भारतीय प्रबंध संस्थान बेंगलूर
INDIAN INSTITUTE OF MANAGEMENT BANGALORE

WORKING PAPER NO: 458

Tax Havens: Conduits for Corporate Tax Malfeasance

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Year of Publication – April 2014

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Abstract

This paper is an effort to demystify tax havens- what they mean, what they offer and why they are harmful. It offers a detailed analysis of abusive tax planning by multinational corporations, involving the use of tax havens, shedding light on how corporations employ ‘egregious’ tax sheltering techniques right from their incorporation to avoid payment of income taxes. The paper also discusses global efforts against the phenomenon and policy recommendations.

Keywords: Tax Havens, Corporate Tax Planning, Corporate Tax Evasion, Transfer Pricing

I. Understanding Taxes -

Definition –

Simply defined, taxes are any compulsory contribution that the State (i.e. governments) impose upon their citizens without any promise for a proportional return (no quid pro quo).The rationale behind taxes is to equip the State with enough funds that enable it to undertake developmental activities such as providing basic health care facilities, infrastructure, defence expenditure etc.

The 4 key functions of taxes are the following (referred to as the 4Rs) (Cobham 2005)

a. *Revenue Generation:* They serve as the most convenient and risk-free source of revenue to the Government.
b. *Redistribution:* Direct taxes being progressive in nature, help in achieving the goals of equitability in income and wealth. Since the rich pay higher taxes, they bridge the gap between the rich and the poor.
c. *Re-pricing:* They enable the State to influence the behaviour of its individual and corporate citizens. For instance, increasing the penalties on environmental pollution or offering tax incentives to save can yield significant benefits.
d. *Representation:* They also strengthen political representation by inducing a civic consciousness among the residents of the country about the manner and use of public funds.

Tax Competition: The true culprit

In its report titled *"The OECD 1998 Report on Harmful Tax Competition"*, the Organization for Economic Cooperation and Development (the OECD) has attracted attention towards harmful tax practices by certain jurisdictions that are attempting to derail the tax policies of other countries across the world. While globalization is reducing trade barriers and opening up new avenues for capital flows and development, attempts to attract foreign funds among countries is also on the rise. The OECD does not interfere as long as the intention of doing so is legitimate and does not involve the use of 'aggressive tax practices' that disrupt the tax systems of other countries.

The report describes the situation as follows:

"…globalization has, however, also had the negative effects of opening up new ways by which companies and individuals can minimize and avoid taxes and in which countries can exploit these new opportunities by developing tax policies aimed primarily at diverting financial and other geographically mobile capital." (OECD 1998)

Why can tax competition prove disruptive?

The OECD 1998 report puts forward the following reasons:

1. *Erosion of national tax-base of non-haven countries:* When income earned in a country is shifted to a low or no tax country, the tax base in the former shrinks significantly. Government collections suffer.
2. *Tax burden shifted to immobile factors:* To maintain the same collection level, the non-haven Government may be tempted to in turn transfer the tax burden to the immobile factors such as property and labour. This will result in sharp inequality in distribution of income and wealth.
3. *Discourages compliance by honest taxpayers:* The honest tax payers are discouraged to comply with tax laws and end up losing faith in their own State. Besides, prevention of evasion entails huge enforcement costs.
4. *Hampers the application of progressive tax rates:* Sharp inequalities defeat the very purpose of progressive taxation.

After knowing briefly what tax competition is, we can attempt to know what tax havens are.

II. Tax Havens: Secrecy jurisdictions of the world –

Definition –

Defining the term 'tax haven' is a hard nut to crack. Till date, there is no unanimously accepted definition of a tax haven. There are, however, certain features or attributes that facilitate the identification of such jurisdictions vis-a-vis the rest of the world. The word 'tax' haven itself indicates the importance of tax rates in such jurisdictions. The taxation rates and policies are so designed and manipulated so as to enable investors to flout tax rules in their home countries (where comparatively high tax rates exist).The key attraction continues to be the avoidance and minimisation of tax liability with infallible anonymity.

Two commonly used ways of achieving this objective are:

1. Establishment of legal entities such as trusts and 'shell companies' that aid in the transfer of tax liability from the high-tax home country to the low-tax tax haven. It should also be borne in mind that the haven also guarantees a good degree of secrecy as to the true identities of people associated with such fake entities.
2. Tactful management of funds and financial flows.

Identification –

Two different tests have so far been applied to identify and label tax havens as such- the objective and subjective approach. (Workman 1982)

a. *Objective approach:* This includes nations which have little or no taxes on all or certain categories of income and maintain some degree of banking or commercial secrecy. This definition has the impact of encompassing even those nations not generally considered as tax havens. For instance, the United States which does not tax interest income on bank deposits held by non-resident aliens, if such interest is not connected with the conduct of a trade or business within the United States.

b. *Subjective approach:* This takes into account the 'reputation' element. A country is deemed to be a tax haven if it promotes itself as one and those specializing in international tax planning consider it to be one.

Characteristics –

As pointed out earlier, tax havens are jurisdictions which design their legislation in a manner so as to assist persons- real or legal- to escape the regulatory requirements imposed upon them in jurisdictions where they undertake the substance of their economic transactions. There are several characteristics or distinguishing features of tax havens and these, in fact, run into large numbers. However, some salient characteristics are summarized below:

a. *Little or no tax on certain categories of income:* In most cases, tax rates imposed are very low compared to those existing in the taxpayer's home country. For instance, Joe Macri, Microsoft Ireland Managing Director clearly pointed out that it was Ireland's low corporation tax rates that drew MNEs to Ireland. He said that while easy access to the EU and availability of cheap labour succeeded in attracting foreign investment 20

years ago, they have now been eroded due to rising costs and falling productivity. He concluded by adding “That leaves us with tax.” (HighBeam Research 2007)

b. *Banking or commercial secrecy:* This is an important prerequisite to afford tax evasion and money laundering opportunities to clients and enable them to use structures created under its law anonymously. Banking secrecy hails back to the common laws of Great Britain. Common law secrecy arises out of an implicit contract between a banker and his client to keep the latter’s affairs confidential. However, most tax havens which were once British colonies have statutorily affirmed and strengthened their banking secrecy laws. In fact, tax havens frequently strengthen their secrecy laws in order to gain a competitive advantage vis-a-vis other tax havens. Also, such secrecy may or may not be backed by statute. For instance, the Swiss banking secrecy laws date back to 1934. Several mechanisms are put in place to ensure maximum secrecy. For instance,

- Very few tax havens require disclosures about the identity of the real owners of a corporation.
- They permit nominee directors to manage the day-to-day affairs of such corporations, thus shielding the true owners from the eyes of law.
- Very few of these havens require accounts to be placed in public record. For those that do, also provide some alternate mechanism that can be exploited by the rich to avoid public glare.
- Many tax havens guarantee secrecy by not revealing details even in case of enquiries by other Governments as to the identity of persons owning bank accounts or corporations or trusts. Switzerland does this effectively by failing to recognize tax evasion as a crime, thereby avoiding any enquiries relating to taxation matters. Some tax havens avoid such requests for information by not holding such information at all or pretending as such.

The main difference between the unreasonably stringent secrecy laws of tax havens and those of non-tax haven countries is that the former will not reveal details even if a violation of laws of another country is involved. No legitimate enquiries are entertained when it comes to breach of individual privacy and confidentiality. Secrecy is an element without which, tax havens would cease to be lucrative investment avenues for global taxpayers. It keeps them

insulated from the fear of being caught or identified. The effect is much more pronounced for corporations for whom reputational concerns are much more important.

As per the briefing paper prepared by the TJN titled '*Identifying Tax Havens and Offshore Finance Centres',* secrecy in tax havens can assume three common forms (TJN 2007):

1. *Bank Secrecy:* This is offered by jurisdictions like Austria, Luxembourg, and Switzerland. The names of account holders are never revealed even when the funds are illegal or tax-evaded. Not only this, the jurisdiction in question also imposes criminal penalties on those who breach this confidentiality.
2. *Ownership Secrecy:* This is relatively less heard of. Certain jurisdictions around the world permit the creation of 'shell/sham' companies, trusts etc., whose ownership and functioning are kept secret. The identity of the 'true' owner or beneficiary is never revealed. For instance, offshore companies in Nevada, Delaware and Wyoming in the United States offer near-unbreakable secrecy facilities.
3. *Barriers to information exchange:* This may take two forms. Either the jurisdictions deliberately refuse to pursue and obtain information held locally (this makes all information-exchange agreements worthless) or they may be unwilling to share information with other jurisdictions. Such non-cooperation may be through a point-blank refusal or the erection of bureaucratic or other obstacles to information exchange.

c. *Right to create legislation:* Tax haven jurisdictions, whether or not countries, hold the power to design their legislations in a manner that undermines the legislation in other jurisdictions. This power does not imply that such jurisdictions are all sovereign. For instance, the state of Delaware in the U.S. is not, nor the Crown Dependencies[1] and the British Overseas Territories[2]. However, some tax havens are sovereign such as Singapore, Panama and the UK. It must be noted that such legislation is not by accident. It is created with intent, to ensure that structures created as a result of such legislation have an impact either solely or mainly outside their territory so as to enable prospective clients to violate regulations in their home country.

[1] Jersey, Guernsey and the Isle of Man
[2] Anguilla, Bermuda, British Antarctic Territory, British Indian Ocean Territory, British Virgin Islands, Cayman Islands, Falkland Islands, Gibraltar, Montserrat, Pitcairn Islands, St Helena and Dependencies, South Georgia and the South Sandwich Islands, the Sovereign Base Areas of Akrotiri and Dhekelia in Cyprus, and the Turks and Caicos Islands.

d. *No substantial activity:* This characteristic has been highlighted by the OECD (OECD 1998). Tax havens provide extremely lax and lenient regulatory structures that facilitate the setting up of a large number of foreign-owned subsidiaries that invest huge amounts in these jurisdictions without any 'significant' presence in terms of business or production activity undertaken. This indeed appears paradoxical- how tax havens attract billions of dollars in funds without having the necessary infrastructure for any production or commercial activity!

e. *Dominance of financial institutions:* They have a large role to play in a tax haven's trade and commerce. In fact, for most tax havens, banking constitutes the largest sector in terms of its contribution to GDP. This is evident in the high foreign banking assets held in comparison to the tax haven's foreign trade.

f. *Lack of controls for foreign nationals:* Foreign nationals are usually not subject to currency controls and similar restrictions in order to attract bank deposits. Exchange controls do not apply to foreign nationals as long as they deal in a currency other than the tax haven's local currency and do not engage in any business in the tax haven.

g. *High marketing and promotion:* Tax havens engage in heavy marketing and promotional activities in order to solicit banking business that constitutes the major source of their GDP.

***Types* –**

There are, broadly, seven classes of tax havens based on the specific attributes that help them attract prospective clients (TJN 2008). Here, we must remember that 'one size *does not* fit all'! Different classes cater to the needs of different consumer classes, based on their specific needs- tax evasion or money laundering or income shifting, to name a few. These classes are:

a. *Incorporation hubs:* These exhibit features of minimal regulation, disclosure and paperwork. They facilitate setting up of offshore entities such as companies, trusts etc. Include tax havens such as Montserrat and Anguilla which are not OFCs.

b. *Secrecy jurisdictions:* These have very stringent secrecy laws and therefore guarantee complete insulation against revelation of identity of persons involved. Some examples are Liechtenstein, Singapore, Dubai and the Turks & Caicos islands.

c. *Specific geographical market suppliers:* These tax havens seem to cater to the demand for special offshore entities for particular countries. For instance, the British Virgin Islands caters to the Chinese demand for offshore entities. Similarly, Panama serves the US market, Jersey, the London market and Vanuatu, the Australian market.

d. *Specialist service market:* Some tax havens cater to demands from particular industry segments due to the unique nature of their legislation that favours the establishment of particular offshore entities. For instance, Bermuda and Guernsey target the reinsurance market, while Cayman attracts hedge funds.

e. *Market entry conduits:* These jurisdictions attract business by offering ‘routing’ opportunities for making investments in select countries, by virtue of their being part of some double taxation treaty that enables them to save taxes on such investments. For instance, Mauritius is a conduit for Indian investments. Similarly, Netherlands facilitates investments throughout Europe.

f. *High Net Worth providers:* These provide excellent fund-management skills to manage the deposits of the world’s wealthiest people who invest in their domain. They also ensure a high degree of secrecy and opportunities for easy interface with the fund manager. Some examples are Switzerland, London and New York.

g. *Low tax regimes:* These are jurisdictions that attract investments by offering tax rates relatively lower than in other parts of the world. It enables them to attract business profits to themselves, thereby contributing significantly to ‘transfer mispricing’. An eminent example is Ireland.

It should, however, be noted that a given tax haven in question may play more than one role mentioned above, but cannot combine all of these.

III. A Siamese Twin- Offshore Financial Centers (OFCs) –

This is not the same as tax havens, though an integral part of it. It refers to those commercial communities set up within tax havens to exploit the structures facilitated by its law to enable global taxpayers to circumvent their home country regulations. It comprises an entire battery of lawyers, accountants, taxation experts, bankers and their associated trust companies that

sell their services to those who wish to use the structures that the tax haven has to offer. This highlights an important distinction between tax havens and OFCs- while the former is confined in a geographical sense, the latter is much more mobile and transient. The OFC community is largely expatriate and follows the flow of money. If for some reason money was to leave one tax haven for another, the OFC community would be sure to follow.

It is noteworthy that all tax havens are not necessarily OFCs, though all tax havens aspire to be so. It is the development of the OFC community within a tax haven that allows it to generate revenue and benefit from the legislation it has created. Without attracting the employment and business that an OFC has to offer, a jurisdiction fails to enjoy the growth associated with being a tax haven. Till date, there are some tax havens that not achieved the objective of being OFCs. Some examples are Montserrat and Anguilla in the British Overseas Territories. However, there also exist jurisdictions like Jersey and the Cayman Islands whose OFCs dominate their local economies. For instance, case of Jersey, OFC activity contributed about 54% of the island's GDP in 1994 and accounted for about 20% of its permanent employment (Hampton 1996).

The 'Offshore' World: No Substance, Only Form

Tax havens and OFCs together comprise the 'offshore' world. Offshore does not represent geography. It refers to the location of the customers of secrecy jurisdictions, who intend to exploit their legislative and regulatory environments. The crux is that these customers are not located in the tax haven where the OFC is located, hence the term 'offshore'. This has important ramifications. What it really means is that commercial transactions are recorded in one place (in the tax haven), undertaken by parties residing elsewhere (offshore). The problem arises because while transactions take place, legally, in the tax haven (where they are recorded), their benefits are realized elsewhere (onshore). This creates a mismatch between the substance and form of transactions undertaken. The Tax Justice Network UK 2008 report aptly puts it as "The offshore world is designed to make things appear other than they are, and by and large succeeds in doing so. This, in a nutshell, is the threat that they pose to the world." (TJN 2008)

Now we know that tax havens and OFCs do not mean the same thing (despite the complementarities between the two concepts). This fact has serious implications on the regulation designed to combat the problem of the 'offshore economy'. Most regulation in this

regard is designed to regulate tax havens in anticipation that the OFCs operating within them will automatically get regulated! There are mainly two issues:

a. The practitioners OFCs are made of have no particular commitment or economic ties to the people or the law of the tax haven in which they operate. This is quite evident from published career information relating to some OFC practitioners which reveals that most of these people do not belong to the tax haven in which they work and more so, have usually worked in more than one tax haven. For instance, OFC operators such as the Big 4 accounting firms that have spread their roots in almost every secrecy jurisdiction in the world. Their mobility allows them to relocate to another jurisdiction with ease, if any problems in the current one arise. This breeds reckless behavior.

b. OFCs constitute the major source of GDP in tax havens, who but for these OFCs, are hardly conducive to any production activity. This allows OFCs an extremely high bargaining power vis-a-vis the tax haven in which they operate. They use their power to secure the desired legislation and often threaten to leave any jurisdiction if their demands are not met. The OFCs' degree of compliance with the tax haven laws is extremely low, owing to their belief that they are way beyond the law in such places. "In effect they have taken these states captive, showing in the process complete indifference to the local populations of these places and their elected representatives." (Christensen and Hampton 1999)

Owing to these issues, regulatory bodies across the globe are demanding a shift in focus from regulation of tax havens to that of OFCs, that happen to be the 'agents' of the unfair tax havens.

List of Tax Havens and OFCs –

Just as in the case of defining tax havens, there is no consensus as to which jurisdictions should be included in this category. The different lists of tax havens or offshore financial centres are based on different methods and indicators to identify such jurisdictions.

Some lists include only specific types of tax havens or OFCs. Different lists based on different criteria for identification have been issued by different regulatory organizations. A list published by the Tax Justice Network in 2007 is one of the most comprehensive and differentiates between tax havens, OFCs and harmful preferential tax regimes and also spells

out clearly the inclusion and exclusion of jurisdictions by three most important tax haven identification bodies, namely OECD, TJN and FSF/IMF.[3]

The list is presented below:

Table 1: The world's tax havens and offshore financial centres

Jurisdiction	COUNTRY CODE	OECD	FSF-IMF 2000	TJN 2005
1. Andorra	AD	■	■	■
2. Anguilla	AI	■	■	■
3. Antigua & Barbuda	AG	■	■	■
4. Aruba	AW	■	■	■
5. Australia	AU	□		
6. Austria	AT	□		
7. Bahamas	BS	■	■	■
8. Bahrain	BH	■	■	■
9. Barbados	BB	▪	■	■
10. Belgium	BE	□		■
11. Belize	BZ	■	■	■
12. Bermuda	BM	■	■	■
13. British Virgin Islands	VG	■	■	■
14. Canada	CA	□		
15. Cayman Islands	KY	■	■	■
16. Cook Islands	CK	■	■	■
17. Costa Rica	CR		■	■
18. Cyprus	CY	■	■	■
19. Dominica	DM	■	■	■
20. Dubai	AE			■
21. Finland (Åland)	FI	□		
22. France	FR	□		
23. Germany (Frankfurt)	DE	□		■
24. Gibraltar	GI	■	■	■
25. Greece	GR	□		
26. Grenada	GD	■	■	■
27. Guernsey, Sark & Alderney	GG	■	■	■
28. Hong Kong	HK		■	■
29. Hungary	HU	□		■
30. Iceland	IS	□		■
31. Ireland	IE	□	■	■
32. Isle of Man	IM	■	■	■
33. Israel (Tel Aviv)	IL			■
34. Italy (Campione d'Italia & Trieste)	IT	□		■
35. Jersey	JE	■	■	■
36. Korea	KR	□		
37. Latvia	LV			
38. Lebanon	LB		■	■
39. Liberia	LR	■		■
40. Liechtenstein	LI	■	■	■
41. Luxembourg	LU	□	■	■
42. Macao	MO		■	■
43. Malaysia (Labuan)	MY		■	■
44. Maldives	MV	▪		■
45. Malta	MT	■	■	■
46. Marshall Islands	MH	■	■	■

[3] See http://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf, page 8-10.

Table 1 (continued): The world's tax havens and offshore financial centres				
Jurisdiction	COUNTRY CODE	OECD	FSF-IMF 2000	TJN 2005
47. Mauritius	MU	■	■	■
48. Monaco	MC	■	■	■
49. Montserrat	MS	■	■	■
50. Nauru	NR	■	■	■
51. Netherlands	NL	□		■
52. Netherlands Antilles	AN	■	■	■
53. Niue	NU	■	■	■
54. Northern Mariana Islands	MP			■
55. Palau			■	
56. Panama	PA	■	■	■
57. Portugal (Madeira)	PT	□		■
58. Russia (Ingushetia)	RU			■
59. Saint Kitts & Nevis	KN	■	■	■
60. Saint Lucia	LC	■	■	■
61. Saint Vincent & the Grenadines	VC	■	■	■
62. Samoa	WS	■	■	■
63. San Marino	SM	■		
64. São Tomé e Principe	ST			■
65. Seychelles	SC	■	■	■
66. Singapore	SG		■	■
67. Somalia	SO			■
68. South Africa	ZA			■
69. Spain (Melilla)	ES	□		■
70. Sweden	SE	□		
71. Switzerland	CH	□	■	■
72. Taiwan (Taipei)	TW			■
73. Tonga	TO	▪		■
74. Turkey (Istanbul)	TR	□		
75. Turkish Rep. of Northern Cyprus				■
76. Turks & Caicos Islands	TC	■	■	■
77. United Kingdom (City of London)	UK			■
78. Uruguay	UY			■
79. US Virgin Islands	VI	■		■
80. USA (New York)	US	□		■
81. Vanuatu	VU	■	■	■
■	Tax Haven OECD, TJN 2007 /Offshore Financial Centre FSF/IMF 2000			
□	OECD member country with potentially harmful preferential tax regime as distinguished by OECD 2000			
▪	No longer regarded a tax haven according to the OECD 2006			

Source: (TJN, Identifying Tax Havens and Offshore Financial Centres 2007)

IV. Use of Tax Havens by Corporations –

Separation of Ownership and Management and Agency problems

Corporations are business entities characterized by a separation of ownership and management. Shareholders, who are the true owners of a corporation have the incentives, but may not have the necessary skills to manage its affairs. Therefore, the task of conducting the affairs of the corporation is entrusted to its 'Directors' (hereafter 'Managers') who are elected representatives of the shareholders themselves. The whole idea behind this arrangement was the belief that elected managers will truly represent the interests of the shareholders and will therefore, strive to maximize firm value. There is extensive corporate finance literature to show that in large, publicly-held corporations, this is not the case. Managers tend to pursue

personal wealth-maximization goals at the expense of the shareholders' interest. (Jensen and Meckling 1976).

Recent trends indicate that in the last few years, corporate managers are resorting to illegitimate means such as sheltering income from federal taxes, in order to report higher profits to shareholders (we must not forget here that in most cases, managers' remuneration is tied to the performance of the corporation through stock option compensation, bonus etc.). For instance, the Enron scandal, though thought of initially as a case of earnings manipulation, brought to light the malicious use of a host of subsidiaries situated in tax havens. The catch here is that while corporate managers undertake aggressive tax sheltering activity pretending to be acting in shareholders' interest (a lower tax outflow enhances the earnings available to equity shareholders), studies have shown that they end up destroying rather than creating value. (Desai and Dharmapala 2009). The rationale is that income successfully shielded from the eyes of the taxation authorities becomes much more opaque and prone to managerial rent-seeking or diversion. This highlights strong complementarities between tax sheltering and managerial diversion- indulging in one reduces the cost of another. Diverting out of sheltered income reduces the possibility of being caught- both by the tax authorities and the shareholders! This could explain the mushrooming of corporate tax shelters across the globe.

What do shareholders want?

Unlike individuals who usually face only monetary penalties on being caught evading taxes, the cost to corporations may be much higher. For instance, news of a firm indulging in the use of tax shelters often results in the firm being classified as a 'poor corporate citizen'. Corporate decisions to shelter are in the hands of the tax manager who is 'expected' to maximize value to the shareholders. However, even though the gains from tax sheltering accrue to the shareholders by way of a higher firm value, they would want managers to be only 'optimally' aggressive in their tax behaviour. They are often averse to extreme tax aggressiveness that can entail huge reputational costs. On an average, there is a decline in stock price on news about tax shelter involvement (Hanlon and Slemrod, 2009). This may also be because such news may cause shareholders to believe that aggressiveness in tax reporting could also imply aggressive earnings management designed to deceive investors (Desai and Dharmapala 2009).

Multinational Enterprises (MNEs): Obscure financial and tax reporting –

Corporate tax evasion has spread its roots across the globe, enveloping even the smallest and murkiest islands one has ever heard about. Why have proportions gone so much out of range? Why is corporate corruption being exported from country to country? The answer is simple- multinational corporations. Simply defined, these are corporations with a 'global presence' through the use of subsidiaries located in different corners of the globe. In turn, these subsidiaries may have their own subsidiaries, resulting in very complex and obscure ownership structures. But one fact stands out- the reins of the entire multinational group remain in the hands of the parent corporation which owns some subsidiaries directly and 'controls' the rest through indirect ownership.

When it comes to tax planning, these entities seem to be better endowed with techniques and mechanisms that can help them dodge taxes. The complexity in their functioning gives them the feature they desire most for this purpose- secrecy. Thousands of subsidiaries can be set up in tax-favoured locations with inter-group transactions determining which subsidiary earns what depending upon the rate of income tax it suffers! On the accounting front, the parent corporation presents a consolidated set of accounts, whereas for taxation purposes, each subsidiary or company within the group is taxed separately. For instance, consider the case of a parent company incorporated in UK which has a branch in France. The income generated in France suffers tax there. The UK follows a system of worldwide-taxation. Thus, the income already taxed in France is now taxed again in UK, allowing credit for taxes paid in France (owing to the Double Tax Avoidance Agreement between UK and France). Similarly, depending on tax rates prevalent in different jurisdictions, MNEs enjoy ample opportunities to decide which activity to carry out where, which jurisdiction to establish a subsidiary in, where to route investments from etc. The problem becomes uglier if murky options like tax havens are so easily available! It is likely that less than 10% of the world's corporations are part of multinational groups but it is estimated that about 60% of world trade in is in the nature of intra-group sales (sales between members of a common MNE group)! (TJN 2008)

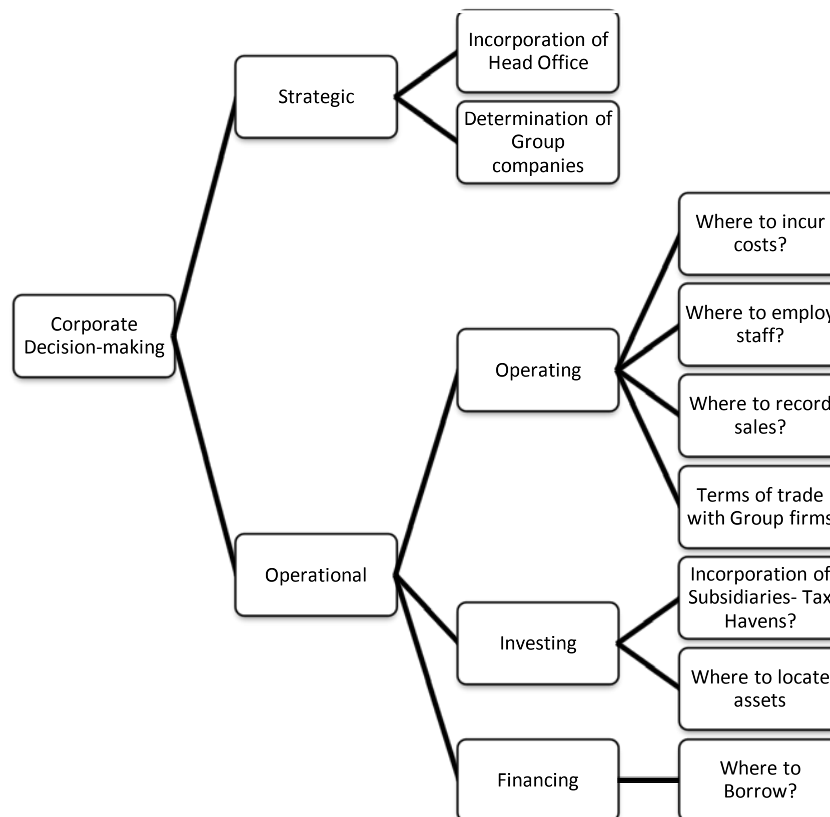
Corporate Tax Evasion: How do Tax Havens fit in?[4]

This is a rather interesting question. Corporations have to make hundreds of big and small decisions in their day-to-day functioning. One would be very surprised to know that tax

[4] This section has been largely drawn from (TJN, Tax Havens Creating Turmoil: Evidence Submitted to the Treasury Committee of the House of Commons 2008), section titled "The Corporate Use of Tax Havens".

planning pervades corporate decision-making since its very inception. By choosing carefully, corporations can ensure minimum tax liability coupled with the highest degree of secrecy and anonymity.

Consider the following diagram highlighting some of the main areas of corporate decision-making that involve the use of tax havens for international tax planning.



A. Strategic Decisions:

These represent crucial decisions that impact the long-term survival and prospects of a corporation.

a. *Incorporation of Head Office:* This decision is one of the most critical ones that any corporation must take. This is because a corporation is taxed in the country in which it is incorporated. Thus, choosing to incorporate in tax-expensive countries such as the U.S, U.K. etc. might prove costly in future. However, major quoted companies usually require to be incorporated in major financial centres such as Frankfurt, London or New York. This can take away sizeable earnings in the form of corporate taxes. Therefore, companies are now resorting to arrangements involving

‘intermediate holding companies’ (hereafter ‘IHCs’) that enable them to be both listed on a major stock exchange and ingeniously evade taxes. IHCs are companies owned by the parent company, which in turn own other operating subsidiaries of the group. No substantial activity takes place in these intermediate locations except that they collect dividends from the subsidiaries they own and often loan it out (without paying dividends) to the parent in the high-tax jurisdiction. The intermediate locations are chosen in very low-tax regimes that owing to the existence of a number of double-tax avoidance treaties with other countries, just miss being characterized as tax havens (though they actually are!). Some popular locations for this purpose are Switzerland, Netherlands, Ireland and Luxembourg.

b. *Determination of Group Companies:* As mentioned earlier, an MNE group must file consolidated accounts with respect to all companies it controls, with the relevant authority in the jurisdiction in which it is registered (for instance, the Securities and Exchange Commission, the SEC in the U.S.). Also, the group exercises a good deal of discretion as to what activities it would want to reflect in its consolidated financial statements. For instance, it may have certain liabilities on its books that may undermine its financial soundness if made public or certain questionable transactions that may raise a red flag and provoke a deeper inquiry into its finances. In such cases, the MNE may want to hide such controversial items and take them ‘off’ its balance sheet. This can be achieved by creating ‘orphan companies’ that though owned by the MNE in reality, are theoretically owned and controlled by a third party. The ownership of such orphan companies can be placed in some shady charitable trust created in a tax haven. The advantage of doing so would be that the multiplicity of layers of secrecy between the MNE and orphan company in the tax haven will make it virtually impossible for any authority to reach its ‘true’ owners. In this way, though transactions with the orphan company will benefit the MNE in question, it is theoretically out of the group, thereby being able to avoid reporting its transactions in the consolidated accounts. Apart from shifting liabilities and hiding controversial transactions, such structures can also be used to indulge in earnings management, i.e. to window-dress the books of accounts, as was done by Enron.

B. Operational Decisions:

These are the not-so-strategic decisions that are required to be made in the day-to-day functioning of the corporation. These can be further divided into:

B.1. Operating:

a. *Where to incur costs:* Corporations tend to shift as much of their costs to high-tax jurisdictions as they can. Legitimate business expenses/costs qualify for deductions in the computation of taxable income. By shifting these to high-tax jurisdictions through intra-group transactions, tax relief in such jurisdictions can be maximised. This trend could be exacerbated if shifting of costs or 'cost-loading' generates other benefits as well. For instance, inflating the cost of production in mining and extractive industries can not only generate tax relief but also reduce the proportion of total production payable to the host government under certain mining and oil concessions in developing countries. Cost-loading can be even harder to detect than sales-mispricing due to the absence of comparables. However, the 'arms-length' principle continues to apply in such cases too. Costs most prone to 'loading' are those incurred on insurance, finance charges, payments for the use of intellectual property and the cost of supply of staff on secondment.

b. *Where to employ staff:* This question appears rather trivial- after all people will be employed where they are required to work. But what if there is a mismatch between the place of employment and the place where duties are undertaken? This is precisely being done by MNEs in collusion with their senior staff in order to place them in locations conducive to tax planning. This generates tax benefits to both the employer and the employee.

   - The manager may prefer to work at a place which is not his long-term home. In this way, some part of his earnings will not be taxed anywhere.
   - The employer saves on national insurance charges and other costs of employing personnel as these are generally low offshore.
   - By choosing to place employees offshore, the employer can shift profits offshore by paying exorbitant amounts for 'management services' (a classic case of transfer mispricing'.)

This phenomenon can have far-reaching consequences. Not only does it upset the local labour market (since it causes overseas staff to be preferred over local staff), but also breeds corruption in the form of high connivance between employers and employees in their tax planning endeavours. This makes these conniving employees much more tolerant to other unethical practices in the organization.

c. *Where to record sales:* In most cases, sales of products or services generates taxable income. Taxes on sales are levied at rates prevalent in the place where sales are recorded. Therefore, in the context of MNEs, it is crucial to determine where sales are to be made, rather recorded. In the case of software and related products, it is easy to relocate sales to the most tax-favoured jurisdiction without leaving much scope for being caught. However, in case of physical/ tangible goods, it is much more difficult to shift sales to other low-tax jurisdictions. Consider the case of minerals extracted from earth in the case of a mining company. Though the ore is meant to be exported any way, the MNE can decide where it would want to record the sales for tax-reasons. For instance, the group may consider the following:

- Ship it in the semi or unprocessed state to a low-tax country, if tax rates in the country of extraction are high, even if that means higher transportation costs. Further processing and value addition takes place in the low-tax country, resulting in tax savings.
- Whether to sell unprocessed ore directly to a third independent party for processing or sell within the MNE to a Central Processing/ marketing organization (a common arrangement) that undertakes further processing and adds a margin for the work done. Typically, such central marketing units are located in tax havens. This enables the shifting of sales/ taxable income to low-tax jurisdictions.

It should however, be remembered that apart from tax reasons, there may be genuine non-tax business reasons governing such decisions such as processing capacity, transportation costs, proximity to marketing centers etc.

d. *Terms of trade with group firms:* Whenever any two independent entities deal or trade with each other, it is expected that the terms would be such that would reflect the best interests of both parties which is in turn reflected in the prices that prevail. Such prices are referred to as ‘arm’s length prices’. However, when two entities that are

bound together by a common group, trade with each other, there are a lot many considerations that tend to distort the trade price between the two. They may choose to transact at prices that though not beneficial for the two of them individually, yield the best possible outcome for the group as a whole. For instance, a company in Bahamas (tax rate 0%) selling to a company in the U.S. (tax rate 40%)[5] has a strong incentive to overcharge for the trade if the two companies belong to the same MNE group. This is because while the Bahamas Corporation suffers no tax on the amount overcharged, the U.S. Corporation can claim higher tax relief on the artificially inflated purchase price. This minimises overall group tax liability. Prices that prevail in trades between members of a group are referred to as 'Transfer Prices'. There can be no intra-group trade without them. However, MNEs must determine these prices themselves, which allows for the possibility of misuse. OECD Transfer Pricing Guidelines require that prices in such circumstances be determined at 'arm's length'. This approach, however, is fraught with several problems (OECD 2010). For instance,

- Determination of arm's length price may not be possible in certain circumstances. For instance, in case of specialized, custom-made products that are not generally sold in the market as such. No comparable prices exist in such situations.
- Companies may trade at arm's length prices *only* in case the trade involves jurisdictions where a scrutiny into the specifics of the transactions is more likely, for instance, the developed economies which are much more austere about tax malpractices.

B.2. Investing

a. *Incorporation of subsidiaries:* An MNE denotes a complex corporate structure characterising a network of subsidiaries and holding companies. By virtue of regulation and taxation law, an MNE must have a subsidiary in each location in which it operates, but MNEs may choose locations for purely tax-driven reasons too. These could be:

- *Relocation of income:* There exist jurisdictions like Netherlands and Ireland that offer very low tax rates on certain categories of income. They tend to tempt MNEs to relocate all or a portion of their taxable income away from their high-tax home

[5] http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx

jurisdictions to these havens. To the tax haven, it helps in attracting income which was not even earned within that territory but relocated from elsewhere, resulting in tax revenues.

- *Obscuring reality:* Some tax havens like Netherlands facilitate the formation of shell or sham companies. These provide impenetrable secrecy as to ‘true’ ownership of corporations through appointment of nominee directors who work at the whim of the true owners. For corporations seeking to obscure or conceal certain transactions from the glare of their shareholders, regulatory bodies, competitors etc., these places suit best.

b. *Where to locate assets:* It goes without saying that any corporation needs to maintain its physical assets in the place where it is likely to use in conducting its operations. For instance, for a manufacturing company, all its plant, equipment etc. must be kept in the place where manufacturing is to take place. However, tax considerations rob the concept of its simplicity. There are certain jurisdictions that intend to promote capital investments by offering tax rebates and deductions on capital expenditures incurred by corporations. For instance, the provision for bonus depreciation in the United States. These reliefs and rebates can be exploited in conjunction with asset leasing arrangements. Some countries provide tax relief on the cost of the asset to the real owner i.e. the lessor but also levy taxes on the rental income he receives from leasing out the asset. On the other hand, some countries provide tax relief to the lessee on the cost of asset made and in such cases, does not tax the lessor on such payments received. Corporations try to choose locations for situating their assets in order to extract maximum tax benefit by trading off the tax laws of one country against those of the other that taxes the other leg of the arrangement. This is called ‘tax arbitrage’. This has resulted in physical assets being located in places quite distant from where they are actually put to use.

The same holds for location of intellectual property (hereafter, IP). Broadly, IP consists of patents (on which royalties are paid) and copyrights (on which licence fees is paid). An MNE can conveniently relocate its IP from the country of its creation to a jurisdiction of its choice before it has been used or before its commercial worth has been established. This also goes for logos which fall under copyrights. For instance, Microsoft holds the copyright for most its products for sale in the USA in Ireland- a

low-tax jurisdiction (note that patent income here is exempt from tax). Though this makes Microsoft the largest company in Ireland, most of the income it generates there has whatsoever nothing to do with its activities there! As the Wall Street Journal puts it "a law firm's office on a quiet downtown street [in Dublin, Ireland] houses an obscure subsidiary of Microsoft Corp. that helps the computer giant shave at least $500 million from its annual tax bill. The four-year-old subsidiary, Round Island One Ltd., has a thin roster of employees but controls more than $16 billion in Microsoft assets. Virtually unknown in Ireland, on paper it has quickly become one of the country's biggest companies, with gross profits of nearly $9 billion in 2004." (WSJ 2005)

C. Financing:

a. *Where to borrow:* Corporations are in continuous need for finances for running their day-to-day operations as well as to make value-enhancing investments. Two major sources of funds are share capital and loan capital. Shareholders are entitled to dividends payable out of a firm's profits while loan capital receives interest, irrespective of whether a corporation earns profits. Loan capital may be raised from external or internal sources- from banks, venture capitalist groups or from 'Internal Finance Companies' (hereafter IFCs). IFCs are members of the MNE group, often incorporated in offshore in low-tax jurisdictions. We are aware that interest is much more tax-favoured than dividends. It qualifies for deduction from taxable income unlike dividend which must be paid out of after-tax profits. Further, dividends attract withholding taxes in the country in which they arise and require payment of a dividend distribution tax in some jurisdictions. This has resulted in what is known as 'Thin Capitalization'. It refers to the phenomenon wherein companies tend to be financed almost entirely through loan capital from foreign subsidiaries. This helps claim tax relief in the high-tax country (where the borrowing firm is located) while interest income in the low-tax country (where the lending IFC is located) escapes taxation, resulting in minimization of group tax liability! To make things worse, group firms can negotiate arbitrarily high interest rates so that a larger chunk of high-taxable profits can be shifted to the low-tax jurisdictions. This makes it just another form of the transfer pricing abuse which is worse in the case of developing economies.

V. Transfer Pricing: The devil in disguise –

What are Transfer Prices

MNEs are global entities with a worldwide presence. The rapid growth of technology and communication facilities has granted them the flexibility to place their operations and activities in any corner of the world. As pointed out earlier, more than 60% of world trade is in the nature of intra-group sales. Besides this, other intra-group transactions involving the transfer of intellectual property, capital (in the form of money) and physical assets are also on the rise. When members of a MNE group (called 'Associated Enterprises' in transfer pricing parlance) trade with each other, the structure of such transactions is driven by both market and group-driven considerations. This makes such transactions fundamentally different from those that take place between independent third-parties that are driven purely by market considerations (that are presumed to take place at *arm's length prices*). It thus becomes absolutely necessary to ascertain the 'correct' price, referred to as the *Transfer Price*, for cross-border, intra-group transactions between related parties. These prices are to be determined by the Associated Enterprises themselves. It must be noted that the mere existence of 'Transfer Prices' does not by itself imply tax evasion or avoidance. It is only when these self-determined prices seem artificially high or low vis-a-vis domestic or international norms that they attract attention for the wrong reasons.

Why do we need Transfer Prices

a. *Profitability:* Though Associated Enterprises may form part of a larger group, they are ultimately separate entities when it comes to reporting profitability. Transfer Prices for intra-group transactions directly determine the profitability of both related parties in a cross-border transaction. For instance, consider a profitable sports goods firm in country A (the parent firm P) that buys goods from one of its own subsidiaries in country B (called firm S). The price S charges from P, determines directly the profits that both report. If it undercharges P, though S reports a loss, the group reports reasonable profits once the final goods are sold.

b. *Tax-base in different jurisdictions:* It must be understood that any transaction between related parties involves two other equally interested parties- the tax authorities of the two countries involved in the transaction. Transfer Prices have a direct impact on the taxable income of both related parties to a cross-border transaction. By choosing to

under or over-price controlled transactions, MNEs can successfully shift their taxable income from one jurisdiction to another, primarily due to tax reasons. For instance, if in the above example, A is a high-tax country while B is not. Is such cases, P and S may set artificially high transfer prices such that P's taxable income is minimized. On the other hand, while S's taxable income is artificially boosted, it suffers taxation at a comparatively low rate, thereby minimizing overall group tax liability.

Issues in Transfer Pricing –

(i) *Jurisdictional issues:* Since any cross-border transaction involves at least two jurisdictions, taxing the transaction in one jurisdiction has an impact on its taxability in the other jurisdiction involved. If the MNE pays tax in one country, should the other country also tax it, if yes, at what rates, should it provide tax relief are some serious issues involved. This highlights the role of Double Taxation Avoidance Agreements (DTAAs) and tax treaties between jurisdictions. It must be noted that corporations are increasingly resorting to 'treaty shopping' which involves exploiting such agreements. For instance, the Indo-Mauritius tax treaty that exempts capital gains from income tax in India, on investments routed through Mauritius.

(ii) *Allocation issues:* MNEs are characterised by common resources- financial capital, managerial talent, intellectual property etc. that are used by its various members. However, both for the purpose of ascertaining financial and taxable income, a correct apportionment of common costs and revenues becomes necessary. However, the 'common' nature of MNE resources makes this a herculean task. MNEs tend to shift common costs to member firms in high-tax jurisdictions and common revenues to low-tax ones.

(iii) *Valuation issues:* Mere allocation of common costs and revenues does not suffice. It must be ensured that the rates at which inter-group services and goods have been exchanged are 'fair' and at par with market rates or simply the rates at which two independent unrelated parties would have transacted with each other (arm's length prices). Transfers may take place at extremely high or low rates compared to their true market value, merely with an objective to shift taxable income away from member firms in high tax countries.

Transfer Pricing Guidelines –

The first set of Transfer Pricing guidelines were publishes by the OECD in 1995 which have largely been followed by large developed countries of the world. Guidelines (TPG) contain guidance on 'comparability analysis' and prescribe five different transfer pricing methods to ascertain whether a transaction between associated enterprises satisfies the arm's length principle. However, all of these methods are fraught with practical difficulties, particularly with reference to finding an 'uncontrolled' comparable price. In line with corporate tax compliance trends and practical difficulties in implementing the guidelines, these have been revised from time to time. For instance, a significant addition to the guidelines came in 2010 with the addition of Chapter IX. The rationale was to address the widespread phenomenon of business restructurings that could significantly impact the tax base in the jurisdictions involved. The addition in 2010 addressed practical difficulties in implementation and provided guidance as to the application of transfer pricing methods, selection of the most appropriate method given the circumstances of the case and application in practise of the two transfer methods referred to as 'transactional profits method' outlined by the TPG, namely the transactional net margin method and the transactional profit split method.[6] Apart from the OECD TPG, several other models such as the UN and OECD Model conventions and domestic litigation such as in the USA have provided a roadmap to nations towards tackling a common problem- shrinking of the tax base. While most countries have adopted some or the other model to its transfer pricing issues, there are still some that rely on general anti-avoidance rules even for the most blatant transfer pricing abuses.

Whatever be the method in use for finding comparables and determining arm's length prices, two significant issues stand out- firstly, it is not easy to find comparables or uncontrolled prices given the very fact that transactions between members of MNEs are in character, fundamentally different than those between unrelated parties and secondly, allowing the flexibility to the tax payer of choosing the method, which in his opinion, best suits the circumstances of the case, is a weapon in disguise.

All in all, despite all transfer pricing regulation in place, the world- including some of the most developed countries- are still grappling with the problem of disruptive shifting of taxable profits by MNEs.

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[6] For details, refer to "Report on the Transfer Pricing aspects of business restructurings: Chapter IX of the Transfer Pricing Guidelines, July 22, 2010", OECD. Link: http://www.oecd.org/tax/transfer-pricing/45690216.pdf

VI. Policy Recommendations –

Based on the pervasiveness of the tax evasion phenomenon and the current global scenario, the following recommendations are made:

1. Increased attention and unified efforts by regulators and governments should be directed towards complete eradication of banking and commercial secrecy from the face of the world. It looks like countries; especially the developed and more powerful ones are faring fairly well in this direction. In the absence of opportunities for dodging taxes, corporations will have to turn 'tax-compliant'.

2. Requiring geographical reporting of income by affiliates of MNE groups including details of number of employees, nature of activity undertaken, profits earned and taxes paid thereon based on jurisdictions in which they operate. This can help all tax authorities involved, in ascertaining the 'true' nature of activities undertaken in their jurisdictions and which amount should be taxed where, keeping in mind the interests of all jurisdictions involved. This will also reduce complex transfer pricing litigation which is costly both for the tax authorities and the corporate taxpayer.

3. Reduce the level of discretion available to the taxpayer corporations in choosing the 'most appropriate' method for determination of arm's length prices. 'Picking' among alternatives may actually defeat the purpose of the regulation.

4. Lay down guidelines for transfer pricing dispute management for developing countries. Such countries have shown tremendous growth in their service sectors, which also happen to be fertile areas for transfer pricing abuse through transfer of intangibles such as services and intellectual property. In such countries, comparables are hard to find and even if available, difficult to analyse and litigate upon. Transfer pricing litigation runs in hundreds of pages and involves numerous accounting and taxation experts, which are scarce in such economies. However, the loss of revenue resulting from transfer pricing abuse for such countries can be substantial. *Trade mispricing* was found to account for an average of *54.7 percent* of cumulative illicit flows from developing countries over the period 2000-2008 (Kar 2011).For instance,

it is estimated that India loses about $314 billion annually to tax evasion.[7] In fact, it is estimated that nearly 70% of the global transfer pricing litigation emanates in India.[8]

5. Focus attention also on 'domestic' transactions between affiliates in business groups (whether or not multinational) which could result in significant shifting of taxable income to affiliates that could either have accumulated tax losses or are tax-favoured for any reason, for instance, firms operating in Export Oriented Units (EOUs) or Special Economic Zones (SEZs) that are often offered significant tax benefits. As a matter of fact, India via its Finance Act, 2012 has extended the scope of transfer pricing to include domestic related party transactions exceeding a certain threshold in value.

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[7] See "In India, Tax Evasion is a National Sport", Business Week, July 28, 2011. Link: http://www.businessweek.com/magazine/in-india-tax-evasion-is-a-national-sport-07282011.html

[8] See "Transfer Pricing norms need fundamental reforms: Assocham", The Times of India, May 16, 2012. Link: http://articles.timesofindia.indiatimes.com/2012-05-16/india-business/31725976_1_transfer-pricing-revenue-between-different-divisions-assocham

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