Alternative Domicile Intelligence

The future of the CDOTs

Sustainable development for the 2020s

A White Paper

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Introduction

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The Crown Dependencies and Overseas Territories are facing a number of different challenges. Their response to them may well determine their future for decades to come.

One of these is primarily economic and the other political, although there is a lot of overlap between the two.

The economic challenge is wide-ranging and global; it is faced by numerous industries and multiple jurisdictions, not just the CDOTs. This is to do with the response, in almost all major industrial countries, to the way that many of their companies structured their taxation arrangements as the world's economy became more global and digital over the last two decades.

Technology firms, coffee companies, much of the pharmaceutical industry and many others

> BEPS has major implications for the CDOTs

have been structured to take advantage of low corporate tax rates in Ireland, Luxembourg and other onshore countries. The reaction against this was a large part of the reason why the G8 asked the OECD to come up with what is now known as BEPS.

BEPS, and various other tax changes related to it, has major implications for the CDOTs, even though these measures are not primarily aimed at offshore jurisdictions or even the alternative

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asset management industry (the long-only industry is exempt from BEPS).

The political challenge faced by the CDOTs, on the other hand, is aimed directly at them. It has arisen partly, if not primarily, as a result of the growth of the so-called tax activist movement. Over the last decade or more, various entities have sprung up to question the legitimacy of offshore financial centres.

The Tax Justice Network, for example, as well as charities like Oxfam, have tried to construct what is essentially a moral argument against offshore finance. They believe that offshore centres promote tax avoidance. And this tax avoidance, they claim, hinders governments from spending money that would otherwise be available to them on essential public services. It has even been suggested that use of offshore centres deprives people in the developing world of their human rights.

These arguments are of course easy to refute. But they have often been left unchallenged by the CDOTs. As a result, when incidents like the so-called Panama or Paradise Papers come along, politicians with their own particular agendas, ones that are hostile to offshore centres, are able to prosper.

The cross-party amendment to the Sanctions and Anti-Money Laundering Bill in the UK Parliament is an example of this. The British Overseas Territories have until the end of 2020 to introduce their own publicly accessible registers of beneficial owners, or the UK will step in and do it for them.

Part of the reason why the CDOTs have come under pressure recently is because many governments have run large budget deficits since the financial crisis. Reducing these deficits is proving very difficult to do. Some of the politicians in charge of these governments believe that if they could stem the flow of funds going through to offshore centres, flows from both their companies and from their citizens, they could reduce their budget deficits substantially.

IFI Global and its publication ADI have said many times that the vital and neutral warehousing role that the major CDOTs play in today's global financial system should be easy to make. The problem is that it has rarely been made, at least on a collective basis. The reason for publishing this White Paper is in part to address this.

The challenge ahead

Before addressing the substantive issues, it should be noted that the growth in reporting (from FATCA, CRS etc) should not be difficult for offshore jurisdictions with established financial industries. Implementation of these reporting requirements might be time consuming and expensive but should otherwise be straightforward. Meeting reporting standards alone is not going to stop the CDOTs from running into problems in future.

The real challenge ahead looks like being over substance. The need to develop sufficient substance to comply with BEPS, to avoid being placed on the EU's blacklist of uncooperative jurisdictions and probably to meet other threats that are coming, including the growth of tax activism, is what the CDOTs should focus on.

The real challenge ahead looks like being over substance

BEPS

At its core, BEPS is the G20's attempt to shift companies' taxable income from subsidiaries, many of whom may be domiciled offshore, back to the jurisdiction where the company is headquartered. The OECD has stated that the tax revenue recouped as a result of BEPS will be between $100 to $240 billion annually, or anywhere from 4%-10% of global corporate income tax revenues.

The G8 asked the OECD to come up with what is now known as BEPS at their St Petersburg Summit in 2013. BEPS measures include new minimum standards on: country-by-country reporting, which for the first time will give tax administrations a global picture of the operations of multinational enterprises; treaty shopping, to put an end to the use of conduit companies to channel investments; curbing harmful tax practices, in particular in the area of intellectual property and through automatic exchange of tax rulings; and effective mutual agreement procedures, to prevent double non-taxation agreements.

BEPS has forced many industries, including alternative asset managers, to look again at their tax structuring and to develop more substance in jurisdictions where their funds are domiciled. Experts who have spoken on this topic at ADI's seminars agree that real and demonstrable substance will be needed in order to get tax treaty benefits in future.

The challenge ahead

EU threatened blacklist of uncooperative jurisdictions

In December 2017 the EU placed a number of jurisdictions – including the CDOTs – on what it called its 'grey list'. It said that these jurisdictions have to improve their transparency and add substance in order to avoid going on to the EU's blacklist at the end of the year.

In May the EU's Code of Conduct Group followed this up with guidance on what it actually means by substance. Until this spring no one was sure what it would demand here. As Deloitte has written: 'The guidance on what is required to demonstrate real economic substance is closely aligned to the guidance published by the OECD in relation to Action 5 of the BEPS project on Harmful Tax Practices. This is positive news as it indicates that the EU negotiators will not be looking to "reinvent the wheel" in terms of defining economic substance.'

Deloitte adds that it is too early to predict what the final legislation on economic substance will look like, although it states that the publication of the guidance document is a significant step forward from the situation announced in December 2017.

Public registries of beneficial owners

The British Overseas Territories are required to make the beneficial owners of companies registered in their jurisdictions public after a cross-party amendment to a Sanctions and Anti-Money Laundering Bill passed through the UK Parliament this spring.

The move to mandate the BOTs to create open registers does not apply to the Crown Dependencies. But MPs Andrew Mitchell and Margaret Hodge, whose amendment has imposed these public registers on the BOTs, have said that they intend to try to make Guernsey, Jersey and the Isle of Man adopt open registers too.

How to respond

Developing real substance and local expertise in offshore jurisdictions would seem to be by far the best way of overcoming these challenges. Having demonstrable substance and local expertise should ensure the successful long-term development for the CDOTs.

But what is substance? It is unlikely to be just about having boots on the ground. It is almost certainly going to mean having people based in a jurisdiction who are qualified to make decisions on behalf of the companies that they work for or with (as well as having boots on the ground, of course).

That is the direction that Guernsey has taken over the last few decades, for example. This is a model that other jurisdictions might want to adopt. In particular they should take note of how fund governance has developed in Guernsey.

BEPS rules on Permanent Establishment mean that the asset management industry will have to be able to show that the directors of their funds, in any jurisdiction (offshore, in the EU or elsewhere) are the real decision-makers in the business. Non-executive directors can no longer simply be rubber stampers of decisions made, for example, by an asset management group back at global HQ. That has been an accusation that has been levelled against directors of funds in some offshore jurisdictions in the past.

Surveying the remuneration of non-executive directors resident in a jurisdiction is as good a yardstick as any for judging its level of substance. If a jurisdiction has a lot of experienced non-executive directors, who are well compensated, it indicates real business activity is taking place there. Research conducted by ADI's sister publication, The NED, shows that this is the case in Guernsey.

The average compensation for an independent fund director in Guernsey is higher than it is in any other jurisdiction, offshore or in the EU

Going through the annual reports of very many offshore funds, as The NED has done, has revealed that the average compensation for an independent fund director in Guernsey is higher than it is in any other jurisdiction, offshore or in the EU. The total remuneration for all independents that The NED was able to get information on in Guernsey was £6,131,000 pa. But information was found on just a minority of Guernsey funds. Overall director compensation is estimated to be about £18 million if all Guernsey domiciled funds are taken into account. And the majority of those serving on Guernsey fund boards are local residents.

How to respond

Directors' fees therefore play an important part in the overall economy of Guernsey. But more importantly they demonstrate that this jurisdiction has well-qualified people that are capable of making decisions for the businesses that they are involved with.

Substance is also the best way to counter the public register threat. That is because it probably will not be sufficient for a jurisdiction just to say that it has its own confidential register of beneficial owners in future. The key is going to be how accurate that register is, how it is maintained and how easy it is to verify the information that is in it.

In Guernsey, for example, beneficial ownership information is held on the Guernsey Register of Beneficial Ownership, maintained by the Guernsey Registry.

Guernsey laws and regulations have, since 2001, required details of beneficial owners of legal persons to be collected and maintained, and since last year has been held in a centralised, but not public, register. Disclosure is limited to local and foreign law enforcement agencies, intelligence services, financial services regulations and tax authorities.

Maintaining an accurate register of beneficial owners requires a jurisdiction to have a good network of locally-based service providers which, again, is all about local substance.

Having a well-maintained and established register of beneficial owners will make it much more difficult for politicians to argue that the information in it must be made public. Imposing so-called 'open', public registers on CDOTs with well-maintained and accurate registers already in operation, would surely be seen as no more than a cynical political ploy.

Making the register public in these circumstances would be of no economic benefit to anyone. But it would almost certainly persuade those that do not want their financial affairs to made public to move to jurisdictions where there is no register at all. Public registers would therefore be self-defeating.

Conclusion

Successful offshore centres of the future will need to have well-established structures with qualified people – in other words they will need real substance. Meeting reporting standards is unlikely to be sufficient to avoid falling foul of various aspects of BEPS or perhaps even being placed on the EU's threatened blacklist of non-cooperative jurisdictions.

But substance is difficult to define. As stated, it is likely to be about more than having a quorum of local employees working out of an office in a particular jurisdiction. Qualified directors, who make decisions for that business, will need to be resident in the jurisdiction too.

This has been the Guernsey model for some time now. As a result, there is arguably more substance in Guernsey than there is in an EU jurisdiction like Luxembourg. There is no director residency requirement in Luxembourg, and relatively few board members of the funds that are domiciled in the Grand Duchy live there. Luxembourg is a very large fund servicing centre but it might struggle to meet some of the substance requirements as outlined in BEPS.

For example, BEPS Action Plan 7 focuses on Permanent Establishment. The principle behind it is to align a company's economic activity with where it pays taxes. In the alternative fund management industry, this means where the fund's directors are based and where their decisions are made. Luxembourg-based alternative funds that wish to continue to benefit from double taxation treaties will likely have to prove that they are based in the Grand Duchy.

And, as it looks like the EU is adopting BEPS standards for its own substance definitions,

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it would presumably not be possible to place offshore jurisdictions on its blacklist that have more substance that those in European fund centres like Luxembourg. Guernsey is a smaller jurisdiction than Luxembourg but, proportionally, its funds industry has more local substance (as defined by BEPS) than the one in the Grand Duchy.

For these reasons it would make sense for more of the CDOTs to adopt the Guernsey offshore model. Doing so makes it much more likely that the challenges mentioned in this White Paper, those common to all the CDOTs, will be overcome successfully.

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