The Commonwealth

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The International Tax and Regulatory Landscape for Small State IFCs

Overview

This brief is aimed at officials working in small states that host international financial centres (IFCs) with responsibility for the regulatory, technical or policy oversight of the operation of those IFCs.

The international tax and regulatory agendas pose particular challenges and issues for jurisdictions that host financial centres, and for resource-constrained small states in particular. Next year (2017) will see further significant developments including the finalisation of both the Group of 20 (G20) and European Union (EU) lists of 'uncooperative jurisdictions'.

This brief provides an overview of the evolving international tax and regulatory landscape, with a particular focus on potential implications for small states that host IFCs. It has been prepared as part of the Commonwealth Secretariat's international taxation and regulation work programme. For further information, please contact Lucas Rutherford, Economic Adviser (l.rutherford@commonwealth.int).

Key messages

- **Implementation of the tax transparency standards** will remain a key area of focus for states seeking to meet deadlines for the automatic exchange of information standard and new features of the exchange on request standard, including beneficial ownership criteria;
- The evolution of **new transparency initiatives** outside of the OECD/Global Forum processes presents both opportunities and challenges for states in terms of a decision for early engagement;
- The **G20/OECD and EU blacklisting processes** will be the key development in 2017 of interest and concern to many small states hosting IFCs. States chosen for 'screening' under the EU process can expect to be contacted in early 2017;
- There is likely to be a push for more **small states to sign up to the BEPS implementation framework**, creating challenges for jurisdictions already struggling to keep up with the agenda;
- The **continued engagement and influence of NGOs**, a **changing 'moral compass'** and the prospect of US corporate tax reform all create the prospect for further developments going forward.

Introduction

The momentum around the international tax and related regulatory agendas continues to build. In addition to a focus on implementation of the base erosion and profit shifting (BEPS) and tax transparency agendas, a number of new developments arose in 2016, largely due to the reporting that followed the release of the so called 'Panama Papers'.

These agendas are impacting and will continue to impact small states that host IFCs. This will pose challenges for jurisdictions whose resources are already stretched in keeping up with existing developments. Building on an already ambitious agenda, 2016 has seen the crystallisation of the G20 and EU blacklisting processes, a renewed focus on implementing standards around beneficial ownership and the emergence of new transparency initiatives.

The paper provides a very brief overview of the status of the G20 international tax agenda. Highlights the developments which emerged in 2016 and are likely continue to unfold, as well as potential new developments on the horizon.

The Tax Anti-Avoidance (BEPS) Agenda

The G20/OECD BEPS project is aimed at better aligning taxation with substantive activity. Thus limiting the ability of multinational enterprises to shift profits to low- or no-tax jurisdictions where little or no activity takes place. The policy proposals delivered at the end of Turkey's G20 Presidency in 2015 were tempered by inevitable compromises that occurred between countries in the OECD and the G20. However, there has been significant agreement in a number of areas which will make the use of IFCs by multinationals in jurisdictions where they do not have substantive activity less attractive.

Implementation is focussed around four agreed minimum standards which aim to:

i. prevent treaty abuse, such as the use of shell companies to gain the tax benefits of a jurisdiction's tax treaty network;
ii. strengthen transfer pricing regimes through increased transparency (country-by-country reporting);
iii. revitalise the OECD's work on harmful tax practices; and
iv. further work to improve dispute resolution procedures.

IFCs that have grown on the basis of treaty networks will need to consider the potential impact of the work on tax treaties. The rejuvenation of the OECD's harmful tax practices work will be of interest to most of the Commonwealth's small state IFCs. In light of their experience of being labelled 'tax havens' as part of the OECD's work on harmful taxation in the early 2000s. The implications of the BEPS agenda for small state IFCs without a corporate tax system, beyond the work on country-by-country reporting, was a topic of discussion at a meeting between Caribbean islands and the OECD on 13 December 2016 in the British Virgin Islands.

Implementation is following the Global Forum model with all jurisdictions invited to participate on an equal footing and with jurisdictions considered 'relevant' expected to participate. A number of small state IFCs have already signed up to the framework. Ongoing work within the framework to define 'relevant' jurisdictions and the EU blacklisting process (see below) likely to see more small state IFCs being invited to engage in the process in 2017.

The Transparency Agenda

A focus on the ongoing implementation of transparency standards has been supplemented by a number of new transparency developments in 2016. The Secretariat will be producing a separate piece on the transparency landscape, however a brief overview is provided below.

Tax transparency standards

The *Global Forum on Transparency and Exchange of Information for Tax Purposes*, the international body charged with monitoring the review of tax transparency standards, has now finalised the first round of evaluations on the existing standard of the **exchange of information on request** (EOIR). Jurisdictions that have not already achieved a 'largely compliant' rating will be focussed on upgrading their status in advance of the publication of the G20/OECD blacklist as part of the Global Forum's 'fast track' process. Otherwise, an ongoing area of focus for jurisdictions will be ensuring that they have everything in place to meet the strengthened terms of reference for EOIR (which include a requirement on the availability of beneficial ownership information) the reviews for which are already underway.

Following the G20's endorsement of the new standard for the **automatic exchange of information** (AEOI) in 2014, all financial centres have now committed to the early adoption of the standard, with first exchanges occurring no later than 2018. Implementation, focussing initially on the legal frameworks to support the domestic collection of information from financial institutions and the international exchange of that information, will need to be in hand. Reviews of a jurisdiction's framework for data protection and confidentiality are ongoing, and jurisdictions will be asked to undertake further steps to meet these standards.

Links to the regulation agenda

There has long been a close relationship between the regulatory standards created under the Financial Action Taskforce's (FATF) anti-money laundering and countering the financing of terrorism (AML/CFT) regulations and the tax agenda. Significantly, the beneficial ownership definitions used in the tax transparency standards are linked to the definitions in the AML/CFT standards. The requirement to make available the beneficial ownership information of legal persons and arrangements has been a feature of the AML/CFT regulations since 2003. Notwithstanding this, the increased attention on beneficial ownership as a consequence of the reporting following the release of the 'Panama Papers', and the call by the G20 for both the FATF and the Global Forum to develop proposals to improve implementation of beneficial ownership standards (G20, 2016b), is likely to increase the scrutiny on a jurisdiction's capacity to meet these standards, both in relation to tax transparency and AML/CFT. The recent evaluation report of the USA highlights that meeting these standards is a challenge for even larger jurisdictions (FATF 2016).

Emerging new transparency standards

2016 has seen the emergence of a new transparency initiative. The initiative for the **automatic exchange of beneficial ownership information.** Although the details are still being developed, this initiative has received a commitment from over 53 jurisdictions and has the broad goal of developing a standardised system for linking registries of beneficial ownership information. A number of small state IFCs have already signed up to the initiative. For others, the decision to commit requires balancing the challenges of allocating resources already stretched with a full international agenda and the benefits that come from being able to shape standards as an early adopter and the 'signalling' benefits (in terms of reputation) that may also arise.

The G20 and EU 'blacklisting' processes

Following their development through the G20 and OECD, the broader roll-out of the international tax avoidance and evasion (transparency) agendas outlined above is now supported by two listing processes being undertaken by the G20/OECD and the EU. The listing of jurisdictions that fail to meet certain standards in order to encourage compliance is not new – it continues to be a feature of the AML/CFT regulatory framework and, as noted above, has also been a feature of the international tax agenda in the past.

A brief overview of the processes is provided below. The Secretariat has also prepared a more detailed summary of the criteria and processes with links to relevant source documents.

The G20/OECD list

At their summit in Hangzhou in September 2016, G20 leaders endorsed the OECD's proposed criteria against which jurisdictions will be assessed for inclusion on a list of 'uncooperative jurisdictions' (G20 2016).

Criteria

The proposed G20/OECD list will include only jurisdictions that fail to meet international tax transparency standards. To be considered cooperative and avoid being listed all jurisdictions with financial centres would need to meet two of the following three criteria:

i. have achieved a 'largely compliant' rating under the peer reviews of the Global Forum for the standard on **EOIR**;
ii. have made a commitment to implement the new standard on **AEOI** with first exchanges by 2018 at the latest;
iii. have in place the necessary **legal basis for exchange.**

However, jurisdictions will be considered uncooperative if they have been found to be non-compliant with EOIR, or have not yet received a rating under certain circumstances.

The criteria will evolve over time as implementation of the standards continue.

Process

The status of a jurisdiction's rating, commitment to AEOI and legal basis for exchange should already be largely known so the final list should be less uncertain than the EU process. A 'fast track' process is available to jurisdictions who apply to have any progress recognised in implementing EOIR in advance of the finalisation of the list.

The list will be finalised at the July 2017 G20 Leader's Summit in Hamburg. Whilst the threat of listing in and of itself may be enough to encourage engagement. G20 leaders also indicated that they 'stand ready' to apply so-called 'defensive measures' (or punitive measures) against listed jurisdictions. However, reaching a consensus amongst G20 members on the actual implementation of such measures may prove more challenging than simply issuing a warning.

The EU list

As part of the EU's work on good tax governance, EU Ministers have committed to the development of a list of 'uncooperative jurisdictions' that will be finalised at the end of 2017. The list involves a three stage process and goes beyond the G20/OECD list's focus on the implementation of tax transparency standards to aspects of a jurisdiction's tax regime considered to facilitate aggressive tax planning and tax avoidance.

Criteria

The EU listing process will be based on three criteria. Broadly, to be considered cooperative and avoid listing, 'selected' (see below) jurisdictions must have:

i. met/committed to **international tax transparency standards** (this appears to be largely aligned to the G20/OECD criteria);
ii. met the **'fair taxation'** criteria, meaning that the jurisdiction does not have harmful tax measures as defined by the EU nor does it facilitate the creation of offshore structures that can be used for profit shifting; and
iii. committed to the **BEPS implementation** framework, including the four minimum standards (see above).

The EU has emphasised that the criteria is linked to international standards and this appears true with respect to the first and third criteria. Expectations around tax transparency should already be well understood by jurisdictions and the need to commit to the BEPS implementation framework would likely have arisen in any event in the course of 2017 as the various implementation working parties identify which relevant jurisdictions should be invited to join the framework to ensure a 'level playing field.'

The BEPS agenda, however, highlights that the devil is always in the detail. The same also seems true of the EU listing criteria given that, though seemingly closely aligned to the policy ambition of the BEPS agenda, the inclusion of the fair taxation criteria as a separate item suggests that the EU may go beyond the agreed standards. One area of potential contention is whether or not a zero or low tax rate will itself be considered harmful which is not the case under the longstanding OECD criteria for harmful taxation.

As with the G20/OECD criteria, the EU criteria will evolve over time in line with the implementation of various standards.

Process

Listing will involve a three stage process:

i. a **pre-assessment phase** involving the selection of jurisdictions for screening, based on their economic relevance and risk posed;
ii. a **screening phase** in which selected jurisdictions will be assessed against the criteria and be invited to engage in a dialogue with the EU; and,
iii. a **listing phase** involving the listing of jurisdictions and an indication of the steps that can be taken to remove a jurisdiction from the list.

The selection of jurisdictions for screening is now underway with early reports indicating that a number of Commonwealth small state IFCs are likely to be selected for screening (BNA 2016). The screening process will take place in the course of 2017 with the final list to be produced by the end of the year. Concurrently, work is underway to identify potential 'defensive measures' which will include both tax and non-tax measures.

Other developments on the horizon

2016 has demonstrated how quickly an already ambitious international tax and regulatory agenda can further evolve. As well as the development of many of the initiatives outlined above, 2017 may be yet another big year of change, challenges

and opportunities for small states in relation to the international tax and related regulatory agendas. Some of these are highlighted below.

Germany's G20 Presidency

Many of the international tax and regulatory developments have evolved through the G20. Therefore, the agenda for each new G20 President is a good indication of any developments on the horizon. Germany's focus will continue to be on the implementation of the BEPS and transparency standards, but also has a new focus on 'tax certainty'. This provides an opportunity for IFCs focussed on value-added services to emphasise the important role that they play in facilitating the smooth flow of global flows of capital that are essential to economic growth.

New transparency developments – the role of tax NGOs

Non-governmental organisations focussed on taxation have bcome increasingly influential in both building public support for reform and consequently helping to frame the international transparency debate. As such their current areas of focus may provide some insight into potential areas for further developments. Whilst subject to some strong resistance, an ongoing area of focus is the emphasis on ensuring that various initiatives involve 'public transparency' which would open it to broader scrutiny. The call for country-by-country reporting reports and beneficial ownership registries to be made public are two such examples.

NGOs may also prove to be an unlikely ally to small states finding themselves caught up in the current blacklisting processes. A number have been quite critical of the politicisation of previous processes that have tended to focus on small, voiceless states and overlooked larger states that may have otherwise been included given the stated goal of the listing process (TJN 2016).

The changing moral compass as a catalyst for further regulatory reform

The international response to the reporting that followed the release of the 'Panama Papers' was largely focussed on furthering the transparency and multinational anti-avoidance agenda. However, the public reaction in many G20 countries perhaps reflects a more fundamental concern about the perceived fairness of domestic and international systems. In a post-Brexit and US election world, this is taking place in the context of a much broader concern about growing inequality and the disaffection many arguably feel as a consequence of globalisation. This may ultimately translate into a further push for reforms in the global and domestic tax and regulatory systems which could impact small states.

An example of this are the arrangements adopted by some small states (and others) seeking to encourage wealthy investors to shift their residence. Pascal Saint-Amans, the head of the OECD's Centre for Tax Policy and Administration, indicated that the OECD is already working on ways to curb such arrangements, to the extent that they can be used to undermine the tax transparency agenda (Houlder 2016).

The Trump Card – US Tax Reform?

Another looming and significant development in the international tax and regulatory landscape will be the policy agenda for the new Trump administration. The long stalled US tax reform agenda is likely to be relaunched. Of particular interest is the suite of corporate tax reform measures, which could result in a significant repatriation of funds of US multinationals currently held in offshore jurisdictions.

Conclusion

The consolidation of the international tax and related regulatory agendas, along with new developments in 2016 (including the blacklisting processes) emphasise the fluid environment in which IFCs based in small states operate. This highlights the underlying challenges facing host Governments in keeping pace with a very dynamic agenda.

In the complex strategic environment in which the reputation of a jurisdiction is at stake, early engagement with these developments is important. The Commonwealth Secretariat continues to stand ready to support its members in engaging with and understanding this complex environment. Assistance would entail giving its small state members a greater voice, ensuring amongst other things that international processes are inclusive and fair and recognise their underlying development challenges.

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