

## OFFSHORE FINANCIAL CENTRES

### Submission to the Treasury Committee House of Commons

#### **SUMMARY**

*OFCs are an endemic source of risk, by their very nature as providers of services to non-residents. They have become designer jurisdictions, whose laws and regulations are crafted to facilitate avoidance and evasion of the laws and regulations of other countries. Policy towards them has been fatally compromised by attempting to distinguish between legitimate and illegitimate uses of offshore. Attempts have been made especially since 1998 to develop a more coordinated international approach towards improved regulation of the offshore system, but these have several limitations and flaws. In practice, the procedure for monitoring of compliance with financial supervision standards is enabling OFCs which are found largely compliant with such standards to represent the process as conferring on them a general seal of approval. It was also mistaken for the campaign against tax havens to be led by the OECD and directed at small OFCs, since OECD countries are themselves divided on the issue, and many of them (including the UK and US) are deeply involved with the offshore system. Hence, they have been rightly portrayed as hypocritical bullies. It is clearly time for a new approach to phase out the offshore system, based on concerted action between all relevant regulatory authorities, nationally and multilaterally. The UK is in a key position to take the lead.*

1. This submission is by Sol Picciotto, Emeritus Professor of the Lancaster University Law School. Over the past 20 years, I have researched and written extensively on tax havens and offshore financial centres (OFCs), including a book *International Business Taxation* (1992). I recently conducted a 3-year research programme supported by the Economic and Social Research Council (ESRC) into *Regulatory Networks and Global Governance*, one of the topics in which was the regulation of OFCs and tax havens. In the course of my research, I have conducted interviews with both regulators and private sector professionals involved with this issue, and visited a number of OFCs, including the Isle of Man, the Cayman Islands, Dubai, Liechtenstein and Vanuatu.
2. In my view, OFCs are an endemic source of risk and instability for the financial system. It is their very reason for existence which creates these risks. The definition of 'offshore' is the provision of services for non-residents. Hence, OFCs offer the cloak of their laws and regulations to persons who are not resident in their territory. The central purpose of this is to make it possible for such persons to avoid or evade the laws or regulations of other countries, usually those in which they are resident. Hence, OFCs by their nature are engaged in a continual war of attrition on the laws and regulations of other countries. This has now become a refined and continuous process since these jurisdictions, which have in effect become captured by elements of the financial services industry, regularly introduce new legislation or amendments to their laws, often at the behest of, or designed by, industry advisers. In effect, OFCs offer a haven for pin-striped pirates.
3. OFCs are quite open about this, and indeed are mistakenly supported by some academics and commentators, on the grounds that they provide 'regulatory competition'. Even if a case can be made for competition between countries of the same or a similar type to attract genuine activities, this does not apply to OFCs, for two main reasons:

(i) they are generally small countries, so that financial services and related activities can be a relatively very large proportion of their GDP; their government revenues from even very low fees (e.g. for company registrations) can enable them to maintain a zero or low direct tax regime, which would not be possible for countries with larger populations and a more balanced economy;

(ii) they offer the cover of their laws to activities which generally have little or no connection with them.

4. OFCs have acted as a corrosive factor on other countries' fiscal and financial laws and regulations. Their existence has led states with major financial centres, including and especially the UK, to introduce laws and regulations which effectively make them participants in the offshore system. The result has been serious distortion of the international allocation of investment, the undermining of national tax systems, and the creation of such a high degree of opacity as to create serious risks for the international financial and monetary system.

5. There has long been a fatal ambivalence in public policy towards OFCs, due to lack of clear understanding of their nature. This has resulted in a compromise policy, which has condoned, allowed, or encouraged 'acceptable' types of offshore activities, while attempting to prevent the 'harmful' aspects, through regulation. There are two major flaws in this approach:

(i) it is often difficult or impossible to distinguish legitimate from illegitimate activities and transactions;

(ii) the same features facilitate and protect both the purportedly legitimate and the clearly illegitimate activities.

6. The view that some offshore services are legitimate rests on the assumption that it is acceptable to try to find ways of avoiding the law. This argument is made especially in relation to tax avoidance, and has been strongly made in the UK, where the view took hold that 'every man is entitled if he can to order his affairs so that the tax attaching ... is less than it otherwise would be' (Lord Tomlin, in *IRC v. Duke of Westminster*, 1936). Especially since the 1970s, this attitude spawned a massive tax avoidance industry, which has poured enormous resources into the entirely unproductive activity of devising complex avoidance schemes. Many of these turn out to be invalid under existing law, others require legislative changes to shore up the basic principles which they try to undermine. The UK has now introduced some specific anti-avoidance rules in its tax legislation, as well as a notification procedure, and there is considerable support for the enactment of a general anti-avoidance rule, such as is available in a number of other OECD countries. However, the cat-and-mouse game of tax avoidance is made much more complex by the existence of tax havens. They offer the facilities to form artificial corporate, trust or other entities, which can be used to manage assets and international transactions, to avoid other countries' taxes. This greatly exacerbates the problems of the Revenue. First, the difficulty of finding out about schemes and arrangements, due to the secrecy rules and lack of information agreements with havens, makes it very hard to take effective enforcement action. Secondly, international tax avoidance schemes can take advantage of loopholes or ambiguities in tax treaties, which it is difficult and time-consuming to renegotiate.

7. Avoidance is inevitably linked to evasion, due mainly to the secrecy offered by havens. While all countries accept commercial, banking and professional confidentiality, most place

limits on this, both for the protection of the public, and especially for the purposes of law enforcement, including tax laws. Havens create an opaque smokescreen by:

- (i) allowing formation of entities such as 'international' companies, with no or minimal information required about directors, shareholders or beneficial owners;
- (ii) reinforcing confidentiality rules by special laws criminalising information disclosure e.g. by bank employees;
- (iii) offering no or very limited provisions to obtain information for the purposes of enforcing other countries' laws.

8. Tax havens and OFCs are virtually synonymous, for several reasons:

- (i) tax liability has a direct and significant impact on competitiveness, so that arrangements to avoid other types of regulation are usually combined with tax avoidance;
- (ii) financial engineering is central to tax avoidance, since it is very easy to create notional and essentially fictitious entities and transactions to organise and route financial flows;
- (iii) it is difficult to counteract avoidance techniques based on financial engineering using standard methods such as taxation of Controlled Foreign Corporations (CFCs), since it is hard to distinguish between 'active' and 'passive' income from financial services.

Consequently, all OFCs are also tax havens, and most tax havens are or have ambitions to become some type of OFC.

9. It is by now well-known that the secrecy offered by the offshore system facilitates money-laundering. This runs the whole gamut of concealment of illicit funds, ranging from tax avoidance through bribery and corruption to terrorist financing. I am sure that the Committee will receive ample evidence detailing the extent of these funds. I will therefore limit myself here to stressing once again the point that it is in practice impossible to distinguish the clearly criminal from potentially legitimate flows, and that in practice all funds using OFCs should be regarded as tainted. Practitioners in and defenders of OFCs like to give examples of legitimate uses, such as enabling confidential family estate planning. However, such activities can easily be done without resorting to OFCs. As already stated, all jurisdictions protect legitimate financial confidentiality. There is no good reason why legitimately confidential transactions should not be done in jurisdictions which accept a high level of financial transparency for regulatory purposes.

10. Some steps have been taken to try to establish such transparency. OFCs have been put under considerable pressure to implement the Recommendations of the Financial Action Task Force (FATF) on anti-money-laundering and countering the financing of terrorism (AML-CFT). Since 1998 also, the Financial Stability Forum (FSF) has established a Compendium of Standards and Codes for all financial centres, including the FATF Recommendations. Compliance with these standards is monitored by the International Monetary Fund (IMF), in conjunction with the World Bank and the FATF, under the Financial Sector Assessment

Programme, which operates a rolling programme of Review of Standards and Codes (RoSCs). Although this is a laudable effort, it suffers from several major flaws, in particular:

- (i) it requires considerable resources to conduct Reviews even every 4-5 years;
- (ii) it relies, especially for the AML-CFT component, essentially on a 'peer-review' process, which tries to use poachers as gamekeepers, and tends to reinforce views from within the existing system;
- (iii) the IMF has rejected the use of 'black-listing' which proved a very effective means of improving compliance when applied by the FATF; although this is admittedly a crude method, no alternative such as a compliance scoresheet or ranking has been introduced;
- (iv) finally, it does not include compliance with international tax enforcement standards.

This means that jurisdictions which have been found to be compliant or largely compliant in a RoSC can in effect use it as a seal of approval.

11. The campaign against tax havens has been led by the Committee on Fiscal Affairs of the Organisation for Economic Cooperation and Development (OECD-CFA), working in tandem with the EU's Code of Conduct group. This has also been flawed in several key respects. The main problem is that the OECD is the wrong forum, even though the OECD-CFA has considerable resources and expertise. The OECD countries have themselves been divided, especially as they include the leading financial centres, several of which are lynch-pins of the offshore system. Thus, Switzerland and Luxembourg continue to offer minimal levels of transparency in tax matters. However, other OECD financial centres are also significantly deficient. In particular, both the UK and the US allow payment of interest gross to non-residents without requiring any notification of payee details, so that they are not able to supply such information even to treaty partner countries.<sup>1</sup> Proposals to introduce notification of such details were shelved, apparently due to fears of a large outflow of portfolio capital and bank deposits. Thus, the OECD campaign was easily and to some extent validly portrayed as a form of bullying of small countries. This led to the establishment of a Global Forum, which has attempted to develop 'level playing field' standards. This effort is greatly hampered by the refusal of some key countries to participate, such as Singapore and Dubai. Overall, little progress has been made. Although many havens made 'commitments' to introduce some transparency, few tax information exchange agreements (TIEAs) have actually been negotiated. This confirms that it was a mistake to abandon the initial intention to establish a multilateral framework for cooperation, since the pursuit of an adequate network of bilateral TIEAs would be a never-ending task.

12. It is clear that a new approach is needed. It must begin with a firm policy commitment to tackle all aspects of the offshore system. This must be done in a fully joined-up manner between all relevant authorities and agencies, both at the national level and multilaterally.

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<sup>1</sup> However, the UK has introduced regulations in compliance with the EU Savings Directive, for individuals (not companies) who are resident in EU or other 'fully reportable' countries: Reporting of Savings Income Information Regulations 2003 (Statutory Instrument 2003/3297, as amended) which came into force on 1 July 2005.

Much can be done by authorities in the OECD countries themselves, using their own powers and resources, especially as they are the hosts for the leading financial centres. In particular, they could obtain more extensive reports from banks on international financial transactions with an offshore component, and make such available to all relevant regulators, including the tax authorities. Some have begun to do this. Notably, Australia has established the AUSTRAC (Australian Transaction Reports and Analysis Centre) database, including data collected under AML legislation, which is more extensive than in most other countries. Importantly, officials of the Australian Tax Office (ATO) have direct access to this database, which is exceptional, perhaps unique, even among OECD countries. This enables the ATO to make systematic analyses of currency flows, to identify possible suspicious transactions. The UK is in a key position, both because of the importance of the City of London as a centre of global finance, and because very many OFCs are British Crown Dependencies, Overseas Territories, or Commonwealth countries. In fact, the initial emergence of OFCs took place with the connivance and even encouragement of some parts of the UK Government, especially the Foreign and Commonwealth Office (FCO), despite concerns voiced by the Inland Revenue. The FCO's proved a very short-sighted policy, which we should now do everything we can to reverse. We can and should take the lead in a renewed drive to end the offshore system.

I would be happy to amplify or provide further details on any points made in this submission, and to give oral evidence if this would assist the Committee.

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