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OFFSHORE FINANCIAL CENTRES IN DECISIONS OF PRIVATE EU INVESTORS. PERSPECTIVES OF FURTHER DEVELOPMENT

Summary: The article presents the subject of offshore financial centres from the perspective of an individual European investor. It analyzes the effects of European regulations, introduced as an answer to the increasing competitive role of third-party territories employing elaborate systems of tax incentives. The research also presents perspectives for offshore financial centres, forced to adapt to the changed legal environment.

Keywords: offshore financial centres, European Savings Directive, tax information exchange.

1. Introduction

The prospect of investing the earnings and financial surplus in territories that offer reduced taxation has always been attractive for both individual investors and economic entities. Countries that choose to reduce their national fiscal proceeds and introduce additional benefits, such as substantial confidentiality of financial information, attract numerous investors who seek the so-called “tax-optimization”. The popularity of “tax havens” has been further stimulated by the development of telecommunications and the increased globalization of world financial markets.

The growing role of offshore financial centres in international capital flow has always been a source of concern for “traditional”, developed economies, as their citizens constitute the majority of offshore account customers interested in reducing their fiscal burden. The expansion of tax havens remains in sharp conflict with the interest of “welfare”’ states, highly dependent on fiscal proceeds from individuals and economic entities. Those countries record a particularly large decrease in fiscal proceeds due to offshore drain of financial assets from local economies. The analyses of tax competition in mature economies show that the phenomenon under study does not only reinforce the volume of capital transfer to fiscally attractive territories, but also – in the form of harmful tax competition[1] – contributes to the unnatural depletion of fiscal proceeds, ineffectiveness of financial markets and solidification of harmful effects, such as business frauds, financing of terrorist activities and money laundering. The discussion on the optimal degree of international regulation of financial flow has led to the formulation of joint initiatives aimed to persuade offshore financial centres to adapt their local legislatures to modern standards. The postulated modifications include implementation of safe financial turnover, "know your customer" procedures that offer transparency of transactions, rules of operation for active participants as well as sound reporting and supervising principles for financial markets.

2. The role of offshore financial centres in financial decisions of individual EU investors

The interest of Europeans in the potential of investing their financial assets abroad has, for many years, concentrated mainly on continental offshore centres. The fiscal incentives of European offshore territories are not the only reason for this interest; other important aspects include long-standing reputation, the advantage of geographical distance and cultural similarities.

The significance of offshore capital is also confirmed by the share of European assets in the foreign deposits structure of offshore capital centres. Analyses of foreign deposits show the leading position of Switzerland as a financial centre for individual investors. Of the total foreign deposits in Switzerland, 90% is of European origin, with 28% representing German investors, 21% – French, and 14% – Italian.

The share of EU-originating deposits in other European offshore financial centres is also significant. In Luxembourg, EU deposits constitute 70% of total foreign deposits, in Jersey – 71%, and on the Isle of Man – 75%. Figure 1 presents sources of foreign deposits in selected European offshore centres and in Hong Kong (with the latter being a good illustration of the trend that geographically distant, non-European offshore financial centres do not attract EU individual investors) [*Data Monitor*… 2007].

[1] ECOFIN council definition provides the following conditions that describe harmful tax competition: a) preferential treatment is implemented with the sole purpose of attracting foreign capital formerly subject to taxation in other territories; b) use of the so-called "ring fencing" practices that exclude local entities from the benefits of preferential fiscal system; c) the tax benefits offered are not based on economic principles – they apply regardless of actual participation or economic activities of the beneficiary on local market, d) the taxation base margin is calculated in striking contrast with the internationally accepted standards (used by the OECD members); e) lack of fiscal transparency, particularly in the methods of fiscal collection and arbitrary tax exemptions.

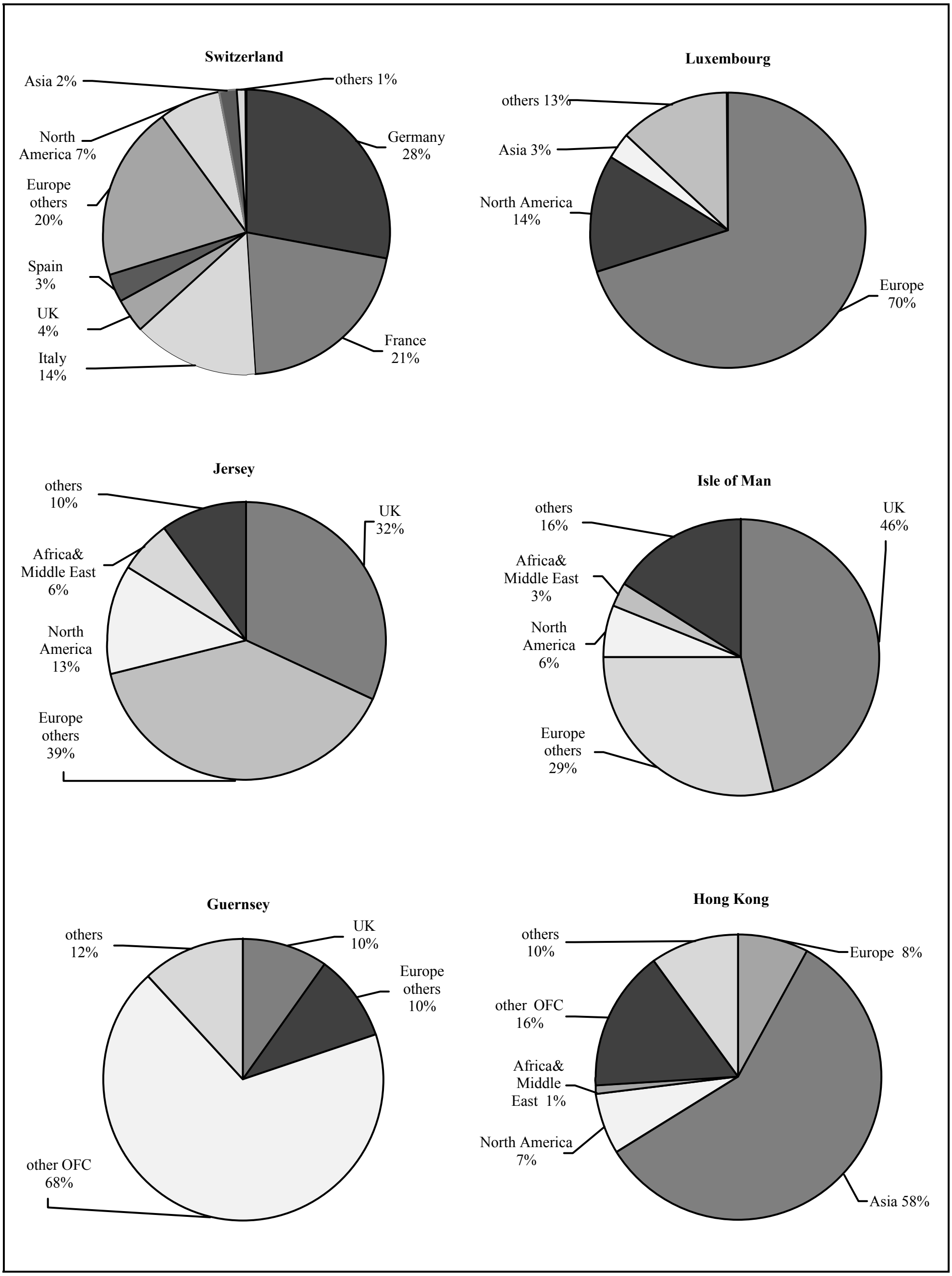

Figure 1. Source of offshore deposits balances

Source: [*Data Monitor*… 2007].

3. EU responses to the increased role of offshore financial centres

EU member states, in response to the growing scale of "escape capital" phenomenon, carefully calculated their losses incurred by the failure to tax the assets held on territories beyond their jurisdiction. The problem at hand involved income generated in fiscally attractive territories, especially to the benefit of highly mobile individuals, well-educated and employed under foreign jurisdiction that favours selected professional groups in their fiscal policies. The problem applied also to movables transferred beyond the jurisdiction of domestic fiscal authorities over the last few decades. The lack of information on this type of funds amassed by individual investors in foreign countries resulted in a decreased tax base of EU member states. Precise identification of the funds would allow for increasing the tax base, with the consequent taxation of such assets.

To this effect, EU member states initiated work on new regulations that would provide more extensive knowledge on the financial investment sources of their citizens. Another important motive for the change of legal climate was the intent to limit the appeal of territories employing competitive tax policies. The main instrument to warrant the fulfilment of fundamental assumptions of the regulators was the so-called *Savings Directive* [*Directive 2003/48/EC*].

The 2003/48/EC Directive on taxation of savings income in the form of interest payments, which came into effect on 1 July 2005, obliged financial institutions of the EU region to disclose any interest payments made to the benefit of EU citizens and generated outside their country of residence. The directive was aimed at providing access to income reports of individual investors locating their assets abroad, with the purpose of effective taxation of such income under local jurisdiction (based on residency).

The aforementioned regulations were particularly effective in relation to private accounts of banks and institutions that offered credits for offshore real-estate purchase, current accounts and investment funds based on foreign bonds, since the directive applied to interest income (savings accounts and deposits) and income based in part on interest payments and interest-related payments (safe investment funds that invest more than 40% of their assets in debenture instruments). The regulations did not apply to dividend payments, pensions, allowances, property rents nor employment income.

To safeguard the principle of banking account confidentiality, several member states introduced mechanisms for circumventing the obligation to disclose information to the country of origin. In the cases of individual accounts held in territories other than the country of residence, the holder could choose not to divulge the information on individual income and, consequently, regulate his or her fiscal dues at source, in the form of withholding tax. As a result, 75% of the total amount collected from taxes would be transferred as bulk reimbursement (without disclosing information on individual investors) to the respective country of residence. The withholding tax instrument, as opposed to automatic exchange of tax information, was granted to three member states on the basis of their strong and long-standing tradition of banking confidentiality, namely: Austria, Belgium and Luxembourg.

The instrument of withholding tax, in the intentions of the regulator, was deemed transitory – a means for individual investors to come to terms with the new regulations. With time, the financial load would be incremented for those investors that chose to persevere in their resolve not to divulge their income to local fiscal authorities. The initial rate of 15% tax was incremented to 20% after 1 July 2008, and on 1 July 2011 the rate will amount to 35% tax on savings income from interest payments.

Financial institutions operating on EU territory expressed their concern that the Directive on taxation of savings will only aggravate the existing problem of customers departing for non-EU financial centres. Consequently, in parallel with the discussion on the final form of the Directive on taxation of savings, EU member states put pressure on offshore financial centres to make them conform with the new regulations in the same way the EU members did. As a result of such pressure, *Savings Directive* was adopted not only in EU member states, but also on non-EU territories of Europe, such as Andorra, Liechtenstein, Monaco, San Marino and Switzerland. In effect, those countries adopted a form of the Directive similar to that of Austria, Belgium and Luxembourg, opening up the possibility of withholding tax instead of the automatic exchange of information with fiscal authorities of the source country.

Savings Directive was also imposed on offshore financial centres of dependent territories. In the majority of cases, this involved a choice between automatic exchange of information and the withholding tax solution. The latter was adopted on British Virgin Islands, the Isle of Man, Guernsey and Jersey, as well as the Netherlands Antilles. Gibraltar, a British dependency, adopted the automatic information exchange variant, with a similar solution adopted on Cayman Islands, Anguilla, Aruba and Montserrat [*Commission Staff*… 2008].

The Directive was not employed on independent offshore territories of the Caribbean region. The geographic distance and the relatively low popularity of these centres among the EU individual investors were the main reasons for the lack of pressure on the part of the EU members with respect to these countries. The postulated mechanism was outright rejected by the offshore centres of the Asia region: Dubai, Singapore and Hong Kong [Swire 2006].

4. The effects of EU regulations

The analysis of the effects of the first variant of *Savings Directive*, establishing the mechanism of automatic information exchange between countries, shows that the highest volume of interest-related income was registered in those of the largest economies that were, at the same time, the most active centres of international financial activity. The most significant volumes of interest-related income were reported in Great Britain, Germany and France. Table 1 presents overall volumes of interest payments falling under the regulations of *Savings Directive*, as reported by EU member countries and third party countries in years 2005-2007.

Table 1. Interest payments reported by countries using information exchange/voluntary disclosure 2005-2007 (million EUR)

EU Member States	2nd half of 2005	2006	2007
Bulgaria	–	–	1.54
Cyprus	5.26	15.05	25.54
Czech Rep.	2.92	17.81	26.75
Denmark	na.	415.31	693.10
Estonia	na.	4.40	na.
Finland	26.02	60.93	na.
France	568.14	2 020.04	na.
Germany	660.73	1 392.06	942.09
Great Britain	9 132.49	na.	na.
Greece	6.85	23.11	na.
Hungary	62.03	5.22	na.
Ireland	258.87	770.72	1 901.24
Italy	280.53	1 615.92	na.
Lithuania	0.09	0.09	na.
Latvia	0.18	0.65	na.
Malta	1.02	2.10	na.
Netherlands	320.65	816.22	370.26
Poland	4.84	15.4	na.
Portugal	na.	0.56	na.
Romania	–	–	7.34
Slovakia	1.87	4.76	na.
Slovenia	0.59	1.35	na.
Spain	488.11	423.42	274.64
Sweden	na.	na.	na.
Dependent and associated territories			
Anguilla	na.	na.	na.
Aruba	0.01	0.09	na.
Cayman Islands	8.81	18.02	na.
Montserrat	na.	na.	na.

Source: [European Commission 2009].

Out of the four dependent and associated territories presented in Table 1, the greatest hopes were kept in relation to offshore assets accumulated in the Cayman Islands – one of the largest offshore centres of the world. The Cayman Islands, in line with previous declarations, submitted their report on interest payments generated, but the reported volume (of as little as 18 million EUR in 2006) proved disappointing for the EU community, proving that *Savings Directive* failed to bring revolutionary results with respect to the contacts between EU residents and offshore territories.

The updated variant of *Savings Directive*, based on the withholding tax on interest payments made to EU residents, was adopted by the majority of offshore financial centres. As a result, this form of *Savings Directive* stirred strong emotions among the regulators. However, the overall volumes of tax transferred to EU member countries on the basis of this mechanism were considerably lower than the earlier estimates made by the most developed economies of the EU region. A detailed overview of tax income generated using the withholding tax regime is presented in Table 2.

Table 2. Tax revenue shared by countries with withholding tax regime 2005-2006 (million EUR)

EU Member States	2nd half of 2005	2006
Austria	9.48	44.32
Belgium	7.51	25.92
Luxembourg	35.90	124.59
Dependent and associated territories		
British Virgin Islands	0.00	na.
Guernsey	4.93	16.83
Isle of Man	13.26	20.35
Jersey	13.26	32.15
Netherland Antilles	na.	na.
Turks and Caicos Islands	0.01	0.02
Third countries		
Andorra	3.50	12.77
Liechtenstein	1.94	7.08
Monaco	3.75	11.70
San Marino	1.13	7.47
Switzerland	77.23	255.92

Source: [European Commission 2008].

It is interesting to note that the revenue shared by the three EU member states employing the withholding tax regime under *Savings Directive* – namely, Austria, Belgium and Luxembourg – was significantly higher than the revenue shared by the offshore centres. In the overwhelming majority of the offshore territories – with the exception of Switzerland and Jersey – the reported revenue was markedly lower than that reported by any of the three EU member states using the same mechanism.

As expected, the largest revenues of withholding tax were received by the largest economies of the EU community. Figure 2 presents the shares of individual EU member countries in total revenue received from withholding tax of interest profit beneficiaries (the chart applies to those countries that received more than 10 million EUR of withholding tax from third party countries over a period of 18 months).

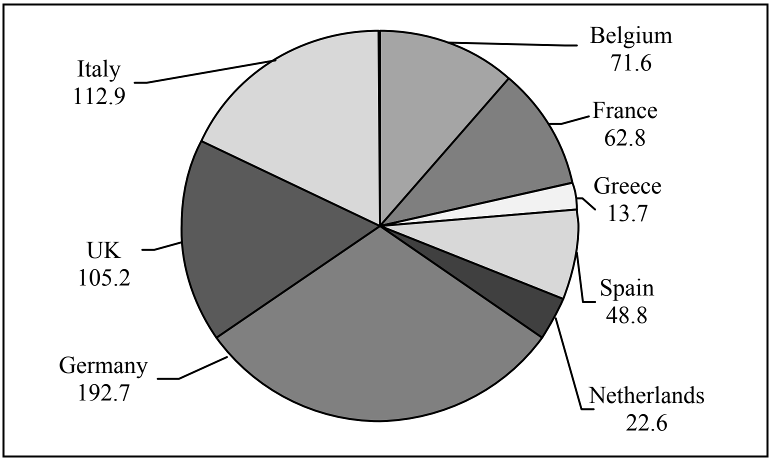

Figure 2. Received withholding tax revenue 2005 and 2006 (million EUR)

Source: [European Commission 2008].

The attempt at estimating the volume of private assets held abroad has only corroborated the scale of the trend, i.e. the amount of assets transferred beyond the jurisdiction of national fiscal authorities. By assuming the mean profitability of savings products addressed to individual investors at the level of 3-5%, the volume of assets transferred abroad is estimated at 34-57 billion EUR for Germany, 20-33 billion EUR for Italy, 11-19 billion EUR for France, 13-21 billion EUR for Belgium[2]. These are considerable amounts, and the volumes were completely beyond local jurisdiction of the respective EU member states prior to *Savings Directive* taking effect.

5. Changes in popularity of offshore financial centres following the introduction of EU regulations

The early years of *Savings Directive* application showed that the adaptation to EU requirements and adopting the regulations on target exchange of information for tax purposes not only diminished the popularity of the most important European offshore financial centres, but in effect improved their international position. The leading offshore territories, such as Switzerland, Jersey, Guernsey and the Isle of Man are the best illustration of this effect. The adaptation to international standards was accompanied by a marked increase of international activities in those territories. The aforementioned centres continued their efforts to improve their global standing by introducing non-fiscal incentives for individual customers. The high level of safety

[2] Author's own calculation, based on the European Commission data.

in financial operations, access to the most advanced investment products and the rapid development of such services as “asset management”, “wealth management” and “family offices” that offers new potential to individual investors has largely compensated the drop of competitive advantage of the prior offshore savings products. Those changes were also stimulated by the growing expectations of private customers, more conscious of the actual mechanisms that influence the financial markets and the potential of individual investment products. The offshore centres, striving to retain the present customer base and attract new clientele, have slowly departed from specialization and niche products towards a wider range of products.

The analysis of changes in financial flow from Europe to two global offshore centres that do not offer the information exchange for fiscal purposes in regard to individual investors – namely, Hong Kong and Singapore – shows a marked popularity increase of offshore financial centres that managed to resist the EU pressure in this respect. At the same time, offshore centres catering mainly for corporate entities, such as the Cayman Islands, showed no significant shifts in financial flows. By adopting the EU regulations of *Savings Directive*, the Cayman Islands have retained their standing of a global player on the market, due to the fact that their products addressed to individual EU investors were marginal (in relation to their total financial market turnover) [*Can Offshore*… 2006, p. 21].

The change in legal environment has played a significant role in the evolution of financial instruments on offer as well as in the introduction of new products for individual investors. One of the effects of new regulations that tightened the system of tax information exchange was the increased interest in products that fall outside the scope of *Savings Directive* – investment funds, life insurance products enhanced by investment options, alternative investments [*The EU Savings*… 2007, p. 9], material investments [*World Wealth Report*… 2007, p. 12]. One particularly significant phenomenon is the development of life insurance products as a substitute for safe investment products covered by *Savings Directive* regulations. A marked increase of life insurance turnover, as opposed to property insurance, was reported in Luxembourg, Isle of Man, Andorra and Gibraltar. A notable growth of capital flow in life insurance products was also reported by the Asian offshore centres of Hong Kong and Singapore. A similar increase was registered in the segment of exclusive investment funds dedicated to qualified investors. This form of closed funds, over the recent years, saw a marked increase in Luxembourg, the Channel Islands and the Isle of Man.

6. The future of offshore financial centres

In the opinion of financial market experts, the introduction of an effective tax information exchange system is only a matter of time. At present, the regulations imposed by *Savings Directive* on individual EU investors in respect to their offshore assets are not particularly burdensome. The obligation to inform local fiscal authorities (based on the place of residence) on the volume of assets held abroad is relatively easy to circumvent for EU residents. However, the impending increase of withholding tax rate on interest payments generated from assets held in most offshore centres that chose not to participate in the automatic information exchange variant will, undoubtedly, augment the existing database of assets held abroad by individual investors. This effect will be further strengthened by future modifications of *Savings Directive*, aimed to close off the existing gaps in the system. As a result, the plans of the developed EU member states to seal the tax base of their residents to enable proper taxation of their income will be accomplished.

One of the most important elements of the future evolution of the individual savings regulations is the attitude of Austria, Belgium and Luxembourg – the three EU member states with a long-established tradition of banking confidentiality. As confirmed in the early years of *Savings Directive* functioning, the new regulations did not result in narrowing the flow of capital to those three countries. The example of those EU countries that are popular global centres of financial activities is distinct proof that for the tax information exchange system to be efficient, it must not only safeguard the co-operation of the third party territories that are popular targets for individual EU investors, but also the wide support for stringent measures on the part of all the 27 member states. The present postulates in respect to future modifications of *Savings Directive* include: full coverage of offshore financial centres (particularly Hong Kong and Singapore), expanding the definition of interest payments for a wider set of financial instruments (also trusts and funds), as well as the elimination of the withholding tax variant [*Report from*… 2008, p. 5].

Further changes in the EU regulations under study will contribute to maintaining a proper investment climate for individual EU investors, eliminating the potential for tax evasion manoeuvres. However, in the experts' opinion, those changes will not result in a significant decrease of offshore centres' popularity. EU member states will gain control over assets invested with the purpose of safeguarding against the value decrease, but will remain powerless in respect to more aggressive forms of capital investment. The freedom to choose financial products, regardless of their structure, location and associated risk level is a prerequisite of the free capital movement principle and a fundament of proper development of financial markets. Any investment product offered by offshore financial centres will be evaluated by individual investors solely from the angle of the aforementioned elements.

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CENTRA FINANSOWE *OFFSHORE* W DECYZJACH FINANSOWYCH EUROPEJCZYKÓW. PERSPEKTYWY ROZWOJU

Streszczenie: Celem artykułu jest zaprezentowanie zmian w popularności centrów finansowych *offshore*, rozpatrywanych w kontekście decyzji finansowych podejmowanych przez mieszkańców Unii Europejskiej. W niniejszej pracy analizie poddano skuteczność działań legislacyjnych krajów Wspólnoty, zmierzających do ograniczenia konkurencyjności terytoriów trzecich, stosujących rozbudowane systemy zachęt podatkowych. Przedstawiono również perspektywy rozwoju centrów finansowych *offshore*, zmuszonych do funkcjonowania w nowej rzeczywistości prawnej.