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SOVEREIGN

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The EU Directive on Taxation Savings

It appears as though this is now a done deal. Italy obtained concessions on its milk quota and dropped its objections. Switzerland has fallen into line. The US legislation has been conveniently deemed compatible. So the new legislation is set to become effective as of 1st January 2005 and, in most European states, will cause an automatic exchange of information on any account which bears interest and which is owned by an EU citizen. For further details on this directive see *page 9*. **If this is of concern to you then please contact your nearest Sovereign office as soon as possible.**

Malta

We reported in Issue 13 of this *Report* that we had been instrumental in drafting and proposing new legislation in Malta, which allowed for the redomiciliation of companies into Malta. Since then we have completed the first ever redomiciliations. Anyone who owns property in Portugal through an offshore company is faced with a large, additional tax burden due to new legislation. Redomiciling the company into Malta will avoid this new tax. We have contacted all our clients suggesting this and other solutions to the new tax burden but many property owners have failed to respond to our correspondence. We would urge anybody who has yet to contact us to do so immediately. **Portuguese property owners who fail to address the issue by the end of this calendar year will face large fines and/or possible expropriation of their properties.**

The Planetary Fund

Sovereign Asset Management Ltd's Planetary Fund has now shown a 21.94% return since its launch in

chairman

February this year. This fund relies on picking medium-sized stocks from a range of different countries, including emerging markets, and should be of interest to anybody looking to recoup losses made on the stock market over the last two years. Please contact Chris Labrow in Gibraltar for further information.

Sovereign (Bahamas) Ltd

After 11 years with the company, Paul Winder has now left our employ as managing director of our Bahamas office. Paul is now working with Ansbacher in Nassau so hasn't even had to leave the building as our own offices are located within the Ansbacher building. We wish Paul well in his new employment and thank him for services rendered. By coincidence, our new managing director is Alan Cole who previously headed up Ansbacher in the Bahamas! Alan brings a breadth of relevant experience to our Bahamas operation as his involvement in the offshore industry has previously encompassed fund management – a particular expertise – offshore company and trust formation and management and the full range of banking and investment services.

Miss World

Congratulations to Kim Falzun who works in our Gibraltar office. Kim entered the Miss Gibraltar contest, sponsored by Sovereign, and came out the winner. She will now represent Gibraltar in the Miss World pageant in China in November this year. We wish her luck.

Howard Bilton BA(Hons)
Barrister-at-Law (England, Wales & Gibraltar)
Chairman of The Sovereign Group

IBM survey says private banks may be in terminal decline

Traditional European private banking may be heading into terminal decline according to a survey of 105 European wealth managers and private banks by IBM Business Consulting Services.

"The traditional European offshore model is dying," said the survey. "Banks must restructure to survive." Analysts forecast that offshore private banking operating revenues would fall by 5% in 2003 following a 50% decline in the previous two years.

European private banks managed about US$8 trillion, 40% of it held offshore. Swiss banks had the largest share of the offshore market, managing about US$2 trillion in private client assets. The report estimated that up to 60% of non-Swiss money deposited in Swiss banks was of EU origin and not declared to relevant tax authorities.

This revenue was under threat with the EU, the US and the OECD putting pressure on offshore territories to share more client information with investigators and the impact of tax amnesties, like the one given by Italy last year which led to an exodus of Euro30 billion from Switzerland.

Respondents to the survey ranked Singapore as number two after Switzerland when asked which offshore centre would become the most important in 2005. Luxembourg was the third most important, followed by the UK, Hong Kong and Jersey.

Survey participants expected offshore revenue growth to return – but only to 8% in 2005. They also anticipated rapid growth of cross-border declared monies that rely on tax arbitrage rather than secrecy.

"Going forward, we therefore expect the gap between onshore and offshore growth to widen with onshore growing faster where respondents expect to see 23% in their revenue growth in 2005," said the survey. "We expect in the long term to see a change in the structure of the European industry towards a more onshore and international declared rather than a traditional offshore-based market."

The survey also noted that the strong push by regulators had led to a change in the ranking of other traditional centres such as the Bahamas, Monaco and the Cayman Islands. "There is a premium price that is still paid for secrecy and confidentiality," the report stated.

Sovereign comment

On *page 9* you will find a special report on the effect of the EU Savings Directive and the agreement between the EU and Switzerland. The statistics about the amount of undeclared money deposited in Switzerland are interesting. We would again remind clients that it is almost always the case that a tax effective structure can be implemented which provides the client with an effective way of saving tax without indulging in tax evasion. Such structures may not be inexpensive – but they are a lot cheaper than paying fines and other penalties for non-declaration of profits. *If you have any doubts about whether your offshore structure is Revenue compliant then we strongly suggest you contact your nearest Sovereign office for a free "health check".*

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europe

UK calls off sovereignty talks with Gibraltar

The UK has effectively abandoned talks with Spain on sharing sovereignty over Gibraltar after Europe Minister Denis MacShane told a Spanish newspaper on 9 June that the chances of achieving an agreement were zero.

MacShane said: "I doubt that at the present time one can seriously expect the issue of Gibraltar to be able to return to the negotiating table with the hope of obtaining positive results. For the citizens (of Gibraltar) and the British parliament, the chances of achieving an agreement, which is not accepted by the Gibraltarians, are simply zero."

Negotiations on shared sovereignty between UK Foreign Secretary Jack Straw and his Spanish counterpart Ana Palacio stalled last summer on a number of "red line" issues, including the use of Gibraltar's military base. Gibraltar overwhelmingly rejected a shared sovereignty deal in an unofficial referendum last November.

Sovereign comment. In issue 13 of this *Report* we said the results of the referendum held by Gibraltar and stated that, in our opinion, this effectively ended any chance of a negotiated settlement over sovereignty. The UK government now seem to have come to the same view. Although Spain is unlikely to give up its attempts to take back sovereignty, it is extremely hard to see how this might be achieved now.

Isle of Man to amend Companies Act

The Financial Supervision Commission (FSC) has published the final version of the proposed Companies (Amendment) Bill which will introduce a number of significant changes to existing legislation.

A company's right to issue bearer shares will be removed. Existing bearer shares will be valid provided the identity of the bearer is disclosed to the company by registering the shares represented by the warrants.

All companies limited by guarantee will be required to state in their annual returns the number of guarantee members and the total amount guaranteed. Additional disclosures relating to shareholders consistent with the disclosure requirements for a company limited by shares will also be required.

In addition, the Bill amends the Companies (Transfer of Domicile) Act 1998 by removing restrictions on what types of companies may apply to transfer their domicile into or out of the Isle of Man. The current legislation is limited to listed companies or their subsidiaries. The Bill widens the FSC's power to determine which forms may be used in electronic submissions to the Companies Registry. The Companies Registry plans to extend its electronic submission service this year to allow users access to company records from their own off-site terminals. Users will also be able to file documents remotely. A full company incorporation service will also be available online.

Sovereign comment

The new provisions regarding the redomiciliation of companies in and out of the Isle of Man will prove useful and are similar to those already to be found in most Caribbean jurisdictions. It might be thought that there is little advantage to the Isle of Man in allowing companies to redomicile out, but these days many multinational companies will not set up subsidiaries unless they are able to flee the jurisdiction in case of change in legislation, tax rate or other disadvantageous factors.

usa+caribbean

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IRS crack down nets 1,200 taxpayers

The IRS said more than 1,200 taxpayers participated in its Offshore Voluntary Compliance Initiative (OVCI) by the 15 April deadline. The OVCI was intended to bring taxpayers, who used offshore payment cards or other offshore financial arrangements to hide income, back into compliance with US tax laws.

Eligible taxpayers could avoid criminal prosecution and certain penalties but would still have to pay back taxes, interest and some penalties. Applicants also had to provide full details on who promoted the offshore arrangements. In all, 1,253 taxpayers from 46 states and 48 countries applied for OVCI. In the first 229 cases reviewed, the IRS identified more than US$50 million in uncollected taxes and 80 new offshore promoters.

The IRS continues to work on other elements of the offshore initiative through the John Doe summons investigation. Since October 2000, the IRS has issued a series of summonses to obtain information on US residents who held credit, debit or other payment cards issued by offshore banks. It now has more than 1,000 offshore payment cardholders under audit.

The IRS has also obtained investor lists from 25 tax shelter promoters under a programme to crack down on "abusive transactions". It said 239 summonses had been issued of which 77 had been referred to the Justice Department for enforcement. Another 78 promoters are under investigation for non-compliance.

Federal financial regulators have issued final anti-money laundering rules under the USA Patriot Act for banks and trust companies, savings associations, credit unions, securities brokers and dealers, mutual funds, futures commission merchants, and futures introducing brokers.

The institutions subject to the final rules will be required to establish programmes for obtaining identifying information from customers. Financial institutions will have until 1 October 2003 to come into full compliance.

Sovereign comment

If a credit or debit card is linked to an offshore company or trust account then it will almost certainly be the case that the underlying income of that offshore entity must also be reported to the IRS and tax paid upon it. *Sovereign* offers its own offshore credit card but we always stress that it should be used as a convenient way of paying legitimate business expenses incurred on behalf of the offshore company to which it is linked. We also stress that any cash withdrawals will almost certainly be taxable and should be declared. We also offer a number of legitimate ways for US persons to set up offshore structures using more sophisticated products such as hybrid companies and rabbi trusts. There is a way of doing all this properly and simply hiding money offshore is not the answer.

BVI passes amendment to the IBC Act

The International Business Companies (Amendment) Act, passed by the Legislative Council in April, effectively ends the use of bearer shares by requiring them to be deposited with a registered custodian and by prohibiting authorised custodians from transferring bearer shares to anyone other than an authorised custodian approved by the Financial Services Commission.

An authorised custodian will be either a licensed bank or trust company in the jurisdiction, or an overseas firm regulated in a domicile acceptable to the Commission. Under the Act, IBCs will also be required to establish and maintain a register of directors and appoint the first director within 30 days of the incorporation of the company. The register of identities of the directors and shareholders will be available only to regulators and law enforcement officials.

Sovereign comment

BVI is one of the last jurisdictions to require bearer shares to be "immobilised". All existing bearer shares must be deposited with a licensed custodian (who will no doubt charge for this service) and the annual fee payable to the BVI government for any company which continues to have bearer shares in existence will increase from present US$300 to US$1,000 per annum. Pre-existing companies have until the end of 2004 to comply. New companies must comply immediately. Companies incorporated after the legislative notice was published but before the legislation came into law have 12 months to comply.

Clearly the costs of having bearer shares held by a custodian are considerable while the benefits of retaining bearer shares are, in most cases, negligible. Sovereign is happy to accept fees for acting as custodian, but it would seem to be better for most people to recall the bearer shares and reissue them in registered form. This would still provide confidentiality because there is no public register of shareholders. Sovereign can supply nominee shareholders if a greater degree of protection is required.

Bahamas responds to new regulatory regime

The number of banks and trust companies operating in the Bahamas fell by 55 to 301 in 2002 in response to new physical presence requirements and tighter regulation under the Banks & Trust Companies Regulation Act 2000.

The Act requires all banks and trust operations, unless specifically exempted, to establish a physical presence in the jurisdiction by 30 June 2004 in order not be deemed as a "shell bank" under the criteria of the Basle Committee on Banking Supervision, USA Patriot Act or the Wolfsberg Group.

Banks and trust companies must also conform to the Central Bank's "Guidelines for the Corporate Governance of Banks and Trust Companies", issued in December 2001, by the end of this year. These set the minimum standards for record keeping and establishment of an "appropriate" office from which to run the business. Banks and trust companies must appoint a minimum of two resident executive officers to manage day-to-day operations in the Bahamas and an independent non-executive resident director.

An Investment Funds Bill to create a new regulatory system for mutual funds, received its second reading in the House of Assembly in April.

Sovereign comment. Regulation in offshore jurisdictions is getting tighter all the time. The Bahamas had a large number of "managed" banks and trust companies which had no infrastructure or staff of their own within the Bahamas. These institutions have been targeted by the Central Bank.

Indian tax authority issues new rule on Mauritius residency

The Central Board of Direct Taxes (CBDT) amended the income tax rules, with effect from 10 February 2003, to state that a company would be deemed to be resident in India under the India and Mauritius tax treaty, if its management is based in India.

The tax authority has been attempting to prevent Indian companies establishing subsidiaries in Mauritius to benefit under the tax treaty. The new ruling further clarifies a circular issued on 13 April 2000, which stated that a certificate of residence in Mauritius issued by the Mauritius Government should be sufficient evidence for accepting the status of residence.

The new ruling said: "The entity would not be entitled to the benefits under the treaty where an assessing officer is satisfied that an entity is a resident of both India and Mauritius, and determines that the entity's effective management is in India, although the entity is incorporated in Mauritius."

The income tax department is expected to begin issuing notices to some Mauritius-based companies to provide information including the location of its directors, location of offices and the location where important decisions are taken. If some members of the board of directors reside outside of India, but the board meeting is held in India, then the effective management will be considered to be in India. If part of the board resides in India, but if board meetings are held outside of India, the management is considered outside of India.

Since 1991, about two-thirds of all inward foreign investment to India has been routed through Mauritius-based companies under the treaty. But a May 2002 ruling of the Delhi High Court stated that a Mauritius certificate would not provide "sufficient evidence" of residence in Mauritius. The case is now before the Supreme Court and a decision is expected soon.

The Mauritius Financial Services Commission signed, on 3 April 2003, a memorandum of understanding with the Southern African Development Community (SADC) which is responsible for regulating capital markets, retirement funds, collective investment schemes and insurance companies in the region.

Sovereign comment

We sometimes wonder whether the Indian CBDT has anything else to do other than ponder the merits of the India/Mauritius tax treaty. It has always been considered that the place of effective control, and therefore the tax residency, of any company is wherever its directors meet and reside. Where there is a split board with some directors in one place and others in another, then the place where they meet and make their executive decisions becomes of paramount importance. This has only really become an issue because too many companies have been taking shortcuts and not actually ensuring that the Indian resident directors fly outside India for regular (quarterly) board meetings. No doubt this was a cost saving but ultimately may be a cost.

Vanuatu makes tax commitment to OECD

Vanuatu signed a commitment to improve the transparency of its tax and regulatory systems and establish effective exchange of information for tax matters with OECD countries by 31 December 2005. It becomes the first country to be removed from the OECD's list of uncooperative tax havens, published in April 2002, and the thirty-second non-OECD country to commit to the principles of transparency and exchange of information for tax purposes.

Vanuatu's commitment, it said, was contingent upon the imposition of coordinated defensive measures against those jurisdictions, including OECD members, that fail to make equivalent commitments or satisfy the standards of the OECD's 1998 Harmful Tax Competition Report.

The OECD said it hoped the remaining six jurisdictions on its list – Andorra, Liechtenstein, Liberia, Monaco, the Marshall Islands and Nauru – would now make similar commitments. Vanuatu will be invited to join the OECD's Global Forum to discuss the design of standards related to its commitment.

The US Treasury Department and Financial Crimes Enforcement Network (FinCEN) issued a notice of proposed rulemaking that would require US financial institutions to terminate correspondent accounts involving Nauru financial institutions. In short, it cuts off Nauru's financial institutions from the US financial system.

Hong Kong publishes Corporate Governance Review Phase II

On 11 June the Standing Committee on Company Law Reform (SCCLR) issued its Corporate Governance Review Phase II Consultation Paper which details proposals to enhance Hong Kong's corporate governance regime.

The SCCLR's proposals relate to different aspects of directorship (including directors' roles, duties, qualifications, training and remuneration, as well as connected transactions, board procedures and board committees etc.); shareholders' rights and conflicts of interests; corporate reporting with focus mainly on external auditors and corporate regulation.

Supplementary guidelines to combat money laundering, including a requirement to identify high-risk clients, were published by the Hong Kong Monetary Authority on 31 March 2003. Banks must comply with the additional requirements before 30 September 2003. According to the supplement, authorised institutions should develop customer acceptance policies and procedures that aim to identify the types of customer that are likely to pose a higher than average risk of money laundering. A more extensive customer due diligence process should be adopted for higher risk customers.The new guidelines are based on the Basle Committee recommendations on "Customer Due Diligence for Banks" and the FATF's review of its 40 Recommendations.

Sovereign comment

Hong Kong has made great efforts to tighten up its money laundering rules and regulations and this is another step taken for that reason. As we have often commented, Hong Kong may be one of the last bastions for confidentiality – certainly for EU residents – as it is not a member of the OECD nor identified by the OECD as a tax haven. This means that, unlike all OECD member states and all OFCs, it is not under pressure to introduce exchange of information. Hong Kong is also one of the only financial centres with efficient banking systems that will not be exchanging information on accounts held by EU residents.

Revenue loses appeal on employee benefit trusts

The High Court held that the provisions of section 43 of the Finance Act 1989 had no application to an employee benefit trust (EBT) set up by employers as a vehicle to reward their employees.

In *Macdonald (Inspector of Taxes) v Dextra Accessories Ltd & Others,* handed down on 16 April, the court dismissed the Revenue's appeal from a determination by special commissioners that contributions made by the employer companies, Dextra Accessories Ltd and five others in the Caudwell group of companies, were deductible in assessing their corporation tax liability for their accounting period ending 31 December 1998.

The group set up the trust for capital and income to be applied "as the trustee... may think fit to or for the benefit of all or any... beneficiary". In December 1998 the six companies who employed the beneficiaries made substantial contributions to the trustee, a company resident in Jersey.

The commissioners concluded that section 43 of the Finance Act 1989 had no application to the employers' contributions. Under section 43(11), payment to an intermediary could not be taken into account by an employer when computing its charge to tax, but that the emolument could when it was paid to the employee. It was accepted that the contributions were held by an intermediary, the trustee, and thus the question was whether the December 1998 contributions were so held "with a view to their becoming relevant emoluments".

Given that payments to any of the people within the class of beneficiaries might or might not be emoluments, it could not be said that the contributions were held for the dominant intention or purpose of "their becoming relevant emoluments". They were at least as likely to become benefits which were outside the concept of relevant emoluments. The dominant purpose test was therefore not satisfied and the appeal was dismissed.

Sovereign comment

As often happens when the Inland Revenue lose a case, they get the law changed. Under the 2003 Finance Act, a company can now only claim a deduction against profits tax when the amounts are actually paid out to the employee, triggering the charge to personal taxation. This clearly reduces the attractiveness of EBTs but doesn't remove it. It is clearly better, particularly for businesses where the owner is also an employee for the company to suffer corporation tax but for the employee to save income tax as there is an effective saving equal to the difference between the corporation tax and the income tax resulting in a saving of a minimum of 10% and a maximum of 20%. The national insurance contribution would also be avoided and the money in the trust could be rolled up tax free giving an additional saving equal to the tax on the investment income generated on the capital sum. Savings can still therefore be considerable under the right circumstances and any business owner should give serious consideration to setting up an EBT. Sovereign has considerable expertise in this area.

Gibraltar ruling on information exchange

The Supreme Court quashed a decision by the Financial Services Commissioner to pass information to a foreign regulatory authority in respect of investigations into suspected violations of securities trading and criminal codes in that foreign country and money transfers involving Gibraltar companies and banks.

The Court found the Commissioner had, in seeking to establish that the information should be passed to the foreign regulator, failed to satisfy the test of necessity and that, because there was a possibility that the information would have been passed to prosecuting authorities in the same jurisdiction as evidence in respect of alleged criminal conduct, the appropriate channel was the prosecuting authority in Gibraltar, namely the Attorney General.

The Court did however uphold the Commissioner's interpretation of his powers to seek information under sections 33 and 38 of the Financial Services Ordinance and, under section 58 of the same Ordinance, to pass information to a foreign regulator exercising functions corresponding to his own.

The Commissioner is now considering the judgment, and is to take further legal advice before deciding whether or not to exercise his right to appeal.

Sovereign comment

It is good news that information should not be passed by the financial services regulator without due process being followed, but this decision may soon be academic. As reported in previous issues, Gibraltar, in common with all other reputable OFCs, has committed to the OECD to introduce exchange of information upon request. Such provisions will override any confidentiality protections currently enjoyed by taxpayers doing business in or through the OFCs. The relevant provisions are due to be introduced on criminal matters by the end of this year and on civil matters by the end of 2005. We would again repeat our warning that OFCs are not a place through which to conduct tax evasion and any offshore structure should be tax compliant. Anybody concerned about an offshore structure should contact their most convenient Sovereign office for an immediate review of their affairs.

UK Revenue defeated in IHT case

The Inland Revenue failed to overturn a High Court ruling from last July which allowed a couple to transfer the family home into a trust, shielding it from inheritance tax, while they remained in the property.

Known as defeasible life interest trusts or family wealth trusts, the Revenue sought to quash the ruling in the *Eversden* case, but the Court of Appeal rejected the Revenue's arguments, and denied it leave to appeal to the House of Lords.

Under a typical scheme, the husband transfers the home to the trust, in which the wife holds a life interest. After six months, the wife's interest is rescinded, and as long as she survives seven years after the transfer, no inheritance tax is payable when she dies.

The Revenue can still petition the House of Lords for the right to appeal. If this fails, the loophole may be closed through an Act of Parliament, possibly in the impending Finance Bill.

Sovereign comment. The UK Revenue will almost certainly apply for legislative change to remove the effectiveness of this type of IHT planning but we believe that whatever form any new law takes will be unlikely to remove the ability to own property by an offshore trust and thereby avoid UK IHT as long as it is carefully structured and set up. In our opinion, one of the great flaws of the scheme under scrutiny here was the fact that the settlor and his family lived in the property rent free. This seems to us to be an obvious reservation of benefit and renders the scheme liable to attack. We believe that the better option is for the tenants to pay market rent for their occupation.

South Africa declares exchange control and tax amnesty

An Exchange Control Amnesty & Amendment of Taxation Laws Bill, to permit repatriation of funds that have been illegally banked offshore, was tabled in the National Assembly in May. For six months from 1 June 2003, individuals and private companies will be able to apply for amnesty from civil and criminal prosecution for illegally expatriating funds. It also relates to foreign income derived prior to the relaxation of foreign exchange controls in 1997. The Bill's contents are already final because it is classified as a finance bill.

Applicants for amnesty include natural persons, resident corporations or trusts. It also relates to estates. The amnesty does not apply to advisers, non-resident individuals or companies. If a person leaves SA temporarily and then returns, he will still be resident.

The tax amnesty relates to foreign assets, the value of which has been partly or wholly derived from amounts that were not declared to the commissioner for the SA Revenue Service. A separate tax amnesty has been announced with reference to SA-sourced income that was not declared to the commissioner in respect of amounts accumulated or converted to foreign assets.

Two separate levies can be imposed. The exchange control levy is equal to 5% of the leviable amount to the extent that it is repatriated to SA within three months after the date of the amnesty approval; and 10% of the leviable amount in foreign currency should it not be repatriated to SA.

The tax levy applies to assets that would otherwise have been subject to SA taxes and is calculated at 2% of the amounts accumulated or converted to foreign assets. This levy may also be imposed on a facilitator. The tax amnesty includes income tax, secondary tax on companies, donations tax and estate duty.

Information is required in respect of foreign assets and their valuation. It is understood that the finance minister may make further regulations in respect of foreign assets indirectly held by way of a shareholding in a company that is not a resident of SA.

Sovereign comment

Tax amnesties, such as those initiated recently by the US and Italy, can be effective but we would be surprised if this amnesty had a similar result. While the economic and political future of South Africa remains uncertain, it seems unlikely that anyone with money outside the country would want to repatriate it.

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OECD reviews changes to Model Tax Convention

The OECD's Centre for Tax Policy and Administration (CTPA) has put out for consultation two alternative proposals to clarify the place of effective management concept as a tie-breaker rule and developing a hierarchy of different approaches that would constitute a new tie-breaker rule.

Developed by the Technical Advisory Group, the first proposal seeks to refine the concept of "place of effective management" by expanding the commentary explanations as to how the concept should be interpreted. The second proposal puts forward an alternative version, which includes three different options as regards a possible second tie-breaker test.

The CPTA has also launched a major project to improve the effectiveness of the Mutual Agreement Procedure (MAP) in Article 25 of the OECD Model Tax Convention aimed at improving dispute resolution for cross-border tax disputes.

The MAP allows tax authorities to resolve differences so as to avoid double taxation and ensure an appropriate application of the convention, but both the volume and complexity of cross border disputes has increased. A working group has been set up to examine how the existing MAP is working and how it can be improved.

Operational issues include: the transparency of the procedures; the role of the tax payer in the process; the cost of the process; and establishing a timeframe for settlement. Substantive issues include the scope and purpose of Article 25, the interaction between MAP and domestic law, constraints on the ability to use or implement the MAP, time limits, suspension of tax and interest.

Moody's approves new Cyprus tax system

Cyprus' new tax system and tax treaty network will improve the island's attractiveness as an international business centre in the European Union, according to international credit rating company Moody's.

The new legislation, which came into effect on 1 January 2003, introduced a uniform corporate tax rate of 10% for all companies, which is the lowest in Europe. Anti-avoidance provisions in Cyprus's current treaty network, which specifically excluded companies which were entitled to tax incentives, will now therefore be non-operative. More importantly various types of income can escape taxation altogether.

The new legislation exempts dividend income from taxation, irrespective of its source, provided that a minimum 1% holding in the company paying the dividend is maintained. There is no withholding tax on dividends paid to non-resident shareholders, irrespective of the existence of a double tax treaty with their country of residence. No withholding tax applies to interest derived from Cyprus, as well as royalties derived from foreign sources.

Companies managed and controlled outside Cyprus are considered as non-resident and taxable on their Cyprus-source income only. Profits from a permanent establishment maintained by a Cyprus company abroad will be exempt from taxation in Cyprus. In conjunction with the use of Cyprus's extensive treaty network, this can also result in such profits escaping taxation in the operating locations.

Trading in securities is completely exempt from tax and capital gains are exempt, except in respect of immovable property situated in Cyprus.

For financing operations, a Cyprus Company acting as an intermediary between a holding and an operating foreign company can finance the latter via interest bearing loans using the Cyprus treaty network. If the financing is from a low tax centre this results in a double dip effect whereby interest would be deductible in the operating location and at the same time would escape taxation in the ultimate recipient's jurisdiction.

Cyprus, together with Malta, was officially given EU observer status at a meeting for the 10 candidate countries to sign the Accession Treaty on 16 April 2003.

Sovereign comment

The new system of taxation is designed to meet approval from Cyprus's tax treaty partners and the EU. The absence of taxation on dividends received in Cyprus makes it a particularly attractive jurisdiction in which to site a holding company with potential advantages over the equivalent regimes in Netherlands, Denmark, Spain and the UK.

European Union Directive on Taxation of Savings

On 3 June European Union Member States finally reached agreement on the Directive on taxation of savings that will require all but three EU Member States to commit to an automatic information exchange system between tax authorities from 2005.

The deadlock was broken after four hours of talks in Luxembourg when EU finance ministers reached an accommodation with Italy, which had withheld final approval pending resolution of an unrelated dispute over milk quotas.

The tax package also contains the Code of Conduct on Business Taxation that will require EU Member States to eliminate 66 tax regimes identified as "harmful", and a Directive to eliminate withholding taxes on payments of interest and royalties made between associated companies of different Member States.

The Directive on savings taxation is due to take effect from 1 January 2005 and that on interest and royalties from 1 January 2004. The Code of Conduct is in practice already operating, although extensions for limited periods of time have been granted for certain business tax regimes.

Under the savings taxation Directive, banks in 12 of the Member States will be obliged to report interest earned on savings accounts to the home state of the account holder, allowing the home state to collect tax on the earnings. But for a transitional period, Belgium, Luxembourg and Austria will be allowed to apply a withholding tax instead of providing information, at a rate of 15% for the first three years, 20% for three years from 2008, and 35% from 2011 onwards.

These three Member States will implement automatic exchange of information if and when the EU enters into an agreement with certain third countries – Switzerland, USA, Liechtenstein, San Marino, Monaco and Andorra – to exchange of information upon request. The European Council reaffirmed that the exchange of information on as wide a basis as possible is to be the ultimate objective of the EU.

When negotiations with Switzerland were launched in 2001, the EU insisted that it give up its bank secrecy laws and commit to information exchange. The Swiss government refused. Switzerland already applies a 35% withholding tax on Swiss-source income. Under the agreement, it will commit to a withholding tax also on non-Swiss source income at the same rates as Belgium, Luxembourg and Austria under the Directive.

Switzerland will share the revenue of the tax withheld on non-Swiss source income, transferring 75 per cent of the revenue to the tax authorities of the resident's Member State. The withholding tax on non-Swiss source income will not be applied if the taxpayer authorises the Swiss bank to disclose information to the tax authorities. In such cases, that interest income should be subject to taxation in the Member State of residence at the same rates as those applied to interest earned domestically. The EU is committed to securing similar agreements with Monaco, Liechtenstein, Andorra and San Marino.

Negotiations were also opened with the USA but despite the Bush administration's refusal to agree a deal, the European Commission decided that the existing bilateral treaties between the US and individual EU Member States were sufficient to provide for exchange of information.

"Banks in 12 of the Member States will be obliged to report interest earned on savings accounts to the home state of the account holder".

The 10 proposed new EU Member States, including Cyprus and Malta, which are due to join as of 2004 are likely to be given until 2007 to begin exchanging information with their new partners. In addition, the UK and Netherlands pledged to adopt the savings tax directive in their dependent and associated territories, which means resident EU investors with investments and bank deposits will be subject to it.

The Isle of Man, Jersey and Guernsey have agreed to introduce a withholding tax when the Directive takes effect. This would apply only to EU resident individuals, who may choose to opt out of the withholding tax by agreeing to the exchange of information to their EU country of residence. It would not apply to business nor to individuals from outside the EU.

Gibraltar, which has been an associate member of the EU since the UK joined in 1973, has taken legal advice on whether it can bring a case against the UK and the EU over the imposition of information exchange under the Directive. The government objects to the UK's refusal to grant Gibraltar a choice between adopting a withholding tax or agreeing to exchange information.

The Cayman Islands has also questioned the "legitimacy" of attempts to compel the Caribbean overseas territories to comply with the Directive. At the end of March 2003, the European Court of Justice's Court of First Instance said that the EU could not require the Cayman to implement the proposed Directive. But, as the court later clarified, this was because the matter fell outside the competence of the European Commission and would depend entirely on the constitutional arrangements applicable in fiscal matters between the UK and the Cayman Islands.

Leader of Government Business McKeeva Bush said: "If they move to impose the Directive on us we shall pursue all legal options to protect this country from such wanton disregard for our survival and viability as an international business centre in good standing."

Other UK overseas territories which may have to implement the Directive are Bermuda, the British Virgin Islands, Anguilla, the Turks & Caicos Islands, and Montserrat.

The Directive has also been criticised by the OECD, which believes that the concessions granted to levy withholding taxes rather than automatic exchange of information will undermine its efforts to get all the world's big economies to abandon banking secrecy.

The Code of Conduct for business taxation was drawn up in 1998 and a report identified 66 tax measures with harmful features – 40 in EU Member States, three in Gibraltar and 23 in dependent or associated territories – which have now been revised or replaced. For beneficiaries of those regimes on or before 31 December 2000, a "grand-fathering" clause has been provided under which benefits have to lapse no later than 31 December 2005.

The Directive on interest and royalty payments, which will eliminate taxes levied at source on payments of interest and royalties between associated companies of different Member States, is due to enter into force on 1 January 2004. Transitional arrangements have been provided for Greece and Portugal for both interest and royalties and for Spain for royalties to delay implementation until the savings Directive takes effect on 1 January 2005.

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