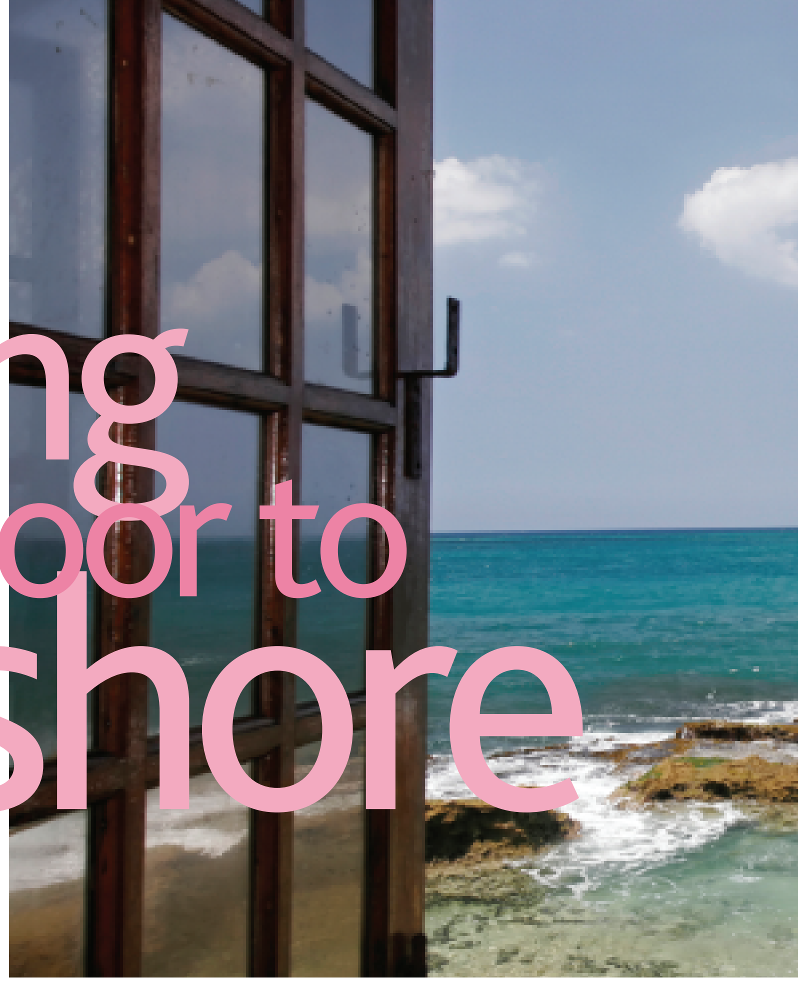
Opening the door to offshore



Offshore financial centres are low-tax jurisdictions with relatively large numbers of financial institutions engaged primarily in business with non-residents. They specialise in providing the commercial infrastructure to help form offshore structures and invest offshore funds.

Executive summary

- Northern Rock's funding methods caused controversy in the press, particularly for its use of an offshore trust. Yet much of the coverage was based on misplaced assumptions about offshore jurisdictions. Reputable offshore financial centres play a legitimate and integral role in international finance and offer corporations attractive risk management and financial planning opportunities.

WHAT HAVE OFFSHORE FINANCIAL CENTRES DONE TO ADDRESS THEIR POOR IMAGE?

Jonathan Rigby Offshore financial centres (OFCs) have recently attracted much more attention than in the past, and international initiatives spearheaded by the OECD, the Financial Action Task Force and the IMF have had a significant effect on the offshore finance industry. A number of smaller, less regulated and less reputable OFCs have been forced to close.

Dean Godwin Most of the principal offshore centres – such as Jersey, Guernsey, the Cayman Islands and Luxembourg – have considerably strengthened their anti-money laundering rules, tightened their laws on certain regulated activities, and begun to phase out tax practices regarded as harmful.

JR Just last year *The Economist,* historically very hostile towards OFCs, published a survey of OFCs which represented a shift towards a much more benign view of their role. The report concluded that, "Although international initiatives aimed at reducing financial crime are welcome, the broader concern over offshore finance centres is overblown. Well-run jurisdictions of all sorts, whether nominally on or offshore, are good for the global financial system."

HOW DOES NORTHERN ROCK FIT INTO THIS?

Daniel Le Blancq Far from being a secret or unusual business practice, the creation of the Granite securitisation structure by Northern Rock was, and is, a common practice among banks and a huge range of other businesses. Securitisation aims to turn a future stream of income into a lump sum of cash today which can be used to grow the business. The Northern Rock securitisation involved the sale of mortgages it had issued to homebuyers to Granite, a Jersey receivables trust. Banks that carry out securitisations often locate these trusts in Jersey or other OFCs where trust law is favourable to the structures and tax neutrality can be achieved.

JR Some commentators argued that Granite was set up to avoid tax, but this is simply not true. At a trust level, Granite is tax-neutral. Like any securitisation, the purpose of the master trust is to allow a company to tap the capital markets by securitising a pool of assets.

DG Unfortunately, it was widely reported that Northern Rock was trying to hide assets offshore, which was not the case; the structure had been firmly in the public domain since it was established.

ARE OFFSHORE JURISDICTIONS BETTER REGULATED IN SOME WAYS THAN MANY ONSHORE FINANCIAL CENTRES?

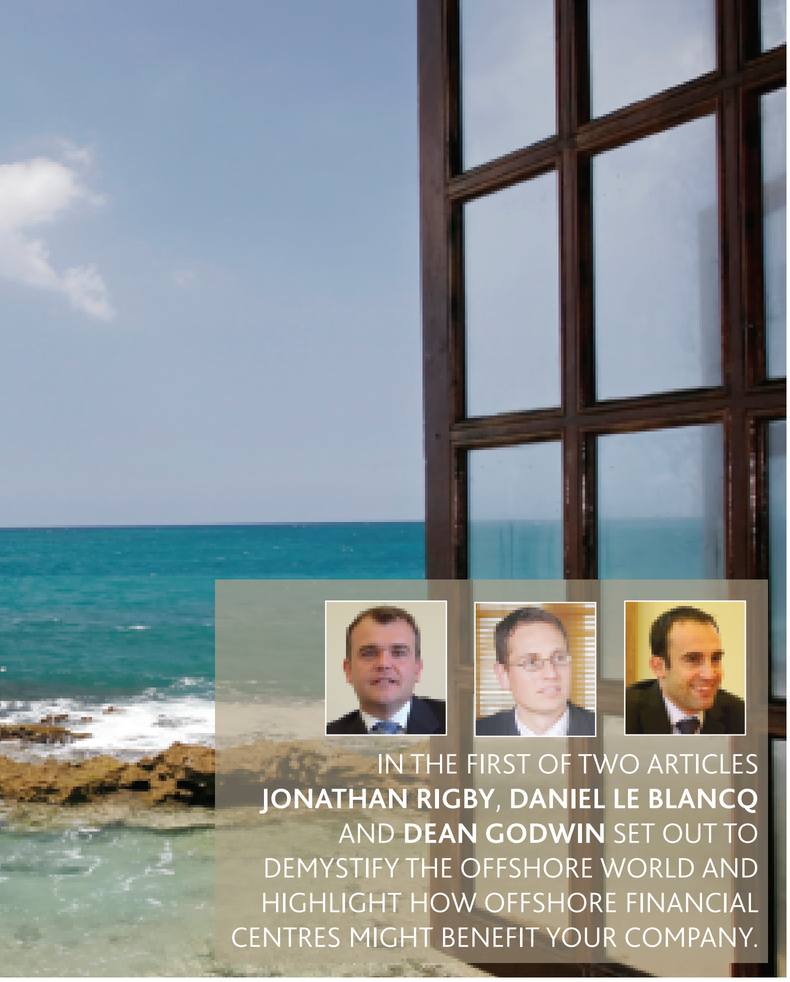
DLB Yes. For example, OFCs have led the way in regulating the provision of fiduciary services. In most offshore jurisdictions a person needs a licence to carry on business as a trustee; this is not true in many onshore jurisdictions.

WHY SHOULD TREASURERS USE OFCS AND WHAT STRUCTURES HAVE SPECIFIC BENEFITS FOR THEIR COMPANIES?

DLB The key benefits of using an OFC are tax-neutrality, light but effective regulation, a flexible legal framework, the presence of vehicles which are not available onshore, and the expertise and specialisation of the offshore service providers.

JR The bedrock of most OFCs is the formation of offshore structures which typically involve offshore companies, partnerships or trusts. They are frequently used as joint venture vehicles, either as a compromise neutral jurisdiction or because the jurisdiction in which the joint venture operates has insufficiently sophisticated corporate and commercial laws.

DG Large corporate groups often form offshore companies, sometimes under a so-called orphan structure, to establish non-



IN THE FIRST OF TWO ARTICLES **JONATHAN RIGBY**, **DANIEL LE BLANCQ** AND **DEAN GODWIN** SET OUT TO DEMYSTIFY THE OFFSHORE WORLD AND HIGHLIGHT HOW OFFSHORE FINANCIAL CENTRES MIGHT BENEFIT YOUR COMPANY.

recourse finance arrangements. Offshore special purpose vehicles are also often used in relation to asset-backed securities transactions, particularly securitisations.
JR In recent years we have seen significant growth in the number of businesses choosing to list on an international stock exchange through an offshore listing vehicle. It is estimated that 90% of the companies listed on Hong Kong's Hang Seng and 35% of those listed on AIM are incorporated in an OFC.

WHY ARE OFCS SO IMPORTANT FOR THE COLLECTIVE INVESTMENT FUNDS INDUSTRY?

DG Mutual funds, hedge funds, private equity funds, unit trusts and SICAVs are often formed offshore to facilitate international distribution. If they are domiciled in an OFC – where the vehicle enjoys a tax-neutral position – investors only have to consider the tax implications of their own domicile or residency.
JR OFCs tend to apply a much lighter regulatory touch to funds targeted at financially sophisticated, high net worth or institutional investors. For example, OFCs tend to impose few, if any, restrictions on what investment strategy the funds may pursue and don't unnecessarily restrict the amount of leverage which funds can employ in their investment strategy. This has made OFCs particularly attractive to the hedge fund industry; the vast majority of the world's hedge funds are domiciled in the Cayman Islands.
DLB Many OFCs – such as Jersey, Guernsey and the Cayman Islands – offer protected cell companies which permit the assets and liabilities of a company to be segregated. This vehicle – which is not usually available onshore – is extremely attractive for multi-class funds.

CHOOSING THE RIGHT JURISDICTION IS KEY WHEN CONSIDERING AN OFC. BUT WHAT ARE THE MAIN DIFFERENCES?

JR All the leading OFCs provide tax-neutrality, a relatively light regulatory environment and a well-established financial services industry. However, there are a number of key differences between these jurisdictions and some or all of them are likely to be relevant when selecting a jurisdiction.

First, there are differences in the types of vehicle available. For example, it is possible to establish a limited partnership in both Jersey and Guernsey but only Guernsey allows the partnership to have its own legal personality. The costs of establishing and running the vehicle and the timescales for obtaining local regulatory approvals (if any) can also vary considerably between jurisdictions.
DG Another factor is the degree of specialisation of each jurisdiction. Cayman, for example, is the world's leading jurisdiction for the establishment of hedge funds and has the strongest presence in the US securitisation market. Guernsey and Bermuda are the main jurisdictions for offshore reinsurance business, whereas Jersey and Ireland are the offshore jurisdictions of choice in the European structured finance market. Jersey and Guernsey are the leading jurisdictions for setting up UK property unit trusts.
DLB If the offshore vehicle is intended to attract third-party investors, it will be important to take into account any investment restrictions. For example, some investors are only permitted to invest in vehicles formed in OECD or EU member states. The investors' tax status should also be considered. Luxembourg is the jurisdiction of choice for establishing pan-European private equity and property fund vehicles largely because it has an extensive double-tax treaty network which is not available in other offshore centres.
DG To ensure the vehicle is not managed and controlled onshore for tax purposes, it is often necessary for directors based onshore to travel to the OFC to attend regular board meetings. The location, time zone and transport links of the OFC can therefore be an important factor in selecting a jurisdiction.
JR The choice of OFC will often be determined by the onshore lawyers, accountants and tax advisers who structure the transaction and are best placed to determine which jurisdiction will work best for which type of transaction. Where there is little to choose between jurisdictions, the advisers will often select the jurisdiction with which they are most familiar and where they enjoy the strongest relationships with offshore service providers.

HOW CAN OFFSHORE SERVICE PROVIDERS HELP IN SELECTING THE RIGHT JURISDICTION?

JR The emergence of a top tier of highly reputable OFCs has created a level playing field between the offshore jurisdictions, which has helped to drive consolidation in offshore finance and led to a number of offshore service providers and advisers adopting a multi-jurisdictional and multi-disciplinary approach.
DG These service providers specialise in setting up and administering offshore vehicles and the best firms are able to offer impartial advice on the relative merits of each of the OFCs in which they operate.

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Next month: specific examples of the ways in which OFCs are being used in risk management and financial planning by many of the world's leading businesses.