

# OVERVIEW OF LEGISLATION AND GENERAL APPROACH TO FINANCIAL REGULATION IN THE EU - AN "OFFSHORE" VIEW.

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## INTRODUCTION : WHAT IS AN OFFSHORE FINANCIAL CENTRE ?

Considering that in a recent study the International Monetary Fund estimated that around 60% of global offshore financial services activity takes place in London, New York and Tokyo, it is perhaps difficult to provide a precise definition of an offshore financial centre ("OFC").

There are, of course, the often-cited indicators :

- low or zero taxation either generally or only in respect of non-residents;
- moderate or light financial regulation ;
- banking secrecy ;
- anonymity and lack of transparency;
- obstacles to the exchange of information ;
- presence in the jurisdiction of large numbers of financial institutions engaged primarily in business with non-residents.

But perhaps the most important indicator, at least in the popular perception of an OFC, is largely a geographical one - small territory, preferably an island, preferably in the Caribbean and more likely than not a common law jurisdiction. This betrays the one criterion which is increasingly used by international organisations in order to allow themselves to exclude major capitals from the definition of an OFC.

In its 1998 and 2000 Reports on « *Harmful Tax Competition : An Emerging Global Issue* »<sup>1</sup> the OECD calls it the "pervasiveness test" by which it means that :

*"the jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy »*<sup>2</sup>.

The OECD has further explained this test as meaning the following :

*« the stock of capital invested in the domestic economy operating outside the offshore financial sector is small relative to the stock of capital under management by the offshore financial sector, compared with other jurisdictions »*<sup>3</sup>.

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<sup>1</sup> Available on the OECD's website, [www.oecd.org](http://www.oecd.org)

<sup>2</sup> Para. 7 of the 2000 Report.

<sup>3</sup> Handout issued by the OECD.

A similar test is employed by the IMF in the two Papers on OFCs it published on 23 June 2000<sup>4</sup> which describe an OFC as :

*"a jurisdiction whose financial system has external assets and liabilities out of proportion to domestic intermediation designed to finance domestic economies".*

In the last four years (and largely as a result of the crisis in the Asian market, globalisation and an increase in systemic risks) OFCs, thus defined, have come under an unprecedented level of scrutiny from a number of international organisations and bodies who have sought to ensure that OFCs operate to the highest standards of regulatory and supervisory practices in the interests of financial stability.

Although certain overlaps exist, these Initiatives fall under three broad categories, namely :

1. Those which address Financial Regulation and Supervision.
2. Those which address Exchange of Information and Transparency.
3. Those which address Levels of Taxation.

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<sup>4</sup> "Background Paper on Offshore Financial Centres" and "Paper on Offshore Financial Centres-the Role of the IMF". Both Papers are available on the IMF's website <http://www.imf.org>

## **1. FINANCIAL REGULATION AND SUPERVISION.**

### **1.1 Financial Stability Forum.**

The Financial Stability Forum ("FSF") was launched on 14 April 1999 by the G-7 in order to promote stability in the international financial system. One of its initial acts was to set up a Working Group on OFCs whose mission was to *"evaluate the impact on global financial stability of the uses made by market participants of financial offshore centres, and the progress made by such centres in enforcing international prudential standards and in complying with cross-border information exchange agreements"*.

On 26 May 2000 the Working Group published a report containing a preliminary categorisation of 42 OFCs *"reflecting their perceived quality of supervision and perceived degree of co-operation"*. This categorisation fell into three groups.

Group I were jurisdictions generally viewed as co-operative with a high quality of supervision and largely adhering to international standards. Eight OFCs were found to fall into this category<sup>5</sup>.

Group II were jurisdictions generally seen as having procedures for supervision and co-operation in place, but where actual performance falls below international standards and there is substantial room for improvement. Nine OFCs were found to fall into this category<sup>6</sup>.

Group III were jurisdictions generally seen as having low quality of supervision, un-co-operative and with little attempt being made to adhere to international standards. Twenty-five OFCs were found to fall into this category<sup>7</sup>.

The FSF made a number of recommendations and invited the IMF to take on the main responsibility for conducting fuller assessments of the jurisdictions in question.

### **1.2 International Monetary Fund.**

In July 2000, the IMF launched its programme of independent assessment of the OFCs listed by the FSF. The terms of reference which the IMF has set

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<sup>5</sup> Dublin, Guernsey, Hong Kong, Isle of Man, Jersey, Luxembourg, Singapore, Switzerland.

<sup>6</sup> Andorra, Bahrain, Barbados, Bermuda, Gibraltar, Labuan, Macao, Malta, Monaco.

<sup>7</sup> Anguilla, Antigua & Barbados, Aruba, Bahamas, Belize, BVI, Cayman Islands, Cook Islands, Costa Rica, Cyprus, Lebanon, Liechtenstein, Marshall Islands, Mauritius, Nauru, Netherlands Antilles, Niue, Panama, Samoa, Seychelles, St. Kitts & Nevis, St. Lucia, St. Vincent & Grenadines, Turks & Caicos and Vanuatu.

itself are comprehensive, based on the following main standards developed by the relevant international supervisory bodies :

- the 25 Basel Core Principles for Effective Banking Supervision ("BCP"), with respect to banking activities ;
- the 17 Core Principles adopted by the International Association of Insurance Supervisors ("IAIS"), with respect to insurance activities.
- the 30 Objectives and Principles established by the International Organisation of Securities Commission ("IOSCO"), with regard to the regulation and supervision of investment and securities activities ;
- there are no international standards as yet in the area of company and trust regulation and supervision, but the IMF has followed the broad principles applied in the Edwards Report on the Review of Financial Regulation in the Crown Dependencies (November 1998) and in the KPMG Report on the Review of Financial Regulation in the Caribbean Overseas Territories and Bermuda (October 2000).
- 9 of the 40 FATF Recommendations on money laundering.

In applying these standards to the OFCs, four key concerns were to be addressed :

1. Licensing practices for the establishment of financial entities.
2. Proper "know your customer" rules and other anti-money laundering requirements.
3. Institutional arrangements which are in place to ensure a proper functioning of the mechanisms for consolidated supervision and information sharing.
4. Reporting requirements, particularly with regard to prudential supervision.

The IMF has offered three assessment modules to the OFCs :

Module 1 : self-assessment assisted by a staff member of the IMF. This would ideally be carried out by an independent body but the assessment would carry no endorsement from the IMF (Edwards Report level).

Module 2 : a team of IMF-appointed evaluators would verify in detail and on-site the information supplied by the jurisdiction and have unfettered access and rights to the supervisory processes and procedures. This type of assessment is the same in substance and form as those carried out on major countries such as Canada.

Module 3 : full IMF type assessment. However, this Module would only be available to jurisdictions having a substantial onshore market in banking and insurance as well as having a securities exchange. Therefore unavailable to most OFCs.

As at the end of 2002, the IMF had assisted in 12 Module 1 assessments<sup>8</sup> and conducted 10 Module 2 assessments<sup>9</sup>. It has scheduled, or is already undergoing, a further 20 Module 2 assessments<sup>10</sup> with a view of assessing all OFCs by the end of 2003.

Four Module 2 assessments have already been published (Aruba, Cyprus, Gibraltar and Panama).

Gibraltar volunteered for a Module 2 assessment back in October 2000. The IMF published its Report in October 2001 and judged that Gibraltar was compliant with 66 out of the 67 internationally-accepted standards. The IMF came to the following conclusions :

*"The results of our assessments indicated that supervision is generally effective and thorough and that Gibraltar ranks as a well-developed supervisor. It meets most of the international standards and 'good practices' and is making considerable progress with respect to those principles with which it is not yet fully compliant or observant.*

*There is a high level of compliance with the [25] Basel Core Principles for Effective Banking Supervision. Gibraltar is compliant with 18 of the principles and largely compliant with the other 7.*

*Insurance is also supervised to a good standard. Gibraltar is observant of 13 of the [17] Core Principles promulgated by the IAIS, largely observant of 3 others and materially non-observant of 1. The latter relates to on-site visits and Gibraltar is aware of this weakness<sup>11</sup>.*

*With regard to the regulation and supervision of investment and securities activities, Gibraltar was assessed with respect to the 30 IOSCO principles and is fully compliant with 19, largely compliant with 3 and 8 are not applicable.*

*In the area of company and trust regulation and the supervision of company and trust service providers, where there are no international standards as yet, Gibraltar is at the forefront of the development of good practices. It is worth noting that Gibraltar was one of the first jurisdictions to have introduced regulation and supervision of the company and trust services business".*

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<sup>8</sup> Andorra, Antigua & Barbuda, Aruba, Dominica, Grenada, Monaco, Netherlands Antilles, Niue, Panama, St. Kitts & Nevis, St. Lucia, St. Vincent and the Grenadines.

<sup>9</sup> Andorra, Aruba, Belize, Cyprus, Gibraltar, Macao, Palau, Panama, Seychelles,

<sup>10</sup> Covering, amongst others, the Crown Dependencies and the remaining British Overseas Territories.

<sup>11</sup> Gibraltar has already addressed this matter notwithstanding the fact that many major countries, including the UK, do not carry out on-site visits to insurance companies.

The IMF also judged that Gibraltar's Regulator, the Financial Services Commission, "*carries out its duties diligently and has an intimate knowledge of the institutions under its supervision*".

It is important to retain two aspects of the IMF assessments. Firstly, the high-level of compliance with international standards by OFCs such as Gibraltar. Secondly, and equally importantly, the commitment by OFCs to subject themselves, and to respond, to this thorough process of evaluation.

### **1.3 Financial Action Task Force (FATF).**

The Financial Action Task Force ("FATF"), which is based at the OECD, was established by the G-7 in 1989 to help protect financial systems from criminal use for the laundering of the proceeds of drug related and other serious crime.

The FATF has adopted a list of 40 Recommendations which have come to be recognised as a statement of best practice in the fight against money laundering<sup>12</sup>.

Since 1998, the FATF has been engaged in a significant initiative to identify key anti-money laundering weaknesses in jurisdictions inside and outside its membership. In this context, on 14 February 2000, it published an initial Report on non-co-operative countries and territories in the international fight against money laundering. The Report set out 25 criteria (consistent with the FATF 40 Recommendations) to identify detrimental rules and practices which impede international co-operation in the fight against money laundering. The Report also contained a set of counter-measures that FATF members could apply in order to protect their economies from the proceeds of crime.

Acting on this basis, the FATF carried out a review of 29 jurisdictions (most of which were OFCs) and in a Report published on 22 June 2000 found that 14 of these were co-operative<sup>13</sup> with 15 being found unco-operative in the fight against money laundering<sup>14</sup>.

The FATF has also been pursuing its more detailed programme for mutual evaluation and compliance by OFCs with the 40 FATF Recommendations. On 22 November 2002, it produced its report on Gibraltar finding that :

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<sup>12</sup> The list of the FATF Recommendations, as well as all the Reports referred to in this section, can be found at the FATF's website : [www.oecd.org/fatf](http://www.oecd.org/fatf)

<sup>13</sup> Antigua & Barbuda, Belize, Bermuda, BVI, Cyprus, Gibraltar, Guernsey, Isle of Man, Jersey, Malta, Mauritius, Monaco, Samoa, St. Lucia.

<sup>14</sup> Bahamas, Cayman Islands, Cook Islands, Dominica, Israel, Lebanon, Liechtenstein, Marshall Islands, Nauru, Niue, Panama, Philippines, Russia, St. Kitts & Nevis, and St. Vincent & the Grenadines. Since June 2000, the list of non-co-operative jurisdictions has been updated with de-listing and new entries. As at 11 October 2002, the list of non-co-operative jurisdictions was as follows : Cook Islands, Egypt, Grenada, Guatemala, Indonesia, Myanmar, Nauru, Nigeria, Philippines, St. Vincent & the Grenadines and Ukraine. The FATF has recommended the adoption of counter-measures against Nigeria and Ukraine.

*"Gibraltar has in place a robust arsenal of legislation, regulations and administrative practices to counter money laundering. The authorities clearly demonstrate the political will to ensure that their financial institutions and associated professionals maximise their defences against money laundering and co-operate effectively in international investigations into criminal funds. Gibraltar is close to complete adherence with the FATF 40 Recommendations".*

#### **1.4 The British OFCs.**

The position of the British OFCs in respect to all the current initiatives on financial regulation and supervision may be summarised as follows.

##### **1.4.1 Gibraltar.**

As seen above, Gibraltar has met all the relevant international initiatives in a constructive fashion. It has been held out by the UK Government to the other British Overseas Territories as a benchmark in financial regulation. Andrew Edwards cited Gibraltar in similar terms in his Review of the Crown Dependencies (see below).

Gibraltar's position is interesting for two reasons : (1) it is the only British territory, outside the United Kingdom itself, to which all EU legislation on financial services and regulation applies and (2) it is probably the only OFC, understood in the popular sense, which is an integral part of the EU.

This obviously means that where EU legislation exists Gibraltar's laws on financial regulation and supervision are no different to those in the 15 Member States. In some cases, Gibraltar's compliance with relevant EU obligations has come faster, and in a more comprehensive manner, than in many Member States. For instance, Gibraltar was, on 1 July 1995, one of the first jurisdictions within the EU to implement the EU's Money Laundering Directive on an all-crimes basis.

As a result of Gibraltar's general legislative autonomy from the UK, the Gibraltar parliament (the House of Assembly) is responsible for the implementation of EU obligations within the internal legal order of Gibraltar. The two main effects of this autonomous legislative responsibility, which are particularly relevant in the area of financial services and regulation, are that Gibraltar has its own legislation in these areas and that it sets up its own authorities.

With respect to legislation, Gibraltar is required to match UK standards of financial regulation wherever EU legislation applies. With respect to the setting up of authorities, Gibraltar has its own regulator, the Financial Services Commission ("FSC").

The FSC was set in 1989. It is fully independent of the Gibraltar Government and totally separate from the Financial Services Authority in the UK although it is appointed by the UK Government. Its functions mirror those of the FSA in the UK.

The FSC is the sole regulatory and supervisory authority for financial services providers operating in or from Gibraltar and is under a statutory obligation to match UK supervisory standards where EU law applies. This was a first and fundamental step towards ensuring that the FSC became a recognised competent authority within the EU.

There is a statutory obligation (Section 12 FSO 1989) for these standards to be regularly reviewed by a team of UK experts appointed by the UK Government. To date, two such reviews have taken place in the areas of banking and insurance and the FSC has been found to match UK supervisory standards. As a result, the FSC can authorise the pass-porting of banking and insurance licences from Gibraltar into the EU. A third review, covering investments services, is expected shortly.

#### **1.4.2 The Crown Dependencies.**

The Edwards Report on the "Review of Financial Regulation in the Crown Dependencies" was published by the UK Government in November 1998.

It provided the first comprehensive analysis of the offshore business, and its supervision, in the Crown Dependencies. The Report reviewed the activities of banks, investment and securities business, insurance companies, trusts and investment services providers and contained an assessment of their anti-money laundering laws. It assessed the practices in the Dependencies against the relevant international standards and good practices.

The Report commended the generally high standards of supervision in the CDs. Andrew Edwards stated :

*"I have no doubt that the Islands are in the top division of offshore centres" ;*

*"Some critics also sometimes object to secrecy, poor regulation and poor co-operation in offshore centres. Such criticisms, if applied to the Crown Dependencies, would generally, in my opinion, be quite wide of the mark. For the most part, the position in the Islands is quite the opposite of what such criticisms would imply" ;*

*"the Islands have impressive arsenals of financial, company and criminal legislation".*

The main recommendations made concerned the following areas :

- the estimated 100,000 offshore companies to make public accounts filings ;

- ownership disclosure of offshore companies to the regulators in the CDs ;
- strict action against offshore trust companies with a need for greater transparency and documentation of trustees and beneficiaries ;
- stricter regulations to address money laundering ;
- mandatory co-operation with the UK Inland Revenue.

### **1.4.3 The British Overseas Territories in the Caribbean and Bermuda.**

In March 1999, the UK Government published a White Paper on "Partnership for Progress and Prosperity – Britain and the Overseas Territories" which, amongst other things, called for an in-depth independent review of the Overseas Territories' financial centres by regulatory experts. In December 1999, KPMG was appointed to undertake such a review in respect of 5 Overseas Territories in the Caribbean (Anguilla, BVI, Cayman Islands, Montserrat, Turks & Caicos) and Bermuda.

The UK Government published the KPMG Report in October 2000.

The review provides a rigorous and comprehensive evaluation of how far the Overseas Territories already match international standards and good practice covering banking, insurance, securities, trusts, company law, anti-money laundering legislation and arrangements which are in place for co-operation with overseas regulatory and law enforcement authorities.

Clearly the level of compliance varied between the territories but, generally, the findings made by KPMG were as follows :

Anguilla	has many of the features necessary to be considered a well-regulated jurisdiction. Willingness to implement changes.
Bermuda	has one of the most developed offshore regulators, meeting or exceeding many international standards. Very strong control on company formation.
BVI	has made demonstrable efforts to bring its financial regulatory system into line with international standards. Making good progress in relation to AML.
Cayman Islands	recent introduction of legislation (2000) has greatly improved assistance to foreign regulators in obtaining relevant information for supervisory purposes and for civil and administrative proceedings.

Montserrat	has clearly made efforts to ensure that its financial services activities are governed by an appropriate statutory framework (otherwise bad report)
Turks & Caicos	much progress has been made in enhancing the regulatory framework (otherwise bad report).

Three general priority areas for further action were identified :

- legislation for the establishment of independent regulatory authorities ;
- enhancement of the anti-money laundering rules ;
- introduction of legal powers (where necessary) to allow regulatory authorities to obtain key information and to exchange it with other regulatory authorities.

## **1.5 Conclusion.**

In 1998, the European Commission granted a research award under Programme Falcone 1998 as part of the project "Euroshore - Protecting the EU financial system from the exploitation of financial centres and offshore facilities by organised crime". The Report, adopted in January 2000, comes to the following conclusion :

*"The distinction between offshore and onshore is losing much of its conventional meaning if construed as the opposition between opacity and transparency. Some offshore jurisdictions (i.e. EU financial centres and offshore jurisdictions and economies in transition) are moving towards tougher criminal law legislation and international co-operation and somewhat more transparency, while others (i.e. non-EU offshore jurisdictions) adhere to their traditions of lenient criminal law, non-cooperation and opacity. At the same time, countries with long traditions as financial centres display the same or lower standards of regulation to those officially termed 'offshore'".*

I consider that this finding corroborates the analysis made in this first section of this paper and, notably, the efforts made by OFCs to commit to assessments and, in the case of many, to have been found to have financial regulation and supervision meeting the highest international standards.

## 2. EXCHANGE OF INFORMATION AND TRANSPARENCY.

### 2.1 OECD.

In 1998 the OECD published its Report on « *Harmful Tax Competition* »<sup>15</sup>. The OECD's Forum on Harmful Tax Practices proceeded to draw up a list of 47 jurisdictions (all OFCs) that appeared to them to have the potential for satisfying the tax haven criteria set out in the 1998 Report. It then conducted a series of technical evaluations and concluded that 41 of these jurisdictions met the tax haven criteria<sup>16</sup>.

These jurisdictions were then required to give a public commitment to the OECD by 28 February 2002 to remove all harmful tax practices by 31 December 2005. Failure to make such a commitment would lead to the jurisdiction featuring on a Black List of Uncooperative Tax Havens and to be liable to the imposition of defensive measures by OECD Member countries.

In April 2002, the OECD published its Black List. Of the 41 jurisdictions which had been found to meet the OECD's tax haven criteria, only 7 had, at that date, refused to make a commitment<sup>17</sup>. Dialogue with these 7 jurisdictions is ongoing.

The 34 "tax havens" which have made a commitment have undertaken to remove the harmful tax practices identified by the OECD. These harmful tax practices are :

- (1) **Lack of effective exchange of information**, by which is meant « *laws or administrative practices under which businesses and individuals can benefit from strict secrecy rules and other protection against scrutiny by tax authorities thereby preventing the effective exchange of information on tax payers benefiting from the low tax jurisdiction* »<sup>18</sup>.
- (2) **Lack of transparency**, by which is meant that « *the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure* »<sup>19</sup>. Typical instances of lack of transparency would be (i) negotiable tax rates, (ii) obstacles to the identification of beneficial ownership, (iii) obstacles to access to bank information and (iv) inadequate rules on the keeping and auditing or filing of accounts<sup>20</sup>.

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<sup>15</sup> A Progress Report was published in 2000. Both Reports are available at the OECD's website : [www.oecd.org](http://www.oecd.org)

<sup>16</sup> The OECD also carried out a parallel evaluation of preferential tax regimes in OECD Member countries. It is to be noted that both Switzerland and Luxembourg have not endorsed the OECD's 1998 Report in full.

<sup>17</sup> Andorra, Liechtenstein, Monaco, Liberia, the Marshall Islands, Nauru and Vanuatu.

<sup>18</sup> Paragraph 52 of the 1998 Report.

<sup>19</sup> Paragraph 7 of the 2000 Report.

<sup>20</sup> Originally, the OECD also identified as a harmful tax practice preferential tax rates offered only to non-residents and to entities with no substantial activities within the jurisdiction. This

The letters of commitment of the 34 "tax havens" can be found in the OECD's web-site. Although individually negotiated, they all contain the same core commitments. These are :

***Effective Exchange of Information.***

- (1) *To allow tax information to be exchanged, only upon specific request, with designated authorities in OECD Member countries, in criminal tax matters by 31 December 2003 and in civil tax matters by 31 December 2005.*
- (2) *Not to introduce bank secrecy laws.*
- (3) *To provide the requested information without regard to whether or not the jurisdiction has a tax interest in the case or in obtaining the information.*

*In criminal tax cases, to provide the information without the requirement that the conduct being investigated would constitute a crime under the laws of the jurisdiction had it occurred there.*

- (4) *To negotiate tax information exchange agreements in accordance with the foregoing, subject to there being full reciprocity including adequate protection against the unauthorised disclosure of information by the receiving jurisdiction. A number of jurisdictions have made this commitment without prejudice to Article 17 of the International Covenant on Civil and Political Rights and Article 8 of the European Convention of Human Rights.*

***Transparency.***

- (1) *To enable beneficial ownership information of companies, partnerships, and other entities organised, operating or having a place of business in the jurisdiction, to be available to the tax authorities in the jurisdiction.*
- (2) *To enable information on the settlors and beneficiaries of trusts organised, operating or having a place of business in the jurisdiction, to be available to the tax authorities in the jurisdiction.*
- (3) *To require companies and other business entities incorporated or operating in the jurisdiction to draw up accounts in accordance with generally accepted international standards; such accounts to be either (i) audited or (ii) filed on a public basis or (iii) filed on a non-public basis with the tax authorities in the jurisdiction.*

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was dropped as a result of opposition by the Bush administration to interference with tax rates.

- (4) *To ensure that the tax authorities in the jurisdiction have access to bank information relevant to tax matters of business enterprises, individuals and other entities including trusts.*
- (5) *To abolish the ability for investors to negotiate the tax rate to be applied.*
- (6) *To abolish share warrants to bearer.*

In January 2002, the OECD published a model instrument on exchange of information, covering both civil and criminal tax matters, which the "tax havens" will be required to enter into either on a multilateral or bilateral basis with every OECD member country.

This agreement will set the standard for exchange of information and such standards will clearly apply in the same way to onshore and offshore jurisdictions.

## **2.2 EU Savings Directive.**

A Directive to ensure the effective taxation of savings income in the form of interest payments within the Community (commonly known as the Savings Directive) was one of the elements of the Tax Package approved by the ECOFIN Council on 1 December 1997<sup>21</sup>.

The objective of the Directive is to enable savings income in the form of interest payments made in one Member State to beneficial owners (individuals) resident for tax purposes in another Member State to be subject to effective taxation in the Member State where the beneficial owner is resident for tax purposes.

Acting on the ECOFIN approval of 1 December 1997, the European Commission submitted a first draft proposal for the Directive in 1998<sup>22</sup>. A principal feature of this proposal was the possibility granted to all Member States to achieve the objective of the Directive either by introducing a system of automatic exchange of information or a withholding tax system (the so-called co-existence model).

Since then, and as a result of well-reported opposition of some Member States to the co-existence model, in particular the UK, the Council departed from its original terms of reference and at the ECOFIN Council at Feira on 20 June 2000 they agreed to abolish the co-existence model and to establish a regime based exclusively on automatic exchange of information. A possibility was however granted to named Member States to apply a withholding tax, instead of exchange of information, during a pre-determined transitional period. The withholding tax applies to the interest.

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<sup>21</sup> "Conclusions of the ECOFIN Council meeting on 1 December 1997 concerning taxation policy, 98/C 2/01.

<sup>22</sup> COM (1998) 295 final - 98/0193 (CNS).

As a result, the Commission withdrew its 1998 proposal and presented a new proposal in June 2001 reflecting the new political agreement reached<sup>23</sup>. The June 2001 proposal was subject to some small amendments in December 2001. This remains the current text<sup>24</sup>. It is expected that the Directive will be adopted in March 2003.

One of the exceptional features concerning the Savings Directive is that the Member States have agreed that its adoption is conditional upon so-called sequencing arrangements. Thus, the following pre-conditions have to be met before the Directive can be unanimously adopted :

- (a) The adoption of « *equivalent measures* » in key third countries. These are named as being the US, Switzerland, Liechtenstein, Monaco, Andorra and San Marino.
- (b) The adoption of the « *same measures* » in all relevant dependent or associated territories of the Member States. These are named as being the Channel Islands, the Isle of Man and the dependent or associated territories in the Caribbean.

The Council spent the year 2002 trying to obtain the said sequencing arrangements, and after some difficult negotiations, particularly with Switzerland, political agreement was finally reached in the ECOFIN of 21 January 2003. The "compromise" reached is as follows :

- the Directive will have to be implemented by 1 January 2004 ;
- twelve Member States will introduce automatic exchange of information as from 1 January 2004 ;
- the three remaining Member States (Austria, Belgium and Luxembourg) will be granted a transitional period during which they will be allowed to apply a withholding tax system (instead of exchange of information) at the following progressive rates - 15% between 1 January 2004 to 31 December 2006, 20% between 1 January 2007 to 31 December 2009 and 35% as from 1 January 2010 ;
- Switzerland and the other named third countries (except the US)<sup>25</sup> will benefit from the same withholding tax transitional period as above ;
- that will remain the position until such time as Switzerland and the other named third countries agree to move to exchange of information upon request as defined in the OECD model agreement;

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<sup>23</sup> COM (2001) 400 final – 2001/0164 (CNS). This proposal is accompanied by a very detained Explanatory Memorandum.

<sup>24</sup> It is annexed to the ECOFIN Council conclusions of 13 December 2001, Document N° 15139/01.

<sup>25</sup> The US will conclude bilateral agreements with the Member States on exchange of information upon request.

- "if and when" the Swiss and other third countries agree to exchange of information upon request, Austria, Belgium and Luxembourg will move to automatic exchange of information.

It remains unclear at the time of writing whether the dependent and overseas territories will be able to benefit from the same transitional withholding tax period or whether they will be required to introduce automatic exchange of information as from 1 January 2004.

The principal effects of this political compromise are that :

- three major Member States are allowed to apply a withholding tax during a transitional period, when dependent territories may be required to apply automatic exchange of information as from 1 January 2004 ;
- the transitional period is open-ended, it will only be closed *"if and when"* Switzerland agrees to exchange of information upon request based on the OECD model ;
- the most that major players, such as Switzerland and the US, will be asked for is to exchange information upon request whereas dependent territories (most of which are not within the EU) and the rest of the EU will be subject to the significantly more onerous obligation of automatic exchange of information.

So much for uniformity, so much for a level playing field. It is highly questionable whether the EU is geographically large enough to be able to achieve the objective it has set itself in proposing this Directive and it is probable that the main effect of the Directive will be an exodus of capital from the EU, even to jurisdictions as near to it as those covered by the sequencing arrangements.

### **3. LEVELS OF TAXATION.**

Although strictly speaking not an issue of financial regulation I would like to conclude with a few words on taxation which is a determining feature of an OFC, is closely interwoven with financial regulation and is highly topical at the moment within the EU, the EU being the only international organisation which is currently tackling tax rates.

There are two initiatives in this area :

- (a) The « *Code of Conduct for Business Taxation* » adopted in a Resolution of the Council of the European Union on 1 December 1997.
- (b) The re-inforced application of the state aid rules to tax measures.

### 3.1 EU Code of Conduct for Business Taxation.

The EU Code of Conduct forms part of the Tax Package approved by the Council on 1 December 1997<sup>26</sup>. It was adopted with the aim of establishing co-ordinated action at European level to tackle what is perceived to be harmful tax competition.

Paragraph A of the EU Code provides that the Code « *covers business taxation* » and « *concerns those measures which affect, or may affect, in a significant way the location of business activity in the Community* ».

Paragraph B of the EU Code provides as follows :

*« tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this Code ».*

It goes on to provide that when assessing whether a tax measure is harmful :

*« ...account should be taken of, inter alia :*

- 1. whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or*
- 2. whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or*
- 3. whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or*
- 4. whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD, or*
- 5. whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way ».*

What is critical in the definition of "harmful" in so far as OFCs are concerned, is the reference to whether a measure grants tax benefits only to non-

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<sup>26</sup> The other two measures in the Tax Package are a proposal for a Directive on the Taxation of Savings Income (also examined in this Paper) and a proposal for a Directive on withholding taxes on cross-border interest and royalty payments between companies (which is uncontroversial).

residents or only to transactions which are ring-fenced from the domestic economy.

Paragraph M of the Code provides as follows :

*"The Council considers it advisable that principles aimed at abolishing harmful tax measures should be adopted on as broad a geographical basis as possible. To this end, Member States commit themselves to promoting their adoption in third countries; they also commit themselves to promoting their adoption in territories to which the Treaty does not apply.*

*In particular, Member States with dependent or associated territories or which have special responsibilities or taxation prerogatives in respect of other territories commit themselves, within the framework of their constitutional relationships, to ensuring that these principles are applied in those territories..."*

On 29 November 1999, the Code of Conduct Group, headed by Dawn Primarolo, submitted to ECOFIN a Report containing a list of 66 measures which were found to be harmful out of the 271 tax measures originally short-listed. 23 of these measures concern OFCs which do not form part of the EU (the Crown Dependencies, the British Virgin Islands, Aruba and the Netherlands Antilles). If one adds to these the 3 measures listed in respect of Gibraltar, it means that 26 of the 66 so-called harmful measures concerned OFCs.

It is clear from a Report presented by the Code of Conduct Group to the ECOFIN Council of 3 December 2002 that all of these OFCs are committed to roll back their harmful tax measures. The final deadline for roll back will be decided, at the latest, by the ECOFIN Council of 7 March 2003. It is to be noted that in the ECOFIN of 21 January 2003, certain grand-fathering concessions have already been granted to some Member States, notably, Belgium, Ireland, Luxembourg, the Netherlands and Portugal.

In response to the Code of Conduct, and to the pressure being exercised by the UK Government, the Crown Dependencies and the BVI have stated that they will be reforming their tax laws, moving to similar tax regimes to that proposed by Gibraltar (discussed hereunder).

### **3.2 Article 87 EC - State Aid.**

At Paragraph J of the Code, the Council noted that « *some of the tax measures covered by this Code may fall within the scope of the provisions on State aid in Articles 92 to 94 of the Treaty* »<sup>27</sup>. The Council further noted that « *the Commission undertakes to publish guidelines on the application of the State aid rules to measures relating to direct business taxation...and commits*

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<sup>27</sup> Since then, re-numbered to Articles 87 to 89 of the Treaty.

*itself to the strict application of the aid rules concerned, taking into account, inter alia, the negative effects of the aid that are brought to light in the application of this Code ».*

On 10 December 1998 the EC Commission published the said Guidelines<sup>28</sup>. The Guidelines set out, and purport to clarify, the Commission's new approach to fiscal state aids.

Of interest to the offshore world is the comment made at para. 26 of the Guidelines to the effect that :

*"Certain exceptions to the tax rules are, however, difficult to justify by the logic of a tax system. This is, for example, the case if non-resident companies are treated more favourably than resident ones or if tax benefits are granted to head offices or to firms providing certain services (for example, financial services) within a group".*

Acting on the basis of fiscal measures which had been identified as harmful by the Code of Conduct Group, on 11 July 2001 the EC Commission opened state aid investigation procedures into 15 fiscal measures. Of these, the only ones which concern an "offshore tax regime" are the two investigations opened in respect of Gibraltar's two principal offshore corporate vehicles, the exempt and the qualifying companies.

The Gibraltar Government challenged the opening decisions before the CFI on procedural grounds and was largely successful<sup>29</sup>.

The Gibraltar Government has some doubt as to whether an offshore tax regime can be considered "selective" for the purpose of Article 87 EC<sup>30</sup> but, without prejudice to that position, it has determined to reform its entire corporate tax regime so as to remove the distinction between "offshore" and "onshore" tax rates.

Gibraltar's new tax regime was notified to the Commission on 9 August 2002. The Commission opened an investigation procedure under Article 88 (2) EC on 16 October 2002 and on 4 December 2002 it invited comments from third parties<sup>31</sup>.

The essential feature of the new tax regime is the abolition of taxation of company profits. The general system of taxation will become :

- a registration fee for all companies ;
- a payroll tax and business property tax for all companies capped at 15% of profits.

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<sup>28</sup> Communication 98/C 384/03, OJ 1998 N°C 384/3.

<sup>29</sup> Joined Cases T-195/01 & T-207/01, Gibraltar Government v EC Commission, judgment of 30 April 2002.

<sup>30</sup> The EC Commission considers that an offshore tax regime is selective because it grants favourable tax treatment to offshore companies as compared to onshore companies.

<sup>31</sup> OJ N° C 300/2, of 4 December 2002.

In addition, companies operating in the financial services sector will be subject to a top up tax at a rate to be determined and utility companies will be subject to a top-up tax of 35% of profits.

The case gives rise to interesting issues, not least, because it is the first time that an entire tax regime has been notified to the Commission under state aid procedures. An issue of particular interest to the offshore world is that one of the doubts which the Commission has expressed at this stage of its investigation is whether the entire regime could be considered selective on the grounds that companies in Gibraltar would suffer tax at a lower rate than companies in the UK, the Member State which has responsibility for Gibraltar under the EC Treaty. The Commission calls this the "regional specificity" theory. As currently framed, it appears to suggest that Gibraltar must have the same tax system as the UK. Both the UK and Gibraltar Governments are of the view that this theory holds no water.

#### **4. CONCLUSION.**

A harmonised OFC approach to financial regulation does not exist. Different OFCs react to financial regulation in a different way in much the same way as a different approach exists amongst the Member States.

The overall conclusion to be reached, at least in respect of the main and more sophisticated OFCs, is that the distinction between offshore and onshore is no longer a valid one particularly in the areas of financial regulation and supervision and on exchange of information and transparency.

Four specific conclusions :

1. Compliance in full with international standards and "good practice" in all matters concerning financial regulation and supervision and anti-money laundering rules. There is a future with compliance. Gibraltar's experience is that there is an increasing market demand for this.
2. Compliance also with transparency and exchange of information upon request in relation to companies and in respect of both civil and criminal tax matters. Thirty four offshore centres have already given a commitment to the OECD to apply the same rules and standards as OECD member countries and to enter into a multilateral agreement or bilateral meetings with them.
3. It is still too early to comment on the automatic exchange of information in a future EU Savings Directive concerning individuals. This is the case, not because OFCs may not be prepared to comply, but because the EU has dramatically failed to provide a level playing field, purports to grant preferential treatment to three Member States and appears

content to accept and inherently discriminatory and unfair permanent regime.

4. OFCs would insist on two things.

4.1 A level playing field - OFCs not to be treated more harshly than major countries. The EU Savings Directive is a grotesque example of the absence of such a level playing field. A level playing field also means greater access for OFCs to standard setting bodies particularly in the area of financial regulation.

4.2 No interference with the setting of corporate tax rates. Once strong regulation and transparency is in place, healthy tax competition must be encouraged. Fixation against low tax rates displayed by some Member States must be cured. Even here, OFCs are prepared to go some of the way by removing the distinction between onshore and offshore tax rates (ring-fencing), notably by committing to the EU Code of Conduct and, in Gibraltar's case, state aid rules. But fiscal sovereignty must be protected and the existing rules which are available must not be distorted or abused in order to pursue a tax harmonisation agenda.

