

By Nigel Feetham, partner in Financial Services

'Tax havens' have come under considerable outside pressure over the last 10 years. As a Gibraltar legal practitioner, I took an early professional interest in writing about developments in the offshore industry and I could sense the change in the wind and prevailing currents that had propelled a handful of small jurisdictions into the forefront of international finance. I took the view that they could not afford to remain still. They would simply not be allowed to do so. A draft 'European Union Code of Conduct on Business Taxation' was being put together (although its conclusions were only to be published on 1 December 1997). It interested me enough to put pen to paper and on the 25 November 1997 I produced a discussion document entitled "Tax Harmonisation Proposals and Reform of the Tax System". It was a Gibraltar-centric document which set out a 'road map' for change of the Gibraltar tax system. I do not normally keep copies of the numerous papers I have written over the years but I kept this one, gathering dust somewhere. 13 years have since passed and much has happened over this period, including the near meltdown of the global financial system that led to the massive bail out of international banks. In short, the message delivered to tax havens was, embrace change or face extinction.

Against this background, Gibraltar, which ranks in the premier league of financial centres, has just announced the overhaul of the existing tax regime (largely in place since 1967) and the introduction of new tax legislation applicable to all businesses with effect from 1 January 2011. It marks the transition for Gibraltar from tax haven to low tax jurisdiction. The basic premise of the new legislative regime is the implementation of a 10% tax rate across the board, coupled with a concept of territoriality as the basis for taxation of companies. Implicit in this is that overseas branches, for example, will not be subject to tax in Gibraltar on profits generated by such branches. This is irrespective of whether the foreign source income suffers tax elsewhere. This is an uncontroversial application of the territorial philosophy for such a tax system does not seek to tax on a worldwide basis. Interestingly, there has been a push towards territoriality over the years (France, Netherlands, Luxembourg, Switzerland have territorial tax systems) and the UK is expected to move in that direction too in respect of foreign branches. Further, whilst 10% is the lowest general rate of corporate tax in the EU, the average rate across all EU Member States has fallen from 35.3% in 1995 to 23.5% in 2009 and with effective rates of corporate tax falling even lower in certain situations.

In my 1997 paper I defended the territorial principle of taxation in any revision to the corporate tax system on the basis of its international acceptability (something that the Foot Review report prepared by Deloitte has recently also accepted). It was evident too that the Irish model of a low tax system was an easy short cut towards 'acceptable' status. Finally, I discussed other challenges for jurisdictions like Gibraltar looking to make the transition including the need for a level-playing field vis Double Taxation Agreements. The 1997 paper has some value, not because of its ambitious predictions, but because of its historical relevance. It is reproduced below for those who are interested in the subject-matter. The lesson to be learnt is that those jurisdictions who road mapped the journey from 'no tax or tax information exchange' to 'low tax with information exchange' have developed a sustainable economic model for the future; whilst those who have not, have put their economic prosperity at risk.

The 1997 tax haven regime was clearly, internationally speaking, unsustainable in the long term. It was what spurred me to write the paper. In the case of Gibraltar, I expected a 10 year transition but it has taken 13. During this time, Gibraltar has developed a solid professional, legislative and regulatory infrastructure and attracted some of the world's leading (re) insurance and gaming companies creating thousands of jobs in the local economy where few previously existed. Looking forward, therefore, if 1997 marked the beginning of the end for 'tax havens', 2011 will herald a new era for well regulated, low tax, financial centres.

One final unavoidable observation is that whilst tax havens have been visible and conspicuous over many decades and attracted the unfavourable attention of high tax jurisdictions, it is not only tax havens that have been used for structuring transactions to minimise tax. In the past, large corporates and multinationals have used tax arbitrage (a lawful means of avoiding tax) to achieve lower effective tax rates, such as using commercial transactions that rely on tax credits or deductions in two or more high tax jurisdictions. The US and the UK tax systems are examples, with both countries revenue authorities aware that differences in tax rules were being used by large taxpayers to reduce their tax burden through structuring deals with counterparts in each territory and sharing the economic benefit. Such transactions were common place for decades, with no or little publicity involved other than through the occasional glimpse in a reported tax case in one country or another. Yet the response from particular countries has not been to try to harmonise the relevant tax rules on an international basis but to focus on denying the benefits of tax arbitrage to their own local taxpayers engaging in these type of transactions, whilst doing nothing to prevent the enjoyment of any foreign tax benefits derived under local tax laws which result in loss of revenue solely for the foreign country.

The underlying tension here between tax competition and tax harmonisation is self-evident but what it also illustrates is that the notion of what is 'fair' or 'unfair' tax competition is highly subjective and still largely driven by pure national self-interest. The big question is, if countries want to stop cross border tax arbitrage will they be prepared in future to agree to a global harmonised tax system? A confident prediction is 'not over the next 13 years', but that would have to be the subject of another paper!

GIBRALTAR FINANCE CENTRE DISCUSSION PAPER 1997: TAX HARMONISATION PROPOSALS AND REFORM OF THE TAX SYSTEM

In this paper, I set out to discuss and examine the recent proposals for tax harmonisation based on the information which has been made public. First, I will consider the background, both at a Community and international level of attempts to remove what is generally perceived as harmful tax competition. I will then consider the increasing international pressure affecting the conduct of offshore business as I do not think that any discussion of the problems in this area will be complete without some mention being made of this. I then assess the inadequacies of the present tax system in Gibraltar and aim to examine the impact of any proposed harmonisation proposals to the present system. Finally, the paper will identify certain preliminary recommended reforms to our tax system which in the writer's opinion would not only create a system more in tune with the needs of international business but also attempts to alleviate the distortionary claims inherent in the Commission's tax harmonisation proposals.

Having said this, it would be unrealistic to suppose that any recommendations discussed in this paper would be transformed overnight into an ideal solution to the problems we face - even supposing that an acceptable solution has been identified. Nevertheless,

whatever else comes out of the initial package of EC reforms, I think it is timely to examine our tax system generally in so far as it impinges on international business transactions. The system which we have in place today is far more of historical relevance than it is to the application of arguments of logic or perhaps even economics. The views expressed in this paper are partly those which the writer expressed in the Meeting of the Members of the Bar on the 12 November 1997. The present paper is naturally a far more elaborate attempt to examine the problems under consideration.

Introduction

Tax harmonisation has been on the European Commission's agenda for the best part of 30 years. The Treaty of Rome itself called for fiscal harmonisation but did not provide an obligatory legal framework to achieve it. This was therefore always going to be an area of EU policy which would be controversial in theory and difficult to implement in practice. To start with there was always the question of what form tax harmonisation would take and at the heart of any debate was the notion of national fiscal sovereignty.

Background

Looking at corporate taxation as opposed to indirect taxation, the first proposals which were put forward by the Commission related to complete harmonisation of corporate taxation across the European Union. This proved to be too ambitious a proposal in view of the profound differences which existed, and still exist, between the tax regimes of each Member State. Any agreement on a unitary corporation tax system was thus always going to be difficult to achieve. It is therefore not surprising that until 1990 the Commission failed to progress on this front. With the advent of the Single European Act and the proposed elimination of border controls, however, the whole issue of tax harmonisation came to the surface once again, particularly since this was seen as an important part of the creation of a Single European Market. The attention, however, was switched to the implementation of a series of Directives and Conventions each dealing with individual measures and designed to harmonise specific aspects of the tax systems of Member States. The Transfer Pricing Convention based on Article 220 of the Treaty of Rome thus purported to reduce the barriers to trade by eliminating economic double taxation arising from transfer pricing adjustments. The Mergers Directive followed as did the Parent Subsidiary Directive. A further draft Directive dealt with the elimination of withholding on royalties and interest within corporate groups.

This year the European Commission has suddenly moved to the top of the European Union's agenda once again the removal of harmful tax competition between Member States. Ostensibly this was mainly in response to the concerns being expressed by Germany, which, for example, estimated that it was losing around £7 billion a year in potential revenues to Luxembourg alone, but the proposals also seem to be driven by the imminent launch of the Single European Currency. Naturally, the problem is far more over-reaching than the concerns expressed by Germany in relation to Luxembourg and is not confined to the tax incentives provided by any single Member State. The Netherlands and Belgium have also come under scrutiny, whereas by the same token both these Member States have themselves proved reluctant to take any first steps towards abolishing special tax incentives for foreign investors whilst Ireland continues to be afforded a special tax regime guaranteed by the Commission until the year 2005 (financial services) and 2010 (Manufacturing). The UK itself has never been much in favour of ceding national sovereignty over domestic tax matters, and has always opposed any steps which would lead to a single European corporate tax. Reflecting the political sensitivity that surrounds direct taxation, the so-called Monti proposals call for,

inter alia, a tax "Code of Conduct". The [draft] Code is based on the premise that it is non-legally binding, but sets out to achieve a political commitment from each Member State on what standards need to be adhered to in tax matters.

It is interesting to note, however, that concerns over tax competition are not just confined to Member States of the EU. Similar concerns have been raised at the level of the OECD and even at roughly the same time. A special "Tax Force" was set up in January 1997 by the OECD to report on the specific problems of tax competition and is expected to do so by the first half of 1998. This is also expected to result in the formulation of some code enforceable only by the political will of its members. It is worth mentioning that whilst most "tax haven" jurisdictions are not members of the OECD in their own right, the OECD Convention is applicable to them as Dependent Territories or Crown Dependencies of the United Kingdom. This would include Bermuda, Guernsey, Isle of Man and Jersey as well as Gibraltar.

The writer feels that any discussion of the present situation cannot be conducted in isolation without some mention of the international pressures offshore centres have increasingly come under over the last 10 years or so.

The Offshore Environment

With the globalisation of trade and investment, the relative size of a jurisdiction is no longer a determining factor in a company's investment or business decision-making process and very substantial levels of business activity are transacted through small, so-called "haven jurisdictions", far out of proportion to their size and international standing. This was accelerated by the mobility and free flow of international investment as between countries, with investors obviously looking for a favourable port of call from which to conduct their business activities. The result has been an almost phenomenal increase in offshore business over the last thirty years.

Attempts by governments to curb what they perceive as harmful tax competition is therefore not something new. The pattern was set by the major capital exporting countries with enactments commonly known as Controlled Foreign Company legislation. Most industrialised nations have now adopted such legislation including the UK, Italy, Spain and most recently Mexico. This has also been accompanied in some countries by a more aggressive and unsympathetic attitude by the tax authorities towards tax avoidance and the use of tax havens for tax avoidance purposes. In this regard it is worth noting that whereas some years ago the dividing line between acceptable tax avoidance and unacceptable tax evasion was clearly defined, the distinction may not be so clear today in relation to certain tax avoidance schemes. Suffices to say that whereas some years ago "off-the-shelf" companies could be sold without much objective assessment by professional advisers of tax planning considerations, today any offshore scheme must be carefully thought through before implementation and must not depend on the Revenue asking too many questions. Moreover, even if offshore transactions are not deliberately designed to evade tax, most countries have established principles in their jurisdiction or national legislation to have regard to the substance of what is being achieved rather than the form alone. The pendulum in many countries now seems to be swinging from what may be regarded as acceptable tax planning to unacceptable tax avoidance, the tax benefits of which many countries are now prepared to disregard. This is therefore the reality of the environment in which lay clients and their professional advisers are expected to work in and professional advisers must not lose sight of this. It

is hoped that one aspect of the move towards harmonisation will be EC clarification of standards of acceptability in the tax planning field.

It is also interesting to note in passing that the UK itself has gone through various progressive developments to make itself attractive for international business activity. Until 1988, the role of the UK in international tax planning was focused on the use of the UK non-resident company. These proved to be very popular vehicles and since they had their management and control outside the UK, were outside the UK tax net. Companies were therefore incorporated in the UK purely for tax planning reasons as they are today in Gibraltar. All this, of course, ended with the 1988 Income and Corporation Taxes Act but was not perceived to be much of a loss because of the financial standing of the City of London and the UK's commitment to relatively low levels of taxation compared to the European average. All that happened since the change of tax rules in the UK was that the Irish non-resident companies have been used as an ideal replacement for the UK resident company, with or without the requirements for publication of company accounts.

Impact of European Tax Harmonisation on the Finance Centre Industry

Naturally, in Gibraltar's case any sudden move towards eliminating tax competition within the EU would prove to have a much more serious effect because of the contribution of the finance centre to the economy. However, the concerns are not just confined to Gibraltar, although admittedly it would be more difficult for the UK to persuade its other dependencies of any "new direction" by virtue of their non-EU status. This, however remains a theoretical possibility, particularly if the OECD follows suit. Having said this, the policy of any UK Government must surely be to help its "Dependencies" to become less dependent not more dependent on UK aid. Indeed, it should not be forgotten that it was the UK who encouraged its Dependent Territories to develop their financial services industry in order to improve each territories revenue earning capacity. It is therefore difficult to believe that any UK Government would now allow these territories to become a burden on the UK taxpayers. It is also hard to see how on the basis of political commitment alone the UK could impose its political will on the democratically elected government of each dependent territory with jurisdiction over their own tax affairs. In the case of Gibraltar, of course, we would be expected to comply with our EU obligations if these tax reform proposals became EU law. But whatever form such legislation may take, the UK must be expected to take into consideration the special circumstances of Gibraltar. This is not to say that Gibraltar can expect to be excluded indefinitely from this area of EU policy if it becomes law, but must at least be afforded a sufficiently reasonable transitional period as would be the case for any new Member State with a less developed economic base than the EU average. It would, for example, be unrealistic to expect that in an enlarged European Community, countries of the eastern block, at different stages of economic development, could implement any requirement for tax harmonisation without at least a five year transitional period. At the same time, for Gibraltar itself to expect any thing other than a transitional period may also be unrealistic. Either Gibraltar is part of the EU or she is not. Unfortunately, as in every club with membership rules, every member is expected to comply with the rules or simply leave the club.

Whilst some other offshore centres have adapted to the financial and political uncertainties which have changed the nature in which global commercial transactions have been carried out to meet their particular needs and requirements, Gibraltar's tax legislation and tax system which drives the centre forward has not changed in its rudimentary form since 1967 when the Companies (Taxation and Concessions)

Ordinance was first enacted. The "Concessions Ordinance", as it is often called, was brilliantly conceived and has proved to be the perfect vehicle for the conduct of offshore business. But like all concessionary tax systems, it was based on the principle that it is perfectly proper to discriminate against your own taxpayers by providing tax incentives for non-residents, provided it did not affect your own tax base and without regard to the fact that it was designed to affect somebody else's. It is not too difficult to see therefore why tax authorities everywhere have become so disenchanted and unsympathetic towards concessionary and discriminatory tax systems.

Naturally, this is no consolation for the genuine concerns which the industry is faced with today. Whilst the present writer does not pretend to assume that this paper can present the answers to these problems, it is the responsibility of our elected leaders and professional bodies alike to give the problem full and careful thought. Whatever happens within the next 10 years (it being unrealistic, to expect that much will in fact happen within the next few years), Gibraltar must explore how our tax system can best evolve, driven in part by future changes brought about in international forums, the domestic laws of other countries aimed at further combating tax competition and the imminent changes to be brought about within the European Community context. Whatever direction the industry takes, we must continue to find ways to best make use of our tax system to attract international business opportunity and investment. And lest one be accused of simply "throwing in the towel", this paper will set out for consideration and further discussion possible avenues to be explored.

Reform of the Corporate Tax System in Gibraltar

Whilst the European Commission can try to prevent discrimination and distortions created by Member States tax systems, it cannot do anything to prevent countries having different domestic tax regimes, for the simple reason that Member States are free to retain their taxing rights. One possibility is to reform our tax system to provide for a territorial principle of taxation. Under such a system only profits which have a Gibraltar source would be subject to tax in Gibraltar. The concept of residence of a company or individual would have little practical importance. It is the location or the source of the profits which would determine tax liability. Admittedly, one would need to study carefully how this could affect the tax base in Gibraltar, but in theory the switch from worldwide taxation to a source based tax system should not dramatically affect the current level of tax revenues. This would obviously not be so in the case of a major capital exporting country which generated most of its revenue from activities undertaken outside the jurisdiction. But Gibraltar does not fall within this category and most taxable revenues are derived from profits generated from within Gibraltar. These would therefore continue to be taxed. Gibraltar also has the added advantage that it does not levy capital gains tax nor VAT and would continue to do so. To avoid any form of discriminatory legislation, Gibraltar would also need to consider exempting withholding taxes on dividends and in the case of individuals and companies, interest. The obvious model to have regard to would be Hong Kong which has so successfully exploited its tax system for many years. Within the Community, France also follows the territorial principle in taxing income arising in France.

Under the above system there is no need to recognise the concept of the Tax Exempt Company. Nor would there be a need to retain the distinction between resident and non-resident companies. All companies would be considered onshore companies. Moreover, there is no discrimination in favour of non-residents nor would Gibraltar be considered to be a tax haven. The change to such a tax system can also be based on objective

economic criteria, being part of Gibraltar's attempt to diversify its economic base by encouraging local entities and entrepreneurs to generate overseas earnings which they might then be encouraged to reinvest in Gibraltar. With the poor prospects of economic development which the Chamber of Commerce is predicting, these changes may certainly help to give an impetus to the economy.

Whilst I do acknowledge that this system may also carry with it a greater risk of tax avoidance, this is something which needs to be carefully looked into and is no better and no worse than the present tax system where despite the provisions for worldwide taxation for Gibraltar residents, it would be unrealistic to assume that every taxpayer who is under an obligation to declare worldwide income actually does so. This is not to say that there is no legal obligation for them to do so. There is, but how can it be enforced? The local income tax office has neither the resources nor the manpower to do so.

The following are the type of activities which could be transacted from Gibraltar under a territorial tax system:-

- ownership of foreign property.
- trading in goods or commodities.
- provision of cross border services such as telecommunications.
- provision of consulting services.

Another possibility to explore would be whether it would be acceptable to provide equal tax treatment in certain areas of business activity regardless of any residency requirement. Under this system we would move away from "special" tax provisions, and away from tax benefits reserved for non-residents. Moreover, if the level of taxation was not significantly lower than the general level, this may prove to be acceptable to the Commission and may still remain an attractive proposition in the area of insurance and investment services, for example.

Of course, there always remains the possibility of lowering the effective rate of general taxation, but this would have to be done progressively and Gibraltar could not expect to complete the transition from tax haven to low tax jurisdiction within the space of a few years without an alternative economic base.

One major inequality of treatment which must be regarded as an unacceptable situation in an otherwise harmonised European corporate tax system would be the imbalance produced by Gibraltar not having a Double Taxation Treaty network in place. This would also need to be addressed. Admittedly, this would not only affect Gibraltar, but also to a lesser extent those Member States whose Double Taxation Agreements with non-EU countries were less favourable than say those of the Netherlands or Luxembourg. Any package of EU reform should therefore be accompanied by an effort to remove these distortions, otherwise the level playing field would not be achieved. The most satisfactory solution, for Gibraltar from an overall view point may be the creation of a single multi-lateral treaty with non-EU Member States applying across the European Community. Meanwhile, Gibraltar should enter into immediate discussions with the UK on the possibility of Gibraltar being included in the existing UK treaty network, which it must be said would not be easy to achieve in the present tax haven environment.

No doubt, the harmonisation debate will continue and nothing contained in this memorandum may add very much to that debate. But the matter is too important not to be discussed constructively both by professionals within industry and at the level of the UK Government. The matter must therefore be looked at from every possible avenue. If no practical solution which we can live with exists, the UK must recognise its responsibilities towards Gibraltar. Whilst a Code of Conduct which by its very nature is not legally binding must be politically acceptable to Gibraltar, whatever else comes out of it, sufficient transitional periods must be made available to Gibraltar.

Interaction with Future EU Harmonisation Proposals

In assessing the adequacy of any proposed changes to the tax system we will, no doubt, need to take into account how any new arrangements may interact with further future EU harmonisation proposals. The territorial tax system could be considered to be the most neutral as between different Member States and with time may even be the best way of achieving the integration of corporate taxation within the EU. This could be based on the system widely used in the United States where the state corporation taxes are computed according to the formula based upon an apportionment of sales and assets originating from each state. This would nevertheless allow Gibraltar to safeguard the position of local entities not operating in the EU which consequently would still enjoy the tax benefits afforded to them by a territorial based system of taxation. Gibraltar would therefore, in the long term, have given impetus to the harmonisation process without having swept away tax benefits for non-EC operating companies.

Summary

Depending on the political will within the Community, the proposals for harmonisation of taxation may take some time yet before they are translated into legally binding obligations. It is recommended, however, that Gibraltar should start considering the long term implications of any directives in this area. The following is a summary of some of the recommendations mentioned above:

- while the Commission should be able to prevent discrimination within a Member States tax system, it cannot be intended to prevent countries having different domestic tax systems for the simple reason that Member States should be free to retain their taxing rights, albeit on a non-discriminating basis.
- it is recommended to explore the possibility of switching from worldwide taxation to a source based tax system. Any loss of tax revenue would obviously need to be taken into account, but if there was any significant short-fall this could be balanced through a system of licensing thereby reconverting taxable income into licence fees. Major Gibraltar exporters and offshore gaming companies would fall into this category. The switch in the tax system would also in theory present the least smallest number of changes to the tax administration and existing infrastructure. It may also be the most politically acceptable to the UK. From a practical point of view, it would be difficult to imagine the European Community being able to block this initiative in the future short of the introduction of a unitary tax system and thereby the creation of a federal Europe. It is important to emphasise, moreover that the proposed changes are also based first, on economic objectives and secondly, on the need to modernise our tax system, be it in line with international acceptable standards.
- measures which only affect Member States in their relations with each other will do nothing to address the differences in treaty network which Member States have with non-members and it is hoped that Member States attach the same

political importance to this imbalance as to the distortions created by concessionary tax systems.

This article was written by Nigel Feetham, partner in the Financial Services Department at Hassans International Law Firm and was first published on www.mondaq.com