

NARRATIVE REPORT ON CYPRUS



PART 1: NARRATIVE REPORT

Cyprus is ranked 27th on the 2020 Financial Secrecy Index, based on a secrecy score of 61 combined with a small scale weighting due to the fact that the Cyprus accounts for 0.48 per cent of the global market in offshore financial services.

History of Cyprus as an offshore financial centre

For Cyprus, establishing itself as an international centre for business and finance has been an important point on the political agenda, particularly since the invasion of the northern parts of the island by Turkey in 1974. The country has limited potential for industrial diversification and is heavily reliant on tourism, therefore finance and business services have been a rare growth sector providing high-paying jobs for an increasingly educated and specialised workforce.¹ As a result, the financial sector plays a prominent role in the Cypriot economy, and the sector is strongly supported across the political spectrum.

Deposits held by Cypriot banks were estimated to be equivalent to more than 900 per cent of GDP in 2010, at the height of the expansion of the Cypriot financial sector. This number fell to under 500 per cent by 2013, after the crisis, and more recently fell again in 2018 after stricter anti-money-laundering rules were imposed on non-resident banking deposits by the Central Bank of Cyprus.

Shipping

Like other tax havens (such as Liberia) the shipping industry has provided a catalyst for the offshore industry. In 1963 Cyprus brought in a legislative and tax regime targetting the merchant shipping industry. Over time, this has attracted international business within the shipping industry to Cyprus, which has led to Cyprus hosting the biggest third-party ship management centre in the EU.² The corporate tax rate is a low 12.5 per cent, and with a range of tax deductions and low capital requirements (thin capitalisation), the effective tax rate can be significantly lower than 12.5 per cent. The Cypriot registry remains one of only two European ship registries that are open registries, meaning it is open to all ships regardless of nationality, and accounts for an estimated 15 per cent of all ships under EU flags.³

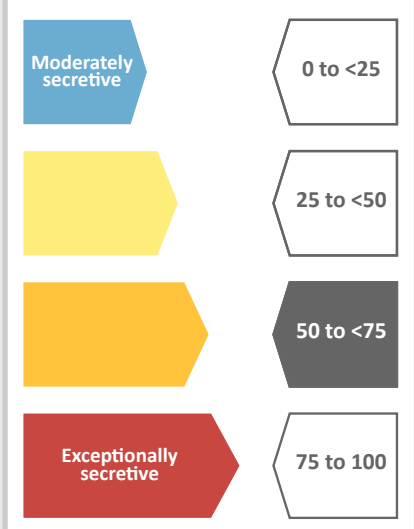
Banking

In the period following EU and Eurozone accession, Cypriot banks consistently offered higher deposit interest rates than the EU average, attracting both domestic and non-resident deposits. Deposits in Cyprus banks have for the previous decade often returned close to double the interest rates of banks in other European countries like Spain or Italy.⁴ Until 2004, Cyprus imposed foreign exchange controls, and with few other sectors to invest in, most Cypriots put their savings in domestic Cypriot banks.⁵

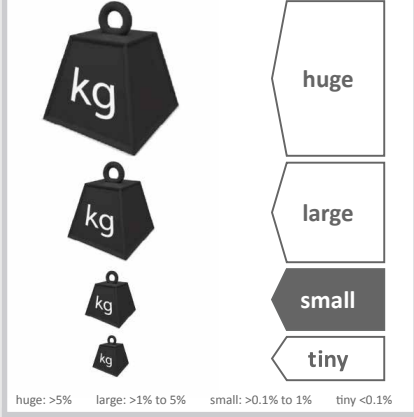
Attracting capital from abroad and retaining so much domestic capital created soaring growth for Cypriot banks in this period. Assets in Cypriots banks increased from over 450 per cent of GDP in 2005 to 896 per cent in 2010. These numbers are high, although not unique

Rank: 27 of 133

How Secretive? **61**



How big? **0.48%**



Cyprus accounts for 0.48 per cent of the global market for offshore financial services. This makes it a small player compared to other secrecy jurisdictions.

The ranking is based on a combination of its secrecy score and scale weighting.
 Full data is available here: <http://www.financialsecrecyindex.com/database>.
 To find out more about the Financial Secrecy Index, please visit <http://www.financialsecrecyindex.com>.
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in the EU: The size of the banking deposits held in Luxembourg is more than twenty times the size of its GDP.⁶ The rapid growth of the banking system of Cyprus increased its exposure to systemic risks, which crystallised after the financial crisis and the sovereign debt crisis in Greece.

The Russian Connection

The links between Cyprus and the Russian economy are deep, complex and longstanding. After gaining independence in 1960, rather than aligning with the West and NATO, the first president of Cyprus, Archbishop Makarios III, sought a so-called middle course for Cyprus, identifying himself with the Non-Aligned Movement. Politically, Makarios was dependent on the support of AKEL, the Communist party that maintained close ties to Moscow. The Communist party in Cyprus is the strongest in Western Europe to this day and has received about a third of the votes in almost every parliamentary election since 1970. Over time, these political ties translated into more personal ties, as the Communist political elite in Cyprus sent their sons and daughters to be educated in the Soviet Union, where they learned the Russian language.

As the Soviet Union dissolved in December 1991, Cyprus was among the few countries where Russians could travel without a visa. In the turmoil of constructing a market economy in Russia, Cyprus was both an accessible and secure destination for Russians to put their money. Cypriot banks, accountants, tax planners, investment managers and lawyers were more than happy to receive Russian money and business, and for those Cypriots educated in the Soviet Union, language and contacts became an important source of business opportunities from the newly emerged market economy. The dominance of Russian inflows and outflows was evident before the bank crisis, official data shows they were five times than those from the second most important source, which was Greece. Several scholars point to the huge amount of two-way FDI with Russia as a sign that Russian wealth holders and companies use Cyprus as a turntable destination for round-tripping capital.

Although good information or data on the nature of Russian business in Cyprus is generally not very accessible, business experts in Cyprus explained the role of Cyprus as a booking centre or back office for Russian companies. Since business is easier to conduct in Cyprus than in Russia — thanks to rule of law, legal standards, banking secrecy, access to international professionals and so on — everything gets booked through Cyprus. Goods sold from

Russia to the EU are often first sold from a Russian company to a Cypriot company before they are sold on to their final destination (a process known as ‘re-invoicing’, widely used for profits-shifting and capital flight). In addition, many Russian oligarchs placed their wealth in Cypriot banks and financial institutions.

Cyprus has been the primary destination of outward capital flows from Russia in recent years, but this pattern clearly changed in the first quarter of 2013 when investment in Cyprus fell and investment in the UK, Luxembourg and the British Virgin Islands, in particular, soared. The increase in capital flows to competing international financial centres is a sign that Russian oligarchs sought out new “safe harbours” for their money following the Cypriot bank collapse.

EU accession and tax reform

Cyprus applied for EU membership in 1990, and joined the EU in 2004. With the EU application came the need to reform the tax code.

“When we started the negotiations, the EU told us that there is no way that a country can join with a 4.5 per cent corporation tax system,” said George Vassiliou, chief negotiator of Cyprus’s EU accession.⁷

The EU accepted Cyprus’s application in principle in 1993, but accession negotiations did not take place until 1998.⁸ The primary goal of the negotiations was for Cyprus to adopt and implement the *acquis communautaire*, the body of European Union law.

In August 2001 the Ministry of Finance engaged Dr. Wolfgang Gassner, an Austrian professor at Vienna University of Economics and Business and chairman of the accounting firm Deloitte & Touche Austria, as an external adviser on tax.⁹ He was to become the main architect behind the new tax system in Cyprus. Gassner had played a central role in aligning the Austrian tax code to the *acquis* in Austria’s accession before it joined the EU in 1995. He emphasised the need for substantial tax reform in Cyprus with the goal of creating a tax system that conformed with European Law and the *acquis* and satisfied the OECD’s Harmful Tax Competition guidelines while remaining as low as possible in the framework of what he called “global tax competition”.¹⁰

Key changes to the tax system

The EU said Cyprus needed to dismantle its system of different tax rules for resident and non-resident taxpayers.¹¹ This is a classic trait of an

offshore tax system, where resident taxpayers are ring-fenced and subject to one set of tax rules, while non-resident businesses and individuals are subject to another. These sorts of practices were both discriminatory according to EU law and out of line with the OECD's Harmful Tax Competition guidelines.¹² EU negotiators emphasised the OECD project's principles during accession negotiations, and both the offshore companies and the 4.5 per cent corporate tax rate were identified by EU negotiators as "harmful tax competition."

In all, the tax reform consisted of 17 pieces of legislation enacted in June and July of 2002.¹³ In addition to abolishing the preferential treatments based on territoriality, the new system sought to clear out a myriad of exemptions, deductions, allowances, special rates and other incentives. The overall strategy of the tax reform was to cut the rates of income tax, while broadening the tax base and making the system more transparent, easier to administer and more efficient.¹⁴ The opportunity to cut income-tax rates came from the need to harmonise value-added taxes (VAT) and excise duties with the EU, where the minimum rate was 15 per cent. This meant that Cyprus had to significantly increase taxes on consumption, which effectively doubled income from indirect taxation. This increase in revenue made up for lower revenue from direct taxation.¹⁵ Cyprus joined the EU with a reformed tax system and the EU's lowest income tax rate at 10 per cent.¹⁶ This made Cyprus a very lucrative destination to place businesses, investments and capital for corporations and individuals from EU countries, making Cyprus a strategic gateway to the European markets for outsiders.

According to Gassner,¹⁷ the new tax system was in many cases more attractive for international business companies than the previous regime. This was due to the fact that non-residents of Cyprus were not subject to withholding tax on dividends and interests, were exempt from taxes on foreign dividends and profits from permanent establishments abroad and were able to offset foreign losses against profits booked in Cyprus — in addition to the already mentioned low tax rate. In combination, when applied to the kind of offshore holding company business that Cyprus tends to attract, these tax measures are classic identifiers of a tax haven.

Shipping

During the EU accession negotiations, the EU raised questions about the shipping-tax regime in Cyprus. According to Savvas Savvides, who was a

central participant in the Cypriot tax reform, the EU recognised that the tax regime in Cyprus did not accord with EU law. In practice, the tax regime that Cyprus offered for registering shipping business meant they were practically untaxed. Still, the EU allowed Cyprus to retain its existing tax regime for the shipping industry, even though it was considered to violate the principles of EU tax law. This was basically an allowance due to the importance of shipping businesses to the economy in Cyprus.

Cyprus and the OECD Global Forum process

The OECD, under the auspices of the G20, established the so-called Global Forum on Transparency and Exchange of Information for Tax Purposes in 2000 for both OECD and non-OECD members. The Global Forum carries out monitoring and peer reviews on how well the members fulfil the standards of information exchange as described in the OECD Model Agreement on Exchange of Information on Tax Matters from 2002.¹⁸

All members get reviewed in the Global Forum process, and the peer reviews are carried out in two phases. The first phase is a review of the legal and regulatory framework, and the second phase is a review of implementation. Cyprus exchanges information based on a network of 44 bilateral Double Tax Agreements as well as with EU members under several EU instruments.¹⁹ The report from the phase one review of Cyprus was published in 2012, and the second phase report was published in late 2013.²⁰

A number of shortcomings were identified in the first phase of Cyprus's Global Forum peer review in 2012 covering the legal aspects of its tax-information exchange. One legal issue that peer review pointed out was a loophole in which Cyprus-incorporated companies that are based outside Cyprus and conduct business outside the country were not required to keep accounting records and underlying documentation for their company.²¹ Another issue pointed out by the first phase OECD review was the existence of unidentified owners through the use of bearer shares.²² A third was that the use of trusts, which is quite widespread in Cyprus, allows for the concealment of the identity of true beneficial ownership of companies by hiding ownership behind an offshore trust. The accounting and "book-holding" requirements of trusts were also identified as unclear under Cypriot law.²³ The availability of bearer shares, corporations that lack company accounts and ones that conceal ownership identities through the use of trusts are all instruments that can be used deliberately to obtain secrecy for either

tax avoidance or money laundering purposes. Therefore, these instruments unarguably provided the Cyprus legal system with classic features of an offshore secrecy jurisdiction.

2013 Bank Crisis and ‘bailout’ negotiations

The nature of EU-Cyprus relations shifted fundamentally after the 2008-09 financial crisis when Cyprus was forced to apply for support through the European Stability Mechanism bailout programme. Finding a solution would prove more difficult than many in Cyprus had hoped. First, estimates for the amount needed to bail Cyprus out were revised upwards after the in-principle understanding. Initially, the bailout requirement was estimated around €11 billion, up from an estimate of €9 billion some months earlier.²⁴ Second, and perhaps more importantly, was the strong resistance to a Cyprus deal from Germany.

German resistance and money laundering allegations

In Germany, many were opposed to the idea of bailing out a country that had experienced a sustained period of growth based on being a “tax haven” and a safe place for “black money.” An intelligence report from the German Intelligence (Bundesnachrichtendienst — BND) was leaked to Der Spiegel, warning that a bailout of Cyprus would in effect be a bailout for Russian oligarchs.²⁵ The idea of using money from German taxpayers to save the wealth of Russian oligarchs infuriated the German public, offended Cypriots and became an important source of mutual distrust between Germany and Cyprus during the remainder of the Troika negotiation process.

For Cyprus, the allegations were not unprecedented. Its reputation as a money laundering haven has followed Cyprus since revelations that former Serbian President Slobodan Milosevic laundered hundreds of millions of dollars through bank accounts and front companies in Cyprus in the 1990s.²⁶ Milosevic used Cyprus to avoid the international embargo on Serbia and to buy military equipment used in the wars in Bosnia and Kosovo.

By 2012 however, Cypriot officials rejected such characterisations and said that they ignored the substantial reforms introduced since EU accession. According to the longtime head of Cyprus’s anti-money laundering agency, Eva Rossidou-Papakyriacou; “Cyprus is doing a lot more than other countries [to combat illegal financial activity]”.²⁷ Most Cypriots saw being a tax haven or money

laundering haven as a thing of the past.²⁸ This was backed up from the Cypriot side by a number of assessment reports from the European anti-money laundering monitoring agency, Moneyval, in which Cyprus was found to have an adequate regulatory framework for anti-money laundering.²⁹

A moment of unusual scrutiny on financial transparency: Evaluations prior to European Stability Mechanism programme

During European Stability Mechanism (ESM) programme negotiations, the issue of whether Cyprus was adequately implementing its anti-money laundering laws had become a central part of the debate surrounding the bailout. Cyprus agreed to let Moneyval and an auditing company, Deloitte, assess the implementation of anti-money laundering measures in Cyprus banks and government institutions. In addition, the OECD’s Global Forum on Transparency and Exchange of Information for Tax Purposes had some months before rolled out the second part of Cyprus’s peer review assessment, which would also investigate the implementation aspects of whether Cyprus was effectively exchanging up-to-date and reliable information for tax purposes with its tax treaty partners.

Finished in late April 2013, a summarised version of the confidential Moneyval report immediately leaked to the press. The report, conducted on six Cypriot credit institutions, was quite damning about how the anti-money laundering regulations of finance institutions in Cyprus had been implemented and stated that “findings significantly revise its previous, more favourable assessment of Cyprus AML system”.³⁰

According to the report, “the institutions included in the sample did not appear to uphold a suitable degree of accuracy in gathering and documenting relevant information from customers, and therefore were not consistently in a position to understand the purpose of the account, define the customers business economic profile and evaluate the expected pattern and level of transactions.”³¹

The report assessed a sample of 390 customers, of which the top 180 depositors and top 90 borrowers in Cypriot banks were included, in addition to 90 randomly selected customers. Approximately 10 per cent of the customers in the sample were “politically exposed persons” (PEPs), whom the banks had not detected or flagged. In one sampled bank, 58 per cent of customers were identified as “high risk” by the audit. When investigating the

identity of depositors, 27 per cent of client files had inaccurate information on who the beneficial owner of the account was. Around 90 per cent of the top depositors and borrowers included in the sample were legal persons such as trusts or companies, and 70 per cent of the cases with complex ownership structures used nominee shareholders and an average of three layers between the stated bank customer and the beneficial owner of the account. In only 9 per cent of these instances was the identity of the beneficial owner independently verified by the bank or a third party. In the four years between 2008 and 2012, the six credit institutions had only conducted four internal investigations for possible money laundering.³² In terms of filing suspicious transaction reports, no customers from the sample were reported to the Financial Intelligence Unit between 2008 and 2010, one was filed in 2011, and a few in 2012. When reviewing transaction logs, the audit found 29 potentially suspicious transactions during the past 12 months alone — none of which Cypriot banks had identified as deserving further scrutiny or potential reporting.³³ In addition, the assessment noted the large backlog of registration of documents at the Company Registrar and that the Registrar generally did not follow up when companies failed to submit annual returns or financial statements.³⁴ To sum up, the report found that “while identifying no regulatory weaknesses, both reports suggest that there are substantial shortcomings in the implementation, by banks, of AML preventive measures.”³⁵

The Global Forum assessment, while being published some months after negotiations ended, complemented the picture drawn up by the Moneyval report. In sum, it found Cyprus to be non-compliant on the implementation of its regulatory framework on transparency and the exchange of information for tax purposes. Key aspects of tax-information exchange partly overlap with the above mentioned anti-money laundering framework and include the ability to access up-to-date annual returns from a company register; access to financial information from third parties such as banks and access to the beneficial ownership of companies and trusts. The OECD assessment found that between 2008 and 2012, only 23 per cent of companies on average filed annual returns,³⁶ and over half were not filed even a year after their deadlines. In such cases, Cypriot authorities could sanction companies for failing to comply with the tax legislation by imposing a yearly fine of €100.³⁷ The report states that “The low compliance rate of filing annual returns with the Registrar may have resulted in Cyprus not exchanging up-to-date information, since this is the primary source used by Cypriot

authorities for obtaining ownership information on companies and partnerships”.³⁸ In terms of how the authorities had handled requests for information, 15 countries made a total of 650 requests between 2008 and 2012, of which half received information — usually after long delays — while the others either received no information or incomplete information.³⁹ Although having well-designed legal frameworks that were in line with international standard both for anti-money laundering and for sharing information for tax purposes, Cyprus was not actually implementing them through administrative and regulatory practices, and thereby left their laws largely ineffective.

“After the storm”

Cyprus has since 2013 restructured and recapitalised its banks, which are now about half the size they were before the crisis. Cyprus has also taken measures to improve financial regulation and supervision according to the ESM agreement. This has included a reform of its company registrar and measures to improve AML supervision. Its fiscal deficit has shrunk, and the public debt is currently considered sustainable. It has pushed through a long list of reforms in areas such as wage policies, public administration, services, and its legal framework.

Cyprus has been able to gradually return to the bond market. The ESM disbursed €6.3 billion in loans, meaning that €3.7 billion of the ESM package was not drawn on by Cypriot authorities. Cyprus successfully exited the programme in March of 2016. However, bringing down the level of bad loans on its banks’ books is still a large challenge for Cyprus.

In October 2015, Cyprus shed its noncompliant status with the OECD, having been found largely compliant with the standards set forth by the Global Forum on Transparency and Exchange of Information for Tax Purposes.

Cyprus initiated participation in the Automatic Exchange of Financial Information in Tax Matters in 2017 under their obligations to FATCA and the Common Reporting Standard.

For the ESM, Cyprus is being showcased as a success story in terms of getting the country back to sustainable debt levels, Cyprus exceeding expectations in its economic performance, and implementing a comprehensive ESM programme with generally strong compliance with program conditionality.⁴⁰

In July 2017, Cyprus began requiring interest on back-to-back intercompany loans, which are often used as sham transactions to avoid tax.

But the country is still running afoul of new, tougher standards. In early 2019, an EU Parliamentary report found that Cyprus, along with six other EU countries, “display traits of a tax haven and facilitate aggressive tax planning.”⁴¹

And in July 2019, in the wake of the Paradise Papers exposé, the European Commission threatened to take Cyprus to the EU’s Court of Justice if it didn’t change its VAT rules, which allow yacht owners to avoid significant amounts of tax on their craft, within two months.⁴² “Tax breaks of this type can lead to major distortions of competition. Due to the size of this sector, these illegal and favourable tax regimes also run counter to the fiscal consolidation processes of these Member States,” the Commission said.

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PART 2: SECRECY SCORE

OWNERSHIP REGISTRATION

- 50 1. Banking Secrecy
- 50 2. Trust and Foundations Register
- 90 3. Recorded Company Ownership
- 100 4. Other Wealth Ownership
- 95 5. Limited Partnership Transparency

LEGAL ENTITY TRANSPARENCY

- 90 6. Public Company Ownership
- 100 7. Public Company Accounts
- 50 8. Country-by-Country Reporting
- 100 9. Corporate Tax Disclosure
- 75 10. Legal Entity Identifier

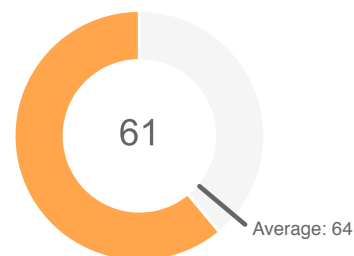
INTEGRITY OF TAX AND FINANCIAL REGULATION

- 53 11. Tax Administration Capacity
- 100 12. Consistent Personal Income Tax
- 40 13. Avoids Promoting Tax Evasion
- 100 14. Tax Court Secrecy
- 50 15. Harmful Structures
- 30 16. Public Statistics

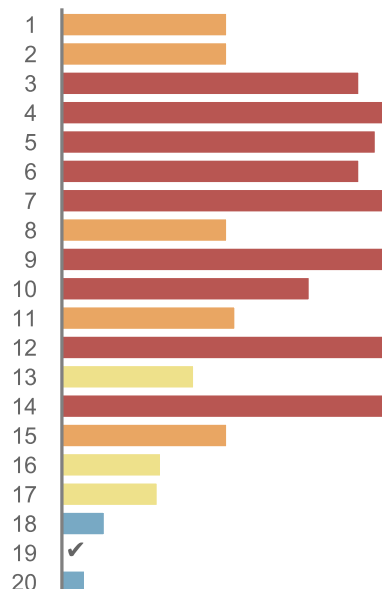
INTERNATIONAL STANDARDS AND COOPERATION

- 29 17. Anti-Money Laundering
- 13 18. Automatic Information Exchange
- 0 19. Bilateral Treaties
- 7 20. International Legal Cooperation

Secrecy Score



Key Financial Secrecy Indicators



Notes and Sources

The FSI ranking is based on a combination of a country's secrecy score and global scale weighting (click [here](#) to see our full methodology).

The secrecy score is calculated as an arithmetic average of the 20 Key Financial Secrecy Indicators (KFSI), listed on the right. Each indicator is explained in more detail in the links accessible by clicking on the name of the KFSI.

A grey tick in the chart above indicates full compliance with the relevant indicator, meaning least secrecy; red indicates non-compliance (most secrecy); colours in between partial compliance.

This report draws on data sources that include regulatory reports, legislation, regulation and news available as of 30 September 2019 (or later in some cases).

Full data is available here: <http://www.financialsecrecyindex.com/database>.

To find out more about the Financial Secrecy Index, please visit <http://www.financialsecrecyindex.com>.