Final report of the independent Review of British offshore financial centres

Michael Foot

October 2009

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Foreword

The three Crown Dependencies and six Overseas Territories within the scope of my Review are facing the worst global economic downturn for over 60 years and intense international focus on the operation of their respective financial centres.

The smallest economies are particularly exposed to the downturn, but none of the nine jurisdictions I have reviewed can afford to be complacent. Most are heavily reliant on financial services and tourism for economic output, government revenue and employment.

It was clear early in the Review process that economic decisions taken by some of the jurisdictions during the long period of economic growth had weakened their resilience in a downturn. Events have proved this to be the case.

Some now face difficult decisions and will need to look afresh at options for controlling public expenditure and increasing revenue. Even those jurisdictions which are not under immediate fiscal pressure may wish to consider whether existing tax regimes expose them to international pressure which might ultimately have a material impact on their economic sustainability whilst potentially also reducing their 'tax take' more than necessary.

Meeting international standards on tax transparency, financial sector regulation and financial crime is an absolute must if the jurisdictions wish to continue to hold themselves out as internationally active financial centres, but international pressure must also be maintained on competitor jurisdictions to raise their standards.

A number of the jurisdictions I have reviewed have a good story to tell, but there is no room for complacency. Others have more to do, particularly on regulation and tackling financial crime.

Some will need technical assistance to help with the fight against financial crime, but the local governments must first demonstrate that they are committed to taking the action necessary to secure the benefits of this assistance in the long-term. There can be no second chances.

At a domestic level, the jurisdictions must take all possible steps to prevent the collapse of financial institutions of systemic importance to the local economy and have workable resolution plans if a collapse cannot be prevented.

The recommendations in my Report addressed to the jurisdictions provide benchmark standards against which each can assess itself. I invite the jurisdictions I have reviewed to consider what action they may need to take to achieve these standards.

I also invite the UK government to discuss and consider governance arrangements with the jurisdictions to ensure that there is a shared understanding of respective responsibilities and expectations.

Michael Foot

1 Overview

Introduction

1.1 This Review was commissioned by the Chancellor of the Exchequer in December 2008 to work co-operatively with the three Crown Dependencies (Guernsey, Isle of Man and Jersey) and six Overseas Territories (Anguilla, Bermuda, British Virgin Islands, Cayman Islands, Gibraltar, Turks and Caicos Islands) to identify the opportunities and challenges generated by turmoil in the financial markets and the subsequent impact on the world economy[1].

1.2 The Review was commissioned against the backdrop of:

- worldwide economic and financial sector difficulties, and specifically the collapse of Icelandic banks impacting on Guernsey and the Isle of Man;
- a report by the Public Accounts Select Committee[2] which concluded that the Overseas Territories had not reached the regulatory standards attained by the Crown Dependencies across the areas of banking, insurance, securities and money laundering; and
- the G20's commitment to raise regulatory standards in the financial sector and a developing focus on the role of offshore 'tax havens' (of which there are many around the world) in facilitating tax evasion and financial crime.

Approach

1.3 The financial centres in the nine jurisdictions have distinct characteristics. Understanding these characteristics, and the reasons for them, has formed an important part of the open and constructive dialogue the Review has had with the jurisdictions.

1.4 Preparing a detailed explanation of the differences between the jurisdictions would not, however, have served well the objective of delivering a report of value to the United Kingdom authorities and the governments of the jurisdictions. The Review has, therefore, pursued the thematic approach set out in the Progress Report published in April 2009 and which provided the basis for consultation with a range of stakeholders.

1.5 The Review has benefited from the willingness of non-governmental organisations (NGOs), financial services providers and individuals to give generously of their time to explain their views during the consultation.

1.6 The thematic approach has inevitably produced recommendations for action that will require more significant action by some jurisdictions than others. But those recommendations addressed to the jurisdictions are intended to provide benchmark standards against which each can assess itself and a basis for considering what action may be necessary, in some cases with technical assistance, to ensure a sustainable future.

[1] The terms of reference for the Review are reproduced in Annex A to the Report.

[2] Foreign and Commonwealth Office: Managing Risk in the Overseas Territories, HC 176, published 1 May 2008.

1.7 The jurisdictions already publish information relevant to their performance against the standards in some of the Review's recommendations. The jurisdictions should consider incorporating this into a single document, published periodically, reporting on how the benchmark standards are being met, or on how and when they will be met.

International significance

1.8 Many of the jurisdictions have developed important niche positions in international financial markets; but their importance in global terms, as measured by financial flows through the banking system, is modest.

Box 1.A: Niche positions in international financial markets

- The Cayman Islands are the world's leading centre for hedge funds and also a significant wholesale banking centre, with high volumes of overnight banking business from the United States.
- Bermuda is the third largest reinsurance centre in the world and the second largest captive insurance domicile, with firms based in the jurisdiction writing significant volumes of business in the United Kingdom and the US.
- The British Virgin Islands are the leading domicile for international business companies, with much business coming from the Far East in addition to strong business links with the US.
- Gibraltar offers a gateway to the European single market.
- The Crown Dependencies provide a gateway to route funds to other financial centres, including London; and they also service the financial needs of many UK nationals living abroad.

1.9 Within the offshore market (as defined in chapter 2), the nine jurisdictions account for over 60 per cent of total financial flows through the banking system. However, this total is significantly inflated by short-term US dollar flows routed through the Cayman Islands in response to prohibitions on the payment of interest on demand deposits in the US.

1.10 Financial flows involving the other eight jurisdictions are broadly equal in total to those recorded for Switzerland.

Significance to the UK

1.11 The significance of the nine jurisdictions to the UK arises from financial flows between them and the UK, and the reputational and financial risks resulting from the UK's responsibility for ensuring the good governance of the Crown Dependencies and Overseas Territories (including meeting international standards) and representing their interests in international fora.

Financial flows

1.12 The UK has consistently been the net recipient of funds flowing through the banking system from the nine jurisdictions, with large regular inflows from the Crown Dependencies partly offset by net outflows to the Cayman Islands.

1.13 The Crown Dependencies make a significant contribution to the liquidity of the UK market. Together, they provided net financing to UK banks of $332.5 billion in the second quarter of calendar year 2009, largely accounted for by the 'up-streaming' to the UK head office of deposits collected by UK banks in the Crown Dependencies.

1.14 Financial flows are also generated by insurance business and fees earned by UK based asset managers, accountants and lawyers. For example, Bermuda insurers and reinsurers reportedly wrote 30 per cent of the 2008 premium at Lloyd's of London, a total of £5.4 billion.

Constitutional relationship

1.15 The UK's constitutional relationship with the Crown Dependencies and Overseas Territories exposes it to reputational risks if, for example, a jurisdiction fails to meet international standards on taxation, financial regulation or fighting financial crime. The UK is also responsible for Gibraltar's compliance with European Union requirements and the financial consequences of any compliance failure might ultimately fall on the UK.

1.16 The UK's degree of financial risk exposure to the other eight jurisdictions varies. There is no track record of the UK providing a subsidy to the Crown Dependencies for crystallised financial risks and no expectation in the Crown Dependencies that the UK would provide financial support should they get into difficulties.

1.17 The UK has, however, taken action in the past to support its Overseas Territories and the National Audit Office has concluded that 'the UK bears the ultimate risk from potential liabilities' arising from the actions of Territory governments[3]. The precise nature of the constitutional relationship (discussed in Annex C and which varies between the jurisdictions) is likely to have a bearing on the degree of financial risk exposure.

1.18 The Foreign and Commonwealth Office (FCO) monitors the Territories' public finances and seeks to mitigate fiscal risk by requiring all the Overseas Territories (with the exception of Gibraltar) to obtain approval by the Secretary of State when seeking to borrow. Borrowing guidelines are set for a number of the Territories which require their respective governments to keep within agreed levels of indebtedness and to maintain a minimum level of liquid reserves.

1.19 The effective operation of this regime is, however, sometimes hampered by the absence of up-to-date and reliable financial data and a consistently proactive approach by the FCO to working with the local governments to ensure that emerging risks are detected early and credible responses developed and implemented.

1.20 The assumption made by some Overseas Territories that there are circumstances in which they should be entitled to financial support may also act as a disincentive to take the difficult decisions that may sometimes be required to meet the objectives of the regime.

1.21 One of the Overseas Territories suggested to the Review that the UK should act as lender of last resort in the event of a shock to a jurisdiction's financial system and economy which was beyond the resources of that jurisdiction to deal with in the short-term. This would be a significant undertaking by the UK and it would be important to ensure that local governments had a strong incentive to put in place and enforce measures to reduce the risk of such circumstances arising.

1.22 If the UK Government wished to explore a loan facility, it would most likely be broadly similar to the kind of facilities that would be available to these jurisdictions if they were eligible for membership of the IMF. The circumstances in which a loan would be provided and the conditionality attached would need to be clear.

1.23 Even if such a facility is not explored, the UK government should discuss and consider governance arrangements with the jurisdictions to ensure that there is a shared understanding

[3] Paragraph 1.1 of the National Audit Office report Foreign and Common Wealth Office, Managing risk in the Overseas Territories , HC 4 Session 2007-2008, 16 November 2007.

of respective responsibilities and expectations. In particular, there is scope to discuss and clarify with the jurisdictions:

- how responsibility for delivering good governance is shared between the jurisdictions and the UK;
- the circumstances (if any) in which the UK might be prepared to provide financial support to a jurisdiction; and
- how risks will be managed to reduce the exposure of the parties.

Managing economic risks

1.24 One way of reducing risks is to ensure that action is taken to improve the resilience of each jurisdiction's economy during periods of economic stress.

1.25 The global economic downturn has tested the resilience of the nine jurisdictions. Although the impact has not been uniform, most have seen public revenue fall below expectations and upward pressure on public spending.

1.26 The negative impact on public revenues has so far been greatest in those jurisdictions where tourism and construction (which is often closely related to tourism) represent a significant proportion of the economy. In some cases, this has combined with a downturn in a jurisdiction's respective financial sector niche.

1.27 The impact has been pronounced in Anguilla, the Cayman Islands and the Turks and Caicos Islands resulting in depleted public sector cash reserves. Bermuda and the British Virgin Islands have also experienced a decline in government income, but the impact has been less severe. Revenues have held up better in the Crown Dependencies and Gibraltar.

1.28 Past economic decisions taken by the local governments in the jurisdictions have inevitably had an impact on their resilience during the downturn. For example, the Crown Dependencies' decision to build up reserves in recent years during a period of rapid economic growth has served to increase their resilience. They had also invested effort in improving the quality of data they obtained, compiled medium-term economic forecasts and 'stress-tested' against economic shocks.

1.29 Decisions taken by some of the Overseas Territories to use increased revenues to raise current and capital public spending, sometimes combined with insufficient attention to data quality and the absence of robust medium-term planning, has left local governments facing difficult short-term choices to restore the public finances. This is clearly illustrated by recent events in the Cayman Islands.

1.30 The lasting impact of the economic downturn will to a large extent depend upon its length and severity. While there is reason to hope that some pressures (particularly on tourism) will ease as the global economy picks up, many of the longer term effects on the financial sector may not have been felt fully as many large financial services firms have yet to implement the results of strategic reviews of their future geographical 'footprint' and product ranges.

1.31 In any event, the global downturn has provided a sharp reminder of the need for some of the jurisdictions to take urgent measures to ensure that robust economic planning and fiscal control measures are in place and observed.

1.32 The UK should satisfy itself that each jurisdiction indeed has a framework capable of identifying and responding to external shocks and encourage local governments to undertake responsible adjustment programmes. Where these programmes are realistic and there is a clear

commitment to take the necessary measures, there is a place for allowing suitably controlled additional public sector borrowing to facilitate adjustment.

1.33 None of the jurisdictions can afford to be complacent. Many of the economic responses to a downturn available to sovereign states are not available to them and the significance of the financial services, construction and tourism sectors in the economies of the majority of the nine jurisdictions combine to suggest the need for a cautious approach to economic planning. Each jurisdiction needs to identify the main changes in the external environment to which it could be vulnerable and plan accordingly.

1.34 Chapter 3 makes a number of recommendations to the jurisdictions which provide benchmark standards against which to review current practice and consider what action might best deliver improved economic resilience and hence sustainability.

1.35 The Review also commends these benchmark standards to the Ministry of Justice and the FCO for the purposes of discharging their oversight of the Crown Dependencies and Overseas Territories respectively. Enactment will not provide a 'quick fix' to current public sector finance problems but should help jurisdictions in their short-term efforts and, importantly, limit the risk of future problems.

The role of tax

1.36 The recommendations in chapter 3 include giving consideration to developing a diversified tax base (where this does not already exist) to maximise sources of revenue to complement measures to increase efficiency in government. Each jurisdiction will need to take its own decisions based on a detailed analysis of its current and future revenue needs.

1.37 Most – if not all – jurisdictions in the developed world seek to make their tax regimes internationally competitive. The jurisdictions would, therefore, also need to consider the impact on their position in this competitive landscape of any decision to broaden the tax base.

1.38 At a practical level, any jurisdiction considering introducing new taxes (or fees) must have the ability to administer them to ensure that they are not avoided. It would be in the UK's interest to provide technical assistance were it requested by a jurisdiction.

1.39 An evaluation of the importance of the Crown Dependencies and Overseas Territories in tax avoidance by UK corporates commissioned by the Review and conducted by Deloitte (see Annex E) should be a useful input into the thinking of any jurisdiction considering tax changes to ensure sustainability.

1.40 As part of that evaluation, Deloitte explored the extent to which the nine jurisdictions' business models depended on tax competition strategies which stood outside the growing international consensus on tax policy norms.

1.41 Deloitte tentatively concluded that the Crown Dependencies and the Overseas Territories were distinguished within the developed world by differentiating themselves from the international consensus, sometimes through tax rates but more often through the absence or near absence of certain forms of taxation. Whilst there were other drivers for doing business in these jurisdictions (including, for example, a stable legal environment and authorities who were responsive to market developments), tax was an important motivating factor.

1.42 Deloitte considered the scope for the jurisdictions moving towards consensus models in the areas of Value Added Tax (VAT) and corporation tax (CT), should local governments wish to consider doing so.

1.43 Deloitte concluded that there was a compelling case for those of the nine jurisdictions which do not already operate VAT or Goods and Services Tax (GST) to consider introducing such

a system to increase the sustainability of their business models by broadening their revenue bases. Deloitte noted that this would be of particular importance for the Overseas Territories should the global trend for reducing reliance on customs duties continue.

1.44 Deloitte also concluded that the Crown Dependencies' industry bases were sufficiently diverse that they had the potential to raise worthwhile levels of revenue from a CT system more aligned with international 'best practice' than the regimes currently in place. By contrast, some of the Overseas Territories' focus on a narrower financial sector niche suggested that the introduction of a broad-based CT would offer less scope for a significant tax take.

1.45 Deloitte concluded that, in any event, the downside of a properly constructed 'best practice' CT system would appear to be relatively limited and would bring the jurisdictions more into the mainstream of the international community. It might also curtail some scope for tax avoidance, but Deloitte estimated that the amount of UK tax avoided by UK corporates using the nine jurisdictions was likely to be significantly lower than estimates produced by previous studies have suggested.

Meeting international standards

1.46 Improved tax transparency is one of three important and inter-related elements of international standards which have been considered by the Review (discussed in chapter 4).

1.47 The principles of transparency and exchange of information developed by the Organisation of Economic Co-operation and Development's (OECD) Global Forum have been endorsed by countries around the world. The G20 London Summit in April 2009 continued the push to implement the minimum standard of each jurisdiction signing at least 12 tax information exchange agreements (TIEAs) with other countries that would allow the latter to obtain information about income earned by their taxpayers outside of their home jurisdiction.

1.48 This renewed international focus on tax transparency encouraged leading international financial jurisdictions such as Switzerland and Singapore to commit to the standard for the first time.

1.49 By the G20 meeting in April 2009, the Crown Dependencies were all considered to have 'substantially implemented' the agreed standard. Bermuda, the British Virgin Islands, the Cayman Islands and Gibraltar have subsequently also 'substantially implemented' the standard, with the remaining two jurisdictions making progress towards it.

1.50 It is anticipated that standards in this area will continue to rise and even those of the nine jurisdictions within the scope of this Review that have met or exceeded the current standard of 12 TIEAs should continue to enter further agreements with relevant countries. This imperative is well understood and it is appropriate that the commitment to tax transparency shown by a number of the jurisdictions has been recognised in statements by the UK Government.

1.51 The nine jurisdictions must show a commitment not just to the letter but also the spirit of international standards. Effective implementation will be an important test of this and evidence will be provided by the OECD's Global Forum through a monitoring and peer review process. It is vital that competitor jurisdictions show the same commitment.

1.52 In the longer term, the trend for greater transparency is likely to result in pressure to move to a system of automatic exchange of information with the aim of combating tax evasion by individuals on a cross-border basis. This is already the objective under the European Union Savings Directive (EUSD) agreed in 2003, although some EU Member States have taken advantage of a transitional arrangement to instead levy a withholding tax on interest payments of 20 per cent (increasing to 35 per cent in July 2011). There is, however, pressure to remove

the withholding tax option and a proposal to apply the EUSD to a broader range of savings income.

1.53 The Crown Dependences are outside the EU but participate in the EUSD framework under Savings Agreements with the Member States. The Crown Dependencies apply the transitional withholding tax option, which under their Savings Agreements they must give up in favour of automatic exchange of information when the three Member States applying withholding tax move to automatic exchange.

1.54 The Isle of Man has committed to moving to automatic exchange of information by July 2011. Guernsey is reviewing its position and Jersey has said that it is ready to introduce automatic exchange of information as soon as the EU brings the transitional period to an end. The Review encourages both jurisdictions to announce a firm date for a move to automatic exchange. At the same time, the UK should call on all EU Member States and third party countries which currently apply the withholding tax option to also make a similarly firm commitment.

1.55 Of the Overseas Territories, Gibraltar is directly subject to the EUSD and in most cases applies automatic exchange. Anguilla and the Cayman Islands have adopted the EUSD and apply automatic exchange. The British Virgin Islands and the Turks and Caicos Islands have adopted the withholding tax option. Again, the Review encourages all the Territories within the scope of this Review to commit to moving to automatic exchange.

1.56 During the course of the consultation, a number of NGOs raised concerns about the extent to which international standards still permit a lack of transparency in the ownership of corporate vehicles in the jurisdictions. This, they feared, facilitated financial crime (including tax evasion).

1.57 The Review shares these concerns (which are discussed in chapter 7), but such transparency issues also arise to a greater or lesser extent in most major jurisdictions.

1.58 The G20 recognised the need to prioritise work to strengthen standards on customer due diligence, beneficial ownership and transparency at its meeting in Pittsburgh in September 2009.

1.59 Although attractive in principle, action by the UK and the nine jurisdictions ahead of changes to international standards would be likely to result in a loss of business to other jurisdictions rather than a resolution of the underlying concerns. The Review has therefore concluded that the UK should take the lead internationally in encouraging improvements to:

- ‘know your customer’ international minimum standards (particularly in respect of the role of ‘eligible introducers’);
- the monitoring of ‘politically exposed persons’ (PEPs); and
- the transparency of beneficial ownership of companies and trusts.

1.60 The third aspect of international standards that was of particular concern to the Review was raising regulatory standards in the financial sector and on measures to tackle financial crime (discussed in chapters 5 and 7 respectively). Reviews by the International Monetary Fund and the Financial Action Task Force have been critical components of a long-standing attempt to raise international standards in these areas. The Review drew heavily on work done by these bodies which was followed up in discussions with the jurisdictions concerned.

1.61 The majority of the jurisdictions have a good story to tell though, as minimum standards continue to rise, there is no room for complacency. Others have more to do.

1.62 Action by some of the Overseas Territories to improve governance arrangements within their regulator (in part by recruiting external experts to the board), and to separate responsibility

for promotion from the regulator in both letter and spirit, may present relatively quick improvements.

1.63 Increasing the quantum and expertise of resources available to the Financial Services Commissions in Anguilla and the Turks and Caicos Islands to bring them up to international standards may take longer. These jurisdictions must, however, explain how and when they will provide these resources. Delivering these commitments is a necessary condition if these jurisdictions wish to continue to offer themselves as international financial services centres.

1.64 At a domestic level, the Review identified several jurisdictions containing locally owned banks which are large in the context of the local economy. Problems in any of these banks could cause significant economic disruption and might lead to requests to the UK Government for liquidity or capital assistance to avoid it. The Review offers a recommendation in chapter 6 on how the risk of such disruption crystallising might be kept to a minimum.

1.65 Anguilla, the British Virgin Islands and the Turks and Caicos Islands recognise that the technical and human resources to fight financial crime also need to be boosted. Bermuda must also remain focussed on continuing to address deficiencies in its approach to tackling financial crime identified in the IMF's Review published in October 2008. Gibraltar and the Isle of Man have more to do to improve compliance with the FATF's 'key and core' recommendations in particular.

1.66 The priority in the fight against financial crime is to provide human and technical assistance to those jurisdictions most in need of it. This must, however, be accompanied by a clear commitment from the local government to tackling financial crime by ensuring that legislation keeps pace with developments and gives both the regulator and the investigating authority the powers they need to detect and prosecute financial crime. The local government must also make a commitment to fund the provision of sufficient resources to secure the benefits of the technical assistance they receive. Again, this is a necessary condition for these jurisdictions continuing to operate as international financial services centres.

1.67 Where such commitments are forthcoming, the UK should discuss with the relevant jurisdictions what mechanisms might be put in place to deliver them in practice. One option would be to establish a unit, recognised by both the jurisdictions and the UK, whose functions might include quality assurance to ensure that the full benefits of technical assistance are secured on a long-term basis. These discussions could also be extended to those jurisdictions which are not in need of immediate technical assistance to discuss how they might contribute to and benefit from any such unit.

1.68 In summary, some of the jurisdictions have consciously chosen to move ahead of the pack of their international rivals and raise their standards further and faster than the minimum international standards now required. It is important that those that move swiftly are seen to benefit from improved international acceptance. It is crucial that international political pressure is maintained on key competitors as the absence of co-ordinated action would generate arbitrage opportunities and encourage a shift of business away from jurisdictions which have met international standards.

Dealing with the retail sector

1.69 Two issues in this area were brought to the Review's attention during the consultation process.

1.70 First, a growing number of the jurisdictions have, or plan to have, a deposit protection scheme for retail bank deposits. Sensibly, those that have introduced such schemes have recognised that the jurisdiction must not face a potentially unlimited liability and that the banks there will also not accept such a commitment. The result has been that some jurisdictions have

capped the aggregate amount of compensation that can be paid in any given period. Chapter 6 provides some observations on the risk of confusing depositors to which this may lead.

1.71 Second, in the Crown Dependencies, where UK nationals (often 'ex-pats') purchase many financial products, one important element of consumer protection in the UK is typically missing. Only in the case of the Isle of Man does an Ombudsman complaints scheme exist along the lines of that in the UK. The jurisdictions should consider whether such a scheme is justified.

Recommendations

1.72 The following chapters consider in more depth the issues discussed in this overview. For ease of reference, the main recommendations made are set out below.

1. The UK should discuss and consider governance arrangements with the jurisdictions to ensure that there is a shared understanding of respective responsibilities and expectations.

2. The quality and extent of financial planning in the jurisdictions should be aligned with that in the best performers (the Crown Dependencies). In particular, jurisdictions should implement a prudent approach to managing government finances by developing: a diversified tax base to maximise sources of revenue; mechanisms to measure and control public spending; and by building financial reserves during periods of economic growth.

3. The UK should be proactive in satisfying itself that the Overseas Territories in particular have frameworks capable of identifying and responding to external shocks and encouraging local governments to undertake responsible adjustment programmes where these are necessary.

4. To meet international standards, jurisdictions which have not already done so should:

- meet the international standard on tax transparency set by the OECD and continue, even after meeting the current minimum of 12 TIEAs, to negotiate further TIEAs, giving priority to those jurisdictions with which they have significant financial links;
- set up the administrative procedures necessary to ensure full delivery of the OECD standard, to a level of compliance that will satisfy the peer review process that is being put in place;
- make an early commitment, with a timetable for implementation, to automatic exchange of tax information under the EU Savings Directive;
- ensure that the regulatory authorities have the necessary resources and expertise to implement and enforce international financial sector regulatory standards;
- move to amend laws and procedures as necessary to achieve compliance with the FATF 16 'key and core' Recommendations.

5. At an international level, the UK should press for improvements in 'know your customer' minimum standards and promote moves towards improved transparency of beneficial ownership of companies and trusts and the monitoring of politically exposed persons.

6. All jurisdictions should ensure that:

- governance arrangements in their regulatory authorities are sufficient to maintain the integrity and independence of all decisions taken;
- responsibility for promotion of the financial centre is separated from the regulator in both letter and spirit.

7 Those jurisdictions that offer (or propose to offer) protection to retail depositors must ensure that compensation schemes can be understood by those depositors.

8 Jurisdictions that lack an Ombudsman scheme should consider whether one is justified.

9 Any jurisdiction that has not already done so should undertake a thorough examination of the range of powers to resolve a crisis in its financial services sector.

10 Local governments should require the regulator to maintain close oversight of any large locally incorporated financial institutions, the failure of which might lead to requests for financial help from the UK. This should be backed by the option of a periodic independent and external review, paid for by the institution itself, commissioned by the local authorities on their own initiative or at the request of the UK.

11 The UK should discuss with those jurisdictions in need of technical assistance to fight financial crime how that assistance might be delivered and the benefits of assistance secured in the longer-term.

2 Financial flows

Introduction

2.1 Many offshore financial centres are closely integrated into global financial services markets. Financial flows are generated by activities that are booked and often carried out in offshore financial centres such as banking, fund management and insurance business. Whilst on an individual basis most offshore centres account for only a small share of global financial flows, some have developed niche positions which give them a significant international profile.

2.2 This chapter examines:

- the international significance of the nine jurisdictions within the scope of this Review both in terms of their niche positions and financial flows through the banking system;
- the significance of the nine jurisdictions to the UK in terms of financial flows between them and the UK; and
- discusses evidence provided to the Review on other income that accrues to the UK from the financial service sectors in these jurisdictions.

International significance

2.3 Many of the jurisdictions have developed important niche positions in international financial markets which underlines the need for each jurisdiction to meet international standards. But to understand the relative importance of these jurisdictions in global financial markets also requires an analysis of financial flows.

Box 2.A: Niche positions in international financial markets

- Bermuda is the third largest centre for reinsurance in the world and the second largest captive insurance domicile. It is the leading non-United States supplier of reinsurance to US insurers and reportedly wrote 30 per cent of the 2008 premiums at Lloyds of London (a total of £5.4 billion).
- The Cayman Islands are the world's leading centre for hedge funds and also a significant wholesale banking centre, with high volumes of overnight banking business from the US.
- The British Virgin Islands are the leading domicile for international business companies, with much business coming from the Far East in addition to strong links with the US.
- Gibraltar offers a gateway to the European single market.
- The Crown Dependencies provide a gateway to route funds to other financial centres, including London; and they also service the financial needs of many UK nationals living abroad.

International financial flows

2.4 International financial flows through the banking system are captured on a point in time basis by data collected by the Bank of International Settlements (BIS). Banks in 42 jurisdictions[1] ('BIS reporting banks') report the claims they have on individuals and entities located in specific jurisdictions. Most claims are in the form of loans made by banks to these individuals and entities.

2.5 The same banks also provide data on their liabilities. Most liabilities are in the form of deposits placed with the banks by individuals and entities located in other jurisdictions.

2.6 By way of example, the data shows that at the end of 2008 banks in the other 41 BIS reporting jurisdictions had claims of just under $5.3 trillion on individuals and entities located in the US and liabilities of just over $4.0 trillion to individuals and entities in the US. So, in broad terms, loans made to residents in the US exceeded deposits made by US residents with banks in other countries by $1.3 trillion.

2.7 The BIS classifies about 20 centres as being 'offshore', including eight of the jurisdictions within the scope of this Review[2]. The Review has made one small amendment by classifying the Turks and Caicos Islands as an offshore centre, rather than, as in the BIS data, part of the Latin America/Caribbean region.

Claims on offshore centres

2.8 Cross-border financial flows into the offshore financial centres, as measured by claims by BIS reporting banks on individuals and entities resident in them, amounted to $3.6 trillion at the end of the fourth quarter of 2008. Chart 2.A shows each offshore centre's percentage share of this total.

[1] There are 42 BIS reporting countries – Australia, Austria, Bahamas, Bahrain, Belgium, Bermuda, Brazil, Canada, Cayman Islands, Chile, Chinese Taipei, Cyprus, Denmark, Finland, France, Germany, Greece, Guernsey, Hong Kong SAR, India, Italy, Ireland, Isle of Man, Japan, Jersey, Luxembourg, Macao SAR, Malaysia, Mexico, Netherlands, Netherlands Antilles, Norway, Panama, Portugal, Singapore, South Korea, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States

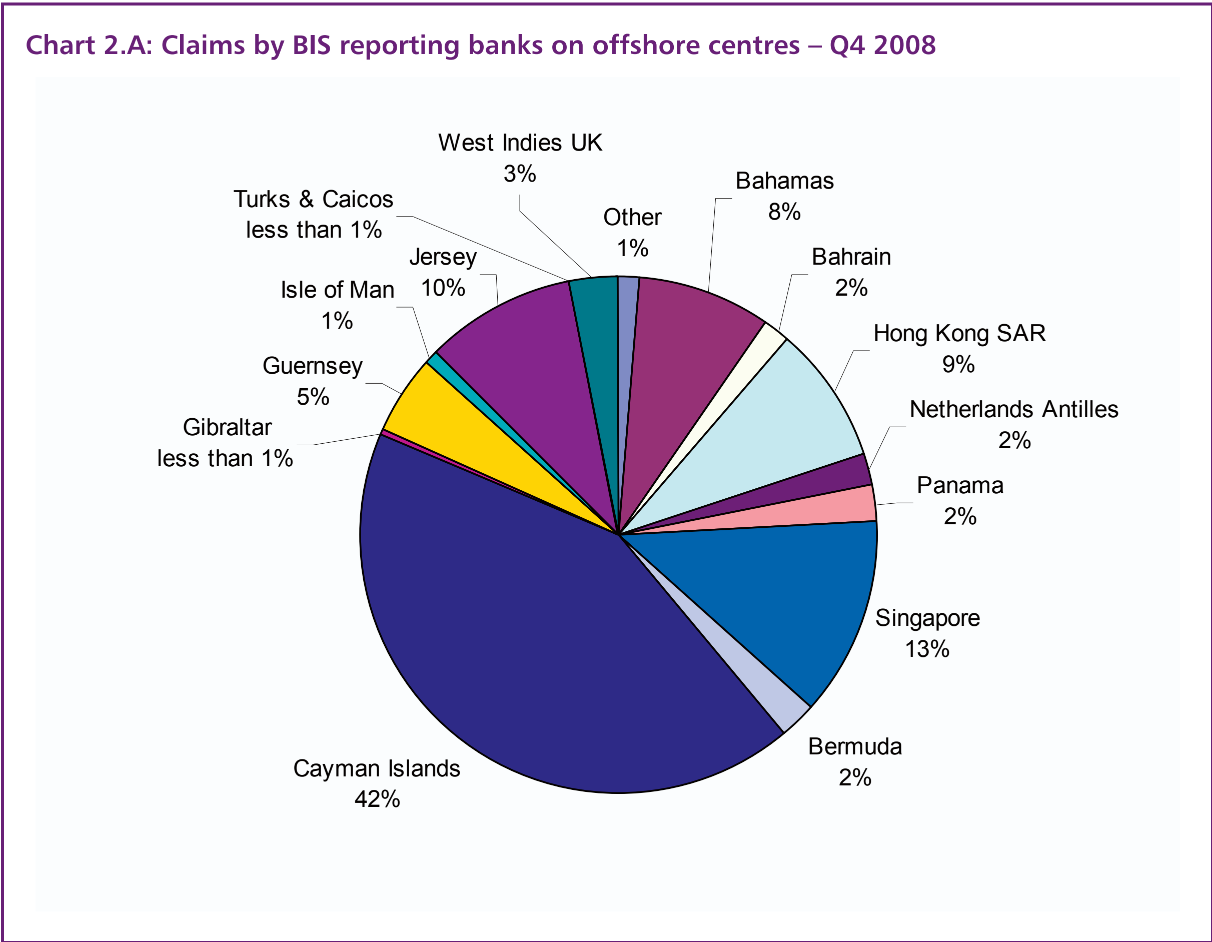
[2] BIS defines the following jurisdictions as offshore centres: Aruba, Bahamas, Bahrain, Barbados, Bermuda, Cayman Islands, Gibraltar, Guernsey, Hong Kong SAR, Isle of Man, Jersey, Lebanon, Macao SAR, Mauritius, Netherlands Antilles, Panama, Samoa, Singapore, Vanuatu and West Indies UK. West Indies UK includes Anguilla and the British Virgin Islands plus four other jurisdictions.

2.9 The aggregate claims by BIS reporting banks on the nine jurisdictions covered by this Review amounted to $2.3 trillion at the end of the fourth quarter of 2008, about 63 per cent of the total claims on all offshore centres. The balance of around 37 per cent was primarily accounted for by claims on Hong Kong, Singapore and the Bahamas.

2.10 BIS reporting banks' claims on the Cayman Islands at the end of 2008 amounted to $1.5 trillion, about 42 per cent of the total. This was higher than any other offshore centre and inflated by the long-standing consequence of US Federal Reserve regulations. Since 1933, the US Federal Reserve has not allowed the payment within the US of interest on overnight (demand) deposits. One result has been that US banks and other residents have routed such deposits through the Cayman Islands, where interest can be paid. It is not possible to estimate precisely the total size of this effect but it may account for more than one-third of the banking funds being placed through the Cayman Islands at any point in time.

2.11 Of the remaining eight jurisdictions within the scope of this Review, all but Guernsey and Jersey had a 3 per cent share or less of the total claims.

Chart 2.A: Claims by BIS reporting banks on offshore centres – Q4 2008



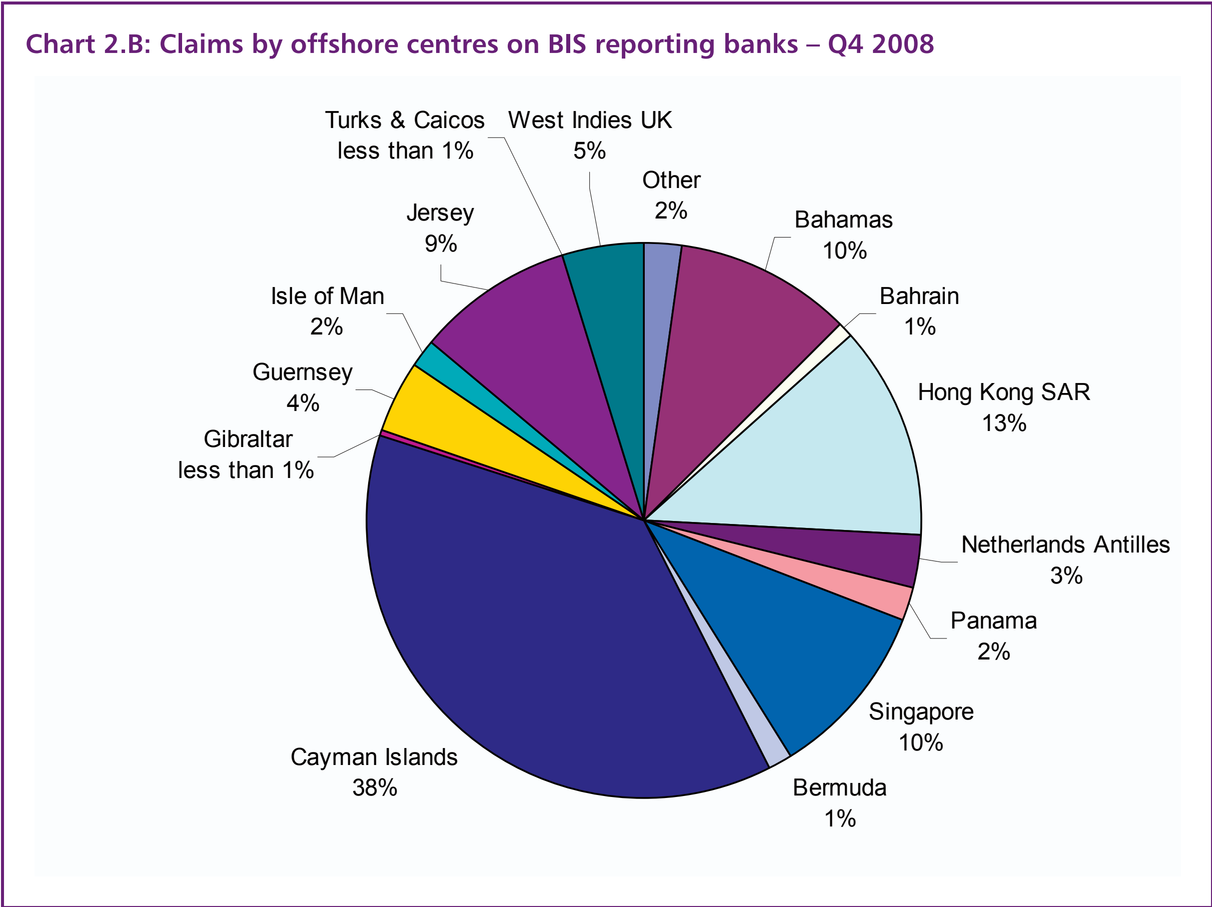
Claims by offshore centres

2.12 Cross-border financial flows from the offshore financial centres to banks in other BIS reporting countries, as measured by claims on individuals and entities resident in other BIS reporting countries, amounted to $4.8 trillion at the end of 2008. Chart 2.B shows each offshore centre's percentage share of this total.

2.13 The nine jurisdictions within the scope of this Review had claims of around $2.8 trillion, some 58 per cent of the total. Again, a significant element was represented by claims from the Cayman Islands ($1.8 trillion or 37 per cent of the total) much of which is likely to be the recycling back to the US of the demand deposits described in paragraph 2.10 above.

2.14 Of the remaining eight jurisdictions covered by the Review, all but Guernsey and Jersey had a 2 per cent share or less of the total.

Chart 2.B: Claims by offshore centres on BIS reporting banks – Q4 2008



A wider comparison

2.15 In summary, the BIS data shows that, excluding the Cayman Islands, financial flows to and from the jurisdictions within the scope of this review are modest within the offshore market. It was, however, suggested to the Review that this comparison would not give a global perspective of the relative importance of the financial centres.

2.16 Undertaking such a wider comparison inevitably requires a selection of other jurisdictions to be made. The Review has chosen Ireland, Luxembourg and Switzerland as three jurisdictions mostly frequently cited during consultations as key competitors of many (but not all) of the nine jurisdictions. Including these competitors in the analysis further illustrates that, in terms of financial flows through the banking system, the importance of the majority of the jurisdictions within the scope of this Review is modest. As Table 2.A shows, financial flows involving eight of the British jurisdictions in aggregate were broadly equal for those recorded for Switzerland at the end of 2008.

Table 2.A: Summary of BIS reporting banks' claims on and liabilities to offshore centres and their 'competitors' at end-2008

	Claims of BIS reporting banks $ trillion	Liabilities of BIS reporting banks $ trillion
Cayman Islands	1.5	1.8
Other 8 British jurisdictions	0.8	1.0
All other 'offshore centres'	1.3	2.0
Ireland	1.2	0.6
Switzerland	0.7	1.2
Luxembourg	1.0	0.9
Total	**6.5**	**7.5**

Significance to the UK

2.17 The Bank of England produces detailed data on the claims by UK banks on the nine jurisdictions covered by this Review and their liabilities to these jurisdictions. This data includes flows between, on the one hand, banks resident in the UK and both banks and non-banks resident in the jurisdictions.

2.18 Claims by banks resident in the UK on banks and non-banks in the jurisdictions (the closest match to the claims numbers quoted in paragraphs 2.8-2.11 above) totalled $413.9 billion at the end of June 2009[3]. The largest claims by banks in the UK were on the Cayman Islands ($243.6 billion) and on Jersey ($95.7 billion).

2.19 Table 2.B below summarises the claims by UK banks on entities in the nine jurisdictions. It shows a rapid increase in balances between 2002 and 2007, followed by a sharp drop after the onset of the financial crisis.

Table 2.B: Claims by UK banks on entities in the nine jurisdictions

	Q2 2009 $billion	Q4 2008 $billion	Q4 2007 $billion	Q4 2005 $billion	Q4 2002 $billion
Bermuda	13.1	16.6	32.2	16.6	7.5
Cayman Islands	243.6	240.2	372.2	228.5	90.9
Gibraltar	4.2	3.6	3.5	2.7	1.4
Guernsey	18.0	18.7	21.9	9.1	6.4
Isle of Man	16.5	14.3	19.1	6.5	4.1
Jersey	95.7	97.7	127.7	78.3	27.3
Turks and Caicos	0.3	0.3	0.1	0.1	0.1
West Indies UK	22.5	27.1	26.2	18.0	8.6
Total	**413.8**	**418.5**	**602.9**	**359.8**	**146.3**

[3] The Bank of England (BoE) defines loans from UK resident banks to non-residents as claims. It includes the reporting institutions' loans and advances to non-residents; claims under sale and repurchase agreements to non-residents; commercial bills and other negotiable paper drawn on non-residents; lending under ECGC special schemes for exports including amounts refinanced; sterling acceptance given on behalf of non-residents; and assets leased out under finance leases and holdings of certain investments outside the UK with an original maturity of one year or more.

2.20 Claims by the nine jurisdictions on banks resident in the UK (the latter's 'liabilities') totalled some $670.9 billion at the end of June 2009[4] (see table 2.C below). The largest creditors were Jersey ($314 billion), Cayman Islands ($172.5 billion), Guernsey ($92.1 billion) and the Isle of Man ($56.6 billion).

2.21 Again, claims rose sharply in most cases between 2002 and 2007 and have fallen back since. The end-June 2009 aggregate figure was around 28 per cent below the level at end-2007.

Table 2.C: Claims on UK banks by entities in the nine jurisdictions

	Q2 2009 $billion	Q4 2008 $billion	Q4 2007 $billion	Q4 2005 $billion	Q4 2002 $billion
Bermuda	16.9	17.4	42.4	17.6	8.5
Cayman Islands	172.5	228.0	316.2	223.1	71.1
Gibraltar	3.5	5.1	8.4	4.7	2.6
Guernsey	92.1	88.0	80.0	53.0	36.4
Isle of Man	56.6	39.2	55.3	32.7	21.7
Jersey	314.0	328.8	407.9	203.1	134.6
Turks and Caicos	0.5	0.5	0.1	0.2	0.1
West Indies UK	14.7	15.9	18.2	13.1	7.5
Total	**670.8**	**722.9**	**928.5**	**547.5**	**282.5**

Net position

2.22 Claims by UK banks on these nine jurisdictions less their liabilities to the nine jurisdictions is a measure of the net financing provided by the jurisdictions to the UK. In aggregate, the UK was a net recipient of funds from the nine jurisdictions of $257 billion at end-June 2009. While this was down significantly from $304.3 billion at end-2008 and $325.6 billion at end-2007, it conforms to the long-standing pattern that the UK has consistently been a net recipient of funds. Much of the decline over the last 2 years in the net position has come from changes in flows to and from the Cayman Islands, which is likely to be connected with the problems of the hedge fund industry over that period.

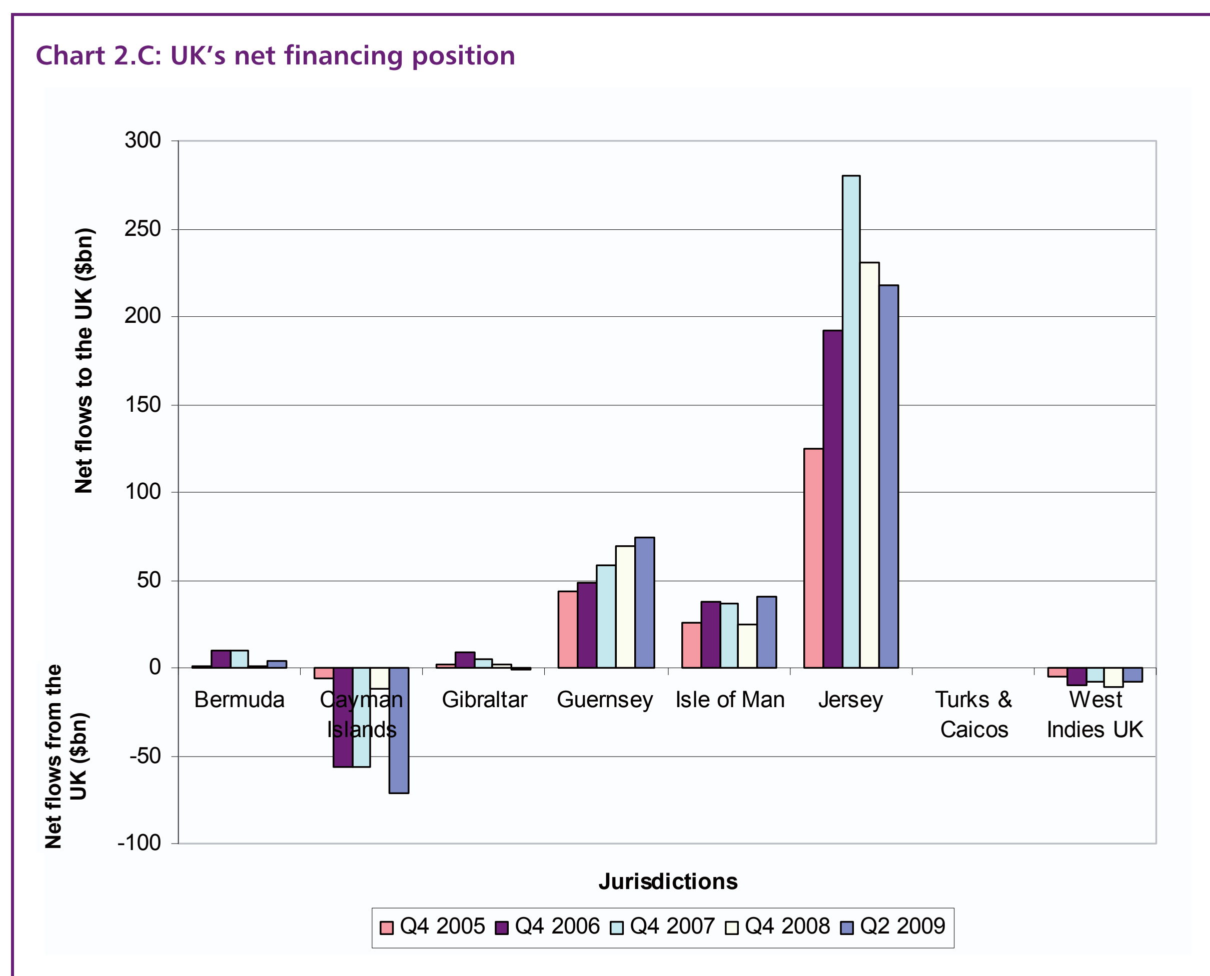
2.23 Typically, UK banks lend net to entities in Cayman Islands and receive a larger volume of funds net from entities in the Crown Dependencies. At end-June 2009, UK banks had net financing of approximately $218.3 billion from Jersey, $74.1 billion from Guernsey and $40.1 billion from the Isle of Man.

2.24 'Up-streaming' allows deposits to be gathered by subsidiaries or branches in a number of different jurisdictions and then concentrated in one centre, in this case the UK, where the bank has the necessary infrastructure to manage and invest these funds. This model is followed by many large banks around the world and is not confined to 'British' jurisdictions. All the major UK clearing banks have significant deposit-gathering capacity in the Crown Dependencies as, of course, did some Icelandic banks up to October 2008.

[4] BoE defines deposits received by jurisdictions as 'UK liabilities'. These comprise deposits and advances received by reporting institutions from non-residents, liabilities arising from acceptances given on behalf of non-residents and certificates of deposit issued in London by reporting institutions and held by non-residents.

2.25 Chart 2.C below provides a summary of the UK's net financing position with the nine jurisdictions.

Chart 2.C: UK's net financing position



2.26 To provide a broader picture, Table 2.D below provides a summary of the UK's financing position with the three 'competitor' jurisdictions identified in paragraph 2.16.

Table 2.D: Summary of net financing position for 'competitor' jurisdictions

	Q2 2009 $billion	Q4 2008 $billion	Q4 2007 $billion	Q4 2005 $billion	Q4 2002 $billion
Ireland	-77.8	-97.5	-134.6	-63.0	-29.9
Luxembourg	-9.9	-18.2	-12.3	-14.3	11.7
Switzerland	8.4	-36.4	137.1	134.2	122.0
Total flows to/(from=-) UK	**-79.3**	**-152.1**	**-9.8**	**56.9**	**103.8**

2.27 Over the period from end-2007 to end-June 2009, Ireland and Luxembourg were consistently the net recipient of funds from the UK, although this net position has decreased from $134.6 billion and $12.3 billion respectively at end-2007 to $77.8 billion and $9.9 billion at end-June 2009. Conversely, the UK has typically been the net recipient of funds from Switzerland ($8.4 billion at end-June 2009, down considerably from $137.1 billion at end-2007).

Other flows of business between the UK and the nine jurisdictions

2.28 During the consultation, the Review was provided with indicative information on other business flows between the UK and the nine jurisdictions.

2.29 Bermuda insurers and reinsurers support the UK's global position as a centre for specialty insurance services through their involvement with the Lloyd's Market. Insurance groups controlled by Bermudian interests reportedly wrote 30 per cent of the 2008 premium at Lloyd's of London, a total of £5.4 billion.

2.30 The Association of Investment Companies (AIC)[5] submitted research they had carried out on fees generated by UK service providers who provide support services to their offshore members.

2.31 The AIC estimated that 108 companies, which they regarded as being investment companies and which are domiciled in the Channel Islands and Isle of Man, paid management fees into the UK of over £300 million a year in recent years.

2.32 Significant UK fund management fee income is also likely to be earned from firms based in jurisdictions such as Bermuda and the Cayman Islands, but aggregate data is not available.

2.33 The Review was also provided with evidence showing the importance of the provision from the UK of auditing and accounting services, tax compliance and transaction advice and legal advice. It is not possible to aggregate this information to provide a central estimate of the annual net total of fees received; but it is clear that the UK professions earn a significant net income from work generated in the jurisdictions.

Conclusions

2.34 In summary, many of the nine jurisdictions covered by this Review have successfully developed niche positions within the global financial services market; but their importance in global terms, as measured by banking flows, is relatively modest.

2.35 Within the offshore market, the nine jurisdictions do account for over 60 per cent of total financial flows. However, this total is significantly inflated by short-term US dollar flows routed through the Cayman Islands in response to prohibitions on the payment of interest on demand deposits in the US. Financial flows involving the other eight jurisdictions in aggregate are broadly equal to those recorded for Switzerland.

2.36 The UK has consistently been the net recipient of funds flowing from the nine jurisdictions, with a large regular inflow from the Crown Dependencies, offset in part by net outflows to the Cayman Islands.

2.37 There are also other significant business flows between the nine jurisdictions and the UK, generated by activities such as asset management. Sizeable net fees are also earned from the provision out of the UK of legal, accounting and other professional services to these jurisdictions.

[5] The AIC represents closed-ended investment companies with shares traded on UK markets.

3 Identifying and managing economic risks

Introduction

3.1 The world is experiencing the worst economic downturn for over 60 years. Economic growth, jobs and government finances have all suffered as a result. The nine jurisdictions covered by this Review are not immune from these impacts, but the extent and severity of the impact has not been uniform.

3.2 The ability of each jurisdiction to deal with these challenges differs and to a large extent has been influenced by the approach to financial planning each has adopted.

3.3 This chapter examines:

- the structure of the economies of the nine jurisdictions;
- the impact of the economic downturn on their respective public finances; and
- the measures which local governments should consider putting in place to improve the resilience of their respective economies during periods of economic stress.

Structure of economies

3.4 The economies in the nine jurisdictions vary significantly in size, with total output ranging from £161 million to £4.3 billion[1] in 2007-2008 (fiscal year ends vary between jurisdictions so direct comparisons should be made with caution[2]). Financial services and tourism are typically major generators of economic output, government revenue and employment. In some jurisdictions, the economy is built almost wholly round these two sectors.

3.5 According to local government statistics, the combined contribution of financial services and tourism to the economy ranges from 35 per cent of gross domestic product (GDP) in Anguilla to 74 per cent in the Cayman Islands. The proportion of government revenue generated by these two sectors is around 50 per cent for the majority of jurisdictions, whilst they account for between 23 per cent and 48 per cent of employment. In the Caribbean, the construction sector is also closely linked to the state of the tourism sector.

[1] The local currency is used for all jurisdictions except Anguilla and the Cayman Islands. The exchange rates used for 2008 are: Anguilla: £1:EC$3.940; US$1:EC$2.70; and the Cayman Islands: US$1:CI$1.2.

[2] Year ends: 31 December: - Anguilla, British Virgin Islands, Guernsey, Jersey; 30 June – Cayman Islands; 31 March – Bermuda, Gibraltar, Isle of Man, Turks and Caicos Islands.

Chart 3.A: Sources of GDP by jurisdiction, 2007-8[3]

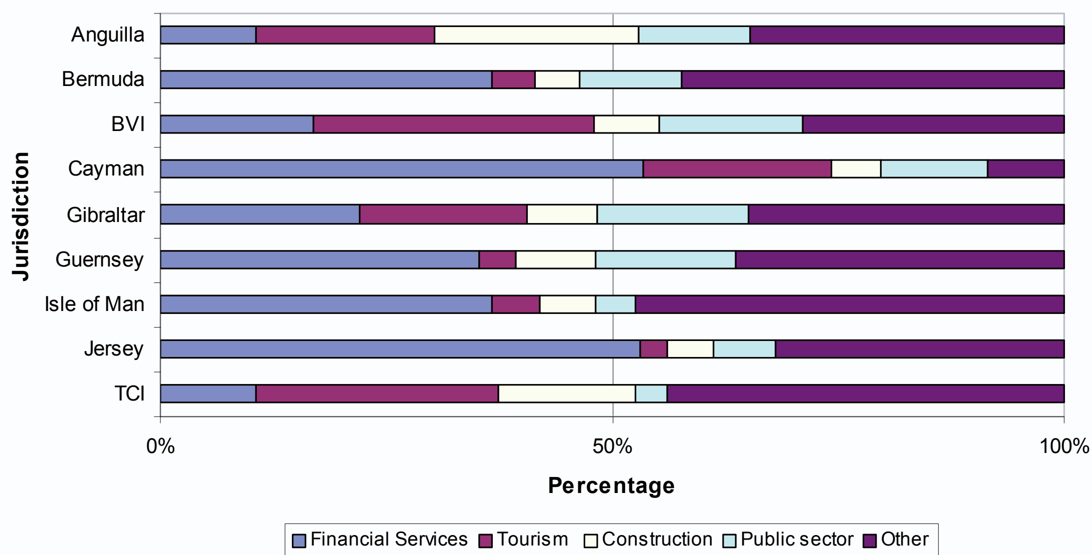
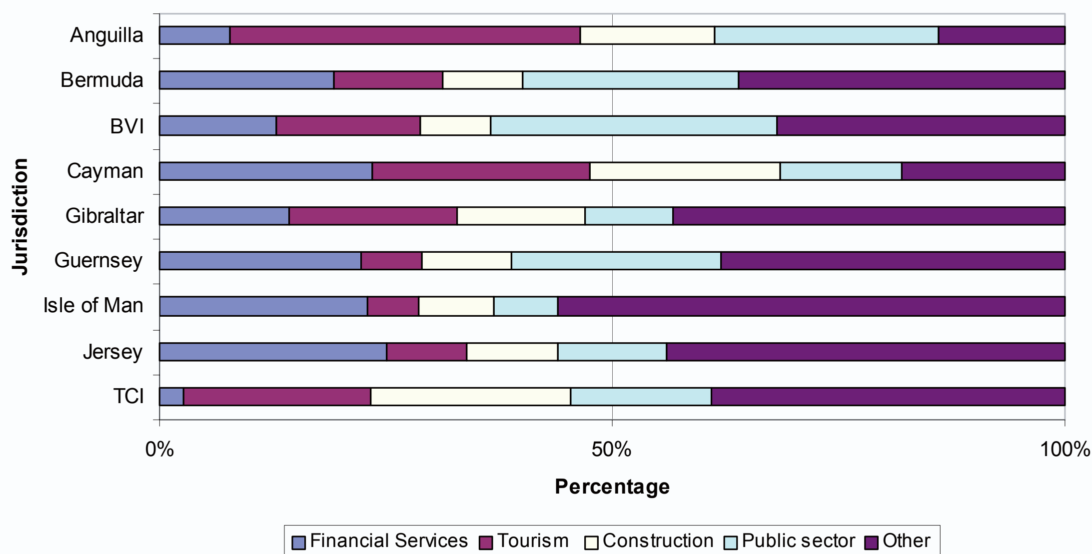


Chart 3.B: Sources of employment by jurisdiction[4]



3.6 Government revenue in the Caribbean Territories[5] and Bermuda is mainly derived from a combination of import duties, financial sector licence fees and other specific charges (including payroll taxes in some of the jurisdictions). There are, however, no taxes levied on income, profits and capital gains, and no sales or value added taxes.

[3] Based on 2007-8 year end official government statistics. Categorisation of sectors is not consistent between jurisdictions and therefore some approximations have been made based on available data. The Cayman Islands sector data is based on the preliminary estimates presented in the inaugural report 'The Cayman Islands' System of National Account 2006-2007.' Estimates are subject to future revisions.

[4] Based on 2007-8 year end official government statistics apart from Anguilla (2001) and British Virgin Islands (2005). Categorisation of sectors is not consistent between jurisdictions and therefore some approximations have been made based on available data.

[5] Defined as Anguilla, British Virgin Islands, Cayman Islands and Turks and Caicos Islands.

3.7 The Crown Dependencies have a wider tax base but the rates of tax charged, on employment income for example, are lower than those applied in the UK. Gibraltar has a fiscal policy closest to the growing international consensus on tax norms identified by Deloitte and discussed in chapter 4.

3.8 Public sector running costs typically account for a significant proportion of government expenditure across the jurisdictions. For example, 43 per cent of government expenditure in the British Virgin Islands in 2008 was on salaries, benefits and pensions for the civil service.

3.9 The concentrated structure of the economies of the majority of the nine jurisdictions leaves them particularly exposed to economic shocks. They also have fewer responses available to them than to sovereign states. Their respective currencies are typically tied to sterling or the United States dollar; and depreciation, even where technically feasible, would be of little or no value given the nature of the jurisdictions' economies. Nor do the jurisdictions have the option of an independent interest rate policy.

Economic growth and employment

3.10 The nine jurisdictions all experienced a period of sustained economic growth between 2004 and 2007. None of the jurisdictions is immune from the impact of the global economic downturn, but the reversal in fortunes has been most pronounced in the Caribbean Territories.

3.11 The economies in the Crown Dependencies have grown strongly in recent years, recording growth of around 5 per cent in real terms. However, all are now forecasting a contraction of their economies or a slowing of growth. Jersey has forecast a decline in real Gross Value Added (GVA) of between 4 per cent and 6 per cent in 2009 and between 1 per cent and 3 per cent in 2010. Growth in GDP is expected to slow in Guernsey to 1 per cent in 2009, while the Isle of Man has forecast real GDP growth of 2.5 per cent in 2009-10, down from 6 per cent growth in 2008-09.

3.12 There have also been increases in unemployment in the Crown Dependencies, though it has generally stayed at relatively modest levels. Guernsey has seen an increase in unemployment from 0.8 per cent at 30 June 2008 to 1.3 per cent at 30 June 2009. There has also been an increase in unemployment in the Isle of Man to 2.3 per cent at 31 August 2009, up 0.7 per cent over a year. Unemployment in Jersey increased from 2.0 per cent in June 2008 to 2.7 per cent in June 2009.

3.13 Gibraltar has also recorded strong growth in recent years and to date appears less affected by the downturn. The Government of Gibraltar estimated in its 2009 budget that growth in GDP to the year ended 31 March 2009 was almost 6 per cent and employment was rising 'to record levels'. This robust position may in part be explained by the fact that Gibraltar has one of the most diversified economies of the nine jurisdictions.

3.14 Real GDP growth in Bermuda averaged 4.4 per cent a year between 2003 and 2007. Official figures recorded a fall of 2.2 per cent in real GDP growth in 2008 and GDP is projected to decline by between 1.0 per cent and 1.5 per cent in 2009. Bermuda has close economic ties to the United States and has been affected by the downturn there. This has been offset by the buoyant insurance sector (Bermuda's major financial sector niche), although there has been a sizeable fall in the number of new insurance companies incorporating in Bermuda, which may reflect the maturity of the market. Employment appears to have held up relatively well in Bermuda, but employment data for 2009 was not available to verify this.

3.15 Growth in the Caribbean economies has been strong in recent years, ranging from average real GDP growth in the Cayman Islands of over 3 per cent to almost 14 per cent in Anguilla in the five year period 2003-7 (according to local government statistics). However, all four jurisdictions are now projecting a slowing in growth or a decline in GDP. Although no precise

forecast is available, the British Virgin Islands expect a contraction in GDP in 2009. The Cayman Islands is forecasting a decline in GDP of 3.3 per cent for 2009, with Anguilla and the Turks and Caicos Islands also likely to experience a contraction.

3.16 The British Virgin Islands have suffered from a synchronised downturn in the tourist sector and a sharp fall in international business company incorporations (the jurisdiction's financial sector niche). New company incorporations were down by 44 per cent between September and December 2008 compared to the same period in 2007 and recorded a year on year fall of around 20 per cent in the first quarter of 2009. The British Virgin Islands do not have up-to-date employment statistics, the most recent available data relates to 2005.

3.17 The picture in the Cayman Islands is more severe with a downturn in tourism coinciding with a decline in the hedge fund industry for which the jurisdiction is the world's leading domicile. New hedge fund launches fell by 18 per cent in 2008 and 10 per cent of all existing funds were terminated (a much higher rate than in previous years). There has also been a marginal increase in estimated unemployment from 5.2 per cent at 30 June 2008 to 5.5 per cent at 30 June 2009.

3.18 Anguilla and the Turks and Caicos Islands have suffered particularly badly from the fall in tourism and construction. Anguilla is forecasting a decline in GDP of 8.2 per cent in 2009, but does not have up-to-date unemployment statistics. The Turks and Caicos Islands do not have GDP forecasts or up-to-date unemployment statistics available.

Impact on public finances

3.19 The global downturn has also had an impact on the public finances of the jurisdictions. As with GDP, the impact has not been uniform. Most of the nine jurisdictions have, however, seen public revenue fall below expectations and upward pressures on public spending.

3.20 Past economic decisions taken by the local governments in the jurisdictions have inevitably had an impact on the resilience of the public finances during the downturn. Decisions taken by some of the Overseas Territories to use increased revenues during a period of growth to raise current and capital spending has left governments now facing difficult short-term choices.

3.21 Chart 3.C. illustrates the fiscal deficits/surpluses for the past two years and forecast for the fiscal year 2009-10. Chart 3.D illustrates the percentage increases (actual and forecast) in outstanding government debt for each jurisdiction over the same time period. Although direct comparisons between all nine jurisdictions are not possible because of the inconsistency in time periods (and variation in the reaction time of the economies to the downturn), general trends in the data can still be observed.

3.22 The Crown Dependencies are all forecasting a decline in government revenues. The Isle of Man has forecast a fall in total tax receipts of 4.5 per cent for the 2009-10 fiscal year against the prior year but expects a modest budget surplus of £0.2 million.

3.23 Guernsey has also budgeted for a downturn in revenues for 2009, but is again forecasting a modest budget surplus of £9 million. Jersey has, however, forecast deficits of £63 million in 2010 and £72 million in 2011 based on their central economic forecasts.

3.24 Guernsey and Jersey have both experienced, and are continuing to forecast, a decline in revenue following changes to the structure of business taxation. It was announced on 14 October 2009, however, that these two jurisdictions had agreed to work together to comprehensively review their fiscal strategies.

Chart 3.C: Fiscal surplus/deficit as percentage of GDP, 2007-8 to 2009-10[6]

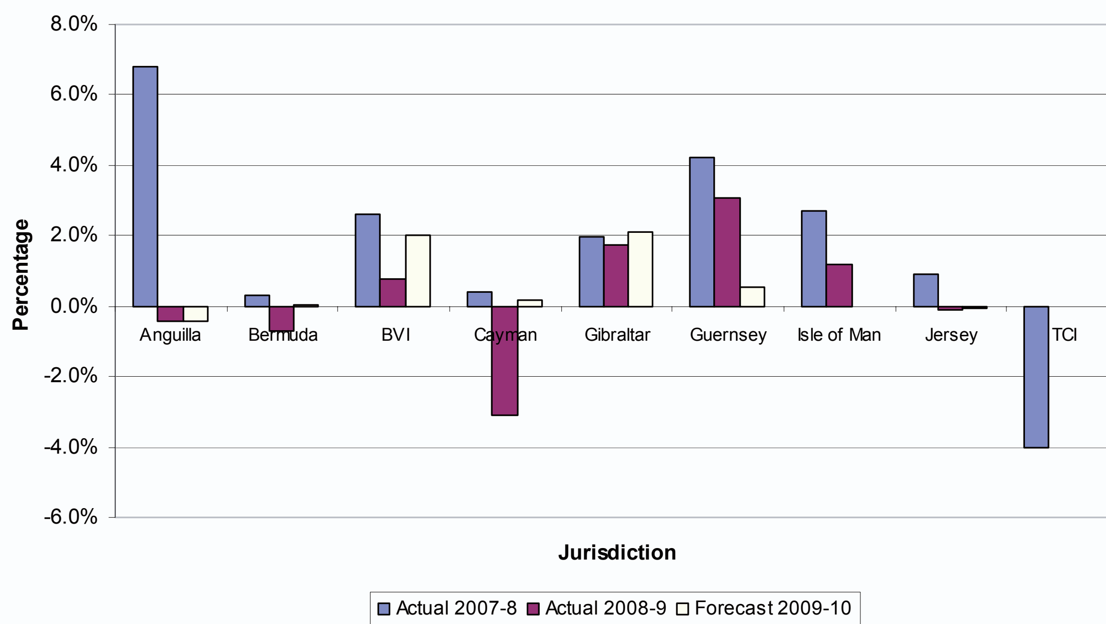
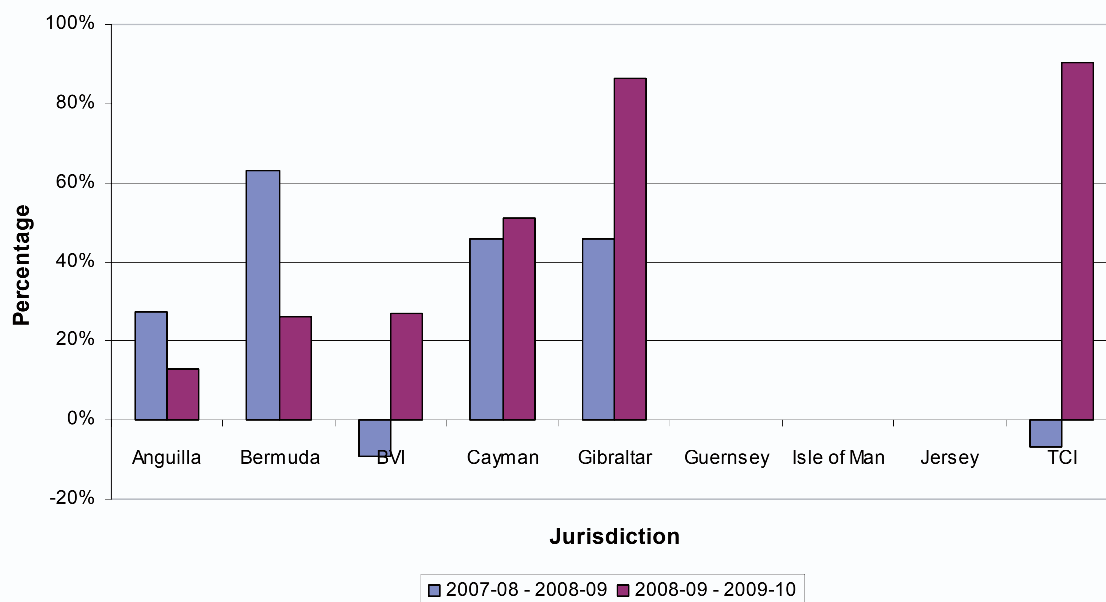


Chart 3.D: Percentage increase in borrowing by jurisdiction, 2007-8 to 2009-10



3.25 None of the Crown Dependencies have, however, taken on significant levels borrowing. This is a measure of the economic resilience achieved by pursuing a policy of building up reserves during a period of rapid economic growth to provide a cushion during a downturn. The

[6] The Turks and Caicos Islands do not have actual outcomes for the 2008-9 fiscal year or forecast data for the 2009-10 fiscal year. The figures for Jersey are expressed as a percentage of GVA.

reserves range from £582 million (at 31 December 2008) in Jersey to £221.3 million (at 31 December 2008) in Guernsey. The reserve fund in the Isle of Man stood at £337 million at 31 March 2009.

3.26 There is also evidence that the Crown Dependencies are taking further action to help combat the effect of reduced revenues. For example, Jersey has identified savings of £17 million in its 2010 Business Plan, whilst also implementing a public sector pay freeze.

3.27 Gibraltar has recently reported an overall budget surplus of £15 million to the year ended 31 March 2009 and has forecast a surplus of £19 million for the year ending 31 March 2010. However, total borrowing is forecast to grow to £350 million for the year ended March 2010, an increase of more than 80 per cent from 2009. This is partially offset by a forecast increase of reserves over the same period to £234 million in 2010 from £129 million in 2009. Net public debt is therefore forecast to increase by 86 per cent from £62.2m (or 7.3 per cent of GDP) in 2009 to £115.8m (or 12.9 per cent of GDP) in 2010.

3.28 Bermuda recorded a modest deficit in fiscal year 2008 and had limited borrowing totalling about 6 per cent of GDP. For the year ended 31 March 2009, the Government of Bermuda recorded a total deficit of around 4 per cent of GDP which was financed by additional borrowing that left total borrowing at around 10 per cent of GDP. Spending in most government departments is planned to reduce by 10.5 per cent in the 2010 fiscal year.

3.29 The downturn in fee income from international business company incorporations has contributed to the deterioration in the public finances in the British Virgin Islands. The national debt increased by 27 per cent to $102.4 million in 2009 and annual debt servicing obligations have grown by 34.6 per cent since 2008. Revenue is forecast to decline by 5 per cent in 2009 compared with the previous year.

3.30 The impact on the public finances in the Cayman Islands has been particularly severe. The Government has recently reported a budget deficit of $67.6 million at 30 June 2009 (compared with a small surplus in the prior year). As Chart 3.D illustrates, central government debt increased significantly on the 2007-8 fiscal year and is forecast to rise again by a further 51 per cent in 2009-10.

3.31 The Cayman Islands Government has acknowledged that the state of the public finances is 'severely challenged'. The principles of responsible financial management contained in the Public Management and Finance Law were not satisfied at the start of the financial year (1 July 2009), removing the option for the local government to increase borrowing without seeking the approval of the Foreign and Commonwealth Office (FCO) in the UK[7]. However, in return for increases in current revenue measures (forecast to bring in additional income of $105.3 million) announced in the latest 2009-10 budget, the FCO has agreed to an increase in government borrowing. The Cayman Islands Government has forecast that it will be fully compliant with all the principles of responsible financial management, despite resisting calls for a widening of the tax base.

3.32 The Government of Anguilla has not confirmed its current fiscal position. However, the latest data available to the Review show that government revenue was 15 per cent below budget during 2008 and a budget deficit in excess of the $5.7 million forecast for 2009 is in prospect (the deficit was $11.9 million at 31 August 2009). If realised, the Government's financial reserves, which totalled $13.5 million in December 2008, would be exhausted by the end of 2009. Anguilla's problems were compounded by a decision to increase public service pay by 25 per cent in September 2008. (Public service pay was subsequently cut by 10 per cent from

[7] See Annex D for an explanation of the FCO's borrowing guidelines.

July 2009.) Anguilla has pressed for an increase in government borrowing, adding to existing debt that totalled just over 25 per cent of GDP in September 2008.

3.33 The public finances of the Turks and Caicos Islands have also deteriorated significantly. The fiscal year 2007-8 was forecast to produce a small surplus but actually produced a deficit of $35.7 million; the true deficit may be higher. Government reserves have been exhausted and unpaid creditors were owed at least $50 million at 30 June 2009.

Improving economic resilience

3.34 The lasting impact of the economic downturn will to a large extent depend upon its length and severity. While there is reason to hope that some pressures (particularly on tourism) will ease as the global economy picks up, many of the longer term effects on the financial sector may not have been felt fully as many large financial service firms have yet to implement the results of strategic reviews of their future geographical 'footprint' and product ranges. In individual cases, these reviews could bring additional employment (where, for example, a financial institution chooses to reduce the number of its international operations and concentrates more work in one of the jurisdictions). However, overall the reviews are likely to lead to a net loss of employment across the jurisdictions over time.

3.35 In any event, the global downturn has provided a sharp reminder of the need for some of the jurisdictions to take urgent measures to ensure that robust economic planning and fiscal control measures are in place and observed.

3.36 The Review has identified a number of benchmark standards which will not provide a 'quick fix' to current public sector finance problems but which, if enacted, should help jurisdictions in their short-term efforts and, importantly, limit the risk of future problems.

Box 3.A: Benchmark standards

- Timely and accurate measurement of economic variables including public revenues and public expenditure.
- Effective measures to control public spending and improve public sector efficiency.
- Identification of options to maximise sources of revenue, including diversifying the tax base.
- Building sufficient reserves to improve economic resilience.
- Medium-term economic planning (ideally with independent input) to support the fiscal planning process.

3.37 The measurement and planning of economic variables, government revenues and government expenditure and the interpretation of the resulting data are fundamental to effective economic management. The absence of timely and reliable data and of the expertise to analyse trends will limit a government's ability to forecast, plan and take well-targeted action as has been seen in some of the Overseas Territories.

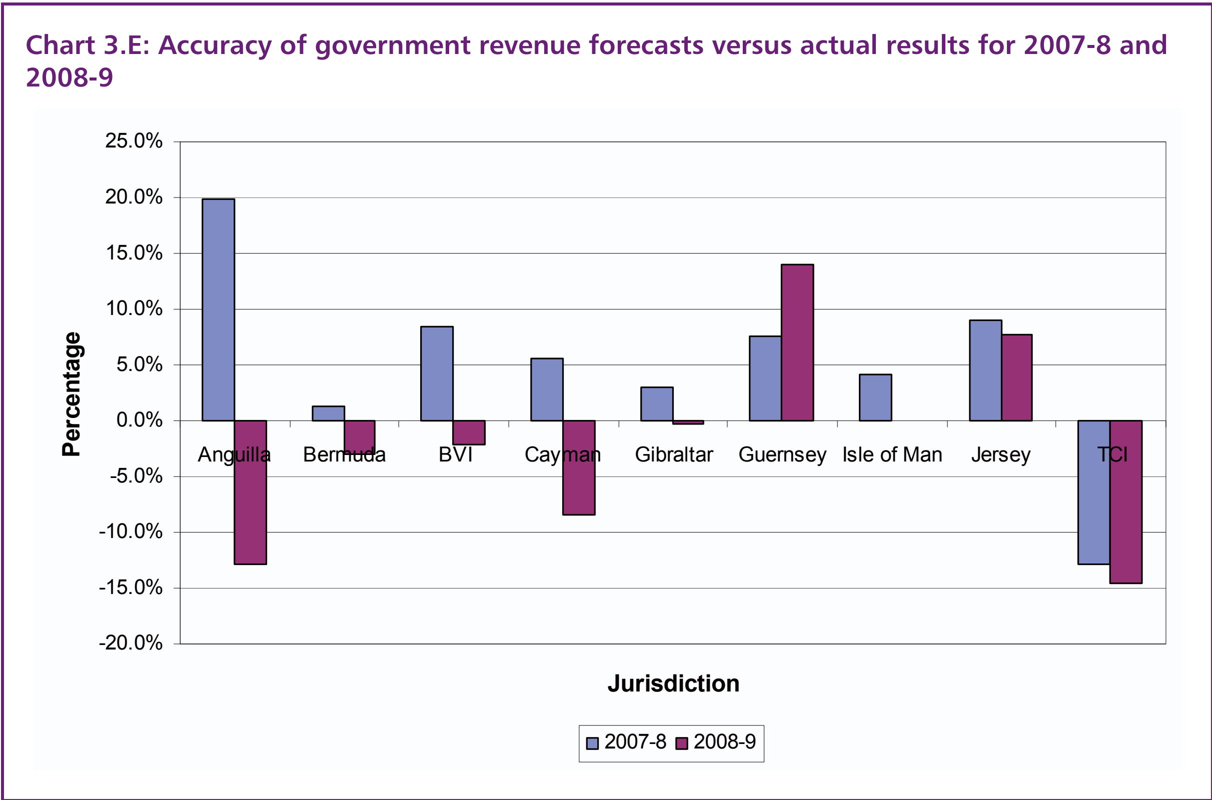
3.38 Weaknesses in data quality have been recognised is some cases. For example, the British Virgin Islands have commissioned an economic impact study better to understand the internal and external contributions of the financial services industry. However, more needs to be done to improve the timeliness and accuracy of economic and financial information. Ensuring that annual accounts for government finances are independently audited on a timely basis and made publicly available would complement efforts in this area.

3.39 Weaknesses in medium-term planning must also be addressed and the **Crown Dependencies** provide examples of good practice in this area. Each has built-up economic analytical capacity, sometimes involving the use of a panel of external advisors to enhance objectivity. Medium-term scenarios and possible stresses for the economy are produced as an integral aid to economic planning in several jurisdictions.

3.40 The **Crown Dependencies** had a better track record than other jurisdictions in forecasting future budget positions. This is illustrated in Chart 3.E, which compares forecast and actual government revenue in 2007-8 (when economic conditions were still relatively good) and 2008-9 (when conditions were worsening). Any inferences must be made with caution because the downturn was more severe in some jurisdictions than others.

3.41 However, all the governments (apart from the Government of the **Turks and Caicos Islands**) underestimated their revenue takes for the financial years 2007-8[8], when the global economic upturn was nearing an end. Once the global economic downturn began, there appeared to be clear differences in forecasting ability (as illustrated by the year ends 2008-9[9]). Forecasts produced by the **Crown Dependencies** and **Gibraltar** were on target or underestimated the actual revenue takes. In contrast, all the **Caribbean Territories** and **Bermuda** overestimated their revenue takes during this period, though in some cases by small amounts.

Chart 3.E: Accuracy of government revenue forecasts versus actual results for 2007-8 and 2008-9



Conclusions

3.42 The benchmark standards outlined above will only bear fruit if those local governments that have not already done so demonstrate a clear commitment to improving economic management. This is their primary responsibility.

3.43 However, the UK's interest in the good governance of the jurisdictions means that the UK should satisfy itself that each jurisdiction indeed has a framework capable of identifying and responding to external shocks and encourage local governments to undertake responsible

[8] For these purposes, this sample includes results for the year ends 31 December 2007, 31 March 2008, and 30 June 2008.
[9] For these purposes, this sample includes results for the year ends 31 December 2008, 31 March 2009, and 30 June 2009.

adjustment programmes. Where these programmes are realistic and there is a clear commitment to take the necessary measures, there is a place for allowing suitably controlled additional public sector borrowing to facilitate adjustment.

Recommendations

The Review recommends that:

- the quality and extent of financial planning in the jurisdictions should be aligned with that in the best performers (the Crown Dependencies). In particular, jurisdictions should implement a prudent approach to managing government finances by developing: a diversified tax base to maximise sources of revenue; mechanisms to measure and control public spending; and by building financial reserves during periods of economic growth;
- the UK should be proactive in satisfying itself that the Overseas Territories in particular have frameworks capable of identifying and responding to external shocks and encouraging local governments to undertake responsible adjustment programmes where these are necessary.

4 The role of tax in sustaining business models

Introduction

4.1 The international response to the global financial crises has put consideration of tax practices centre stage. Particularly close attention has been paid to the tax practices adopted by jurisdictions with offshore financial centres.

4.2 The international focus has been on whether so-called 'low tax' jurisdictions are pursuing tax practices which are harmful and on the willingness of all jurisdictions to share tax information to reduce the scope for tax evasion by companies and individuals.

4.3 How the nine jurisdictions measure up to the emerging international consensus around tax norms and international standards on tax transparency is material to their economic sustainability. In recent months, a number of multinational companies and financial institutions have announced plans to leave some of the jurisdictions, citing international pressure on tax. Even without these international pressures, the fiscal pressures discussed in chapter 3 of this Report could be expected to encourage governments to consider options for increasing revenue.

4.4 This chapter draws on an evaluation of the importance of the Crown Dependencies and Overseas Territories in tax avoidance by UK corporates commissioned by the Review and conducted by Deloitte (reproduced in full in Annex E). The evaluation did not consider tax evasion and avoidance by individuals which the international community is addressing through improved transparency.

4.5 This chapter:

- examines the extent to which the sustainability of the business models in the nine jurisdictions is dependent on the continuation of existing tax models; and
- reviews the progress that has been made by the nine jurisdictions in meeting the international standards for tax transparency.

The role of tax

4.6 The nine jurisdictions operate in a global market where most (if not all) countries seek to make their tax regimes competitive. Most developed economies raise revenues through a wide range of taxes. Treaties between different jurisdictions to avoid double taxation (i.e. the imposition of two or more taxes in different jurisdictions on the same income, asset or transaction) facilitate cross-border economic activity, although not all jurisdictions have such treaties.

4.7 At a simplified level, Deloitte has divided jurisdictions into three categories:

- 'full-tax' treaty jurisdictions which have a fully developed range of taxes levied at significant levels and extensive double taxation agreement (DTA) networks;

- 'tax arbitrage-oriented' treaty jurisdictions which have similarly well developed tax systems but which may be viewed as making their territories available for international tax arbitrage;
- 'limited/no treaty' jurisdictions which typically have fewer forms of taxation and limited DTA networks.

4.8 Deloitte tentatively concluded that the Crown Dependencies and Overseas Territories (which fall within the third category) were distinguished within the developed world by differentiating themselves from the international consensus, sometimes through tax rates but more often through the absence or near absence of certain forms of taxation.

4.9 The tax regimes in most of the Overseas Territories have not evolved beyond the imposition of specific transaction and consumption taxes: they operate a range of customs duties on imports, on which they are heavily reliant for revenue. With the exception of Gibraltar, the Overseas Territories have not introduced income taxes, corporation taxes, or value added tax (VAT) or goods and services tax (GST).

4.10 The tax regimes in the Crown Dependencies and Gibraltar have developed to include income and corporation taxes, with the latter consistently levied at a lower rate than the main rate in the UK.

4.11 The development of indirect taxes in the Crown Dependencies has been more diverse. Guernsey does not currently apply VAT or GST. Jersey introduced a system of GST in 2008 with an international services exemption fee which allows financial services companies to pay a flat fee in return for an opt-out from the regime. The Isle of Man operate VAT as part of the European Union VAT territory: receipts collected in the UK and the Isle of Man are pooled and then shared in accordance with an agreed formula.

Adapting to a changing global tax environment

4.12 Whilst there were other drivers for doing business in these jurisdictions (including, for example, a stable legal environment and authorities who were responsive to market developments), Deloitte concluded that tax was an important motivating factor.

4.13 Deloitte noted that the jurisdictions' main competitors were increasingly countries with developed tax systems and tax treaty networks such as Switzerland, Luxembourg and Ireland. The Review was keen to understand the impact on the competitive position of the nine jurisdictions should local governments wish to move closer to developing international tax norms.

4.14 Deloitte considered the scope for the jurisdictions moving towards consensus models in the areas of VAT and corporation tax (CT).

4.15 Deloitte concluded that there was a compelling case for those of the nine jurisdictions which do not already operate VAT or GST to consider introducing such a system to increase the sustainability of their business models by broadening their revenue bases. Deloitte noted that this would be of particular importance for the Overseas Territories should the global trend for reducing reliance on customs duties continue.

4.16 Deloitte also concluded that the Crown Dependencies' industry bases were sufficiently diverse that they had the potential to raise worthwhile levels of revenue from a CT system more aligned with international 'best practice' than the regimes currently in place. By contrast, some of the Overseas Territories' focus on a narrower financial sector niche suggested that the introduction of a broad-based CT would offer less scope for a significant tax take.

4.17 Deloitte concluded that, in any event, the downside of a properly constructed 'best practice' CT system would appear to be relatively limited and would bring the jurisdictions more into the mainstream of the international community. It might also curtail some scope for tax avoidance.

4.18 However, Deloitte recognised that given the diverse tax regimes and industry bases of the Crown Dependencies and Overseas Territories, a single template for all the jurisdictions might not be appropriate. A detailed impact assessment of the effect of introducing tax changes in individual jurisdictions would also need to be undertaken. (The report suggests a methodology for producing a more comprehensive impact assessment.)

4.19 At a practical level, any jurisdiction considering introducing new taxes (or fees) must have the ability to administer them to ensure that they are not avoided. It would be in the UK's interest to provide technical assistance were it requested by a jurisdiction.

4.20 It is also of interest to the UK that Deloitte concluded that were the Crown Dependencies and Overseas Territories to take action which reduced their competitiveness, the business would be unlikely to flow to the UK.

Quantifying the 'tax gap'

4.21 Deloitte considered UK corporates' use of the Crown Dependencies and Overseas Territories and identified some activities which could be considered tax avoidance. To assess the impact of these activities on the UK, Deloitte built on previous studies, which had attempted to quantify the UK corporate 'tax gap' due to tax avoidance, and estimated (based on companies' published accounts) the 'expectations gap' between the tax these companies might broadly be expected to pay and the tax actually paid. Deloitte estimated that the amount of UK corporate tax potentially avoided by UK corporates was likely to be up to £2.0billion per annum, with avoidance through the nine jurisdictions an unidentified sub-component.

Tax information exchange agreements

4.22 The principles of transparency and exchange of information developed by the OECD's Global Forum have been endorsed by countries around the world. The G20 London Summit in April 2009 continued the push to implement the minimum standard of each jurisdiction signing at least 12 tax information exchange agreements (TIEAs) with other countries that would allow the latter to obtain information about income earned by their taxpayers outside of their home jurisdiction.

4.23 This renewed international focus on tax transparency encouraged leading international financial jurisdictions such as Switzerland and Singapore to commit to the standard for the first time.

4.24 In April 2009, the OECD published a three tier list that categorised jurisdictions into those that had 'substantially implemented' information sharing agreements, those that had pledged to do so and those that had not agreed to share information.

4.25 The Crown Dependencies were all considered to have 'substantially implemented' the agreed standard. However, in general the Overseas Territories were behind the Crown Dependencies. Bermuda and more recently the Cayman Islands, British Virgin Islands and Gibraltar have subsequently 'substantially implemented' the agreed standard. The Turks and Caicos Islands have signed five TIEAs and Anguilla has signed four agreements.

4.26 It is anticipated that standards in this area will continue to rise and even those of the nine jurisdictions within the scope of this Review that have met or exceeded the current standard of

12 TIEAs should continue to enter further agreements, giving priority to those jurisdictions with which they have significant financial links.

4.27 This imperative is well understood and it is appropriate that the commitment to tax transparency shown by a number of the jurisdictions has been recognised in statements by the UK Government.

4.28 The nine jurisdictions must show a commitment not just to the letter but also the spirit of international standards. Effective implementation will be an important test of this and evidence will be provided by the OECD's Global Forum through a monitoring and peer review process. It is vital that competitor jurisdictions show the same commitment.

4.29 The peer review process will be carried out in two phases. The preliminary stage will be to monitor and review the legal and regulatory framework to identify possible domestic law obstacles to information exchange. The second phase of the review will identify any practical barriers to the effectiveness of exchange of information.

Automatic information exchange

4.30 In the longer term, the trend for greater transparency is likely to result in pressure to move to a system of automatic exchange of information with the aim of combating tax evasion by individuals on a cross-border basis. Automatic information exchange is the systematic and periodic transmission of taxpayer information by the source country to the residence country and is supported by a number of NGOs in the UK.

4.31 This is already the objective under the European Union Savings Directive (EUSD) agreed in 2003, although some EU Member States have taken advantage of a transitional arrangement to instead levy a withholding tax on interest payments of 20 per cent (increasing to 35 per cent in July 2011). There is, however, pressure to remove the withholding tax option and a proposal to apply the EUSD to a broader range of savings income.

4.32 The Crown Dependences are outside the EU but participate in the EUSD framework under Savings Agreements with the Member States. The Crown Dependencies apply the transitional withholding tax option, which under their Savings Agreements they must give up in favour of automatic exchange of information when the three Member States applying withholding tax move to automatic exchange.

4.33 The Isle of Man has committed to moving to automatic exchange of information by July 2011. Guernsey is reviewing its position and Jersey has said that it is ready to introduce automatic exchange of information as soon as the EU brings the transitional period to an end. The Review encourages both jurisdictions to announce a firm date for a move to automatic exchange. At the same time, the UK should call on all EU Member States and third party countries which currently apply the withholding tax option to also make a similarly firm commitment.

4.34 Of the Overseas Territories, Gibraltar is directly subject to the EUSD and in most cases applies automatic exchange. Anguilla and the Cayman Islands have adopted the EUSD and apply automatic exchange. The British Virgin Islands and the Turks and Caicos Islands have adopted the withholding tax option under the EUSD. Again, the Review encourages all the Territories within the scope of this Review to commit to moving to automatic exchange.

Conclusions

4.35 The governments in the jurisdictions might wish to reflect on how they measure up to the emerging international consensus around tax norms and on what this may imply for their

economic sustainability to complement consideration of potential responses to fiscal pressures discussed in chapter 3.

4.36 The jurisdictions have participated in international moves to deliver greater co-operation between jurisdictions on the exchange of tax information. Efforts to improve information exchange are likely to continue. The jurisdictions within the scope of this Review must keep pace with international developments and move towards full automatic information exchange wherever possible. However, it is vital that pressure is maintained on competitor jurisdictions also to meet the standards to ensure that international objectives are delivered.

Recommendations

The Review recommends that the jurisdictions:

- meet the international standard on tax transparency set by the OECD and continue, even after meeting the current minimum of 12 TIEAs, to negotiate further TIEAs, giving priority to those jurisdictions with which they have significant financial links;
- set up the administrative procedures necessary to ensure full delivery of the OECD standard, to a level of compliance that will satisfy the peer review process that is being be put in place;
- make an early commitment, with a timetable for implementation, to automatic exchange of tax information under the EU Savings Directive where they have not already done so.

5 Delivering effective regulation

Introduction

5.1 Effective regulation of financial services business, which is compliant with international standards, is a requirement for a sustainable business model and not an option. This is recognised by the nine jurisdictions within the scope of the Review but the standards achieved in practice have been mixed.

5.2 This chapter:

- examines the compliance of the nine jurisdictions with international regulatory standards; and
- identifies areas for improvement.

International assessment process

5.3 The nine jurisdictions within the scope of this Review are subject to the International Monetary Fund's Financial Sector Assessment Programme. The programme assesses each jurisdiction against 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, which are discussed in chapter 7.

5.4 The initial phase of the programme was completed in 2005. A further round of assessments was subsequently launched and assessments of Bermuda and Gibraltar had been completed before the Review started work (both were published in 2008).

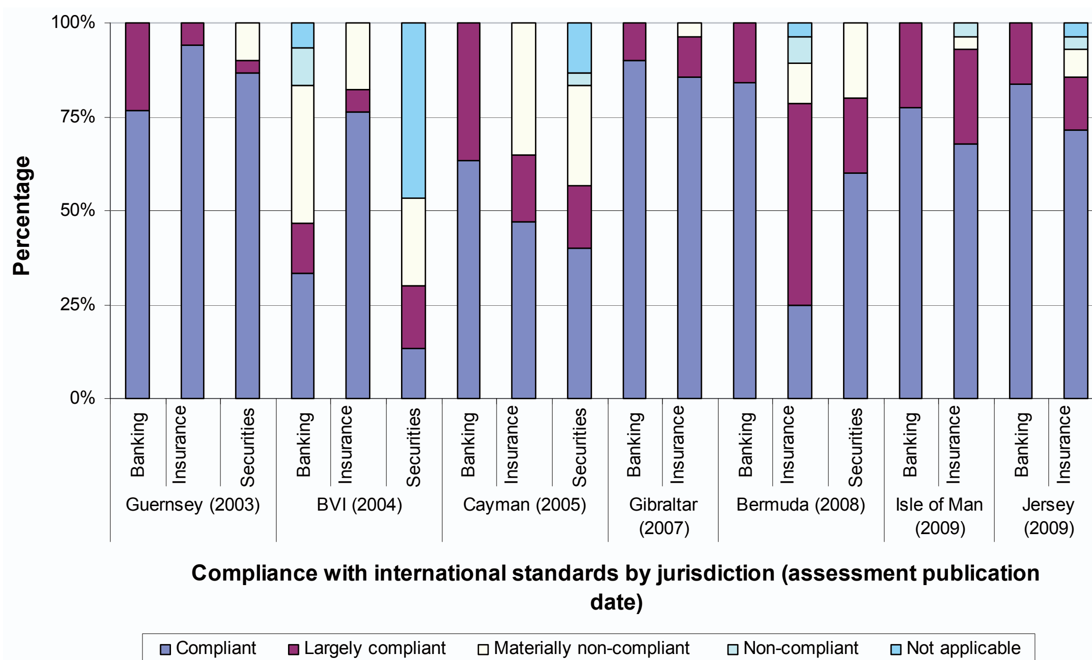
5.5 The Review drew on the findings of these detailed assessments, which were followed up in discussions with the jurisdictions.

5.6 Second round assessments of the Cayman Islands, the Isle of Man and Jersey were underway during the course of the Review and the information prepared by the authorities for this process provided a ready source of information for the Review. The IMF published its assessments of the Isle of Man and Jersey in September 2009.

Compliance with international standards

5.7 The IMF assessment programme shows a mixed picture on compliance with international regulatory standards across the jurisdictions within the scope of this Review (see Chart 5.A). The Crown Dependencies have received positive IMF assessments, but there is scope for improvement in some of the Overseas Territories. This is most evident in the smaller Territories (not shown in the chart), where compliance costs bear most heavily because of a lack of economies of scale and the difficulty of attracting staff with the necessary expertise.

Chart 5.A: Comparative levels of compliance with IMF assessed principles of regulation in banking (Basel), insurance (IAIS) and securities (IOSCO)[1]



5.8 None of the jurisdictions can afford to be complacent as international standards continue to rise. Each jurisdiction must be willing and able to co-operate with other regulatory authorities and exchange regulatory information.

5.9 The Financial Stability Board has responded to the G20's call to identify non-cooperative jurisdictions and to initiate a peer review process, and has announced that it will report on the development of a framework to strengthen adherence to international regulatory and prudential standards at the November 2009 meeting of G20 Finance Ministers and Central Bank Governors.

Resources

5.10 No regulatory authority can expect to satisfy the requirements of the peer review process unless the quantum and expertise of resources employed are sufficient.

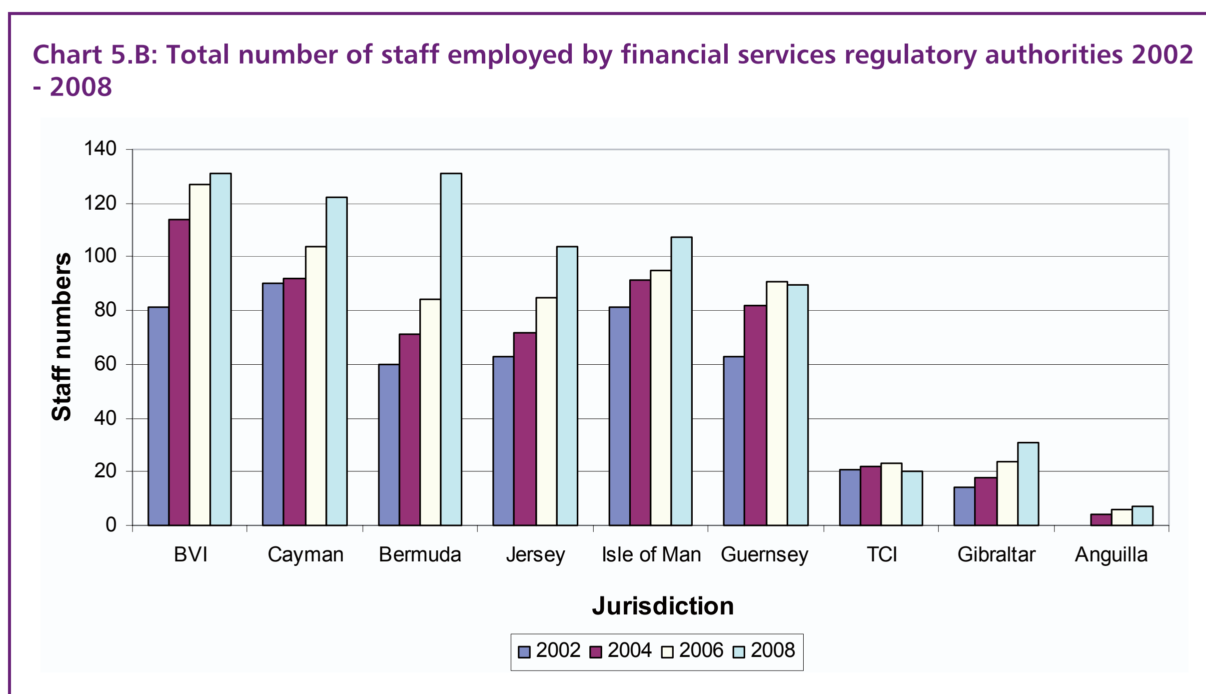
5.11 Chart 5.B gives an indication of the comparative size of the regulatory authority in each jurisdiction, although specific comparisons should be made with caution because of the variation in the functions performed by the regulatory authorities. For example, around 50 per cent of the staff employed by the Financial Services Commission in the Turks and Caicos Islands are employed in the registry of companies.

5.12 Chart 5.B shows clearly, however, that total staff numbers have generally been on a rising trend. The jurisdictions have recognised the need to increase capacity to: meet the demands of international standards; deliver effective front-line supervision; and also to secure the competitive advantages derived from being a well regulated jurisdiction.

[1] Comparisons between those jurisdictions with only first round assessments and those with second round assessments should be made with care because of developments in the methodology applied by the IMF. Gibraltar, Jersey and the Isle of Man were not assessed against IOSCO principles in the most recent assessments. The ratings shown for banking supervision and securities for Bermuda reflect the Bermuda Monetary Authority's analysis of the IMF's assessment which did not itself include compliance ratings for these areas. Anguilla and the Turks and Caicos Islands have not been included in the Chart, as the assessments published in 2003 and 2005 respectively did not provide compliance ratings.

5.13 Bermuda and Gibraltar have more than doubled the number of staff employed since 2002, whilst the British Virgin Islands and Jersey have both increased staff resources by more than 60 per cent.

Chart 5.B: Total number of staff employed by financial services regulatory authorities 2002 - 2008



5.14 Anguilla has also seen an increase in staff resources, but the picture in the Turks and Caicos Islands is more variable. However, both jurisdictions employ fewer than ten staff to supervise licensed financial services providers. This is below the 'critical mass' that can be effective in implementing prudential and anti-financial crime requirements across a range of financial institutions.

5.15 The ratio of staff allocated to the regulation of licensed entities has also outpaced the increase in licences issued in most of the jurisdictions (Chart 5.C). This crude measure does not, of course, take account of 'critical mass' requirements or factors such as the real or perceived degree of regulatory risk generated by different licence classes.

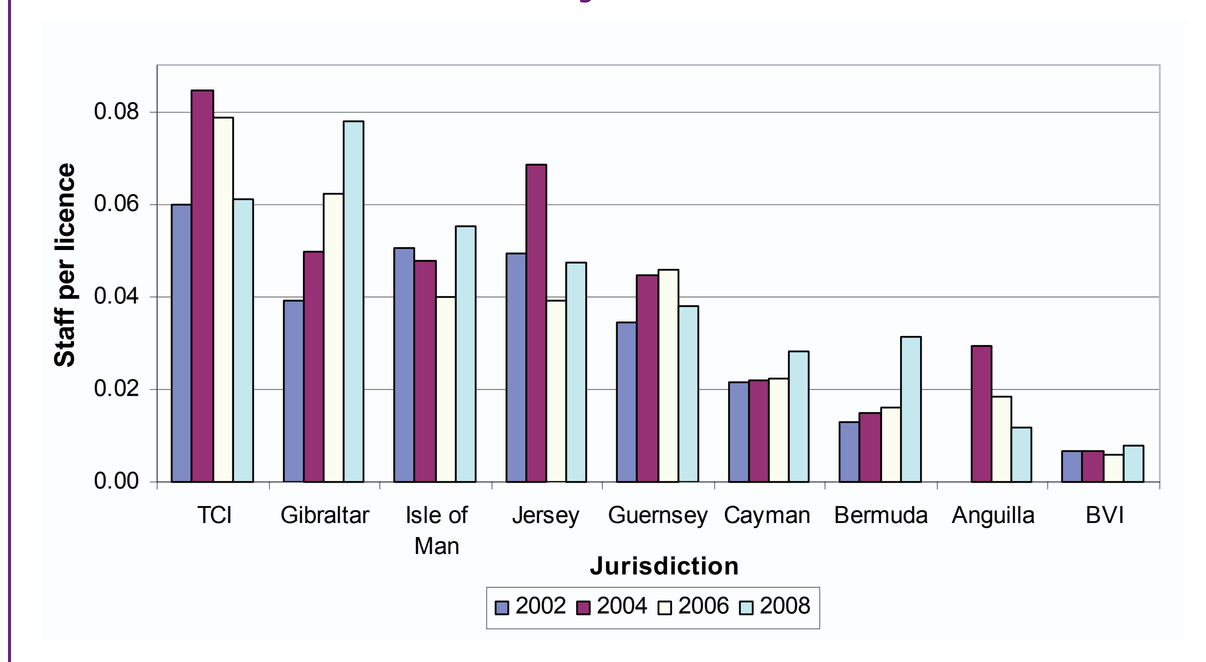
5.16 The limitations of the measure are illustrated by the results for the Turks and Caicos Islands. Whilst the Financial Services Commission appears comparatively well resourced, the burden of regulation appeared to the Review to fall disproportionately on a small number of senior staff and there is little on-site examination capacity.

5.17 The analysis for the Cayman Islands excludes almost 10,000 mutual funds (on 2008 figures) which were registered by the Cayman Islands Monetary Authority (CIMA) but did not require a licence. This suggests that the introduction of more intrusive regulation of hedge funds could put pressure on CIMA's resources.

5.18 Whatever the limitations of the analysis, the challenge for all jurisdictions will be to maintain resource levels during a period when fee income has or may reduce as the economic effects of the global downturn are felt.

5.19 The immediate challenge for the authorities in Anguilla and the Turks and Caicos Islands is to increase the quantum and expertise of resources available to their respective Financial Services Commissions. These jurisdictions must explain how and when these resources will be provided. Delivering these commitments is a necessary precondition if these jurisdictions wish to continue to offer themselves as international financial services centres.

Chart 5.C: Ratio of staff allocated to the regulation of licensed entities 2002-2008



Technical assistance

5.20 Even with a clear political commitment, recruiting additional high quality regulatory staff in Anguilla and the Turks and Caicos Islands will take some time. This raises the question of whether the UK should provide an oversight function to reinforce the regulator to reduce reputational and potential financial risks to the UK. (The Governor retains responsibility for international financial services regulation in both jurisdictions.)

5.21 The responsibility for operating an oversight function would most naturally fall to the Financial Services Authority (FSA) in the UK. In practice, the function could only be discharged by the FSA setting up an office in Anguilla and the Turks and Caicos Islands. This would confuse lines of accountability, provide a disincentive for these jurisdictions to take responsibility for their own actions and increase the UK's financial risk exposure to the jurisdictions. It would also be likely to require legislation to extend the FSA's powers. In short, it has little to commend it.

5.22 The alternative would be to provide technical assistance. This might, in the first instance, better be targeted at the fight against financial crime (see chapter 7). Such a focus would, however, permit assistance to the regulator to boost its capacity to tackle financial crime.

Regulatory co-operation

5.23 Some of the jurisdictions work closely with the UK to ensure that mutual regulatory objectives are secured. In the case of the Crown Dependencies, this co-operation is formalised in memoranda of understanding. The Crown Dependencies' concerns about how the arrangements operated in practice at the height of the banking crises have been widely reported. The Review has not sought to reach conclusions on those cases. It is, however, important that there is effective co-operation between the FSA and the regulators in the nine jurisdictions when this is required to deliver effective regulation.

5.24 There must equally be effective co-operation between the nine jurisdictions and other regulators with whom they deal, whether that is the Securities and Exchange Commission in the US or the regulator in one of the eight other jurisdictions within the scope of the Review.

5.25 The nine jurisdictions already co-operate with each other on policy development and the sharing of information. The Review considers, however, that more could be done and that a greater degree of co-operation on policy issues could help the jurisdictions to influence the debate on raising international regulatory standards.

Independence and integrity

5.26 Improvements to governance structures in the financial services commissions in Anguilla and the Turks and Caicos Islands could be achieved relatively quickly to bring them into line with best practice. This process has already started in the case of the latter.

5.27 Independent non-executive board members not linked to the local financial services industry are a necessary requirement of good governance, which typically means that some of the regulatory Commissioners should be drawn from outside the jurisdiction. Evidence across the jurisdictions is that a number of regulators are accountable to bodies that include evidently independent and external members. This involves additional travel and other expenses but the potential benefits justify this initiative.

5.28 Even where good governance arrangements are in place, the independence and integrity of regulatory decisions can come under pressure. The potential for pressure is, however, particularly high in jurisdictions such as those within the scope of the Review where the financial services industry is a major contributor to the local economy and lines of communication between government, regulator and industry are short.

5.29 The Public Accounts Committee in the UK has recognised the challenges posed for small jurisdictions where direct personal or family relationships often exist between officials and citizens[2]. And a number of NGOs in the UK saw the 'capture' of local politicians and regulators by the industry in a small jurisdiction as a major problem.

5.30 One way this pressure is likely to manifest itself is through a blurring of the line between financial regulation and promotion of the financial centre. In most cases, promotion and regulatory functions are institutionally separate, but the potential for a blurring of the boundaries is ever present. It is incumbent on the regulator and those responsible for the administration, licensing or registration of financial services business not to assume a dual role in promoting, facilitating or negotiating the introduction of business.

5.31 In the case of Anguilla, responsibility for financial promotion should be removed from the Registrar of Companies where it currently lies.

Conclusions

5.32 Those jurisdictions with high regulatory standards must remain focussed on ensuring that they keep pace with rising international standards. Jurisdictions which do not currently meet international standards must, as a matter of priority, explain how and when they expect to do so. Local governments in these jurisdictions must take responsibility for this process and show clear leadership if they wish to retain an internationally active financial services centre.

[2] Foreign and Commonwealth Office: Managing Risk in the Overseas Territories, HC 176, chapter 3.

Recommendations

The Review recommends that:

- those jurisdictions which have not already done so should ensure that the regulatory authorities have the necessary resources and expertise to implement and enforce international financial sector regulatory standards;
- all jurisdictions should ensure that governance arrangements in their regulatory authorities are sufficient to maintain the integrity and independence of all decisions taken;
- responsibility for promotion of the financial centre should be separate from the regulator in both letter and spirit.

6 Financial sector crisis management and resolution arrangements

Introduction

6.1 The importance of effective arrangements to resolve a financial crisis was very much in the public eye in the UK when this Review was commissioned. The impact of the crisis had also been directly felt in Guernsey and the Isle of Man following the collapse of two Icelandic banks.

6.2 Jurisdictions without deposit protection schemes were prompted by the crisis to consider their introduction. But experience has shown that consideration of resolution arrangements must extend beyond such schemes to consider, for example, the operation of insolvency and bankruptcy law.

6.3 The effectiveness of financial crisis management and resolution arrangements is clearly important for the jurisdictions themselves. It is, however, also of interest to the UK given its good governance responsibilities and potential financial contingent liabilities in some cases.

6.4 This chapter:

- outlines the deposit protection principles published by the Basel Committee on Banking Supervision and the International Association of Deposit Insurers (IADI);
- reviews the deposit protection schemes currently in place in the jurisdictions within the scope of this Review;
- proposes preventative measures that could be put in place to reduce the exposure of jurisdictions to risk of the failure of a major local financial institution; and
- considers the potential impact of the failure of such an institution and the sufficiency of resolution arrangements in the event of such a collapse.

Deposit protection principles

6.5 Protection of retail deposits (within defined limits) is a requirement in the European Union and is also widely provided in other parts of the world. In the immediate aftermath of the problems in the banking sector around the world, the existence of deposit protection schemes was increasingly seen as necessary to provide assurance to retail depositors. Although pressure from depositors has abated, a number of jurisdictions within the scope of this Review which do not currently have schemes are pursuing plans to introduce them.

6.6 This renewed interest in deposit protection, and the strain placed on existing schemes by large banks getting into difficulties, encouraged the Basel Committee on Banking Supervision and the International Association of Deposit Insurers (IADI) jointly to publish core principles on deposit protection. (Those most relevant to the Review are reproduced in Box 6.A below).

Box 6.A: Core Principles for Effective Deposit Insurance Systems

Principles

Mitigating moral hazard: Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net.

Governance: The deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.

Relationships with other safety-net participants: A framework should be in place for close co-ordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants.

Compulsory membership: Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection (e.g. retail and small business depositors) to avoid adverse selection.

Coverage: Policymakers should define clearly in law, prudential regulations or by-laws what an insurable deposit is. The level of coverage should be limited but credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features.

Funding: A deposit insurance system should have available all funding mechanisms necessary to ensure prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required.

Public awareness: In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the benefits and limitations of the system.

Early detection and timely intervention and resolution: The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks.

Reimbursing depositors: The deposit insurance system should give depositors prompt access to their insured funds.

Deposit protection schemes

6.7 Some jurisdictions within the scope of this Review have compensation schemes which extend beyond deposit protection. The analysis in this chapter focuses, however, on deposit protection schemes which were the main focus of attention in the jurisdictions.

6.8 The Isle of Man has had a deposit protection scheme in operation since 1991. Compensation is paid out of levies collected from deposit takers in the jurisdiction, from sums loaned to the scheme by the Isle of Man Government and from any other sums that may be borrowed by the scheme manager. There is no standing fund (i.e. money is not collected before a bank failure).

6.9 All licensed banks in the Isle of Man are members of the scheme, which sets the compensation limit at £50,000 of net deposit for current and deposit accounts and up to £20,000 for most other categories of depositor such as companies and trusts.

6.10 The scheme manager determines the total liability under the scheme in any financial year of the scheme. The total amount which could be levied on scheme participants is currently capped

at £200 million. If the total amount owed to eligible depositors was greater than £200 million, the amount per depositor would be reduced proportionately to ensure that the liability cap was not exceeded.

6.11 The scheme introduced by Guernsey in November 2008 similarly sets the compensation limit at £50,000 and includes a liability cap of £100m in any five-year period. Again, there is no standing fund but the local government has agreed in principle to assist the scheme by guaranteeing an insurance policy of £20 million (a sum it can afford) to provide liquidity to the scheme.

6.12 The scheme in Gibraltar (introduced in 1998) applies the requirements of the EU Deposit Guarantee Schemes Directive and does not include a liability cap (which would not be consistent with the terms of the Directive). Gibraltar's potential liability would be increased if the EU increases depositor compensation limits to €100,000 in 2010.

6.13 The Gibraltar authorities have stated that the absence of a liability cap poses no consequent threat because the majority of the 12 banks operating in Gibraltar are large multi-national operations, which have either significant home state public ownership or have tacit or explicit state support. The remaining banks are primarily smaller wealth managers.

6.14 The remaining jurisdictions within the scope of this Review do not currently have deposit protection schemes in place. Jersey is, however, consulting on introducing one and Bermuda and the Turks and Caicos Islands are known also to be considering the possibility of introducing schemes.

Issues for consideration

6.15 The liability caps which feature in the deposit protection schemes in the Isle of Man and Guernsey seek to strike a balance between providing comfort to retail depositors and not leaving banks within the jurisdiction facing a potentially unlimited liability. In practice, the liability cap means that the compensation paid to depositors in the event of a bank failure could be significantly less than £50,000 if payments at that level would exceed the cap.

6.16 The effect of the cap would be to vary the maximum payment to depositors depending on the size of the bank which had failed. Depositors with a large failed bank might receive less than £50,000 because the cap had been triggered, whilst depositors in a small failed bank would be more likely to receive compensation up to the £50,000 depositor limit.

6.17 Some depositors may not understand the implications of the liability cap. Misunderstandings could potentially result in accusations by depositors that they had been misled. Any jurisdiction within the scope of the Review which currently has, or is considering introducing, a scheme with a liability cap should therefore:

- review its scheme in the light of the Basel Committee's principles and consider in particular whether the existence of the 'cap' is or can be adequately explained to depositors, and whether clearer guidance could be introduced; and
- consider whether the future business model for that jurisdiction requires a deposit protection scheme for all depositors or whether the jurisdiction should not be seeking to attract foreign retail deposits. Reduction or elimination of these might allow jurisdictions to provide protection to local residents (who typically and reasonably want to bank locally) without the need for a liability cap.

6.18 Whatever the structure of the scheme in place, the ability to pay out quickly in the event of a bank failure is key. The Basel Committee and IADI identified the need to give depositors prompt access to their insured funds as one of their key principles. The need for the quick,

efficient and transparent operation of the scheme were also lessons from the failure of Kaupthing Singer and Friedlander (Isle of Man) Limited[1].

Box 6.B Lessons from the Isle of Man

Framework: Coverage of the deposit protection scheme and to what level should be clearly defined.

Planning: Quick, efficient and transparent operation of the deposit protection scheme must be planned for robustly prior to any default, and periodically reviewed and tested rigorously.

Communication: Means of communication to key stakeholders should be clearly defined, and organised through implementation.

Funding: The deposit protection scheme should be affordable, with sources of funding identified and in place.

Legislation: Other legislation (e.g. liquidation and insolvency law) with which the deposit protection scheme may interact, should be identified, examined and reviewed.

Payment: The time period within which claims are paid out should be clearly set out and any early payment mechanisms should be carefully defined.

6.19 The Basel Committee has said that deposit protection schemes should have a means of obtaining supplementary back-up funding for liquidity purposes when required. This would be provided by an ability to borrow, including from the local government.

6.20 The availability of a loan for liquidity purposes is particularly important where there is no standing fund or where such a fund is in the early years of being built. Without it, sufficient funds may not be available to pay out quickly in the event of a bank failure.

6.21 In practice, loan finance would most likely come from the local government in the event of a significant bank failure. Jurisdictions which are considering introducing a deposit protection scheme should identify the sources of funding to deliver the prompt settlement of depositors' claims.

6.22 Jurisdictions should also review how the settlement of claims by the scheme would interact with other aspects of the legal framework such as insolvency and bankruptcy law and make any changes which might be appropriate.

Ombudsman schemes

6.23 A separate but related issue to deposit protection insurance was brought to the Review's attention during the consultation process. In the Crown Dependencies, where UK nationals (often 'ex-pats') purchase many financial products, one important element of consumer protection in the UK is typically missing. Only in the case of the Isle of Man does an

[1] In October 2008, the Isle of Man Financial Supervision Commission suspended Kaupthing Singer and Friedlander (Isle of Man) Limited ('KS&FIOM') banking licence, accordingly KS&FIOM ceased to trade as a bank. The Isle of Man Court also made a Provisional Liquidation Order in relation to KS&FIOM. The Isle of Man sought to introduce an alternative to liquidation of the company (Scheme of Arrangement) and activation of the Island's Depositors Compensation Scheme. However, this failed after the proposed Scheme of Arrangement did not gain the necessary levels of support when creditors voted on it in May. The bank was subsequently placed into liquidation in May 2009 and the DCS activated for depositors of the bank. However the Isle of Man government had already paid out £85m to depositors under the Government's two Early Payments Schemes, providing advance payments of up to £10,000 per depositor.

Ombudsman complaints scheme exist along the lines of that in the UK. The jurisdictions should consider whether such a scheme is justified.

Resolution

6.24 The Basel Committee and the IADI recognised that deposit insurance systems could not, by themselves, deal with systemically significant bank failures or a systemic crisis. In these cases, it was the responsibility of all participants (including the state) within the financial system to work together to resolve the crisis and this has been evident in responses in the UK and elsewhere to the crisis in the banking sector.

6.25 In the context of the jurisdictions within the scope of this Review, systemic risks can flow from the collapse of a foreign-owned bank with a presence in the jurisdiction and from the collapse of a locally-owned bank.

6.26 In the case of foreign-owned banks, the bulk of deposits collected in one of the jurisdictions will typically be remitted to the parent bank located elsewhere, limiting the chances of securing these deposits if the parent bank collapses.

6.27 Whilst this risk cannot be eliminated without undermining the business model which encouraged the bank to establish a presence in the first place, it can be reduced by a combination of tough licensing conditions and close contact with the parent bank's regulator. The Review was encouraged that a number of jurisdictions already give careful consideration to the type and standing of foreign-owned banks when considering licence applications.

6.28 In the case of locally-owned banks, the regulator's objective must be to limit the risk of a collapse. This is particularly the case for such banks where serious liquidity or solvency problems would have damaging consequences for the local economy were they to occur. The Review has identified a small number of locally owned banks in the Overseas Territories that are systemically important in the context of the local economy.

6.29 In one case, the Government of Bermuda acted swiftly during the course of the Review to commit $200 million to underwrite a preference share issue of a local bank. Such prompt action helped the share issue to be oversubscribed, leaving the local Government without any short-term financing obligation.

6.30 This demonstrated the importance of the regulator maintaining close oversight of systemically important banks (and other financial institutions) and being ready to act decisively in the event of problems occurring. To reinforce this process, the local authorities on their own initiative or at the request of the UK should have the power to require a periodic independent and external review of any such institution, paid for by the institution itself.

6.31 More generally, any jurisdiction that has not already done so should undertake a thorough examination of the range of powers available to resolve a crisis in its financial services sector. Jurisdictions might also consider (where they have not done so already) whether there are parts of the financial sector which should be scaled back to reduce risk exposure.

6.32 One of the Overseas Territories suggested to the Review that the UK should act as lender of last resort in the event of a shock to a jurisdiction's financial system and economy which was beyond the resources of that jurisdiction to deal with in the short-term. This could include the local consequences of the failure of a financial institution.

6.33 A lender of last resort facility would be a significant undertaking by the UK and it would be important to ensure that local governments had a strong incentive to put in place and enforce measures to reduce the risk of such circumstances arising.

6.34 If the UK Government wished to explore a loan facility, it would most likely be broadly similar to the kind of facilities that would be available to these jurisdictions if they were eligible for membership of the IMF. The circumstances in which a loan would be provided and the conditionality attached would need to be clear. But as this Review makes clear, there are a number of ways for a jurisdiction to reduce the risk of getting into a position where such a facility is needed.

Conclusions

6.35 It is important that all the jurisdictions within the scope of this Review learn the lessons from the financial crises. The means to fund deposit protection schemes must be identified and the terms of such schemes must be clear to retail depositors.

6.36 All possible steps must be taken to guard against the collapse of a financial institution of systemic importance to the economy of a jurisdiction. Contingency plans should, however, also be in place to resolve such a situation should it occur. These plans should take full account of other parts of the legal framework, particularly insolvency and company law, to ensure that the plans would be deliverable in practice.

Recommendations

The Review recommends that:

- those jurisdictions that offer (or propose to offer) protection to retail depositors must ensure that compensation schemes can be understood by those depositors;
- jurisdictions that lack an Ombudsman scheme should consider whether one is justified;
- any jurisdiction that has not already done so should undertake a thorough examination of the range of powers to resolve a crisis in its financial services sector;
- local governments should require the regulator to maintain close oversight of any large locally incorporated financial institutions, the failure of which might lead to requests for financial help from the UK. This should be backed by the option of a periodic independent and external review, paid for by the institution itself, commissioned by the local authorities on their own initiative or at the request of the UK.

7 Fighting financial crime

Introduction

7.1 One of the major concerns expressed about offshore jurisdictions is that they do not do enough to help combat cross-border financial crime. Weaknesses often cited include an excessive importance given to protecting the secrecy of beneficial owners of funds, and lack of active co-operation with overseas investigators.

7.2 The internationally active fraudster will seek out the weakest jurisdictions to conduct their business. The jurisdictions covered by this Review need to be – and to be seen to be – active in seeking out and turning away dubious financial business. If not, their reputation (and that of the UK) will suffer.

7.3 Over time, international efforts to fight financial crime have moved forward considerably but weaknesses remain in international standards.

7.4 This chapter:

- reviews the record on fighting financial crime of the nine jurisdictions within the scope of this Review;
- discusses what action should be taken by the jurisdictions, in some cases with the support of the UK; and
- considers the scope for improvements to existing international standards.

International assessment process

7.5 International standards to fight financial crime are set by the Financial Action Task Force (FATF), an inter-governmental body established to develop and promote policies to combat money laundering and terrorist financing. The FATF (or one of the associated bodies) conducts periodic reviews of jurisdictions to see how they measure up against the FATF 40+9 Recommendations to counter money laundering and terrorist financing. Sixteen of these Recommendations are designated as 'key and core'.

7.6 The IMF's Financial Sector Assessment Programme (discussed in chapter 5) includes an assessment of compliance with the FATF's Recommendations. Anguilla, Bermuda, the British Virgin Islands, the Cayman Islands and the Turks and Caicos Islands are members of the Caribbean FATF and are also subject to its peer review process.

Compliance with FATF Recommendations

7.7 Compliance with the FATF's Recommendations requires an effective partnership between the authorities in the jurisdictions, the financial services industry and those, such as lawyers, who provide support services to the industry and its clients.

7.8 Governments must demonstrate a clear political commitment to tackling financial crime. In the first instance, this can be achieved by ensuring that legislation to tackle financial crime keeps pace with developments and provides regulatory authorities, investigators and prosecutors with

the powers they need. Such legislation provides an important signal to private sector practitioners and to potential criminals.

7.9 Legislation is, however, only as good as its enforcement. It will not be effective unless the financial services regulator has the resources to ensure that regulated entities are acting with due diligence and investigators have the resources and expertise to investigate suspicious activity. Prosecutors must also have the resources they need to prosecute financial crime within the jurisdictions and to assist prosecutors in other jurisdictions.

7.10 Some of the jurisdictions within the scope of this Review have made considerable efforts to tackle financial crime and have a good story to tell. Others have taken their eye off the ball or have so far failed to demonstrate the necessary commitment.

7.11 Jersey has, for example, received a positive IMF assessment of compliance against the FATF 40+9 Recommendations and was rated as compliant or largely compliant with 15 out of the 16 'key and core' Recommendations. Bermuda, on the other hand, was assessed as having considerable room for improvement as was the Turks and Caicos Islands, whilst Gibraltar and the Isle of Man have more to do to improve compliance with the 'key and core' Recommendations in particular.

7.12 In some cases, weaknesses have been recognised. For example, the Bermuda authorities' response to the IMF's assessment recognised the need to enhance and accelerate the jurisdiction's efforts to fight financial crime.

7.13 The state of play on compliance is illustrated in Charts 7.A and 7.B. The charts use IMF assessments of Jersey, Isle of Man, Bermuda and Gibraltar. CFATF assessments are used for the British Virgin Islands, the Cayman Islands and the Turks and Caicos Islands as the most recent available for these jurisdictions.

7.14 No compliance ratings have been published for Anguilla during the period covered by the charts, but the jurisdiction was preparing for a CFATF peer review when the Review visited in June 2009. Guernsey was last assessed by the IMF in 2003 but the results have been excluded from Charts 7.A and 7.B because of changes to the methodology and criteria applied since then. The IMF is expected to assess Guernsey in 2010.

Chart 7.A: FATF 40+9 compliance

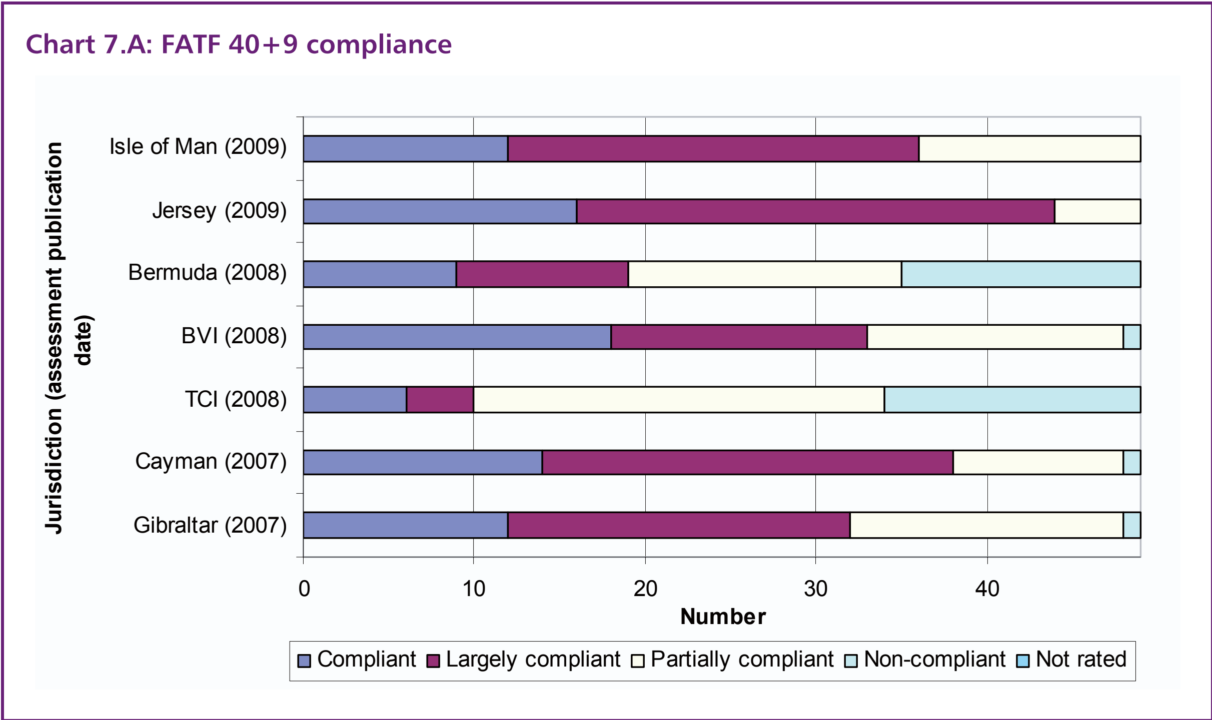
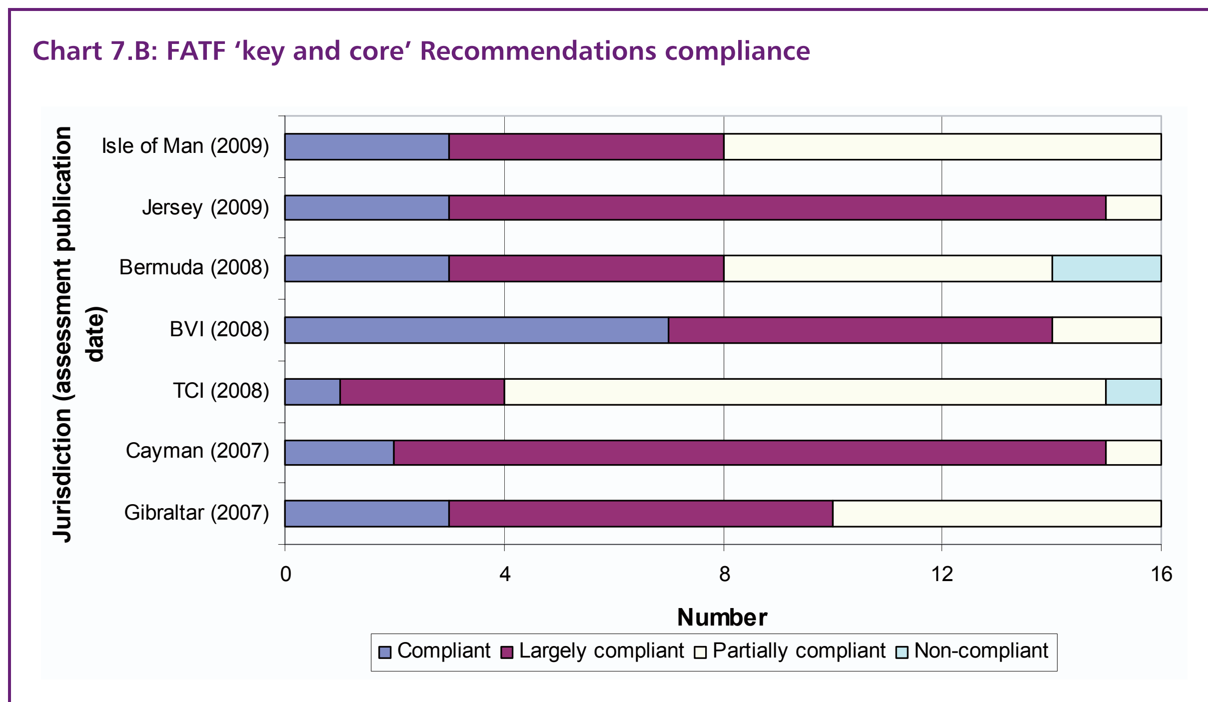


Chart 7.B: FATF 'key and core' Recommendations compliance



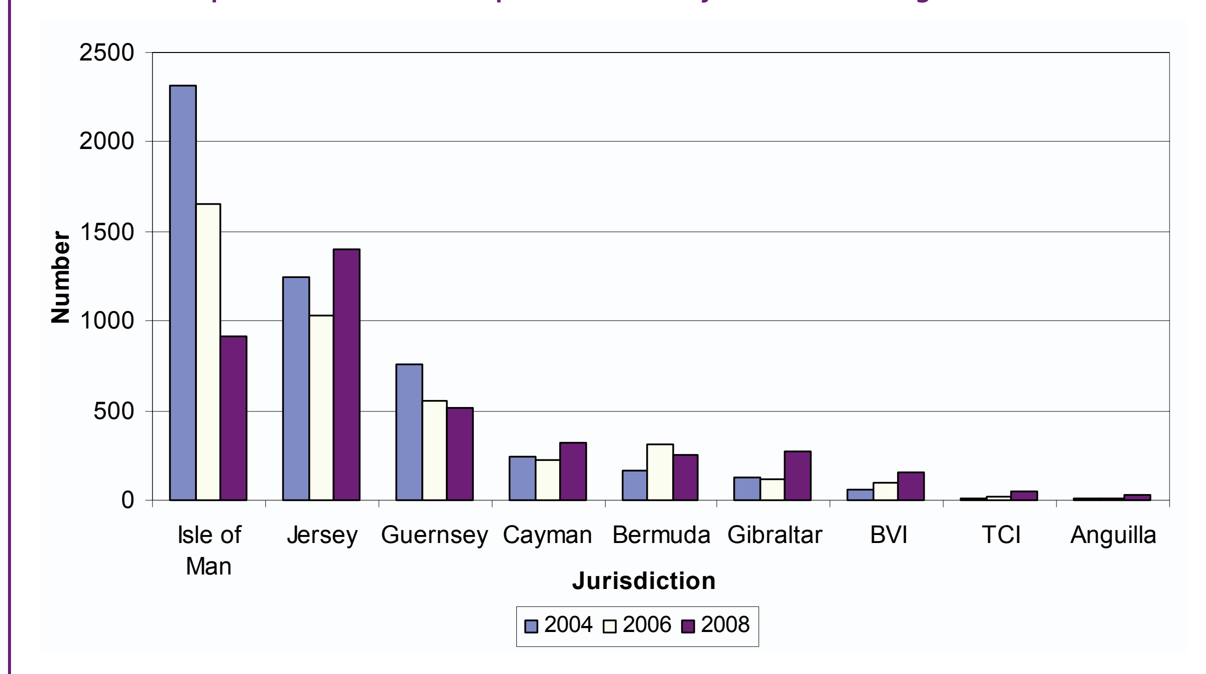
Detection

7.15 Looking at the picture in more detail, the number of suspicious transaction reports (which are mostly made by local regulated financial institutions to the local financial intelligence unit when financial crime is suspected) provides an illustration of attitudes in a jurisdiction. Although there is no 'correct' number of suspicious transaction reports (STRs), the financial sector niche in the jurisdiction can be used to provide a rule of thumb. For example, a jurisdiction with a large banking sector will tend to record more STRs than one with a small banking sector because of (a) the key role that banks play in transmitting funds and (b) the banking sector typically has more advanced techniques for identifying financial crime. It is also typical for a jurisdiction with an international business company sector to attract a higher incidence of financially suspicious activity while funds and insurance business typically have a lower incidence.

7.16 Although data provided by the jurisdictions (and reproduced in Annex D) shows that the number of STRs in the Overseas Territories are broadly on a rising trend, the numbers of STRs in 2008 were lower than might be expected in Anguilla (30) and the British Virgin Islands (153), both of which have international business companies as their international niche. On the face of it, the number of STRs in the Turks and Caicos Islands also appears low (50).

7.17 Both Guernsey and the Isle of Man were exceptions to the rising trend in the number of STRs, with the Isle of Man recording a fall of more than 60 per cent between 2004 and 2008. The Guernsey authorities attributed the fall to the 2004 figure being inflated by the effect of an international tax amnesty in a third country. The Isle of Man authorities also cited this reason combined with the education of the financial services industry producing fewer but better quality STRs. The Isle of Man anticipates, however, that the implementation of its 2008 Proceeds of Crime Act, with its wider reporting requirements, will see the return to a rising trend.

Chart 7.C: Suspicious Transaction Reports received by Financial Intelligence Units



7.18 Customer due diligence (CDD) must of course be undertaken in order to identify suspicious transactions. Again, there is a need for a number of the jurisdictions within the scope of this Review to improve compliance against the FATF's main CDD Recommendation (Recommendation 5). None of the jurisdictions has been assessed as better than partially compliant and Bermuda and the Turks and Caicos Islands were last assessed as non-compliant.

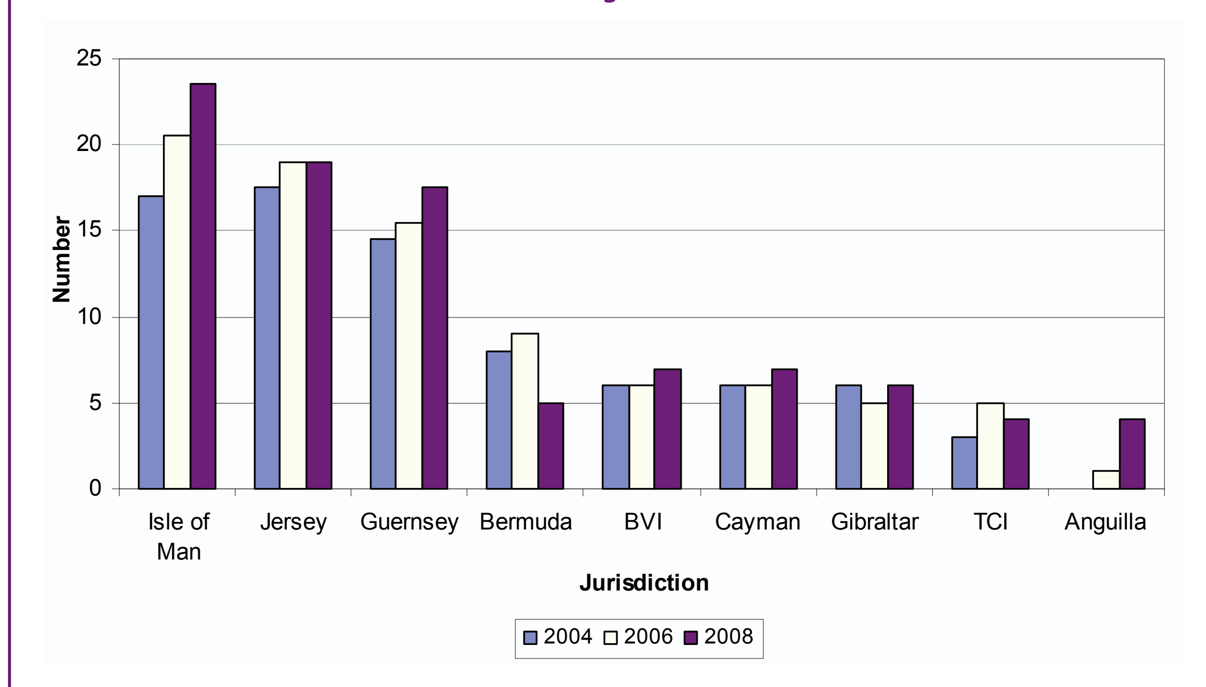
7.19 A number of NGOs in the UK were particularly concerned about the track record of some jurisdictions in complying with FATF Recommendation 6 on enhanced due diligence for politically exposed persons (PEPs). Compliance with this recommendation is important to prevent people in positions of power, often in developing countries, from misusing the financial resources of those countries for their own ends. Bermuda and the Turks and Caicos Islands were both rated as non-compliant in 2008. It is likely that Anguilla will also need to take steps to improve compliance with Recommendation 6.

Investigation

7.20 The financial services regulator also has an important role to play in holding regulated entities to account and supplying information to the financial crime investigatory authority, variously called the financial intelligence unit (FIU) or the financial crime unit.

7.21 Chart 7.D shows that the number of staff employed in FIUs increased or remained stable in most jurisdictions between 2004 and 2008.

Chart 7.D: Number of staff in financial intelligence units



7.22 The appropriate number of staff required for an FIU to be effective will, in part, depend on the number of STRs, which in turn may be influenced by the prevailing attitudes to fighting financial crime in a jurisdiction.

7.23 The number of staff employed in the FIUs in the Overseas Territories appears low, particularly when a complex case can consume significant resources. The FIUs in some jurisdictions confirmed to the Review that resource stretch was a concern.

7.24 The shortage of expertise in some areas was also a concern in some cases. For example, the absence or shortage of staff with the skills to undertake a forensic examination of computer hard drives would undermine the effectiveness of an FIU. As with the financial regulator, staff levels below a certain minimum are always likely to lead to problems.

Prosecution

7.25 On the face of it, prosecutions in some jurisdictions are running at a lower level than might be expected.

7.26 In 2008, there was one prosecution for financial crime in Guernsey, two in the Isle of Man and eight in Jersey. Prosecutions in the Overseas Territories in the same year ranged from 15 in Gibraltar (three for money laundering and 12 for fraud) to one (for money laundering) in Bermuda.

7.27 The jurisdictions with low prosecution rates tend to argue that the perpetrators of financial crime are typically located in other jurisdictions and so prosecutions will take place elsewhere. Those jurisdictions which have achieved high levels of compliance with the FATF Recommendations also argue that improvements in the detection of financial crime have deterred criminals from using the jurisdiction.

7.28 Whilst these arguments carry some weight, it is likely that suspicions will remain in some quarters about the vigour with which prosecutions are pursued. The direct personal relationships between officials and citizens which exist in small jurisdictions (also discussed in chapter 5) may expose prosecutors to pressure, which may be subtle, not to pursue cases against individuals who may play a prominent role in the life of the jurisdictions.

7.29 Jurisdictions should continue to make every effort to guard against such pressure and may, in some cases, wish to bring in personnel from outside the jurisdiction to limit any potential conflict of interest.

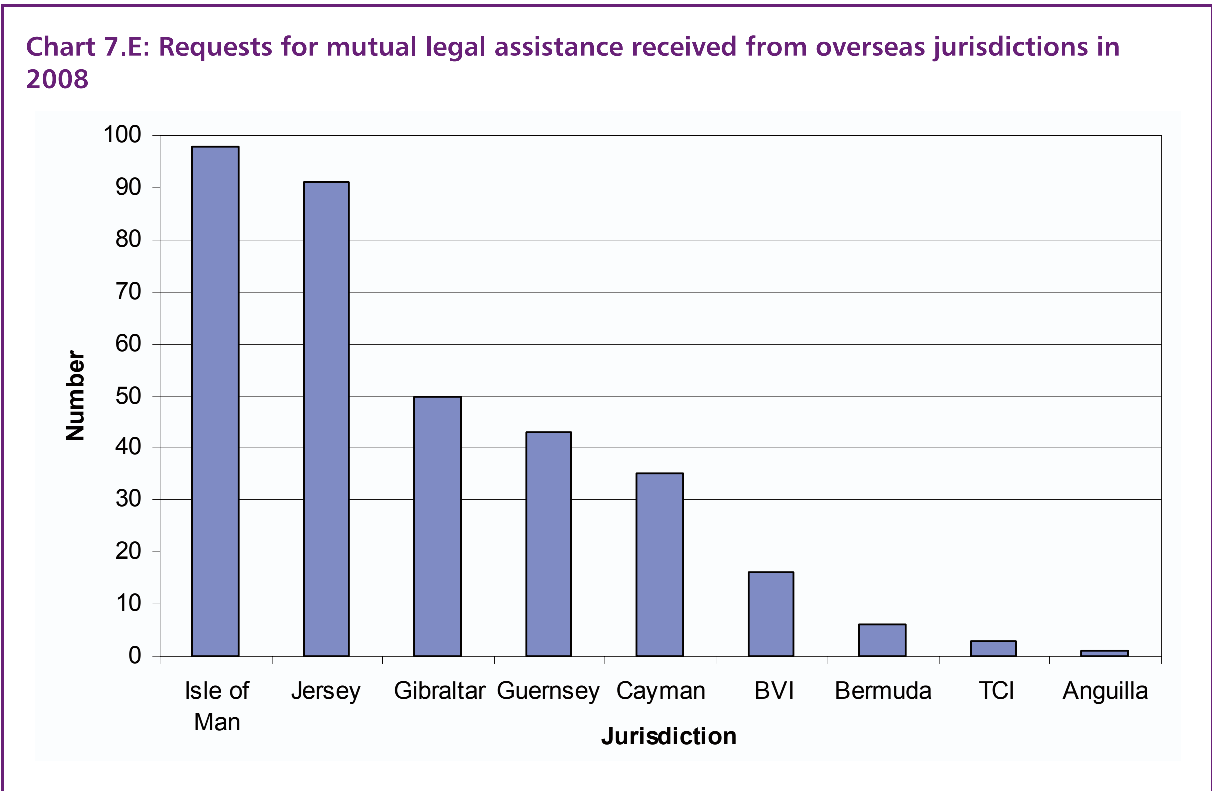
International co-operation

7.30 The nine jurisdictions must also co-operate fully with other jurisdictions to assist the prosecution process. In broad terms this can take two forms: the dissemination of information in STRs to other jurisdictions and responding to formal requests for assistance from other jurisdictions.

7.31 The dissemination of STRs to other jurisdictions is an important plank of international co-operation to tackle financial crime. The data on the number of STRs disseminated (see Annex D) shows that the jurisdictions within the scope of this Review do share information with the authorities in other jurisdictions.

7.32 All of the nine jurisdictions have received requests from other jurisdictions for mutual legal assistance (see Chart 7.E). (Some of the jurisdictions within the scope of this Review have formal mutual legal assistance treaties with other jurisdictions.)

Chart 7.E: Requests for mutual legal assistance received from overseas jurisdictions in 2008



7.33 Requests for assistance must be acted upon in a timely manner. To achieve this, jurisdictions must ensure that Attorneys General have sufficient and appropriately qualified staff at their disposal.

7.34 Fighting financial crime is expensive but in addition to the benefits of meeting international standards, tangible financial benefits can also be secured. For example, in 2007 the British Virgin Islands and Bermuda shared $46 million of forfeited assets.

Delivering improved compliance with international standards

7.35 Taking effective steps to tackle financial crime is a requirement not an option. The Review has concluded that the technical and human resources devoted to the fight against financial crime in Anguilla and the Turks and Caicos Islands need to be boosted to achieve compliance

with FATF Recommendations. Bermuda must also remain focussed on addressing the deficiencies in its approach to tackling financial crime identified in the IMF's assessment published in October 2008; while in the case of the British Virgin Islands, the authorities should review carefully whether their FIU should not be more proactive in dealing with suspicions in the international business company sector.

7.36 The priority is to provide human and technical assistance to those jurisdictions most in need of it. This must, however, be accompanied by a clear commitment from the local government to tackling financial crime by ensuring that legislation keeps pace with developments and gives both the regulator and the investigating authority the powers they need to detect and prosecute financial crime. The local government must also make a commitment to fund the provision of sufficient resources to secure the benefits of the technical assistance they receive. This is a necessary condition for these jurisdictions continuing to operate as international financial services centres.

7.37 Where such commitments are forthcoming, the UK should discuss with the relevant jurisdictions what mechanisms might be put in place to deliver them in practice. One option would be to establish a unit, recognised by both the jurisdictions and the UK, whose functions might include quality assurance to ensure that the full benefits of technical assistance are secured on a long-term basis. These discussions could also be extended to those jurisdictions which are not in need of immediate technical assistance to discuss how they might contribute to and benefit from any such unit.

International standards

7.38 During the course of the consultation, a number of NGOs raised concerns about the extent to which the lack of transparency in the ownership of corporate vehicles in the jurisdictions facilitated financial crime (including tax evasion).

7.39 The Review shares these concerns, but such transparency issues also arise to a greater or lesser extent in most major jurisdictions. For example, within the UK, most trusts are not subject to financial regulation and therefore no agency monitors the ownership or behaviour of these trusts.

7.40 In the US, a more egregious loophole exists in the fact that a number of individual States, notably Delaware, permit the creation of international business companies without adequate monitoring of their beneficial ownership.

7.41 There are also understandable concerns in relation to international minimum standards with respect to 'know your customer' rules. The Review highlights two where the adequacy of existing standards is doubtful.

7.42 Both issues are complex and are described only in summary. The first relates to what are known as 'eligible introducers' of new customers. At present a regulated financial firm in jurisdiction A is allowed to take on a corporate or individual client from jurisdiction B, on the assurance from a suitably qualified intermediary in B that the client meets the necessary standards of probity and has provided the information about the client that FATF standards require. Such an intermediary providing these assurances is known as an eligible introducer.

7.43 The Review was encouraged to find that in the British Virgin Islands, home to some 800,000 international business companies, the local regulator does require that a licensed company service provider (who actually handles and services the incorporation of each company) can at any time require full know your customer (KYC) information on the client. Indeed, the local regulator goes further and requires, on a random check basis, that this KYC information be remitted back to the British Virgin Islands for checking.

7.44 Nevertheless, the current minimum standards mean that a professional intermediary many thousands of miles away may vouch for the bona fides of the company being registered in a jurisdiction like the British Virgin Islands. The Review considers that the FATF should conduct tougher checks than it currently does in its peer group reviews of the standards in these third jurisdictions. The Review also believes that there is a compelling case for all relevant KYC information to be passed to the company service agent in the jurisdiction at the time of incorporation, rather than relying on the information being passed when and if requested.

7.45 The second issue relates to politically exposed persons (PEPs). Each jurisdiction should have in place systems to detect and identify PEPs and share information with other jurisdictions. The Review supports the call by Transparency International[1] for the UK to press the FATF to raise international standards in this area.

7.46 The G20 recognised the need to prioritise work to strengthen standards on customer due diligence, beneficial ownership and transparency at its meeting in Pittsburgh in September 2009.

7.47 Although attractive in principle, action by the UK and the nine jurisdictions ahead of changes to international standards would be likely to result in a loss of business to other jurisdictions rather than a resolution of the underlying concerns. The Review has, therefore, concluded that the UK should take the lead internationally in encouraging improvements to:

- 'know your customer' international minimum standards (particularly in respect of the role of 'eligible introducers');
- the monitoring of PEPs; and
- the transparency of beneficial ownership of companies and trusts.

Conclusions

7.48 There can be no let up in the fight against financial crime. Jurisdictions within the scope of this Review should move rapidly to achieve full compliance with the FATF 'key and core' Recommendations. Some will need technical assistance to do so, but the benefits of such assistance will only be secured on a long-term basis if the local government makes and keeps a clear commitment to tackle financial crime and fund sufficient resources. There can be no second chances.

7.49 The international community has recognised the need to improve international standards to fight financial crime. The UK should take the lead in encouraging improvements. Improving compliance in the jurisdictions within the scope of this Review would strengthen the UK's hand.

[1] Transparency International UK: Combating Money Laundering And Recovering Looted Gains – raising the UK's game. Published June 2009

Recommendations

The Review recommends that:

- to meet international standards, jurisdictions which have not already done so should move to amend laws and procedures as necessary to achieve compliance with the FATF 16 'key and core' Recommendations;
- at an international level, the UK should press for improvements in 'know your customer' minimum standards and promote moves towards improved transparency of beneficial ownership of companies and trusts and the monitoring of politically exposed persons;
- the UK should discuss with those jurisdictions in need of technical assistance to fight financial crime how that assistance might be delivered and the benefits of assistance secured in the longer-term.

A Terms of reference

A.1 The UK Government's decision to commission an independent review of British offshore financial centres; their role in the global economy; and their long-term business strategies was announced in the 2008 Pre-Budget Report.

Terms of reference

A.2 HM Treasury published the terms of reference for the independent review on 2 December 2008. These are set out below:

Purpose

A.3 The Chancellor of the Exchequer has asked Michael Foot to conduct an independent review of the long-term opportunities and challenges facing the British Crown Dependencies and Overseas Territories as financial centres, which have been brought into focus by recent financial and economic events.

Scope

A.4 The review will work first with Crown Dependencies then Overseas Territories with significant financial centres to identify opportunities and current and future risks (and mitigation strategies) to their long-term financial services sector, including:

- financial supervision and transparency;
- taxation, in relation to financial stability, sustainability and future competitiveness;
- financial crisis management and resolution arrangement; and
- international co-operation.

A.5 The review will take account of Crown Dependencies' and Overseas Territories' respective constitutional relationships with the UK. Changes to the UK's constitutional relationship with Crown Dependencies and Overseas Territories are out of scope for the review.

Timing

A.6 The Review will report to the Chancellor of the Exchequer, copied to the Lord Chancellor, Foreign Secretary, and the Governments of the UK's Crown Dependencies and Overseas Territories; and will produce interim conclusions for Budget 2009; with fuller conclusions later in the year.

Financial centres covered

A.7 Only those Crown Dependencies and Overseas Territories with significant financial centres are included within the scope of the review. These are:

Crown Dependencies

- Guernsey;
- Jersey; and
- Isle of Man.

Overseas Territories

- Anguilla;
- Bermuda;
- British Virgin Islands;
- Cayman Islands;
- Gibraltar; and
- Turks and Caicos Islands.

B Consultation

B.1 The Review has consulted the authorities in the jurisdictions within the scope of the Review.

B.2 It has also consulted HM Treasury, HM Revenue and Customs, the Foreign and Commonwealth Office, the Ministry of Justice, the Department for International Development and the Financial Services Authority in the UK.

B.3 The Review has also benefited from the willingness of a wide range of other interested parties to give generously of their time. These organisations and individuals are listed below and include non-governmental organisations, financial services providers and individual members of the public:

Action Aid

Anguilla Bar Association

Anguilla Financial Services Association

Association of Bermuda Insurers and Reinsurers

Association of British Insurers

Association of Guernsey Banks

Association of Investment Companies

Association of Private Client Investment Managers

Bank of Bermuda

Bank of Butterfield

Bank of England

Bankers Association of the Turks and Caicos

Barclays Bank

Bermuda Bar Council

Bermuda International Business Association

BNP Paribas Jersey Trust Corporation Ltd

CAFOD

Cains Advocates Ltd

Capital International Ltd

Cayman Islands Bankers' Association

Cayman Islands Bar Association

Cayman Islands Fund Administrators

Cayman Islands Law Society

Cayman National Bank and Trust Company (Isle of Man) Ltd

Christian Aid

Citibank (Channel Islands) Ltd

CMI Financial Management Services Ltd

Deloitte

Depositors of Kaupthing, Singer & Friedlander (Isle of Man) Bank (KSFIOM)

Ernst & Young

Financial Ombudsman Service, UK

Global Witness Ltd

Guernsey Association of Trustees

Guernsey Society of Trust and Estate Practitioners

Guernsey Bar Council

Guernsey Society of Chartered and Certified Accountants

Guernsey Insurance Companies Management Association

Guernsey International Business Association

Guernsey Investment Funds Association

HSBC Bank International Ltd

Insurance Managers Association of Cayman

Investment Management Association

Isle of Man Finance

Isle of Man Bankers Association

Isle of Man Fund Management Association

Jersey Finance Ltd

KPMG

Linklaters

Lloyds Banking Group

Lloyd’s of London

Marsh Management Services

Michael Hardy

Mourant

National Bank of Anguilla

Ogier

Organisation of Economic Co-operation and Development

Oxfam

Ozannes

Peter Beckett and Vilma Rocha

Pricewaterhouse Coopers

Royal Bank of Scotland

Royal Anguilla Police

Society of Trust and Estate Practitioners

Tax Justice Network

TCI Bank

TCI Bankers' Association

TCInvest

TISEF Limited

TUC

Transparency International

Trustee Investment Strategy for Endowments and Foundations

Volaw Trust and Corporate Services Ltd

Walkers

Summary of Constitutional Relationships

Crown Dependencies

C.1 Jersey, Guernsey and the Isle of Man are dependencies of the Crown. Her Majesty The Queen is Head of State of each Dependency and appoints a Lieutenant Governor as her personal representative.

C.2 The Dependencies are not part of the UK.

Domestic policies

C.3 Each Crown Dependency determines its own domestic policies through a directly elected legislative assembly. UK legislation does not extend to the Dependencies, but they may request its extension to them by an Order in Council.

C.4 Each Dependency determines its own fiscal policy and raises its own public revenue.

C.5 The Crown Dependencies also have their own legal systems and courts of law.

International representation

C.6 The UK ordinarily represents the Crown Dependencies internationally. When the UK ratifies a treaty it does so on behalf of the United Kingdom of Great Britain and Northern Ireland and any of the Crown Dependencies that wish the treaty to apply to them.

C.7 In certain circumstances, the Crown Dependencies may be authorised to represent their own interests internationally by a process of entrustment.

C.8 The UK is also responsible for the defence of the Crown Dependencies. Each makes an annual voluntary contribution towards the costs of their defence and international representation by the UK.

European Union

C.9 The Crown Dependencies are not members of the European Union. They do, however, have a special relationship with the EU. Protocol 3 of the UK's Treaty of Accession to the European Community makes them part of the customs territory of the Community, and the common customs tariff, levies and agricultural import measures apply to trade between the Crown Dependencies and non-member countries. Other Community rules do not generally apply.

Overseas Territories

C.10 The Overseas Territories are constitutionally not part of the United Kingdom. All of them have separate Constitutions made by an Order in Council. All those within the remit of this Review have Governors. Each Governor is appointed by and represents Her Majesty The Queen. The Governor both represents Her Majesty in the Territory, and represents the Territory's interests to the UK Government.

C.11 Each Governor is responsible to the Secretary of State and, through him, to The Queen and the UK government, for the security and proper governance of the Territory.

Self-government

C.12 The degree of self-government enjoyed by an Overseas Territory depends on its stage of constitutional development. In most Overseas Territories, the Governor has special responsibility for defence, external affairs, internal security, including the police, the public service, and the administration of justice. In Anguilla and the Turks and Caicos Islands this extends to international financial services. Territory governments are responsible for the proper management of their local economies.

C.13 Most Overseas Territories' constitutions provide for certain reserve powers to protect the UK Government's overall responsibility for the good governance of the Overseas Territories. These include the power of a Secretary of State to instruct the Governor in the exercise of his functions; the power to disallow Overseas Territories legislation; and (except Bermuda) the power to legislate for the peace, order and good government of the Territory by Order in Council.

C.14 Bermuda has almost full internal self-government, with a premier presiding over a cabinet, whose meetings the Governor does not attend.

C.15 In Gibraltar, which also has a large measure of internal self-government, the Governor is responsible for defence, external affairs, internal security and certain functions in relation to appointments to public offices. The Chief Minister chairs the Council of Ministers meetings, which the Governor does not attend.

C.16 Gibraltar is within the EU and so its financial centre is required to comply with EU requirements on regulation, money laundering and exchange of information.

C.17 The 2006 Turks and Caicos Islands Constitution was amended by an Order in Council on 14 August 2009[1] for the next two years. The amendment order suspended the legislature, dissolved the cabinet and scrapped the constitutional right to jury trial. In place of the previous structure the Governor may take advice from an Advisory Council and receive recommendations from a Consultative Forum. Prior to the amendment to the 2006 Constitution, the Governor was inter alia responsible for the regulation of international financial services; he now has control of all aspects of government, including finance and financial services.

International representation

C.18 Unless expressly authorised to do so by the UK Government, Overseas Territories do not have the authority to become party to treaties in their own right. The UK must, therefore, extend treaties to the Overseas Territories. This is done either at the time of the UK's ratification or later following a consultation process.

C.19 The Territory Government is, however, sometimes entrusted with authority to conclude international agreements. Bermuda and the British Virgin Islands have a standing entrustment which allows them to negotiate treaties in specific areas.

UK objectives

C.20 A UK government objective is to maintain financial stability within the Overseas Territories' financial services centres. Other objectives are to support international standards, and manage

[1] Statutory Instrument No. 701, 2009, *The Turks and Caicos Islands Constitution (Interim Amendment) Order 2009*.

the reputational risk and the risk of contingent liabilities to the UK. It is the FCO's goal that all Overseas Territories fully implement international standards of regulation and supervision.

C.21 The UK government understands that the Overseas Territories' economies are significantly reliant upon revenue from financial services business and a substantial downturn in this sector, for whatever reason, could result in pressure on the UK Government to provide direct economic aid.

Borrowing Guidelines

C.22 To mitigate the risk of excessive Overseas Territory borrowing creating contingent liabilities for the UK, the FCO has agreed Borrowing Guidelines with a number of territories. The guidelines define three ratios, which together specify a prudential framework for Overseas Territory government and government-guaranteed borrowing. The ratios impose maximum limits for the total volume of outstanding debt and the annual cost of debt-service, and a minimum level for Government reserves. If all three ratios are not met, further Overseas Territory borrowing will not ordinarily be approved by the UK Government.

C.23 The FCO has Borrowing Guidelines in place for Anguilla, the British Virgin Islands, the Cayman Islands and the Turks and Caicos Islands. The Cayman Islands have enshrined these guidelines in local legislation.

C.24 Although there are no guidelines in place for Bermuda and Gibraltar, Bermudian law limits debt to a percentage of GDP, which the FCO monitor. In Gibraltar, the law places an upper financial limit on net public debt in addition to restrictions on the percentage of GDP, recurrent revenue and the debt service ratio.

D Financial crime and regulatory resources

D.1 This Annex records data provided by the jurisdictions during the course of the Review. Where no data is given for a year, it is either not available for that year or has not been provided.

Anguilla

Table D.A: Regulatory resources[1]

	2002	2003	2004	2005	2006	2007	2008
Resources							
Total staff in post	-	-	4	6	6	6	7
Total annual revenue (US$000)	-	-	267	516	645	791	1,012
Licences							
Licences in issue	-	-	102	179	248	325	417
Licences in each class:							
Banking	-	-	7	7	7	7	7
Corporate service providers	-	-	30	30	35	42	45
Trust service providers	-	-	13	16	18	19	19
Insurance[2]	-	-	47	99	138	180	263
Collective investment schemes (Mutual Funds)	-	-	5	27	50	77	83
Inspections							
On site inspections completed	2	15	7	8	10	9	28
Inspections by licence class:							
Banking	-	3	-	-	-	3	4
Corporate service providers	2	12	6	7	7	2	14
Trust service providers	-	-	1	1	3	1	3
Investment business	-	-	-	-	-	1	7
Collective investment schemes (Mutual Funds)	-	-	-	-	-	-	-
Money transfer agents	-	-	-	-	-	2	-

[1] The Anguilla Financial Services Commission did not exist until 2004. The Financial Services Commission was preceded by the Financial Services Department which conducted onsite examinations during 2002 and 2003.

[2] As at 31 December 2008, 184 of the insurance providers were captive insurers.

Table D.B: Financial crime

	2002	2003	2004	2005	2006	2007	2008
Total staff in post	-	-	-	1	1	1	4
Suspicious transaction reports:							
Received	6	8	5	9	7	6	30
Investigated	6	8	5	9	7	6	30
Not pursued	-	-	-	-	-	-	-
Disseminated to local agencies	-	-	-	-	1	-	3
Disseminated to international agencies	-	3	-	-	-	-	6
Other types of disposal	-	4	-	2	-	1	25
International co-operation and assistance							
Letters of request for assistance	1	-	-	1	-	-	1
Number of requests made to other jurisdictions	-	-	-	1	-	-	44
Prosecutions							
Local prosecutions for financial crime	-	-	-	-	2	3	8
Prosecutions in other jurisdictions where evidence contributed	1	-	-	-	1	-	1
Proceeds of crime asset recovery							
Assets frozen (US$000)	-	-	-	-	-	-	1,476
Assets seized (US$000)	-	-	-	-	-	-	60
Assets confiscated	-	-	-	-	-	-	-

Bermuda

Table D.C: Regulatory resources

	2002	2003	2004	2005	2006	2007	2008
Resources							
Total staff in post	60	66	71	83	84	107	131
Total annual revenue (Bd$000)	10,039	12,237	15,414	23,596	22,483	28,971	29,250
Licences							
Licences in issue	2,639	2,795	2,647	2,694	2,857	2,879	2,645
Licences in each class:							
Banking	5	5	5	5	5	5	5
Investment business	52	54	52	53	57	57	61
Trust business	29	32	31	33	33	32	31
Collective investment schemes	912	1,022	1,149	1,182	1,302	1,303	1,133
Fund administrators[3]	-	-	-	-	-	-	41
Money service business[4]	-	-	-	-	-	1	2
Insurance	1,641	1,682	1,410	1,421	1,460	1,481	1,372
Inspections							
On site inspections completed	16	20	17	32	26	43	34
Inspections by licence class[5]:							
Banking	6	3	5	5	4	4	2
Investment business	10	15	7	11	2	7	4
Trust business	-	2	5	12	7	5	2
Collective investment schemes/funds	-	-	-	-	-	-	-
Fund administrators	-	-	-	-	-	-	6
Money service business	-	-	-	-	-	-	0
Insurance	-	-	-	4	13	27	20

[3] Fund administrators were required to be licensed from 7 March 2008.

[4] Money service businesses required licenses from 16 January 2007.

[5] There is no on site regime in place for investment funds. The trust business onsite programme began in 2003. The effective start date for the onsite program for fund administrators was 7 March 2008.

Table D.D: Financial crime

	2002	2003	2004	2005	2006	2007	2008
Total staff in post[6]	4	5	8	7	9	9	5
Suspicious transaction reports:							
Received	2570[7]	275	162	200	314	246	256
Investigated	42	16	26	14	1	4	24
Not pursued	-	-	-	-	-	-	-
Disseminated to local agencies	-	-	-	-	-	-	5
Disseminated to international agencies	23	50	49	39	45	37	25
Other types of disposal	2528[8]	259	136	186	314	204	232
International co-operation and assistance							
Letters of request for assistance	2	3	9	8	6	7	6
Number of requests made to other jurisdictions	-	3	4	4	4	8	6
Prosecutions							
Local prosecutions for financial crime	7	6	9	5	9	6	8
Prosecutions in other jurisdictions where evidence contributed	3	1	7	6	10	16	5
Proceeds of crime asset recovery							
Assets frozen (Bd$000)	-	-	-	-	-	-	-
Assets seized (Bd$000)	-	207	149	525	1,771	129	45,703
Assets confiscated (Bd$000)	-	121	93	467	1,724	85	22,894

[6] 2002-2007 figures relate to the Financial Investigation Unit of the Bermuda Police Service. Figures for 2008 and 2009 relate to the Financial Investigation Agency.
[7] The high number of STRs received during 2002 can be attributed to the activities of certain entities that were closed down during that period.
[8] STRs retained for intelligence value.

British Virgin Islands

Table D.E: Regulatory resources

	2002	2003	2004	2005	2006	2007	2008
Resources							
Total staff in post	81	97	114	121	127	130	131
Total annual revenue (US$000)	113,837	112,940	121,789	145,947	159,065	178,243	184,599
Licences							
Licences in issue	3013	3010	3285	3589	3836	3995	4153
Licences in each class:							
Banking	13	11	10	8	9	9	9
Fiduciary	194	221	235	232	231	234	206
Investment business	2446	2391	2613	2886	3112	3280	3534
Insurance	360	387	427	463	484	472	404
Inspections							
On site inspections completed	7	-	6	18	27	27	52
Inspections by licence class:							
Banking and fiduciary: banks	-	-	-	1	1	-	6
Banking and fiduciary: trust companies	7	-	5	5	10	14	22
Investment business	-	-	-	-	-	-	4
Insurance	-	-	1	13	16	13	14
Insolvency	-	-	-	-	-	-	5

Table D.F: Financial crime

	2002	2003	2004	2005	2006	2007	2008
Total staff in post	-	-	6	6	6	7	7
Suspicious transaction reports:							
Received	140	65	61	101	102	104	153
Investigated	140	65	61	101	102	75	104
Not pursued	-	-	-	-	-	29	49
Disseminated to local agencies	-	-	-	-	2	-	6
Disseminated to international agencies	-	-	-	-	-	-	12
Other types of disposal	-	-	-	-	-	-	-
International co-operation and assistance[9]							
Letters of request for assistance	-	-	33	52	26	33	16
Number of requests made to other jurisdictions	3	-	-	4	3	7	1
Prosecutions							
Local prosecutions for financial crime	-	-	130	12	43	21	2
Prosecutions in other jurisdictions where evidence contributed	-	-	-	-	-	-	-
Proceeds of crime asset recovery							
Assets frozen (US$000)	-	-	1,700	52,071	-	1,600	45,455
Assets seized / confiscated (US$000)	-	-	445	4,138	2,622	46,314	45,455

[9] These figures include AML and general statistics. Additional data on FSC and FIU has not been included.

Cayman Islands

Table D.G: Regulatory resources

	2002	2003	2004	2005	2006	2007	2008
Resources							
Total staff in post	90	88	92	95	104	116	122
Total annual revenue (KY$000)	10,012	5,572[10]	11,999	12,515	17,517	18,834	19,300
Licences							
Licences in issue	2,399	2,307	2,337	2,357	2,367	2,386	2,374
Licences in each class:							
Banks	382	347	318	305	291	281	278
Fiduciary Services	347	333	320	318	333	320	318
Insurance	742	786	837	871	907	940	951
Investment and securities[11]	922	835	856	856	829	838	820
Money services businesses	6	6	6	7	7	7	7
Inspections							
On site inspections completed	94	33	53	50	53	53	51
Inspections by licence class:							
Banking[12]	68	15	31	20	19	9	23
Fiduciary services[13]	19	9	12	2	4	6	3
Insurance[14]	6	8	9	12	8	11	13
Investment and securities	1	1	1	16	22	27	12

[10] The figures reflect the half-year position as the Authority transitioned from calendar year to fiscal year ending in June.

[11] Registered mutual funds are not included in the investments and securities or licences in issue total as they are not subject to licensing. These figures are: 2002 – 3,593, 2003 – 4,168, 2004 – 5,249, 2005 – 6,429, 2006 – 7,481, 2007 – 8,751, 2008 – 9,231.

[12] All fiscal years ending June, except for 2002, which was on a calendar year basis.

[13] Calendar year.

[14] Inspections have been under-reported in the past. An insurance manager may have several insurance companies under management that have to be inspected.

Table D.H: Financial crime

	2002	2003	2004	2005	2006	2007	2008
Total staff in post	-	-	6	6	6	7	7
Suspicious transaction reports:	**2002**	**2003-4**	**2004-5**	**2005-6**	**2006-7**	**2007-8**	**2008-9**
Received	443	282	244	221	219	247	320
Investigated	-	-	195	170	189	213	284
Not pursued	-	-	49	51	30	34	36
Disseminated to local agencies	-	-	36	27	28	36	87
Disseminated to international agencies	-	-	20	19	33	34	22
Other types of disposal	-	-	32	44	26	45	57
International co-operation and assistance	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Letters of request for assistance	46	55	46	46	45	27	35
Number of requests made to other jurisdictions	6	1	1	2	-	4	3
Prosecutions							
Local prosecutions for financial crime	-	-	-	3	16	14	9
Prosecutions in other jurisdictions where evidence contributed	7	5	9	2	6	4	2
Proceeds of crime asset recovery							
Assets frozen (KY$000)	7,700	64,400	31,827	178	21,376	227	298
Assets seized	-	-	-	-	-	-	-
Assets confiscated (KY$000)	-	3,604	-	-	4,677	902	103

Gibraltar

Table D.I: Regulatory resources

	2002	2003	2004	2005	2006	2007	2008
Resources							
Total staff in post	14	16	18	21	24	27	31
Total annual revenue (£000)[15]	-	913	1,279	1,237	1,464	1,591	1,708
Licences							
Licences in issue	229	231	242	258	273	307	308
Licences in each class:							
Banking	19	18	17	18	18	18	19
Insurance	58	64	73	83	88	94	97
Investment	74	71	72	75	85	108	120
Trust and company service providers	78	78	80	82	82	87	72
Inspections							
On site inspections completed	28	38	63	61	58	83	88
Inspections by licence class:							
Banking	21	15	36	21	18	16	14
Fiduciary	7	21	13	14	19	33	25
Insurance	-	-	1	13	12	12	24
Investment	-	2	13	13	9	22	25

[15] Annual revenue is from the audited financial statements as at 31 March of the following years: 2002-3. 2003-4, 2004-5, 2005-6, 2006-7, 2007-8 and 2008-9.

Table D.J: Financial Crime

	2002	2003	2004	2005	2006	2007	2008
Total staff in post	7	7	6	5	5	5	6
Suspicious transaction reports:							
Received	180	130	123	108	118	142	270
Investigated	140	82	80	49	81	97	148
Not pursued	40	48	43	59	37	45	122
Disseminated to local agencies	140	82	80	49	81	97	148
Disseminated to international agencies	48	28	35	24	32	63	42
Other types of disposal	-	-	-	-	-	-	-
International co-operation and assistance							
Letters of request for assistance	-	56	32	47	50	46	50
Number of requests made to other jurisdictions	-	-	-	-	-	-	-
Prosecutions							
Local prosecutions for financial crime	25	19	14	39	39	28	35
Prosecutions in other jurisdictions where evidence contributed	15	23	19	34	36	29	42
Proceeds of crime asset recovery							
Assets frozen	-	-	-	-	-	-	-
Assets seized	-	-	-	-	-	-	-
Assets confiscated	-	-	-	-	-	-	-

Guernsey

Table D.K: Regulatory resources

	2002	2003	2004	2005	2006	2007	2008
Resources							
Total staff in post[16]	63	77	82	89	91	94.1	89.3
Total annual revenue (£000)	5,805	6,610	7,198	7,799	8,662	9,683	10,013
Licences							
Licences in issue	1,415	1,364	1,386	1,423	1,505	1,590	1,737
Licences in each class:							
Banking	67	61	54	50	50	47	48
Fiduciary	200	202	201	198	205	203	203
Investment[17]	428	428	446	486	554	636	680
Insurance	720	673	685	689	696	704	806
Inspections							
On site inspections completed[18]	133	128	123	96	107	97	115
Inspections by licence class:							
Banking	26	26	22	12	20	17	16
Fiduciary	53	52	51	48	43	40	27
Insurance	28	31	27	20	30	28	31
Investment	26	19	24	16	14	12	32

[16] Staff numbers are actual numbers until 2006 and on a full-time equivalent basis from 2007.

[17] Investment funds are not included within the investment numbers, nor within total licences in issue. These figures are: 2002 – 672, 2003 – 662, 2004 – 703, 2005 – 778, 2006 – 691, 2007 – 1,122, 2008 – 1,216.

[18] The on site inspections to licensees also cover entities managed and administered by the licensee. This applies particularly in the investment and insurance areas where, for example, a review of the effectiveness of the AML/CFT frameworks of licensed managers, also encompasses those licensed insurers which they manage. In 2008, the onsite inspections figure includes 9 inspections of registered businesses.

Table D.L: Financial crime

	2002	2003	2004	2005	2006	2007	2008
Total staff in post[19]	-	14.5	14.5	14.5	15.5	16.5	17.5
Suspicious transaction reports:							
Received	777	705	757	650	555	760	519
Investigated	638	583	634	534	383	557	418
Not pursued	139	122	123	116	172	203	101
Disseminated to local agencies	628	556	434	445	304	393	436
Disseminated to international agencies	1,174	661	617	552	370	427	543
Other types of disposal	-	-	-	-	-	-	-
International co-operation and assistance							
Letters of request for assistance	-	-	35	60	52	46	43
Number of requests made to other jurisdictions	-	-	-	-	1	1	2
Prosecutions							
Local prosecutions for financial crime	-	1	-	1	1	5	1
Prosecutions in other jurisdictions where evidence contributed	-	-	35	60	52	46	43
Proceeds of crime asset recovery							
Assets frozen (£000)	-	4,195	107,999	3,483	105,160	3,252	234
Assets seized (£000)	-	24	-	17	-	-	-
Assets confiscated (£000)	-	92	25	336	83	336	68

[19] Includes police Fraud staff outside of FIU.

Isle of Man

Table D.M: Regulatory resources

	2002	2003	2004	2005	2006	2007	2008
Resources							
Total staff in post[20]	81	88	91.5	91.16	94.76	96.76	107.16
Total annual revenue[21] (£000)	8,585	7,940	8,111	7,612	8,128	7,248	12,609
Licences[22]							
Licences in issue	515	582	607	609	676	750	778
Licences in each class:							
Banking	61	60	57	56	51	48	44
Corporate services	91	140	166	175	179	172	185
Investment	82	88	86	88	88	92	87
Trust services	-	-	-	-	26	91	120
Insurance	263	277	280	275	313	327	318
Gambling	18	17	18	15	19	20	24
Inspections	2002	2003	2004	2005	2006	2007	2008
On site inspections completed[23]	162	210	164	254	252	241	287
Inspections by licence class:							
Banking	31	22	17	19	41	48	59
Investment	52	46	33	71	74	89	47
Corporate and trust services	-	28	34	64	59	43	100
Insurance	N/C	35	41	61	33	18	37
Gambling	79	79	39	39	45	43	44

[20] Includes staff from FSC (including Companies Registry), Insurance and Pensions Authority and Gambling Supervision Commission.

[21] FSC only.

[22] Includes staff from FSC, Insurance and Pensions Authority and Gambling Supervision Commission.

[23] Includes FSC, Insurance and Pensions Authority and Gambling Supervision Commission. In the years 2005-07, joint inspections carried out by FSC for licence classes 'banking', 'investment' and 'corporate and trust services' were recorded separately. In other years, joint visits were allocated to the lead team, removing double counting.

Table D.N: Financial crime

	2002	2003	2004	2005	2006	2007	2008
Total staff in post	18	17	17	19	20.5	21.5	23.5
Suspicious transaction reports:							
Received	1,836	1,916	2,315	2,265	1,652	1,561	918
Investigated[24]	1,836	1,916	2,315	2,265	1,652	1,561	918
Not pursued	-	-	-	-	-	-	-
Disseminated to local agencies	-	-	-	376	333	262	150
Disseminated to international agencies	-	-	-	301	302	213	283
Other types of disposal	-	-	-	-	610	590	424
International co-operation and assistance[25]							
Letters of request for assistance	-	-	117	108	103	84	98
Number of requests made to other jurisdictions	-	-	-	-	85	109	153
Prosecutions[26]							
Local prosecutions for financial crime	-	-	-	3	7	7	2
Prosecutions in other jurisdictions where evidence contributed	-	-	7	3	3	4	1
Proceeds of crime asset recovery							
Assets frozen (£000s)	-	1,080	557	0	250	0	675
Assets seized	-	-	-	-	-	-	-
Assets confiscated	-	-	-	-	-	-	-

[24] Further enquiries are made with regard to all STRs/SARs; local, national and international criminal databases are checked as well as public source information. Where appropriate, they are disseminated to local/international agencies, where they may be used to supplement ongoing investigations, or may cause and investigation to be initiated.

[25] Includes: Financial Supervision Commission and Attorney General's Chambers.

[26] Includes: Financial Crime Unit and Customs & Excise Investigation Section

Jersey

Table D.O: Regulatory resources

	2002	2003	2004	2005	2006	2007	2008
Resources							
Total staff in post	63	81	72	81	85	100	104
Total annual revenue (£000)	10,930	11,727	12,297	13,463	13,928	15,179	15,850
Licences							
Licences in issue	751	754	687	800	1,078	1,034	1,097
Licences in each class:							
Banking	57	55	51	47	46	48	47
Investment	148	145	124	120	119	113	113
Trust and company service providers	245	248	190	184	279	188	186
Collective investment functionaries	126	138	158	281	359	381	438
Money service business[27]	-	-	-	-	-	5	5
Insurance[28]	175	168	164	168	275	299	308
Inspections[29]							
On site inspections completed	130	59	55	126	113	155	197
Inspections by licence class:							
Banking	-	-	-	25	25	27	26
Investment	-	-	-	24	20	23	17
Trust and company service providers	-	-	-	54	32	72	53
Collective investment schemes	-	-	-	23	22	27	19
Insurance[30]	-	-	-	-	14	6	16
Anti-money laundering unit[31]	-	-	-	-	-	-	66

[27] Money service business was not a regulated activity until 2007.

[28] Includes insurance and general insurance mediation business

[29] The Commission restructured its compliance division in 2004. Up to this time, information was recorded on the total number of inspections conducted, rather than licence classes covered by an inspection. Consequently, information in respect of inspections by licence class is not available for the years 2002-2004.

[30] Includes insurance and general insurance mediation business

[31] The Anti-money laundering unit did not start supervising compliance with AML./CFT legislation until 2008.

Table D.P: Financial crime

	2002	2003	2004	2005	2006	2007	2008
Total staff in post	17.5	17.5	17.5	19	19	19	19
Suspicious transaction reports:							
Received	1,612	1,272	1,248	1,162	1,034	1,517	1,404
Investigated	1,612	1,272	1,248	1,162	1,034	1,517	1,404
Not pursued[32]	-	-	-	-	-	-	-
Disseminated to local agencies	-	-	-	-	-	-	-
Disseminated to international agencies	-	-	-	-	-	-	-
Other types of disposal	-	-	-	-	-	-	-
International co-operation and assistance							
Letters of request for assistance	94	114	127	107	77	77	91
Number of requests made to other jurisdictions	23	17	37	10	6	16	6
Prosecutions							
Local prosecutions for financial crime	-	-	-	7	10	7	8
Prosecutions in other jurisdictions where evidence contributed							
Proceeds of crime asset recovery							
Assets frozen (£000)	843	197,978	16,921	46	15,001	49,552	3,862
Assets seized (£000)	843	197,978	16,921	46	15,001	49,552	3,862
Assets confiscated (£000)	-	-	-	-	1,113	1,595	105

[32] Information collected from 1 January 2009.

Turks and Caicos Islands

Table D.Q: Regulatory resources

	2002	2003	2004	2005	2006	2007	2008
Resources							
Total staff in post	21	22	22	21	23	18	20
Total annual revenue (US$000)[33]	N/C	4,510	4,909	6,480	6,952	7,715	7,725
Licences							
Licences in issue	67	69	71	83	89	95	98
Licences in each class:							
Banking	8	7	6	7	8	9	11
Corporate service providers	31	32	34	36	38	43	43
Trust service providers	27	28	28	29	30	30	30
Investment business	-	-	1	6	7	7	8
Collective investment schemes	1	2	2	5	6	6	6
Inspections							
On site inspections completed	-	-	1	11	20	41	8
Inspections by licence class:							
Banking	-	-	1	2	6	-	3
Corporate service providers	-	-	-	4	7	25	3
Trust service providers	-	-	-	4	4	11	1
Investment business	-	-	-	1	2	3	-
Collective investment schemes	-	-	-	-	1	2	1

[33] Annual revenue per year end: 31 March.

Table D.R: Financial crime

	2002	2003	2004	2005	2006	2007	2008
Total staff in post	4	4	3	4	5	4	4
Suspicious transaction reports:							
Received	-	-	5	5	21	36	50
Investigated	-	-	5	5	21	36	50
Not pursued	-	-	5	-	-	-	-
Disseminated to local agencies	-	-	-	-	-	5	26
Disseminated to international agencies	-	-	-	5	9	-	11
Other types of disposal	-	-	-	-	-	-	-
International co-operation and assistance							
Letters of request for assistance	-	-	-	1	3	1	3
Number of requests made to other jurisdictions	-	-	-	-	-	-	-
Prosecutions							
Local prosecutions for financial crime	-	-	-	-	-	-	-
Prosecutions in other jurisdictions where evidence contributed	-	-	-	-	-	-	-
Proceeds of crime asset recovery							
Assets frozen (US$000)	-	-	-	6,000	26	186	16,000
Assets seized (US$000)	-	-	-	6,000	-	186	16,000
Assets confiscated (US$000)	-	-	-	-	-	-	-

E Deloitte tax study

The study follows overleaf.

Understanding Corporate Usage of British Crown Dependencies and Overseas Territories

A Report to the Independent Review of British Offshore Financial Centres

23 September 2009

Audit . Tax . Consulting . Corporate Finance .

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1 Executive summary

Deloitte was commissioned to provide an overall evaluation of the importance of the British Crown Dependencies and Overseas Territories (the "CDs and OTs") in the context of tax avoidance by UK corporates.

The CDs and OTs compete in a global marketplace for financial services business, where most (if not all) countries seek to make their tax regimes internationally competitive. Tax has played a significant role within the business models of the CDs and OTs, but there are other major drivers, so there is scope for them to compete for financial business while moving closer to the emerging international consensus on key tax policy issues.

1.1 Why do corporates use the CDs and OTs?

Retail banks have typically established offshore deposit-taking operations in the CDs and OTs to serve local and expatriate customers in and near the offshore centres, although they have also proved popular with investors from further afield. Their customers' tax position has been a more significant driver than their own.

Use of certain CDs and OTs, particularly for incorporation of special purpose companies, facilitates (albeit typically somewhat tangentially) tax based structured finance activity by investment banks, which can have significant tax revenue effects.

Funds are attracted to the CDs and OTs by certainty of tax exempt status (which may be achievable in jurisdictions such as the UK, but with more difficulty), and by the established legal, regulatory and professional infrastructure. Luxembourg and Ireland are the main competitors in this market.

The scope for avoidance of UK tax by multinational corporates ("MNCs") using the CDs and OTs is restricted by their lack of Double Tax Treaty protection, and has been significantly curtailed in recent years by the introduction of successful anti-avoidance legislation in the UK. MNCs do, however, explore ways of increasing their competitiveness through reducing taxes on their customers, employees and other counterparties.

The CDs' and OTs' main competitors are increasingly countries with developed tax systems and tax treaty networks, but which may be viewed as making their territories available for international tax arbitrage. If the CDs and OTs took action which reduced their competitiveness, the broad impact would almost certainly be that the business would flow, not to the UK, but to one or more of these alternative jurisdictions.

1.2 Can we quantify the tax impact of these activities?

Although some previous studies have attempted to quantify the UK corporate "tax gap" due to tax avoidance, we have not identified any which directly address the contribution of the CDs and OTs.

Our report builds on previous studies which have estimated (based on companies' published accounts) the "expectations gap" between the tax these companies might broadly have been expected to pay, and the tax actually paid. We have then differentiated those elements of the gap which relate to items which can be assumed to be in line with policy intentions of the UK Exchequer, and those that cannot.

Our conclusion is that the unexplained corporation "tax gap" (of which avoidance involving use of the CDs and OTs will be an unidentified sub-component) is likely to be significantly lower than previous estimates.

1.3 Adapting to a changing global tax environment

The CDs and OTs are responsible for their own tax policy. However, in the context of the "international norms" for tax policy emerging after the financial crisis, it is reasonable to explore to what extent their business models depend on tax competition strategies which stand outside the growing international consensus, and the scope for moving towards it without undermining competitiveness. We have focused on consensus models which we have identified in the areas of VAT and corporation tax.

Our tentative conclusions are:

- Although we recognise that the CDs and OTs are extremely heterogeneous and operate elements of tax systems that show considerable variations, they are to a greater or lesser extent distinguished within the developed world by differentiating themselves from the international consensus, sometimes through tax rates but more often through the absence or near absence of certain forms of taxation.
- There is a compelling case for those CDs and OTs which do not already operate VAT or Goods & Services Tax ("GST") to consider introducing such a system to increase the sustainability of their business models by broadening their revenue bases. This would be of particular importance for the OTs, should the global trend for reducing reliance on Customs Duties continue.
- The CDs' industry bases are sufficiently diverse that they have the potential to raise worthwhile levels of revenue from a Corporation Tax ("CT") system more aligned with international "best practice" than the zero/ten regimes currently in place. By contrast, the more narrow industry focus of some OTs suggests that the introduction of a broad-based CT would offer less scope for a significant tax take.
- However, the downside of a properly-constructed "best practice" CT system would appear to be relatively limited. It could bring the CDs and OTs more into the mainstream of the international community, and potentially curtail some scope for tax avoidance.
- Given the diverse tax regimes and industry bases of the CDs and OTs, a "one size fits all" approach may not be appropriate.
- The level of administrative capability in certain of the CDs and OTs may also be a constraint on the development of these tax systems.

There is limited public domain information available to support robust quantitative conclusions, and detailed impact assessments would be needed.

Although beyond the scope of our report, we note that increased transparency, regulation and information exchange are natural ways to address issues of tax evasion.

2 Introduction

2.1 Our remit

Deloitte was commissioned to provide an overall evaluation of the importance of the British Crown Dependencies and Overseas Territories that represent financial centres[1] in the context of tax avoidance by UK corporates.

The context of this work is the independent review being carried out by Michael Foot into the long-term opportunities and challenges facing the CDs and OTs as financial centres, which has been brought into focus by recent financial and economic events. We were asked to provide the following:

- An explanation of why offshore financial centres are used in different commercial structures; providing insight into both the tax drivers and the consequences of such structures;
- An update of previous studies in the context of the current debate around corporate tax avoidance;
- An analysis of the potential impacts for the CDs and OTs of adapting to changes in the global tax environment, not least following the financial crisis.

2.2 Our approach

2.2.1 Summary of key findings

Because of the nature of financial services, the CDs and OTs compete in a global arena in which most (if not all) countries seek to make their tax regimes internationally competitive. The key features of this global competitive landscape, and the positioning of the CDs and OTs within it, are outlined in Section 2.3 and following below, and then developed throughout this report. To help illustrate the role played by tax within the business models of the CDs and OTs, our report focuses on the interaction of the CDs and OTs with the UK.

Our report first examines the importance of tax relative to other drivers of UK companies' decisions to operate in the CDs and OTs, which necessarily deals with specific UK taxation issues and perspectives. We then consider the impact of these operations on the UK in terms of the tax avoidance debate, by attempting to quantify the tax loss to the UK from corporate tax avoidance.

The business models adopted by the CDs and OTs have come under increasing pressure, both as a result of the tax avoidance debate conducted in the international arena and also as a result of economic pressures faced by the jurisdictions themselves. We have therefore also sought to assess the extent to which it is possible to identify a consensus regarding "best practice" taxation models in the global landscape, and where the CDs and OTs stand in relation to such models. Finally, to the extent that their business models stand outside the international "best practice" consensus, we offer some initial observations on the likely impact for the competitiveness of the CDs and OTs of moving towards this consensus model.

Section 3 sets out a summary of our key findings.

[1] We were asked to consider Jersey, Guernsey, the Isle of Man, Gibraltar, the Cayman Islands, Anguilla, the Turks & Caicos, the British Virgin Islands and Bermuda. Other Crown Dependencies and Overseas Territories are outside the remit of this report.

2.2.2 Why do corporates use the CDs and OTs?

Our approach to explaining the use of the CDs and OTs has consisted of a series of thematic case studies. These studies have been arranged by:

- Key industry sectors (Banks; Funds; Securitisation; Insurance; Trusts);
- Areas where specific tax arbitrage opportunities exist (VAT; Corporate tax; Stamp duty; Withholding taxes);
- Areas where non-tax arbitrage opportunities exist (Legal factors; Regulatory factors).

The focus has been on what factors influence location decisions together with an analysis of why particular CD or OT regimes are considered to be favourable for a particular sector. Where appropriate, we have provided diagrams which illustrate typical structures used. This is covered in Section 4.

2.2.3 Can we quantify the tax impact of these activities?

We have provided an overview of the key public-domain literature which has influenced the current debate regarding tax avoidance by corporates and its potential relevance to the use of the CDs and OTs. We have also provided an assessment of the potential UK "tax gap" due to tax avoidance by analysing the tax disclosures in the financial statements of 50 of the largest companies in the FTSE to gain an insight into the difference between their published tax charges and their "expected" charges, and how much of this difference is potentially due to tax avoidance (of which, activities involving the CDs and OTs would be a component). This is covered in Section 5.

2.2.4 Adapting to a changing global tax environment

We recognise that the British Offshore Financial Centres are responsible for their own tax policy, but (in the context of emerging international "best practice" norms around tax and information exchange policy) it is reasonable to explore to what extent their business models depend on competition strategies which stand outside this consensus, and the impact on their competitiveness and the sustainability of their revenue bases of moving towards such a model. This is covered in Section 6.

2.3 Background

2.3.1 Typical patterns in the evolution of taxes

Most developed economies now raise revenues from a wide range of taxes. Typically these taxes tended to evolve historically, sometimes substantially and over long periods of time, often in the following sequence:

- Taxes on particular transactions, property, and forms of consumption;
- Personal income taxes;
- Corporate income taxes;
- Social security (and National Insurance) taxes;
- VAT.

The pattern has been varied, and heavily influenced by such factors as the need to finance wars and the development of welfare states.

As more countries have developed a broad range of taxes, there has also been an awareness of tax competition issues, and of the need to avoid excessive distortions of business activity, with the introduction of a range of reliefs and exemptions targeted to mitigate negative effects of taxation without facilitating avoidance.

2.3.2 Different tax profiles visible in the world today

Given the very widespread occurrence of these taxes globally, it has been essential for the encouragement of cross-border activity and investment to mitigate the impact of double taxation[2]. Key to this has been the development of Double Taxation Agreements ("DTAs"), the focus of which tends to be on income (and Social Security) taxes and corporation taxes. There is now a very extensive network of direct tax DTAs worldwide - the UK, for example, which has the largest network, has concluded in excess of one hundred such DTAs.

These treaties are now fundamental to the operation of cross-border transactions and investments in the global economy, and the international competition which they have facilitated has led to a degree of market-led harmonisation of taxation systems between jurisdictions. The harmonisation of VAT rules within the European Union ("EU"), and the EU's influence in the extension of VAT systems more widely, have had a similar impact in respect of indirect taxation, so that it is now possible to talk in terms of an emerging consensus regarding a "best practice" for CT and VAT. Our study develops these ideas more fully in Section 6.

The role of DTAs in the global taxation landscape is in fact so central, that it is increasingly appropriate to distinguish countries' tax profiles by reference to the following categories[3]:

- "Full-tax" Treaty jurisdictions - i.e. those with a fully developed range of taxes levied at significant levels, and extensive DTA networks (these would include the UK, US, France, and Germany, for example);

- "Tax arbitrage-oriented" Treaty jurisdictions – those with similarly well developed tax systems but which may be viewed as making their territories available for international tax arbitrage (these might include Luxembourg, Ireland, the Netherlands and Switzerland);

- "Limited/no Treaty" jurisdictions - the CDs and OTs fall into this category. Insofar as this might be taken to imply the absence of at least some of the more "modern" forms of taxation as set out under Section 2.3.1 above, it would be more true of the OTs than of the CDs. But none of these territories has extensive DTA networks. The popular image of these jurisdictions fails to recognise that the attractiveness of a no- or low-tax regime will be limited where DTAs are needed to mitigate costs on transaction flows between territories.

Although a separate issue, it is also worth noting that different countries have different traditions as regards the extent of confidentiality of banking customer information from the State, and there is only limited correlation between this and whether countries are "Limited/no Treaty" or "Tax arbitrage-oriented" - there are examples of strong confidentiality tradition countries in both.

2.3.3 Evolution of the tax regimes of the CDs and OTs

In terms of the model of tax regime evolution outlined at 2.3.1 above, most of the OTs have not progressed beyond the imposition of specific transaction and consumption taxes: they operate a range of customs duties on imports, on which they are still heavily reliant for revenue-raising. With the exception of Gibraltar, they have not introduced income (or Social

[2] Double taxation is the imposition of two or more taxes in different jurisdictions on the same income, asset or transaction.

[3] For these purposes we have focused on Europe and North America. The pattern becomes more complex if the Middle East and the Developing world are included. This categorisation inevitably involves a degree of over-simplification, but is nevertheless instructive.

Security) taxes, corporation taxes, or VAT/GST. They have therefore not positively changed their tax model to attract business.

The CDs and Gibraltar did introduce income tax, and extended it to apply to companies. The subsequent development of their corporate taxation model to some extent represented a tactical policy. For example, Jersey applied a 20% income tax rate, but with exemptions for certain foreign-owned companies, designed to make the territory more attractive to international investors. Guernsey, the Isle of Man and Gibraltar had similar models. This type of approach (of which there were then examples in many countries with quite different tax profiles) was characterised by the Organisation for Economic Co-operation & Development ("OECD") and EU in the late 1990's and early 2000's as harmful tax practices. Between 2006 and 2009, following pressure to reform their tax systems, the CDs changed their models to variants of a "zero/ten" approach, whereby most companies are taxed at 0%, but some - generally in financial services, property or utilities - are taxed at 10% or 20%. The result was a loss of revenues for the CDs, and a benefit at that time for the UK (which previously would have given credit for the higher level of local taxes suffered by UK companies with operations in the CDs).

The development of the CDs in respect of indirect taxes has been more diverse. Guernsey does not currently have a VAT system. Jersey has a GST system (introduced in 2008) with an international services exemption ("ISE") which allows financial services companies to pay a flat fee in return for an opt-out from the regime. The Isle of Man operates VAT, as it is part of the EU VAT territory: receipts collected in the Isle of Man and the UK are pooled and then shared out in accordance with an agreed formula. Again, these outcomes have to some extent brought tactical responses to market opportunities and pressures (for example, the fact that Jersey remains outside the scope of the EU's VAT system has enabled it to retain a modest advantage over the UK as a location for some categories of securitisation Special Purpose Vehicles ("SPVs"), since many services performed for the SPV do not incur VAT charges).

2.3.4 The competitive landscape

This background also helps to illuminate the competitive landscape within which the CDs and OTs operate.

The historical development of the "offshore" market

Many retail banks initially established operations in the CDs in particular to offer services to customers located in and near the offshore centres, and to those elsewhere, such as expatriates, who wished to maintain an offshore bank account[4]. These markets continue to represent an important focus for the CDs in particular. UK customers and expatriates looking for offshore banking are attracted by the development of an "onshore-like offshore" market, with British-looking providers and products located outside the UK but part of the UK clearing system. Increasingly significant numbers of internationally-mobile executives require financial services products which are sufficiently flexible to follow their career movements without giving rise to unnecessary tax inefficiencies due to territory-specific tax rules. Other financial services providers, such as insurers, have also produced offerings targeted at the same markets.

In terms of the corporate market, following the abolition by the UK of foreign exchange controls in 1979, the CDs benefited from significant sterling-financed investment flows by UK companies. However, any tax benefits from this activity were curtailed by the introduction in 1984 of the UK's controlled foreign company legislation, and successive tightening of it over subsequent decades. These rules broadly aim to tax profits of foreign subsidiaries of UK companies accumulated in lower-tax jurisdictions by diversion from the UK.

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[4] The UK's tax system has historically incentivised and continues to incentivise the holding of assets and the receipt and retention of income offshore by some categories of taxpayer. The clearest current example of this is the treatment of non-UK domiciled individuals ("non-doms"), whose income and gains from non-UK assets are taxed only when remitted to the UK. This incentivisation is less now than at times in the past as a result of changes to UK tax legislation, for example the changes in the early 1990's to the offshore trusts regime.

In recent years, the business conducted in the CDs has become increasingly global, for example through the growth of the cross-border funds industry (including, for example, Japanese funds, and vehicles for Russian investment into the UK property and other markets).

Competition from "tax arbitrage-oriented" Treaty jurisdictions

Because of the importance of mitigating withholding taxes on cross-border flows (interest, royalties, and so on), the CDs and OTs increasingly face competition, not merely from other jurisdictions with similar tax profiles, but from "tax-arbitrage oriented" Treaty countries (especially Luxembourg, Ireland and Switzerland). The thematic case studies in Section 4 draw attention to a number of industry sectors and transaction types where this is the case (for example, securitisations of trade receivables through offshore vehicles).

Competition from "full-tax" Treaty jurisdictions

"Full-tax" Treaty jurisdictions also recognise the need to make their tax regimes internationally competitive. For example, UK investment trusts pay little or no tax in practice (however, they have to satisfy a number of detailed tests to achieve this result). The UK has also introduced a regime to ensure that SPVs used in securitisation structures generally have a high level of certainty of paying tax only on their commercial profits (the objective of this was precisely to make the UK an attractive location for securitisation activity). However there are frequently complex requirements to be met, which may reduce the level of certainty. By contrast, both funds and SPVs established in the CDs and OTs are able to achieve certainty of tax result without such hurdles. This certainty of treatment, together with regulatory authorities which aim to be highly responsive to customer needs in respect of, for example, speed of turnaround, and established specialist support infrastructures, are therefore key components of the competitive models of the CDs and OTs.

The total theoretical absence of distortion by taxation of economic decisions can probably only be achieved in the absence of taxation or else by very broad and clearly available exemptions. But "full-tax" countries do seek and sometimes achieve this in practice by targeted reliefs. A key issue as to how successful they are is the degree of certainty with which they are available.

The impact of "atypical" features of tax regimes

Where avoidance by corporates of tax does occur, it is in some key instances a corporate reaction to aspects of taxation policy which are "out of line" with typical tax policies globally. These are frequently legitimate policy choices, which appear to be successful in raising tax revenues while leaving vibrant domestic markets. However, they do create tensions which incentivise companies and financial institutions to investigate offshore opportunities. In almost all cases, a wide range of other jurisdictions could be used in place of the CDs and OTs.

Arbitrage opportunities between "full-tax" jurisdictions

Some tax-motivated arrangements (such as Tax Based Structured Financing Arrangements – "TBSFAs") work by identifying and exploiting arbitrages in tax treatment between two "full-tax" jurisdictions – often the UK and the US – rather than arbitrages between a "full-tax" jurisdiction and one of the CDs and OTs or jurisdictions with similar tax profiles. Although these arrangements may involve SPVs in the CDs and OTs, a number of other jurisdictions might equally serve this purpose, and it is likely that these or similar transactions could and would continue to be structured without using the CDs and OTs or a jurisdiction with a similar tax profile at all.

Conclusions

Given the above considerations, there can be little doubt that, if the CDs and OTs were to take actions which significantly curtailed their competitiveness, a broad range of "full-tax" jurisdictions – including for example the US – as well as "tax arbitrage-oriented" jurisdictions could be used. It is therefore most likely that the broad impact of such actions would be that the business would flow, not to the UK, but to one of these alternative jurisdictions. Whilst these jurisdictions admittedly lack some of the traditional "familiarity" to investors of the CDs

and OTs, continuing trends in globalisation may mean that this is a less significant factor going forward.

3 Key findings

3.1 Scope and context

Deloitte was commissioned to provide an overall evaluation of the importance of the British Crown Dependencies and Overseas Territories in the context of tax avoidance by UK corporates. Our study does not consider tax evasion, or tax avoidance by individuals. We do not therefore cover the use by individuals of corporate vehicles to "disguise" individuals' identities. There is an established agenda to address these issues through increased transparency, regulation and information exchange.

The global financial crisis has directly impacted the CDs and OTs and the businesses which operate there. It has also underscored the need to develop a more effective international framework for determining the acceptable parameters of tax competition and for promoting tax information exchange, which has already been on the agenda of international bodies for some time. Against that background, it is more important than ever that there should be greater clarity around why corporates use the CDs and OTs; whether the tax impact for the UK of these activities can be quantified; and how the CDs and OTs might continue to adapt to this changing global tax environment.

3.2 Why do corporates use the CDs and OTs?

A number of key themes can be identified in relation to the ways in which UK corporates operate in the CDs and OTs.

Many **retail banks** have established deposit-taking operations, particularly in the CDs, to offer services both to customers located in and near the offshore centres, and to those elsewhere, such as expatriates, who wish to maintain an offshore bank account. UK customers and expatriates looking for offshore banking are attracted by the development of an "onshore-like offshore" market, with British-looking providers and products located outside the UK. These activities are not motivated primarily by the bank's own tax considerations. **Insurers** also offer a range of protection and investment products intended to appeal to the same markets.

The use of certain CDs and OTs, particularly for the incorporation of special purpose companies, has facilitated tax based structured finance activity by **investment banks.** Although the use of these vehicles in the CDs and OTs is typically somewhat tangential to the structure, the tax revenue effects can be significant.

Funds (this study focuses on hedge funds, private equity funds, and general retail investment funds) are generally able to achieve "gross" returns, i.e. without the imposition of tax on the fund, and this is important if they are to attract tax-exempt investors. They are also typically highly mobile, so that it is not easy in practice for a host jurisdiction to impose tax on them. The CDs and OTs offer certainty of tax exempt status (which may be achievable in other jurisdictions such as the UK, but frequently with complex requirements to be met which may reduce the level of certainty), ease of establishment, and ready availability of specialist support infrastructure. Other jurisdictions such as Luxembourg and Ireland compete directly in providing a de facto tax free regime for funds with high levels of certainty.

By contrast, **multinational corporates** do not generally expect to achieve gross returns, and typically do pay substantial amounts of tax. Non-tax factors (for example, innovative or less burdensome company law) are often the key factors influencing location decisions. Where tax mitigation is an objective, the CDs and OTs or other jurisdictions with similar tax profiles are not always viable or attractive as they lack EU or Double Tax Treaty protection from withholding tax or anti-avoidance legislation.

There are some areas where MNCs have sought to pilot through these issues, for example through locating brands and other intellectual property offshore, which have been significantly countered by developments in Controlled Foreign Company and Transfer Pricing

anti-avoidance legislation). Equally they explore ways of reducing taxes on their customers, employees and other counterparties so increasing their competitiveness and/or terms of trade (an example of this would be the exploitation of the Low Value Consignment Relief regime for VAT).

Some tax planning taking place through the CDs and OTs seems to be a corporate response to features of UK taxation which differ from "typical" tax policies globally – examples are Stamp Duty Reserve Tax ("SDRT")[5], levied on the transfer of UK securities, and the so-called "I minus E" regime for life assurance. In almost all cases, a wide range of other jurisdictions could be used in place of the CDs and OTs, and sometimes are. Nevertheless, the UK raises substantial tax revenues from these sources (for example £10,849 million in SDRT revenues in 2007/08 [6]), while succeeding in retaining very substantial business onshore.

The competition faced by CDs and OTs is not merely from other centres which have historically been largely outside the international network of Double Tax Treaties, but increasingly from countries which have well-developed tax systems and Double Tax Treaty networks, but can be viewed as making their territories available for international tax arbitrage. If the CDs and OTs took action which reduced their competitiveness, the broad impact would almost certainly be that the business would flow, not to the UK, but to one or more of these alternative jurisdictions.

On many occasions the UK has introduced successful anti-avoidance measures to protect its tax base without targeting the CDs and OTs specifically.

Other factors, including a stable legal environment and responsive authorities, are frequently key drivers of companies' location decisions.

3.3 Can we quantify the tax impact of these activities?

We have reviewed attempts to quantify the UK "tax gap" relating to CT[7]. There have been a number of studies in this area, but few deal with the loss of tax to the UK specifically, and none of those we have identified directly addresses the contribution of the CDs and OTs to the UK corporate "tax gap".

For our assessment, we have built on the approach adopted in the TUC's 2008 pamphlet "The Missing Billions: the UK tax gap"[8]. We have calculated, by reference to the published 2008 financial statements of 50 of the largest companies in the FTSE, the difference between the tax these companies might broadly have been expected to pay (on the basis of reported profits at the UK headline CT rate) and the tax actually paid. We have then sought to identify the elements of this "crude gap" which relate to items which can be assumed to be "policy intended" (i.e. in line with policy intentions of the UK Exchequer – for example, those that arise because of the differential treatment of "tax depreciation" and "commercial depreciation"). The residual balance represents "potentially policy unintended" differences. A proportion of this residual balance may well of course represent differences which cannot

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[5] Strictly, SDRT is levied on transactions of securities listed on the UK's stock exchanges; stamp duty continues to be levied on transacations of unlisted UK securities.

[6] Per the Office of National Statistics, total Stamp duty take for 07/08 was £14,214 million. SDLT made up £3,275 million.

[7] We do not consider VAT, Stamp Duty or withholding tax. CT has been the focus of the most high-profile previous reports, and of the work to date by the OECD and other international bodies. It is also in practice generally extremely difficult to isolate the specific role of the CDs and OTs in avoidance of these other taxes, although we note that estimates have been made in, for example, the area of LVCR.

[8] This estimates the UK tax loss from corporate tax avoidance by large companies at £11.8 billion p.a., but does not differentiate the specific role of tax havens. The TUC report analyses the reported results of 50 of the largest FTSE companies for the years 2000 – 2006, whereas our study is based on accounts for 2008.

be isolated from the published information, but which could be identified as "policy intended" if sufficient analysis was available. The "tax gap" due to avoidance is therefore a component of that residual difference.

We estimate the total UK Corporation tax potentially lost to avoidance activities to be up to £2.0 billion per annum, although it could be much lower, with avoidance through the CDs and OTs being an unidentified sub-component.

3.4 Adapting to a changing global tax environment

The CDs and OTs are responsible for their own tax policy. However, in the context of the "international norms" for tax policy emerging after the financial crisis, it is reasonable to explore to what extent their business models depend on tax competition strategies which stand outside the growing international consensus, and the scope for moving towards it without undermining competitiveness. In developing this analysis, we have focused on consensus models which we have identified in the areas of VAT and CT as well as a commitment to information exchange.

There is a strong consensus among economists and policy-makers that a form of VAT (or, as it is sometimes referred to, GST) is the most efficient method of releasing resources for public spending by raising revenues at the expense of consumption, without distorting market-driven investment or spending patterns. Although there is less academic consensus around CT, direct taxation of profits is the norm in most countries in which businesses operate. Most global businesses expect to, and do, pay substantial amounts of tax on their profits, and most countries are in a position to extract a "price" for operating in their territories. The emerging pattern is of successful revenue-raising from locally generated active business profits. Relief for any such taxation borne by MNCs in the CDs and OTs should often be available against parent company tax liabilities, reducing any "disincentive" effect from locating there as a result of such a policy.

The current tax regimes of the CDs and OTs are not uniform. The CDs have variants of a so-called "zero/ten" CT regime, whereby most companies are taxed at 0%, but some – generally in financial services, property or utilities – are taxed at 10% or 20%. Of the OTs, only Gibraltar has CT (reducing to 10% from 2010). The Isle of Man operates VAT, Jersey has a GST, and Guernsey has neither. The OTs have a range of Customs Duties.

It is extremely difficult on the basis of the information available to us to offer more than a very limited assessment of the likely impact for the CDs and OTs of moving towards such a consensus model (in respect of VAT, CT, or both), not least because of the differences in their geographical market, natural competitors and profile of industry sectors. To provide a robust basis for decision-making, it would be necessary for the CDs and OTs to conduct detailed studies of the costs and benefits in their specific circumstances. We have suggested a methodology for producing a more comprehensive impact assessment.

In general, there would appear to be a compelling case for those CDs and OTs which do not already operate VAT/GST to consider introducing such a system, potentially to provide a broader revenue base (in particular for the OTs, should the global trend for reducing reliance on Customs Duties continue)[9]. Although we have identified a consensus model, that is not the same as saying that there should be total uniformity (i.e. "one size fits all"). We believe there is scope for jurisdictions to make individual policy choices, and recognise that there is a domestic political aspect to these.

The CDs' industry bases are sufficiently diverse that they have the potential to raise worthwhile levels of revenue from a CT system more aligned with international "best practice" than the zero/ten regimes currently in place. By contrast, the more narrow industry focus of

[9] GST differs from VAT in that it incorporates a single point of tax and hence no need to measure input and output taxes. It may therefore offer a simpler alternative taxation mechanism, but may still require a step change in administration for users on introduction.

some OTs suggests that the introduction of a broad-based CT would offer less scope for a significant tax take.

However, the downside of a properly-constructed “best practice” CT system would appear to be relatively limited. It would reinforce the international institutional framework under which CT is successfully levied elsewhere, and could help counter some of the more egregious examples of tax avoidance by constraining the degree of freedom which corporate groups are able to exercise in using these territories.

It should be acknowledged that not all of the CDs and OTs are in the same position as regards the existence of appropriate infrastructure to support the introduction or extension of these taxes.

Although beyond the scope of our study, we would note that some of the effects discussed above also follow from individual tax evasion. Increased transparency, regulation and information exchange (through, for example, Tax Information Exchange Agreements (“TIEAs”) and extension of the EU Savings Directive (“EUSD”)) are natural ways to address these issues.

4 Why do corporates locate in the CDs and OTs?

This section seeks to address the question "how and why do corporates use the CDs and OTs?" We have provided a series of thematic case studies to illustrate the key issues. These studies have been arranged as follows:

- Key industry sectors (Sections 4.1 - 4.5, covering: Banks; Funds; Securitisation; Insurance; Trusts)
- Areas where specific tax arbitrage opportunities may exist (Sections 4.6 – 4.9, covering: VAT; Corporate tax; Stamp duty; Withholding taxes)
- Areas where non-tax arbitrage opportunities exist (Sections 4.10 – 4.11, covering: Legal factors; Regulatory factors).

Banking

Many retail banks have established deposit-taking operations, particularly in the CDs, to offer services both to customers located in and near the offshore centres, and to those elsewhere, such as expatriates, who wish to maintain an offshore bank account. Once established there, some banks sought to expand the range of services offered to onshore-based customers. UK customers and expatriates looking for offshore banking are attracted by the development of an "onshore-like offshore" market, with British-looking providers and products located outside the UK. These activities are not motivated primarily by the bank's own tax considerations, although tax benefits do incentivise retail banks to structure their operations as subsidiaries, rather than as branches whose profits would be taxable in the UK. Access to the UK's clearing system, and the established infrastructure (regulators, banking expertise and professional staff) are also important factors.

The use of certain CDs and OTs, particularly for the incorporation of special purpose companies, has facilitated tax based structured finance activity by investment banks. Although the use of these vehicles in the CDs and OTs is typically somewhat tangential to the structure (which will frequently work by exploiting arbitrages in tax treatment between two "full-tax" jurisdictions), the tax revenue effects can be significant.

Funds

Funds (this study focuses on hedge funds, private equity funds, and general retail investment funds) are generally able to achieve "gross" returns, i.e. with no or modest imposition of tax on the fund. This is important if they are to attract tax-exempt investors (including pension funds). They are also typically highly mobile, so that it is not easy in practice for a host jurisdiction to impose tax on them.

The CDs and OTs offer certainty of tax exempt status: this may be achievable in other jurisdictions such as the UK, by using tax transparent vehicles such as English Limited Partnerships, which dominate the private equity scene, or corporate vehicles benefiting from specific tax exemptions (for example, from tax on capital gains in the case of investment trusts, approved unit trusts or OEICs), but frequently with complex requirements to be met which may reduce the level of certainty.

The CDs and OTs also offer ease of establishment, and ready availability of specialist support infrastructure (legal, regulatory and professional). Where access to a double tax treaty network is required, the use of the CDs and OTs will be constrained.

Other jurisdictions such as Luxembourg and Ireland compete directly in providing a de facto tax free regime for funds with high levels of certainty.

Securitisations

The originator in a securitisation will typically be located in a "full-tax" jurisdiction. It will generally extract substantially all of the profits from the SPV, and these would normally form part of the originator's taxable profit in its "home" jurisdiction.

The SPV itself will typically earn only a minimal profit for the role it plays in the securitisation. All costs within the SPV are tightly controlled, and there is little tolerance in the structure for uncertain costs (including tax). The UK introduced a specific tax regime for securitisations in 2006, the broad purpose of which is to tax securitisation companies only on the small profit retained in the SPV. However, the tax position offshore has generally been even more certain and non-tax factors such as familiarity and lower compliance costs have resulted in offshore securitisation SPVs (particularly in Cayman and Jersey) continuing to be used where withholding tax issues do not mean a domestic SPV is required.

Although the overwhelming majority of securitisations are entirely commercial, like any other transaction it can be used for tax planning. For example, there have been structures in Jersey (and other locations such as Luxembourg) where the SPV issued preference shares rather than debt, allowing investors (who may be related, rather than third parties) to enjoy a tax favoured return.

Insurance

There can be little doubt that tax considerations have historically played an important role in UK groups' decisions to locate captive insurers offshore. However, the scope for achieving substantial tax benefits has reduced significantly in recent years following the introduction of the UK's CFC rules, and has been further curtailed by changes from 1 July 2009, so that it is likely to become more common for UK parent companies to be assessed to tax on the profits of captive CFCs. It remains to be seen what impact this will have on existing captives located in the CDs and OTs, and the formation of new captives there.

The use of Protected Cell Companies ("PCCs") and Segregated Account Companies ("SACs") may in some circumstances be effective for avoiding the impact of the UK CFC rules, but concerns around the degree to which assets and liabilities are legally ring-fenced have meant that their use has been less common in practice than might otherwise have been the case.

International life insurance operations (based predominantly in the Isle of Man of the CDs and OTs) typically benefit from a specific exemption from the CFC rules, as they require significant local business substance in practice. The market for international life products includes UK expatriates, and also UK residents (for whom a key perceived attraction is that the underlying investment return in the fund will be subject to little or no tax as it builds up, whereas income and gains in a UK onshore life fund will be subject to tax under the so-called "I minus E" regime). The customers' tax considerations have been a more significant driver of this market than the insurers' own tax positions. Ireland and Luxembourg are the main other competitor jurisdictions in this market.

Other key considerations include capital requirements, the regulatory environment (and responsiveness of the regulator), and ready availability of expertise and infrastructure.

Trusts

The use of trusts by corporates is less widespread than their use by individuals, although corporates (including many banks) do provide offshore trust services to individuals. Trusts continue to be important in tax planning for UK non-doms and their families in particular.

Corporates do make use of trusts in some circumstances, most commonly to provide benefits to employees in a tax efficient manner (for example, through Employee Benefit Trusts); for executive pension schemes; and for other reasons, including to hold securitisation SPVs, and where the legal requirements around UK trusts (for example, their legal duration) are restrictive.

We are aware that some groups (anecdotally a small number) have used trusts instead of subsidiaries to hold cash deposits in low or nil tax jurisdictions to avoid the UK CFC rules, on the

grounds that trusts are neither controlled by the UK parent nor companies. Although there are understood to be few instances of such planning, it is believed to involve substantial amounts. The loss of control entailed in putting interests in subsidiaries into trusts may not always sit easily with corporate governance policies.

VAT

From a VAT planning perspective, all of the CDs and OTs (except for the Isle of Man) benefit from being located outside the EU, although no more so than any other non-EU territory.

Corporates do explore ways of reducing taxes on their customers, employees and other counterparties, so increasing their competitiveness and/or terms of trade - LVCR operations located in the Channel Islands in particular are an example of this, and do give rise to lost tax to the Exchequer.

Corporation tax

By contrast with funds, multinational corporates do not generally expect to achieve gross returns, and typically do pay substantial amounts of tax. Non-tax factors (for example, innovative or less burdensome company law) are often the key factors influencing location decisions. Where tax mitigation is an objective, the CDs and OTs or other jurisdictions with similar tax profiles are not always viable or attractive as they lack EU or Double Tax Treaty protection from withholding tax or anti-avoidance legislation.

Whereas ten or twenty years ago it was possible to find examples of UK groups with mainstream treasury and intangible property located in the CDs and OTs, the combination of witholding tax on key cashflows, CFC-based assessment of profits in the UK, and lack of Double Tax Treaty protection severely circumscribe such planning, for which jurisdictions such as Ireland, Luxembourg, Netherlands or Switzerland are more attractive.

Stamp duties

Companies have historically routed land transactions through offshore territories (including the CDs and OTs, and other jurisdictions which do not levy tax on land transactions) to mitigate SDLT, although anecdotally the volume of SDLT planning transactions has declined due to the introduction of increasingly effective anti-avoidance legislation by HMRC.

Offshore companies can be used to mitigate the impact of UK stamp duty on share transactions. Jersey and Guernsey companies are particularly attractive in some instances as their shares can be listed on the UK stock exchanges and settled through CREST.

Withholding taxes

The lack of double tax treaty networks, and the fact that they are not entitled to the benefits of the EU Interest and Royalties Directive, places the CDs and OTs at a competitive disadvantage compared with many other jurisdictions in arrangements which involve withholding taxes. This is not necessarily decisive for structures involving UK withholding tax on interest payments (as evidenced by the number of securitisation companies over UK assets located in Jersey), but is more likely to be prohibitive where royalties are involved.

Legal factors

The CDs and OTs are able to offer legal regimes which are familiar in many respects to practitioners of English law, but offer greater flexibility in some areas than UK company law (in particular, in relation to company distributions and financial assistance), which can be important in some arrangements. However, there are many other jurisdictions around the world that offer a similar level of company law flexibility. Speed of company formation is also cited as an attraction, although it is not consistently faster than in the UK.

Regulatory factors

In our experience, large financial businesses place a significant premium on the stability, transparency, effectiveness and reputation of a jurisdiction's regulatory systems and the extent to which it co-operates with other regulators.

Insurers look to work with regulators who are responsive to their needs. Benign capital requirements may also be a differentiating feature. In some key instances (for example, with the reinsurance industry in Bermuda), these regulatory factors have been a key driver of the development of specific industry sectors.

4.1 Banking

4.1.1 Background

Traditional banking has a straightforward "core" business: banks make money by lending cash to individuals and businesses for a higher return than the costs they incur in raising it. Investment banks undertake a wider range of transactions including helping third party businesses raise funds from bond or equity issues in return for a fee[10].

Banking regulations govern the minimum amount of capital that a bank must have available (although most have substantially more than the minimum to make themselves more attractive to investors) principally in order to protect the position of its depositors from the effect of losses on its loans, or other assets or trading activities[11].

4.1.2 Factors influencing location decisions

Offshore banking

Deposit taking offshore involves two main markets. First, normal retail banking services to the individuals and businesses located in the offshore bank's geographical proximity. Secondly, accepting deposits from individuals who are not necessarily located in their geographical proximity (and who may have little or nothing to do with the UK) but who wish to maintain an offshore bank account with a UK bank of good repute and receive interest income gross of tax (UK bank deposits are paid net of 20% tax to individuals). There are a number of reasons why individuals may choose to do this, some of which are legitimate but some of which are not (e.g. tax evasion). Legitimate reasons include:

- Individuals who are not domiciled in the UK, whose non-UK income if not remitted to the UK may not be subject to UK tax as a matter of policy. (Individuals who are not tax resident in the UK are not subject to UK tax at all.)

- Wealthy individuals who fear that they would be subject to kidnap risk and other threats if the true extent of their wealth were widely known in their own home jurisdictions.

- There is a certain cachet associated with the mainstream banks operating in the CDs in particular, which is appealing to some account holders.

- A key factor for locating in the CDs and Gibraltar has been access to the UK's clearing system. Companies with overseas (non-CD) subsidiaries have then set up CD bank accounts to access the clearing system.

These reasons have different implications for the choice of offshore centre. Tax planning need not involve "banking secrecy", whereas wealth concealment and, clearly, tax evasion would do so.

The Exchequer is well aware of offshore deposit taking, and indeed the practice is tacitly accepted as genuinely commercial[12]. It should, however, also be acknowledged that the

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[10] They will also provide hedging transactions to third party counterparties and earn income through fees and/or direct profits from running a "book" in the underlying hedging instruments as well as, within strict limits, speculative gains from movements in the underlying hedge.

[11] Increasingly, although some commentators question the effectiveness of different banking regulatory regimes, at least in principle "onshore" and "offshore" banks are subject to similar regulation as there has been a trend toward global banking regulatory harmonisation. In addition the amounts of capital that a bank must have available are calculated in part based on the whole group. Thus the top company in the structure is responsible for holding sufficient capital to back the whole group including the offshore entities.

[12] For example, the Controlled Foreign Companies anti-avoidance legislation includes a specific exemption for banks with subsidiaries in jurisdictions with low taxes that retail deposits and then lend the funds on deposit

offshore deposit taking has, from 1 July 2009, represented an absolute tax benefit for the banks because profits can now be repatriated back to the UK tax-free following the introduction of the tax exemption for dividends[13]. Such benefits clearly incentivise retail banks to structure these operations as subsidiaries, rather than as branches whose profits would be taxable in the UK. Also, once established there, some banks sought to expand the range of services offered to onshore-based customers. However, only having a customer base eager to do business offshore makes offshore retail banking business profitable and attractive.

Investment banking

The location of investment banks is motivated by a number of factors, including:

The "cluster" effect

Investment banking requires a large pool of highly skilled specialists. There are strong "cluster" effects, so it is focused on the City of London and other financial centres. Accordingly, their core UK business is largely onshore. The investment banks themselves have not historically accounted for as many corporation tax receipts for HMRC as retail banks, although this is partly explained by the very high level of salary and bonuses paid to their employees (tax deductible for corporation tax purposes), which would have attracted significant Income tax and, more recently social security contributions. (In earlier years social security receipts would have been eroded by very widespread NIC avoidance over bonuses, which has now been very substantially addressed.)

Use of SPVs for TBSFA[14]

Some banks are also involved in creating and marketing proprietary TBSFAs. A typical TBSFA will involve a bank in one jurisdiction lending or investing in a bank in a second jurisdiction, involving one or more SPVs, in such a way that Bank 1 is not taxed on its investment income and/or Bank 2 is entitled to additional tax deductions that would not otherwise be available. The tax benefit is split between Bank 1 and Bank 2. It should also be noted that the role of either bank could be adopted by non-banking corporates, although in practice at least one of the two will be a bank.

Such SPVs come into existence in the first place for a variety of reasons, one of which is to act as an easily controllable asset whose value can be readily ascertained.

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back to their parent company in the UK. As such, offshore deposits typically flow back to UK. Subsidiaries falling outside the offshore deposit takers exemption generally find it hard to escape the UK CFC net. Insofar as offshore deposit taking is seen as questionable by HMRC, the issue is generally the transfer pricing between the subsidiary and parent.

[13] However, the same could be said of any CFC that has previously benefited from a CFC exemption (whether in a CD, OT or any other jurisdiction with low tax relative to the UK), and in case it is a very new development, so it plays no role in a historic explanation of why these banks are there. It should also be noted that other reliefs were generally available to shelter dividend income prior to the exemption (such as Eligible Unrelieved Foreign Tax credits).

[14] It is difficult to define a TBSFA, although the OECD has noted that they typically have the following characteristics:

- A customised product structured to meet the specific financial objectives of either the bank or a third party customer of the bank
- Requires the participation of professionals from multiple disciplines within the bank
- Generates higher than normal returns or significant fees
- Involves the creation and use of Special Purpose Vehicles (SPVs)
- Involves exposure to elevated levels of market, credit, operational, legal and reputational risk.

In addition, TBSFA may include the use of hybrid entities and/or instruments (i.e. entities or instruments which are characterised differently for tax purposes in different jurisdictions), may have tax savings as their main purpose but may also be commercially motivated, and a perceived lack of transparency due to their complexity and multiple jurisdictions involved.

Motivating factors for locating SPVs offshore include:

- Stamp duty - SPVs are generally incorporated offshore, and one reason for this is stamp duty[15]. It is generally necessary for the ownership of the SPVs to change hands one or more times, and if they were UK incorporated then each ownership transfer would attract SDRT at ½%.

- Levy of tax - It is also attractive that SPVs should be located in jurisdictions where there is certainty that the territory of incorporation will not seek to levy tax on them.

Note that such SPVs are also very often tax resident in the UK or US (strictly, they often elect to be "disregarded" in the US, but the end result is similar). Reasons include:

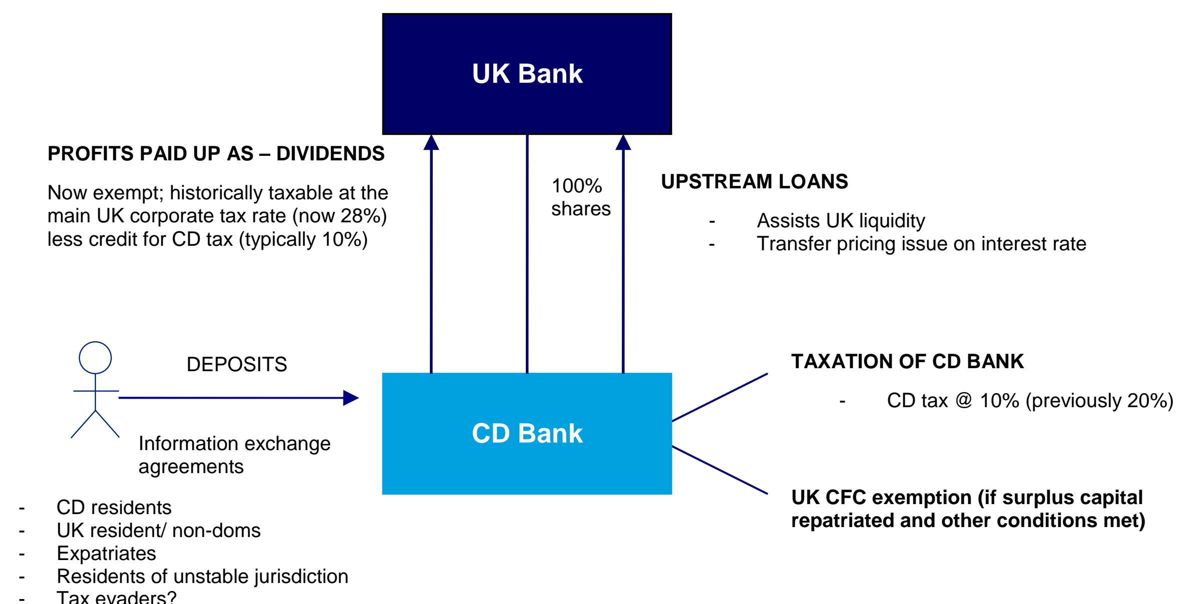
- That it is simply the SDRT benefit that is being sought. (Of course, if the TBSFA did not occur, no SDRT would be payable, any incremental loss of tax revenue as a result of the TBSFA lies elsewhere.)

- It can be quite difficult to avoid their being tax resident in the UK as they are in practice managed and controlled in the UK (and it is problematic for them to be managed and controlled in Cayman or the BVI, involving directors travelling there for board meetings, and so on).

- Tax planning itself sometimes calls for them to pay tax in one jurisdiction or another in any event.

- The SPVs themselves may earn very little profit – they undertake negligible activities and their sometimes large income and expenditure cashflows balance out, so there is little tax benefit for the banks in keeping them offshore.

Example of a typical structure: Offshore deposit taker



When offshore deposit takers were first established, it was for commercial reasons so far as the bank was concerned, and typically the bank's profits arising from offshore deposit taking were taxed at the UK rate (at least when repatriated to the UK). As a result of tax changes in the CDs and the UK, the bank's CD profits will now only be taxed at 10%. (Paradoxically, the

[15] Another driver is well understood, flexible corporate law.

CD tax changes were the result of pressure from the OECD and EU.) It does not follow that there is UK tax leakage, because it is not clear that the same amount of deposits could be attracted on the same terms if taken in the UK (i.e. in place of the offshore deposit-taking activity), so the same profits could not be earned if the bank focused its attention onshore instead. Ultimately the funds attracted offshore go to improve liquidity in the UK through the loan from the CD subsidiary to its UK parent.

4.1.3 Competitive position of the CDs and OTs

Offshore banking

Commercially, offshore deposit taking is driven by geographical proximity and reputation. Although it clearly has tax benefits for the UK parent companies if the offshore deposit taker is in a jurisdiction with a lower rate of tax (i.e. due to an exemption from the Controlled Foreign Companies (CFC) anti-avoidance legislation), fundamentally, this business needs to be established in jurisdictions to which customers are attracted, which principally means the CDs who are able to provide an 'offshore' location which is nevertheless close, familiar and appealing to depositors with some UK connections or at least having some trust in a UK style of retail banking.

From the UK's perspective the CDs are most commonly found to be the offshore jurisdiction in which offshore deposits are taken - from their local population of individuals and businesses and from non-local individuals looking to earn a gross return on interest income.

The CDs have the established infrastructure in place (e.g. regulators, banking expertise, professional staff) to service these businesses, which attract deposits from many jurisdictions other than the UK, and which include other similar banking operations not owned by UK parents, which will continue taking deposit business irrespective of the UK environment.

Investment banking

As outlined above, TBSFAs work by identifying and then exploiting arbitrages in tax treatment between two "full-tax" jurisdictions (often the UK and the US), rather than arbitrages between a "full-tax" jurisdiction and a "limited/no treaty" jurisdiction.

The key features of the jurisdictions where the SPVs used in TBSFAs are based are:

- The ease of doing business there (for example: the ability to incorporate, pay capital out of, and unwind the SPVs without significant costs or time delays);

- The fact that their use (generally to solve a commercial issue such as the need to have readily transferable pools of valuable assets) does not typically generate additional problems; and

- Certainty over their tax costs.

In this regard the SPV jurisdictions merely facilitate the TBSFAs, and a number of jurisdictions might equally serve this purpose. For example, any non-UK territory could be used to avoid SDRT on transfers of SPVs. Banks make an additional, largely anecdotal, argument in support of their Cayman and BVI incorporated subsidiaries: they claim that by structuring financing arrangements in a tax efficient manner they can reduce the rate of interest due from the borrower (and hence the interest tax deductions) compared to a straightforward loan.

Where the CDs and OTs are used, SPVs are generally incorporated in Cayman or BVI (although, as noted above, they are often UK tax resident). This is largely due to

- A "cluster effect" - local expertise in those jurisdictions

- Company law environments which facilitate speed and ease of doing business.

4.1.4 Conclusions

Many **retail banks** have established deposit-taking operations, particularly in the CDs, to offer services both to customers located in and near the offshore centres, and to those elsewhere, such as expatriates, who wish to maintain an offshore bank account. Once established there, some banks sought to expand the range of services offered to onshore-based customers. UK customers and expatriates looking for offshore banking are attracted by the development of an "onshore-like offshore" market, with British-looking providers and products located outside the UK. These activities are not motivated primarily by the bank's own tax considerations, although tax benefits do incentivise retail banks to structure their operations as subsidiaries, rather than as branches whose profits would be taxable in the UK. Access to the UK's clearing system, and the established infrastructure (regulators, banking expertise and professional staff) are also important factors.

The use of certain CDs and OTs, particularly for the incorporation of special purpose companies, has facilitated tax based structured finance activity by **investment banks.** Although the use of these vehicles in the CDs and OTs is typically somewhat tangential to the structure (which will frequently work by exploiting arbitrages in tax treatment between two "full-tax" jurisdictions), the tax revenue effects can be significant.

4.2 Funds

4.2.1 Background

Funds are any form of legal vehicle that allows a collection of different investors to invest in a class of assets. A likely tax objective for any fund is for the investors to be in the same tax position by investing in the fund as would have been the case if they had invested in the assets directly[16].

In practice, as funds have proliferated and globalised, so that they need to target broader classes of investor for their investor base, the fact that some investors (e.g. pension funds) are tax exempt increasingly dictates that funds seek, and achieve, gross returns, leaving the issue of taxation to investors. This case study considers three distinct types of fund: hedge funds[17], private equity[18], and general retail investment funds.

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[16] Many fund vehicles are tax transparent, and some of those that are not enjoy, as a matter of policy, a tax status that is intended to approximate to tax transparency (e.g. UK investment funds and Real Estate Investment Trusts (REITs)). A consideration behind such policies in the UK and elsewhere is that were an attempt made to impose significant taxation on the funds there is a risk that the taxing jurisdiction would make itself uncompetitive in terms of location of funds and fund management or in terms of investment by global funds in underlying asset classes. By contrast, most multinational corporations expect to, and do, pay significant amounts of corporation tax.

The UK approach has historically been to treat onshore funds, insofar as they are established in corporate vehicles rather than tax transparent entities, as prima facie taxable but with either relief to minimise double taxation for the investors (for example, returns from funds are generally taxed as dividends with credit in the hands of investors) or the benefit of other policy-approved exemptions. By contrast, other jurisdictions will either exempt funds from taxation altogether, or provide broader and simpler exemptions (so that the taxation of investors when they receive their returns is often the only occasion of tax).

[17] Hedge funds are distinct from other funds because when they invest in a specific asset, generally issued to the market, they will seek to hedge their position with the aim of ensuring a positive outcome irrespective of market movements. For example, a long/short fund will involve itself in short selling, the practice of selling securities that have been borrowed from a third party with the intention of buying identical assets back at a later date to return to the lender. The short seller hopes to profit from a decline in the value of the assets, when he will pay less to repurchase the assets than he received on selling them, and as such takes this position in order to hedge the fund's long position in the same sector.

Hedge funds are typically open only to a limited range of professional or wealthy investors. This provides them with an exemption in many jurisdictions from regulations governing short selling, derivative contracts, leverage, fee structures and the liquidity of interests in the fund. A hedge fund will typically commit itself to a particular investment strategy, investment types and leverage levels via statements in its offering documentation, thereby giving investors some indication of the nature of the fund.

[18] By contrast to hedge funds, private equity funds invest in equity and potentially also debt securities in operating companies that are not publicly traded on a stock exchange (or which are taken off the stock exchange as a result of the private equity investment). Investments in private equity most often involve the acquisition of an operating company; in a typical leveraged buyout transaction, the private equity fund acquires majority control of an existing or mature firm. (This is distinct from a venture capital or growth capital investment, in which the investing funds typically invest in young or emerging companies, and rarely obtain majority control.) Private equity deals typically feature very significant levels of leverage – this is due in part to historic willingness from banks to lend at very high multiples to successful private equity firms, and on favourable terms. The leverage is "pushed down" to the operating company, to match cash inflows from its trade with interest expense due to the banks.

One factor common to most funds is that although the funds themselves, once established and marketed, may not need much ongoing maintenance, their underlying investments do need to be managed. Funds pay a management fee to a management company, which will either manage the fund itself or, more commonly, outsource the role to specialists located in the major financial centres. In the case of funds structured as partnerships, there may be a general partner who takes a priority profit share of the partnership (fund) profits, instead of earning a management fee, although such general partners in turn may pay a fee to a management or advisory company to which it may delegate some or all aspects of this role.

4.2.2 Factors influencing location decisions

Investment funds

The location of investment funds is motivated by a number of factors, including:

- Levy of tax - The funds themselves are generally based in jurisdictions which do not, in practice, levy material tax at the fund level. General investment funds will certainly consider locating in "full-tax" jurisdictions such as the UK, to access the UK's double tax treaty network (or those of other competitors with similar tax profiles) and thereby minimise withholding taxes suffered on the fund's investments, and/or avail themselves of the benefits of specific policy-approved tax regimes or exemptions. Typically this would be where some form of approved status in the UK brings specific tax exemptions (e.g. from tax on capital gains in the case of investment trusts, approved unit trusts or Open Ended Investment Companies (OEICs)), which in practice result in relatively modest corporate tax being paid. The "onshore" option is, however, typically more complex in tax terms, entailing compliance costs to arrive at the same end position as some "offshore" locations.

- Regulatory protection - Investors, particularly in general investment funds, may require a certain degree of regulatory protection. The UK is seen as a somewhat complex regulatory jurisdiction (for example there have been five or six different changes to the UK funds regime within the past 18 months). Thus, where funds are locating offshore one of the determining factors is the regulatory environment.

- Public perception - It should also be noted that public perception of the jurisdiction in which funds are based is increasing in importance. Investors are beginning to think that funds may be more secure onshore and this has been reflected by credit agencies giving funds in certain "limited/no Treaty" jurisdictions lower ratings.

As with hedge funds, capital for private equity is raised primarily from institutional investors and wealthy individuals. As such it is subject to fewer regulatory constraints than mainstream investment funds aimed at general investors.

Private equity ("PE") partnerships[19]

Historically, English[20] Limited Partnerships have tended to be the vehicle of choice for most PE funds due to their governance under the Limited Partnership Act 1907, the established body of case law, the ability to settle any dispute under the English legal system, and their lack of any legal personality. It is now not uncommon for private equity funds to be formed using limited partnerships in other territories, for instance Guernsey, with a non-UK General Partner ("GP"). This is for a variety of reasons:

- Some investors may simply prefer to participate in a fund formed in a jurisdiction with no or low tax given their own tax status (if, for instance, they have any concern that the UK might assert that the existence of a UK GP could in any way bring them into the charge to UK tax, or because the use of an English limited partnership brings with it a UK tax filing requirement). For example, HMRC has only recently started to insist on compliance with the statutory obligation to supply a UK "Unique Tax Reference" (UTR) for all members of a partnership, UK-resident or otherwise. This has led to a compromise between the British Venture Capital Association and HMRC whereby partners will be allocated UTRs but the allocation will remain invisible to the investor for two or three years to prevent strong adverse reactions. The principal objections would likely come from the major State pension funds in the US: these institutions devote perhaps 5-7% of their assets under management to private equity but individual fund participations will be infinitesimal in relation to their whole balance sheet. For an entity which is in principle tax-exempt, a small part of their portfolio could generate an entirely disproportionate compliance burden;

- There may be non-UK tax considerations (e.g. US) for some investors which dictate the use of offshore partnerships;

- To avoid possible debate with HMRC as to the deductibility of expenses such as placing agent fees (potentially very significant sums paid to third parties for identifying Limited Partner ("LP") investors);

- There is also a VAT advantage to non-EU GPs with regard to the recovery of input VAT on management fees charged by the managers.

Some of these reasons may be more to do with perception than reality, but given the challenge for UK based private equity groups of attracting international investors to their funds, they will be a factor that the funds need to take into account.

The GP itself may well be a UK corporate. It receives a priority profit share of the partnership's income and capital profits (economically equivalent to a management fee) for running the partnership's investments; however, a significant proportion of this profit share (less expenses) may be passed on to a separate investment manager or advisor, and so the GP may not itself have high profits.

A typical ownership, funding and profit extraction structure for a private equity fund is set out in the following diagram. A word of caution: each fund's structure is very different, and usually more complex, for a range of commercial reasons. The diagram does however illustrate some key issues affecting location decisions around entities in the structure. Although there are a number of points at which entities in the CDs & OTs (typically Channel

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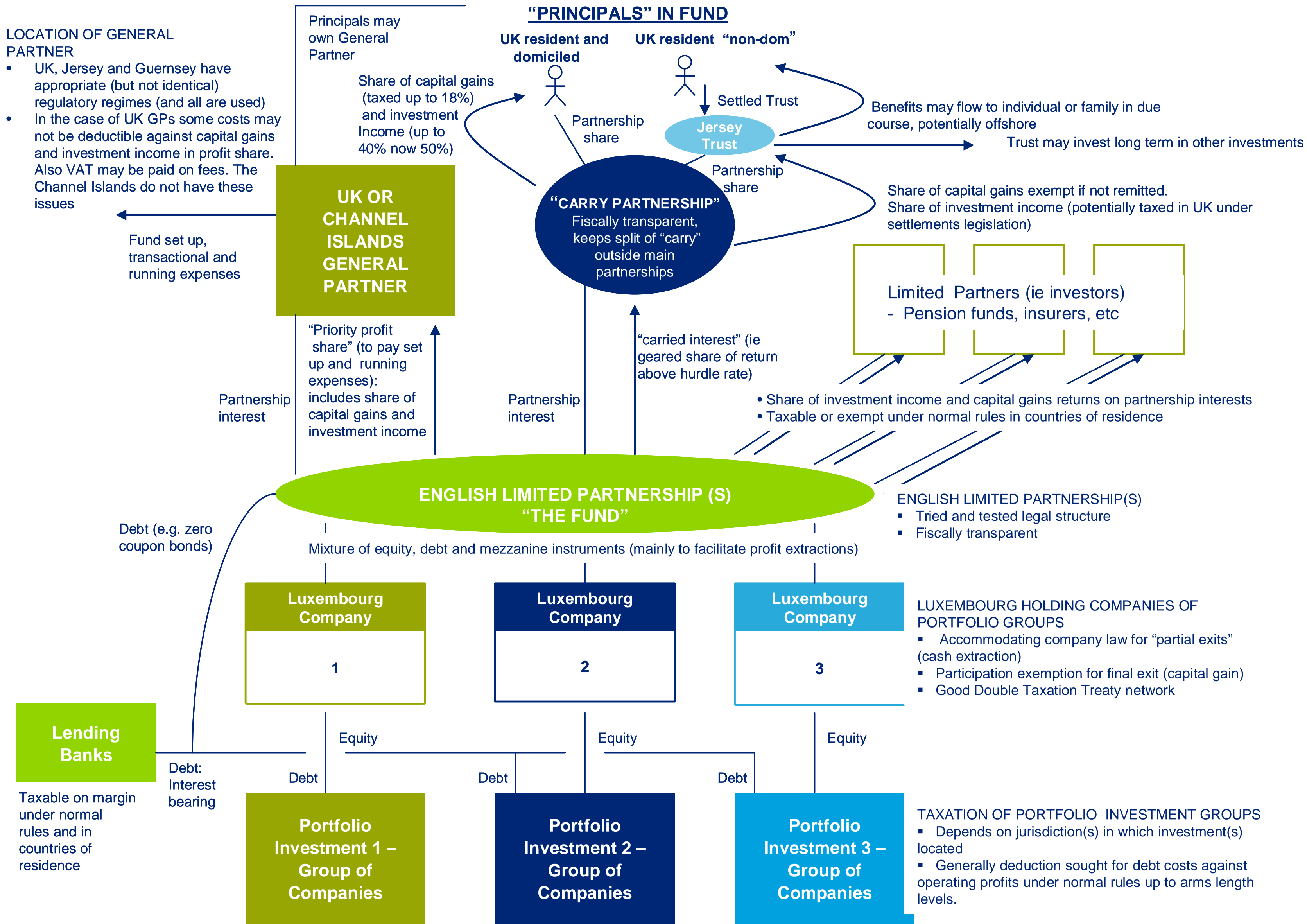
[19] Private equity funds are generally structured through limited partnerships so long as they are respected as transparent for tax purposes not just by HMRC but also by the tax authorities of any other territory in which an investor is based. Partnerships are administratively cumbersome unless the number of partners is small, which is why only private equity, with its limited number of institutional and very wealthy investors, is able to manage it effectively. However, they are the 'purest' form of investment vehicle, in that by operation of law the results of the partnership are apportioned directly to the partners. A limited partnership is usually formed of one general partner ("GP"), who has unlimited liability, and who is the principal corporate in the structure representing the private equity house itself, and many Limited Partners ("LP"), being the investors themselves.

[20] The advantage of an onshore Limited Partnership structure over an offshore structure is largely cosmetic. As a transparent entity, the Limited Partnership does not create a tax liability in itself in the UK; it does not have a tax residence / liability in its own right.

Islands entities in practice) are used, by far the most significant issue affecting the tax efficiency of the whole structure is likely to be the tax deductibility of interest and other funding costs on the acquisition of portfolio companies in the jurisdictions in which those companies are established. This will depend on the pre-existing location of those businesses and will be largely unaffected by the choices of location in the structure. In the case of the UK, anti-avoidance legislation in 2005 moved to block the deductibility of costs of funding in respect of non-arms' length levels of debt in the structure. Again, these rules operate independently of the location of entities in the structure.

A typical private equity structure is set out diagrammatically below



Hedge fund management

Funds which operate on a global basis set up their investment fund companies in jurisdictions that will be attractive to investors from all over the world. Factors that are taken into account are:

- The location of the investors
- The countries in which the fund will invest
- The effect of any tax or exchange controls on cash flows through the investment company
- The confidence of the investors in the selected jurisdiction
- The regulatory position
- The quality of local service providers.

Some investment management companies also locate their main management company offshore, for administrative purposes but also to facilitate exit planning. The management fee paid by the fund is all received by the offshore main manager but where that manager delegates its duties to a UK based manager or advisor, nearly all the management and performance fees are received in the UK (depending on the actual activities undertaken in the UK, i.e. advisory or management) and are subject to UK transfer pricing requirements. In addition, where the UK manager undertakes all the discretionary management of an offshore fund, there is currently a "safe harbour" exemption which manages the permanent establishment risk[21] of the offshore fund where it can be demonstrated that the UK manager and the offshore fund act independently of each other.

4.2.3 Competitive position of the CDs and OTs

Investment funds

Investment funds are typically transparent for tax purposes and so there is no particular incentive for them to access an extensive double tax treaty network[22]. This largely removes any rationale for staying onshore in the UK. Where they do so, it is typically to remain close to their UK investor base, particularly when the UK makes available specific tax exemptions[23].

For these purposes, the key comparison is with Dublin and Luxembourg as locations for funds. Both locations offer no tax and regulation that is less onerous than in the UK. Jersey and Guernsey manage to offer similar attractions, and their geographical proximity to the UK facilitates UK investment management activity.

The CDs are used for investments by sophisticated investors, where the UK regulatory framework does not allow for certain types of investment structure, or would make the investment too costly, and where a tax exempt regime is needed. Some investors even accept modest tax inefficiency on income in return for investment choice and no capital gains tax until exit.

General investment funds are often structured through the Channel Islands to take advantage of the regulatory regimes, unless there is a specific incentive, sometimes tax-based, for them to remain onshore.

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[21] The risk that an offshore entity will create a taxable presence in the UK through a branch or agency.

[22] The investors in a fund are too numerous for the investment income received by the fund, and apportioned to its investors, to be treated as anything other than subject to withholding tax.

[23] The UK funds regime is often a follower of innovation in other "mainstream" jurisdictions (e.g the REITS legislation is based on its US equivalent).

Private equity partnerships

With regard to private equity, many entities within a typical structure will be UK based. The treatment of most carried interest as a capital gain (thus taxable at 18% rather than 50%) and the UK's non-dom regime make the UK an attractive jurisdiction. Where the GP in a structure is based offshore, for the reasons outlined above, a significant number are being formed in territories such as the Channel Islands. Again, this is primarily because they are readily accessible for those living and working in the UK.

The UK, along with other jurisdictions, allows acquisition debt to be pushed down to the target companies (subject to the transfer pricing rules from 2005 to ensure that the debt is on arm's length terms). This makes the UK and other jurisdictions that allow debt pushdown more attractive for private equity to target acquisitions than those that do not.

Hedge fund management

Within the hedge fund industry, the Cayman Islands is the domicile of choice for the vast majority of the world's hedge funds. The reasons for this include:

- The tax exempt status of funds in Cayman
- Regulatory requirements are less burdensome[24] in Cayman which is preferable to hedge funds
- Familiarity for international (and particularly US) investors with the use of Cayman as the location of the fund.

On the occasions when access to treaty networks is important, Luxembourg or Ireland are often selected as alternative jurisdictions where tax at the fund level is usually minimal due to favourable fund tax regimes.

Although the UK has not historically been the domicile of choice for hedge funds, recent developments in the UK Budget 2009 have led hedge fund managers to question whether the UK should be an option. For example, UK individual investors in hedge funds are usually taxed at income tax rates on any proceeds they receive on disposal of units in a non-UK resident hedge fund given the "trading" nature of hedge funds for tax purposes. As such there has historically not been any tax advantage for hedge funds to achieve distributor/reporting status. The UK government announced in Budget 2009 new provisions to improve the competitiveness of the UK asset management industry by introducing clearer guidelines on what constitutes "trading" and what constitutes "investing" for UK tax purposes for UK Alternative Investment Funds ("AIFs"). Based on the typical strategies of hedge funds, if a hedge fund was established as a UK AIF, it could take advantage of these provisions and achieve distributor/reporting status thereby providing their UK individual investors with an improved tax profile.

4.2.4 Conclusions

Funds (this study focuses on hedge funds, private equity funds, and general retail investment funds) are generally able to achieve "gross" returns, i.e. with no or modest imposition of tax on the fund. This is important if they are to attract tax-exempt investors (including pension funds). They are also typically highly mobile, so that it is not easy in practice for a host jurisdiction to impose tax on them.

The CDs and OTs offer certainty of tax exempt status: this may be achievable in other jurisdictions such as the UK, by using tax transparent vehicles such as English Limited Partnerships, which dominate the private equity scene, or corporate vehicles benefiting from specific tax exemptions (for example, from tax on capital gains in the case of investment trusts, approved unit trusts or OEICs), but frequently with complex requirements to be met which may reduce the level of certainty.

[24] To be regulated, a Cayman Fund is only required to have its annual accounts audited. Equivalent funds in other jurisdictions are typically subject to more burdensome regulation (e.g. an Irish fund is required to have a custodian and an administrator).

The CDs and OTs also offer ease of establishment, and ready availability of specialist support infrastructure (legal, regulatory and professional). Where access to a double tax treaty network is required, the use of the CDs and OTs will be constrained.

Other jurisdictions such as Luxembourg and Ireland compete directly in providing a de facto tax free regime for funds with high levels of certainty.

4.3 Securitisation

4.3.1 Background

A securitisation is a special form of raising finance[25].

The purpose of the SPV in a securitisation structure is to legally ring-fence the rights over different elements of the cashflow. By separating the cash-generating assets (or rights over them) from the originator's main business, it is possible for the borrower to raise more finance than would otherwise be the case (because the ring-fenced assets are then insulated from the general business risks inherent in any commercial operation). It is therefore very important as part of the overall credit enhancement of securitisation that the SPV's costs, of which tax is one, are very carefully predicted and then managed, so that there is very little cost inefficiency and uncertainty inherent in the structure. Uncertainty over costs incurred by the SPV is very unattractive to investors, and rating agencies will "stress test" the availability of sufficient cashflows to service the debt against possible variations in factors held to be uncertain.

The originators typically extract materially almost all of the profit from the SPV into the originator, where it will typically form part of taxable profits in the originator's jurisdiction (i.e. the UK in the case of a UK business). The SPV is left with only the minimum profit necessary to make the structure legally effective and to comply with any tax rules in this regard. The primary business purpose of the SPV is not to make money in its own right but to facilitate the financing transaction.

The SPV is often held by a charitable trust so it is not in the same legal and tax ownership group as the originator. This is generally taken as additional evidence that the SPV stands alone, and hence is isolated from the borrower's other commercial risks. The charitable trust is entitled to any residual benefits left behind in the SPV when the securitisation is unwound,

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[25] The main benefit of securitisation over other financing methods is that it allows more funds to be raised (and/or for funds to be raised more cheaply) than through more conventional debt finance. In addition, if the business raising funds is regulated, it is often more efficient from a regulatory perspective. Securitisation developed in the US and expanded rapidly in Europe and globally in the 20 years before the credit crunch. Because domestic mortgages have been the "flagship" asset class to be securitised, and it funded cheap mortgages secured on rising house price values, it has been associated with the factors leading to the crunch. However, its basic concept of segmenting risk in order to allow more finance to be raised more efficiently is the same concept (applied to debt) which underpins the reasons why the stock market is a successful form of raising equity finance. It seems almost certain therefore that this concept will reassert itself as the economy recovers.

In order for a borrower (often referred to as 'originator') to be able to raise funds through a securitisation, it must own assets with reasonably assured associated cash inflows. Examples of assets commonly used in securitisation include mortgage portfolios, trade receivables, rental property, and credit card balances.

The originator then typically sells either the assets themselves, or the right to the income earned on those assets, or at least the first call on such income, through highly secured debt arrangements, to an SPV for a cash lump sum. (In practice for various reasons there may be a number of SPVs.) The SPV issues debt into the market, secured on the back of the cash-generating assets. There are generally separate categories of investors buying different "tranches" of the debt issued by the SPV, with different priorities of rights over the cashflows, earning different rates of return. The proceeds of the debt issue to the market are used by the SPV to pay for the assets acquired from the originator.

All of these steps typically take place on the same day, and the debt issue by the SPV has generally been subject to stringent due diligence by or on behalf of potential investors in its debt issue, for example to check that the assets to be acquired by the SPV do indeed have steady associated cash inflows, that the assets have been created appropriately by the borrower and have been effectively ring-fenced for the primary benefit of the investors. At the time of the securitisation, credit agencies give a credit rating to the bonds issued.

although such benefits are always likely to be minimal, and there has been criticism that it has not happened in practice.

The originator invariably continues to collect the cash due in respect of the assets (and indeed the mortgage holders, tenants, trade debtors or credit card holders may not know or need to know about the securitisation).

4.3.2 Factors influencing location decisions

The originator in a securitisation will typically be located in a "full-tax" jurisdiction – wherever the business happens to be. For example, a retail bank or building society securitising UK mortgages will typically be located in the UK. Some asset classes give rise to multi-jurisdictional deals, for example a multinational might securitise trade receivables generated in several of its large European subsidiaries.

SPVs may or may not be located in offshore jurisdictions. Factors for choosing location include:

- *Predictable tax base*

  As all costs within the SPV are tightly controlled, and the SPV itself will only earn a minimal profit for the role it plays in the securitisation, there cannot be an uncertain tax cost for the SPV, so SPVs will prefer to locate in jurisdictions with predictable tax bases. The CDs and OTs are attractive in this regard.

- *Legal simplicity and familiarity and cost efficiency*

  Another purpose of locating offshore is to work within a legal framework that is familiar and established in undertaking securitisation transactions. As a result compliance costs are often highly competitive and uncertainties are reduced.

- *Withholding tax considerations*

  A significant consideration for many securitisations of UK assets is withholding tax. There is, in practice, a tripartite market for securitisations, with the most appropriate location dependent on the nature of the assets concerned and the withholding tax treatments of the associated cashflows.

  - In the case of many asset classes and securitisation structures, the end consumer (e.g. the mortgage holder or in the case of a mortgage securitisation, or tenants in respect of property) would be obliged to withhold tax on payments made to the originator (which would now be collecting them on behalf of the SPV) if the SPV were located anywhere other than the UK. These securitisations take place onshore, almost without exception.

  - Other classes of securitised assets can escape withholding tax issues if the SPV is located in a jurisdiction that enjoys the benefit of a sufficiently extensive double tax treaty network. Bank debts would fall into this class of assets. The CDs and OTs would therefore be excluded from acting as the SPV location for both these types of securitisation, but Ireland, Luxembourg and Netherlands may be able to do so. By contrast, there is typically no withholding tax issue for the borrower if the SPV is onshore.

  - There is a third class of assets where withholding tax may not be levied on payments and therefore is not a concern. It is possible to securitise UK credit card balances[26] and trade

[26] Because the debts are treated as short term – less than 365 days and so both the interest and capital elements of payments from the credit card holders are outside the scope of UK withholding tax.

receivables[27] offshore without withholding tax issues, and both Cayman and Jersey are used extensively for such securitisations.

A holding company may be located in the CDs and OTs, which in turn holds a number of UK tax resident securitisation SPVs. This holding company would serve minimal purpose other than holding investments, would earn very small profits, if any, and would pay minimal tax even if resident in the UK.

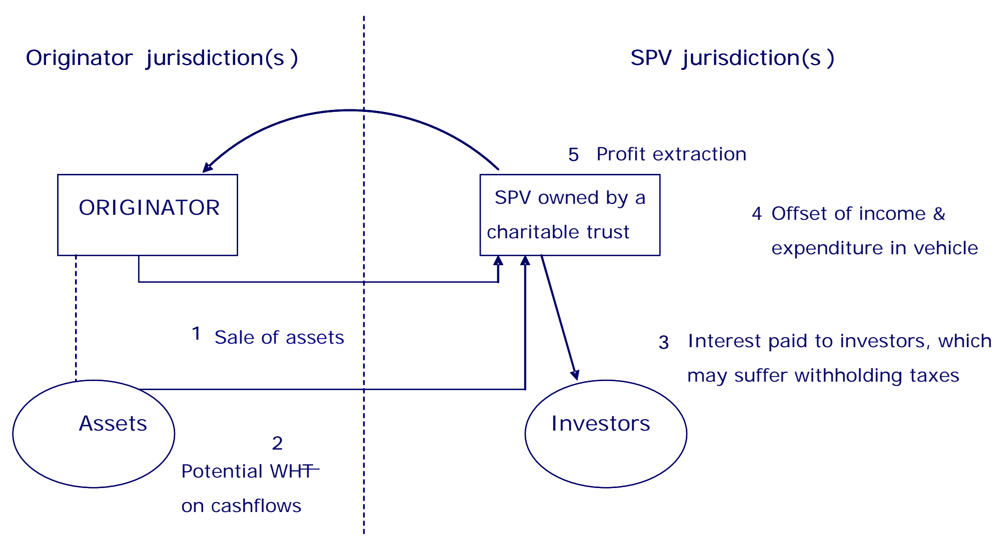
- *VAT*

  European VAT rules do also have a bearing in territory location (in that it makes SPVs located outside the EU more attractive for VAT recovery purposes). This is discussed in greater detail in the VAT thematic case study.

- *Direct tax*

  Although the overwhelming majority of securitisations are entirely commercial, like any other transaction it can be used for tax planning. For example, there have been structures in Jersey (and other locations such as Luxembourg) where the SPV issued preference shares rather than debt, allowing investors (who may be related, rather than third parties) to enjoy a tax favoured return.

Example of a typical structure: tax issues[28] driving European securitisation structures



[27] Because the amounts due are not debts that attract interest and hence withholding tax.

[28] The key tax issues driving securitisation structure:

- Minimisation of any tax charge arising on the sale of assets/receivables by the originator to the SPV.
- Prevention of tax leakage through withholding taxes, whether on payments made by the end user to the originator (now collecting cash on behalf of the SPV) or on interest payments made by SPV to investors. The CDs and OTs do not charge withholding tax on interest payments; the UK would do so but securitisations typically structure the debt to take advantage of the "Quoted Eurobond" exemption.
- Need to ensure that no unexpected tax liabilities arise in the SPV itself.
- Profit extraction: An important feature of almost all securitisations is the requirement for a mechanism to allow the originator to extract any excess cash out of the SPV (over and above the required to meet the SPV liabilities and to leave a modest profit in the SPV). This is often achieved through a fee mechanism as a deferred purchase consideration or contingent interest. We would expect this profit would then be taken into account when determining the originator's tax liability.
- Note that under modern accounting requirements, most securitised assets remain on the originator's balance sheet.

4.3.3 Competitive position of the CDs & OTs

Locating onshore

- Withholding tax

  In practice the main influencing factor from a tax perspective for the location of the SPV is often withholding tax. For this reason many securitisations have to take place in the UK and others have to take place in jurisdictions with extensive treaty networks. The CDs and OTs would not be considered in these cases[29].

- New UK securitisation regime – Increased UK competitiveness

  In 2006, the UK introduced a new securitisation regime, with special rules applying to securitisation companies. A company that meets the definition of a securitisation company is taxed on its 'retained profit' rather than on the profit shown in its accounts. The broad purpose of the regulations is to continue to tax securitisation companies on the small amount of profit retained in the securitisation vehicle, rather than on fluctuating accounting profits that may arise as a result of fair value accounting. As the securitisation market recovers, the existence of this specific regime in the UK should encourage further securitisation SPVs to be located in the UK, as tax cashflows should be comparatively certain. This regime offers many of the commercial attractions of 'offshore' locations to securitisation activity but without creating the opportunity for avoidance noted above.

  It is noted that the tax position offshore has, however, generally been even more certain and non-tax factors such as familiarity and lower compliance costs have resulted in offshore securitisation SPVs continuing to be used where withholding tax does not mean a domestic SPV is required.

Locating offshore

- Legal simplicity and familiarity and cost efficiency

  Where withholding tax is not an issue, many securitisation vehicles have been located in Jersey (in the European time zone) and Cayman (for the Americas). Given the role of familiarity in determining the location of financial businesses, these centres have dominated the "offshore" securitisation scene although theoretically other centres might arguably have similar advantages. They do have specific advantages in terms of ease of company formation, and favourable legal environment, but these are not unique.

- Predictable tax base

  From a tax perspective, Jersey and Cayman have been able to offer the certainty of minimal/no taxation.

4.3.4 Conclusions

The originator in a securitisation will typically be located in a "full-tax" jurisdiction. It will generally extract substantially all of the profits from the SPV, and these would normally form part of the originator's taxable profit in its "home" jurisdiction.

The SPV itself will typically earn only a minimal profit for the role it plays in the securitisation. All costs within the SPV are tightly controlled, and there is little tolerance in the structure for uncertain costs (including tax). The UK introduced a specific tax regime for securitisations in 2006, the broad purpose of which is to tax securitisation companies only on the small profit retained in the SPV. However, the tax position offshore has generally been even more

[29] For example, most multi-jurisdictional trade receivables deals in Europe used Jersey SPVs, until the Spanish market developed to the point where Spanish receivables became a specific feature of such deals. Due to specific Spanish withholding tax rules it was then necessary to find an alternative EU and/or Double Tax Treaty jurisdiction – which was most typically Ireland.

certain and non-tax factors such as familiarity and lower compliance costs have resulted in offshore securitisation SPVs (particularly in Cayman and Jersey) continuing to be used where withholding tax issues do not mean a domestic SPV is required.

Although the overwhelming majority of securitisations are entirely commercial, like any other transaction it can be used for tax planning. For example, there have been structures in Jersey (and other locations such as Luxembourg) where the SPV issued preference shares rather than debt, allowing investors (who may be related, rather than third parties) to enjoy a tax favoured return.

4.4 Insurance

4.4.1 Background

This section addresses the principal drivers for locating insurance activity in the CDs and OTs. For these purposes "insurance activity" includes life insurance, general insurance and reinsurance. In terms of business organisation it covers providers of retail and wholesale insurance to third parties; group reinsurers within an insurance group; and captive insurers, which may be defined as insurers that are owned by a non-insurance group and that are used to insure group risk[30].

4.4.2 Factors influencing location decisions

The factors which influence location decisions for insurance activities, and their relative importance, depend on the type of business in question. Whether a business is retail or wholesale; whether it is sold remotely over the internet or telephone or face to face; and whether it requires a large claims function (for example to deal with many claims) or a smaller one (for example where a reinsurer is simply following the fortunes of a primary insurer) all bear on the location decision.

In general, therefore, access to distribution channels; the availability of passporting rights to provide insurance services cross border; the existence of specialist expertise in the relevant types of insurance; the stability and sophistication of the legal and regulatory regime; the quality and extent of the skilled labour pool and infrastructure, including support and professional services; and the geographical location relative to markets and stakeholders and accessibility of the location are relevant factors whose importance varies according to the business in question.

As discussed further below, the insurance activities that have shown most propensity to locate in the CDs and OTs are:

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[30] Insurance is a form of risk management used to protect against the risk of a contingent loss. One party, the policyholder, enters into a contract with another, the insurer, under which the insurer indemnifies the policyholder against the risk of a loss in exchange for the payment of a premium. The insurer pools the risks it accepts, and in exchange for a given premium from each policyholder protects that policyholder against the financial effects of a much larger, possibly devastating loss. Insurers make money from a combination of their pure underwriting result (i.e. premiums less claims) and their return from investing the money they hold to back the insurance policies.

Reinsurance is a means by which an insurer can protect itself by insuring risk that it has accepted with another insurance company (it is "insurance of insurance"). This enables the risk to be diversified and volatility reduced. Reinsurance may also provide capital that allows the insurer to assume greater individual risks than its size would otherwise allow. For example, if the primary insurance company can underwrite only £10 million net in limits on any given policy, it may be able to underwrite a larger sum and then reinsure (or "cede") the amount in excess of £10 million to another insurer. Reinsurance is also used where an insurer that does not have regulatory permission in a territory wants to assume risk there: a locally licensed insurer will typically underwrite the business and then reinsure all or a large part of it to the unlicensed insurer in exchange for a fee. This is known as "fronting" and is often used by captives for certain classes of business where they do not have local licences.

The UK, in common with most territories, regulates insurance and applies regulatory rules to those insurers that are established in its territory. It also requires insurers underwriting certain classes of business (whether they are established in the UK or not) to have a valid licence from the UK or other European Economic Area (EEA) regulator. These requirements are more prevalent in the retail sector than in the wholesale and reinsurance sectors. It should, however, be noted that in a number of territories the ability of the ceding insurer to gain regulatory capital credit for its reinsurance ceded may be dependent on the status of the reinsurer.

A captive is a wholly-owned subsidiary of a non-insurance corporate group that insures or reinsures the risks of its fellow group members. In addition insurance and reinsurance groups commonly have group reinsurance companies which perform the function of aggregating and pooling risk for the insurance group.

- Reinsurance (including group reinsurance)
- Captive insurance
- Certain types of retail business in specific locations – notably international life business in the Isle of Man and motor business in Gibraltar (Gibraltar is the only CD and OT that is within and has access to the single passporting rights of the EEA).

For these businesses, in addition to the factors mentioned above, three principal considerations in respect of a location are:

1. Capital requirements;
2. Regulatory environment;
3. Taxation consequences.

Capital requirements

Insurers have to meet regulatory standards which set out a minimum amount of capital, as protection for policyholders. The level and the method of calculation vary from jurisdiction to jurisdiction and according to the type of business. Many jurisdictions also state which types of assets can be used to meet the minimum capital requirement. The capital requirements in CDs and OTs are lower than in the UK[31]. The advantage of locating capital in jurisdictions with relatively benign capital requirements, even where the insurer holds capital in excess of the minimum for commercial reasons (including to meet the requirements of credit rating agencies, which are invariably higher) is that it gives the insurer greater freedom and flexibility over investment decisions.

Regulatory environment

Insurers look to work with regulators who are responsive to their needs. This might include the speed and quality of access to decision makers, availability for meetings, rapidity of approving start-up operations, and so on. The responsiveness of a territory's regulators is a significant factor in its success in attracting business, and can lead to an influx of activity and expertise such that it becomes a natural place to locate. As noted below, this appears to have been a key factor in Bermuda's achieving a dominant position in the global reinsurance market.

Another significant factor in the regulatory environment is the territory's reputation and whether, in the case of reinsurance business (including captive insurers that use fronting insurers) the regulator in the ceding insurers' territories will give credit for that reinsurance. This is expected to become increasingly important in the context of the Single Market as territories outside the EEA will seek recognition as "equivalent" for regulatory purposes under the Solvency II regime.

Taxation considerations – insurer

Generic tax considerations

Like other businesses, insurers view tax as a cost to be managed in maximising post-tax returns to their shareholders. Tax charges could arise in various ways; for a group headquartered in the UK the following will need to be considered:

- UK corporation tax levied on group companies resident in or operating through branches or agencies in the UK, as well as equivalent taxes in other countries in which group companies operate.

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[31] Uunder the Solvency II directive, which is scheduled for implementation in 2012, capital requirements will be standardised across the EEA, including Gibralter. A number of non-EEA jurisdictions, including many of the other CDs and OTs are expected to apply for recognition as having "equivalent" regimes. Application of the rules will, however, be in the hands of each jurisdictions regulators, and absolute harmonisation is not expected in practice.

- Withholding taxes (typically imposed by third countries) suffered by a group insurance company on its premium or investment income.

- Withholding taxes on payments made by the insurer to its parent.

- Taxation under the UK's Controlled Foreign Company regime (imposed on the UK parent in respect of profits of subsidiaries located in low-tax jurisdictions subject to certain exemptions – see below). Many developed jurisdictions have similar regimes so insurance groups headquartered in other countries might be exposed to comparable "CFC" taxation there.

Insurers therefore have an incentive, provided they do not fall foul of the CFC rules, to locate in jurisdictions with a zero or minimal corporation tax rate on the insurer (as is broadly the case in most of the CDs and OTs), with no withholding taxes on payments out of the insurer to its parent and where relatively little withholding tax is levied on investment income (although this is also a function of the type and location of investments made). These considerations do not always pull in the same direction. For example, because low-tax jurisdictions are unlikely to have access to Double Tax Treaty networks, it may be difficult to mitigate a withholding tax cost on premiums or investments if the arrangement involves an entity based in a "limited/no Treaty" jurisdiction.

General insurers and reinsurers should be considered in the same way as other multinational financial businesses. It should however be noted that, conceptually, life insurers providing investment products for individuals stand midway between active corporate multinational corporate businesses (which typically suffer and expect to suffer profits tax) and funds earning a passive investment return (which do not).

Withholding tax issues

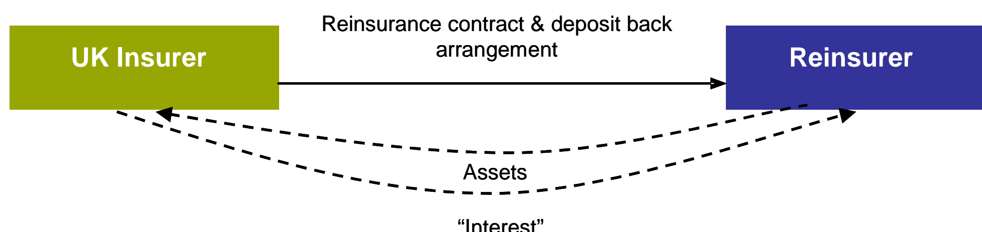
Most insurance and reinsurance flows are not in general subject to withholding taxes on premiums or claims. There is however an exception in the US, where a Federal Excise Tax is charged on premiums paid out of the territory to other jurisdictions, unless exempted by a double taxation treaty. This provides a disincentive to insuring or reinsuring from the US to a less favoured territory, including the CDs and OTs. Certain other countries also levy taxes on premiums paid abroad, but withholding taxes on claims payments are far less common.

The investment return on an insurer's capital and reserves is potentially subject to withholding tax, depending on where the insurer is located, and CDs and OTs will not generally benefit from tax treaties that mitigate this cost.

Withholding tax issues can also arise in the context of certain types of insurance arrangement. One example is deposit-back reinsurance (e.g. of life business). Regulatory capital considerations frequently mean that, especially where significant blocks of insurance business are reinsured, a proportion of the premium (i.e. assets) transferred by the insurer to a reinsurer under a contract of reinsurance are deposited back with the insurer.

A typical deposit-back reinsurance arrangement might be structured as follows:

Typical deposit-back reinsurance arrangement



- Insurer reinsures a proportion of the insurance liabilities relating to a particular block of business to Reinsurer;

- In consideration for accepting the reinsured liabilities, Insurer pays Reinsurer a premium;

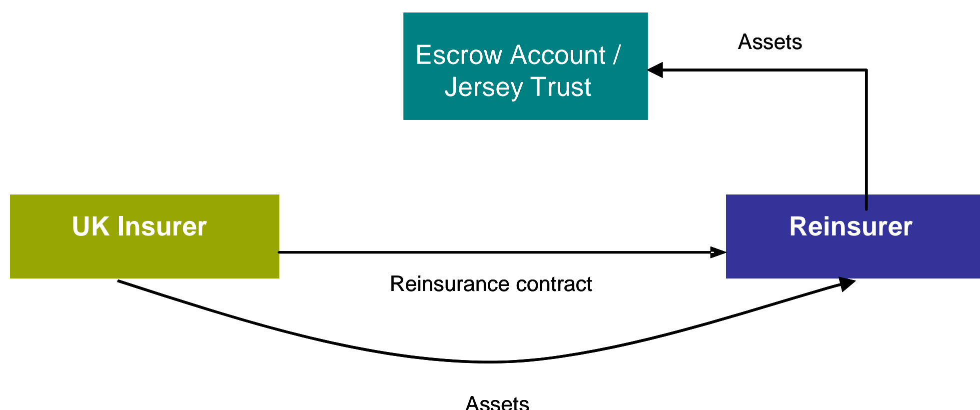
- Reinsurer deposits back with the Insurer an amount equal to the premium it has received. These assets are legally and beneficially owned by Insurer. However, Insurer has a liability to Reinsurer such that the deposited-back assets are "economically" owned by Reinsurer;

- The arrangement might typically include some form of payment from Insurer to Reinsurer in recognition of the fact that Reinsurer has economically lent the assets back to Insurer, and Insurer is able to generate an investment return on them. This payment might take the form of interest, or an adjustment to an "experience account" which tracks the ongoing movements between insurance reserves and the value of the insurance fund in respect of them.

Depending on the accounting treatment applied to the arrangement, and the nature of the underlying assets, the "interest" payment made by Insurer to Reinsurer may suffer withholding taxes. Where Reinsurer is located in the CDs and OTs (or more generally a jurisdiction without access to a network of Double Tax Treaties), such withholding taxes would represent an absolute cost, and would therefore add to the commercial cost of the transaction. This would therefore tend either to discourage the use of reinsurers based in the CDs and OTs for such arrangements, or to provide a strong incentive for the arrangement to be structured so as to minimise the risk of withholding taxes arising.

As an alternative, to mitigate the counterparty risk that Insurer has in relation to Reinsurer (especially if the reinsurance represents a significant proportion of the insurer's total business), the arrangements are sometimes structured so that the reinsurer deposits the assets back into an escrow account or a Jersey (for example) trust, with the insurer having a charge over the assets, as follows:

Alternative deposit-back reinsurance arrangement using Escrow account or Jersey trust



Under this arrangement, the assets would typically be legally and beneficially owned by the reinsurer, so again, depending on the nature of the underlying assets, withholding tax issues might arise. However, it will be clear that the considerations driving the structure are commercial, not tax-oriented.

Reinsurance

Bermuda is probably the dominant centre for the reinsurance market worldwide and is now better known as a reinsurance centre rather than as a captive location. To some extent it achieved this position in the late 1980's – 1990's, when it was able to capitalise on its existing pool of insurance expertise (mainly developed in the captives market) and its ability to set up new insurance operations quickly to attract the large capital flows following the depletion of existing insurers' capital by a series of large-scale catastrophes. Its proximity to,

and therefore ability to service, the North American market has also been a key success factor, as has the fact that its culture and legal systems are familiar to both the North American and UK markets[32].

Some multinational insurance and reinsurance groups that are not themselves headquartered in a CD or OT have set up reinsurance subsidiaries or branches in those territories (particularly Bermuda) which, as the case may be, operate within the local market or reinsure group insurance risk, or both. Aside from that, and from those captives that use fronting insurers in other territories, the other CDs and OTs are not predominantly known for reinsurance.

By comparison with a direct insurance business, which enters into a large number of different contracts and requires a large number of people to operate and service them (sales force, underwriters, policy administration, loss adjusters, claims management, risk management, investment management, actuaries, etc), a reinsurance business typically deals with fewer contracts and requires fewer people to service them. At the extreme, a reinsurer can underwrite its business for a period by negotiating a single contact with, for example, a fronting insurer. The nature of reinsurance is that it can move capital, risk and reward between the insurer and the reinsurer, and where they are in different territories the profit or loss on the contract moves with it. The main weapon in HMRC's armoury against an undue loss of tax from reinsurance arrangements is transfer pricing. The other avenues open to HMRC, depending on the facts, are to argue that a reinsurer located offshore does not have sufficient substance to carry on its business there and is in fact carrying on business through a permanent establishment in the UK; or to argue that the company is in fact managed and controlled in the UK and so is UK resident for tax purposes.

In relation to life insurance business, the UK's "I minus E" regime imposes a tax on policyholders' investment returns as they accrue, whereas most other countries allow these to roll up gross and confine taxation within the insurance company to shareholder return. Historically, it was possible for a UK life insurer to reinsure life investment business to a reinsurer in a jurisdiction that operates a "gross" return basis, so that investment return on that business was not taxed as it accrued, and the UK insurer was in effect able to offer gross returns to its UK investors. Legislation now exists to deem the investment return on such business to accrue to the insurer, although its effect can in practice be punitive. This legislation has been extremely effective in preventing the reinsurance of life investment business from the UK, and is one of the reasons that the life reinsurance market is dominated by reinsurance of pension business liabilities.

Captive insurance

Captive insurance forms a very significant proportion of the insurance activities conducted in the CDs and OTs, and the CDs and OTs are very prominent in the global captive insurance market. For example, last year Bermuda, the Cayman Islands and Guernsey were in the top 5 locations worldwide by number of captives, and Guernsey and Isle of Man were in the top 5 European locations by number of captives[33].

The global captive insurance market has grown significantly over the last decade. The key reasons for the sustained appetite to form captives are as follows:

- Reduction of risk management costs – a captive insurer is able to mitigate the impact of the acquisition costs of a third party insurer (commissions, marketing costs, and so on), and to improve cashflow since amounts which would otherwise have been paid out as premiums are instead able to earn investment return.

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[32] Bermuda's double taxation treaty with the US also gives certain Bermudan insurers the protection of a "permanent establishment" article, which enables them to carry out certain functions in the US without creating a US taxable presence.

[33] Source: Insurance Information Institute, data for 2008. Numbers of captives worldwide: Bermuda – 989; Vermont – 800; Cayman Islands – 740; Guernsey – 381; Luxembourg – 208. Numbers of European captives: Guernsey – 381; Luxembourg – 208; Isle of Man – 161; Ireland – 154; Switzerland – 48.

- Access to reinsurance and capital markets – broadly speaking, reinsurers deal only with insurers and other reinsurers. The formation of an in-house insurer is therefore a prerequisite for groups wishing to access the wholesale market, for example to reinsure specialised risks. It may also provide better access to capital markets, for example through securitisations.

- Price stability – third party insurers will typically have to set prices based on conditions in the market as a whole, which may be inconsistent with the circumstances of the group wishing to insure its risks.

- Tax – this is discussed below.

There can be little doubt that tax considerations have historically played an important role in UK groups' decisions to locate captives offshore. Although some tax consequences apply irrespective of the location of the captive (such as the ability for the paying company to gain tax deductions for premiums paid) the principal benefits of establishing a captive in one of the CDs and OTs might have included the potential ability of the captive to accrue underwriting profits and investment income on the insurance funds tax-free.

However, the scope for achieving substantial tax benefits has reduced significantly in recent years since the introduction of the UK CFC rules. With very few exceptions, the location of most captive insurance companies of UK groups in one of the CDs or OTs will give rise to CFC apportionment of their profits to their UK parents. (The same is true of many group reinsurers, although they may be more likely to be able to qualify for an exemption.) Historically such groups have avoided CFC apportionment by paying 90% or more of their profits to their parents as dividends (which gave rise to a CFC exemption but meant that such dividends were taxable in the hands of the parent companies) but this dividend exemption was repealed from 1 July 2009. Accordingly CFC apportionments are likely to become more common.

Therefore, whilst tax was probably a factor historically in attracting captives to some CDs or OTs, given the current CFC rules it seems likely that they remain there – and that new captives establish there - largely for other reasons, including capital, regulatory and ready availability of expertise and infrastructure.

This picture is consistent with the position in respect of the US (the location of the largest number of parent companies of captives[34]), where we understand that many - possibly most - offshore captives elect to be taxed as domestic US corporations. This election has been made available as a matter of policy, to allow companies to avoid the unfavourable implications of the Federal Excise Tax combined with US Controlled Foreign Corporations legislation whilst still obtaining the benefits of freedom from US state insurance regulations.

Protected Cell Companies

Protected Cell Companies ("PCCs")[35] and variants have also become popular in recent years. The alternative structures are conceptually similar:

- PCCs and Segregated Account Companies ("SACs") take the form of a single legal entity, consisting of a core (or general account, which provides administration and support services to the cells) and cells (which may have separate legal owners). The intention is that assets and liabilities of each cell are ring-fenced from those of the other cells.

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[34] Source: AON, 2008

[35] PCCs and variants are broadly companies which segregate assets and liabilities of different share classes. Guernsey was the first jurisdiction to make statutory provision for PCCs (in 1997), although in Bermuda Segregated Account Companies were used previously, but without the full force of statute. These vehicles are now fairly widespread, with over 30 jurisdictions having similar legislation. Among the CDs and OTs, Bermuda and Guernsey are the leaders in this market, with for example Jersey having a very small number in existence. In some jurisdictions, PCCs may only be used for insurance activities but elsewhere they are also used in investment funds structures and in trust/estate planning.

- Incorporated Cell Companies ("ICCs") were established because of concerns about the robustness of this legal ring-fencing of cells. Each cell is a separate legal entity, again with (probably) separate owners.

These arrangements provide ready access to a corporate structure without necessitating the full paraphernalia that would normally go with it (directors, company secretarial support, and so on), and have therefore been used as a cost-effective option for small and medium-sized operations wishing to establish a captive (a so-called "rent-a-captive"). They have also been targeted at groups wishing to segregate their risks – for example, a global group might wish to manage regional risks separately.

UK tax legislation does not currently look through the control of PCCs and SACs to the individual cells to determine whether "control" exists for the purposes of CFC rules. (Because each cell in an ICC is a separate legal entity, it would appear that the individual cells would be capable of being treated as CFCs.) In practice, however, concerns around the degree to which assets and liabilities are genuinely ring-fenced[36] have meant that their use has been less common in practice than might otherwise have been the case. In addition, the precise drafting of the CFC tests may in certain circumstances (for example, where there are only a few cells in a PCC or SAC structure, and in a particular year one cell's results represent a disproportionate share of the results of the structure as a whole) mean that the CFC rules do in fact bite. Concerns regarding this risk may also have meant that PCCs have not been used as extensively as they might have been for CFC mitigation purposes.

We would note that HM Treasury has recently launched a consultation on converting OEICs into a protected cell structure. The purpose behind this plan, which would be compulsory, is to isolate the assets and liabilities of individual sub-funds from each other, no doubt influenced by events during the credit crunch, so that potential liabilities from riskier sub-funds cannot spill over into other funds. This underlines the fact that the primary driver of the structure has been and continues to be the legal ring-fencing of risk within it.

International Life Insurance

Of the CDs and OTs, the Isle of Man is the largest base for international life insurance products. In 2006, it was the second largest domicile worldwide in this market, measured by premium income, behind Ireland and ahead of Luxembourg.[37]

To the extent that life insurance operations are owned from the UK, the CFC considerations outlined above will also be relevant to them. However, an exemption is available for so-called "exempt activities" (where there is genuine commercial substance in the offshore jurisdiction). Because life insurance operations typically require significant local business substance, in particular around core underwriting skills, there would be an expectation that this exemption would tend to apply to such business, in line with tax policy.

The international life insurance market is examined further – from the perspective of the customer's taxation position – below.

Insurance Premium Tax

Insurance Premium Tax ("IPT") is a tax on general insurance premiums, and is levied by reference to the location of risk of the insured. As the CDs and OTs do not have IPT, it is theoretically possible to avoid paying IPT by locating the risk insured there. However, in practice this would involve having significant establishments in those locations, and the fact pattern to support this is unlikely to be widespread.

[36] Following, for example, the case of Cable & Wireless and Pender (Isle of Man) Insurance Company Limited vs Messenger Insurance PCC Limited- see the Corporate Tax case study.
[37] Source: Axco.

Taxation considerations – customer

In common with other industry sectors, insurance businesses may be attracted to the CDs and OTs not for tax benefits on their own account but in order to win business by considering the tax issues of their customers.

A number of life insurance companies have established operations in the CDs to sell life insurance products – mainly investment bonds – to UK residents and UK expatriates. A key perceived advantage of these so-called "offshore bonds" is that the investment return in the underlying life fund will be subject to little or no taxation as it builds up, whereas income and gains in a UK "onshore" life fund will be subject to tax (the UK imposes a tax on policyholders' investment returns as they accrue, whereas most other countries allow these to roll up gross and confine taxation within the insurance company to shareholder return).

Whether an offshore investment will in fact result in a better tax position for a particular investor than a similar onshore product will depend on a number of factors, in particular the individual's personal circumstances. For example, the investor may be subject to higher rate tax (currently 40%) on the gross gains from an offshore bond, but to tax at 20% on the net gains from an onshore investment.

The offshore bond market was initially targeted mainly at UK expatriates, who might want a "gross" return, but for whom a familiar brand would be a key decision factor. Over time, the focus has shifted to encompass UK resident high net worth individuals. Offshore life products are increasingly being sold out of Ireland and Luxembourg, not least because they offer a common base for sales across Europe.

Although these "offshore" subsidiaries of UK life companies would be likely to be CFCs, many of them have qualified for an exemption as having so-called "exempt activities" (because they have genuine commercial substance in the offshore jurisdiction). Nevertheless, the desire to sell "offshore"–branded products to customers has been the main motivation for companies operating in this market.

As noted above, the UK is unusual in trying to tax the policyholders' investment return in the life fund as well as the shareholders' profit. This potentially creates a competitive disadvantage to the UK, which has been addressed through ring-fenced provisions such as the Overseas Life Assurance Business regime for non-UK resident policyholders. In this respect, it appears more appropriate to see the fundamental contrast as being between "net" return basis and "gross" return basis regimes, rather than between "full-tax" regimes such as the UK, and the CDs and OTs or other jurisdictions with similar tax profiles. This suggests that the CDs and OTs should not be the primary concern in terms of tax policy.

There are also some sales of offshore insurance products for Inheritance Tax ("IHT") planning purposes to UK non-domiciled individuals ("non-doms"). Offshore insurance investment vehicles are treated as non-UK situs assets for IHT purposes, and so are a way for non-doms (who do not suffer IHT on non-UK situs assets) to carry out estate planning. In essence, this is no different to a non-dom owning an overseas property for IHT purposes. In common with the provision by banks of offshore deposit facilities, this appears to be a fairly logical result of the UK policy framework for the taxation of non-doms. Given the existence of these rules, the CDs in particular provide a route for funds arising in respect of these markets to be channelled back to the UK.

4.4.3 Competitive position of CDs and OTs

Bermuda, Guernsey, the Isle of Man, Gibraltar and Cayman are favoured as insurance locations over other CDs and OTs due to their local expertise. Territories have developed their own specialisations including the following (the list below is in no way intended to imply that others of the CDs and OTs do not have capabilities in these areas):

- Reinsurance (Bermuda[38]);
- Captives (Bermuda, Guernsey and the Isle of Man plus Cayman for US healthcare captives and Gibraltar for EU licences);
- International life assurance (Isle of Man);
- Motor insurance (Gibraltar);
- Insurance PCCs or SACs (Bermuda and Guernsey).

However, the CDs and OTs face intense competition in all of these areas from other locations – for example, in the key captives market, Luxembourg, Switzerland, Ireland and Vermont. If the CDs and OTs took action which significantly reduced their competitiveness, it is likely that the result would be that this business would flow to one of these alternative jurisdictions or another such territory. Whilst it is no doubt the case that these jurisdictions lack some of the traditional "familiarity" of the CDs and OTs, globalisation trends may mean that this is less significant going forward.

4.4.4 Conclusions

There can be little doubt that tax considerations have historically played an important role in UK groups' decisions to locate captive insurers offshore. However, the scope for achieving substantial tax benefits has reduced significantly in recent years following the introduction of the UK's CFC rules, and has been further curtailed following the repeal of the dividend exemption from 1 July 2009, so that CFC apportionments are likely to become more common. It remains to be seen what impact this will have on existing captives located in the CDs and OTs, and the formation of new captives there.

The use of Protected Cell Companies ("PCCs") and Segregated Account Companies ("SACs") may in some circumstances be effective for avoiding the impact of the UK CFC rules, but concerns around the degree to which assets and liabilities are legally ring-fenced have meant that their use has been less common in practice than might otherwise have been the case.

International life insurance operations (based predominantly in the Isle of Man of the CDs and OTs) typically benefit from a specific exemption from the CFC rules, as they require significant local business substance in practice. The market for international life products includes UK expatriates, and also UK residents (for whom a key perceived attraction is that the underlying investment return in the fund will be subject to little or no tax as it builds up, whereas income and gains in a UK onshore life fund will be subject to tax under the so-called "I minus E" regime). The customers' tax considerations have been a more significant driver of this market than the insurers' own tax positions. Ireland and Luxembourg are the main other competitor jurisdictions in this market.

Other key considerations include capital requirements, the regulatory environment (and responsiveness of the regulator), and ready availability of expertise and infrastructure

[38] In addition, Bermuda has been a destination of choice for so-called corporate "inversion" (whereby a group reconstruction is undertaken to change the tax residence of the holding company) by insurance groups. A number of US insurance groups, as well as several UK insurers have redomiciled in this way to Bermuda in recent years. Whilst tax considerations no doubt played a part in these decisions (and in certain cases this was noted in public statements by the companies), this would appear to be primarily an issue of international competitiveness rather than of tax avoidance (see, for example, the 2002 report "Corporate Inversion Transactions: Tax Policy Implications" by the USA's Office of Tax Policy, which concludes "A comprehensive re-examination of the US international tax rules and the economic assumptions underlying them is needed….Our system of international tax rules should not be allowed to disadvantage US-based companies competing in the global marketplace"). This issue is therefore not discussed further here.

4.5 Trust services

4.5.1 Background

Common law trusts[39] are most frequently used by individuals for succession planning and passing wealth down through the generations. They are also used to protect the interests of beneficiaries incapable of managing their own affairs (for example, young children). They may also have tax advantages, although policy may seek to neutralise or counteract this.

Their use by corporates is far less common, although some examples have been identified and are listed in the next section. It is worth noting first, however, that corporates do provide offshore trust services to individuals who wish to make use of them (many banks, for example, have subsidiaries in the CDs which help individuals to establish and then operate trusts), and therefore trusts do, indirectly, increase the scale of offshore business. The main users of trust services provided by corporates in these locations are believed to be individuals who may be resident but are not domiciled in the UK. In addition there is a growing market that focuses on wider international wealth, where the settlor and beneficiaries have no significant contact with the UK. Many of the traditional financial centres, such as Jersey and Guernsey, have been attempting to reduce their dependency on the UK market by attracting customers from other markets, such as the Gulf and other Asian centres.

With regard to the UK market, it is common practice for non-domiciled individuals[40] ("non-doms") to set up trusts for reasons that include three main tax considerations:

- Non-doms can become UK-domiciled (for IHT purposes only) if they remain in the UK long term. Non UK assets transferred to a trust before UK domiciled status (for IHT purposes) is attained remain outside the UK inheritance tax net.

- If a non-dom holds non-UK assets directly, and wishes to sell them to raise funds to purchase UK assets, then he is treated as having remitted the funds onshore when he buys the UK assets. However, if his trust holds the non-UK assets then it can sell them to buy UK assets without triggering a remittance charge. Any benefit conferred outside the UK is only taxed when it is later enjoyed in the UK.

- The trust can also hold the non-dom's UK assets. Any gain on the disposal of UK assets is not taxed on the non-dom until such time as a benefit comes out of the trust.

Without these planning opportunities, the "remittance basis" would lose much of its appeal to wealthy non-doms. Given these opportunities, the remittance basis approximates (albeit with much complexity and high compliance and maintenance costs) to a broad exemption of investment income and gains. Without such opportunities, the result would be very substantially

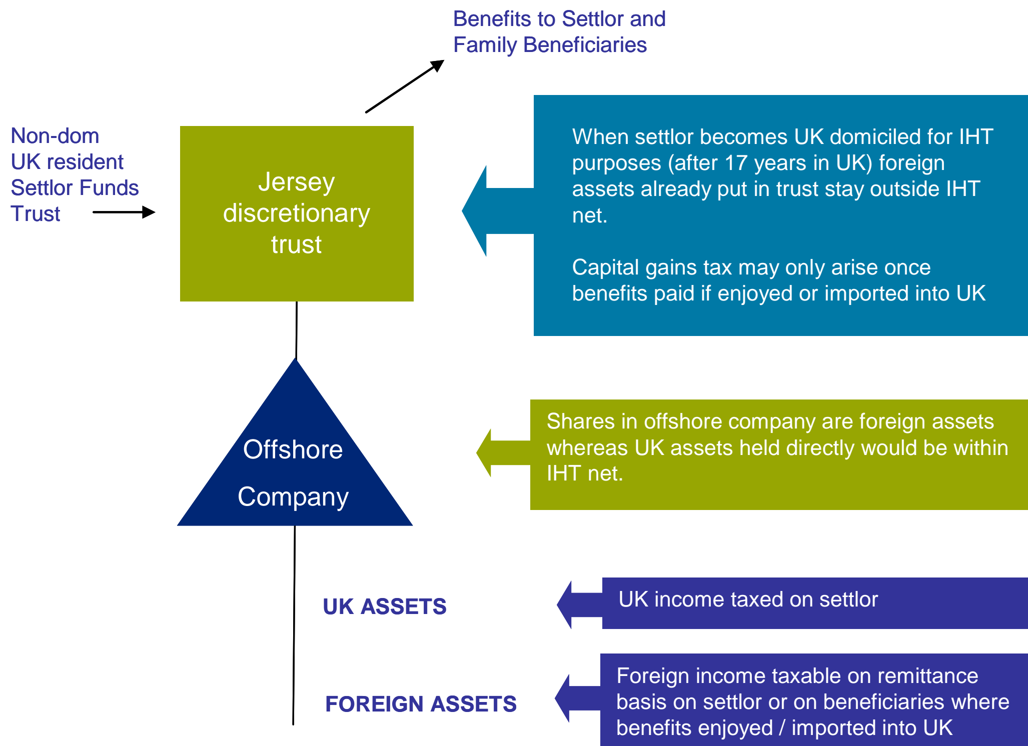
[39] A trust is an English legal concept, based on the law of equity, although similar vehicles are commonly found in other common law jurisdictions. It involves a person, called a settlor, passing property to another person, called a trustee, who then holds the legal title in the property on behalf of others, called beneficiaries (who may or may not include the settlor). This permits the separation of control of trust assets (held by the trustee) from the people who are intended to benefit from them (so that, for example, family wealth can be preserved from the risks that children inheriting "too early" might dissipate it). It also permits the separation between a number of beneficiaries of property rights that are either inherently non-divisible or could only be divided at economic cost (e.g. traditional "estates").

There are also civil law entities such as Stiftungen, and Foundations. These resemble trusts in certain respects, albeit they also resemble corporate vehicles in others. They have not proved to be as popular as trusts, although some financial centres, such as Jersey, have now introduced foundations in an attempt to attract business from European countries with a civil law legal framework.

[40] People who are UK tax resident and domiciled are taxed on their worldwide income and gains; by contrast non-domiciled individuals who are remittance basis users are taxed on their UK income, gains on UK assets, and on income and gains from other assets only when remitted to the UK. They also only suffer inheritance tax on UK sited assets unless they have been resident in the UK for 17 out of the previous 20 years.

different, and in fact somewhat perverse in policy terms, as non-doms would have some incentive to remain in the UK but a positive disincentive then to invest in UK assets or deal on UK markets (such as the art market).

Example of a typical offshore trust structure for a non-dom individual



Direct use of trusts by corporates

Corporates do make use of trusts in some circumstances, most commonly to provide benefits to employees in a tax efficient manner, to act as counterparties (e.g. in pension trust scenarios) or for other non-tax commercial reasons.

- Employee Benefits Trusts ("EBTs") are usually reserved for high net worth employees and executive remuneration tax planning[41]. The use of an EBT can be structured to create a materially lower tax charge for the executive (for example, by lending him cash rather than gifting it to him outright) and the resulting deferral, or even avoidance, of tax in the hands of the employee (at 40% historically, 50% shortly) is more valuable to the employee than the corporate tax deduction would be for the employing company (at 30% historically, 28% now).

- Offshore pension trusts are often used for executive pension schemes[42]. A primary reason for creating an offshore scheme is for internationally mobile executives who work in a succession of foreign countries over their career and wish to consolidate their pension rights - as well as to minimise the complexity, if not the actual tax cost, of the interaction of the tax rules of more

[41] The basic concept is that the employing company puts assets into the trust, which increase in value tax-free (as tax is not paid on gains made by the trust). When assets are appropriated to the employee, it is treated as taxable employment income in his hands (and at that point in time the employing company is generally entitled to a corporation tax deduction). In effect, the trust acts to defer the tax timing for both the employee's income and the company's deduction, and in this regard does not create a corporation tax advantage.

[42] All-employee pension trusts are generally onshore schemes because there are tax deductions available for pension contributions to qualifying onshore pension schemes without any obvious tax disadvantages for the employees participating.

than one "onshore" jurisdiction. These schemes may include foreign nationals as well as executives originally based in the UK.

- Offshore pension funds are tax effective in so far as there is no tax on fund growth accruing to non-resident members and offshore centres do not impose source taxation when funds are distributed to non-resident members. (However, in the absence of a treaty network, income arising on fund investments may be subject to onshore withholding taxes.) Despite these advantages, offshore pension trusts offer no protection from income tax charged by various countries on the benefit of employer contributions. Nor are fund distributions generally protected from taxation in the pensioner's state of residence (although the UK exempts a lump sum paid by a foreign scheme from UK income tax to the extent it relates to overseas service while non-resident). Whilst PAYE/NIC may be lost to the Exchequer, the employer will not receive any deductions for payments made into the trust (although again we note that the PAYE/NIC may typically be worth more than the corporate tax deduction). That said it is very difficult to compare offshore and onshore pension schemes, given the fact that they invest in different assets and therefore experience varying returns on the funds, net of any tax.

- When UK groups incorporate overseas subsidiary companies, they need to consider whether that subsidiary might fall within the UK CFC regime. We are aware that some groups (anecdotally a small number) have used trusts instead of subsidiaries to hold cash deposits in low or nil tax jurisdictions to avoid the CFC rules, on the grounds that trusts are neither controlled by the UK parent nor companies[43]. However, the loss of control entailed in putting interests in subsidiaries into trusts may not always sit easily with corporate governance policies.

- We are aware of government contracts which have included within their terms the need to ring fence assets within a trust of 100 years' duration (to protect them from being diverted into other projects). A UK trust cannot exceed a stated period longer than 80 years, and English law does not fully recognise trusts which have been established for a defined general purpose, where there is no clearly identifiable class of beneficiaries who can enforce the trust. Accordingly, companies bidding for such contracts are obliged to set up non-UK trusts (typically in Jersey) but which are UK tax resident.

- Trusts are typically used in securitisation structures, for example to hold SPVs taking ownership of the assets being securitised. This is discussed in more detail in the Securitisation section.

4.5.2 Factors influencing location decisions

There are many factors that affect the decision to locate a trust in a specific overseas jurisdiction:

- Robust and predictable legal framework - in the case of the CDs, their trust law is based on English law, and therefore has the additional benefit of familiarity.

- Smaller jurisdictions may be more willing to change their trust legislation to bring it in line with commercial need.

- Geographical proximity – different locations may sometimes be more convenient for particular markets.

- Costs - the costs of setting up trusts in a specific jurisdiction are also considered. Mauritius, for example, has recently been used as a low-cost overseas jurisdiction since it introduced trust law. However, there may be consequent concerns about the quality of the local expertise in a complex area.

[43] The CFC regime seeks to prevent groups artificially diverting profits into low tax jurisdictions by subjecting parent companies to tax on the profits of their low tax subsidiaries as if they were earned by the parent companies (there are several exemptions for genuine commercial activities located overseas). Although there are understood to be few instances of such planning, it is believed to involve substantial amounts.

- Access to a jurisdiction with a network of double tax treaties is not typically seen as an influencing factor in choosing location. This is in part because there is potential difficulty for trusts to access double tax treaty in any event as it may be unclear, particularly to civil law jurisdictions, who has "beneficial ownership" of trust assets for Tax Treaty purposes.

- In addition, wealthy individuals are perhaps more likely than corporates to be able and willing to locate themselves in jurisdictions which have very low rates of tax, if any, but which do not offer access to Double Tax Treaties.

4.5.3 Competitive position of the CDs and OTs

Once a benefit from establishing an offshore trust has been identified, it could be established almost anywhere that has common law (or equivalent concepts in civil law) – although it would presumably be important for the user to minimise tax leakage in the alternative jurisdictions considered. In practice, common law is an important factor because the use of trusts is very well established.

Because, for reasons set out above, access to double tax treaty networks is not a significant feature in trust location decisions, the CDs and OTs are not disadvantaged relative to the main European "tax arbitrage-oriented" jurisdictions - for example, Switzerland, Luxembourg and the Netherlands - and have a positive advantage in being common law rather than civil law territories.

UK preference on establishing trusts in the CDs

UK corporates and individuals that use trusts generally choose to establish them in the CDs. This is due to a combination of factors, the most significant being:

- The legal framework (which is very similar to that the UK trust model and hence well understood);

- Responsiveness of the legislature to commercial need;

- Geographical proximity; and

- Absence of taxation on the trust itself.

4.5.4 Conclusions

The use of trusts by corporates is less widespread than their use by individuals, although corporates (including many banks) do provide offshore trust services to individuals. Trusts continue to be important in tax planning for UK non-doms and their families in particular.

Corporates do make use of trusts in some circumstances, most commonly to provide benefits to employees in a tax efficient manner (for example, through Employee Benefit Trusts); for executive pension schemes; and for other reasons, including to hold securitisation SPVs, and where the legal requirements around UK trusts (for example, their legal duration) are restrictive.

We are aware that some groups (anecdotally a small number) have used trusts instead of subsidiaries to hold cash deposits in low or nil tax jurisdictions to avoid the UK CFC rules, on the grounds that trusts are neither controlled by the UK parent nor companies. Although there are understood to be few instances of such planning, it is believed to involve substantial amounts. The loss of control entailed in putting interests in subsidiaries into trusts may not always sit easily with corporate governance policies.

4.6 VAT

4.6.1 Background

In order to understand the use of offshore financial centres in VAT planning, it is necessary to first understand how the VAT system works. The essential features of the regime are set out at Appendix 5. In addition, the following key points are particularly relevant to this case study:

Financial services

Certain financial services which, if provided by UK suppliers to UK customers would be standard-rated and carry a VAT cost (which would be an absolute cost if the customer itself made exempt supplies[44]), are outside the scope of VAT but with recovery of input tax if made to a customer outside the EU.

Low Value Consignment Relief

Territories outside the EU also benefit from Low Value Consignment Relief ("LVCR"). Under EU law, retailers based outside the EU can sell goods to consumers in the UK worth less than £18 without charging 15% import VAT (17.5% from 1 January 2010). LVCR was originally introduced to ease the administrative burden on consignments of low-value goods.

Betting and gaming

Betting and gaming supplies are also VAT exempt. Further, UK-based online casinos are charged Remote Gaming Duty ("RGD") and UK-based bookmakers are charged Gross Profits Tax ("GPT") – both at 15%.

4.6.2 Factors influencing location decisions

For the purposes of VAT, the Isle of Man is within the EU; the Channel Islands and the OTs are not within the EU (Gibraltar is in the EU for many purposes but not for VAT). For this reason, the Isle of Man is not typically used by UK companies for VAT planning.

In this sense, location-based VAT planning is not specifically related to the use of CDs and OTs (even excluding the Isle of Man) because the treatment for, say, the US would be identical, and indeed location in the US and other non EU "full-tax" jurisdictions can feature in VAT planning.

HMRC carries out checks that companies claiming to supply services outside the EU are actually doing so. HMRC will question whether the customer (which is, of course, sometimes a related party to the supplier) is genuinely established outside the EU. HMRC look to the place of the customer's incorporation but also whether it has sufficient human and technical resources to undertake its purported business. This is sometimes difficult for financial services businesses, which may have limited physical evidence to support their assertions regarding where they are established.

4.6.3 Competitive position of CDs and OTs

The CDs (other than the Isle of Man) and OTs are in effect on a level playing field with the rest of the world outside the EU when it comes to VAT matters. In that regard, the CDs (excluding the Isle of Man) and OTs are in direct competition with other non-EU jurisdictions.

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[44] Insurance, banking, investment fund management, and betting and gaming services are all exempt supplies when supplied by UK companies to UK customers. Similarly, supplies of most financial services, and betting and gaming services, by UK companies to EU customers are also effectively "exempt". However, supplies of most financial services (but *not* betting and gaming services) by UK companies to customers outside the EU are outside the scope of VAT but with input tax recovery (the justification being to level the playing field for EU financial services businesses competing with the rest of the world).

Therefore, a financial services business selling its services to customers within the EU will generally not be able to recover the input VAT it has suffered, but an identical business selling its services to customers outside the EU will be able to recover its input VAT.

Supplies to securitisation SPVs

Securitisation special purpose vehicles (SPVs) incorporated outside the EU are generally efficient from a UK VAT perspective because a UK service provider (for example, of management services) will not be required to account for UK VAT[45]. This makes the use of offshore SPVs in securitisations more attractive. It should be noted that, given the very large asset values and resulting cashflows securitised, the VAT benefit, which is a function of the management fees, is relatively minor. However, in the years leading up to the credit crunch, securitisation was a mature and competitive market and even minor price differentials were keenly sought.

It should also be noted that some EU Member States have differing interpretations of the scope of the financial services exemption from VAT in respect of management services, which has the effect of allowing them to replicate the benefits of the CDs (excluding the Isle of Man) and OTs[46].

LVCR

The Channel Islands have been popular locations for retail businesses selling small, high value items (such as CDs and contact lenses) directly to UK consumers, and taking advantage of LVCR. In respect of imports from jurisdictions outside the EU and commonly associated with manufacturing and direct distribution, such as the Far East, the LVCR is a welcome easing of the administrative burden. However, EU manufacturers can route their distribution to UK consumers through the Channel Islands (i.e. taking the physical movement of goods outside the EU for part of the distribution channel) and thereby avoid charging import VAT to UK consumers. In a number of cases, goods have been manufactured in the UK, shipped to the Channel Islands (a zero rated export for the UK manufacturer), and then shipped back to UK consumers for sale free of VAT.

The rise of “e-tailing” on the internet allows companies significantly greater opportunities for direct marketing than in the past which has impacted on the markets for such goods.

In theory any non-EU territory would work for LVCR purposes – the Channel Islands are used simply because their geographical proximity to the UK reduces distribution costs. The practice is thought to give rise to considerable tax loss to the UK exchequer. Rt Hon Stephen Timms, MP, Financial Secretary to the Treasury, has estimated that the loss might be in the region of £110 million per annum for 2008 and continuing to rise[47]. This would represent goods with a VAT-free value of around £625 million.

Betting and gaming

Guernsey and the Isle of Man both operate beneficial RGD and GPT regimes and the Isle of Man is perceived to operate a relatively benign regulatory regime for gaming and betting companies. Gibraltar is another jurisdiction known for its online gaming companies. The desire to escape UK RGD has been cited as a reason for relocating internet sports betting operations to Gibraltar.

4.6.4 Conclusions

From a VAT planning perspective, all of the CDs and OTs (except the Isle of Man) benefit from being located outside the EU, although no more so than any other non-EU territory.

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[45] For example, a UK credit card issuer (“Bank Limited”) might incorporate a Jersey SPV (“SPV”). SPV will hold the credit card receivables and Bank Limited will manage them on behalf of SPV. There is no UK VAT charge from Bank Limited to SPV because SPV, the customer, is outside the UK; further, the Jersey SPV would be exempted from Jersey Goods & Sales Tax and hence would not suffer domestic VAT in Jersey.

[46] Although in principle there is a common EU VAT regime, all Member States implement the EU VAT Directive differently. Ireland and Luxembourg are believed to exploit differences in interpretation over the scope of the “financial services exemption” from VAT to allow many aspects of management fees to be treated as exempt. This eroded Jersey’s price advantage and in recent years Jersey has suffered competitively as a location for securitisation SPVs, given its lack of Tax Treaty network.

[47] House of Commons debate, 27 January 2009.

Corporates do explore ways of reducing taxes on their customers, employees and other counterparties, so increasing their competitiveness and/or terms of trade - LVCR operations located in the Channel Islands in particular are an example of this, and do give rise to lost tax to the Exchequer.

4.7 Corporate Tax[48]

4.7.1 Background

One obvious way for multinational groups to reduce their tax costs is to generate profits in low-tax jurisdictions (referred to as "low-tax jurisdiction planning" for the purposes of this case study). Another is to enter into transactions, of greater or lesser commercial substance, which seek to either generate returns that are non-taxable or to claim double tax deductions for the same expense (referred to as "double dip planning" for the purposes of this case study).

The UK has extensive anti-avoidance legislation to counter low-tax jurisdiction planning, the most important provisions being:

- The Controlled Foreign Companies legislation; and[49]
- Transfer pricing[50]legislation.

Further, withholding tax is generally required on interest and royalty payments to offshore jurisdictions outside the UK double tax treaty network.

In a similar way, the UK also has anti-avoidance legislation to counter double dip planning. As well as specific targeted anti-avoidance rules, which tend to block known schemes or arrangements, it has anti-arbitrage rules[51] which apply as more generalised preventative measures.

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[48] A UK tax resident company is chargeable to corporation tax on all its profits, wherever the profits arise and whether or not those profits are received in, or transmitted to, the UK. A non-UK tax resident company is chargeable to corporation tax only if it carries on a trade in the UK through a branch or agency. It may also be subject to UK income tax on UK source income that obliges the paying company to withhold tax ("withholding tax", for example on interest or royalties paid from the UK), subject to relief via double tax treaties that can reduce the rate of withholding tax or eliminate it altogether.

It therefore follows that an overseas subsidary of a UK parent will not generally be subject to UK tax unless it receives UK source income or has a UK branch. Further, subject to certain anti-avoidance provisions, the UK parent will not be taxed on the subsidiary's profits until they are repatriated to the UK. On 1 July 2009, the UK introduced an exemption from UK tax for most dividends, and so it is entirely possible that UK parents will never be taxed on subsidiary company profits.

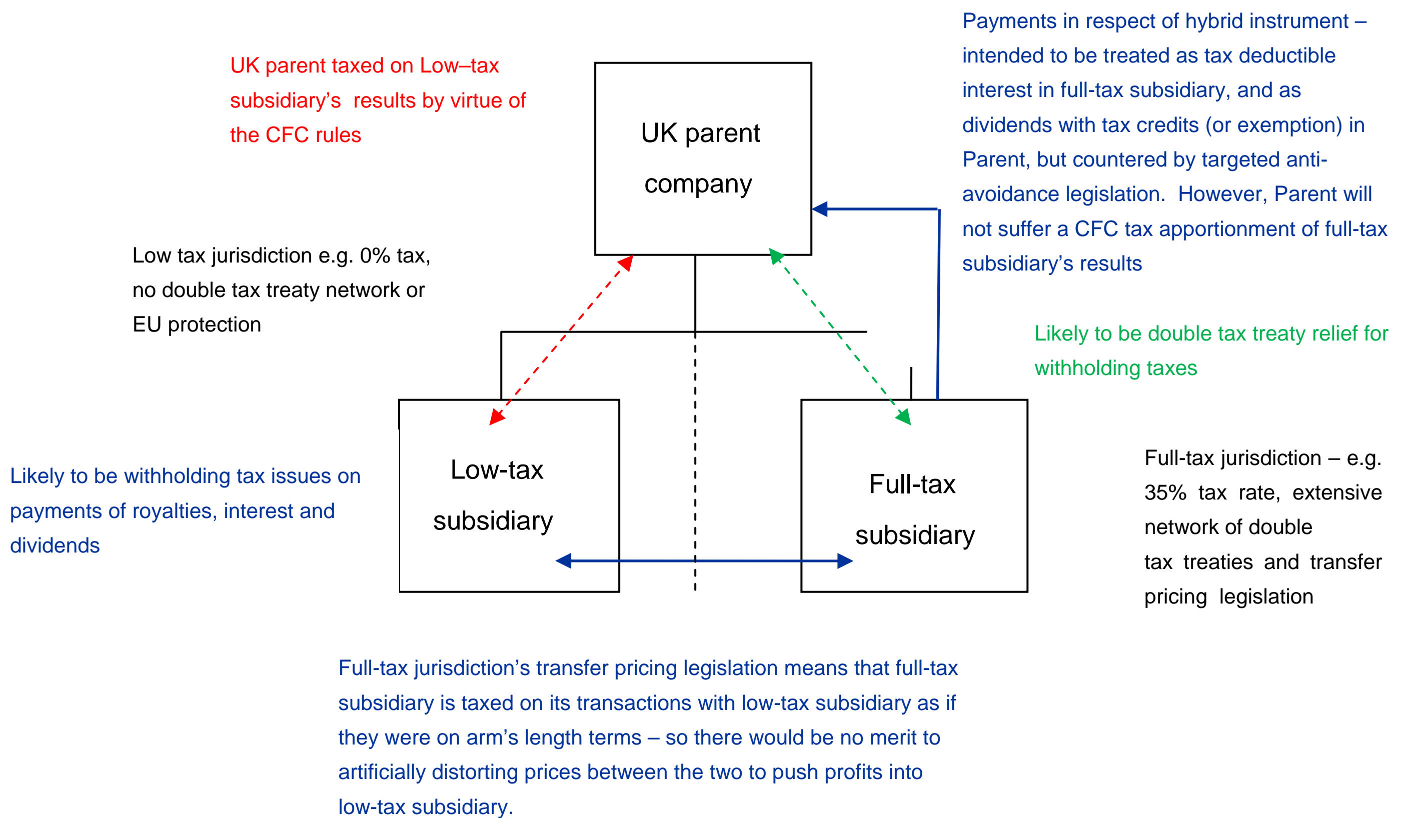
[49] The CFC legislation attributes the profits of subsidiaries based in low-tax jurisdictions to their UK parents, unless (broadly) the subsidiaries have a genuine economic reason for operating in those countries, or the countries in question are on a "white list".

[50] The transfer pricing legislation obliges companies within a group to treat intragroup transactions at an arm's length price for tax purposes.

[51] The anti-arbitrage rules apply to two separate situations. The first situation, where the "deductions rules" apply, relates to schemes involving a hybrid instrument (that is, one with both equity and debt characteristics) or a hybrid entity (broadly an entity subject to tax in more than one jurisdiction) to create or increase UK tax deductions. The second situation, where the "receipts rules" apply, relates to relatively narrow circumstances where an amount that represents a contribution of capital is received by a UK resident company in a non-taxable form while creating a tax deduction in the paying company.

Diagrammatic representation of typical tax planning issues

This simplified diagram demonstrates some of the tax issues concerned in planning schemes.



4.7.2 Factors influencing location decisions

Location decisions for corporate tax planning depend on whether the planning in question is low-tax jurisdiction planning or double dip planning.

Factors relevant to low-tax jurisdiction planning

Clearly, for low-tax jurisdiction planning, the jurisdiction chosen needs to have a materially lower mainstream corporation tax rate than the UK to be effective. The CDs and OTs could potentially fall within this category. However they are particularly vulnerable to the anti-avoidance measures mentioned above because of their lack of access to double tax treaties or the EU Treaties (although Gibraltar has access to the EU treaties).

Factors relevant to double-dip planning

In the case of double dip planning, low-tax jurisdictions have even less relevance and are used, if at all, to facilitate a structure of arbitrage between two "full-tax" jurisdictions.

Factors relevant to both types of planning

Other factors influencing the locations used in both low-tax jurisdiction and double dip planning include:

- Peculiarities of local taxation legislation. For example, in some circumstances the US will treat a preference share dividend as if it were a payment of interest, and hence allow a tax deduction. This facilitates arbitrage based on securing "debt" treatment in the US and "equity" treatment in other jurisdictions.
- Use of accounting rules. For example, accounting rules typically allow book deductions in arriving at net accounting profit for items such as write-downs in the value of subsidiaries

(including write-downs deriving from payments of dividends out of the subsidiary) which would not be tax deductible per se. However, some aspects of the CFC and Double Tax Relief rules rely on accounting profit measures, so that transactions entailing such write-downs have been used to achieve more favourable tax results (sometimes referred to as "tax credit hyping"). Known schemes of this nature have been counteracted.

- Peculiarities of local company law or the law taxing partnerships. For example, some Luxembourg partnerships do not attribute their income to their partners until the income is formally distributed to the partners. This allows the partners to refrain from booking profits until some later point in time, and hence to defer the taxation point.

- Ease of setting up any special purpose vehicles, returning capital from them, and the eventual unwind of the structure (this is also largely a matter of local company law).

- Minimal leakage through the imposition of local taxes, such as VAT, capital duty and stamp duty.

4.7.3 Competitive position of the CDs and OTs

Low-tax jurisdiction planning

The CDs and OTs could, in theory, take a direct role in low-tax jurisdiction planning, if UK corporates could establish operations offshore without triggering the anti-avoidance legislation. In practice this is now very difficult to do. Whereas ten or twenty years ago it was possible to find examples of UK groups with mainstream treasury and intangible property located in the CDs and OTs, the combination of withholding tax on key cashflows, CFC-based assessment of profits back in the UK, and lack of Double Tax Treaty protection severely circumscribe such planning, for which jurisdictions such as Ireland, Luxembourg, Netherlands or Switzerland are more attractive[52].

We have identified the following use of CDs and OTs for low-tax jurisdiction planning:

- **Trusts or Protected Cell Companies**

  Some UK groups have undertaken CFC planning through the Channel Islands in particular using trusts or Protected Cell Companies (on the grounds that neither is controlled by the parent and hence are outside the CFC net altogether), but these are proving less popular than might be expected due to commercial concerns over the lack of control. Despite the growing number of offshore centres which offer protected cell companies (indeed the Treasury announced consultation regarding introducing a protected cell regime for Open-Ended Investment Companies in July 2009), the integrity of the cellular structure does not appear to have been fully tested in the bankruptcy courts of any jurisdiction, and in particular it has not been scrutinised in an onshore court[53]. (See also the Insurance case study).

[52] We are aware that CFC planning for Canadian parented groups can be effective if structured through Bermuda. This is very much the exception that proves the general rule that "limited/no Treaty" jurisdictions are very difficult to use in low-tax planning jurisdiction schemes.

[53] The fundamental question is whether a bankruptcy court will, as a matter of its own private international law, treat the protected cells of a protected cell company, and the company itself, as a single entity whose assets should be available *pari passu* to all unsecured creditors even though they may have transacted with the company only in respect of one particular cell. The recent litigation in Guernsey and England involving the Guernsey protected cell company Messenger Insurance PCC Limited was settled without requiring any decision on such fundamentals and so has, if anything, increased corporates' reluctance to use PCCs.

- **Captive Insurance**

  Corporates have incorporated captive insurance companies in Guernsey. The Insurance case study contains more information in this regard. In brief, profits of captives (outside the PCC structure) are generally chargeable to UK tax under the CFC legislation.

- **Debt raising through securitised assets**

  Corporates have securitised assets as a means of raising debt through Jersey and Cayman. The Securitisation case study contains more information in this regard. In brief, securitisation SPVs generally earn no or minimal profit.

Double dip planning

We have concluded that the CDs and OTs have less relevance in relation to double dip planning. This is for the following reasons:

- **Uncertainty over DRIC status of CDs and OTs**

  Many tax reliefs which are normally available to members of groups are denied where one of the companies involved in a transaction is a Dual Resident Investing Company ("DRIC"). A DRIC is defined as one that is tax resident in the United Kingdom and is also within a charge to tax under the laws of a territory outside the United Kingdom. There is an argument that a company incorporated in one of the OTs (other than Gibraltar) or a jurisdiction with a similar tax profile cannot be a DRIC even if it is tax resident in the UK because these jurisdictions do not have any charge to tax at all. However, it should also be noted that HMRC does not agree with this analysis, and its use is not widespread.

- **Arbitrage anti-avoidance rules**

  In a similar vein, part of the arbitrage anti-avoidance rules can only apply to payments that are tax deductible in more than one jurisdiction. There is an argument that companies resident in one of the OTs (other than Gibraltar) or a jurisdiction with a similar tax profile that are also tax resident in the UK cannot be subject to the arbitrage provisions because these jurisdictions do not levy tax (and therefore cannot allow a tax deduction).

- **Double tax treaties**

  It should also be noted that most corporate tax planning by corporates will involve companies incorporated in Luxembourg, Switzerland or Ireland rather than the CDs and OTs, because these European jurisdictions typically have better access to treaty networks (minimising withholding tax costs) and have less reputational risk issues associated with them.

  In addition, UK corporates have acted as counterparties in tax-based structured financing transactions with banks. These transactions sometimes involve offshore territories, but more as a means to facilitate the transactions than as elements which save tax in their own right. The Banking thematic case study expands on this point.

4.7.4 Conclusions

By contrast with funds, multinational corporates do not generally expect to achieve gross returns, and typically do pay substantial amounts of tax. Non-tax factors (for example, innovative or less burdensome company law) are often the key factors influencing location decisions. Where tax mitigation is an objective, the CDs and OTs or other jurisdictions with similar tax profiles are not always viable or attractive as they lack EU or Double Tax Treaty protection from withholding tax or anti-avoidance legislation.

Whereas ten or twenty years ago it was possible to find examples of UK groups with mainstream treasury and intangible property located in the CDs and OTs, the combination of witholding tax on key cashflows, CFC-based assessment of profits in the UK, and lack of Double Tax Treaty protection severely circumscribe such planning, for which jurisdictions such as Ireland, Luxembourg, Netherlands or Switzerland are more attractive.

4.8 Stamp duty[54]

4.8.1 Background

This case study focuses on two specific UK taxes – Stamp Duty Land Tax ("SDLT") and Stamp Duty Reserve Tax. Although many countries have taxes similar to SDLT, SDRT is somewhat unique to the UK.

Stamp Duty Land Tax[55]

The UK is by no means unique in levying taxation on transacting in land and property[56]. It is also worth noting that several jurisdictions treat corporate vehicles that hold land as transparent for the purposes of levying land taxes on the companies' shareholders. As such the UK is not particularly unusual in its taxation of land transactions.

In the past, substantial amounts of real property have been transferred without attracting full stamp duty (prior to 1 December 2003) or SDLT through various planning techniques. Some have been relatively unrefined, but nevertheless contrived, such as transfers of legal title to nominees owned by a potential purchaser, followed by a contract of sale that was not completed by a chargeable conveyance (and some very large listed property groups habitually held real estate through group nominees in anticipation of this opportunity). Others have been more sophisticated. Some were merely opportunistic mitigation. For example, property owners have transferred land to unauthorised unit trusts established offshore, particularly in Jersey, to take advantage of a specific stamp taxes relief for transfers into unit trusts[57] (until the so-called "seeding relief" was repealed in 2006). Subsequent transfers of units in UK unit trusts are chargeable to duty at ½% (whereas a property transaction would be chargeable at 4%), and transfers of units in non-UK unit trusts are free of UK duties altogether.

[54] Historically, stamp duties are a form of taxation that is levied on documents and hence, broadly, on transactions (though one that could be avoided to the extent that transactions could be completed without stampable documents). In the past, a physical stamp had to be attached to or impressed upon a document which required stamping to denote that stamp duty had been paid - otherwise the document was not legally effective. More modern versions of the tax no longer require a physical stamp.

The scope of the UK's stamp duty has been reduced dramatically in recent years but its rate as applied to land has increased and opportunities to avoid it have been reduced. Stamp duty was largely abolished in the UK from 1 December 2003, either absolutely (e.g. goodwill and other intangible assets, as well as for example receivables, are now entirely exempt from stamp duty) or by replacement with SDLT and SDRT. The only transactions that continue to fall with the stamp duty regime are transfers of shares and securities where there is a physical (as opposed to electronic) instrument of transfer, the issue of bearer instruments and certain transactions involving partnerships, which are generally stampable at a rate of ½%.

[55] SDLT was introduced for land and property transactions from 1 December 2003, in place of stamp duty on equivalent transactions. Strictly, SDLT is not a stamp duty per se, but a form of self-assessed transfer tax charged on land transactions. The percentage due depends on the type and value of the property being transferred, but all transactions with a value in excess of £500,000 attract SDLT at 4%.

[56] Sometimes referred to as real estate transfer taxes, land taxes or duties on immovable property. Examples of countries levying transfer taxation include Ireland, Hong Kong, Singapore, Switzerland and the USA (albeit at a state rather than a federal level). There are also examples of countries levying taxation on the holding of land including Germany and France (and in the UK, business rates and the council tax have elements of a property holding tax).

[57] Section 64A Finance Act 2003

In recent years the UK has introduced substantial specific and general anti-avoidance legislation[58] into the SDLT provisions, which has gone some way towards reducing the appetite for planning in this area.

An obvious way of mitigating stamp duty costs on land transfers is to hold real estate via companies and then sell the company rather than the underlying real estate when one wants to dispose of it. Stamp duty would then be ½% rather than 4% if a UK company was used (and zero if a foreign company was used). Some other countries with real estate transfer taxes do have rules which "look through" such transactions to some extent and seek to impose the tax charge avoided. Although HM Treasury keep this under review, so far it has not happened in the UK. We understand from our discussions during the lengthy consultation exercise prior to the introduction of SDLT that the primary concerns relate to compatibility with EU law and practical difficulties with extra-territorial enforcement.

Whereas there is much support in economic theory for land ownership taxes, commercial property transfer taxes are open to criticism because they deter transactions such that portfolio adjustments can be expected to take place less often and in response to correspondingly more pronounced market shifts, thus increasing price volatility and reducing the value of real estate as collateral for business finance (especially of small businesses). On the other hand, in practical terms stamp duty is an easy tax to collect, at a time when large amounts of cash are changing hands, and there is little evidence that serious problems have arisen as a result of these issues (even in the credit crunch). However it might be that if the "safety valve" of the possibility of mitigating stamp duty were removed, such issues might become more serious. In practice considerable sums in stamp duty are raised and in very many transactions substantial stamp duty is paid without any attempt at mitigation. As far as domestic property is concerned, it may be seen as outweighed by the benefit of principal private residence ("PPR") and related capital gains tax reliefs.

Stamp Duty Reserve Tax [59]

SDRT is due on the transfer of shares and securities issued or registered in the UK[60], and now accounts for the majority of share transfer taxation. It is collected automatically and effectively through the CREST system[61]. There are general exemptions from SDRT for the transfer of shares (in the form of CREST depository receipts) in overseas companies that are not tax resident in the UK, are not unit trust schemes and do not have a local UK presence. In practice these conditions are not generally difficult to achieve unless the company

[58] A good example of effective general anti-avoidance legislation is Section 75A Finance Act 2003, enacted in 2006, which applies where a person disposes of land to another person in a number of connected transactions and the SDLT payable as a result is less than the amount that would have been payable on a notional sale of the land between the two. The section sets aside the connected transaction and simply levies SDLT as if the two had entered into a straightforward sale agreement. It does not specify the nature of the multiple connected transactions themselves.

[59] SDRT was introduced in 1986 to deal with transactions in shares where no instrument of transfer was executed. It is a transaction tax, charged at a rate of ½% on 'agreements to transfer chargeable securities'. 'Chargeable securities' for these purposes include stocks, shares and rights to stocks and shares in a UK company or in those shares of a foreign company which are kept on a register in the UK. Most categories of loan stock are not chargeable securities. Thus, if a company is incorporated outside the UK and is not kept on a UK register then there is no SDRT charge in the trading of its shares. Share transfers outside of CREST are subject to stamp duty rather than SDRT. However, this paper uses the term SDRT for both, for ease of reference.

[60] On occasion, a foreign company may wish to list its shares or debt securities on a UK stock exchange through the 'Depository Receipts' system. Thus, shares in a US company that is listed on, say, the London Stock Exchange must trade through CREST via depository receipts. Unless the depository receipts fall within an SDRT exemption then their trade will be subject to SDRT.

[61] CREST is the UK's electronic registration and settlement system for equity share trading. In other words it is the book entry transfer system for UK and Irish registered equity and corporate stocks and eliminates the need for a document such as a stock transfer form to be drawn up.

concerned is attempting to float solely on AIM, the junior market of the London Stock Exchange.

Very few countries seek to charge stamp duties on share transfers, and so in this regard the UK is somewhat unique[62]. Perhaps unsurprisingly, corporates do seek to minimise their SDRT burden through the use of non-UK companies – although clearly the extent of this is limited by their willingness and ability to predict when companies are to be formed and transferred; and make use of non-UK companies in advance. The liability attaches to the purchaser of the shares so unless this is an intragroup transaction (and many intragroup transactions are relieved from stamp duty in any event) there is also the issue of recouping from the purchaser the value of at least some of the tax saved, to make the planning worth the vendor's while.

4.8.2 Factors influencing location decisions

SDLT

With regard to property, a number of transactions have undoubtedly been routed offshore to mitigate SDLT. Many have involved the use of Jersey Property Unit Trusts or offshore partnerships.

SDRT

SDRT (and stamp duty on share transfers) can be avoided in a reasonably straightforward manner by simply using non-UK companies within group structures. This technique is commonly employed by groups entering into structured tax efficient financing structures, which typically involve placing large amounts of valuable consideration into subsidiary companies which are then transferred at least once, and often multiple times, between the parties concerned. The parties concerned hope to make corporate tax savings through the use of structured financing structures; however the subsidiaries are often incorporated offshore so that the transfers do not attract UK stamp taxes.

Tax planning using a Jersey or Guernsey company

Clearly it is harder for companies to avoid SDRT on transactions in their own shares if they wish to list on a UK exchange. However, there is a specific provision whereby shares in Jersey and Guernsey companies can be traded on CREST without lodging a depository receipt, and so transfers in Jersey and Guernsey listed companies are not subject to SDRT[63] at all.

4.8.3 Competitive position of the CDs and OTs

SDLT

With regard to SDLT, the CDs and OTs compete with other jurisdictions that do not levy tax on land transactions or on tax land wrapped up in a corporate vehicle on a "look through" basis.

SDRT

With regard to SDRT, the CDs and OTs compete with most jurisdictions in the world, although Jersey and Guernsey do have a unique advantage over all other territories (as outlined above).

[62] Some do have capital duties (i.e. a tax on the creation of companies) but as these largely apply once only (as opposed to on all transfers of existing shares) they are generally considered to be less problematic. Ireland has both capital duty and stamp duties.

[63] This is the reason why numerous Real Estate Investment Trusts and also some 'inversions' (that is, converting a UK parented listed group into a foreign parented listed group, chiefly to mitigate the effect of the UK Controlled Foreign Company rules) have been structured through the Channel Islands.

Closure of stamp duty planning ideas involving CDs and OTs

It is significant that stamp duty planning opportunities have been closed on many occasions, and in almost every Finance Bill this decade, and it has not been seen as necessary, nor would it have been effective, to specify use of companies or entities from any of the CDs and OTs in the counteraction measures, for the obvious reason that any benefit achieved from using such an entity could equally well be achieved by one located elsewhere. For example, the US has a number of types of corporate vehicles which can be used without necessarily attracting US taxation (except perhaps some reporting requirements) and which benefit from flexible, “light touch” company law.

4.8.4 Conclusions

Companies have historically routed land transactions through offshore territories (including the CDs and OTs, and other jurisdictions which do not levy tax on land transactions) to mitigate SDLT, although anecdotally the volume of SDLT planning transactions has declined due to the introduction of increasingly effective anti-avoidance legislation by HMRC.

Offshore companies can be used to mitigate the impact of UK stamp duty on share transactions. Jersey and Guernsey companies are particularly attractive in some instances as their shares can be listed on the UK stock exchanges and settled through CREST.

4.9 Withholding tax[64]

4.9.1 Background

Withholding tax, in the context of payments made by corporates, is most commonly due on interest[65], royalties[66] and dividends[67]. A handful of jurisdictions also levy withholding taxes on management charges, although this is less common, and some also treat certain payments associated with derivative contracts as interest and therefore seek to levy withholding tax on them[68]. This case study largely focuses on interest and debt, being the areas where corporates most frequently ecounter withholding tax issues.

The recipient of a payment from which tax has been withheld would, absent some form of relief, be subject to double taxation on the payment (i.e. through withholding tax levied in the payer's jurisdiction and through the usual domestic taxation system in the recipient's home jurisdiction). Relief might be granted under the terms of the recipient's domestic legislation, but may also be given via a double tax treaty agreed between the payer's jurisdiction and the recipient's jurisdiction. The double tax treaty will generally reduce the amount of tax that the payer's jurisdiction is entitled to withhold, often to nil (subject to anti-avoidance provisions designed to stop payments being routed through a "treaty-friendly" jurisdiction in order to

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[64] Withholding tax is an amount withheld by a person making certain kinds of payment and paid directly to the payer's tax authority. The amount the payer deducts may vary, depending on the nature of the product or service being paid for. The recipient is assessed by the payer's tax authority on the gross amount and the tax to be withheld is computed on that gross assessment. The purpose of withholding tax is to facilitate or accelerate collection, by collecting tax from payers rather than a much greater number of payees, and by collecting tax from payers within the taxing jurisdiction rather than payees who may be outside the taxing jurisdiction. It may also be used to counteract tax evasion and tax avoidance. Typically the recipient will also be assessed to tax in its own jurisdiction.

[65] Where payments of annual interest are made to an overseas lender by a UK borrower the borrower is obliged to deduct withholding tax at the basic rate of income tax (currently 20%). Annual or yearly interest is broadly that which arises on a loan which is capable of lasting at least one year; accordingly no withholding is required on short-term debt (i.e. on a loan with a duration of 364 days or less, although rolling 364 days terms will be treated at long-term debt). It should also be noted that in a group context until Finance Act 2009, it was necessary for a borrower to actually pay interest to a group overseas lender in order for the borrower to be able to claim a tax deduction for the interest, thus creating a historic tension between the need for the borrower to make physical payment to get the tax deduction, and reluctance by the lender to suffer withholding tax on payments made to it.

[66] Withholding tax at 20% is levied on payments of royalties in respect of patents and certain other intellectual property made to individuals and non-resident companies. Royalty payments (other than patent royalties) for the purposes of withholding taxes are not defined in the UK statutory legislation; instead it is necessary to turn to case law. Broadly speaking, royalty payments will be (i) paid under a legal obligation; (ii) annually recurring or capable of such recurrence; and (iii) "pure income profit" in the hands of the recipient. "Pure income profit" is broadly income which the recipient benefits from without a corresponding need to incur expenditure to do so (examples would include copyright royalties received by an author). The UK legislation in respect of whether withholding tax is required on payments in respect of intellectual property other than patents can be very difficult to apply in practice because many types of payments in respect of intellectual property are classified by the payer in terms of whether they are pure income profit for the recipient.

[67] The UK is somewhat unusual in that it does not levy withholding tax on dividend payments made to overseas recipients. Of the 27 EU member states, only Cyprus, Estonia, Malta, Slovakia and the UK do not charge withholding tax on distributions to both corporates and individuals (although Hungary only charges withholding tax on distributions to individuals).

[68] The US is an example of a country which levies withholding tax on derivative contract payments. The UK ceased to charge such withholding tax from 1994, and instead disallows the interest element of payments by non-financial- traders to entities in jurisdictions which have not signed treaties with the UK that include provisions covering interest.

benefit from double tax reliefs)[69]. It will usually also oblige the recipient's jurisdiction to allow exemption or credit relief to the recipient in respect of any taxes withheld by the payer's jurisdiction, although in practice the incidence of withholding taxes often increases the total tax cost for the recipient.

Double tax treaty relief must generally be applied for by either the payer or the recipient from their tax authorities[70]. Where a payer is involved in tax avoidance arrangements it may prefer to mitigate withholding taxes in some other manner, as claiming treaty relief generally involves disclosing details of the avoidance arrangements to one or more tax authorities (or it may be uncertain that double tax treaty relief is due, by virtue of the anti-avoidance provisions within the treaty itself).

In the absence of double tax treaty relief[71], other forms of relief are sought in order to stop the payer having an obligation to withhold tax from payments. With regard to UK-source interest, there are three commons means of doing so – deep discount bonds ("DDBs")[72],

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[69] The *Indofood* case is an interesting example of so-called treaty shopping, although it was a commercial contract law dispute rather than a case involving any tax authority. The case concerned whether a Mauritian company (Indofood) which had issued loan notes was entitled to redeem them from third party investors. The parent company of Indofood was incorporated under Indonesian law, and carried on a substantial business in food production and distribution. In 2002 it wished to raise capital by the issue of loan notes on the international market. Had it done so itself, it would have been obliged under Indonesian law to deduct withholding tax at 20% from the interest paid to non residents. In 2002 there was a double tax treaty between Mauritius and Indonesia, the effect of which was to restrict the Indonesian withholding tax rate to 10%. The parent therefore procured the incorporation of a wholly owned subsidiary (Indofood) in Mauritius to issue the loan notes, with the subsidiary on-lending the funds raised back to the parent. The Mauritius/Indonesia treaty was terminated as from 1 January 2005 and as a result, the rate of withholding tax payable on the interest due from the parent to its subsidiary the went up from 10% to 20%. Indofood sought to redeem the loan notes early (as the arrangements were no longer economically viable for its parent), but the lenders refused on the grounds that the increased withholding could be avoided by interposing a Dutch special purpose vehicle in the structure, which would allow for reduced withholding under the Indonesia/Netherlands double tax treaty. The Court of Appeal was required to consider how Indonesian law would apply to the proposal and took the view that neither Indofood (under the existing structure) nor Newco (under the proposed structure) could be beneficial owners of interest payable to it and therefore could not benefit from the Indonesia/Netherlands double tax treaty (and should not have benefited from the Mauritius/Indonesia double tax treaty). The Court, overturning the judgment in the High Court, therefore held that it would be unreasonable to require the Issuer to implement a structure which would probably lead to a dispute with the Indonesian tax authorities and/or litigation at which it was unlikely to be successful. Accordingly, Indofood was permitted to redeem its loan notes.

[70] It should be noted that there are genuine commercial circumstances where it is not practically possible for the treaty relief to be applied for even if it could, in theory, be due. One example is in the private equity environment. Private equity investments are usually structured via partnerships, with each investor becoming a limited partner in the investment partnership. Interest paid to the partnership is treated as paid directly to the partners (because the UK views most partnerships as transparent for tax purposes); indeed a transparent partnership is unable to request treaty clearances in its own right. Companies paying interest to the partnership find it impossible to track the treaty status of each of the limited partners (and indeed will probably not be aware of their identities) and so cannot claim treaty relief on their behalf even if it should be due.

[71] Interest payments to qualifying EU companies may also be exempt from withholding tax if they meet the conditions for the EU Interest and Royalty Directive. The Directive is incorporated into UK Sections 757-767 Income Tax (Trading & Other Income) Act 2005. The application of these rules is restricted to payments between associated EU companies, meaning EU companies where one holds directly 25% or more of the capital or voting rights in the other; or a third EU company holds directly 25% or more of the capital or voting rights in them both. As with a treaty claim, the application of the Directive is not automatic and a clearance application needs to be made.

[72] A bond is a negotiable written instrument evidencing a debt. Under the terms of the contract, the issuer is obliged, among other things, to pay the holder a fixed principal amount on a specified future date, and often to also make periodic payments of interest. Bonds issued at a discount are those where there is a difference between the value of the bond at issue and its (higher) maturity or face value. Issuing a bond at a discount is a way of rewarding the investor, either instead of or as well as paying interest, and they are typically used in transactions to transfer value without making regular cash or interest payments. A deep discount bond (DDB) is one under

quoted Eurobonds[73] or structuring the borrowing so that it is funded by a UK Bank[74]. With regard to royalties, the withholding tax position is largely determined by the specific facts of a particular situation and we are not aware of any planning techniques in common use other than to structure transactions involving intellectual property through treaty partner jurisdictions (an area subject to increasing scrutiny from HMRC, particularly with regard to transfer pricing and "treaty-shopping"). With regard to dividends, there is clearly no need for planning due to the UK's general exemption from levying withholding tax on distributions.

4.9.2 Factors influencing location decisions

Clearly withholding taxes, if unrelieved in one form or another, do represent a real cost to business and therefore groups will seek to mitigate them if possible.

As set out above, it is relatively straightforward to manage withholding tax exposures on interest payments irrespective of the identity of the recipient or the jurisdiction in which the recipient resides provided that the borrower is prepared to issue DDBs or quoted Eurobonds.

It is far less easy to manage withholding tax exposures on royalty payments, and it is very rare for UK corporates to structure intellectual property holdings through countries without double tax treaties with the UK (or that benefit from the application of the EU Interest & Royalties Directive). We note that HMRC already has several tools at its disposal with which to challenge cross-border intellectual property holdings, of which the main ones are the Controlled Foreign Company rules, transfer pricing and the application of double tax treaty relief (i.e. whether the purported holder of the intellectual property is the true beneficial owner of the intellectual property).

4.9.3 Competitive position of the CDs and OTs

The CDs and OTs are at a genuine competitive disadvantage compared to EU countries and/or jurisdictions with a comprehensive treaty network such as the US as they:

- Have not entered into extensive double tax treaty networks; and

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which the discount exceeds a certain proportion of the issue price. The unwind of the discount is generally tax deductible for the borrower on an accruals basis in line with the accounting rules. The UK courts have determined that a discount is distinct from interest, and that paying companies are not obliged to withhold tax in respect of discounts. Accordingly, DDBs represent a mechanism to pay "quasi interest" to parties not qualifying for treaty relief with no obligation to withhold tax. They are commonly used by offshore private equity partnerships and securitisation vehicles have often used DDBs for this purpose. Given the ready availability of non treaty routes, withholding tax mitigation is not the driving factor for the funds being offshore, but once offshore then it is particularly favourable to find a jurisdiction that can also offer certainty of tax treatment such as Jersey. We also note that private equity partnerships are subject to the UK transfer pricing rules if the "interest" is excessive.

[73] Quoted Eurobonds are issued to the public and institutional investors by (usually) large corporates as part of their funding raising activities. Payments of interest on a 'Quoted Eurobond' are excluded from the general requirement to deduct income tax. The definition of a 'Quoted Eurobond' is a security (including a share) that is issued by a company, is listed on a recognised stock exchange, and carries a right to receive interest. Usually a legal team will be required to manage the listing and the Channel Islands stock exchange is a popular location to list such bonds due to the relatively low costs of listing and because the Channel Islands automatically require IFRS to be applied, unlike listings on EU exchanges. They are often used for the shareholder debt component of leveraged buyouts, although anecdotally some groups have used quoted Eurobonds to fund internal financing arrangements (relying on the fact that although the Eurobonds are listed on a recognised stock exchange in practice there is not always a ready supply of purchasers for their bonds and therefore they are simply traded among connected parties).

[74] The UK bank may then mitigate its credit risk by entering into a loan/hedging contract with a non-UK party (e.g. through a sub-participation agreement) as the UK bank can benefit from an exemption from withholding tax as it is paying interest in the ordinary course of its banking business.

- Are not entitled to the benefits of the EU Interest & Royalties Directive (although Gibraltar has access to the EU treaties).

This prohibits their use in royalty and intellectual planning-based avoidance arrangements.

Given the relatively straightforward manner in which UK withholding tax on interest payments can be mitigated (i.e. short-term debt, the use of deep discount bonds, the quoted Eurobond exemption) the competitive disadvantages are not necessarily prohibitive, as evidenced by the number of securitisation companies over UK assets located in Jersey. However, many corporates would prefer to use "easier" jurisdictions and so do chose to locate financing arrangements elsewhere (Switzerland, Luxembourg, Ireland and the Netherlands are the key alternative candidates, particularly for multinational groups whose treasury operations lend more widely than just to the UK and therefore need to consider withholding taxes across many jurisdictions). The willingness of the Channel Islands stock exchanges to provide easy access to listing facilities for quoted Eurobonds demonstrates their flexibility towards international financing.

As a general point, withholding taxes are becoming harder to sustain in the current market. More widely, given the fact that most funding into the UK will generate a UK tax deduction for the borrower but that some lender jurisdictions may not tax its interest income thereby creating a tax advantage, most financing transactions will place more weight on achieving a tax-free status for the lender than withholding tax mitigation in the UK.

4.9.4 Conclusions

The lack of double tax treaty networks, and the fact that they are not generally entitled to the benefits of the EU Interest and Royalties Directive, places the CDs and OTs at a competitive disadvantage compared with many other jurisdictions in arrangements which involve withholding taxes. This is not necessarily decisive for structures involving UK withholding tax on interest payments (as evidenced by the number of securitisation companies over UK assets located in Jersey), but is more likely to be prohibitive where royalties are involved.

4.10 Legal factors

4.10.1 Background

In many ways, the UK operates a relatively benign company law regime[75]. New companies can be set up in a few days with shareholder capital; proforma constitutional documents are set out in the legislation; constitutional documents are generally wide-ranging and allow for wide variety in company activity. However, there are two aspects to UK company law in particular which are generally regarded as being less attractive to business than some other jurisdictions – prohibitions on certain distributions[76] and on financial assistance[77]. There are various other factors that are also of some importance[78] but these are generally seen as less critical than distribution and financial assistance restrictions. This is because the two prohibitions can act, together or separately, to prevent a company repaying its wealth to its shareholders in the manner of its choosing.

UK companies are also required to file their statutory accounts and other key documents at Companies House, and these then become publicly available documents even for private companies. Some owners of private companies might prefer to keep commercially sensitive accounts information out of the public domain (while acknowledging that some otherwise private information is rightly required by certain government bodies such as HMRC). There is an argument that the administrative costs of preparing and then filing statutory accounts outweigh the benefits that they bring such as creditor protection[79]. Many other jurisdictions maintain some form of corporate register, although different jurisdictions take different approaches as to which documents are held.

4.10.2 Factors influencing location decisions

Where a choice is open to them, corporates generally look for regimes that offer:

- Certainty of legal treatment; and
- Minimum amount of administrative burden (both in terms of ongoing compliance and also the structure of particular transactions).

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[75] Set out in the Companies Act 2006 and the Companies Act 1985 (as amended by the Companies Act 1989).

[76] A UK company is not permitted to pay money out in the form of dividends in excess of its retained earnings (commonly referred to as its "distributable reserves"). This provides a limited amount of protection for creditors in that a company cannot pay dividends that will reduce its capital below a certain level. In practice, the UK rules mean that a company is prohibited from declaring a dividend out of share capital and other non-distributable reserves (although funds locked up in share capital can be accessed through longer and more cumbersome routes such as a capital reorganisation). There are strict accounting rules defining whether profits arising from a particular transaction are distributable or not. (In UK GAAP the relevant accounting standard is FRS18. The Institute of Chartered Accountants in England & Wales has also issued a guidance document, Tech 01/08.)

[77] In law, financial assistance refers to any assistance given by a company for the purchase of its own shares or the shares of its holding companies. The rationale for such laws is purely economic with a view to maintaining the value of the company; where such assistance is given in breach of applicable law it will render the relevant transaction void and may constitute a criminal offence. In many developed jurisdictions such assistance is prohibited or restricted by law. For example all EU member states are required to prohibit financial assistance by public companies, although some members go further (for example, Belgium, Bulgaria, France, and the Netherlands prohibit financial assistance by all companies). The Companies Act 2006 reverted English law to the minimum level of regulation required under EU directive 77/91/EEC by abolishing the prohibition for private (but not public) companies. Anecdotally, financial assistance is a particular issue for financing companies.

[78] For example: ease of liquidation, directors' duties and liabilities, administrative burden, etc.

[79] For example, privately held companies incorporated in most US states are not required to prepare and file statutory accounts without a noticeable erosion of creditor protections.

In this regard jurisdictions which have fewer restrictions regarding distributions or financial assistance, or which allow companies to maintain a greater degree of privacy can be attractive in comparison to the UK. However, it should also be noted that in many ways the UK offers a more flexible legal environment than many other parts of Europe (for example, many European jurisdictions require documents to be notarised by a notary public – broadly, a solicitor – before they take legal effect).

However, the existence of a simple and flexible legal framework would not outweigh most other concerns, such as geographical proximity to business activities, tax leakage or uncertainty, fear of political instability, and so on.

4.10.3 Competitive position of the CDs and OTs

The legal environment of the CDs and OTs may be attractive for the following reasons:

- Legal frameworks that are more flexible than the UK's are a common characteristic of many of the CDs and OTs. The CDs have legal systems that bear a strong resemblance to the UK's in many respects (e.g. the law of trusts, and many aspects of company law[80]), which makes them the default location for those looking to move offshore (for example, companies who wish to insert a non-UK company at the head of their listed groups) for company law purposes.

- That said, administration associated with establishing new companies within the CDs and OTs is increasing due to the introduction of anti-money laundering legislation (and it has been difficult to establish new companies in the Channel Islands for some time).

- It may also be easier for interested parties to influence their legislature than in the UK, and changes can be made much faster than in the UK, so the CDs are seen as more responsive than the UK to the needs of business[81]. Gibraltar, Cayman, Bermuda and BVI are viewed in a similar way with regard to flexibility and responsiveness[82].

- However, the CDs and OTs compete with other jurisdictions which are relatively small in size so that changes can be effected rapidly, and which are similarly willing to consider legislative change. Other alternative jurisdictions[83] will be used just as commonly by corporates, particularly non-UK corporates.

4.10.4 Conclusions

The CDs and OTs are able to offer legal regimes which are familiar in many respects to practitioners of English law, but offer greater flexibility in some areas than UK company law (in particular, in relation to company distributions and financial assistance), which can be important in some arrangements. However, there are many other jurisdictions around the world that offer a similar level of company law flexibility. Speed of company formation is also cited as an attraction, although it is not consistently faster than in the UK.

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[80] The Channel Islands' company law regimes are mostly based on the UK's Companies Act 1948. There are sufficient similarities that UK legal practitioners are able to practice in the Channel Islands and vice versa.

[81] One example would be the introduction by Guernsey of the Protected Cell Company concept, which was requested by the insurance industry.

[82] Anecdotally, speed of company formation has also been an attraction for many. However, some of the jurisdictions – Guernsey, for example – do not have noticeably quicker times for company formation than the UK, and formation times in the CDs are increasing due to increased levels of anti-money laundering legislation.

[83] For example, Singapore is seen to offer a very flexible corporate regime, as is the US state of Delaware.

4.11 Regulatory factors

4.11.1 Background

It is not within the scope of this study to comment extensively on the regulatory regimes of the CDs and OTs. However, because regulatory considerations are frequently cited as a factor in companies' location decisions, it is appropriate to include some high-level comments on instances where these factors are influential.

In general, weak regulation is increasingly viewed as a source of competitive disadvantage. The key reasons for this are:

- Many financial businesses entail risks which, if unregulated, can be significant enough to threaten the economic stability of individual countries or even regions. Jurisdictions therefore recognise that to operate an insufficient regulatory oversight of these businesses is to be excessively exposed to financial instability;
- "Offshore" jurisdictions will typically want their regulators to be treated as "equivalent" to "onshore" regulators, to avoid additional "host" requirements being applied to institutions based in that offshore jurisdiction but operating onshore. In that context reputational issues are important;
- Jurisdictions do not want counterparties of institutions which they regulate to perceive the latter as having higher risk and uncertainty by virtue of their location[84].

4.11.2 Factors influencing location decisions

Where we have identified instances in which regulatory considerations have played a central role in location decisions, the issue has not been whether financial services providers can identify arbitrage opportunities between "weak" and "strong" regulatory regimes, but with:

- The responsiveness of the regulatory authorities (specifically in respect of the speed with which it is possible to establish new operations);
- Regulatory capital requirements; and
- Regulatory authorisations.

These points are illustrated below in the context of the competitive position of the CDs and OTs, by reference to examples from the **insurance industry**.

4.11.3 Competitive position of the CDs and OTs

Speed of establishment

In the wake of the terrorist attack on the World Trade Centre in 2001, approximately $20bn of new capital was raised to meet the shortfall across the market. The majority of this capital flowed to Bermuda in the form of new start-up insurers and reinsurers (including Axis, AWAC and Montpelier). By contrast, relatively little new capital flowed to other established insurance centres, such as Lloyd's of London. In addition to the attractiveness of the regulatory capital regime, a critical reason for this was that new entrants were able to be established in a matter of weeks following the World Trade Centre attacks. In many other centres, including the UK, that process would have been expected to take approximately 6 months.

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[84] Memorandum from Deloitte to the House of Commons Treasury Committee's inquiry into Offshore Financial Centres (http://www.parliament.uk/documents/upload/OFCWrittenEvidence.pdf), section 4.3. See, for example, the IMF's 2003 Assessment of the Supervision and the Regulation of the Financial Sector of Jersey (Volume 1): "The financial regulatory and supervisory system of Jersey complies well with international standards", with parallel comments in the 2003 assessments for the Isle of Man and the Bailiwick of Guernsey.

A similar situation occurred following hurricanes Katrina, Rita and Wilma in 2005, when the insurance market was swiftly recapitalised with an estimated $34bn of new capital, approximately 27% of which went into start-ups, largely in Bermuda (including Harbor Point, Ariel Re and Flagstone). Once again, the short establishment timetable was a key factor. By this stage, Bermuda had also achieved a very significant market infrastructure in the area of catastrophe business, and the "cluster effect" was instrumental in attracting further new business.

Regulatory capital requirements

Regulatory capital requirements, which can to some extent be determined by local regulatory authorities, can also play an important part in companies' location decisions. Requirements regarding the minimum level of regulatory capital which insurers must hold – which tends to be a multiple of the minimum capital required under the EU Solvency I Directive – vary between jurisdictions, and companies may prefer to hold lower levels of capital, all else being equal. For most forms of insurance business, the expectations of the rating agencies tend in practice to be the key driver of the level of capital held by insurers, so that headline minimum capital requirements in a particular jurisdiction will be less definitive. However, an exception is for "pure" motor insurers, and this has therefore been a sector where Gibraltar – the required minimum capital level of which has typically been lower than in, say, the UK – has established a successful industry profile. Elsewhere, for instance in banking, global agreements such as Basel have meant that these factors are less important[85].

Regulatory authorisations

Insurers are typically required to be licensed by a jurisdiction's regulatory authority in order to be allowed to transact business in that jurisdiction. Within the EU, insurers regulated by one member state's regulator are permitted to transact business in other member states on a so-called "freedom of services" ("FOS") basis[86]. Gibraltar-regulated insurers are therefore able to transact business within the EU on a FOS basis[87]. However, Gibraltar does not operate VAT, and therefore charges for certain management services to persons in EU member states will not attract VAT. This, combined with the flexibility to transact business with the EU on a FOS basis, gives Gibraltar a unique proposition which may be attractive to certain businesses, depending on their circumstances.

4.11.4 Conclusions

In our experience, large financial businesses place a significant premium on the stability, transparency, effectiveness and reputation of a jurisdiction's regulatory systems and the extent to which it co-operates with other regulators.

Financial services providers look to work with regulators who are responsive to their needs. Benign capital requirements may also be a differentiating feature. In some instances (for example, the reinsurance industry in Bermuda), these regulatory factors have been a key driver of the development of specific industry sectors.

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[85] See also Footnote 32 above for comments on the impact of the Solvency II Directive.

[86] The 2nd Council Directive of June 1988 established the freedom to provide services, defined as the covering by an insurer established in one Member State of a risk situated in another Member State, regardless of where the policyholder is resident or established.

[87] Although not a separate member state, Gibraltar entered the EU together with the United Kingdom in 1973. It has exemptions from certain Community measures, including in respect of VAT.

5 Can we quantify the tax impact of these activities?

5.1 Introduction and overview

In evaluating the importance of the CDs and OTs in the context of tax avoidance by UK corporates, it is natural to attempt to quantify the so-called "tax gap" attributable to use of the CDs and OTs. There have been a number of public-domain studies which consider to a greater or lesser extent tax loss through avoidance, but few deal with the loss of tax to the UK specifically, and none of those studies we have identified directly addresses the contribution of the CDs and OTs to the UK corporate "tax gap". Nevertheless, these studies have influenced perceptions of the extent and therefore importance of the issue of tax loss through avoidance (and therefore, by implication, the role of the CDs and OTs as an element of the wider picture), and it is therefore reasonable to review their methodologies and conclusions. This is covered in Sections 5.2.1 and 5.2.2 below. A summary of the studies reviewed is set out in Appendix 1.

Our review focuses on CT, rather than VAT, Stamp Duty or withholding tax. CT has been the focus of the most high-profile previous reports, and of the work to date by the OECD and other international bodies. It is also in practice generally extremely difficult to isolate the specific role of the CDs and OTs in avoidance of these other taxes, although our thematic case studies identify specific exceptions to this – for example, in respect of Low Value Consignment Relief for VAT[88].

For our assessment, we have then built on the approach adopted in the TUC's 2008 pamphlet "The Missing Billions: the UK tax gap". We have calculated, by reference to the published 2008 financial statements of 50 of the largest companies in the FTSE, the difference between the tax these companies might broadly have been expected to pay (on the basis of reported profits at the UK headline CT rate) and the tax actually paid. We have then sought to identify the elements of this "crude gap" which relate to items which can be assumed to be "policy intended" (i.e. in line with policy intentions of the UK Exchequer – for example, those that arise because of the differential treatment of "tax depreciation" and "commercial depreciation"). The residual balance represents "potentially policy unintended" differences. A proportion of this residual balance may well of course represent differences which cannot be isolated from the published information, but which could be identified as "policy intended" if sufficient analysis was available. The "tax gap" due to avoidance is therefore a component of that residual difference, with avoidance through the CDs and OTs, being an unidentified sub-component. This is covered in Section 5.3 below.

5.2 Update on existing studies

5.2.1 General points recognised in the material reviewed

The following general points should be kept in mind when considering the available "tax gap" literature (and they are therefore applicable to all of the studies discussed in detail below):

1) None of the studies we identified (nor the quantitative assessments derived from them and quoted in the Press) directly addresses the effect or contribution of the CDs and OTs or other jurisdictions with similar tax profiles to the UK "tax gap". The authors of these studies sometimes recognise as much, and acknowledge that they are writing with the specified aim of provoking changes that would enable more study in the area, so we do not wish to criticise them in this regard, but this observation does mean that the specific concerns of our study are not addressed in the literature.

[88] We note that the quantification of tax loss due to LVCR may depend on information privy to HMRC.

The studies that do directly address the role of "tax havens[89]" generally (even if they do not estimate the size of the impact for the UK) are:

a) Desai (2006), which estimates that multinational corporations with affiliates in regionally close "tax havens" pay 1.4% - 2.1% less tax than those multinationals without affiliates in regionally close "tax havens"; and

b) Swedish National Tax Agency (2008), whose estimates imply that a maximum of 10% of the total tax gap for Sweden is due to "tax haven" transactions (although this is likely to be an overestimate given that the figure captures all tax avoidance with an international element by large corporations).

2) Any identified "tax gap" cannot be taken as a measure of how much revenue would be available to the UK Exchequer if, for example, the UK tax rules were revised. To conclude on that point would require analysis of current tax take against a tightly defined counterfactual hypothetical tax system.

3) It cannot simply be assumed that any existing "tax gap" is harmful compared to the alternatives. Again, to conclude on that point would require analysis against a counterfactual tax system, taking into account business reactions to the counterfactual position. In fact, it has been argued that the presence of regionally close "tax havens":

   a) allows countries to maintain higher tax rates than would otherwise be feasible; and

   b) lowers the hurdle rate of return for inward Foreign Direct Investment ("FDI") to countries with nearby "tax havens" that are relatively easy to access (Desai 2006).

   If such jurisdictions were to take action which significantly reduced their competitiveness, this could therefore have an overall negative impact on the UK domestic economy and tax revenues[90].

4) Many of the studies argue that they are providing conservative estimates of the "tax gap", or are likely to miss some elements of "illicit" financial flows or other tax avoidance. Our comments below, however, will point out that the scale of the "tax gap" might instead be overestimated. The result might be that, rather than the figures being clear over-estimates, we cannot say with certainty whether or not they are statistically reliable.

5) It is very hard to relate estimates produced by studies based on global accounting information and macroeconomic data to specific estimates published by HMRC of tax that might have been avoided but for counteraction methods. First, there is sometimes a cat-and-mouse element to tax avoidance and counteraction, so the same amounts may be avoided and recovered repetitively rather than it being appropriate to simply add all such specific estimates together. This is reflected in the multiplicity of avoidance rules that (for example) prevent on different bases the deduction of some interest costs, even though the high level policy of the UK is to allow the deduction of interest costs on what is internationally a relatively favourable basis. Secondly, particularly since the introduction of the 2004 Disclosure of Tax Avoidance Scheme rules, counteraction may be sufficiently swift to prevent much of the loss of tax that

[89] We have used the term "tax haven" where it occurs in the studies under consideration. However, it is problematic, not least because it is used in different studies – implicitly or explicitly – to refer to varying populations of jurisdictions. It is also inaccurate if it is taken to imply no-tax regimes; for example, all the CDs tax personal income of residents at 20% - the UK basic tax rate. As noted in the Background section of our report, a more informative distinction would be between Treaty jurisdictions, "Tax arbitrage-oriented" Treaty jurisdictions, and "Limited/no Treaty" jurisdictions.

[90] Practical examples of this would include the fact that professional talent and business are attracted to the UK to provide investment management services to the funds industry in the CDs; and the fact that bank deposit takers in the CDs make up-stream loans to the UK.

might have occurred had the planning to which it related been allowed to run. Thirdly, the global data relates to taxes, not just of the UK, but of all countries in which the MNCs studied operate. Whilst the key relevant features of most of the larger countries have sufficient similarity to make this analysis meaningful, it does abstract from very detailed features of particular countries' tax rules.

The same points, except the fourth, also arise in relation to our own analysis in Section 5.3 below.

5.2.2 Specific points relating to individual studies

5.2.2.1 Studies using trade mispricing

A number of studies have used the concept of "trade mispricing" [91] to estimate the quantum of illicit transactions between corporates. Among the studies we have reviewed, those that use trade mispricing as the basis of their estimates are:

- Christian Aid (2009): False profits: robbing the poor to keep the rich tax free
- Global Financial Integrity (2009): Illicit Financial Flows from Developing Countries: 2002 – 2006

The results of the above studies have then been used in subsequent studies by the Tax Justice Network and Tax Research.

The focus of the trade mispricing studies is on identifying illicit financial flows (which are broadly defined as those taking place otherwise than on arm's length terms), quantifying those illicit financial flows, and then assessing the extent to which they represent outflows of value from developing countries to either the developed world or to "tax havens". They then go on to suggest that tax is the key motivating factor for diversion of profits from the developing world. It should be pointed out that tax loss from developing countries: a) is not directly relevant to this study; and b) does not provide insight into tax loss due to the CDs and OTs specifically.

Tax analysis of trade mispricing

The above studies focusing on trade mispricing do not demonstrate that it is tax that causes the pricing differences identified in the analysis[92]. Indeed, shifting income from developing countries to developed countries (which, according to the studies, accounts for substantive amounts of profit diversion, particularly to the US) would often make little sense from a tax planning perspective, as profits are generally subject to higher tax in the developed world than in developing countries (given, for example, the "tax holidays" offered by many developing countries to attract FDI).

The studies also include mispricing that may occur between unrelated parties (for example, where company 1 exports goods to unrelated company 2 at a deliberately depressed price, allowing company 2 to sell them at their true market price and then "split the difference" with company 1). This practice would clearly be fraudulent, and the focus of our report is tax avoidance, not evasion. However, we would make the following comments:

- Better governance, not just in developing country tax administrations but also within companies is the obvious way to address such activity.

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[91] "Trade mispricing" is used to refer to a range of practices involving distortions of the prices charged for goods or services to achieve a benefit for the parties involved, including extraction of capital or reduction of tax liabilities.

[92] Money laundering and/or capital flight are acknowledged by the authors of the reports to be alternative explanations; we would judge them to be far more likely than tax motives. We also note that a desire by residents of developing countries to extract funds from those countries without triggering exchange controls (e.g. by pricing a transaction flow out of their territory at an artificially high level) may offer a third, non-tax explanation.

- It may be that the illegally earned cash is deposited into a "tax haven", and indeed that the developing country's fisc has been denied tax revenue, but this does not make tax the motivator for the mispriced transaction. The policy prescription for the "tax haven" would be automatic information exchange with the international community, and pressure being brought to bear for the introduction of more robust and effective Anti-Money Laundering legislation.

- No clear explanation is given of why the mispricing occurs. In the above example company 1 is still "worse-off" economically than it would have been had it charged a full arm's length price. Where this phenomenon does occur, therefore, it would appear more likely to be a matter of bribery of individual owners or managers of company 1. However, the policy prescription would still be for better governance, information exchange and effective Anti-Money Laundering legislation.

Some of the illicit flows might be to "tax havens" instead, but that would require substantial physical presence in those jurisdictions for the mispricing approach to be practical. This is in line with Desai (2006): "The Demand for Tax Haven Operations", which found that the presence of affiliates in large "tax havens" has a stronger effect than presence in small "tax havens" on taxes paid by multinational corporations.

Finally, the studies calculate that the tax lost to developing countries as a result of flows from them is the mispriced amounts multiplied by a uniform corporate tax rate. This assumes that the flows out of developing countries would be taxable in the first instance (which, insofar as developing countries offer tax holidays may not be the case); that all of the flows are of a revenue nature (capital flows are generally taxed with a lighter touch than revenue flows) without regard to the many complexities of actual tax systems; and that compliance is perfect.

As outlined above, the policy solutions to genuine trade mispricing are for developing countries (working with developed countries) to address governance issues within and outside of their tax systems, and for pressure to be applied widely for the adoption of anti-secrecy measures such that illicit flows are clearly identifiable through information exchange between fiscs. The developed world could also help developing countries to assess and formulate more effective tax policies. For example, by granting tax holidays to attract inward investment, developing countries often leave tax "at the table" for the parent company's jurisdiction to collect through CFC and other rules[93].

Economic analysis of trade mispricing

The mispricing approach might overestimate the "illicit" financial flows. The main reasons for this are as follows:

- The reports use interquartile analysis to establish an estimate of the arm's length price charged on transactions of products within the same product groups (and assume that prices outside the interquartile range must be mispriced and hence represent illicit flows). However given this method of interquartile analysis, the existence of any distribution of pricing away from a fixed point will result in the existence of quartiles which companies can fall outside, and hence to "illicit" flows (i.e. the result is driven by the methodology).[94]

- It does not take into account any quality differences between different products in the same product group. For example, one group contains nuclear reactors, computers, machinery and boilers – which represent an enormous diversity of technological expertise, and also in some cases scarcity of skill likely to push up pricing. It is not surprising therefore that the most diverse product groups are identified as the ones most "misused". Put starkly, the overwhelming likelihood is that developed countries make more nuclear reactors, and developing countries more computer parts.

[93] We expand upon this argument in Section 6.1.3.2 under the heading "Global pool of CT".

[94] The assumption that the interquartile price range will be the normal arm's length price is widely supported by tax authorities and the OECD, but the issue remains.

- The Christian Aid study only takes into account mispricing in one direction – when it results in a financial flow out of developing countries. They do not consider mispricing that potentially shifts income in the other direction. This mispricing in the other direction would be a loss to the developed country tax authorities, although it would represent a gain to developing countries in terms of income. These flows are considered in the GFI (2009) study below, but deemed to result from spurious data, and hence the gross flows out of the country were used also by the GFI (2009) in their headline results. The effect of the netting off of inward flows due to mispricing in the GFI study is to reduce the estimated outflow by £100bn.

It should be noted, however, that the authors of the Christian Aid (2009) and GFI (2009) studies are aware of many of the above shortcomings. Indeed, the Christian Aid (2009) study gives several reasons that their estimate of illicit financial flows through mispricing is also biased downwards:

- Overpriced and underpriced transactions in a grouped record may offset each other so that the transaction overall is classified as normal.

- Due to quality differences, some abnormally priced products may be classified as normal priced transactions.

- Some marginally mispriced but high volume transactions may be missed from the analysis but nevertheless represent materially mispriced flows.

5.2.2.2 "The Missing Billions" pamphlet

The "Missing Billions" pamphlet produced by the TUC (2008) compares the average reported percentage current tax charge in the FTSE top 50 companies' financial statements to the UK statutory rate, and finds that the account charge is about 5% lower on average across the years under review. It asserts that this is due to tax avoidance by UK corporates, and extrapolates the extent of this perceived avoidance across the large corporate sector.

The study puts the total tax "expectation gap" (and the UK tax avoided by companies) at £11.8billion.

Tax analysis of the study

We have built on this approach for our own assessment at Section 5.3 below. However, we note the following points here:

- Much of the 5% difference is accounted for by deferred tax[95]. Essentially, deferred tax is an accounting measure of the future tax consequences of transactions and events recognised at the date that the financial statements are drawn up. The main component of deferred tax is the difference between tax depreciation and accounting depreciation. For example, over time the total amount of tax relief ("tax depreciation") available for the cost of an asset may be the same as the cost that will be recognised in the financial statements ("accounting depreciation"). However, the rule that determines the profile in which these can be recognised may differ. Deferred tax is broadly a measure of the amount by which the balance of future tax depreciation will exceed the balance of future accounting depreciation, or vice versa. Moving tax deductions onto an accounting basis was considered as part of Corporate Tax Reform in 2002, before being rejected. It is true that deferred tax is not tax which is payable immediately and in an expanding business may not be payable for many years. However, this is a function of the decision by the Exchequer to retain a mismatch between book and tax depreciation, and is not a matter of tax avoidance.

- We also note that pension tax relief is largely given on a paid rather than an accounting basis. The current requirement for greater funding of the "pension crisis", and the subsequent need

[95] An accounting concept, meaning a future tax liability or asset, resulting from temporary differences between book (accounting) value of assets and liabilities and their tax value, or timing differences between the recognition of gains and losses in financial statements and their recognition in a tax computation.

for additional pension funding throughout the corporate sector, may well give rise to a significant part of the downward effective tax rate trend noted by the TUC.

- The pamphlet does not seek to compare UK tax revenues with other comparable jurisdictions. We note that the UK collects more corporate tax as a percentage of Gross Domestic Product ("GDP") than many of its peers. [96]

- The premise of the paper seems to be to point out the "unfairness" of the current tax system, as legislated and intended by policy, to labour relative to capital income. It does not address the role of specific jurisdictions, only hinting at the role of "tax havens" as a part of a wider tax reform agenda.

- The report adjusts book profits for goodwill in an attempt to estimate taxable profits. No other tax adjustments are considered, such the introduction of tax incentives like Research and Development ("R&D") relief or the Substantial Shareholdings Exemption (which exempts from the charge to tax capital gains made on most subsidiary companies) whereby amounts recognised in the accounts as expenditure or gains may differ from the amounts for which tax relief is available or on which taxable gains are taxed (either absolutely, or at a particular point in time). Neither are non-tax factors considered as explanations for the apparent trend, such as changes to accounting standards, or the wider economic environment.

- Finally, two of the companies[97] included within the 50 are not, in fact, UK parented and therefore should be excluded.

Economic analysis of the study

Extreme outliers are sometimes excluded from statistical analysis if they are known or suspected to be data errors. Alternatively, there might be a known event causing the outlier, the effect of which the analyst wants to remove from the data so it does not distort other results. Other than in the above two circumstances, the "outlier" is a data point that is as valid as any other data and should be included in the analysis. The TUC study deletes the top and bottom three companies (12% of the sample).

5.2.2.3 Global Financial Integrity ("GFI") 2009 report

This study attempts to identify illicit flows from developing countries. However, its focus is on evasion as well as avoidance, which takes it beyond the scope of our review. The report is partly based on the mispricing approach commented on above. It combines this with an estimate of additional "illicit" flows through one of:

- "Hot Money (Narrow) Model" – analysis of the "net errors and omissions" line-item in a country's external accounts. The net errors and omissions figure balances credits and debits in a country's external accounts and reflects unrecorded capital flows and statistical errors in measurement. The paper interprets persistently large and negative net errors and omissions figures as an indication of illicit financial outflows;

- "Hot Money 3" – in addition to the above, this incorporates various recorded flows of short-term capital transactions carried out by the private sector; or

- "World Bank Residual Model" – which measures a country's source of funds against their recorded use (outflows and expenditure of capital). This can be done on the basis of changes in the stock external debt ("SED") or net debt flows ("NDF").

The total estimate is therefore a combination of flows due to mispricing and "clandestine use of the international banking system used to send money out of a country" that the above three measures aim to capture.

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[96] *The Institute of Fiscal Studies: Green Budget January 2006*. Over the period from 1999 to 2003, UK corporate tax amounted to 3.3% of GDP, compared to Germany at 1.3%, the USA at 2.2%, France at 2.9% and Italy at 3.2%. Of the G7, only Japan (3.4%) and Canada (3.7%) were higher.

[97] Xstrata and BHP Billington

Comments on the study and results are as follows:

- The study does not directly address the CDs and OTs, or the UK specifically, as the focus is on illicit flows from developing countries.

- In addition to tax avoidance, the study aims to capture the effect of "illegal commerce, which is the driving force behind these illicit financial flows" (page 1). Detailed consideration would be needed to determine whether the full estimate is relevant for the current study, or whether only the flows through trade mispricing should be considered. It is not known what percentage of the Hot Money or World Bank Residual Model estimates is related to corruption, money laundering or other illegal activity captured in the estimates but not relevant for our current study. It does seem, however, that the methods overestimate the amount that would be relevant for our current study. The extent of overestimation would depend on how successful the methods are in capturing all illicit flows in addition to corporate tax avoidance.

- The GFI study aims to identify the "illicit" flows from "developing" countries, but includes 160 countries in the sample, including Russia (G8 country) and Brazil, India, Argentina and China (G14 countries) and Estonia, Hungary, Poland and Romania (EU countries). This seems a very wide net to cast. The authors state that the classification follows the IMF's International Financial Statistics, apart from excluding Korea and Singapore which are deemed to be industrial countries in the study.

- As the report uses the mispricing approach, the above comments on this method apply, except that the GFI paper does take account of capital inflows. The results are reported on both a net and a gross basis. The net figure is approximately £100bn - £150bn lower than the headline gross estimate for 2006. The paper argues for the use of the gross method, as the inward flows are deemed to be the result of spurious data, "since it is hard to imagine legitimate traders using the trade misinvoicing mechanism to bring money into the country" (page 3). That said, the GFI study is aware of the limitations of its approach.

- The report concludes that illicit flows were between $859bn and $1,056bn in 2006. However, chart 10 on page 13 of the study shows that to draw this range, the methods leading to the highest results have to be selected. The lowest combination available leads to flows of between $378bn and $396bn although this uses the Hot Money (Narrow) estimate that misses data from 31 countries. The full range using the NDF measure of World Bank Residual Model in addition to trade mispricing would lead to a lower estimate of $716bn in 2006. Nevertheless, the full range from the study, taking it at face value, is from $378bn to $1,056bn ($716bn to $1,056bn if the Hot Money approach is disregarded). This is particularly relevant as this study is quoted in the Tax Research LLP report on "tax haven" impact discussed below.

- It seems the highest result is used as the methods leading to the lower estimates are argued in the report not to capture all relevant flows. The authors state the alternatives were explored in order to identify the combination of methods that "provide the most comprehensive and unbiased estimate."

5.2.2.4 "Direct tax cost of tax havens to the UK" note

This note, "The direct tax cost of tax havens to the UK", by Tax Research LLP, uses estimates from studies that have been commented on above and seeks to apply them specifically to the UK.

- First, the figure of £11.8 billion for illicit flows is quoted from the TUC report 'the Missing Billions'. Next, the GFI headline result of illicit flows between $859bn and $1,056bn in 2006 is quoted. The results quoted in the note are therefore sensitive to any adjustments to the output of these reports. The note also does not recognise the avoidance/evasion distinction that we have identified in the GFI paper above, and so its £3bn tax gap estimate is certainly an overstatement of avoidance.

- The OECD average tax rate of 25% used, and the estimate that 10% of illicit flows to Europe are attributable to the UK, are not supported.

5.2.2.5 Other studies of interest

We would also make the following comments about other studies included within our review.

Oxfam (2000): "Tax havens …"

This does not deal directly with "tax havens" as such, but refers to pressure to lower taxes due to tax competition (to which it assumes they contribute). The estimates are based on differences in tax rates, attributed to the effect of these jurisdictions.

- The link between these jurisdictions and tax competition is not established. Tax competition would likely exist with globally mobile capital even in the absence of "tax havens". As noted at various points throughout this report, the CDs and OTs increasingly face competition from, in particular, "tax arbitrage-oriented" jurisidictions such as Luxembourg, Ireland and Switzerland (see for example, the Background section).

- The two calculations in the report are based on unsupported assumptions of rates of return and tax rates, which are arguably too high to be realistic (page 10) – the outcome of the calculations is highly dependent on these assumptions, so that small downward adjustments could produce significant differences in the "tax gap" estimates[98].

- The return on FDI is not synonymous with the CT base. For example, FDI might be financed with debt, in which case returns would enjoy interest deductibility for tax purposes.

- The study seems to have no relevance to tax loss from the UK, or to CDs or OTs.

The Oxford University Centre for Business Taxation (2009) paper "Tax evasion, tax avoidance and tax expenditures in developing countries: A review of the literature"

The paper recognises in general that the methods in previous studies cannot be used to study the effect of "tax havens" on taxes paid. The authors suggest micro analysis of multinational companies' accounts data to investigate whether or not the existence of subsidiaries in such jurisdictions does lead to less tax paid. They find that the claims that "tax havens" cause part of the tax gap in the developing world are not based on rigorous empirical analysis (page 56).

Swedish National Tax Agency (2009): Tax Gap Map for Sweden

This study uses various macroeconomic methods relying on National Accounts and Financial Accounts data to estimate the "tax gap" by tax payer and tax type. It is specific to Sweden, and provides an estimate of the "tax gap" in respect of that country arising from:

- Private individuals;
- Micro companies;
- Small and medium sized companies;
- Large companies; and
- Public sector, other organisations etc.

The "tax gap" arising from the actions of the above groupings is further divided into the following categories:

- International;
- Undeclared work; and

[98] We refer to evidence from the OECD and Institute for Fiscal Studies ("IFS") that where jurisdictions have reduced tax rates, this has not in general resulted in a lower tax take.

- Other national tax gap.

The international "tax gap" due to all companies includes the effect of VAT, custom duty and other avoidance. This accounts for 27% of the total for Sweden. Further breakdown provided in the report shows that CT avoidance linked to the international category accounts for 14.5% of the total for Sweden.

The final breakdown in the study provides an estimate of the tax on CT avoidance due to transactions with "tax havens" for micro companies, and small and medium sized companies. However, the estimates of the breakdown are based on tax agency expert knowledge and interviews: "The calculations have been made based on experience of compliance-controlling within the different risk areas" (page 51). As such, it is difficult to make informed comments on the results. Also, the "tax haven" effect has not been estimated for large corporations, but a higher figure of all tax avoidance schemes and all international transactions is included.

- Transactions with "tax havens" account for 3% of the international "tax gap" for micro companies, and 0.4% of the total "tax gap" associated with micro companies.

- Transactions with these jurisdictions account for 13% of the international "tax gap" associated with small and medium sized companies, and 7% of total "tax gap" associated with small and medium sized companies.

- The breakdowns are not provided for large companies.

Using the above, and the estimate for large companies including the total non-"tax haven" specific tax avoidance result, implies that maximum 10% of the total "tax gap" estimated for Sweden would be due to activity involving these jurisdictions. This is an overestimate of the proportion of "tax haven" related avoidance, as the large company figure includes all international tax avoidance schemes. Also, crucially, the figure may not be comparable to the UK.

The Desai (2006) papers

The shorter paper, Desai et al (2006): "Do tax havens divert economic activity?" makes a convincing case that lowering the cost of accessing "tax havens" can lead to:

- Lower hurdle rates on investments into nearby high tax jurisdictions, as inward FDI is able to avoid some tax by using the "haven"; and

- Making it possible for non-"tax haven" jurisdictions to maintain relatively high corporate income taxes while attracting FDI, against the prediction of most theoretical tax competition models.

The above would be relevant to consideration of the effect if the CDs and OTs were to take action which significantly reduced their competitiveness — the UK might be overall better off with them in place on the grounds that their existence allows more investment to flow to the UK than would otherwise be the case.

The longer paper, Desai (2006): "The Demand for Tax Haven Operations" is a robust estimation of the impact of "tax haven" affiliates on tax paid by US multinational corporations. The study uses company level data on international affiliates of multinational companies and tax paid. The data and results relate to US multinational companies. One of the findings is that multinational parent companies with affiliates in "tax havens" in the same geographical region make 2.1% lower tax payments compared to companies without such affiliates. That result is for "large tax havens", defined as having a population of over 1 million. For "small tax havens", the effect is 1.4% lower tax payments. The paper did not find a significant effect of affiliates in "tax havens" that are not in the same region as the parent company

5.3 FTSE 50 analysis

5.3.1 Key findings

- We have built on the approach adopted in the TUC's 2008 pamphlet "The Missing Billions: the UK tax gap" (see Section 5.2.2.2 above), as follows:

- We calculated, by reference to the published 2008 financial statements of 50 of the largest companies in the FTSE a "crude tax gap" (the TUC report analysed published data for 2000-2006). This is the difference between the tax these companies might crudely have been expected to pay (on the basis of their reported profits if taxed at the UK headline corporation tax rate) and cash tax actually provided for through the "tax charge" in their accounts.

- We then sought to identify the elements of this "crude gap" which relate to items which can be assumed to be "policy intended" (that is, in line with policy intentions of the UK Exchequer). For example, tax law lays down a code of "capital allowances", also known as "tax depreciation," which is given as a tax deduction instead of the "commercial depreciation" which is charged in the accounts. The residual balance represents "potentially policy unintended" differences. A proportion of this residual balance may well of course represent differences which cannot be isolated from the published information, but which could be identified as "policy intended" if sufficient analysis was available.

- The "tax gap" due to avoidance is therefore a component of that residual difference, with avoidance through the CDs and OTs being in turn an unidentified sub-component of that.

- The 50 companies in our sample experienced a negative "crude tax gap" of £17.8 billion – that is, the cash tax payments provided for through the "tax charge" in the accounts actually exceed the level of their "crudely expected" tax charge (arrived at by applying the standard statutory tax rate to their profits before tax). Of course, this negative gap represents a balance of negative and positive elements.

- Most elements of the "crude tax gap" arise as a result of "policy intended" items. Examples include the rate at which "tax depreciation" is allowed, the exemption from tax of profits on the sale of subsidiaries and similar transactions, and certain accounting adjustments that mean that the cash tax they expect to pay is not provided for through the "tax charge" but somewhere else in the accounts.

- The elements which we consider are most likely to contain "potentially policy unintended" items (and which might therefore to some extent reflect tax avoidance activity) are, perhaps unsurprisingly, the least descriptive items: "prior year adjustments", "other timing differences" and simply "other".

- It is important to appreciate that not all of the differences identified as "potentially policy unintended" will relate to UK – many of the companies included in the analysis generate a substantial proportion (in some cases, a large majority) of their revenues outside the UK. As was done in the TUC study, we make an adjustment (although necessarily a high-level one) to reflect this point.

- Our main conclusion is that the potential "tax gap" (representing the residual balance of "potentially policy unintended" differences) is likely to be significantly lower than the estimate arrived at in the Missing Billions report. We estimate the total UK corporation tax potentially lost to avoidance activities to be up to £2.0 billion per annum, although it could be much lower.

- Making these estimates is difficult from readily available information – the "glossy" consolidated group accounts produced by all major corporate groups. However, this is not due to a shortage of information and analysis available in the accounts - almost all the financial statements we reviewed run to more than 150 pages, and many to more than 300 pages. Not all disclosures reflect standard terminology – were more standardisation to be imposed, it is likely that accounts would be even longer. Accounting rules, like tax laws, are very complex. All this makes the disclosures hard to interpret.

- However, more detailed analysis could be undertaken. In the UK at least, almost all companies also have to file individual company accounts at Companies House, and they provide further information, although considerable time and expense would be incurred in compiling it. Finally, HMRC has access to significantly more information than is available from public sources – in particular, in companies' tax returns - and is therefore in a position to resolve some issues that are uncertain on the basis of public information.

5.3.2 Methodology

As set out at Section 5.2.2.2, The "Missing Billions" pamphlet produced by the TUC compares the average reported "current tax charge" (as a percentage of profit before tax) in the top 50 companies' financial statements to the UK statutory rate of tax. It then goes on to apply the resulting "tax gap" percentage to the profits earned by the companies in its sample, to estimate tax avoidance undertaken by the sample companies. Then it estimates how much of the tax avoidance relates to UK tax, and grosses up the UK tax avoidance figure for the 700 taxpayers whose affairs are managed by HMRC's Large Business Service. As this is the only major study which speaks to the UK tax gap specifically, we have adopted a similar methodology. We have built on the analysis by identifying various factors that have contributed to the "crude tax gap" through a more detailed review of the relevant companies' statutory accounts (and in particular the taxation notes to the accounts). In other respects we have largely followed the TUC approach.

We tried to examine the same 50 corporate groups that were reviewed for the "Missing Billions" pamphlet, which at the time of drafting were the 50 largest companies in the FTSE index. In the intervening period[99], three groups that were included within the TUC analysis have left the FTSE[100], and five others have dropped outside the top 50[101]. In order to maintain as much consistency with the TUC results as realistically possible, we have retained within our analysis those groups which are still listed on the FTSE (as none has fallen to a position in the FTSE lower than 63rd), but have replaced the delisted groups with the top 3 newcomers[102].

5.3.3 Quantifying the "Crude Tax Gap"

The total profit before tax of the 50 groups within our sample amounts to £96.0 billion. Their "total tax charge" (i.e. the total tax charge provided through their profit and loss accounts for the year) is £41.5 billion, and their "current tax charge" (i.e. the tax element of their total tax charge providing for cash tax for the current year) is £52.8 billion[103].

Table 1 – Corporate tax rates for FTSE 50

Company	Current tax rate	Effective tax rate	Statutory tax rate
Royal Dutch Shell	48.11%	47.90%	54.60%
BP Plc	39.04%	36.80%	28.00%

[99] Our review covers each company's statutory accounts for the year ending within calendar year 2008. Our review is limited to one financial period, and although one year represents a reasonable "snapshot" of that particular time in the UK economy, it does not necessarily represent "business as usual". However, when taken with the years reviewed in the TUC's "Missing Billions" pamphlet, it does provide a meaningful comparator to their earlier work.

[100] Hanson, Imperial Chemicals Industries and HBOS.

[101] Man Group, Legal & General, Wolseley, Reuters and British Land Group.

[102] Tullow Oil, Eurasian Natural Resources and Antofagasta.

[103] 17 of the companies within the sample prepare accounts in a currency other than Sterling, as permitted under IFRS. We have translated the results of companies reporting in US Dollars into Sterling at the average rates for the relevant period of account (www.oanda.com).

HSBC Holdings plc	36.25%	30.18%	28.50%
Vodafone Group Plc	24.36%	24.94%	30.00%
GlaxoSmithKline plc	28.20%	29.24%	28.50%
Royal Bank of Scotland plc	-2.32%	5.71%	28.50%
Barclays plc	27.32%	13.00%	28.50%
Anglo American	21.48%	28.60%	28.50%
AstraZeneca plc	35.43%	29.39%	28.50%
Rio Tinto plc	51.38%	40.77%	28.00%
British American Tobacco plc	25.65%	27.82%	28.00%
BHP Billiton plc	30.25%	32.03%	30.00%
Tesco plc	21.30%	24.01%	30.00%
Lloyds TSB Group plc	91.08%	-4.71%	28.50%
Xstrata plc	33.49%	25.23%	25.00%
BG Group plc	37.82%	42.39%	34.80%
Diageo plc	17.34%	24.94%	29.50%
BT Group plc	9.41%	12.04%	30.00%
Standard Chartered plc	23.77%	26.87%	28.50%
Unilever plc	22.02%	25.87%	30.00%
Reckitt Benckiser plc	22.73%	24.02%	28.50%
Aviva plc	-10.26%	62.63%	28.50%
National Grid plc	41.30%	56.96%	28.00%
SABMiller plc	24.92%	27.09%	28.00%
Prudential plc	6.46%	81.15%	28.50%
Imperial Tobacco Group plc	58.13%	28.99%	29.00%
BAE Systems plc	23.15%	25.43%	28.50%
Cadbury Schweppes plc	60.75%	7.50%	28.50%
Centrica plc	206.24%	132.07%	28.50%
Scottish and Southern Energy plc	541.28%	-110.69%	28.00%
Man Group plc	17.65%	17.41%	30.00%
Tullow Oil Plc	39.08%	24.41%	50.00%
British Sky Broadcasting group plc	298.33%	311.67%	29.50%
Marks & Spencer Group plc	10.40%	27.29%	30.00%
J Sainsbury plc	34.24%	31.32%	30.00%
Rolls-Royce Group plc	-4.92%	28.91%	28.50%
Legal and General Group plc	-4.83%	47.52%	28.50%
WPP Group plc	30.09%	31.19%	28.50%
Old Mutual plc	51.60%	-14.79%	28.50%
Land Securities Group plc	0.80%	1.18%	30.00%
Wm Morrison Supermarkets plc	20.61%	29.77%	28.00%
Reed Elsevier plc	20.26%	25.12%	20.50%
Wolseley plc	118.62%	48.97%	29.00%
Reuters Group plc	18.46%	2.33%	28.00%
Associated British Foods plc	22.01%	25.81%	29.10%
Compass Group plc	30.57%	29.86%	29.00%
Shire plc	2.97%	36.90%	25.00%
Eurasian Natural Resources Corporation Plc	33.11%	29.87%	30.00%
Antofagasta Plc	20.76%	19.92%	17.00%
British Land Company plc	0.00%	3.53%	30.00%
Average	**47.12%**	**32.33%**	**29.38%**
Weighted average	**54.97%**	**43.27%**	

International Financial Reporting Standards ("IFRS") permit corporate groups to reconcile to a tax rate other than the UK statutory rate if doing so would give a fairer view of their tax results[104]. We have therefore performed our analysis against the rate that companies judge to be their "natural" rate rather than the UK statutory rate. The average effective current tax rate[105] is 46.1%, compared to an average statutory tax rate of 29.4%. (During the periods covered by these accounts the UK statutory rate fell from 30% to 28%, so the use of a non-UK "natural" rate does not appear to have made much difference.) So, the "crude tax gap" across the sample of groups is actually "negative" rather than positive – companies are paying more tax than would be expected from simply applying the statutory rate to their profits before tax. This is a change from the position identified in the TUC analysis, and merits further attention in the future when results for 2009 and subsequent years become available.

This "crude tax gap" equates to tax above expectation of £17.8 billion (although not all of these "excess taxes" will be UK taxes).

Some companies made accounting (or "book") losses in the period under review. Is it appropriate to include them within this tax gap analysis? The main argument against is that book losses are, by definition, accounted for in the year in which they arise; however for tax purposes the resultant losses can be offset against tax in both earlier and later years. Also, as the TUC identified, book losses can disproportionately affect calculations of average profits. If the loss making companies[106] are excluded from our analysis then the effective current tax rate increases to 56.0% (compared to a statutory rate of 29.5%).

5.3.4 Elements of the "Crude Tax Gap"

Why do the groups in our sample have current tax charges that differ from what you would expect given their accounting profits, and are the reasons in accordance with UK tax policy, or potentially contrary to it?

Although not all the descriptions given in the published accounts are in standard form, there is considerable commonality and we have been able to group them under the following captions. Table 2 shows the full reconciliation and also identifies those components which we think may contain "potentially policy unintended" matters. Although the discussion that follows refers to UK tax rules, the numbers usually also include matters relating to similar rules under other countries' tax systems.

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[104] Several companies in the sample are not headquartered in the UK or are dual-headquartered, and therefore might choose to reconcile to a tax rate other than the UK statutory rate (Royal Dutch Shell, Unilever, Reed Elsevier, Shire, Tullow Oil, Antofagasta, Xstrata and BHP Billiton). Others have significant operations overseas which can affect their "mix" of taxable profits, or are subject to differing tax regimes.

[105] The current tax charge in the accounts expressed as a percentage of profit before tax. As the TUC report argued, current tax is the closest approximation within company accounts to the tax that will be paid in the short term, and to this extent can be said to represent cash tax payments.

The TUC analysis was performed on the current tax rate expressed as a percentage of profits before tax and goodwill; we have moved away from the base for two main reasons. The first is that under IFRS companies do not amortise goodwill on a straight-line basis as was common under UK GAAP but instead only write goodwill off to the profit and loss account when it is impaired. Fewer companies show goodwill adjustments in 2008 than has historically been the case. Secondly, following the introduction of Schedule 29 Finance Act 2002, some goodwill impairments are now tax deductible. Accordingly, we decided to treat non-deductible goodwill, as identified in each company's tax reconciliation note, as a separate item in our tax gap analysis.

[106] Royal Bank of Scotland, Aviva, Legal and General, Prudential, Rolls-Royce, British Land Company, Land Securities Group and Reuters.

Table 2: reconciliation of expected tax to current tax

	Total	"Potentially policy unintended"
	£ billion	£ billion
Expected tax charge[107]	**35.0**	
Deferred tax and other timing differences	10.8	(0.4)
Non-deductible goodwill	11.0	
Other non-deductible items	7.4	
Accounting concepts		
- Associated companies	(3.9)	
- Prior year adjustments	(2.6)	(1.3)
Non-taxable profits	(6.0)	
Tax reliefs and tax losses	(1.4)	
Geographical distribution of profit	3.6	
Other	(1.1)	(0.5)
Current tax charge[108]	**52.8**	
Total "potentially policy unintended" differences		**(2.2)**

5.3.5 Deferred tax and other timing differences

Deferred tax is an accounting concept that recognises that some items get reflected in the accounts in different years from those in which they influence the tax results. Deferred tax liabilities are, broadly, amounts of UK corporation tax and similar foreign taxes that may be payable in future periods as a result of matters that have already been reflected in the accounts. Similarly, deferred tax assets are amounts of such taxes recoverable in future periods as a result of things like the carryforward of unused tax losses and the carryforward of unused tax credits which will reduce tax in later years without affecting the accounts. Just one example of how deferred tax can arise is pension costs. These are tax deductible in the UK when they are actually paid, but must be accrued in IFRS accounts on an actuarial basis. If a company books a pension charge to its accounts of £100m, but only pays £80m, then the difference of £20m may create a deferred tax asset of £5.6m (28%, being the UK tax rate, applied to £20m). Over time, the balance of £20m is likely to be paid into the pension scheme without any further "hit" to the accounts, and these payments will generate tax deductions worth £5.6m, but of course one cannot be sure exactly when this will occur. Conversely, capital expenditure can be a major driver of deferred tax liabilities, as it may generate tax relief through "tax depreciation" at a faster rate than the "book depreciation" reflects.

In our sample of 50 groups, deferred tax and "other timing differences" were the second biggest reconciling item between current tax charges and expected tax; they accounted for £10.8 billion of the difference. Note that, in contrast to the findings of the TUC on the earlier years, in 2008 deferred tax credits for these companies reduced the book tax charge rather than increased it:

[107] Profit before tax multiplied by the statutory tax rate.

[108] The amount of income taxes payable in respect of the taxable profit for a period. It is the tax that the entity expects to pay in respect of a financial period.

Table 3: Current tax and deferred tax

	£ 'billion
Current tax charge	52.8
Deferred tax charge	(11.2)
Rounding	(0.1)
Total tax charge	41.5

In other words, companies in this sample are now seeing their previous deferred tax liabilities convert into actual cash tax payments as represented by current tax. This is consistent with our finding that the total net deferred tax liabilities accumulated over the year have decreased from £46.7 billion to £31.6 billion. This in part represents the reduction in the main rate of capital allowances in 2007, thus decreasing the disparity between book and tax depreciation, but may also be due to the current economic environment.

56% of the deferred tax liability balance is due to "tax depreciation" being historically more generous than book depreciation. Differences between the book impairments and tax amortisation of intangibles make up an additional 14% (possibly in part as a result of a tax election available to companies to amortise intangibles for tax on a 4% straight-line basis, rather than in line with book amortisation). Unspecified items accounted for a further 11%. The remainder is accounted for by a number of smaller balances[109].

The companies with the largest absolute deferred tax liability balances are BP, Vodafone and Xstrata. This is unsurprising in that all three have invested heavily in capital infrastructure assets (3G licences in the case of Vodafone) and business acquisitions. The companies with the largest deferred tax charges relative to their current tax charges are Shire and Marks & Spencer. In the case of Marks & Spencer this may be due to its extensive store refurbishment programme.

We characterise deferred tax movements as being in line with UK tax policy. Tax depreciation, elections regarding amortisation of intangibles, the setting aside of certain fair value adjustments and the ability to defer certain capital and foreign exchange gains are all basic features of UK tax legislation (and so can be said to represent the intentions of Parliament). So, in 2008, was the fact that overseas profits were generally not taxed until repatriated to the UK. Since 1 July 2009, many such profits are exempt from UK tax even on repatriation as a result of the "dividend exemption" that has now been enacted.

However, alongside the addition to the expected tax charge of £11.2bn caused by deferred tax, there is a reduction of £0.4bn attributable to "other timing differences". In the absence of further current analysis of this figure, we have characterised it as "potentially policy unintended."

5.3.6 Non-deductible goodwill

There are two types of goodwill within group statutory accounts – consolidation goodwill and purchased goodwill. Consolidation goodwill arises as a result of an excess of the cost of an investment in a subsidiary, over the book value of its net assets, and can only arise on consolidation. As it never appears in the books of individual companies on which tax returns are based, it is never tax deductible. In our experience this typically accounts for the most significant goodwill recognised in consolidated accounts.

Purchased goodwill is the difference between the total consideration a company pays to acquire business assets and the book value of the assets themselves. Purchased goodwill

[109] Including deferred gains, overseas profits not yet remitted back to the UK, and fair value adjustments to accounting values and deferred foreign exchange gains which have not yet affected the tax result.

arises in the books of individual companies, and is tax deductible insofar as it arises on asset purchases from unrelated parties after April 2002 (when legislation specifically allowing the deduction was introduced by Finance Act 2002). Such goodwill from previous purchases is non-deductible.

6 groups within the sample disclosed non-deductible goodwill in their tax reconciliation notes; others may have included it within the general non-deductible items caption. Of the groups with separate disclosure, Royal Bank of Scotland accounted for 75% of the total non-deductible goodwill as a result of writing down its investment in ABN Amro.

In the main, goodwill adjustments will be in accordance with UK tax policy. In the case of consolidation goodwill, this follows from the fact that it is never deductible as tax is based on individual company rather than consolidated accounts.

In the case of purchased goodwill, one could ask whether the extent of the disallowance might have been understated (i.e. that companies are claiming tax deductions for otherwise non-deductible goodwill as a result of tax avoidance activities). We are aware of historic tax planning which has attempted to crystallise book goodwill after April 2002 in ways that HMRC view as artificial. The effectiveness of this planning has been disputed by HMRC and legislation has been introduced to make it clearly ineffective.

However, we do not consider purchased goodwill – whether through avoidance or otherwise – is likely to be significant in the current sample. In addition, companies engaging in tax planning known to be at odds with HMRC's views might well not "book" the benefit of these transactions in the accounts until a later year in which the treatment has been agreed or dispute resolved. The benefit of the tax planning would then appear in the accounts as a prior year adjustment. We return to this point below. As regards non-deductible goodwill, our view is that it should be treated as "policy intended". This is in line with the TUC's approach; indeed it is the only adjustment in reconciling the current tax charge to the statutory rate which the TUC treated as "policy intended".

5.3.7 Other non-deductible items

This caption covers many items. Most will be on-policy[110]. Some will involve the application of anti-avoidance legislation to the group's tax affairs – an example would be transfer pricing adjustments on intragroup transactions that result in excess[111] expenses being disallowed (and will include both the results of successful challenges from HMRC and other fiscs, but may also include provisions booked against the possibility of future successful challenges).

One might question whether the extent of disallowances might be understated. We considered the weighted average disallowances (expressed as a percentage of the expected tax charge) suffered by profitable groups[112], and found it to be 10.9%, excluding two outlying companies in broadly breakeven positions for whom any disallowance will be disproportionately high when expressed as a percentage of expected tax. If we were to assume that 10.9% was a fair benchmark to expect of groups with a lower level of disallowance, then we can compare their actual level of disallowance (£2.10 billion) to the level they would need to have booked to reach that average value, a figure of £3.56 billion. Can one account for the shortfall of £1.5 billion? 8 of the companies disclosed no effect due to disallowances at all, and can reasonably be assumed to have taken the decision not to disclose disallowances separately but to include them in a different caption; if these 8 are excluded, then the shortfall falls to £315 million. There is no real basis for ascribing this figure to avoidance rather than to different patterns of disallowable expenditure.

[110] Examples of on-policy items would include various disallowances for leasing or purchasing expensive cars, depreciation on items not qualifying for capital allowances, business entertaining expenditure, expenses of a capital rather than a revenue nature.

[111] That is, in excess of the rate that would be charged between unconnected parties acting at arm's length.

[112] We excluded loss-making companies from the analysis on the grounds that they already have natural shelter for their profits and therefore have little incentive to minimise disallowances.

5.3.8 Non-taxable profits

There are a number of reasons why profits might be non-taxable. The most important of these is the substantial shareholdings exemption, which exempts from UK tax disposals of qualifying subsidiary companies (broadly, holdings by a trading group of more than 10% of the shares in a trading subsidiary, provided held for more than 12 months).

- We reviewed the accounts of a number of companies which disclosed significant non-taxable income in their tax reconciliations. In many cases, the groups concerned had made disposals of material subsidiary undertakings, which we can reasonably assume would benefit from the exemption. For example, in the year HSBC disposed of its US consumer finance units.

- Some accounting entries can create non-taxable income (i.e. by creating book profit that would not be recognised as taxable profit). For example, Barclays' accounting treatment of the Lehman Brothers acquisition created just such a book profit, which under current tax law was not subject to taxation.

- Some jurisdictions offer tax holidays (i.e. periods when companies are exempted from local taxes) as an incentive to encourage investment. This is most commonly found in developing countries keen to improve their infrastructure and cash tax receipts, and so may account for some non-taxable income in the oil and exploration and mining industries in particular. However, the benefit of such holidays may be clawed back in the form of higher taxation in the UK when profits are repatriated.

The key question with regard to this caption is whether some items might be treated as non-taxable through the application of avoidance, which as a matter of policy should be subject to tax. The very wide number of explanations for why items might fairly be treated as non-taxable means that the type of averaging analysis undertaken for at Section 5.3.7 above is difficult to apply in any meaningful way here (because there seem to be very plausible specific explanations where the accounts disclose larger non-taxable items).

The largest elements of non-taxable profit do indeed relate to merger, acquisition and disposal activity (as in both the HSBC and Barclays examples) and this is in many ways the mirror image of the fact that goodwill amortisation from such activity is non-deductible. For example, HSBC earned non-taxable profits of £554m in the year but suffered non-deductible goodwill impairment of £1.64bn. We believe that both these are "policy intended" consequences. Treating goodwill impairment as the only "policy intended" consequence gives a very distorted view: in the case of HSBC for example it would categorise the bank as a major tax avoider, even though its cash tax charge of £1,839 million significantly exceeds tax expected (on the basis of the statutory tax rate) of £1,445 million.

5.3.9 Accounting concepts (associated companies and prior year adjustments)

Two accounting concepts materially affect tax charges.

The first is that of associated companies. Associates are, broadly, companies in which the group holds between a 20% and a 50% interest; they are more significant than simple investments but are not true subsidiaries and therefore cannot be fully consolidated into the group's results. IFRS requires their post-tax results to be brought into the consolidated profit and loss account as a single item above the consolidated group's tax line (i.e. in the group's pre-tax results). This means that the tax charge in the accounts understates the tax actually paid as a proportion of pre-tax profits. The adjustment in the tax reconciliations simply corrects that understatement. 21 groups in the sample had associates' profit adjustments in their tax reconciliation, of which Royal Dutch Shell had by far the largest adjustment.

This adjustment is "on-policy", in the sense that it arises from the way tax is accounted for rather than affecting tax actually paid.

The second accounting concept is prior year adjustments. These arise when companies have under- or over-stated their current tax charge for a previous year, and have to correct it

in the current year. 43 of the groups in the sample had prior year adjustments to current tax in 2008. The majority of these (33 of them) were tax credits rather than charges.

To the extent that this implies that companies have tended to over-estimate their current tax in the first place, the correction of this over-estimate should be regarded as "on-policy". However, one reason why groups might overstate tax is that they have engaged in tax planning which they cannot be sure will be successful. This, potentially, would be "policy unintended".

Success or failure of tax planning is not the only uncertainty groups face. The tax authorities may challenge the tax treatments of ordinary business flows and indeed different authorities might mount challenges from opposing standpoints. This can happen in the case of transfer pricing in particular, where the different countries in which products are researched, designed, manufactured, and sold might each claim a disproportionately larger share of the value. Material uncertainties are disclosed in a number of accounts over transfer pricing issues, uncertainties which can take years to resolve.

Our conclusion is that, at this stage of analysis, up to 50% of this adjustment should be treated as "potentially policy unintended".

5.3.10 Tax reliefs and tax losses

Tax reliefs are "on-policy" items. An example is enhanced R&D tax relief[113] (a relief enjoyed by GlaxoSmithKline). Similarly the utilisation of brought forward tax losses (a relief enjoyed by Vodafone, which incurred substantial tax losses in the past on its 3G mobile phone licences), reflects a basic feature of UK tax legislation.

5.3.11 Geographical distribution of profit

This caption principally reflects the fact that profits earned overseas are generally subject to tax in locations in which they are generated, which will almost certainly have a different tax rate to the UK. Some groups, such as Royal Dutch Shell, recognise this in their tax reconciliations, by reconciling to a different rate from the UK statutory one. Others continue to reconcile to the UK rate, but disclose net differences in tax rate. An example of this would be HSBC, whose current tax charge is adjusted, for example, for Hong Kong profits which are taxed at a statutory rate of 16.5%. Overseas tax amounts to half of its tax charge, but overseas profits represent more than 50% of the group's overall profits.

In addition, in many countries, companies suffer State, cantonal or local taxes on their profits and have tax withheld on some flows of income.

We have tried to test whether the composite tax rate (that is, the weighted average rate of tax that might be expected given the major countries in which a group operates) is reasonably reflected in the accounts disclosures (taking together both the disclosure of the tax expected at the statutory rate, and the disclosed adjustment due to geographical profit distribution). Although there are limits to the information available, there is no clear indication of bias. Similarly we explored whether the effective rate of UK tax on UK operating profits – profit before interest costs as well as tax – is out of line with effective rates of overseas tax on overseas operating profits. Where information is available, this might give a crude measure of whether the UK gets what might be viewed as its "fair share" of the groups' tax receipts. (Were it not to do so, it might not represent avoidance, but in part a bias in the groups' tax burden benefiting other countries with, for example, less generous interest deductibility rules). Again, this exercise produced no clear indication of bias.

Our conclusion is that this item is "policy intended".

[113] available to companies which undertake qualifying R&D and which grants a "super deduction" of 150% for qualifying R&D expenditure

5.3.12 Other

This is a catch-all caption to account for items that do not neatly fall into any of the other categories, and amounts to £1 billion. Some companies have provided enough detail in their accounts to allow us to gain a reasonable understanding of the amounts they have posted through this caption; others have not.

Where explanations have been given, they appear to be "on-policy". Examples include the effect of demergers and discontinued operations (i.e. companies have chosen to separate out the tax relating to discontinued operations from that relating to continuing operations, and have disclosed the discontinued operations element as "other"), foreign exchange losses on external debt, and movements in the value of financial instruments not designated as hedges.

However, once the explained items are removed from the analysis, an unexplained amount of £500 million remains to be justified. In the absence of any other information, we have at this stage classified this amount of £500 million as "potentially policy unintended".

5.4 Quantification of the "tax gap" potentially arising from tax avoidance

We have identified unexplained differences potentially including tax avoidance of up to £2.2 billion in the above calculations. However, not all of this will relate to the UK.

Following the TUC "Missing Billions" pamphlet, we initially sought to estimate the UK proportion of this loss by reference to dividends paid by the companies in the period. The average dividend for the period, expressed as a percentage of profit before tax, was 60% (notably higher than in the TUC report, perhaps reflecting companies' attempts to maintain dividend policies in difficult economic times from prior year distributable reserves). The average tax charge, again expressed as a percentage of profit before tax, was 43.23%. Applying the same TUC methodology in the circumstance of this year creates the absurd result that more than 100% of the tax avoidance should be attributable to the UK. Therefore, we decided to follow the TUC in assuming that 44% of profits and hence tax should arise in the UK.

This would suggest that up to £1.0bn of UK tax could have been lost to the Exchequer from these 50 groups in the year, although further analysis might be expected to reduce that figure.

The "Missing Billions" then goes on to gross up the tax avoidance across all of the tax-payers serviced by HMRC's Large Business Service ("LBS"). The most recent published figures for the LBS are for 2006/07, and show total corporation tax paid of £24.85 billion[114]. Although these results were current when the TUC report was drafted, the fact that the total tax charges of our 50 sample companies now amount to £52 billion suggests that it may no longer be valid to assume that the LBS payment results can be applied here. This is not entirely surprising. Quite aside from the passage of time, other factors are in play. Firstly, a number of taxpayers in the LBS are not corporate tax payers; they are members of the LBS due to their significant PAYE/NIC obligations (examples include primary care health trusts and local education authorities). Secondly, the composition of taxpayers that make up the LBS 700 will have changed considerably in the period since 2006. For these reasons we decided to assume that, in line with the TUC, our 50 sample companies account for around half of the tax paid by the LBS population.

Accordingly, the element of the UK tax gap potentially attributable to tax avoidance by companies in the LBS population is estimated to be up to £2.0 billion, although again it is likely that further analysis would reduce the figure. Avoidance through the CDs and OTs would in turn be an unidentified component of this.

[114] Source: HMRC's Large Business Service report 2008

6 Adapting to a changing global tax environment

Section 6.1 sets out our hypothesis regarding the emerging international "best practice" taxation model. Section 6.2 sets out the key elements of this "best practice" taxation model for CT and VAT. Section 6.3 examines the key features of the existing tax regimes of the CDs and OTs. Section 6.4 provides an impact assessment of moving to this "best practice" model for the CDs and OTs, using specific examples.

6.1 The tax hypotheses

It is our hypothesis that there is an emerging and growing international consensus around:

- Value Added Tax / Goods and Services Tax
- Corporate profits tax or corporation tax
- Tax information exchange.

In addition to these, the great majority of countries in the world raise tax revenues from personal income tax, Social Security charges and a collection of specific consumption and transaction taxes. These are also important sources of taxation in most countries and are therefore covered to some degree in the comments that follow. Although these are outside the scope of our impact assessment, they are considered at a very high level below, because they typically raise a significant proportion of tax revenues.

There are strong similarities between many CT systems in countries around the world, and equally strong similarities between many VAT systems. These convergences tend to align more closely as countries copy and learn from each other. To a significant extent it is possible to speak of "best practice" characteristics of both tax systems - characteristics which are already widespread, seen as desirable and competitive, and are being studied for possible adoption by others.

6.1.1 Taxes on particular goods and services

Historically, taxes on the sale of particular goods and services, or ranges of goods and services, have been major revenue earners for Governments. All such taxes impose an economic burden, over and above the cost to the taxpayer in paying the tax, compliance costs, and the costs of the authority in collecting it. This is because such taxes increase the absolute cost to the consumer of supplies within their scope and therefore lead to a reduction in demand for such products, distorting consumer decisions, and an allocation of resources less consistent with those that consumers, in the absence of such tax, would bring about in the market. Such taxes can nevertheless be justified where there are deliberate policy reasons for wishing to discourage consumption, or (in the case of luxury items) for distributional reasons, or simply to raise revenue where demand for the product in question is not very price elastic so the economic distortions produced are limited.

For many countries, including we suspect some OTs, dependence on this sort of revenue is vulnerable to trends and policies towards trade liberalisation so they may need to consider alternatives for budgetary reasons.

6.1.2 VAT

In recent years there has been a growing consensus among academic economists and policy-makers that, in general, a form of VAT offers the best approach to revenue raising[115]. Economic theory suggests that the impact of such tax is borne finally by consumers (admittedly, perhaps through a one-off increase at the price level) and does not cause inflation on an ongoing basis.

Some commentators argue that VAT is intrinsically "unfair" as it imposes a burden on consumption by the poorest members of a given community as well as the richest. As such, it can be a regressive tax. However, by selectively excluding those essential goods and services from the scope of VAT which make up a greater percentage of the household outgoings for poorer consumers relative to richer consumers, it is possible to mitigate the regressive effect. However we note that excluding essential goods and services is not a particularly efficient way of mitigating VAT's regressive nature, because although the poor spend more on (say) food as a percentage of their income, the rich eat more in absolute terms. It is better to offset the distributional effects though other changes in the tax and benefit system (e.g. child benefits and tax credits).

6.1.2.1 Benefits of a VAT system

Globally, there is a convergence in the practical rules of many VAT systems which mirrors the academic economic consensus around these desirable features. In large part this is because the EU requires its Member States - representing 19% of global trade, five of the G7 countries and 491m people[116] - to operate VAT systems, and to do so according to harmonised EU rules. But many countries outside the EU have also adopted VAT (or GST) systems. The largest economy in the world – the United States – is one of the few not to have a VAT system, but it does have fairly comprehensive sales taxes operating at State (rather than Federal) level – and is closely monitoring global developments in VAT systems[117]. This degree of practical convergence around academic theory is unusual and merits attention.

VAT is seen as the most efficient method of raising revenues for a number of reasons including:

Non-distortive on wide range of goods and services within its scope

In principle such tax can be applied to the whole range of goods and services (i.e. to the broadest possible tax base so that choices between goods and services within that base are undistorted). Such a broad base also enables the rate of tax to be correspondingly low (minimising any loss of competitiveness and/or distortion of choices between products inside and outside the tax base). VAT is generally therefore the most efficient method of raising tax revenues as an expense on consumption (without distorting market-driven investment or spending patterns). Frequently in practice this model is complicated by the argument that basic goods and services such as health and education should be exempt, although economists generally argue that the social benefits sought by these exemptions should better be achieved in other ways.

Non-discriminatory as between domestic and imported supply

Further features of VAT, as it has become increasingly internationally standardised, tend to reinforce these benign characteristics. The tax is typically applied at each stage of production, giving credit for tax paid on "input" supplies consumed in the business against tax charged on "output" goods and services. Thus the net amount of "output" tax less "input" tax

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[115] GST differs from VAT in that it incorporates a single point of tax and hence no need to measure input and output taxes. It may therefore offer a simpler alternative taxation mechanism, but may still require a step change in administration for users on introduction.

[116] The EU in the World Economy, Dur A and Elsig M. (2008)

[117] GAO – Report to Congressional Requesters, 'Value-Added Taxes: Lessons Learned from other Countries on Compliance Risks, Administrative Costs, Compliance Burden, and Transition' (April 2008).

credit reflects the value added of each business - and the burden of the tax falls neutrally between all consumer products, whether these are produced by one single business or whether they are the result of a long chain of production and supply across many businesses. Export goods and services are exempted from the tax (while typically giving credit to exporting businesses for "input" tax suffered) so that the burden of the tax falls on the domestic consumer without loss of export competitiveness. Imported goods and services are taxed as if they were domestic stages of production so that there is neutrality in the domestic market between domestic and foreign suppliers and producers.

6.1.2.2 Limitations of a VAT system

Although VAT is generally favoured by economists, the administration of this tax is difficult, requiring credits and sometimes refunds that expose it to fraud even in developed jurisdictions (e.g. through Missing Trader Intra-Community fraud ("MTIC")[118]). Also, when introduced in developing economies without a benefit system there may be no obvious way of correcting the adverse distributional impact. Hence in these contexts it has been very controversial (and is criticised by Christian Aid in their recent study Death and Taxes: the true toll of tax dodging, May 2008). However economists and the OECD point out that by targeting consumption (and doing so evenly across the board) it is uniquely well adapted to release resources (by reducing private consumption) to finance public expenditure with minimal additional adverse affects such as distorting choice between different goods and services or penalising investment and thereby growth. This point appears valid, although zero rating and other exceptions in practice fray the non-distortion point at the edges.

6.1.2.3 Conclusions

Because VAT is borne by the customer (including the poor), there is an argument that the question of whether to impose it should above all be a matter of local political choice, rather than of consensus-led "best practice". The key counterarguments are that (i) in an increasingly liberalised free trade environment, where the trend is to reduce Customs Duties, there is a pragmatic need to find alternative sources of revenue; and (ii) whether rightly or wrongly, the weight of academic economic opinion in its favour is simply too great to ignore.

Therefore, in conclusion, as a practical matter using VAT seems logical and hard to refute.

6.1.3 Corporation tax

Most countries have a CT[119]. Globally rates vary from 9% in Montenegro to 45% in Guyana[120]. The G7 nations broadly have headline rates between 28% and 35%. (For some countries this will understate the burden of the tax where CT operates at different levels, for example in the United States, which imposes tax at Federal, State and local/municipality levels.)

6.1.3.1 Economic theory

In contrast to VAT, there is little academic consensus around, or comfort in, the basic concept of CT[121]. In part this is because companies are legal constructs which do not "really

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[118] IT relies on the VAT free cross border transfer of goods within the EU and is known as MTIC Fraud but is also referred to as 'Carousel' fraud because the goods go round in a circle.

[119] Deloitte International Tax Guides, January 2009.

[120] Deloitte Corporate Tax Rates 2009.

[121] For example, OECD Economics Department 620 and 713 ('Tax and Economic Growth' by Asa Johansson and others, and 'Economic Growth and the Role of Taxation - Theory' by Gareth Myles) argue that tax on corporate profits (which after all part-finance and incentivise investment and thereby growth) has a more adverse effect on economic growth than income tax (part of which is raised from savings and business income) which in turn has a more adverse effect than VAT (levied on consumption). The same argument was used historically by Denis Healey in the 1970s for introducing generous reliefs and allowances which almost eliminated the CT take. In our

exist" – the feeling is that tax must economically be borne by "real people" and, if this is so, would it not be better to tax those people directly? For this reason, CT has often been viewed in economic and policy literature as a kind of prepayment of the personal income tax of the shareholders in the company. This approach was reflected from the 1970s onwards in a policy which spread internationally in favour of so-called "imputation" systems, under which shareholders were typically given a tax credit for CT paid. However, rarely did these arrangements give the shareholders full credit for such taxes. If anything, the tide has now turned and there is little doubt ("pure" economic analysis notwithstanding) that – at least in the quoted sector – much CT paid by companies in many jurisdictions is paid at levels over and above what would be imposed if the individual shareholders in the company were taxed directly on their share of the profits. In part this reflects the fact that (at least with quoted companies) shareholders on their own, without the benefit of the stock exchange mechanism and the limited liability afforded by incorporation, could not take the equity risks and derive the considerable economic benefit from this risk-taking that the companies which they hold shares in do on their behalf[122].

6.1.3.2 Benefits of a CT regime

The characteristics below would suggest that the introduction of CT in a particular jurisdiction may not materially adversely affect decisions to invest there. CT also has the additional advantage that it is counter-cyclical for the taxpayer: in boom times, more tax is paid than in more difficult economic periods.

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view these theories have some merit but are based on models which implicitly assume both 'rational economic behaviour' and a closed economic system with a single Government/tax rate, or a simplified competitive model in which the returns on investment in country X are determined solely by the tax system of country X. In reality we believe that because of the institutional framework of public accounting and reporting under which MNCs have to operate, their economic decision making has ceased to be 'rational' in a technical economic sense in that most do not aspire to or achieve complete mitigation of reported taxes on profits which would damage them reputationally and the viability of which would be doubted by analysts. Secondly as a fact, incrementally increased or reduced profits based taxes in one jurisdiction may be offset at least partially by reduced or increased tax takes by other fiscs because CT rules are not typically exclusively territorial-source-based but based partly on source and partly on residence, and embody extraterritorial features such as withholding tax, transfer pricing rules, controlled foreign company rules and elements of taxation of foreign dividends and profits. Moreover these features exist to varying degrees in the practical international consensus model of CT which has emerged from national decisions to reform taxes and counteract arbitrage and from models promoted by the OECD itself through its models for Double Taxation Treaties and many other pronouncements. Certainly counteracting CT avoidance is a much greater focus of OECD efforts than enforcing models of VAT.

[122] The US Government Accounting Office (GAO) reported to Congressional Requestors in July 2008 on a 'Comparison of Reported Tax Liabilities of Foreign- and US-Controlled Corporations' (GAO08-957). The focus of the study was to respond to concerns within Congress that foreign owned corporations were paying too little US tax both absolutely and relative to US owned corporations. There was some focus on transfer pricing in the report but little firm conclusion as to its impact on the question. In summary, the study focused on those US companies paying no tax in a series of years (typically 69-70 percent over the years 1998-2005) and found a small or declining differential (3 percent in 2005 for the large companies) between foreign and domestic owned companies. Moreover this might be explained by the higher proportion of start up businesses among the foreign owned. Somewhat oddly, there seemed little focus on the role of interest deductions in explaining any differential and low tax payments by companies generally, despite some comment on how most companies reporting no liability established a loss position in respect of current year results (which would include interest deductions) – tax practitioners and policy-makers would likely focus on interest as a potentially major explanatory factor. The most striking conclusion of the study was however that large companies – those with assets of at least USD 250m or gross receipts of at least USD 50m – were much less likely to pay no tax (typically 20-30 percent except in the recession years after 2001 when there was a temporary increase to around 50pc for the large foreign companies). To the extent that large corporations are more likely to be listed and others more likely to be closely held, the study may provide indirect support for the proposition that there is a greater taxable capacity in practice among the quoted groups. In any event the conclusion is at odds with the popular belief that large MNCs are particularly successful in mitigating their tax liabilities.

Corporation tax is a "below the line" expense

Multinational companies which are quoted now operate in a global framework where, notwithstanding they will plan to mitigate their tax liabilities, they do not seek or realistically expect tax-free returns (in contrast to investment funds or many private investors). Under accounting standards which are increasingly internationally harmonised, they account for the cost of CT separately from other costs of the business, and such costs are not a charge against "earnings before tax". Accordingly, they are somewhat discounted by equity analysts who, indeed, may be suspicious if the CT charge in a corporate group's accounts is too low and may doubt the sustainability of this position. Companies themselves may fear to adopt behaviours which drive tax rates too low for reputational reasons. Corporate accounting also frequently requires that where tax costs of current activity are deferred, a provision is made for future crystallisation of the deferred tax so that the cost is in any case recognised in the current accounts. Therefore, all other things being equal, whilst a corporate would typically prefer to pay less CT than more, many companies will, in practice, be less motivated to save a pound of CT than a pound of most other categories of expenditure (including VAT, payroll taxes, and so on, which are generally "above the line").

Global pool of CT

Moreover, in the increasingly globalised economy, direct taxation of profits is the norm in most countries in which businesses operate. The return on investments in a given country may be taxed: (i) in that country; (ii) in the countries of trading counterparties relevant to that investment; (iii) in the country of residence of the investing legal entity; or (iv) in any of the countries of residence of parent companies of that company in the chain of ownership of companies in the corporate group up to and including the top company in the structure.

Frequently taxes paid in one location will tend to reduce the level of tax paid in others, so to some extent taxes in different locations offset each other, and a reduction in tax in one jurisdiction will result in an increase in tax elsewhere[123]. (This is not generally the case with turnover taxes, and is a key reason why such taxes are unwelcome to multinationals.) For these reasons many multinationals may (quite rationally) assess the location of investments primarily on a pre-tax basis and pursue tax mitigation strategies as a separate exercise[124].

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[123] Relief for tax suffered on profits by a business in another jurisdiction, which is distributed to the parent company, is broadly given through (a) double taxation relief or through (b) a dividend exemption system:

a) Double taxation relief
Most fiscal authorities charge tax on profits arising in their country, whether it arises to a resident or a non-resident. The result is that foreign profits arising to residents of a jurisdiction may be liable to both foreign and domestic taxes. To reduce this double taxation, "credit" relief countries may allow a credit for tax suffered on dividends paid from the other country. This may either be provided for under a double tax treaty between the countries, or by means of unilateral relief (note that the UK operated such a credit relief system until July 2009, and was notably one of the countries which allowed unilateral relief). The maximum relief that a company may deduct is typically limited to the domestic tax suffered on the foreign income.

b) Dividend exemption
A number of jurisdictions apply a dividend exemption system. In the UK, the dividend exemption applies to qualifying distributions paid on or after 1 July 2009. Dividend receipts will remain taxable unless they fall within an exempt category. The exemptions are very broad and it is expected that the majority of dividends should qualify for an exemption. The dividend exemption regime combined with the UK CFC provisions typically provide for the same tax effect (albeit different timing of tax) to the credit system outlined above i.e. its purpose is to provide for tax to be suffered only once on income.

[124] The tax rules driving this result include taxation (usually with credit) of foreign source profits, or making exemptions conditional on underlying tax being paid and/or "controlled foreign companies" rules in the case of head office countries; and withholding tax, domestic disallowances, and extended taxable presence rules in the case of third countries. The tax department of a multinational would expect to have much more influence on (for example) intragroup financing arrangements (which may have fewer commercial consequences) than investment location decisions.

The above considerations suggest that there is, as it were, a "global pool" of CT which a corporate group is relatively acquiescent in paying. The size of the pool may vary according to the tax profile of each multinational and be somewhat flexible at the margin (as companies would, as noted, prefer to pay less tax rather than more), but there is a real sense in which much of the pool is available to different national fiscs to compete for. For this reason, competition internationally has generated a market-led harmonisation of CT (as countries imitate features of each others' tax systems to eliminate arbitrage and achieve a greater share for themselves of the pool available) rather than creating a "race to the bottom" of ever smaller CT receipts as some commentators have feared. By and large, the evidence indicates that a broader base provides at least as high a tax take as a higher rate, which suggests instead a race towards an international consensus model regarding both a broad base and a modest rate.

Double Taxation Agreements

Most provisions of typical Double Taxation Agreements relate to CT (and Income Tax). Countries without a CT regime leave trading counterparties little incentive to negotiate DTAs and so deny such countries commercial opportunities which are dependent on Treaty protection (often involving withholding taxes).

6.1.4 Personal income tax ("IT")

Personal income tax extends beyond the scope of our study, because it applies to non-business income, but in most countries it is largely collected by the business sector through the operation of payroll tax regimes. A similar point arises in relation to Social Security charges (below). However, they are considered briefly here because they typically contribute a significant proportion of total tax revenues. In the UK, for example, IT raised 10.2% of GDP in tax revenue in 2003[125]. Most countries have IT. The highest marginal rates range from 63% in Denmark to 10% in Bulgaria, with no IT in most of the OTs.

Historically, there has been an evolution of the principal features of personal income tax in most countries. For example, the need to finance expensive wars has been an important driver[126].

More recently, however, the rates of tax applied have become "flatter", i.e. there is less gradation between the highest and lowest marginal rates. For example, in the UK in the 1970s, the highest marginal rate reached 98% while the basic rate was in the 30-35% range; now the rate for high rate tax payers is 40% (with a proposed rate of 50% applying to taxable income above £150,000) while the basic rate is 20%. In addition, the relative weight of the tax has been thrown into reverse, so that capital income is now, if anything, more lightly taxed. For example, in the UK tax relief is given on pension contributions of up to 100% of an individual's earnings in each tax year, subject to an overall annual limit. It is expected that the availability of higher rate relief on contributions to Registered Pension Schemes will be restricted from 6 April 2011 for people with taxable earned income of over £150,000. Given widespread national budget deficits post-credit crunch, there is evidence that this is part of a general trend (developments in the US and Ireland are just two other examples). In addition there are Individual Savings Accounts ("ISAs") where interest on an investment is not taxed, subject to overall contribution limits. All this reflects both developing economic theory and practical experience - that capital is relatively mobile and can move to less heavily taxed environments, whereas labour is less mobile and cannot so easily do so.

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[125] Tax Administration in OECD and selected non-OECD countries: Comparative Information series (2006), Forum on Tax Administration (February 2007).

[126] For example, in the UK, income tax was introduced to finance the wars against revolutionary (and later, Napoleonic) France at the end of the 18th and beginning of the 19th Centuries. Initially the rate was 10% but it grew to 30% in the First World War and reached 50% by the end of the Second World War. This linkage was important in creating a climate of opinion that it is an individual's patriotic duty to pay the tax. To some extent associated with that, the tax has – to a varying extent in different times and places – been seen as part of a programme of policies to redistribute income from the wealthiest to the poorest parts of society. In that spirit, in the UK at least, labour income was historically taxed less heavily than investment income.

6.1.4.1 Compliance and costs burden

In practice in most developed countries the great majority of IT receipts are now collected at source by employers by way of deduction from employees' wages, for example Pay As You Earn ("PAYE") in the UK. In practice this represents a major compliance burden on employers, particularly small businesses. In the UK, a 2006 survey undertaken for HMRC estimated that 10% of all the administrative burdens of the UK tax system on business were burdens only on employers of 1-10 employees and only in respect of employee taxes, principally personal IT[127].

Not only are compliance costs a major burden on business, but also, to the extent that employees are in fact mobile and can insist on being given post-tax wage rates, the cost of paying higher wages (to compensate for the tax) imposes further costs on business. (Although, in general capital is more mobile than labour, in many cases labour can be mobile too.) Since these costs take the form of the employing businesses' labour costs, they are costs reflected in the pre-tax earnings of companies in the published accounts; this is probably the most significant measure of performance looked at by analysts in the equity markets.

6.1.4.2 Recent global trends: increased tax on higher rate earners

The increase in the IT rate on the highest rate tax payers together with the curtailment of pension contribution deductibility may be part of a new global trend post credit crunch towards higher top marginal rates[128]. This may be in response to higher budget deficits and the view that many top earners are perceived to be responsible for the excess of the boom.

There is evidence of a trend among economists towards the view that IT on employment (as opposed to savings) income and Social Security is preferable to corporation tax, and to the extent that workers do not save, the tax base approximates to that of VAT. However, unlike CT, these taxes are above the line costs; not very countercyclical; and indeed at the margin a disincentive to employment when the economy is in recession and beginning to recover.

6.1.5 Social Security taxes

Most countries have Social Security taxes. Social Security taxes have arisen particularly in Western countries in the 20th Century to finance the provision of social benefits such as old age pensions, unemployment, sickness and disability insurance and sometimes healthcare. By implication as and when these were introduced the authorities had concluded that the social and political appetite to finance these benefits through general taxation (including personal IT at high marginal rates targeted at the relatively income-rich) had been at least temporarily exhausted.

In principle the costs of such taxes are borne largely by employees, employers or both, in the case of employed workers, and by self-employed business people to the extent that they are covered by Social Security schemes. However, the major burdens in most countries have come to be a direct cost and liability to employers. As such, they are again a component of businesses' reported earnings before tax.

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[127] Administrative Burdens: HMRC Measurement Project: Report by Tax Area, KPMG (20 March 2006).

[128] The US for example recently released the Obama proposals which announced wide-ranging changes to the US international tax system including increasing resources for the IRS to investigate both legal tax planning and illegal tax evasion particularly by individuals. In 2009, Ireland announced an emergency budget raising capital tax to 25% and the high-income levy, which was only introduced in 2008, is doubled to 6% on gross income above €175,000.

6.1.6 Tax Information Exchange Agreements & European Union Savings Directive

Since the late 1990s a series of international initiatives have placed increasing pressure on low tax jurisdictions seeking to reform their business models. This had its origins in a 1996 G7 meeting at which the OECD was asked to develop measures to "counter the distorting effects of harmful tax competition". This resulted in the publication of the 1998 OECD report "Harmful Tax Competition: An Emerging Global Issue". The report set out the criteria for identifying a "tax haven". In broad terms, the criteria were no or nominal tax and a lack of transparency or effective exchange of information. In 2000, the OECD analysed 47 jurisdictions and determined that 35 met the criteria of "tax havens". 31 of those countries reacted by giving their commitment to the OECD's principles of transparency and information exchange. More recently, the OECD produced an updated 2008 publication of "Tax Co-operation: Towards a Level Playing Field". The publication focused on developing methods for distinguishing between jurisdictions which are adopting changes and those which are note. An update was issued following the G20 summit earlier this year.

The OECD and the EUSD (see 6.1.6.2 below) are both applying pressure on "tax havens" to improve transparency and effective exchange of information. The OECD has introduced the concept of TIEAs whilst the EU has itself enacted legislation, the EUSD, aimed at breaking secrecy barriers.

6.1.6.1 Tax Information Exchange Agreements

The principles of transparency and exchange of information developed by the OECD's Global Forum on Transparency and Exchange of Information have been accepted by countries around the world. The standard model TIEA was released by the OECD in 2002 after consultation between representatives of OECD member countries and delegates from a number of parties which the OECD had listed as "harmful tax jurisdictions". The model is intended to establish the standard of what constitutes effective exchange of information and provides for either bilateral or multilateral signatories.

TIEAs typically include various provisions covering type of information exchange (i.e. on request or automatic), taxes covered and safeguards to ensure that appropriate confidentiality is maintained and that any information exchanged may only be disclosed to those concerned with the enforcement of taxation in their requesting jurisdiction.

International consensus: movement towards taxation in country of residence

The international consensus (in practice more than in theory) is increasingly that individuals should primarily be taxed on investment returns in their country of residence. This is driven as much by international competitiveness issues as by theory. This general movement towards taxation in the country of residence is reflected by the trend in tax treaties to move away from the imposition of withholding taxes and towards interest and similar articles giving sole taxing rights to the lender's country. As noted earlier, investment funds are able to earn "gross" returns from their investors.

This trend is controversial as it implies a shift of taxing rights to capital-wealthy countries away from the developing world and encourages a form of "tax competition" in attracting wealthy residents. A long term answer may be a revised global framework which may even include revenue transfers to developing countries.

In the short term the focus on TIEAs helps to combat tax evasion and to address the corruption that may be a source of the "mispricing" noted by the Christian Aid studies.

Approach of OECD countries to improving exchange of information

Taxation in the country of residence can only be effective if information can readily be obtained from countries from which income is sourced. OECD member countries have taken a variety of approaches to promoting increased information exchange and there is a sense that measures such as those outlined below are likely to become more widespread:

- Canada has developed what has been referred to as a “carrot” and “stick” approach to TIEAs. The incentive element is to treat foreign sourced business income received by Canadian corporations from overseas operations in jurisdictions with a TIEA in force as “exempt surplus”; this means that it is not taxed when repatriated. The deterrent element is to treat all foreign sourced income from countries with no Canadian DTA or TIEA as passive and hence subject to Canada’s CFC regime, whether from active business (that would otherwise be exempt from CFC apportionment), or not. This means that all foreign profits earned in non-TIEA partner countries will be taxed in the hands of the Canadian shareholders whether repatriated or not. Canadian businesses would still receive a tax credit for any foreign tax paid in respect of these profits; however not being able to defer active business profits offshore is a heavy constraint.

- Australia denies beneficial withholding tax rates to residents of countries it considers “tax havens”. On entering a TIEA (or DTA with a robust information exchange Article) jurisdictions will be re-classified as “information exchange countries”; this leads to reductions in the withholding tax rates for residents from 30% to 22.5%.

- Italy, Mexico and Spain all place onerous requirements on transactions with countries that do not adhere to the OECD standards. Mexico and Spain actually have a number of “listed” jurisdictions, but will remove countries from this list if they enter into a TIEA or DTA.

6.1.6.2 EU Savings Directive

The EU Savings Tax Directive of 2005 was intended to ensure that citizens of one member state do not evade taxation by depositing funds outside the jurisdiction of residence and so distort the single market. Under the Directive either tax on savings is withheld at source and passed on to the EU Country of residence or a country may opt to openly exchange information on non-resident holders of deposits. The EUSD applies:

- Only to interest or interest-derived payments;

- Only to payments to EU resident individuals[129] ("beneficial owners") and certain EU intermediary entities;

- Only when payments are made by paying agents in the EU and other defined territories (including some of the CDs and OTs – see below); and

- Only when payments are made cross-border.

Some countries (Austria, Luxembourg[130], British Virgin Islands, Guernsey, Isle of Man, Jersey, Antilles and Switzerland) operate a withholding tax system whereby paying agents in those jurisdictions withhold tax on distributions paid to individuals at source. Those countries which operate the withholding tax also have to report interest paid on savings to the resident's tax authority. They must indicate how much of the total amount relates to customers in each prescribed territory. The identity of the recipient will not be reported, thus preserving individual confidentiality (which is typically the reason this system is adopted in preference to information exchange). However, recently Belgium confirmed that it will move to the information system under the amended Directive and give up withholding. Further developments are expected.

The Isle of Man has confirmed that it will move to automatic exchange of information from 1st July 2011. Jersey has also confirmed its intention to do so, provided that other “withholding tax” countries also move to an information exchange model.

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[129] The European Commission recently agreed on a proposal to widen the Directive’s scope to cover trusts and foundations, not just individual deposits.

[130] The European Commission has decided to refer Luxembourg to the European Court of Justice over its incorrect application of certain provisions of the Savings Tax Directive as regards interest payments made to beneficial owners who benefit from so-called "non-domiciled resident" status in their country of residence. Luxembourg paying agents do not levy withholding tax on interest payments to such beneficial owners.

6.2 Outline of the key features of the emerging consensus "best practice" taxation model

The following sub-sections set out the key elements of our hypothesis regarding the emerging consensus "best practice" taxation models for CT and VAT.

6.2.1 Hypothesis of international "best practice" CT system

- Companies are potentially liable to tax in a jurisdiction if they are incorporated there, effectively managed and controlled there, or have a permanent establishment (a tax "branch") there.
- Tax is imposed on active, domestic-source business profits.
- Taxable profits are largely determined in line with accounting profits. This would likely be IFRS or US GAAP.
- A number of more detailed features are likely to apply, the more important of which are:
  - There is an assumption that dividends and capital gains from subsidiaries and substantial shareholdings would be exempt
  - The arm's length principle would apply
  - Tax grouping (e.g. for loss relief) would be allowed in specified circumstances
  - Costs attributable to generating taxable income are tax-deductible.
- Further impact assessment would be required in relation to the appropriate tax rate. For the purposes of our comments below we have assumed a rate of 12% (as being just below the Irish headline tax rate for active profile), but a full assessment would need to consider inter alia:
  - The need to raise worthwhile amounts of tax revenue;
  - Whether the Irish headline rate of 12.5% in respect of active profits in effect represents a de facto "ceiling" for the CDs in particular, because of regional competition;
  - Whether the same rate is appropriate as a hypothesis across all CDs and OTs.
- It is assumed that there would be no threshold (i.e. profit level below which an entity/group would be exempt from tax).
- Although the working assumption is that exemptions from the regime should be minimised in most cases, further consideration would need to be given to whether certain vehicles/activities might be exempted. For example, in line with the principle that the objective of the tax system is to tax locally-generated active business profits, and recognising that funds are typically highly mobile (and that attempting to impose tax on them is therefore unlikely to be successful in practice), funds vehicles would be exempt. This might be achieved through a system of rulings that they are passive, with some general rulings for types of "approved" exempt entities. Fund-related active business – for example, fund management or administration – would be within the charge to CT.

6.2.2 Hypothesis of international "best practice" VAT system

- VAT would apply in respect of companies belonging, or with an establishment, in a jurisdiction.
- The system would be "cascading" (so that credit is given for input tax suffered in against output tax on making taxable supplies).

- Imports would be subject to VAT through the recipient self-accounting for VAT.
- Exports would be zero-rated or equivalent, to ensure suppliers established in the jurisdiction are not disadvantaged in export markets.
- There would be detailed rules - beyond the scope of this study - regarding determining the place, timing and valuation of supplies, as well as regarding the establishment of VAT groups.
- The starting assumption would be that the tax should be broad-based (i.e. with few exemptions). However, we recognise that in practice patterns do vary, in particular:
  - Most jurisdictions with VAT exempt Financial Services, primarily because of difficulties around measuring the value added;
  - Many jurisdictions make exemptions for reasons of social policy, although economic theory would tend to hold that there are more efficient mechanisms than exemption of achieving those social policy objectives (e.g. through welfare payments).

Further impact assessment would be required in relation to the appropriate tax rate. This assessment would need to consider inter alia the need to strike a balance between raising worthwhile amounts of tax revenue, and (in particular) the distributional and other impacts on the domestic consumer, which it is appropriate to resolve through domestic political processes.

Deposit takers in the CDs now enjoy the benefit of an absolute tax reduction, due to a combination of the UK CFC exemption on offshore deposit taking, and the fact that from 1 July 2009 dividends paid back to the UK are exempt in the UK recipient company. It might therefore be appropriate to consider a supplementary profits tax for active business financial services entities which are non-ISE exempt.[131]

6.3 Key features of the tax regimes of the CDs and OTs

In the following section, we consider the key characteristics of the tax and tax information exchange regimes of the CDs and OTs and assess the extent to which they follow the consensus "best practice" models identified above.

6.3.1 The CDs

Corporation tax

The CDs' approach to taxes on businesses is similar and all have variants of a zero/ten regime (i.e. where most companies are taxed at 0% but some in financial services are taxed at 10% and others – utilities and property companies – at 20%)[132].

VAT/GST

Guernsey does not currently have a VAT system. From the perspective of tax avoidance by UK corporates, it is therefore (together with the other CDs and OTs except the Isle of Man)

[131] The broad logic of the ISE exemptions appear to be that exempted companies should bear no VAT since the final consumption of their services is not in Jersey. On that basis, there would be no justification for them to pay the supplementary tax.

[132] It is worth noting that that the CDs, as a result of the OECD pressure over discrimination and the introduction of zero/ten regimes, did "leave money at the table" (so to speak) for the UK to levy on the deposit takers (i.e. by reducing their domestic CT burden, thus allowing the UK to tax profits repatriated back to the UK with fewer associated tax credits). The introduction of the UK dividend exemption from July 2009 will reduce the final level of tax on profits, but will likely be seen as a windfall benefit by the deposit takers, who will continue to operate in the CDs in the same way as ever because that business is not tax-driven.

effectively on a level playing field in terms of competitiveness with all other countries outside the EU.

Jersey (unlike Guernsey) has GST which was introduced in May 2008. Jersey operates an international services exemption ("ISE") which applies to financial services for "International Companies". This allows financial services companies to pay a flat fee in return for an opt-out from the regime. In addition, it enables the company to recover input VAT suffered. This may be a significant feature in Jersey's competitiveness relative to the EU in relation to attracting some particular lines of financial business such as securitisation. However, to the extent that the businesses attracted in this way provide services to non-Jersey customers and counterparties, it can be justified as being a streamlined administrative way of arriving at the same final result as an EU-type VAT system, in that in either case VAT costs are not intended to be borne by final consumers located abroad. It is worth observing at this point that Jersey has shifted its tax burden from IT and CT to GST as a presumably unintended but logical result of EU/OECD pressure. It introduced a "zero 10" regime (i.e. where most companies are taxed at 0% but some in financial services are taxed at 10%), in place of its previous regime (which imposed a 20% income tax rate on some inbound and domestic-owned businesses, while leaving many inbound businesses exempt). This led to a budgetary cost to the Jersey fisc, which its relatively new 3% GST partially filled.

The Isle of Man operates VAT. Under the agreement formerly known as the Common Purse but now called the Customs and Excise Revenue Sharing agreement, VAT receipts collected in the Isle of Man and the UK are pooled and then shared out to an agreed formula. This is in recognition of the fact that many VAT registered businesses based on the Isle supply goods and services that are consumed in the UK, such that VAT is paid in the UK but collected on the Isle, and vice versa.

Exchange of information

The CDs share a common approach to information exchange and have all "substantially implemented" the internationally agreed standard for exchange of information as defined by the OECD[133]. The Isle of Man has set a precedent in the regard and been highlighted by the OECD as being one of the leading financial centres to address its transparency issues in the recent "Towards a Level Playing Field 2008 Assessment" by the Global Forum on Taxation. Jersey and Guernsey have also adopted this approach.

In addition, although the CDs are outside the EU and therefore not required to apply the EUSD they have all done so, as noted under 6.1.6.2 above.

6.3.2 The OTs

Corporation tax

The OTs do not have CT systems, with the exception of Gibraltar which currently has a CT rate of 27% which is due to reduce to 10% from 2010[134].

Consumption taxes

The OTs (Anguilla, Bermuda, Turks and Caicos, British Virgin Islands & Gibraltar) operate a range of customs duties on imports; again, economic theory and a desire to broaden the revenue base would suggest there is a compelling case for considering introduction of VAT/GST. In addition, there is a view that there will be a trend for Caribbean countries to reduce import duties. This would suggest that there is a capacity to introduce VAT/GST as a form of replacement.

The feature of most OT tax systems, compared with "full-tax" ones, seems to be that they are heavily reliant on raising tax revenues through specific consumption taxes and are under developed in other more mainstream taxes.

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[133] A jurisdiction is recognised as having "substantially implemented" the internationally agreed tax standard if it has signed at least 12 agreements on exchange of information - Overview of the OECD's work on countering international tax evasion – A background information brief, 16 July 2009.
[134] Deloitte International Tax Guides, Deloitte (January 2009).

Exchange of information

Since December 2009, Bermuda has implemented 13 TIEAs, British Virgin Islands 14, Cayman Islands 12, Gibraltar 7, Anguilla 4, and the Turks and Caicos Islands 4[135]. Cayman Islands, Gibraltar & British Virgin Islands have all adopted measures to comply with the EUSD. Bermuda, we understand, has not complied for constitutional reasons.

6.3.3 Conclusions

For all the reasons set out under 6.1 above, a one-dimensional tax competition model whereby it is assumed that the lower tax rate the better (and zero is best) is not appropriate, at least as regards VAT and CT.

We recognise that the CDs and OTs are extremely heterogeneous and operate elements of tax systems that show considerable variations, both in their extent and in their nature. However, to varying extents they are distinguished within the developed world by differentiating themselves, sometimes through tax rates but more often through the absence or near absence of certain forms of taxation, from the international consensus as here described. Partly for historical reasons, their tax policy strategies show elements of the one-dimensional competition model.

[135] Source: OECD website, September 2009.

6.4 Assessing the impact of moving to a "best practice" taxation model

This section provides high level comments on particular key impacts potentially arising from the CT and VAT "best practice" hypotheses. We also discuss the analysis and considerations that would be required for a more robust and full assessment of the impacts. More detail on the required analysis, and a possible approach to it, is given in Appendix 2 and Appendix 3 of the report. Such impact assessment is beyond the scope of this study.

The discussion is framed in terms of assessing the likely impacts on Jersey and the Cayman Islands of moving towards a "best practice" hypothesis model, by way of illustrating the potential implications for the CDs and OTs more generally. We selected these two territories because between them are reasonably representative of the CDs and OTs in terms of their geography, economic and tax profiles, and constitutional arrangements, and also because useful statistical information is available in respect of them.

We discuss the assessment of CT and VAT impacts separately. A full assessment of the impact of the "best practice" tax system would have to consider the combined effects from both taxes in the context of overall budgetary considerations.

6.4.1 Possible effects of CT in Jersey and the Cayman Islands

We have set out in Appendix 2 some of the considerations and analysis that would be required before conclusions could be drawn about the impact of introducing CT (or changing the rate or basis of existing tax). That would include setting out the proposed changes in more detail. Such analysis is out of the scope of this report. It is possible, however, to comment on the possible impacts at a more conceptual level with reference to some key drivers of the impacts.

6.4.1.1 Incremental effect on tax liabilites of companies

The first step towards estimation of the impact would be to consider what effect the "best practice" CT hypothesis has on incremental tax liabilities of different types of companies in different industry sectors. The hypothesed CT system relates to the tax liabilities of companies with active business profits. In the finance sector, this is likely to include, for example:

- Banking;
- Fund management, that is, the profit on the income from managing funds rather than the passive income accruing to fund owners;
- Trust services, that is, the profit on the income from serving trusts rather than the passive income to trusts themselves; and
- Custodian fees.

The CT hypothesis would also apply in respect of the after tax profit of most non-financial corporations.

Whether or not, and to what extent, the hypothesis leads to an incremental impact depends on the tax rate already applied on their profits. One key consideration is the domicile of the parent companies of subsidiaries in the different sectors of the jurisdictions. Multinational corporations may already be subject to CT on repatriation, CFC rules, or be able to claim credit against foreign tax paid. If that is the case, and if such multinational corporations make up a large proportion of the tax base, the impact of CT in Jersey or the Cayman Islands might be relatively limited on these entities. In part, the tax would accomplish a transfer of revenue from the domicile tax authorities to Jersey or the Cayman Islands.

As described in Appendix 2, detailed analysis of the composition of the affected sectors would be required for a robust estimation of the incremental effect on tax liabilities over the tax base. At a much higher level, by way of example, banks operating in the Cayman Islands in 2008 were domiciled as follows (% of number of banks)[136].

- Europe 29.2%
- USA 26.7%
- South America 16.4%
- Asia & Australia 10.3%
- Caribbean & Central America 8.2%
- Canada, Mexico 5.0%
- Middle East & Africa 3.6%

Many of the key bank domicile jurisdictions in the above regions have CT systems which give credit for foreign tax paid. Therefore it might be safe to assume that for a substantial proportion, perhaps around half[137], of banks in the Cayman Islands the tax would not be incremental. In Jersey the impact on financial sector companies could be further limited to a 2% increase in total tax liability due to the existing zero/ten tax system even where they cannot claim credit for Jersey tax paid.

On the other hand, some deposit takers in Jersey may benefit from CFC exemptions and tax exemptions on dividends repatriated to the UK. In this case any changes to the CT suffered in Jersey would be incremental to the companies in question. The possible supplementary CT charge for such businesses proposed for consideration would add directly to their incremental tax liability, and may reduce the strength of the "money at the table" argument.

Some of the non-financial sectors of the CDs and OTs might have a lower multinational company penetration than the finance sector. In this case, a higher proportion of the tax would tend to be incremental. This would also apply to Jersey, as non-financial sectors (other than utilities) fall largely outside the zero/ten system.

The incremental impact in Jersey would however be reduced by income tax credit available to Jersey shareholders on CT suffered (although this would have a negative effect on total revenue available from the introduction of CT). The overall impact of the hypothesis would therefore depend on the domicile of shareholders as well as companies.

As discussed in Appendix 2, detailed analysis of the domiciles of companies in different sectors and their existing tax liabilities would be required for firmer conclusions on the incremental impact. Nevertheless, it is not likely that the full amount of tax would be incremental from the point of view of companies or shareholders in either of the jurisdictions.

6.4.1.2 Effect on location and investment decisions

Insofar as the CT has an incremental effect on total tax liabilities, it may cause: the exit of companies in key sectors; reduced future FDI; or reduced investment by domestic companies. As discussed in Appendix 2, to assess this would require analysis of the costs and benefits of locating in the jurisdictions and the international mobility of the companies in

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[136] Economics and Statistics Office: "The Cayman Islands' Annual Economic Report 2008", Figure 4A.1

[137] The US, Japan, Australia, Italy, Spain and Canada – among other jurisdictions – have "taxation with credit" systems. In addition, France and Germany operate exemption systems, but with CFC rules to tax profits in lower tax jurisdictions on a "current" basis. It would therefore appear reasonable to assume, in respect of the list of domiciles set out here, that most of the US, Canada/Mexico, Asia/Australia and a sizeable proportion of Europe would fall into this category.

different sectors. It would also require analysis of the effect of the tax on hurdle rates of return in the different sectors. Such analysis is out of scope of this report.

We might, however, speculate about the mobility of some key sectors. Table 1 shows the composition of the financial sector GDP and Gross Value Added ("GVA") (including key support sectors) for the Cayman Islands and Jersey respectively.

Table 1: High level composition of the finance sectors in the Cayman Islands and Jersey

Cayman Sub-sector[1]	GDP %	Jersey Sub-sector[2]	GVA %
Banking	31%	Banking	64%
Accountancy	20%	Funds	12%
Law	18%	Trusts & company admin	12%
Fund administration	13%	Accounting	2%
Insurance	8%	Legal	9%
Estate & trust	5%		
Support	5%		

Source: 1) "Economic Benefits of the Financial Services Industry in the Cayman Islands", Oxford Economics,2009 2) Jersey financial sector 2007 GVA data supplied by HMT (based on data from Jersey Comptroller of Income Tax, JFSC, Office of Statistics)

Banking is the main component of the financial sectors in both jurisdictions. Insofar as the banks are located in the jurisdictions because of demand for offshore banking services by their customers, they would be less likely to relocate due to a CT on their business profits. The key benefit from locating in the jurisdictions — ability to offer offshore banking services — would not be affected by the "best practice" CT hypothesis.[138] Relocation to other offshore jurisdictions would be a possibility, but there may be other reasons limiting the scope or appetite for moving, such as costs and access to particular geographic markets.

The accountancy, legal and other support services are likely to be closely tied to the location of the core financial sector: banks, funds, insurance companies and trusts. In fact, it has been estimated that 95% of the business of law firms, company managers and accounting firms in the Cayman islands is directly related to the core financial services providers.[139] Therefore, if the key financial services providers such as banks and funds are not induced to relocate by the tax hypothesis, the immediate support services are also likely to remain. Of course, this "cuts both ways" — any reduction in the core financial sector would be keenly felt by the supporting sectors.

6.4.1.3 Wider effects on the economy and output

Exit by companies would have a direct effect on output of the jurisdiction in question. Also the changes to investment incentives of those that remain, through changes in hurdle rates of return[140], would lead to output effects, as well as potentially having productivity, wage and GDP growth effects. These effects would be felt through direct impacts as well as indirect and induced impacts through the linkages in the economies of the jurisdictions. Full analysis of these effects, sketched in Appendix 2, is outside the scope of this report.

We can, however, illustrate some of these linkages at a high level. For example, in the Cayman Islands the core financial sector is directly responsible for 21% of GDP. The close

[138] Wider changes to the tax systems and information sharing arrangements, beyond the best practice hypothesis, could of course affect this.

[139] Oxford Economics: "Economic Benefits of the Financial Services Industry in the Cayman Islands", 2009

[140] The "hurdle rate" is the minimum return on a project a company is willing to accept before starting a project given its risks and loss of opportunity to invest in other projects.

support functions contribute another 15% of GDP. Further, it has been estimated that another 19% of GDP in the Cayman Islands is due to indirect and induced effects of the total financial sector, including close support services. That is, for the Cayman Islands, roughly 30% of the non-financial sector output, relies on the financial sector through indirect and induced effects.[141]

According to 2007 GVA data for Jersey, the finance sector alone contributed 53% of value added in Jersey. Other business activities that are likely to be closely linked to the finance sector contribute another 18% of value added.

Similar linkages would apply to any employment effects from lower output and employment.

Again, there are two sides to the linkages. Any falls in financial sector output in response to the tax hypothesis would have significant wider effects in the economies of Jersey and the Cayman Islands. On the other hand, if the financial sector output is not substantially reduced as a reaction to the tax hypothesis, the effects on the rest of the economy are likely to be limited also.

There would also be further impacts through reduced spending power by any domestic shareholders. However, in the case of Jersey, this could be reduced due to the credit available against income tax payments. This would lead to lower induced impacts in the wider economy than would otherwise be the case (but would also lower overall revenues).

6.4.1.4 Revenue effects

The incremental effect on tax revenues from the "best practice" proposals is clearly of key interest. Unfortunately it is not possible to comment on the revenue effects without undertaking the above analysis (as further expanded in Appendix 2). Some direction could be obtained from existing CT receipts. In Jersey these were £196m in 2007. Given that the current zero/ten system captures mostly finance companies, and finance contributes 53% of Jersey GVA, it might be tempting to scale up this figure for the 12% rate in the hypothesis, extended to cover all value added. This would not be robust, however, due to possible wide differences in the profitability of the non-finance sector, and as it would ignore any reaction by companies and effect on the economy from the higher rate and wider tax base under the hypothesis.

6.4.2 Possible effects of VAT in Jersey and the Cayman Islands

It is not possible to provide detailed comments on the impacts of the hypothetical VAT scenario without undertaking the type of analysis outlined above and in Appendix 3, which is out of the scope of this report. Here we provide high level conceptual comments on the key drivers of the impacts illustrating some of the key considerations with public data where readily available.

6.4.2.1 Impact on retail prices

Apart from administrative costs, the impact of VAT on the economy is driven largely by the effect on retail prices of the tax. Both Jersey's and the Cayman Islands' existing tax and duty systems have some features that could act to limit the incremental impact of the 5% VAT hypothesis to less than 5% increase in retail prices.

Jersey currently operates a GST system with a rate of 3%. In addition to the increase in the rate to 5% under the hypothesis, there might also be impacts on retail prices in Jersey from a change in the tax base. For example, a change in categories of expenditure covered or size threshold of companies required to register for VAT would lead to an effect on the average price of the different expenditure groups[142].

[141] Oxford Economics: "Economic Benefits of the Financial Services Industry in the Cayman Islands", 2009

[142] It is hypothesised that the ISE exemption in Jersey would stay in place.

In the Cayman Islands the impact on retail prices could be limited somewhat by a reduction in import duty rates. This is particularly relevant for the Cayman Islands due to the relatively high level of imports as a proportion of domestic production: in 2008, total imports to the Cayman Islands were 38.9% of GDP[143].

The scope for import tariff substitution and its effect can vary substantially between different categories of products and services. This is highlighted by data available on imports of consumption goods and total household expenditure in the Cayman Islands. According to the Economics and Statistics Office, in 2008 the total imports of Food and Beverages were CI$196.8 million[144], while the total household expenditure on Food, Beverages, Restaurants and Hotels was CI$164 million[145]. Although corporate consumption contributes to the import figures, they illustrate a high proportion of imports by category of consumption. On the other hand, for the Clothing & Footwear category, the same figures were CI$14.6 million and CI$47 million – imports being a more modest 31% of household expenditure. The existing duty rates also affect the scope for import tariff subsitution — for example most basic foodstuffs are not subject to import duty in the Cayman Islands[146].

Exemptions for reasons of social policy would also limit the impact of the VAT hypothesis on retail prices in both jurisdictions.

Detailed analysis of underlying data on import duties, value of imports by category, household expenditure per category, as well as possible changes to the existing import duties, would be required for a full analysis of the impact of the VAT hypothesis on retail prices. Such analysis is out of scope of this report.

6.4.2.2 Impact on aggregate demand and output

The impact on aggregate consumption and output would be driven by the impact on retail prices and consumers' reaction to it. If the VAT hypothesis leads to an increase in prices, consumers are likely to reduce their consumption of the goods and services affected. The resulting impact on aggregate demand can have a direct effect on domestic output. The impact will vary according to:

- Amount of the price increase; and
- Responsiveness of demand to price changes (price elasticity of demand).

The effect on the economy as a whole would vary in part according to expenditure patterns in the jurisdictions. Table 2 shows allocation of household expenditure by main category in the Cayman Islands and Jersey.

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[143] Economics and Statistics Office: "The Cayman Islands' Annual Economic Report 2008"

[144] Economics and Statistics Office: "The Cayman Islands' Foreign Trade Statistics Report 2008"

[145] Economics and Statistics Office: "The Cayman Islands' 2008 Consumer Price Index Basket"

[146] Cayman Islands Customs

Table 2: Proportion of household expenditure by expenditure group

Category of expenditure	Cayman Islands	Jersey
Food and non-alcoholic beverages	7.5%	8.8%
Alcoholic beverages and tobacco	0.7%	2.3%
Clothing and footwear	3.5%	3.5%
Housing, water, electricity, gas and other fuels	39.9%	26.3%
Household goods and services	5.6%	4.9%
Health	2.4%	2.1%
Transport	9.4%	10.4%
Communication	7.0%	2.2%
Recreation and culture	4.1%	12.8%
Education	2.8%	2.1%
Restaurants and hotels	4.0%	5.2%
Miscellaneous goods and services	13.2%	9.3%

Sources: Jersey Household Expenditure Survey 2004/05, the Cayman Islands Economics and Statistics Office.

Given the relatively high import dependency of both Jersey and the Cayman Islands, the direct impact on domestic output would be limited as a relatively high proportion of the demand reduction would be directed at imports rather than domestic production. This is likely to vary by sector, as the proportion of imports in total expenditure varies from sector to sector.

There would be an effect on domestic production depending on the extent to which its outputs and inputs are subject to VAT over and above present taxation. Currently in the Cayman Islands the domestic production of goods subject to duty is partially protected against foreign competition by the amount of the duty. Introducing VAT and reducing duty rates would both have a negative impact on the domestic producers. This is partially a distributional impact – although domestic producers are made worse off, the economy as a whole may be no worse off, and may be better off, depending on the relative distortions from custom duties and VAT as well as their amounts before and after the change.

The direct impacts on aggregate demand and output would lead to further second round indirect and induced effects through the supply and use linkages in the economy and the reduced spending power of consumers.

Exports would not be directly affected as they would be zero rated under the VAT hypothesis.

6.4.2.3 Revenue effects

The incremental effect on tax revenues from the "best practice" proposals is clearly of key interest for VAT also. Unfortunately it is not possible to comment on the revenue effects without undertaking the above analysis (as further expanded in Appendix 3).

Some direction could be obtained for Jersey from the estimations undertaken by the Crown Agent before introduction of the current GST system. The Crown Agents report in 2005 estimated, based on 2003 data, that a broad based GST system at a rate of 5% could lead to revenues between £64 million and £83 million depending on whether financial services are zero rated or exempted. The tax base was estimated to be 63% of GDP. The estimated

revenues in the Crown Agents report from a narrower UK type tax base of 48% of GDP, at 5% GST, were between £44 million and £62 million.[147]

6.4.2.4 Distributional impacts

Distributional impacts are often a key concern regarding VAT. The main distributional impact would be through the cost of living of different socio-economic groups through different expenditure and income patterns. There could also be employment impacts fed through from the output impacts.

Jersey has published its Household Expenditure Survey 2004/5, which provides average weekly household expenditure on different goods and services by:

- Income groups (quintiles);
- Tenure (Lodgers & Tied, Owner-occupied, Private Rental and State/Parish Rent);
- Household composition;
- Employment status;
- Age; and
- Parish (region).

This would provide a rich dataset for analysis of distributional effects of VAT introduction (or changes) across the above socio-economic groupings, in terms of percentage of total expenditure by the groups. In this analysis different impacts would arise particularly from different proportions of expenditure being directed towards exempt or zero rated categories by the different socio-economic groups.

According to the Jersey Household Expenditure Survey 2004/05, for example, 13% of the expenditure of the lowest income quintile was on Food & Non-Alcoholic Drinks, compared to 7% of the expenditure of the highest quintile. For the category Housing, Fuel & Power the figures were 29% and 25% respectively. Therefore using a lower rate on food and exempting housing costs from VAT would have a relatively larger benefit for the lowest income quintile, and the cost of living impact in terms of proportion of total expenditure might be relatively lower for the lowest income groups.

However, the cost of living impact as a percentage of income has in the past been of more interest. It is those impacts that cause VAT generally to be thought of as a regressive tax, as poorer people spend a higher proportion of their income, and therefore would pay a higher proportion of their income as tax. In a more detailed analysis it might be possible to combine the Jersey Household Expenditure Survey 2004/05 data, and equivalent data for the Cayman Islands, with income distribution data to estimate distributional cost of living impacts as a proportion of household income.

Any employment impacts would also tend to vary by socio-economic groups and therefore lead to distributional impacts. For example, the Cayman Islands Labour Force Survey data in Table 3 below shows that the proportion of workers who are native to the Cayman islands vary widely between different sectors of the economy. Note, however, that the high level split provided by this data is likely to include various social groups in both categories; the Non-Caymanian category would capture expatriate workers as well as immigrant labourers.

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[147] Crown Agents, States of Jersey: "Proposal for the design of a prototype Goods and Services Tax, Final Report" Crown Agents reference no: T23079, January 2005, page 26.

Table 3: Proportion of Caymanian / Non-Caymanian labour force by industry

Industry	Caymanian	Non-Caymanian
Agriculture and Fishing	30%	70%
Manufacturing, Mining, Printing and Publishing	43%	57%
Electricity, Gas and Water Supply	67%	33%
Construction	38%	62%
Wholesale and Retail	47%	53%
Restaurants and Bars	37%	63%
Hotels and Condominiums	20%	80%
Transportation, Post and Telecommunication	71%	29%
Financial Services	64%	36%
Real Estate, Renting and Business Activities	43%	57%
Public Administration	79%	21%
Education, Health and Social Work	41%	59%
Other Community, Social and Personal Service	51%	49%
Private Households with Employees	12%	88%
Not Stated	26%	74%

Source: the Cayman Islands' Labour Force Survey Report Fall 2008

The direct and second round effects discussed above would have to be estimated before the analysis of distributional impacts could be completed.

6.4.2.5 Administrative capabilities

Design of a new tax regime would take time and money and its introduction would necessitate additional regulation and compliance costs. In addition, VAT in particular can impose a high compliance burden on businesses as they are required to file returns for input taxes suffered and output taxes charged.

In relation to the OTs in particular, although they have experience of revenue-raising through other forms of tax, CT and VAT are different taxes to those historically administered in these jurisdictions so new procedures and approaches would in any case be necessary.

It is our understanding that the CDs and OTs are likely to have very different levels of infrastructure capabilities currently, and will therefore face varying degrees of practical challenges should they decide to introduce new taxes in particular.

6.4.3 Conclusions

As noted at the beginning of this section, we selected Jersey and the Cayman Islands (as being reasonably representative of the CDs and OTs in general) to illustrate the potential impacts if the CDs and OTs were to move towards the "best practice" CT and VAT hypotheses outlined in Section 6.2.

Introducing CT may lead to an exit of companies where relative tax liabilities exceed the cost of relocation (including loss of benefits from locating in Jersey and the Cayman Islands). Further, increase in tax liabilities for domestic and remaining companies may lead to reduced investment and output effects. However, the full amount of tax is likely not to be incremental from the point of view of companies or shareholders in either of the jurisdictions. Some multinational companies will be able to offset the tax against domestic tax liabilities. In Jersey, financial sector companies are already subject to 10% CT and the impact may also be reduced by income tax credit available on CT suffered. Further, in particular for deposit taking, the key benefit of locating in the jurisdictions is the ability to offer offshore banking

services to clients, which would limit the extent to which companies are willing to relocate if they are to continue to serve that market.

The financial sector is a key part of the economies of Jersey and the Cayman Islands both directly and through links to the rest of the economy. Insofar as the financial sector is not substantially reduced, the rest of the economies would be less affected also. On the other hand, to the extent that the hypothesis impacts the financial sector, it would have substantial direct and follow on impacts throughout the economies.

The impact of introducing VAT is driven largely by effects on retail prices. Increasing retail prices would reduce the spending power in households, and lower aggregate demand and output of the domestic economy. It would also give rise to distributional impacts depending on household spending patterns, although these could be offset by the use of tax revenues collected.

However, both Jersey's and the Cayman Islands' existing tax and duty systems have some features that could act to limit the incremental impact of the VAT hypothesis, if the VAT partially substitutes for existing taxes or import tariffs. Further, a high proportion of final consumption in both jurisdictions relates to imports, and therefore the direct effect on domestic output would be smaller than in larger economies.

Appendix 1 – Studies reviewed

'False profits robbing the poor to keep the rich tax free', Christian Aid, *March 2009*

'Death & Taxes: The true toll of tax dodging', *Christian Aid, May 2009*

'The morning after the night before: The impact of the financial crisis on the developing world', *Christian Aid, November 2008*

'Tax Havens: releasing the hidden billions for poverty eradication', *Oxfam, June 2000*

'The Missing Billions', *Trade Union Congress, February 2008*

'Where on Earth Are You: Major corporations and tax havens', *Tax Justice Network, April 2009*

'The direct tax cost of tax havens to the UK', *Tax Research LLP, Richard Murphy*

'The tax gap series', *The Guardian, February 2009*

'Profit Shifting in the EU: Evidence from Germany', *IFS, Alfon Weichenrieder, April 2006*

'The Impact of Non-Profit Taxes on Foreign Direct Investment: Evidence from German Multinationals', *IFS, Thiess Buettner and Georg Wamser, April 2006*

'Taxes and the size of foreign owned capital stock: which tax rates matter?', *IFS, Michael Devereux & Ben Lockwood, April 2006*

'Capital Structure and International Debt Shifting in Europe', *IFS, Harry Huizinga, Luc Laeven and Gaetan Nicodeme, April 2006*

'Tax Havens and the Financial Crisis', *Oxford University Centre for Business Taxation, Geoffery Loomer and Giorgia Maffini, April 2009*

'Mind the Tax Gap', *Tax Justice Network, 2006*

'Closing the Floodgates: Collecting tax to pay for development', *Tax Justice Network, 2007*

'Tax evasion, tax avoidance and tax expenditure in developing countries: A review of the literature', *Oxford University Centre for Business Taxation, Clemens Fuest and Nadine Riedel, June 2009*

'Economic growth and the role of taxation – theory', *OECD - Gareth D. Myles, Exeter/IFS, 15 July 2009*

'Tax and Economic Growth', *OECD – Asa Johansson, Chrisopher Heady, Jens Arnold, Bert Brys and Laura Vartia, 11 July 2009*

'The Impact of Taxation on the Location of Capital, Firms and Profit: A Survey of Empirical Evidence', *Oxford University Centre for Business Taxation, Michael P Devereux, April 2006*

'The Price of Offshore', *Tax Justice Network, March 2005*

'Magnitudes: dirty money, lost taxes and offshore', *Tax Justice Network, March 2009*

Appendix 2 - Assessing the impact of introducing a "best practice" CT model

This Appendix sets out some of the key impacts to be assessed in relation to introducing, or changing the rate of CT, a possible overall approach for assessment of the impact, and the data and analysis required. We will discuss the issues in terms of introduction of CT, but similar issues apply also to changes in the rate or coverage of existing CT. We set out:

- The main relevant impacts to be assessed;
- The likely data requirements to undertake the assessment; and
- A sketch of a possible methodology to be followed. This is not intended as a fully laid out methodology, and indeed there are various alternatives, but it is rather given as an indication of the types of considerations, analysis and data required for a full impact assessment.

Direct impacts of Corporation Tax

The potential direct socio-economic impacts of CT include:

- Effect on location decisions by businesses;
- Effect on investment decisions by businesses;
- The total capital stock and GDP;
- Employment; and
- Tax revenues.

The above will of course be inter-related. One way to understand the chain of causality of the impacts is as follows:

- The introduction of CT would be likely to change the attractiveness of jurisdictions as a location to invest and do business in. This can be thought to take effect through the effective average tax rate ("EATR") faced by the companies – the effect on overall after tax profitability of business.
- In addition to the above, the introduction of CT changes the post-tax return on investment, through changing the effective marginal tax rate ("EMTR"), affecting the decision of how much to invest, given a choice of location.
- The actual effect of the above two possibilities depends on various aspects of the structure of the economy and other international tax treatment of multi-national companies operating in the jurisdictions.
- Assuming, however, that the above effects lead to reduced investment or exit of companies, this leads to a fall in output of the economy (if companies exit) and/or fall in the capital stock in the economy over the medium term.
- The fall in capital stock can lead to a fall in GDP and (possibly) GDP growth.
- Exit by any internationally mobile companies affected by the tax would also lead to direct employment effects, and any fall in GDP over the medium term due to a lower capital stock could also have employment effects.
- Fall in capital stock may also lead to a fall in the marginal productivity of labour, with negative effect on real wages in the medium term.

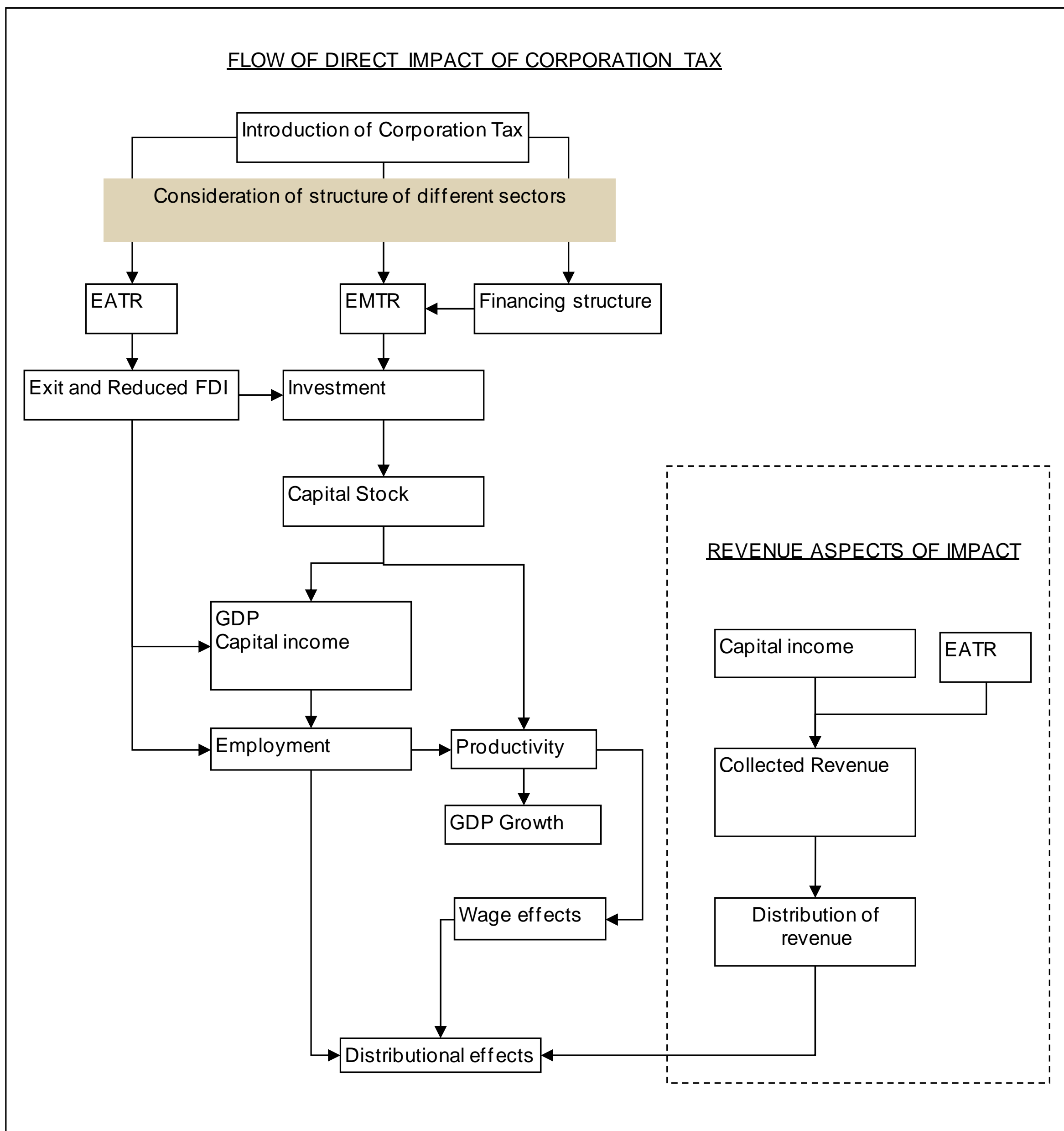
- Depending on the structure of the economy and the incidence of the tax across the economy, the various above effects would also have distributional impacts. These may be affected by the use of revenues raised by the tax.

- The above impacts will affect the amount of capital income available for the tax base, with subsequent direct effect on revenues available.

The below diagram presents at a high level a flow of effects from the introduction of CT, assuming it does impact the effective tax rates faced by at least some companies.

This should consider the incremental changes to any existing system brought about by introduction of the hypothetical best practice system.

Figure 2.1: Representation of direct impacts of CT



The assessment of whether or not, and to what extent, the above impacts may arise requires detailed analysis of the extent to which the tax will have an actual incremental effect on the tax liabilities of companies, the relative strength of various location incentives before and after the tax change, the structure of the economy and incidence of the tax across the

different sectors, financing costs of the different sectors and the organisation of the production in different sectors. We discuss these further below.

Assessing effect on location decision by businesses

Three main factors need to be assessed:

- The impact of the tax introduction on the effective rate of tax faced by different companies;
- Importance of tax as a factor in location decisions by companies; and
- Potential international mobility of companies.

The factors are likely to vary depending on the sector and type of business. To assess the impact across the economy, detailed information of the structure of the economy in terms of sector components and types of businesses in the sectors, as well as the applicability of the tax across them would also be required.

Full assessment would therefore require detailed tax proposals including analysis of how they would apply across different businesses and sectors.

Impact on effective tax rate faced by companies

Understanding the impact on the effective tax rate faced by companies would require a detailed understanding of:

- Type of companies and activities caught in the tax net. For example, the tax on active business profits is designed to leave funds outside the tax basket, whereas at least some of banking and most of insurance, accounting and legal components of financial sector profits are likely to be in the tax base.
- The structure of the various sectors in terms of domiciles of companies operating in them and any tax treaties that would be applicable to multinational companies.
- The extent to which multinational companies in the tax base would be able to offset the new tax against their existing tax liabilities. If this is the case, the introduction of a tax would result in a redistribution of revenue between tax authorities of different jurisdictions. This is likely to be a key factor in limiting the potential adverse impacts from introduction or change of CT.

One practical approach would be to complete the above analysis for a sample of companies in each sector of the economy. Nevertheless, the information required for a full consideration of above issues is likely to require considerable effort to collect and collate.

The output of the above investigation would be an estimate of the effect of the CT on the effective average tax rate for different types of businesses in the various sectors of the economy.

Importance of tax in location decisions

The importance of tax in location decisions needs to be assessed in order to estimate the impact of an increase in effective tax rate on future foreign direct investment or potential exit of companies operating in the jurisdictions. Factors influencing this, and therefore to be explored, include:

- Other benefits from location in the jurisdictions, such as (potentially) access to a specialist labour pool, access to markets, taxes on labour income, and other regulations. These benefits include the ability of banks to offer offshore deposit taking services to their customers.
- Relative importance of tax savings versus “above the line” cost savings that might be available from location in CDs and OTs.

Collection of sufficient information for detailed analysis of the above is likely to require surveys and interviews with key companies in different sectors, as well as desk top analysis.

Potential international mobility of companies

Closely linked to the above point on the importance of tax in location decisions, the factors influencing the potential international mobility of companies include:

- Cost of relocation compared to the cost of paying the additional tax;
- These would include loss of any benefits from locating in the CDs and OTs, such as access to specialised labour pool, access to markets, other regulations, and so on.
- The amount of increase in tax costs; and
- The availability of alternative jurisdictions to be based in, and the relative benefits from being based in those jurisdictions. The alternative jurisdictions considered should not be limited to other CDs and OTs.

The above factors would have to be analysed in detail for different sectors of the economy.

Aggregation to sector and economy wide effects

The above analysis would produce impacts on different types of companies in various sectors of the economy. In order to aggregate these to sector and economy wide impacts on output and FDI, the composition of the sectors would have to be investigated in terms of:

- Proportion of output and FDI in each sector due to companies domiciled in various jurisdictions; and
- Proportion of output and FDI in each sector due to different types of companies that might react differently to tax changes (as would be identified in the above steps).

Again, these are likely to require extensive data gathering and collation effort.

Assessing direct effect on investment decision by businesses

In addition to the above impact, changes in CT liability would affect investment decisions of companies through an effect on their cost of capital. To the extent that the the tax is incremental, to achieve the same post-tax return following an introduction of a tax, the pre-tax return from investments has to increase. This means that the hurdle rate of investment increases and less investment takes place, other things being equal.

One practical approach to estimating the impact of this would be to undertake the analysis at sector level. This would require:

- Estimation of the tax effect on average across different sectors as above (possibly separately for multinational companies and domestic companies in the sector);
- Mix of domestic and multinational company production in each sector;
- Analysis of difference between depreciation rate, depreciation tax treatment and economic rate of depreciation in each sector;
- Average gearing level in each sector; and
- The existing cost of capital (debt and equity) in each sector before the introduction of the tax.

The result of the above analysis would be an increase in required pre-tax return (cost of capital) for each sector of the economy.

Assessing the direct effect on capital stock and GDP

In the approach being sketched, the effect on capital stock and GDP from introduction of the tax would combine:

- The impact through potential changes to entry/exit decisions of companies; and
- The impact through investment decisions by companies.

Required analysis for the aggregate GDP impact from the entry/exit decisions has been described above.

Conversion of the cost of capital effect to an effect on capital stock requires assuming a production function for each of the sectors. One possibility is to use a Cobb-Douglas production function, where the elasticity of the capital stock to cost of capital is (minus) one by definition — one percent increase in cost of capital would lead to a one percent decrease in capital stock. The production function is, however, likely to vary between different sectors, and different assumed production functions can lead to different estimated impacts. Further, the concept of using a production function approach to represent the financial sector services could be contentious. It would therefore be important to research the relationships between cost of capital, investment and capital stock (or output directly) in more detail for each sector to achieve robust estimates of the total effect.

Where applicable, the production function would also influence the effect of capital stock on final output (contribution to GDP) by the different sectors. The analysis will also require an estimate of the share of capital (as opposed to labour or other inputs) as an input to production for each sector. At a minimum, this would require data on composition of GVA in each sector.

Assessing direct employment effect

The direct output effect estimated above can be translated to an employment effect. One crude possibility would be to assume that the employment/output ratio is maintained as constant. At a minimum, this would require information on employment and output in each sector.

"Second round" impacts of corporation tax

The above discussion covered estimation of the direct impact of introducing CT. Equally important and potentially larger would be the indirect and induced impacts that arise as the direct impacts work through the economy.

Ideally the analysis would be based on fully specified macroeconomic models of the jurisdictions, reflecting the supply relationships in the economy as well as labour supply and employment effects. One less involved way to estimate some of the second round impacts would be to consider the supply inter linkages in the economy through input-output multiplier analysis.

- Indirect impacts — change in output from the direct impacts leads to change in demand for inputs to production, and demand for products and services that form those inputs.
- Induced impacts — from changes in compensation of employees and other incomes, due to both direct and indirect impacts, which may cause further changes in spending, and in turn further changes in final output and employment.

The analysis would require detailed macroeconomic input-output data for the economies, from which the multipliers can be calculated. Alternatively, the supply and use relationships in the economy could be investigated through bespoke surveys of particular key sectors in the economy (such as the financial sector).

The changes in the capital stock could also influence the overall productivity of the different sectors, with effects on real wages as well as GDP growth of the economy as a whole. Full consideration of these effects would require a macro-economic model of the jurisdictions economies, taking into account labour supply decisions, balance of payments effects and long term policy constraints (such as exchange rate pegs and long term budget constraints).

Revenue impact of corporation tax

Estimation of the revenue available from CT requires the results of the various analyses above as well as additional considerations including:

- The total available tax base, before allowing for reactions of businesses to the tax;
- Effect of the direct and second round impacts on the available total tax base;
- Collection effectiveness; and
- Forecast GDP growth and its effect on the tax base (tax buoyancy / revenue elasticity).

Distributional impacts of CT

The above discussion has considered the impact of CT in aggregate. The aggregate or sector level impacts would also have a distributional (or socio-economic) dimension. For example, if the employees in the sectors out of scope of the tax are largely of particular socio-economic groups (such as expatriates), the distributional impact of the tax could be strong.

In addition to the impact of the tax on output and employment in each sector, the analysis of the distributional impacts would require detailed information on composition of the labour force in each sector in terms of different social groups of interest (e.g. by average income, nationality, or ethnicity).

Consideration of the full distributional impact would also require assumptions on the use of the revenues raised by the tax, which could in part be used in part to offset any undesired socio-economic impacts arising from the introduction of the tax otherwise.

Assessing impact of Supplementary Finance Sector Tax

The hypothetical best practice tax proposals include the possibilities of a supplementary tax on profits of foreign deposit takers who benefit from exemption from CFC rules as well as exemption on tax when repatriating dividends to the UK.

In this case, any supplementary tax would have a direct effect on the effective tax faced by the company. The tax would function as a corporate income tax. Therefore, the impact of this supplementary finance sector tax could be estimated in the same way, and would be subject to the same data requirements, as discussed for CT in general above.

Appendix 3 - Assessing the Impact of introducing a "best practice" VAT model

This Appendix sets out some of the key impacts to be assessed in relation to introducing or changing the rate of VAT, a possible approach for assessment of the impact, and the data and analysis required. We will discuss the issues in terms of introduction of VAT, but the points made apply also to changes in the rate of existing VAT. We set out:

- The main relevant impacts to be assessed;
- The likely data requirements to undertake the assessment; and
- A sketch of a possible methodology to be followed. This is not intended as a fully laid out methodology, and indeed there are various alternatives, but it is rather given as an indication of the types of considerations, analysis and data required for a full impact assessment.

It is important to consider whether the VAT would replace any existing consumption taxes and to what extent it would do so. It is the total incremental impact on the changes of the existing system that should be assessed. For example, if the VAT revenues replace revenues from import duties, it could be that the net impact on the economy and particular social groups is positive (depending on the relative incidences of VAT and customs duties). The first crucial step in the analysis is therefore to estimate to what extent the VAT introduction would lead to changes in the total effective rate of tax on various consumption categories.

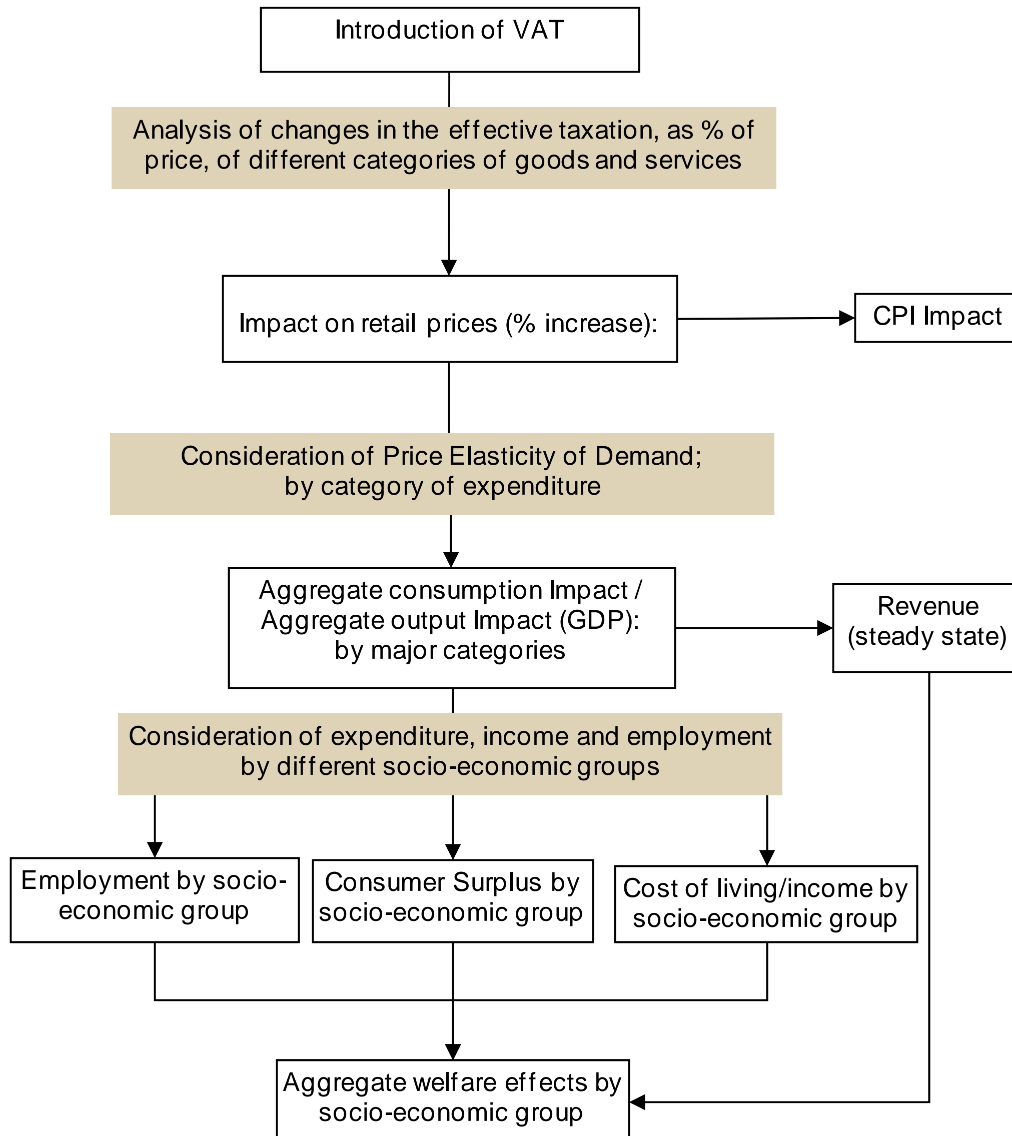
Direct impacts of VAT

The main impacts of VAT that are usually of most concern to commentators include:

- Inflation and competitiveness effects — what one-off effect will the introduction of VAT have on the overall price level, and what more sustained effects could it have on the rate of change of the price level (i.e. inflation) and the international competitiveness of the economy?
- Revenue effects — how much will the tax raise in total?
- Aggregate demand effects — how much will demand respond to the price increase from introducing VAT?
- Distributional effects — how will various socio-economic groups be impacted by the VAT? This would include impact on:
  - Cost of living;
  - Employment; and
  - Consumer surplus.

These are represented in Figure 3.1 below.

Figure 3.1: Direct impacts from introduction of VAT



There would be further second round effects as discussed below.

Direct impact on retail prices

If there are no existing consumption taxes, the percentage increase on price due to VAT is given by the VAT rate on each category of expenditure.

When VAT substitutes for existing taxes, the change in effective rate of taxation has to be analysed for different categories of expenditure. This should consider:

- The effective tax burden (e.g. custom duty) on different categories of expenditure before VAT introduction; and
- The effective tax burden (e.g. some remaining custom duty and new VAT) on different categories of expenditure after the VAT introduction.

This would require data on:

- Existing custom duties (or other taxes) by category of imports (expenditure) that can be matched with macroeconomic corporate and household consumption data;

- Consumption expenditure in different categories;
- Proportion of imports in total consumption, by category of expenditure, so an existing average effective rate of tax per category can be calculated; and
- The applicable VAT and custom duty (other tax) rates after the VAT introduction, taking into account any lower rates of VAT for some expenditure and exemptions and zero rating.

The analysis of the above data would give an impact of VAT on retail prices of different categories of expenditure in percentage terms. This percentage impact can be used in subsequent analysis.

Alternatively, more detailed bottom-up analysis could be undertaken if information on the actual prices charged for goods and services, and import prices of the goods and services can be obtained.

Aggregation of the impacts according to weightings of a general consumer price index would also give the magnitude of a one off step change in the level of the index from the introduction of VAT. This is distinct from any possible sustained inflation effect (see below).

Direct impact on aggregate demand and output

Any change in prices faced by consumers would have an effect on demand for the products and services in question. This will lead to an aggregate demand effects, and therefore output effects on the economy. The information required to analyse the direct impact includes:

- The price elasticity of demand for different categories of expenditure, measuring how much demand responds to a change in price; and
- The proportion of imports in final expenditure by category, which is needed to analyse how the overall change in aggregate demand by category of expenditure is allocated between domestic output and imports.

The second step may be particularly relevant to the CDs and OTs, as a high proportion of final consumption is likely to be imported.

Administration costs

VAT might lead to increased administration costs for businesses as well as the public authorities.

Analysis of sector compliance costs typically involves surveys of a sample of the affected companies, the results of which are then scaled up to reflect the overall structure of the economy and the breadth of the VAT net.

There would also be additional costs of public administration of the VAT regime.

"Second round" impacts of VAT

Similarly to CT, any fall in aggregate demand and output directly due to introduction of VAT would lead to additional effects on the economy through indirect and induced linkage effects in the economy.

The analysis and data requirements for estimation of the second round impacts are also similar to those for the CT second round impact analysis.

Revenue impacts of VAT

Estimation of the revenue available from VAT requires the results of the various analyses above as well as additional considerations including:

- The total available tax base, that is, the final consumption expenditure after consumer reaction and second round effects have been resolved, and including allowance for potentially exempt or zero rated categories;

- Collection effectiveness; and

- Forecast consumer expenditure growth and its effect on the tax base (tax buoyancy / revenue elasticity).

Distributional impacts of VAT

One of the typical concerns with VAT introduction is its potential distributional impacts. These include effects on:

- Cost of living of different social groups;

- Employment by different social groups; and

- Consumer surplus of different social groups.

As with the CT impact, the aggregate employment effect could be estimated by relating it to the changes in output of the domestic economy, discussed above. Relating this to different social groups would require information on the composition of the labour force in each sector in terms of different social groups of interest (e.g. by average income, nationality, or ethnicity).

Analysis of the effect on cost of living and consumer surplus requires information on expenditure patterns of different social groups of interest. It would also need to take into account changes in consumption as a response to the tax. Depending on the available data, the analysis could consider the increase in average cost of living in absolute terms and as a percentage of income or total expenditure, by income group, ethnicity or other relevant (and available) socio-economic breakdown of interest.

Full analysis of distributional effects would also have to consider use of the tax revenue raised.

Inflation impact of VAT

Commentators are often also concerned about the inflation impact of indirect taxes such as VAT.

As discussed above, depending on existing taxes that might be replaced, introduction of VAT may lead to a one-off increase in retail price level, or a temporary jump in the observed inflation rate. This is separate from a sustained increase in rate of change in prices, or expected inflation.

The risk of inflation arises from potential resistance to residents being made worse off by the price rise. This depends on a number of factors, including the monetary and fiscal infrastructure, and how workers and firms respond to the increase in prices. Workers may press for higher wages to compensate for their fall in real living standards, and firms may or may not accommodate those wage demands, depending on the overall state of demand in the economy. Ultimately whether such knock-on inflationary effects become “embedded” depends on the robustness of the existing monetary and fiscal infrastructure and the response of the authorities.

Full analysis of the effects would require modelling of the interaction between labour markets, product markets, balance of payments effects, and monetary policy including decisions about currency pegs. This would require a fully-specified macro-economic model of the jurisdictions. The key inputs to the models would be assumptions made about policy variables such as reaction of the monetary authorities. Therefore the analysis could also usefully be conducted off-model, but would nevertheless require consideration of the above interactions.

Experience in countries that have adopted VAT shows the concern about inflation has been largely unfounded. VAT has not been inflationary, even though in some countries such as Japan and Denmark, it has resulted in once-and-for all increases in the price level. Only in a minority of cases has it been found that VAT could have contributed to increased inflation, and in these cases this was in association with expansionary credit and wage policies. Indeed, it has also been argued that VAT could lead to a lower long term rate of inflation.

Appendix 4 – Acronyms

AIF	Alternative Investment Fund
CD	Crown Dependency
CFC	Controlled Foreign Company
CPI	Consumer Price Index
CT	Corporation Tax
DTA	Double Taxation Agreement
DRIC	Dual Resident Investment Company
EATR	Effective Average Tax Rate
EEA	European Economic Area
EBT	Employee Benefit Trust
EMTR	Effective Marginal Tax Rate
EU	European Union
FDI	Foreign Direct Investment
FOS	Freedom of Services
GDP	Gross Domestic Product
GP	General Partner
GPT	Gross Profits Tax
GST	Goods and Services Tax
GVA	Gross Value Added
HMRC	HM Revenue and Customs
ICC	Incorporated Cell Company
IFRS	International Financial Reporting Standard
IHT	Inheritance Tax
IPT	Insurance Premium Tax
ISE	International Services Exemption
IT	Income Tax
ISA	Individual Savings Account
LBS	Large Business Service (division of HMRC)
LP	Limited Partner
LVCR	Low Value Consignment Relief
MNC	Multinational Corporate
MTICF	Missing Trader Intra-Community Fraud
NDF	Net Debt Flow
NIC	National Insurance Contribution

OECD	Organisation for Economic Co-operation and Development
OT	Overseas Territories
PAYE	Pay As You Earn
PCC	Protected Cell Company
PPR	Principal Private Residence
REIT	Real Estate Investment Trust
RGD	Remote Gaming Duty
SAC	Segregated Account Company
SDLT	Stamp Duty Land Tax
SDRT	Stamp Duty Reserve Tax
SED	Stock External Debt
SPV	Special Purpose Vehicle
TBSFA	Tax Based Structured Financing Arrangement
TIEA	Tax Information Exchange Agreement
UTR	Unique Taxpayer Reference
VAT	Value Added Tax

Appendix 5 – Key features of UK VAT Regime

Rules on place of supply

When determining the VAT treatment of supplies of goods or services, it is important to first determine where the supply takes place, as this will in turn determine which jurisdictions have taxing rights.

The place of supply of financial services is where the customer belongs. This has been determined by EU law and implemented into UK law. If a business provides a taxable supply of financial services, such as managing third party debt, to a UK customer then that supply attracts UK VAT; if the supply is not to a UK customer then it does not attract UK VAT. A non-UK customer may suffer domestic VAT on the supply depending on whether there is a domestic VAT regime where that customer is based and whether that regime would consider the supply to be taxable.

The place of supply of goods is broadly the place where the goods are located when their dispatch or transport to the customer begins (or the place where they are physically located when the supply takes place if they are not to be dispatched or transported).

Nature of supplies

Very broadly, businesses trading above a relatively low limit are required to register for VAT, and charge VAT to their customers. The rate of VAT they charge is typically either 0% (zero-rated) or 15%, reverting to 17.5% on 1 January 2010 (standard-rated). When accounting to HMRC for the VAT they collect from customers (output VAT), businesses are normally entitled to reclaim VAT charged to them by their suppliers (input VAT).

One exception is where businesses make "exempt supplies". These supplies are exempt from VAT and so businesses making such supplies are not required to charge their customers output VAT on them. However, where a business makes exempt supplies, it is also not entitled to reclaim input VAT which it incurs in making them.

The rules for cross-border supplies to customers in the EU are different, and use different language, but the end result (i.e. that input VAT cannot be recovered for businesses in the UK making exempt supplies to customers in the EU) is the same. For simplicity of expression, in this document we use the terms outlined above. Finally, for completeness, we note that the supply of management services from outside the EU does carry a VAT benefit until 1 January 2010. Non-EU companies supplying management services to a UK customer are not obliged to charge the customers input VAT until that date.

The question as to whether a particular supply is exempt is largely one of policy. Some are exempt out of public interest (e.g. university education fees, funerals), some because the quantum of the individual transactions involved would make the timing of VAT cashflows impossible to manage (e.g. residential property), and some due to administrative factors (e.g. financial service transactions which can become enormously complicated due to movements in financial markets).

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HM Treasury contacts

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If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London

SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861

E-mail: public.enquiries@hmtreasury.gov.uk

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