case of the banking sector in particular, the Basel Core Principles require

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518 Internationally, the policy response involved the production by Basel and IOSCO of papers on sound practices in dealings with highly leveraged institutions. A specific policy response Considered in the US but not recommended was direct and regulation of hedge funds, to which market discipline was strongly preferred: “[p]lacing the onus on market participants to provide discipline makes good economic sense...” (Bernanke).
519 The standards and practices in question would not typically fall to be implemented by the structuring domicile in the activity chain; and indeed the service provider deficiencies identified by the IMF and the FSF relate to activity typically conducted in “onshore” jurisdictions.
520 Note that inherent in cross-border financial transactions is a distribution of associated service providers and activity across several jurisdictions.
521 The IMF attributes this in part to higher income levels and concern for reputation among OFCs.
523 Ibid, p 1. The study does not give individualised governance measures, but for the latest (2006) World Bank Institute measures for the Cayman Islands, see chart 11 (see p ix of the appendices).
524 The Economist, “Places in the Sun: A special report on offshore finance”, 24 February, 2007, p 5. In point of fact, and as particularly apposite examples of the “good” referred to, in the context of the recent credit and liquidity pressures, Cayman Islands vehicles have provided structures for the facilitation of liquidity for investment banks; and US Treasury officials and a group of major US financial institutions had discussions on the establishment of a “super fund” facility to provide liquidity to US markets. While the fund ultimately did not proceed for commercial reasons, the Cayman Islands was selected as the domicile for the facility.
52. In the case of the Cayman Islands, the Cayman Islands Monetary Authority (CIMA) has a statutory obligation and wide associated powers under the Monetary Authority Law to cooperate with international counterparts and while it is not a pre-requisite for cooperation to occur, has a number of Memoranda of Understanding with foreign regulators, including the UK Financial Services Authority. As noted in the response to Question Seven, in relation to the international cooperation elements under the various international standards, the IMF found a high level of compliance; and the CFATF assessed Cayman as “compliant” or “largely compliant” against the relevant FATF standards.

53. CIMA has provided assistance to the UK FSA on numerous occasions, over the last four-year period handling 30 requests for such assistance. Five of those requests related to FSA investigations into possible serious breaches of the Financial Services and Markets Act, including cases of insider dealing and other market abuses; the rest were routine requests for regulatory verifications.

54. In relation to tax transparency and as a fundamental proposition, the disclosure obligations of foreign parties under home country tax laws are not displaced by any OFC rules or practices. For the purposes of intellectual clarity, and in the context of characterisations of OFCs in popular commentary that assume the contrary, it must also noted that:

There is no obligation in customary international law for tax administrations to provide tax information to, or exchange information with, foreign tax authorities absent any express treaty based obligation. Exchange of tax information between or among tax administrations typically occurs on the basis of obligations set out in bilateral or multilateral agreements, most commonly so-called double taxation treaties or agreements. Such agreements are generally voluntary and relatively comprehensive in relation to taxation rights. They also typically partition taxing rights and set out mutual benefits, whether in the form of reciprocal receipt of tax information or otherwise.525

55. It is frequently the case that transactions structured in OFCs generate “onshore” reporting obligations, for example by the involvement of onshore participants that are subject to regulatory and tax requirements in their home jurisdictions, by the operation of accounting standards, or by dint of the listing of issued securities on stock exchanges.526 Many OFCs, including the Cayman Islands, also regularly report transactional statistics to the BIS and the IMF, which are published in the statistical offerings of those organisations.

56. The Government of the Cayman Islands maintains no public policy bars to the transparency and provision of information components of cooperation in tax matters and has been an active participant in the OECD process which has developed a set of technical standards in respect of transparency and exchange of information and is currently dealing with level playing field issues.527 Further to an official announcement by HM Treasury that the Cayman Islands was on the UK DTA negotiation list, bilateral discussions commenced in 2004; and the Cayman Islands looks forward to concluding a DTA with the United Kingdom.528

57. The Cayman Islands has implemented the EU Savings Directive through domestic legislation and bilateral agreements with all 27 EU Member States and for the 2006 reporting period provided the necessary reports to the UK and 17 other member states in relation to aggregate savings income of US$22.6 million. The Cayman Islands is engaged in bilateral discussions on tax cooperation matters with a number of OECD member states under the general auspices of the OECD Global Forum on Tax Matters. This exercise is ongoing.

526 There are Cayman Islands companies listed on many international exchanges, including London (both LSE and AIM board), New York (NYSE and NASDAQ), Tokyo, and Dublin.
527 As explained in the report produced from the 2005 OECD Global Forum meeting in Melbourne, Australia, “The level playing field is fundamentally about fairness to which all parties in the Global Forum are committed. In the context of exchange of information achieving a level playing field means the convergence of existing practices to the same high standards for effective exchange of information on both criminal and civil taxation matters within an acceptable timeline for implementation with the aim of achieving equity and fair competition.” (p 1).
528 The Cayman Islands entered into a tax information agreement with the US in 2001 and has an administrative unit in place, the Tax Information Authority, that acts as competent authority on tax cooperation matters, including on the EUSD reporting. The functions and powers of the Authority are established in the Tax Information Authority Law, 2005 (see www.tia.gov.ky).
Question Four—To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?

58. Authorities such as the IMF have credited financial innovation with diversification of risk and the enhancement of liquidity.\(^{527}\) The products falling within the cohort of innovative financial structures would likely be regarded as including “complex financial instruments” to which the question refers, eg hedge funds, structured finance, securitisations. In the course of its analysis of the flip-side costs of financial innovation as revealed by the market turmoil that manifested in Summer 2007, the IMF cautions that “policymakers should avoid a ‘rush to regulate’, especially in ways that unduly stifle innovation . . . .”. The IMF cautioned further that while structured finance and the originate-to-distribute model of securitisation required careful examination given their role in the market crisis, that it was important to note that securitisation per se was not the problem.\(^{528}\) Finally, the IMF suggests that continuing financial innovation is likely to design new beneficial financial instruments with enhanced transparency and risk-minimisation features.\(^{531}\)

59. There is evidence that financial innovation is stimulated by environments that allow the mitigation or elimination of dead weight cost.\(^{532}\) Complex financial instruments intended for institutional or sophisticated investors are also most likely to grow outside of a “one size fits all” retail investor-oriented regulatory environment. In this regard, a number of jurisdictions including small OFCs, offer such an environment, either as a general feature of their regimes or via regulatory and/or tax segmentation.

60. To the extent that Question Four may be based on the compound assumption that complex financial instruments are festerings of non-transparency and instability endemic to OFCs, the facts are that these are institutional products designed and consumed by or on behalf of mainstream “onshore” institutional market participants and structured through an array of jurisdictions, not just small OFCs. They are also subject to such transparency requirements as are imposed by international and/or “onshore” accounting and other standards. The negative consequences that have been associated with the inappropriate and/or ill-informed use of such vehicles arguably flowed from inappropriate business models and assumptions as well as failures to follow long-standing admonitions to investors to understand contracts prior to entering into them.

Question Five—How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets?

61. The level of taxation, which in the present context must be understood as including not only headline rates of tax but also the cost of compliance with taxation regimes of ever-increasing complexity, is undoubtedly an element in explaining the position of OFCs in worldwide financial markets. Thus, the decisions of the UK, the US, Japan and more recently Canada in relation to the taxation of non-residents transacting financial services business within their respective jurisdictions undoubtedly accounts for a significant part of their success in this sector. In the UK context, this type of “tax competitiveness” has been recognised by successive governments.\(^{533}\) Financial centres outside of OECD countries have tended to emulate this sort of strategy.

62. The commercial sensitivity to/impact of transparency is a function of the type of financial services business being conducted. Institutional business, that is, business conducted by and for regulated financial services entities, is generally transparent.\(^{534}\) Private client business may have greater (and not illegitimate) privacy concerns. Thus, jurisdictions that compete principally for institutional business such as the UK, the Cayman Islands and Bermuda are content to share tax information in the context of the EU Savings Directive (EUSD). In contrast, jurisdictions that are oriented towards private client business (eg Switzerland) have tended for that reason to opt for the withholding tax option under the EUSD.

63. Cayman has never had direct taxation; and as a specialist in institutional business, does not market based on non-transparency or indeed solely on absence of taxation. Rather, the lack of direct taxation and associated compliance costs in the Cayman Islands along with other factors previously discussed in the response to Question One enables the jurisdiction to provide a tax-neutral platform for the intermediation of investment capital. Unless investors are tax-exempt in their home jurisdictions, this does not result in non-taxation, as also previously explained in the response to Question One.

527 In its April 2008 Global Financial Stability report, ibid, n22, the IMF observes, for example, that “financial innovation and low policy rates have helped keep corporate default rates at historically low levels long after they had been forecast to rise” (p 9).
528 Ibid, p xii.
529 Ibid, p 76.
530 As explained in paragraphs 33 and 34 above.
531 G Brown, n6.
532 See paragraph 55 above.
Question Six—How do the taxation policies of Offshore Financial Centres impact on UK tax revenue and policy?

64. An extensive review of tax competition academic literature offers no clear guidance as to the level of impact of specific taxation policies on other jurisdictions. Similarly, analysis of the conclusions of special interest groups with an interest in tax competition suggests that the assumptions made, rather than the evidence, tends to produce those conclusions.\textsuperscript{531} It is however reasonable to conclude that the tax policies of all countries with significant cross-border financial services activity influence each other. The response to Question Nine below is also relevant.

Question Seven—Are British Overseas Territories and Crown Dependencies well-regarded as Offshore Financial Centres, both in comparison to their peers and international standards?

65. The Cayman Islands has established itself as a stable, sophisticated international financial services centre, providing institutionally-focused, specialised services to a global client base. The seeds of the centre were sown as early as the 1700s: two important legacies of history remain from that era—English common law and tax neutrality.\textsuperscript{536} The Cayman Islands has always been an open, free-market economy, and from the 1960s onwards, successfully invested its “historic capital” to the benefit of the financial services sector. The sector currently accounts for approximately 30\% of GDP and 21\% of the labour force. Many of the market participants are affiliated with established international institutions.\textsuperscript{537}

“Efforts to achieve compliance with international standards have been top priority in the Cayman Islands… The Cayman Islands authorities have devoted substantial attention and resources to improving the country’s anti money-laundering, legal and institutional framework… An extensive program of legislative, rule and guideline development has introduced an increasingly effective system of regulation, both formalising earlier practices and introducing enhanced procedures”

IMF Report on Supervision and Regulation of the Financial Sector in the Cayman Islands (March 2005)

66. The government fully associates itself with the statement in the 1999 FCO White Paper that “[i]n the long run, it is the quality jurisdictions that will prosper best. There must be no weak links which can help to undermine the international financial system”.\textsuperscript{538} The Cayman Islands, in concert with the other Caribbean OTs and Bermuda, fully supported the FCO’s initiative in the wake of the White Paper for an independent review (conducted by KPMG in 1999–2000) of financial regulation in the six territories and continues to share the FCO’s commitment to maintaining appropriate standards, out of regard for both the UK Government’s reputation and our own.\textsuperscript{539}

67. The government takes a principled and pragmatic approach to maintaining Cayman’s position as a leading financial services centre. In terms of principle, the “operating manual” is based on adherence to relevant international standards; respect for the rule of law, due process and the right to privacy; progressive reinforcement of Cayman’s international cooperation channels; and constructive engagement on international issues affecting the provision of cross-border financial services, based on a level playing field.

68. The pragmatic angle on these principles is that they promote commercial certainty and control reputation risk for global clients. The Cayman Islands fully understands and accepts that in operating a financial services centre involves serious obligations—recognizing that these obligations are not static due to evolution of international standards and the business itself.

69. It has been decidedly Cayman’s experience that adherence to relevant international standards—not absence of regulation—fuels sustainable growth of the sector. Like the City of London, we put a premium on promoting commercial certainty for our clients, with which a lax approach to quality and standards is not compatible.

70. Over 20\% of the licensing/registration revenue from the regulated sector is re-invested into the regulator’s operations (the Cayman Islands Monetary Authority), equating to C$14.5 million (£9 million) in the 2007–08 fiscal year, demonstrating the importance with which the Authority’s functions are regarded. Key features of the regulatory regime include:

— Observation of recognized and relevant international standards—Basel, IAIS and IOSCO core principles; FATF 40 + 9.


\textsuperscript{534} As noted, Cayman has never had a system of direct taxation and instead employs an indirect, consumption-based taxation system.

\textsuperscript{535} Licensees are published on the CIMA website www.cimoney.com.ky.

\textsuperscript{536} Secretary of State for Foreign and Commonwealth Affairs, Partnership for Progress and Prosperity: Britain and the Overseas Territories, Cm 4262, 1999, p 23 (£12).

\textsuperscript{537} In relation to the Cayman Islands, the KPMG Review (Cm 4855-IV, 2000, HMSO) found a seriousness in developing compliance with international regulatory standards; strong international cooperation arrangements; and a comprehensive AML framework highly responsive to international standards. (Summary of principal findings, p 6). Note that the FATF CFT standards were not within scope as they post-dated the KPMG assessment—but see Question Eight.

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The Authority is a member of a number of regulatory bodies in the banking and insurance areas and has applied for IOSCO membership.

71. The IMF assessment of financial regulation in the Cayman Islands published in 2005 found as follows:

- Overall—"... [A]n extensive program of legislative, rule and guideline development has introduced an increasingly effective system of regulation, both formalizing earlier practices, and introducing enhanced procedures".
- Banking—"The laws, rules and statements of guidance governing prudential supervision are up-to-date and generally meet international standards. The licensing process for new entrants is sound and comprehensive. Off-site monitoring and on-site inspection are well-developed and integrated. . . ."
- Insurance—"The measures and policies in place for insurance supervision are sound . . ."
- Securities—"In broad terms, the supervisory regime reflects those of developed countries . . . A sound legal, taxation and accounting system appears to be in place . . . Regulation in accordance with the IOSCO Principles is well-implemented except in the mutual funds area."
- On the international cooperation elements under the various international standards, the assessment found the Cayman Islands “compliant” or “largely compliant” (Basel Core Principles); the standards “implemented” and “partly implemented” (IOSCO Principles) and “largely observed” (IAIS Principles); and “compliant” or “largely compliant” (FATF Recommendations).

In relation to the AML/CFT portion of the IMF assessment, approximately 94% of the ratings assigned were in the “compliant” or “largely compliant” category and 6% in the “non-compliant” or “materially non-compliant” category.

72. The full IMF report (“Assessment and Supervision and Regulation of the Financial Sector”, in two volumes) can be accessed from www.imf.org. Since the assessment, the Authority in cooperation with government as necessary has made significant strides in addressing the IMF recommendations.

“... In terms of the AML/CFT compliance culture in the Cayman Islands, it was evident to the assessors that the country in general and the financial service providers in particular all have a keen sense of awareness of AML/CFT issues. Additionally, the financial service providers displayed a healthy compliance culture, based on an appreciation of the reputational risk of AML/CFT for the jurisdiction. The strong compliance culture was also demonstrated by the financial service providers' pro-active cooperation with the authorities in implementing AML/CFT measures. CCAF, AML/CFT Mutual Evaluation/Detailed Assessment Report on the Cayman Islands (November 2007)

73. As required by FATF AML/CFT standards and confirmed by external assessments, the Cayman Islands’ legal regime criminalises money laundering in accordance with the UN Vienna (1988) and Palermo (2000) Conventions. With the support of the FCO, the Cayman Islands was the first regionally, and among the first worldwide, to criminalise money laundering on an all serious crimes basis (ie not limited to narcotics crime), by the 1996 Proceeds of Criminal Conduct Law (PCCL). Money Laundering Regulations under the PCC, L apply comprehensive AML/CFT obligations in relation to customer due diligence, recordkeeping, systems of internal control and suspicious activity reporting and training, on all financial business within scope of the FATF standards.

74. In a number of respects, the AML regime in the Cayman Islands outpaced international standards, for example, in the breadth of activity coverage (“gatekeepers” providing trust, company and other services and real estate transaction were in scope before this was the international standard); in the undertaking of . . .
retrospective due diligence on all clients existing prior to the implementation in 2000 of upgraded AML legislation; the breadth of the statutory obligation to report suspicious activity under the AML legislation; and the immobilization of bearer shares.

75. The Cayman Islands is a founding member and past Chair of the Caribbean Financial Action Task Force (CFATF), an FATF associate member body established in 1990, and has undergone to date three evaluations by that organisation (in 1995, 2002 and 2007) in addition to the external AML/CFT evaluations by KPMG (see n50), the FATF Review Group of the Americas in 2000–01 and the IMF (see paragraph 71 above). The conclusions and findings of all of these evaluations recognise and reflect Cayman’s strong commitment to FATF standards. The IMF report noted that:

The Cayman Islands financial industry and regulators have developed an intense awareness of the measure required to combat money laundering and the financing of terrorism, as a result of legal reforms and improved supervisory procedures since 2000. There is an effective regime to implement these procedures and good evidence of a developed compliance culture. 547

76. As previously noted, the most recent evaluation of the Cayman Islands in relation to international AML/CFT standards is that conducted by the CFATF in 2007. This was a “third-round” evaluation, based on a more comprehensive and advanced version of the FATF standards and evaluation methodology than prevailed at the time of the IMF assessment. 548 The evaluation rated Cayman as “compliant” (the highest rating) or “largely compliant” (C/LC) on 38 of the 40 + 9 standards; “partially compliant” on 10 and “non-compliant” on one.549 This compares very favourably with the out-turn of the 19 FATF third-round evaluations conducted as at February 2008, where there was an average of 29 for C/LC ratings (including a high of 43 and a low of 12). Eighty percent of the 19 FATF countries had combined C/LC scores lower than those of the Cayman Islands, which puts the territory in the top five, along with the US, UK, Singapore and Belgium. 550 The Cayman Islands is currently working hard to address the shortfalls that were identified in the CFATF evaluation, and expects to substantially complete that work by the time of the next CFATF plenary in October/November 2008.

77. In terms of transparency standards in particular, Cayman received a rating of “compliant”, meaning that the regime was not found to have obstructive secrecy provisions that would impede effective implementation of the FATF 40 + 9. Cayman was also rated “compliant” on the FATF standards relating to the transparency of legal persons and legal arrangements. This transparency performance is further reflected in the C/LC ratings achieved on the international cooperation standards.

78. The Cayman Islands’ highly rated international cooperation regime is articulated in comprehensive statutory law enforcement and regulatory channels contained in the Monetary Authority Law (regulatory cooperation); the Mutual Legal Assistance Treaty (United States of America) Law; the Criminal Justice (International Cooperation) Law (CJICL); the Misuse of Drugs Law; and the Proceeds of Criminal Conduct Law (all law enforcement cooperation).

79. Since US ratification of the Mutual Legal Assistance Treaty (MLAT) in 1990, Cayman and the US have cooperated in over 250 requests for assistance under the Treaty, resulting in successful law enforcement actions. 551 Similarly, in relation to countries other than the US, 160 requests for assistance in criminal matters have been dealt with under the CJICL over the period 2003–07 (mid-year). Like the MLAT channel, the CJICL provides for a broad range of mutual legal assistance, including executing searches and seizures; providing information and items of evidence; identifying or tracing proceeds, property, instruments or such other things for the purposes of evidence; immobilising criminally obtained assets; and assisting in proceedings related to forfeiture and restitution. Assistance is available, including at the investigative stage, to all 146 Vienna Convention countries, including the UK.552

80. Financial services market share and quality and repute of market participants may also be taken as an indicator of the degree to which the OTs and Crown Dependencies are well-regarded.

544 IMF Report Vol I, p 7. Taking into account the IMF regulatory and AML/CFT assessments, the UK NAO November 2007 Report “[FCO]: Managing risk in the Overseas Territories” (HC 4 Session 2007-08) also noted that “[g]regulators in the key centres of Bermuda and the Cayman and British Virgin Islands . . . achieved major improvements since 2000” (p 21).

545 The FATF and FATF-style regional bodies (eg the CFATF) all use the same evaluation standards and methodology, requiring assessment based on over 200 criteria. The Cayman evaluation team comprised experts from the Bahamas, Canada, Jamaica, the US and the CFATF secretariat and was the first CFATF evaluation to include FATF member country experts on the assessment team.

546 The distribution of Cayman’s C/LC ratings by category of FATF standard totals is as follows: Legal System: all; Preventive Measures: 20 out of 22; Institutional and other Measures: eight out of nine; International Cooperation: all; and Nine special [CFT] recommendations: six out of nine. The single “NC” rating was for lack of express requirements concerning correspondent banking activity. The full evaluation report is available at www.cfatf.org.

547 In terms of further peer comparisons, inasmuch as three of the subject EU member states would be classified as OFCs, the IMF report noted that: “. . . achieving major improvements since 2000”. (p 21).

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550 In terms of further peer comparisons, inasmuch as three of the subject EU member states would be classified as OFCs, the IMF report noted that: “. . . achieving major improvements since 2000”. (p 21).

551 Including in relation to the Enron matter, in which a number of Cayman Islands entities were the victims of fraudulent activity centred in the US.

552 The CJICL was used (as well as other statutes), for instance, to provide assistance to the Italian authorities in relation to the Parmalat matter; and as reported in the 2007 UNODC/World Bank report, “Stolen Asset Recovery (StAR) Initiative: Challenges, Opportunities, and Action Plan”, to freeze an aggregate US$33 million to Peru in the Montesinos/roybery, theft and corruption matter (pp 19–20). Assistance has been provided to the UK on innumerable occasions under the CJICL and other channels.
Question Eight—To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?

81. The Cayman Islands has criminalised terrorist financing in accordance with the 1999 UN International Convention on the Suppression of the Financing of Terrorism, via the Terrorism Law, 2003. In addition, various prior Orders in Council promulgated by the UK on behalf of its OTs, pursuant to UN S/RES 1373 and S/RES 1267, apply.

82. The most comprehensive external evaluation to date of Cayman’s compliance with international CFT standards (the FATF 9 Special Recommendations) was undertaken via the 2007 CFATF evaluation. Cayman received zero “Non-compliant” ratings, six “largely compliant” and three “partially compliant”. Of the latter, the one relating to SR VII (wire transfer rules) self-corrected (as the assessors noted it would) as of the 1 January 2008 entry-into-force date for the required statutory provisions enacted in June 2007. The actions required in relation to the remaining two (SR VIII—Non-profit organisations and SR IX—cash transports) are being addressed.

83. The evidence available to us thus far is that Cayman tends not to be abused for the purposes of terrorist financing—there have been no domestic prosecutions (for want of cause) and no international requests for assistance in relation thereto; and the Financial Reporting Authority statistics for suspicious activity reports (SARs) by reason for suspicion for 2005–06 attribute 1% of SARs to suspected terrorist financing, and zero for 2006–07. Notwithstanding, private and public sector vigilance will be maintained.

Question Nine—What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?

84. We respectfully submit that in relation to transparency and financial stability the subject of the Inquiry there is no reason for the policy resources of HM Treasury to be consumed by OFCs that comply with international standards, except insofar as may be necessary to ensure that corresponding fair treatment for such compliance follows.

85. In respect of possible areas of examination in the context of HM Treasury fiscal policy, there is to date no convincing evidence that the existence of OFCs has caused tax takes to fall or a “race to the bottom”.553 There is however what Sharman describes as the mirage that large amounts of tax revenue might flow from a campaign against tax havens.554

86. Recent academic studies555 have examined the effect of low direct tax jurisdictions on those with conventional tax regimes and produced a series of conclusions as follows.

(a) Firstly, open economies have incentives to tax mobile multinational firms less heavily than they do other firms, since multinational tax bases are more elastic and the efficiency costs of taxing them are greater. As a practical and political matter, it is very difficult to differentiate tax burdens in this way. Foreign tax havens may help to achieve this differentiation, since multinational firms use tax haven operations to reduce their effective tax rates; the studies observe both that such differentiation can be an optimal configuration and that countries may not realize the role of tax havens in achieving it.

(b) Secondly, the evidence indicates that the establishment of affiliates in tax havens is complementary to economic activity outside of tax havens, by facilitating investment via access to lower-cost capital: in practice, tax havens do not divert economic activity from high-tax locations in the same region; just the opposite.

87. Hines has noted that, contrary to popular rhetoric, modern research points to the legitimate role of OFCs as “pressure valves” for the world economy, by enabling economic activity to occur which would otherwise be overly pressurized in other economies by state ownership of the financial sector, or non-competitive regulatory, tax or other policy.556 In fact, the OECD has also acknowledged this role:

The more open and competitive environment of the last decades has had many positive effects on tax systems, including the reduction of tax rates and broadening of tax bases which have characterised tax reforms over the last 15 years. In part these developments can be seen as a result of competitive forces that have encouraged countries to make their tax systems more attractive to investors. In addition to lowering overall tax rates, a competitive environment can promote greater efficiency in government expenditure programs.557

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556 Hines, J R, presentation to STEP International Conference, Panama, May 2008
88. Similarly, in a statement for the record of the US Senate Committee on Finance, the US Treasury noted that:

Increasingly the ability of US companies to grow and prosper depends on their ability to do business globally. In the 1960s, the decade during which many of our current tax rules regarding cross-border activities and investment were first enacted, international trade and investment flows were much less important than they are today to the US economy . . .. The US business tax system imposes a burden on US companies and US workers by raising the cost of investment in the US and burdening US companies as they compete with foreign companies in foreign markets.558

The statement goes on to outline possible areas for consideration to make US tax system less burdensome, which include, in an inherent validation thereof, fuller domestic integration of certain features that the use of OFCs/tax havens currently provide in relation to the treatment of foreign earnings by US companies.

Question Ten—What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres?

89. The abuse of double taxation treaties tends not to occur within financial centres per se, but rather within corporate taxation units within capital exporting countries, including those units within the UK. Most of the smaller OFCs either do not have double taxation agreements with other countries, or have treaties which contain anti-abuse provisions and/or do not apply to their “offshore” sectors.

90. The Cayman Islands does not currently have (nor has it ever had) a double taxation treaty with the UK. In the course of treaty talks with HM Treasury, anti-abuse protections have been discussed.

Question Eleven—To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?

91. The basis on which countries with significant financial centres collect and provide tax information to foreign tax authorities has been the subject of a recent and comprehensive study by the OECD.559 The study clearly shows that the expenditure of resources on the investigation of non-compliance with foreign taxation regimes, in the absence of a domestic tax interest, occurs on the basis of treaty obligations. This appears to be the practice of the United Kingdom with respect to non-resident persons with bank deposits and other financial activities in whom the UK has no tax interest. It appears sensible and prudent to the government of the Cayman Islands to maintain the same policy approach.

LIST OF ABBREVIATIONS/ACRONYMS

AML Anti-money laundering
AML/CFT Anti-money laundering/combating the financing of terrorism
ASBA Association of Supervisors of Banks of America
Basel Basel Core Principles for Effective Banking Supervision or associated Basel Committee
BIS Bank for International Settlements
CGBS Caribbean Group of Banking Supervisors
CFATF Caribbean Financial Action Task Force
CFT combating the financing of terrorism
CIMA Cayman Islands Monetary Authority
CJICL Criminal Justice (International Cooperation) Law
DTA double taxation agreement
EU European Union
EUSD European Union Savings Directive
FATF Financial Action Task Force
FATF 40 + 9 Financial Action Task Force 40 Recommendations on Money Laundering and 9 Special Recommendations on Terrorist Financing
FCO Foreign & Commonwealth Office
FSA Financial Services Authority
FSF Financial Stability Forum
HMT Her Majesty’s Treasury
IAIS International Association of Insurance Supervisors
IASB International Accounting Standards Board
IMF International Monetary Fund
IOSCO International Organisation of Securities Commissions
LSE London Stock Exchange
MLAT Mutual Legal Assistance Treaty
NAO National Audit Office

FIGURES AND CHARTS

Chart 1
Cayman Islands Banks by Region (as at 2007)
(281 total)

- Middle East 4%
- South America 5%
- Caribbean & Central America 8%
- Asia & Australia 10%
- Canada & Mexico 16%
- United States 27%
- Europe 30%

Source—Cayman Islands Monetary Authority

Chart 2
Individual vs. Institutional Bank Deposits in Cayman Islands Banks (as at 2007)
Total Deposits = US$1.67 trillion

- Individual 3%
- Institutional 97%

Source—Cayman Islands Monetary Authority
Chart 3A
BIS Banking Liabilities by Region (as at 2007)
Total = US$31.1 trillion

Europe 62%
Offshore 14%
North America 13%
Asia 3%
Other 8%

Source—Bank for International Settlements Quarterly Review June 2008

Chart 3B
BIS Offshore Centre Banking Liabilities (as at 2007)
Total = US$4.4 trillion

Cayman Islands 42%
Singapore 18%
Jersey 8%
Isle of Man 2%
Hong Kong SAR 11%
Guernsey 5%
Bahrain 5%
Bahamas 9%

Chart 4

EXTERNAL POSITIONS OF BIS-AREA BANKS 2000–07


OFCs Included—Aruba, Bahamas, Bahrain, Barbados, Bermuda, Cayman Islands, Gibraltar, Guernsey, Hong Kong SAR, Isle of Man, Jersey, Lebanon, Macao SAR, Mauritius, Netherlands Antilles, Panama, Samoa, Singapore, Vanuatu, West Indies UK.
Explanatory Notes
The size of each red circle is proportional to the outstanding stock of cross-border claims of reporting banks located in the particular geographical region. Some regions include countries which do not report data. The thickness of a line between regions A and B is proportional to the sum of claims of banks in A on residents in B and claims of banks in B on residents of A. The size of the circles and thickness of the lines are scaled by the overall stock outstanding, and thus are not directly comparable across panels.

Key to Abbreviations
ASIA OSC ......... Hong Kong SAR, Macao SAR and Singapore
ASIA PAC ......... China, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Taiwan (China), Thailand
CARIB ............... Aruba, Bahamas, Bermuda, Cayman Islands, Netherlands Antilles, Panama
CH .................. Switzerland
EM EUROPE .... Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia, Turkey, Ukraine
EURO ............... 27 euro-area countries
JP ................... Japan
LAT .................. Argentina, Brazil Chile, Colombia, Mexico, Peru
OIL ................. OPEC member states (excluding Indonesia) plus Russia
OTHER .............. Australia, Canada, Denmark, New Zealand, Norway, Sweden
UK .................. United Kingdom plus Guernsey, Jersey, Isle of Man
US ................... United States

Source—BIS Working Paper No 244, January 2008
Chart 6
Investment Managers of Cayman Islands Hedge Funds by Region

- North America: 61%
- Europe: 26%
- Caribbean: 8%
- Asia: 4%
- Latin America: 1%
- Other: 1%

Source—Cayman Islands Monetary Authority

Chart 7
CAYMAN ISLANDS MONETARY AUTHORITY
Funds by Minimum Initial Subscription

- <$99,999: 16%
- $100,000-$499,999: 23%
- $500,000-$999,999: 12%
- $1,000,000-$4,999,999: 37%
- $5,000,000-$9,999,999: 9%
- >$10,000,000: 3%

Source—Cayman Islands Monetary Authority
**Chart 8**

Captive Domiciles by Percentage of Total Captives (as at 2007)

- **Total Captives = 5,119**
- **Bermuda**: 19%
- **Cayman Islands**: 15%
- **Vermont**: 11%
- **British Virgin Islands**: 8%
- **Guernsey**: 7%
- **Barbados**: 5%
- **Luxembourg**: 4%
- **Turks & Caicos**: 3%
- **Isle of Man**: 3%
- **Singapore**: 1%
- **Switzerland**: 1%
- **Dublin**: 3%
- **Other U.S.**: 15%
- **Other**: 4%

**Source**—Business Insurance Magazine (March 2008)

**Chart 9**

CAYMAN ISLANDS CAPTIVES BY RISK LOCATION (AS AT MARCH 2008)

- **90%** North America
- **4%** Worldwide
- **3%** Caribbean & Latin America
- **1%** Africa, Asia & Middle East
- **1%** Europe

**Source**—Cayman Islands Monetary Authority
INTERNATIONAL DEBT SECURITIES OUTSTANDING AS AT DECEMBER 2007 BY RESIDENCE OF ISSUER (INCLUDES MONEY MARKET INSTRUMENTS, BONDS AND NOTES)

Source—Bank for International Settlements Quarterly Review, June 2008

Developed Countries—Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States.

Offshore Centres—Aruba, Bahamas, Bermuda, Cayman Islands, Hong Kong SAR, Lebanon, Netherlands Antilles, Panama, Singapore and West Indies UK.

Developing Countries—Africa & Middle East: Israel, Qatar, South Africa, Tunisia, United Arab Emirates—Asia & Pacific: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand—Europe: Croatia, Hungary, Poland, Russia, Slovakia, Turkey—Latin America & Caribbean: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela.
Memorandum from the Jersey Financial Services Commission

INTRODUCTION

1.1 This submission, in response to the Treasury Committee’s inquiry into offshore financial centres, is made by the Jersey Financial Services Commission (the “JFSC”). The JFSC is Jersey’s financial services regulator.

2. EXECUTIVE SUMMARY

2.1 This paper seeks, in particular, to draw the Committee’s attention to:

2.1.1 The role of the JFSC as Jersey’s independent, appropriately resourced financial services regulator with clear purposes, aims and statutory powers.

2.1.2 Jersey’s modern framework for the prudential supervision of financial services businesses, and the comprehensive measures in place to prevent and detect money laundering and the financing of terrorism;

2.1.3 Jersey’s commitment to meeting international regulatory standards and the independent assessments that have confirmed that Jersey does indeed meet those standards.

2.1.4 The JFSC’s active engagement with the international regulatory community and the involvement of its staff in providing support and training to other regulatory bodies.

2.1.5 The assistance and co-operation that the JFSC provides to other regulatory bodies.

2.1.6 The JFSC’s commitment to providing publicly available information on the breadth and size of Jersey’s finance industry.
3. The JFSC

3.1 The JFSC is responsible for the regulation and supervision of the financial services industry in Jersey. It is a statutory body corporate, set up under the Financial Services Commission (Jersey) Law 1998 (the “Commission Law”).

3.2 The JFSC also operates Jersey’s Registry for companies, limited partnerships, limited liability partnerships and business names. The types of companies on the Register include special purpose vehicles and, on a smaller scale, structured investment vehicles. Jersey companies are either required to provide beneficial ownership information to the JFSC or, in cases where the company is administered by a regulated trust company business (see 4.1), the JFSC may obtain such information from the trust company business. By law, trust company businesses are required to obtain beneficial ownership information on companies they administer. (Failure to do so is a ground for a criminal penalty or a regulatory sanction to be applied (which, in the latter case, may include the revocation of a firm’s regulatory licence)).

3.3 The Commission Law provides for a Board of Commissioners to be the governing body of the JFSC. The Board presently consists of 10 Commissioners, who—as required by the Commission Law—are made up of a balance of persons covering providers of financial services, users of financial services and persons representing the public interest.

3.4 The Commission Law established the JFSC as an independent body, fully responsible for its own regulatory decisions. The JFSC is accountable for its overall performance to the States of Jersey (the Island’s parliament).

3.5 The JFSC’s key purpose is to maintain Jersey’s position as an international finance centre with high regulatory standards by:

3.5.1 reducing risk to the public of financial loss due to dishonesty, incompetence, malpractice or the financial unsoundness of financial service providers;

3.5.2 protecting and enhancing the Island’s reputation and integrity in commercial and financial matters;

3.5.3 safeguarding the Island’s best economic interests; and

3.5.4 countering financial crime both in Jersey and elsewhere.

3.6 In support of its key purpose, the JFSC aims to:

3.6.1 ensure that all entities that are authorised meet fit and proper criteria;

3.6.2 ensure that all regulated entities are operating within accepted standards of good regulatory practice;

3.6.3 match international standards in respect of banking, securities, trust company business, insurance regulation, anti-money laundering, and terrorist financing defences;

3.6.4 identify and deter abuses and breaches of regulatory standards; and

3.6.5 ensure that the JFSC operates effectively and efficiently, and is accountable to the States of Jersey.

3.7 The JFSC presently has a staff complement of 105 (full-time equivalent).

3.8 Further information about the structure and governance of the JFSC can be found on its website (www.jerseyfsc.org) and in its recently published 2007 Annual Report.560

4. The Regulatory Environment

4.1 The JFSC has responsibility for the prudential oversight of banks, insurance companies, fund services businesses, investment businesses (investment managers, dealers and advisers), trust company businesses (trust and company service providers), general insurance mediation businesses and money service businesses (bureaux de change and money transmitters). Collectively, these will be referred to herein as “regulated businesses”.561

4.2 The legal basis for overseeing regulated businesses is contained in the following laws: the Banking Business (Jersey) Law 1991; the Collective Investment Funds (Jersey) Law 1988; the Financial Services (Jersey) Law 1998; the Insurance Business (Jersey) Law 1996 (the “four regulatory laws”). Copies of these laws are publicly available from the website of the Jersey Legal Information Board.561

4.3 The four regulatory laws, combined with the Commission Law, provide the JFSC with the statutory power to conduct off-site and on-site supervision of regulated businesses. (With regard to the latter, 155 on-site examinations were completed in 2007.) The four regulatory laws also provide the JFSC with various tools and powers to ensure that it can carry out effective supervision. The JFSC is able to require the provision of information and documents, to conduct investigations and to enter and search premises (upon issue of a warrant).

4.4 In addition, the four regulatory laws provide for the JFSC to be able to revoke a regulated business’s licence (or refuse to licence an applicant), to set conditions on a licence, to issue directions requiring a regulated business to take or not take specific action, to appoint a manager to manage a regulated business, and to issue public statements that warn the public and/or censure the regulated business.

4.5 The four regulatory laws also provide for criminal offences to be committed where (inter alia) a person conducts a financial service business without the relevant licence from the JFSC or provides information to the JFSC that is false or misleading.

4.6 The JFSC has powers under the four regulatory laws to issue Codes of Practice that set standards that regulated businesses must meet. The Codes that have been issued are available from the JFSC’s website and these set, for example, conduct of business rules and financial resource requirements.

4.7 The Committee may have noted from the list of regulated businesses in 4.1 that Jersey is one of the few jurisdictions in the world that comprehensively regulates and supervises trust and company service providers.

4.8 The JFSC currently supervises 47 banks, 184 insurance companies, 480 fund services businesses, 115 investment businesses, 192 trust company businesses, 120 general insurance mediation businesses and 48 money service businesses.

5. ANTI-MONEY LAUNDERING AND COUNTERING THE FINANCING OF TERRORISM (“AML/CFT”)

5.1 As well as the prudential supervision of regulated businesses, the JFSC is also responsible for overseeing regulated businesses for their compliance with AML/CFT legislation and associated regulatory requirements, as well as for their compliance with United Nations and European Union sanctions requirements.

5.2 The JFSC issues and maintains Jersey’s “Handbook for the Prevention and Detection of Money Laundering and the Financing of Terrorism”. This is available from the JFSC’s website. The Handbook sets AML/CFT regulatory requirements on regulated businesses.

5.3 Non-compliance with Jersey’s AML/CFT legislation by a regulated business attracts a range of criminal offences, with various levels of fine and terms of imprisonment. In addition, the four regulatory laws provide for AML/CFT breaches to attract regulatory sanctions by the JFSC (including those listed in 4.4). For example, in a recent case, AML/CFT breaches were a significant factor in the JFSC’s decision to close down a trust company business.

5.4 The JFSC works closely with Jersey’s joint police/customs financial intelligence unit (the “Joint Financial Crimes Unit” or “JFCU”). There is a regular exchange of information in relation to regulated businesses, in particular where a suspicious activity report submitted to the JFCU indicates that there may be issues at the regulated business that the JFSC should look into. Conversely, there have been a number of instances where an on-site examination of a regulated business has resulted in the JFSC becoming aware of potential breaches of AML/CFT (and other) legislation and a referral to the JFCU has been made. Investigations and criminal prosecutions have resulted from these referrals. These have included a major criminal prosecution where a regulated trust company and one of its directors was convicted of breaching statutory “know your customer” requirements and fined a total of £100,000.

5.5 Regulated businesses play a key role in the Island’s fight against criminals and the “know your customer” requirements they must follow enables them to be in a position to recognise suspicious or unusual activity by their clients. The vigilance of regulated businesses is reflected in the large number of “suspicious activity reports” submitted by them to the JFCU. For example, in the period January 2005 to December 2007 regulated businesses submitted in excess of 3,500 SARs for investigation. (Further statistical and other information about SARS and the work of the JFCU generally can be obtained from the States of Jersey Police Annual Performance Report).

5.6 The States of Jersey has recently adopted a new law (currently awaiting Privy Council approval) that will extend the remit of the JFSC to overseeing lawyers, accountants, estate agents, high value goods dealers, and a number of other business sectors, for their compliance with their statutory AML/CFT obligations. The JFSC has already recruited the additional staff necessary to ensure that it has the resources to carry out effective oversight of these new sectors.

6. **Compliance with International Standards**

6.1 Jersey’s government has publicly committed the Island to meeting international standards on financial regulation and AML/CFT controls. The JFSC is fully supportive of this and attaches particular importance to independent assessments of its compliance with standards set by the FATF, IOSCO, IAIS, and the BCBS.

6.2 In 2003, the IMF carried out an assessment of Jersey’s compliance with these standards. The IMF concluded that “the financial regulatory and supervisory system of Jersey complies well with international standards”. The full text of the IMF report can be obtained from the JFSC’s website.565

6.3 Since then, there have been significant changes in the international standards to be met, most particularly in respect of those set by the FATF and the BCBS, and more emphasis on the effectiveness with which those standards are being met. The JFSC (and other relevant Island agencies) has been, and continues to be, actively engaged in a process of updating relevant legislation, regulations and procedures to ensure that the Island will continue to meet international standards.

6.4 The next assessment of Jersey’s regulatory standards by the IMF—under its FSAP666 Updates programme—will take place in October and November of this year. The enactment of updating legislation and the implementation of updated Codes of Practice, and the planning undertaken for the IMF assessment generally, is expected to put Jersey in a good position to achieve standards of compliance that compare favourably with those of other countries, including many EU Member States and G7 countries. The IMF assessment will also include “stress-testing” to assess the likely resilience of the banking sector to financial sector shocks. The JFSC is confident that its regulatory framework for banks in Jersey will ensure that they are well prepared to cope with such shocks.

6.5 Jersey’s AML/CFT systems have recently been subject to review by the European Union’s Committee on the Prevention of Money Laundering and Terrorist Financing. The committee has been considering which jurisdictions should be considered by Member States to have equivalent AML/CFT systems to the European Union. In a “Common Understanding” published last month the committee stated that “the UK Crown Dependencies (Jersey, Guernsey and the Isle of Man) may also be considered as equivalent by European Union. The full text of the IMF report can be obtained from the JFSC’s website.565

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7. **International Engagement**

7.1 The JFSC is committed to active engagement with the international regulatory community and does this in a number of different ways.

7.2 The JFSC is a member of the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Offshore Group of Banking Supervisors (OGBS), and the Offshore Group of Insurance Supervisors (OGIS).

7.3 Officers of the JFSC sit on IOSCO Standing Committee 5 (investment management) and also the Implementation Task Force, which developed the Methodology used to assess compliance with IOSCO’s Objectives and Principles. An officer of the JFSC also sits on the IAIS’s pensions committee and the OGIS management committee.

7.4 The JFSC has been a member of the OGBS since its creation in 1980, and has played a leading role in the OGBS’s anti-money laundering programme; particularly through the OGBS Chairman Colin Powell, who is also Chairman of the JFSC.

7.5 Through its membership of the OGBS, the JFSC works with the Financial Action Task Force (FATF) (the international body responsible for setting AML/CFT standards) and the Basel Committee on Banking Supervision (BCBS). The JFSC’s Chairman attends all FATF meetings. The Chairman co-led the FATF typologies project on the misuse of corporate vehicles, the report on which was published in October 2006. The JFSC’s Chairman also co-chaired the Basel Committee Working Group on Cross-Border Banking, which issued a paper on customer due diligence for banks. The OGBS is also involved in Interpol’s Working Group on Anti-Money Laundering and Terrorist Financing.

7.6 As part of the OGBS, the JFSC has also participated in the development by the OGBS of a statement of best practice for trust and company service providers.

7.7 The JFSC also attends and contributes to the work of the Wolfsberg Group, an association of eleven global banks, which aims to develop financial services industry standards, and related products, for “Know Your Customer” and AML/CFT policies.

7.8 The JFSC’s Companies’ Registry division is also active internationally. The JFSC’s Director, Registry sits on the board of the European Business Register (EBR). The EBR is responsible for maintaining access to the data of 20 million companies held in the Registries of 19 European jurisdictions (including the United Kingdom and Jersey). The EBR also manages a number of research projects funded by the European Union.

565 http://www.jerseyfsc.org/the commission/international_co-operation/evaluations/imf-assessments.asp
566 Financial Sector Assessment Programme.
567 See http://www.hm-treasury.gov.uk./documents/financial_services/money/fin_crime_equivalence.cfm
The JFSC’s Director, Registry also sits on the board of the International Association of Commercial Administrators (IACA) as the director representing the international section chair. IACA is the association of all United States and Canadian companies’ registries.

The JFSC actively monitors international regulatory developments. For example, it has recently completed a comprehensive review of the April 2008 Financial Stability Forum’s report on “Enhancing Market and Institutional Resilience” and assessed what action the JFSC should take in support of the report’s recommendations.

The expertise of the JFSC has resulted in its staff being asked to participate in assessment exercises and to provide training to regulators and other bodies. Some examples are given below.

Officers of the JFSC have been seconded to the International Monetary Fund (IMF) to act as subject experts on IMF assessments of the standards of financial regulation in Cyprus, Vanuatu and the Bahamas.

In addition, a JFSC officer provided AML/CFT training at a seminar hosted by the World Bank for North African and Middle East regulators. Earlier this year, a JFSC officer provided AML/CFT training to the financial services regulator in Nevis. Later this month, a member of the JFSC’s staff, at the invitation of the European Commission under its TAIEX\(^6\) programme, will provide anti-money laundering training to the Serbian Ministry of Finance.

To assist in the development of the skills of overseas regulatory staff, the JFSC has provided secondments to officers of financial service regulators from the British Virgin Islands, Bahrain, China, the Netherlands and Vanuatu. JFSC staff have also provided training on “Effective Supervision” to regulators situated in a number of Caribbean jurisdictions as part of initiatives funded by the IMF or the Foreign and Commonwealth Office.

The JFSC also hosts periodic awareness-raising seminars for staff of the Metropolitan Police and the Serious Fraud Office on the “uses and abuses of offshore structures” and how to investigate them. Other organisations that have benefited from awareness-raising seminars from subject specialists at the JFSC include the Royal Canadian Mounted Police, French investigating magistrates and the City of London Police.

8. **International Co-operation and Transparency**

The four regulatory laws provide the JFSC with wide powers to assist regulators in countries or territories outside of Jersey. For example, these include the following powers that may be exercised by the JFSC in order to assist an overseas regulator:

- **8.1.1** the power to refuse or revoke a licence;
- **8.1.2** the power to impose, revoke or vary conditions of registration;
- **8.1.3** the power to obtain information and documents;
- **8.1.4** the power to appoint an inspector;
- **8.1.5** the power to communicate information that is in the possession of the JFSC (notwithstanding confidentiality provisions).

In response to formal requests for assistance from an overseas regulator the JFSC can serve notices on persons/businesses in Jersey requiring the production of evidence on behalf of the overseas regulator making the request. Over the past four years, the JFSC’s Enforcement Division has responded to formal requests for assistance from overseas regulators on 42 occasions. Generally speaking, these requests from overseas regulators sought information to assist with investigations linked to suspected insider dealing, market manipulation or the provision of false and misleading information. In addition to these formal requests, the JFSC’s supervision divisions respond each year to numerous routine requests from overseas regulators, for example, to confirm that a particular business is registered, that no adverse information about persons/businesses in Jersey requiring the production of evidence on behalf of the overseas regulator:

- **8.3** Jersey legislation does not require bi-lateral agreements to be in place in order for the JFSC to co-operate internationally. Notwithstanding this, the JFSC is of the view that bi-lateral agreements can be of assistance in setting out the practical steps to be taken when assistance is required. They also publicly demonstrate the JFSC’s clear commitment to international regulatory co-operation.

8.4 To date, the JFSC has concluded 33 bilateral memoranda of understanding with overseas financial services regulators. The full list is available from the JFSC’s website.\(^5\)

8.5 In addition, the JFSC has concluded a letter of intent with the Hong Kong Securities and Futures Commission and a Statement of Co-operation with the China Banking Regulatory Commission.

8.6 Jersey was amongst the first jurisdictions to become a signatory to IOSCO’s multilateral memorandum of understanding. The memorandum sets a benchmark for co-operation on combating securities and derivatives violations, and commits Jersey to sharing a wide range of information about the illegal use of the securities and derivatives markets with securities regulators in other countries. Before

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\(^5\) Technical Assistance and Information Exchange programme.

\(^6\) [http://www.jerseyfsc.org/the_commission/international_co-operation/list-of-memoranda.asp](http://www.jerseyfsc.org/the_commission/international_co-operation/list-of-memoranda.asp)
signing the memorandum, the JFSC had to satisfy IOSCO that it has the necessary laws, powers and practices to co-operate effectively in investigations. A full list of the 47 signatories to the memorandum can be found on IOSCO’s website.570 The signatories include regulators in major European countries, the Far East and the United States.

8.7 Given the increasingly cross-border nature of financial services, the JFSC recognises the importance of the publication of statistical information on the size of Jersey’s finance industry. The JFSC publishes data in a number of different ways.

8.8 On a quarterly basis the JFSC collates information on the breadth and size of Jersey’s finance industry. This includes, for example, information on the size of bank deposits and funds under management. These statistics are formally published by another Island agency, Jersey Finance Limited, and can be viewed on its website.571

8.9 The JFSC is a voluntary contributor to the IMF’s Information Framework (the “Framework”). The Framework is intended to help improve transparency in the operations of international and offshore financial centres by providing jurisdictions with a common template in their information dissemination efforts. The Framework also provides the IMF with a mechanism to collect comparable information on a regular basis to facilitate monitoring developments in financial centres. The most recent data submitted to the IMF can be viewed on the JFSC’s website.572

8.10 Another IMF statistics initiative that the JFSC voluntarily contributes to is its Co-ordinated Portfolio Investment Survey (“CPIS”). The purpose of the CPIS is to collect information on the stock of cross-border holdings of equities and long- and short-term debt securities valued at market prices prevailing at the time of the CPIS, and broken down by the economy of residence of the issuer. Jersey’s CPIS data is published on the IMF’s website,573 along with the data from the other 73 contributing jurisdictions.

8.11 On a quarterly basis, the JFSC provides statistics to the Bank for International Settlements (BIS) under its Locational International Banking Statistics programme. Currently, 40 jurisdictions report their aggregate national locational data to the BIS, which uses them as the basis for calculating and publishing global figures. The data are published as part of the BIS Quarterly Review available from the BIS website.574

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571 For example, see http://www.jerseyfinance.je/content/2852/index.html
572 http://www.jerseyfsc.org/the_commission/general_information/statistics/international_monetary_fund.asp
574 http://www.bis.org/statistics/bankstats.htm