Offshore finance centres – bad news or just a bad press?

Rod Roman of Ernst & Young examines the effects of changing perceptions of offshore finance centres and the consequences for UK multinationals' tax burdens.

The articles in this month's International section are intended to help corporate treasurers better understand the debate about offshore finance centres, the practical environment and their prospects. The first article examines the uncertain future, but offers a message of hope. The next article looks at a major aspect of offshore centres, securitisations, as carried out in the Channel Islands. Finally, we offer some guidance on what non-tax attributes to look out for in choosing a centre.

Offshore finance centres face a multi-layered attack as far as UK multinational companies (MNCs) are concerned. The global threat is represented by the OECD. Its attack is based upon harmful tax competition and transparency. Then, along the same lines as the OECD, there is a regional threat from the EU. And, finally, a local threat in the form of the Finance Act 2000 (FA2000), which has attempted to reduce UK MNCs' appetite for going offshore. As a result, UK companies will now find it harder to use offshore tax havens to reduce their overall tax burden.

Justified pariahs?

Offshore finance centres suffer a lot of bad publicity, but is it totally justified? Of course, the use of offshore centres cannot be condoned where they have been used to facilitate fraud or to escape the eyes of the regulator. But it is worth noting that many of the world's biggest financial scandals and failures have been in highly regulated environments. Baring's Nick Leeson, Hammersmith & Fulham's and Orange County's interest rate swaps, Metallgesellschaft's oil, Daiwa's traders, and Sumitomo's copper – none of these had a single offshore finance centre aspect to them.

In fact, there is a respectable argument that offshore centres are potentially better environments for control. This is because they tend to focus on certain groups of transactions: for instance, the Isle of Man and Guernsey for insurance and reinsurance and in taking offshore deposits. The operations of a financial institution are much simpler to understand in such jurisdictions than they are, say, in London, where the complexities of how an institution will execute proprietary trading on a global basis, together with associated derivative hedging, will often be intractable. Perhaps then, the true challenges for the regulators lie in their own backyards and concern cross-border communication.

The second area is tax. Here, of course, we will naturally hear a chorus of disapproval from OECD tax authorities. What they really do not like is the ability of tax havens to attract capital out of domestic locations into a low-tax environment. But, to some extent, using low-tax vehicles are essential to providing anything like a reasonable return on capital to investors.

Rod Roman

There is no global tax system that operates to give a fair tax burden for a multinational. If UK plc makes £100 of losses in the UK and makes £100 profits in the US then the overall result is no net profit and a tax payment of, perhaps, £40. It is not surprising then that multinationals seek to avoid this situation by tax planning. Most corporations see tax as a cost, and like any other cost they try to reduce it in the way they conduct their businesses.

Of course, a tax haven is really only the use of a tax system to affect investment decisions. Every OECD country has tried to affect investment decisions with tax rules to a greater or lesser degree. In the UK before the Lawson budget of 1984, for instance, it was nigh on impossible for a domestic manufacturer to pay tax because of stock relief and 100% capital allowances.

There is nothing morally wrong with tax havens, and OECD countries have all the ammunition they need to deal with them.

The US started its anti-tax haven rules in the mid-1960s with the 'sub-part F' regime, and now practically all OECD countries have anti-offshore finance centre legislation.

It is a telling statistic that since the 1960s tax revenues from corporates in OECD countries have been fairly constant at 9% of total taxes. It suggests that corporations' use of tax havens has not had a material impact in eroding the tax base.

New lease of life?

Following the EU's attack on harmful tax competition, along with changes to Controlled Foreign Company (CFC) rules, a gradual tightening of transfer pricing rules and an increasingly more aggressive position taken by tax authorities in general, you could be excused for thinking that traditional international tax planning involving the use of offshore centres had a limited life. However, with the emergence and continuing rise of e-commerce, and the inherent mobility and increased efficiency it allows for many existing and new business ventures, it would seem that offshore centres have received a stay of execution and will continue to be used in international tax planning for some time to come.

The key commercial driver for organisations entering into e-business is profit arising from a number of factors: greater efficiency that stems from increased information sharing; the elimination of intermediaries made redundant by internet technology; and geographic transparency, which lowers the barriers to entry for new players into global markets. The greater efficiencies will generally lead to cost savings which, with careful planning and structuring, can be located in an offshore centre or low tax jurisdiction.

Supply chain

The flexibility afforded by e-commerce allows organisations to plan the location of their operations based on cost or strategic considerations, such as tax planning, supporting infrastructure and the availability of a skilled workforce rather than geographic considerations. This means that, where there is e-commerce-led business transformation within an organisation, there is an ideal opportunity to apply tried and tested international tax planning tools to restructure the supply chain operations to increase overall business efficiencies and to capture substantial operational savings in a tax advantaged jurisdiction.

On the sales side, the internet provides businesses a new route through which to reach the market. Many sales contracts that may have been concluded locally in the past can now be made through a centralised on-line ordering facility that can be located almost anywhere, with little or no human intervention. With planning, the location of servers, web sites, call centres and the like needed to support a centralised on-line ordering facility can be located in such a way that profits are taxed at advantageous rates in an offshore or low tax centre, while exposure to creation of a taxable presence in other high tax jurisdictions is minimised. Obviously, profits follow risk, assets and functions – but with appropriate commercial planning a substantial amount can be transferred.

The greater connectivity offered by e-commerce also allows for manufacturing and distribution arrangements to be made more tax efficient. For example, in a manufacturing group, the greater efficiencies may manifest themselves in: lower production costs achieved through highly integrated collaborative forecasting; lower procurement overheads; improved supply chain visibility; and reduced transaction processing costs through sales order administration. By using supply chain planning techniques much of this profit can be located in the offshore company.

New routes to market – the end of the middle-man?

The rise of the internet has allowed businesses to find new routes to market, that in many cases makes elements of more traditional approaches redundant. For example, a manufacturer may be able to supply goods directly to a customer by advertising its products over the internet through a web site or exchange, so reducing the need to transact with sales entities – sometimes even to the extent that the sales entities are completely superfluous. The increased profit following from the cost savings generated though cutting out the 'middle-man' can, with careful planning, be captured in an offshore trading company and taxed at attractive rates.

Industry exchanges

The first real internet growth area for business focussed on transactions between businesses and customers (B2C). However, this has now been far outstripped in sheer dollar volume by transactions between businesses (B2B) using electronic exchanges or netmarkets. The on-line auctions are delivering huge price reductions and enabling businesses to strip out cost from within the supply chain. As mentioned before, by using supply chain planning techniques, these savings can be taxed at advantageous rates using offshore or low tax centres.

For the exchange or netmarket there is also an opportunity to take advantage of low tax rates offered by offshore centres or jurisdictions such as Ireland or Switzerland. For example, an exchange located in Ireland may be taxed at 12.5% on its trading profits, rather than at the relatively high tax rate of 30% in the UK – an attractive saving to the business manager and a 25% improvement on the after tax earnings. This is equally attractive to the owners of the exchange where it is intended that there will eventually be an IPO, since the tax savings will be reflected in the market capitalisation of the exchange. Other locations for the exchange may be even more attractive to the owners where the ownership can be structured to provide protection from capital gains on the eventual IPO.

A key concern for the owners of an exchange located in an offshore centre will be the exposure to controlled foreign company or anti-deferral rules. The rules differ from jurisdiction to jurisdiction, but as a general rule where the owner or participant in the exchange has less than a controlling interest and/or there are substantial trading activities, then typically the rules will not apply. Accordingly, there must be some operational substance in the jurisdiction in which the exchange is held. This might take careful planning where, for example, executive personnel of the exchange have a need to be located close to their customers rather than in the offshore location.

Choosing a location

The decision as to which offshore or low tax location to use will depend on a number of factors, including availability of required infrastructure, degree of connectivity and geographic accessibility. For tax purposes, in addition to attractive tax rates, a certain degree of treaty protection is generally desirable, particularly when there is permanent establishment exposure through the e-business activity. Current favourites include Ireland and Switzerland, as both countries have strong treaty networks, skilled labour forces, strong telecoms and technology infrastructure. Further, even though they both have attractive tax rates, neither of them are the subject of the EU's attack on harmful tax competition, as Ireland has won approval for its policies from the EU, and Switzerland is not a member (at least not yet).

As always, though, the decision will depend on the facts and circumstances of each case. ■

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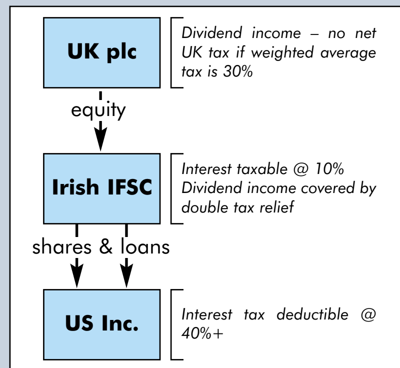
Tax planning pre-FA2000

Pre-FA2000, tax planning for a UK multinational was almost too easy. It was possible to invest in, say, the US, via Ireland, and achieve a position whereby interest was deductible in the US at about 40% and only taxable in Eire at 10%, with perhaps no further UK tax (see *Figure 1*).



FA2000 international tax changes
The tax changes have done four key things, regarding offshore finance centres:

- lowly taxed income (less than 30%) and highly taxed income cannot be 'mixed' offshore from 31 March 2001;
- an offshore holding company cannot be exempt from the Controlled Foreign Company (CFC) rules if it receives interest as well as dividends from its subsidiaries. Therefore, intercompany interest, previously free of UK tax in a haven, is likely to become taxable;
- a CFC will have to remit back to the UK any intra-group service income (for example, treasury services) which was previously free from the UK when earned in a tax haven; and
- an onshore system for mixing is being introduced from 2000 which initially should make onshore holding companies more attractive than offshore ones, at least for income streams if not capital gains. ■

OECD countries will be better served by altering their own domestic rules when dealing with offshore finance centres rather than trying to bully those countries in to changing their own tax rules. They are only playing the same game every OECD country has always played – just much better.

What is the threat from the OECD?
In June this year, the OECD named 35 offshore financial centres that it claims have lacked transparency and failed to co-operate sufficiently in exchanging information with overseas tax authorities.

If these territories do not co-operate within one year, then sanctions of one sort or another are threatened. To put this into perspective, the organisation also named 47 harmful tax practices from OECD countries.

The Channel Islands and the Isle of Man are on the list, but despite this, the signs for both are encouraging. Frances Horner, Head of Tax Competition at the OECD, commented: "I would be very surprised if we don't come to a meeting of minds with these jurisdictions."

The Cayman Islands and Bermuda, however, did not even feature on the original list because of their undertakings to co-operate.

What is the threat from the EU?
The EU's approach has been in line with that of the OECD, except that the commission had tried to impose a 20% withholding tax on savings to enforce tax collection. This initiative encountered considerable opposition which culminated in its abandonment after the Helsinki summit. The EU is now concentrating upon transparency and exchange of information. However, the EU has no jurisdiction over the Isle of Man and the Channel Islands. The EU exerts influence primarily through the islands' relationship with the British government

What is the threat from the Inland Revenue?
The UK tax changes are a threat to offshore finance centres because, unless advisers can get comfortable with their continued value, then from 1 April 2000 there are benefits from bringing some of their activities onshore.

The kinds of activities that are most at risk include:

- offshore finance centres where most of their income is derived from providing services to members of the group; and
- offshore finance centres which are mainly holding companies, particularly where they mix income streams (see example).

The continued value of these types of operations will need re-evaluating.

The kinds of activity least likely to be affected include:

- commercial functions conducted offshore between the group and the end customer; and
- financing arrangements where offshore structures are used to access certain categories of investor (securitisation, for example).

How should treasurers respond?
The threat from the OECD centres around disclosure. Basically, getting a reduced tax charge by hiding something in a tax haven is going to get much harder if the OECD get its way – although corporates should not be hiding things offshore anyway.

Greater transparency and disclosure should not, therefore, hold any fears for a UK corporate group. At present, it appears that the offshore centres which conduct respectable businesses will be complying with the OECD.

The UK tax changes are a more fundamental concern. Corporate treasurers should be challenging their advisers and tax colleagues to justify the continued use of offshore structures in the face of the root and branch changes in FA2000. There will still be a place for offshore finance centres in the post-FA2000 world, but they will probably have to change the kind of business they do, and the way they do business, on a regular basis.

We should expect a decade of cat and mouse games now the government has thrown down the gauntlet by abolishing mixing. Accordingly, corporate treasurers should be looking for flexibility in the use of offshore centres. I am expecting questions such as 'what is the unwind plan?' and 'what are the breakage costs?' to crop up more often.

Mixing was, up until FA2000, generally thought to be a standard feature of the UK tax system. It was about as aggressive as claiming capital allowances. Through the public debate, the government has branded it 'tax avoidance'. With one stroke the population of tax avoiders was dramatically increased. They should expect to see plenty more 'tax avoidance' as UK multinationals strive to maintain their forecast tax charges in the face of what is now one of the most complex and hostile regimes for taxing overseas investments on the planet. ■

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