

# OFCs in the Crosshairs

## – but not alone in their struggle to survive

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**Offshore Financial Centres (OFCs) have been in the headlines and on the lips of politicians with great frequency over the course of the last two years.**

While the slowly gathering economic recovery will ultimately lead to an improvement in the general business environment, as well as the ability of tax authorities globally to generate more revenue, there is no doubt that attention will not shift away from the offshore world.

While many of the attacks over the last 18 months have been designed to paint OFCs as villains and a partial cause of the global economic crisis, the facts that have been revealed make it plain that the crisis did not have its origins in the offshore world.

Part of the greater focus on the offshore world has arisen because onshore authorities wish to tighten their tax nets in order to improve their ability to generate revenue from taxpayers, in view of the clear and reasonable need to recover some of the vast amounts of money that have had to be spent propping up their economies. Two aspects have gained attention in the move to improve tax revenue – tax avoidance, and tax evasion.

Tax avoidance is a perfectly legitimate activity aimed (whether at a personal or corporate level) at reducing the tax burden within the limits permitted by the law of the land. This is not the same as tax evasion (breaking the law). Despite that, a number of commentators, and politicians, have spent some time seeking to treat them as the same thing.

In the offshore world, crude tax evasion, such as hiding assets by non-declaration or under-reporting to onshore tax authorities has declined and will continue to decline, as the drive for transparency has opened up access for onshore authorities to pursue their citizens for illegal activities across the globe. While generally the laws of many countries (such as England and Wales) do not recognise another country's tax laws, the mutual obligations assumed under Double Taxation Treaties (DTTs) and Tax Information Exchange Agreements (TIEAs) now provide explicit duties to assist in enforcing information between governments to assist in the enforcement of their own tax laws.

OFCs have co-operated in this area, not just because they had to (though it is fair to say that it is recent onshore pressure that has brought about a very active implementation of previous commitments to transparency), but because OFCs view themselves as responsible financial centres providing a base for companies and individuals seeking, with proper advice and disclosure onshore, to structure their affairs as tax efficiently as the applicable onshore and offshore laws allow. The majority of offshore work in the major OFCs consists of providing services to companies and individuals who are operating in full compliance with their own tax laws, and these OFCs would not want it any other way.

While some alarming figures for revenue lost to tax avoidance have been put forward, actual studies of the effects of tax avoidance, such as the Deloitte Report of 23 September 2009 (part of the Independent Review of British OFCs) suggest that they are considerably overstated. After careful review of some of the other estimates of losses suffered by the UK due to tax avoidance (including a figure of GDP 1.8 billion), the Deloitte Report came up with an estimated loss of GDP 3 billion, and it could not quantify the element attributable to the legitimate use of OFCs, rather than other legitimate avoidance techniques not involving OFCs. A number of other studies have put forward estimates of the effect of tax avoidance on a more global scale and, again, the figures in the headlines are noted as being overstated (by, for example, assuming the worst outcome). It has also been found that there is no basis for determining what proportion of avoidance is attributable to the offshore world.

Noting all of the above, even against the background of the gradual economic recovery, it is still expected that the significant structural issues that face the major economies of the west, including funding their retirement and benefits systems with gradually ageing populations, will require continuing efforts by onshore governments to improve the efficiency of the onshore tax net. That will likely be coupled with moves to prevent the use of offshore structures by changes to tax legislation and efforts to demonise OFCs in an attempt to completely close them down.

There has been considerable discussion on the harmful effects of tax competition. It has been broadly accepted by a number of studies that tax competition is healthy for the global economy. The fact is that it is still alive and well in the onshore world (examples are the differential tax rates among the various States of the United States of America, or the different tax rates which operate across the European Union). Just recently there has been discussion in Australia of attracting more international finance by lowering certain taxes. It seems unlikely that this principal will change in the near future when it is accepted practice in the onshore world.

One of the issues raised in more recent onshore discussions has been the absence of tax in the major OFCs. Of course this is not true, as most have, for their small size, relatively sophisticated infrastructures, which are funded by taxes or fees. However, they do not tax in the same way as many major countries do. As an example, the principal sources of government revenue in Bermuda include customs duties (levied on goods imported) and payroll tax (charged on businesses and their local employees and reflecting a percentage of the gross remuneration paid to those employees up to a certain level). Lower taxes are sufficient as OFCs are not required to support the huge and complicated infrastructure of large and advanced western countries. It should be noted that the major OFCs do not receive financial aid or grants from onshore governments or global monetary institutions.

Some of the suggested “improvements” to the offshore tax regimes, such as VAT or corporate profit tax, are simply not required in all OFCs and may in fact be extremely harmful to OFCs and their economies by driving out the business which is the main stay of the economy. Additionally, the collection of such taxes requires a large infrastructure which in turn would require more tax. The sovereign right of countries to determine their tax system seems to be overlooked in many discussions on OFCs own tax structures.

On the topic of regulation, over recent years, there have been a series of investigations undertaken by the International Monetary Fund and the Financial Action Task Force of OFCs and by OECD member states. A number of guidelines and principals for regulation and supervision of significant industries and businesses have been established including for example: banking, insurance, the administration of trusts, investment services and fund vehicles. These are based on “minimum international standards” to which all jurisdictions are expected to subscribe. While not necessarily complying in every respect with every requirement, OFCs perform well in these assessments, as they strive to meet the agreed standard to be applied onshore and offshore. Indeed, as noted in Transparency International’s published list, the world’s worst offender according to its assessment of global transparency was the State of Delaware in the USA. The old arguments about lack of regulation in the offshore world are simply no longer true. In fact it is evident that in order to continue to justify their existence in view of the development of these international standards, many major OFCs have been amongst the first to work to meet these regulatory tests. They have had to do this to ensure that their economies may continue to benefit from the flow of business from the onshore world by demonstrating their willingness to accept international standards that apply equally across the board.

It is now clear that the next wave of attacks on OFCs may well arise in the area of the actual implementation of the rules on transparency. It is likely to be specifically in the areas of the enforcement of, and the practical use of, the Tax Information Exchange Agreements which have become the accepted standard by which the OECD judges whether financial centres (onshore or offshore) meet international standards of transparency.

Many OFCs have now been added to the OECD “White List”, each having entered into a considerable number of TIEAs or DTTs. A number of these jurisdictions, for example the Cayman Islands, have been subject to an examination (by the General Accounting Office of the United States of America) as to their co-operation in the effective use of their agreements and were declared to be fully co-operative. Where treaties have been ratified and in place for some time, there is no evidence of significant cross the board issues with the governments of major OFCs in relation to obtaining information under those treaties.

It has been suggested that the offshore world must move to the automatic exchange of tax information rather than the present treaty based request system, with its checks and balances to protect the legitimate rights of taxpayers which exist in all civilised countries. In the context of a worldwide system of automatically exchanged tax information, where this is a global standard applicable to all, it must be right to expect such rules to apply to OFCs. In the absence of an equal application of such requirement onshore and offshore, requiring it solely for the OFCs would clearly be unfair and discriminatory.

At present, the only automatic Tax Information Exchange Agreements that I am aware of consist of arrangements between the United States of America and Canada, and those partial arrangements that exist under the Savings Directive implemented in the European Union. There is, it would appear, no international consensus yet on the automatic exchange of tax information. This may be due in part to the huge sensitivity for each sovereign nation of controlling information relating to their tax base and the amount of revenue that can be generated from it. In part it may as well be due to the complexity and cost of the task of exchanging information, particularly when one looks between for example, two sophisticated, very well developed and strongly interlinked economies, such as those of the UK and the USA.

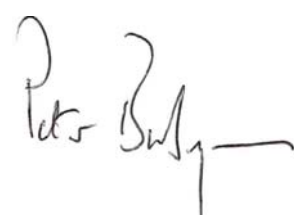
There may be another element at play in the current drive to reduce the significance of OFCs and that would be the desire to support the major onshore financial centres. It would be hard to avoid the fact that, in world terms, the Cayman Islands is the world’s largest centre for hedge funds, and is a source of massive investment, undertaken through vehicles established in that jurisdiction, into all regions of the globe. It is a major switching point for capital, and provides an efficient means for global investment. Similarly, Bermuda is a significant international centre for reinsurance, and has played a world changing role in that industry for the last 25 years. It provides, for example a significant proportion of the cover available to the USA in respect of property and casualty coverage and, as such, represents a major source of support for the citizens and businesses of that country by providing a means of spreading risk beyond its economy. Jersey, as noted in the recent Foot<sup>1</sup> and Deloitte Reports, along with Guernsey and the Isle of Man, is the source of significant capital raised by UK based banks and invested with and managed by them, generating substantial revenue for those institutions, not to mention ultimately the UK Treasury.

In a world in which competition between major international financial centres is acute, for example between London and New York, and with cities like Shanghai, Hong Kong and Singapore looking to move into a leading position within the next 20 years, governments will be looking to retain their influence and control over the flow of capital and their ability to tax it. Significant capital is passing through OFCs into the major developing countries, and the developed countries may well prefer to interrupt this flow rather than have significant capital routed to these emerging competitor centres.

It seems, perhaps, that a further element in the challenge to OFCs may be the perception of the need to return the focus of international finance and business to the traditional, mostly European and North American financial centres. However, if that is correct, then these attempts are based on a fundamental misconception. OFCs such as the Cayman Islands, Bermuda, and Jersey, Guernsey and the Isle of Man play a role as a means for the efficient transfer of capital across the globe, for investment, for insurance, for development and for global economic advancement (since businesses reach into all corners of the world). OFCs function as part of the international financial machine and are, effectively, lubricants in it, not because they take something out of it. If anything, they enhance and provide benefits to the major economies with which they work, as evidenced by the recent Deloitte Report on the benefits to the UK economy of the Crown Dependencies, or the contribution to the US insurance industry of the spreading of risk through Bermuda reinsurance companies.

Wealth is increasingly developing outside the traditional major economic centres, in the up and coming powerhouses of China, Brazil, India and Russia, which have significant funds to be invested worldwide and yet are still recipients of substantial inward investment. A considerable volume of the inward investment has flowed through OFCs and the OFCs can continue to play a supporting role to these countries and the new developing financial centres in them. Businesses in those countries may well find it beneficial, for their expanding global investment, to make use of the efficiencies afforded by the OFCs to improve the return on their external investment. In a world in which OFCs have recently seen much antagonism, a new group of supporters and beneficiaries may be forming.

OFCs are still in the cross hairs, but they are not alone in their struggle to survive. A more sober fact based analysis of their role may lead to a wider understanding of that role and to acceptance of the value they offer, onshore and offshore.



**END NOTES:**

1. Michael Foot’s Independent Review of British Offshore Financial Centres.