



# A tailwind in the UAE's favour

With traditional tax havens under duress to disclose more information, the UAE is getting increased attention as the only GCC country to be on the famous OECD white list. This fact is also helping the UAE in its ambition to rise as an international financial centre. **Utpal Bhattacharya** investigates.

**I**t seems there is no going back for world leaders on the promises they've made to bring serious changes to the way the global financial economy is run in the future. Faced with an unprecedented credit crisis in terms of magnitude and large swathes of the global population becoming impoverished, politicians have decided to play hardball.

Of course, something had to give in a capitalism that focused only on profits while nothing else mattered. This was an era where profiteering became synonymous with racketeering and avarice became a virtue as those with the trait were rewarded with monstrous bonuses

that only fuelled more greed. It was an era of unscrupulous bankers and salesman who lived on others' hard-earned money and sold fanciful dreams that ultimately came to naught and brought the world to its knees.

But what a journey it was from the turn of the millennium to the climactic heights of 2007-2008, when nothing seemed to be going wrong from New York to Shanghai, when everything moved north and when 24-year-old recent college graduates drove swanky sports convertibles and lived in penthouses.

Obviously, nature had to intervene to return some measure of balance and

sanity to the system. Otherwise, with the way inflation was feeding into the system, those whose hard labour made it possible for all the glitz to be created wouldn't have been able to carry on much longer. And those who had been using the system to grow fatter by instigating Ponzi schemes and selling rubbish as asset-backed securities would have forgotten what it was like to work in the real world.

A lot of water has flowed under the bridge since the US housing market first faced a reality check in the summer of 2007. One thing led to another until Wall Street started caving in a year later with behemoths like Lehman Brothers filing for

bankruptcy. The world could have faced a much larger crisis had governments across the world not taken unprecedented monetary and non-monetary measures, bringing new liquidity into the system and keeping interest rates down. Today, a majority believes that the fear of recession is history and that green shoots are real. Clearly, the recovery will take its own sweet time, but most believe that it will begin in the east. Some signs to back up that belief are already there.

## What next?

Between the unfolding of the crisis and now, policymakers have taken the help of a number of lessons from the past, including those learned during the Great Depression, to stave off a much bigger global catastrophe. However, having managed that phase reasonably well, politicians are now beginning to focus on measures that are needed to save the world from future crises of similar or greater magnitude.

Led by the US, Europe and the rest of the G-20 economies, talks of bringing greater accountability to the financial markets have begun in earnest. Certain areas have caught policymakers' attention more than others, from hedge funds to rating agencies to dirty money. The so-called tax havens are also in the thick of the action. Countries that lose hundreds of billions of dollars in tax payments every year (such as the US and UK) want to bring some of these "lost" revenues into their respective countries, especially at a time when every penny has become important.

All that is happening in the financial world is of immense importance to everyone. But for countries in the GCC that aspire to be regional or international financial centres, these developments affecting the future of tax havens have attained significant importance. A lot of regional wealth is booked in some of these offshore tax-neutral centres from the region for reasons of both asset protection and discretion. However, with the spotlight on these jurisdictions and the pressure from powerful countries for them to disclose information, the purpose they served for clients in the Middle East and elsewhere for many years is now threatened. In the future, international financial centres and

tax havens will not be able to maintain the same confidentiality of client information. Information will be out in the open, in the public domain.

A G-20 communiqué issued at the group's April summit in London emphasised that the era of banking secrecy was over. Following the communiqué, three OECD lists were placed before the world. Famously known as the white list, the grey list and the black list, these lists comprise the names of various offshore international financial centres and have sent a clear message to the financial world that opacity and secrecy will not be tolerated when it comes to the issue of disclosure.

The definitions of the lists are straightforward. All of the "good boys" are on the white list, while the not so good are on the grey. Those jurisdictions that have substantially implemented the internationally agreed tax standard are on the coveted white list. On the grey list are those centres and countries that have committed to the internationally agreed tax standard but have not yet substantially implemented it. The black list comprises jurisdictions that have not committed to the internationally agreed tax standard.

An offshore financial centre must sign tax information exchange agreements with at least 12 countries and others to be on the white list. Traditional onshore financial centres can be on the white list if they have a double tax treaty network. Since the announcement of these three lists, various jurisdictions have been frantically signing these agreements to be on the white list.



Laurence Black

Significantly, Switzerland, which is the world's leader in offshore private banking and has a market share of nearly 27 per cent, is on the grey list, while the UAE, an aspiring international financial centre, is in the white list.

Switzerland is not the only country to find itself on the grey list. Some other famous names are on that list too, including the British Virgin Islands and the Cayman Islands.

The G-20 has also come up with a toolbox for countries to consider as countermeasures against using tax havens. These include increased disclosure requirements on the part of taxpayers and financial institutions to report transactions involving non-cooperative jurisdictions, withholding taxes in respect of a wide variety of payments, denying deductions in respect of expense payments to payees resident in non-cooperative jurisdictions, reviewing tax treaty policy, asking international institutions and regional development banks to review their investment policies and giving extra weight to the principles of tax transparency and information exchange when designing bilateral aid programs.

Other measures are also in the offing, while the US is pushing its own agenda by introducing the Stop Tax Haven Abuse Bill. After the G8 summit in L'Aquila in July, it now increasingly appears that the OECD will start looking at the quality of tax exchange agreements, rather than just at the number of them, to determine whether countries are removed from the grey list. This story is certainly a developing one that is becoming more gripping as onshore economies try to bring as much revenue into the mainstream as possible from offshore centres.

## Offshore wealth

Technically, tax havens have been around for centuries. The modern concept of the tax neutral jurisdiction was, however, born after World War I. There are claims and counterclaims regarding which was the first modern tax neutral jurisdiction. Most pundits seem to favour Switzerland.

Through decades in the last century, developed countries in the west never raised much of a finger against these jurisdictions that were used by the rich for

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# In defence of international financial centres

Global leaders are expected to continue with the pressure they have created for international financial centres to disclose more tax-related information at this month's G-20 summit in Pittsburgh. **Jennifer Thomson and Philip Paschalides** rise to the defence of these international centres and their business models.

The axiom has often been repeated that a good scapegoat is nearly as welcome as a solution to the problem. Indeed, the truth of this statement has been keenly felt in international financial centres (IFCs) such as the Cayman Islands, the British Virgin Islands and Jersey, which have experienced an unprecedented level of media attention over the past 12 months. As world leaders faced the heat on the woeful state of the global economy (and found it difficult to explain the involvement of regulators and central banks in the debacle), attention quickly turned to IFCs, which felt they were being employed as convenient decoys by those seeking to escape the critical attention. The hype reached a climax around the time of the G-20 summit in April.

The governments of – and the financial services professionals working in – the most successful and mature IFCs have despaired at the lack of understanding of their business models and the benefits that they offer to the G-20 and other onshore jurisdictions. Their relative size and absence of representation at the decision-makers' tables has made it difficult for IFCs to get their message across.

While the reality is much less interesting and glamorous than the outdated stereotype peddled by the entertainment industry and the media, it is important that it be understood by policymakers onshore and by the custodians of our global economy.

Even the most mature IFCs are often criticised for offering some or all of the following services: moderate or light financial regulation, banking secrecy and anonymity and low or zero taxation.

## Regulation

Although one of the most frequently cited characteristics of IFCs are their light financial regulation, it is noteworthy that none of the banks in the Cayman Islands (the world's fifth banking centre)

failed during the recent crisis. Indeed, the Cayman Islands Monetary Authority, the Jersey Financial Services Commission and the British Virgin Islands Financial Services Commission (which regulate hedge funds, banks and insurance companies) are full members of the International Organisation Securities Commission, are members or observers of the Offshore Group of Banking Supervisors and adopt the Basel core principles for banking.

The Cayman Islands, the British Virgin Islands and Jersey are already subject to and have had a number of successful compliance reviews by the FATF and the IMF over the past decade with respect to their anti-money-laundering and financial regulation. Obviously, this endorsement from such international bodies suggests that the level of regulation is entirely appropriate and proportionate, given the activities and business models of these jurisdictions.

## Banking secrecy

It is undeniable that the financial services industry in certain jurisdictions has flourished owing to very strict banking secrecy legislation. Businesses in those countries have attracted a high net worth client base looking to invest in a location that guarantees them privacy in their financial affairs. It is often assumed that the sole reason for establishing an offshore bank account is tax evasion, but there are entirely legitimate reasons for doing so that are unrelated to tax evasion, such as seeking the benefit of political stability, client service, reputation and financial security.

An individual living in a country with a repressive political regime may well, for example, select such a jurisdiction as a safe harbour for his or her financial affairs. However, to the extent that tax evasion is a motivating factor, any guarantee of secrecy in the mainstream financial centres is a thing of the past – all the indications are that the ability of the tax authorities in

other jurisdictions to access information previously denied them is increasing at great speed, and the well-publicised battles between UBS and the US government are a clear indicator of the changing times. Will this have an impact on this area of their business? Of course it will. But a number of these jurisdictions already have diversified financial services industries that will continue to attract different types of business, and a number of them left behind this sort of business model some time ago.

Some IFCs may historically have attracted business on the back of their confidentiality legislation, but that feature has played a less and less significant role over the years. Such IFCs are unlikely to be affected by any push to change their banking secrecy legislation. A number of them (such as the Cayman Islands) have already undertaken an assessment of confidentiality provisions on their statute books with a view to removing a few stray provisions that have long been considered redundant in practice. The international focus on tax information exchange and transparency has, in some cases, simply acted as the catalyst for the IFCs to engage in practices to which they were already committed in principle and to spring clean their legislative cupboards in order to ensure that their regimes reflect the reality of the business being conducted there. Financial centres are focusing on what type of business it is that they do and the type of business they want to do.

## The IFC business model

The more mature IFCs (for whom the end of secrecy is not an issue) are generally sophisticated business communities boasting a developed infrastructure that can attract and accommodate a high standard of professional service providers. It would simply not be possible for an IFC like the Cayman Islands to become and function as the fifth largest banking centre

by volume of deposits were it not so. Such IFCs have evolved from the secrecy model, where assets may be immobilised inside a jurisdiction, to provide a much more dynamic service, acting instead as conduits through which the currents of international capital may flow efficiently. For them, the age of banking secrecy has been over for many years.

Such mature, institutionally-oriented IFCs are home to companies, trusts and partnerships (each an IFC vehicle) that act as investment funds, issuers in capital markets and structured finance transactions, providers of insurance and alternative risk transfer arrangements, as well as financing or ownership vehicles for commercial aircraft and ships or for infrastructure projects taking place in virtually every part of the globe. The clients who arrange, sponsor and participate in these structures are high profile fund managers, leading banks, governments and supranational organisations, and they are all utilising mature IFCs on account of the various features offered by them, which enable and optimise certain commercial activities.

Mature IFCs have a number of features. They are generally common law jurisdictions that have enacted specialist legislation to facilitate certain types of investment structure or financing transactions. Mature IFCs also have creditor-friendly legal systems, which make them a good venue for finance transactions because creditors are given a strong legal position against their debtors.

Another feature of IFCs is that they offer legal neutrality, such that investors from one nation can do business with investors from another on neutral ground and on equal footing with one another, enabling international capital to be pooled freely. Mature IFCs are generally politically, socially and economically stable, both making them ideal service jurisdictions and also giving them stronger sovereign credit ratings from the rating agencies. This consequently makes lending to IFC vehicles less risky and enables more efficient financing.

Mature IFCs attract a highly professional workforce and offer strong local representation from quality service providers such as lawyers, accountants, administrators and banks. In addition,

mature IFCs generally have no exchange controls or other factors that impede the free movement of capital or constitute a cost to or charge on investment structures.

### The truth about tax

One factor is noticeably absent from the above list, perhaps because it is not really a factor in its own right in many cases: tax neutrality. The choice of term is intentional. It means that the decision to use an IFC vehicle is neutral for tax purposes. The term does not mean that an IFC is used to avoid a tax. IFC vehicles will never escape paying taxes that are due in the jurisdiction where they operate or have assets, and investors who hold the equity or debt of IFC vehicles will always themselves be liable to pay any taxes due in their home jurisdiction. Tax neutrality merely means that investors or finance parties take advantage of the many legal and other structural benefits offered by an IFC without any dilution of their returns, since no levy is made by the IFC on either capital or income as it flows through the IFC.

The business model of the mature IFCs is therefore geared up to facilitate the collection of capital at a single neutral point and to enable cost-effective movement of that capital to the places in the global economy where it can make a difference or earn a handsome return.

For mature IFCs following that business model (such as the Cayman Islands, the British Virgin Islands or Jersey), the tax haven label so unthinkingly applied to them by the media constitutes a gross misunderstanding of what business these jurisdictions engage in and how vital it is to the workings of the global economy.

### Exchange of information

Of course, the media spotlight has centred on tax evasion as the primary mischief to be eliminated in our time of crisis. The fact that banking secrecy (and its alleged support of unwholesome activities) is not a major consideration of most IFC business models is evidenced by the developments in tax information exchange over the last 12 months.

Although the initiatives of the OECD in countering "harmful tax competition" had been ongoing since 1998, they received

fresh support as a direct result of the global financial crisis. In the months before and after the April 2009 G-20 summit, at which the consideration of tax havens was on the agenda, there has been a clear rush by many IFCs to sign up tax information exchange agreements in order to meet the internationally agreed tax standard.

A number of the most reputable IFCs were either judged at the outset as having substantially implemented the standard and thus appeared on the OECD's so-called white list or have since then been added to that list. Other countries are expected to follow suit.

The OECD has indicated that over the coming months, its committee on fiscal affairs and the global forum will review its standards to take account of more qualitative issues. It is not anticipated that the serious jurisdictions operating as IFCs will do anything but welcome and respond to the outcome of those reviews. Many are active or contributors to OECD committees addressing tax harmonisation issues and will welcome opportunities for further cooperation and seek to consolidate their position as valuable contributors to the global economy.

### Revising the political agenda

IFCs expect to find themselves on the agenda at the next G-20 summit in Pittsburgh and therefore, once again, inspire column inches and headlines and are the subject of discussion by world leaders. Hopefully, recent events will have convinced the G-20 of the cooperative intentions of the IFCs and, by September, those leaders will have understood that this cooperation runs deeper than merely signing up to the requisite number of exchange agreements. During the same period that IFCs were the object of constant misunderstanding and misrepresentation, they were ironically participating in the measures designed to promote stability in the global economy. One wonders how many IFC vehicles are now supporting the US government TALF programme.

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various purposes, from asset protection to tax evasion to money laundering. But it is wrong to assume that most assets under management in these centres have their origins in ill-begotten wealth or laundered money. Some of these centres have thrived because of financial skills, bespoke services and other efficiencies.

There are various estimates of assets held offshore. The Tax Justice Network published a report entitled "The Price of Offshore" in March 2005. Based on data from the Boston Consulting Group, McKinsey, Merrill Lynch/Cap Gemini and the Bank for International Settlements, this report estimated that the world's high net worth individuals held around US\$11.5 trillion of assets offshore. It also estimated a notional tax loss of US\$860 billion a year at a rate of 7.5 per cent return. This figure was believed to be extremely conservative, as it did not include tax losses from tax competition or trade mispricing. It also did not account for individual holdings of liquid assets below US\$1 million among other exclusions.

According to a more recent report published by the Swiss Bankers Association last January, private banking assets held offshore in 2007 totalled US\$7.3 trillion. The report on wealth management in Switzerland further mentioned that global wealth climbed to US\$109.5 trillion in 2007 from US\$99.6 trillion in 2006. The share of assets held offshore in private banking grew at a rate of 8.2 per cent in this period, compared to onshore assets, which grew at a rate of 9.1 per cent. The report thus established that the onshore market tends to grow faster than the market for offshore private banking.

Of course, this has not stopped the US (which has a market share of nearly 40 per cent of total assets under management globally) from venting its frustrations about the revenues that it loses due to offshore tax evasions. The US estimates that it loses US\$100 billion in tax evasion through offshore centres every year. Switzerland and some of its largest banks are at the centre of that controversy.

## Implications for the GCC

Sandy Shipton, executive director



Sandy Shipton

of wealth management at the Dubai International Financial Centre (DIFC), finds the excess attention on tax havens almost like a deliberate diversion from the real malady affecting the global banking system. Although he does agree that not all is substance in a number of these jurisdictions and that many of them have a lot to explain, he argues that there is much more to it than just tax evasion that led to the global downturn.

"The US provides a myriad of allowances and exceptions for its own corporations to make use of certain financial centres, including Delaware. The volume of cash that enters the Miami, Florida economy from that ghastly drug trade is astronomical. So I take this latest fashion of tax haven bashing with a jaundiced view, as those who protest today have created these financial centres like the Channel Islands, Monaco and Hong Kong over a long period of time," he says.

Despite Shipton's stand, it is apparent that emerging financial centres like Dubai now have a strong tailwind coming in their favour as a result of the pressure that some of the traditional destinations are facing. The fact that the UAE is on the OECD white list is certainly helping Dubai in its ambition to rise as an international financial centre, admits Shipton.

Laurence Black, chairman of STEP Arabia, agrees. He adds that transparency is here to stay, as the OECD has drawn a clear demarcation between what is white and what is grey. There is also a black list. Some of these jurisdictions will be forced to sign tax information exchange

agreements with the US and with European countries, which means that the old model of not disclosing information is ending, Black says.

"This move is going to make a significant difference to the global financial industry, particularly where trusts are involved. Switzerland, for example, is affected by it, as it is on the grey list. But since the UAE is on the white list, and since people know that the DIFC is a very credibly regulated destination with a good supply of financial and technical expertise, it is going to see major support from investors going forward," he adds.

Black notes that some of the above is already happening, as people have started moving jurisdictions from some of the traditional destinations to the DIFC, especially now that the UAE has found its name on the white list.

"There is ample evidence of people moving existing businesses that no longer fit the traditional jurisdictions to the UAE. They are moving their structures, whether corporate or trusts, to the UAE, and they are increasingly using the UAE as a booking centre," he says.

The STEP Arabia chairman also expects new businesses to automatically divert to the DIFC or Qatar in the region, given the recent developments.

## The DIFC's positioning

Shipton is, however, quite categorical in saying that not everyone is welcome to the centre. He points out that whatever the DIFC has achieved in the past four to five years has not come as a gift, but rather because of hard work. The high principles set by the financial centre will not be compromised at any stage.

"We are more interested in substance than form. We are not interested in attracting holding company arrangements at the DIFC. We are not about virtual, post office box entities, but about families or substance, and we are proud of what we have achieved," says Shipton.

The DIFC has some 900 establishments today, 250 of which are the world's leading banks. A number of prominent GCC families have also set up family offices at the centre. Shipton discloses that large and prominent families from Asia, India

and Europe have set up their family offices in the DIFC. There are more coming, too, not just because of the white list, but also because of the DIFC's positioning and its location between China and the west.

A massive transition in global asset ownership is going on right now, with China being the largest credit agent to the US. The DIFC is at the right location with good infrastructure and a good regulatory environment to help in the process, notes Shipton.

"The concern today is of raising the standard and not lowering it. We cannot walk away from what the G-20 has shown us. We cannot walk away from the American and the European strictures, even though we might find them not that relevant to what we are doing in the DIFC," he adds.

## Other regional centres

Black sees the Qatar Financial Centre (QFC) as the only competition that the DIFC faces in the region. He explains that Bahrain has traditionally serviced Saudi Arabia and has not grown in recent years to cope with the additional work. Qatar, however, has emerged as a competitor for Dubai, even though the DIFC has a head start and has created far more confidence and awareness than the QFC, he says.

Among other aspiring centres in the region, the RAK Free Trade Zone is making efforts to position itself as a destination for attracting trust and asset holding companies. This free zone is in an advanced stage to set up its own trust and Islamic trust regulations.

Jas Sekhon, regional director of international companies at the RAK Free Trade Zone, has been charged with creating a destination in the emirate's free zone for international investors and entities to set up their international holding companies.

"We are setting up as the holding company jurisdiction, where one can hold and trade one's global assets. Our target is not the billionaire families, but those that have business turnovers of US\$200-300 million," he says.

The RAK model is very different from that of the DIFC. With some of the traditional centres under pressures, Sekhon reckons that lawyers and accountants who deal



Jas Sekhon

with small and medium enterprises will find the RAK Free Trade Zone to be an ideal destination.

The RAK Free Trade Zone will allow common law trust and civil law foundations. It will also license only those entities that are already licensed in another respectable jurisdiction, like the UK or Switzerland.

Sekhon says that the RAK model is attracting significant attention. The free zone already has a presence in Europe and is looking at increasing the European presence of European advisers and clients to address concerns of the expense and administrative burden of establishing an entity in the UAE that is competitive with Hong Kong or Singapore.

## The dangers

A lot of Sekhon's confidence comes from the tax information exchange agreements that traditional havens are now being compelled to sign. He says that the criteria that differentiated the grey from the white list were about the degree of information that a country or a centre disclosed. With that differentiation not being there in the future, it will become a more level playing field. The UAE has already entered into 47 double tax treaties over a number of years. Sekhon sees this fact as a major differentiating factor between jurisdictions.

"Traditional offshore havens always succeeded because of no taxes and confidentiality. But with the latter concept now not being there, it has put us in a unique position, as the UAE is a legitimate

no-tax onshore jurisdiction. Money is going from offshore centres to onshore centres now," Sekhon asserts.

He adds: "The UAE needs to ensure now that it captures some of these funds that are legitimate investments and does not attract illegitimate sources that will ultimately tarnish the reputation of the jurisdiction."

Shipton and Black also issue a word of caution. Both say that there is always a danger of overdoing things and are of the view that the UAE's financial centres need to be careful that they do not end up attracting questionable investors or money.

And they're right. With the intense pressure to disclose, liquidity has already started moving and some of that liquidity is under scrutiny. For onshore financial centres like the DIFC, more vigilance will be a must going forward, while the opportunity of attracting the right wealth should not be missed.

Black further emphasises that the responsibility does not lie with the regulators alone, as practitioners have to ensure that best practices are followed. Central banks in the region should now start thinking about regulating the onshore activity of various service providers as well and not just rely on banks for disclosures, he insists.

Adds Shipton: "The principles that are being set now are by other people's club rules. And these other club rules, whether from the US or Europe and whether they are brought in through the collective of the OECD, we must pay regard to them. What we have achieved here is not an automatic gift. If we are on the white list, it is critical that all parts of the UAE should ensure that these high principles are not offended."

It is true that a combination of factors is helping regional centres. The DIFC has not only set the right foundations, but also has a head start over the others. Only time will tell how much Dubai and the UAE benefit from the circumstances that the world is in now. One thing is for sure, though. Both the practitioners and the regulators in the UAE have their work cut out for them, as they will have to ensure together that the country remains on the white list for a very long time.