International Tax Avoidance and Tax Havens

Government loses corporate tax revenue from the shifting of profits and income into low-tax countries. The annual cost of offshore tax abuses is estimated to be around $100 billion per year. Tax avoidance and evasion may take different forms like a multinational firm constructs a factory in a low-tax jurisdiction rather than in a high tax jurisdiction to take advantage of low foreign corporate tax rates. There are many activities that are often referred to as avoidance but they can also be classified as evasion, such as transfer pricing. When a firm charge low prices for sales to low-tax affiliates but pay high prices for purchases from them. If these prices, which are supposed to be arm's length, are set at an artificial level, then this activity might be viewed as evasion. In case of tax avoidance and evasion terms like tax minimization, tax sheltering, and aggressive tax scheme or tax aggressiveness are frequently used. Therefore a clear understanding of their meaning and scope is very important.

Tax minimization refers to any activity that reduces explicit taxes. This includes tax concessions such as capital allowances, accelerated depreciation, and research and development tax deductions that are designed to encourage investment and growth in the economy. Tax avoidance refers to companies (and individuals) entering into transactions that have no economic significance, and with the sole or dominant purpose of reducing taxes. Tax sheltering is similar to tax avoidance, but usually refers to schemes that are marketed by tax consultants and sometimes involve a series of transactions in an attempt to disguise the ultimate nature of the arrangement. Tax evasion refers to activities that are illegal under tax legislation such as not reporting foreign income or claiming fraudulent deductions.

The decision to enter into an aggressive tax scheme involves balancing the costs and benefits involved. The main benefits of corporate tax aggressiveness are:

(I) increased after-tax profits represented in a firm's performance metrics such as earnings per share;

(II) a reduced tax liability;

(III) A reduced effective tax rate that can send a positive signal to investors, thereby reducing the cost of equity; and

(IV) increased cash and liquidity;

The costs of tax aggressiveness include:

(i) transaction costs incurred in setting up the tax planning strategy, such as registration and legal fees to establish off-
The cost of newly established industrial undertakings, exemption from tax of new established physical infrastructure facility, exemption of income from the business of software development or Nationwide Telecommunication Transmission Network, Information Technology Enabled Services etc. However, these provision are there only for the industrial and economic development of Bangladesh.

Tax Havens - Jurisdictions:

Some jurisdictions have been identified as tax havens by OECD in 2000. The table below lists the countries that appear on various lists, arranged by geographic location.

<table>
<thead>
<tr>
<th>Caribbean/West Indies</th>
<th>Anguilla, Antigua and Barbuda, Aruba, Bahamas, Barbados, British Virgin Islands, Cayman Islands, Dominica, Grenada, Montserrat, Netherlands Antilles, St. Kitts and Nevis, St. Lucia, St. Vincent and Grenadines, Turks and Caicos, U.S. Virgin Islands</th>
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<tbody>
<tr>
<td>Central America</td>
<td>Belize, Costa Rica, Panama</td>
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<tr>
<td>Coast of East Asia</td>
<td>Hong Kong, Macau, Singapore</td>
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<tr>
<td>Europe/Mediterranean</td>
<td>Andorra, Channel Islands (Guernsey and Jersey), Cyprus, Gibraltar, Isle of Man, Ireland, Liechtenstein, Luxembourg, Malta, Monaco, San Marino, Switzerland</td>
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<tr>
<td>Indian Ocean</td>
<td>Maldives, Mauritius, Seychelles</td>
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<td>Middle East</td>
<td>Bahrain, Jordan, Lebanon</td>
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<td>North Atlantic</td>
<td>Bermuda</td>
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<td>Pacific, South Pacific</td>
<td>Cook Islands, Marshall Islands, Samoa, Nauru, Niue, Tonga, Vanuatu</td>
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<td>West Africa</td>
<td>Liberia</td>
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The geographical distribution shows that the tax havens are concentrated in the Caribbean and West Indies and Europe. The OECD has three lists: a white list of countries implementing an agreed-upon standard, a gray list of countries that have committed to such a standard, and a black list of countries that have not committed. The gray list includes countries not identified as tax havens but as "other financial centers." Many countries that were listed on the OECD's original blacklist protested because of the negative publicity and many now point to having signed agreements to negotiate tax information exchange agreements (TIEA) and some have negotiated agreements. Most recently, the OECD has focused attention on its Base Erosion and Profit Shifting (BEPS) initiative. As part of this initiative the Global Forum on Transparency and Exchange of Information for Tax purposes has begun rating countries on various criteria. The countries are rated
as compliant, largely compliant, partially compliant, or noncompliant. As of 2014, 71 countries have been reviewed out of which 42 countries have been rated as noncompliant.

There are criticisms that many countries are tax havens or have aspects of tax havens. But they are not treated as tax havens. These jurisdictions include countries such as the United States, the UK, the Netherlands, Denmark, Hungary, Iceland, Israel, Portugal, and Canada. Three States in the USA also gets focused, they are Delaware, Nevada, and Wyoming. There are also some smaller countries or areas in countries that have been characterized as tax havens like Campione'dItalia, an Italian town located within Switzerland. Netherlands is often considered as a tax haven, particularly for corporations which allows firms to reduce taxes on dividends and capital gains from subsidiaries and for a wide range of treaties that reduce taxes. In 2006, Bono and other members of the U2 band moved their music publishing company from Ireland to the Netherlands after Ireland changed its tax treatment of music royalties. Newspaper report shows that the role of Netherlands in facilitating movement to tax havens through provisions such as the various "Dutch sandwiches", which allow money to be funneled out of other countries that would charge withholding taxes to non-European countries, to be passed on in turn to tax havens such as Bermuda and the Cayman Islands. These stories forced European Commission to begin investigating whether certain arrangements in Ireland, Luxembourg, and the Netherlands constitute prohibited state aid.

Methods of Corporate of Tax Avoidance:
If a firm can shift profits to a low-tax jurisdiction from a high-tax one, its taxes will be reduced without affecting other aspects of the company. There are different methods for shifting profit from a high-tax jurisdiction to low-tax jurisdiction, such as allocation of Debt and Earnings Stripping, Transfer Pricing, Contract manufacturing, Hybrid Entities, and Hybrid Instruments, Cross Crediting and Sourcing Rules for Foreign Tax Credits.

Allocation of Debt and Earning Stripping:
Under this method of shifting profits from a high-tax jurisdiction to a low-tax jurisdiction, the taxpaying company borrow more in high-tax jurisdiction and less in the low-tax one. This shifting of debt can be achieved without changing the overall exposure of the firm. A more specific practice is referred to as earnings stripping, where either debt is associated with related firms or unrelated debt is not subject to tax by the recipient. As an example of the stripping method, a foreign parent may lend to its U.S. subsidiary. Alternatively, an unrelated foreign borrower not subject to tax on U.S. interest income might lend to a U.S. firm.

A subsidiary of an MNE in a low corporate tax regime can lend money to a subsidiary in a high-tax regime. The debt repayments and interest expenses are then offset against corporation tax in the high-tax regime, thus reducing tax payments. In certain cases intra-company debt balances at certain companies may be many multiples higher than its external debt balances. Similarly, interest rates paid on intra-company debt may be multiples higher than interest rates paid on external debt. Lack of disclosures over intra-company debt enables abuses and keeps investors from being able to assess any earnings impact of potential regulatory changes.

Transfer Pricing:
The second major way that firms can shift profits from high-tax to low-tax jurisdictions is through the pricing of goods and services sold between affiliates. To properly reflect income, prices of goods and services sold by related companies should be the same as the prices that would be paid by unrelated parties. By lowering the price of goods and services sold by parents and affiliates in high-tax jurisdictions and raising the price of purchases, income can be shifted. An important and growing issue of transfer pricing is with the transfers to rights to intellectual property, or intangibles. If a parent developed in the United States is licensed to an affiliate in a low-tax country income will be shifted if the royalty or other payment is lower than the true value of the license. For many goods there are similar products sold or other methods such as cost plus or markup can be used to determine whether prices are set appropriately. Intangibles such as new inventions or new drugs, tend not to have comparables, and it is very difficult to know the royalty that would be paid in an arm-length price. Thus, intangibles represent particular problems for policing transfer pricing.

One problem with shifting profits to some tax haven jurisdictions is that if real activity is necessary to produce the intangibles, these countries may not have labor and other resources to undertake the activity. However, firms have developed techniques to take advantage of tax laws in other countries to achieve both a productive operation while shifting profits to no-tax jurisdictions. An example is the double Irish, Dutch sandwich method that has been used by some U.S. firms. In this arrangement, the U.S. firm transfers its intangible asset to the Irish holding company. This company has a subsidiary sales company that sells advertising (the source of Google’s revenue) to Europe. However, sandwiched between the Irish holding company and the Irish sales subsidiary is a Dutch subsidiary, which collects royalties from the sales subsidiary and transfers them to the Irish holding company. The Irish holding company claims company management in Bermuda, with a 0% tax rate. This strategy allows the Irish operation to avoid even the low Irish tax of 12.5% and, by using the Dutch sandwich, to avoid Irish withholding taxes.
Contract Manufacturing:
When a subsidiary is set up in a low-tax country and profit shifting occurs as in the acquisition of rights to an intangible, a further problem occurs: the low-tax country may not be a desirable place to actually manufacture and sell the product. For example, an Irish subsidiary’s market may be in Germany and it would be desirable to manufacture in Germany. But to earn profits in Germany with its higher tax rate does not minimize taxes. Instead the Irish firm may contract with a German firm as a contract manufacturer, who will produce the item for cost plus a fixed markup.

Marketing Services and Trading Company Structures:
Companies can fragment functions (e.g. R&D, product design, logistics, transport, order fulfilment, or customer support) using marketing services or trading company structures, shifting profits from high-tax to low-tax jurisdictions. In a marketing services agreement, an MNE designates sales staff in high-tax jurisdictions as "marketing" personnel. Although these marketing personnel maintain sales relationships, the company’s remote employees in a low-tax jurisdiction actually finalize the sale, so that the majority of the profit is then booked in the low-tax jurisdiction rather than in the high-tax jurisdiction when the real sales activity took place.

In a principal or trading company structure, the potential abuse comes when a company designates a subsidiary in a low-tax jurisdiction to control function such as ordering from third-party manufacturers and inventory management for the whole group, despite the actual products and inventory in many cases never flowing through the country where this subsidiary is based. The company will then state that subsidiaries in high-tax jurisdictions, which generally account for the bulk of sales, are simply responsible for distribution, in spite of the physical products being held or services to end customers being provided, in that jurisdiction.

Cross Crediting and Sourcing Rules for Foreign Tax Credits:
Income from a low-tax country that is received in a country can escape taxes because of cross crediting: the use of excess foreign taxes paid in one jurisdiction or one type of income to offset tax that would be due on other income. In the past the foreign tax credit was proposed on a country-by-country basis. Because firms can choose when to repatriate income, they can arrange realizations to maximize the benefits of the overall limit on the foreign tax credit. Firms that have income from jurisdictions with taxes in excess of U.S. taxes can also elect to realize income from jurisdictions with low taxes and use the excess credits to offset U.S. tax due on that income.

OECD BEPS Project:
The project on Base Erosion and Profit Shifting (BEPS) was initiated by the Organization for Economic Cooperation and Development (OECD), and backed by the G20 world leaders in the St Petersburg Declaration of September 2013. Its final outputs were released on October 2015, approved by the OECD Council and the G20 Finance Ministers. The general aim of the BEPS reforms is to ensure that MNEs are taxed "where their economic activities take place, and value is created". However, these are still proposals, which need to be implemented through national law and administrative action, as well as tax treaty changes. The project will continue and pursue uncompleted work on some topics. Implementation will take three main forms:

- changes to national law, in some cases regionally coordinated;
- revisions of the OECD Transfer Pricing Guidelines (TPG); these are expected to be applied immediately through administrative action by OECD members, as well as by G20 states, although some may enact domestic regulations to apply their own versions;
- changes to tax treaties and their commentaries: a multilateral convention aiming to ensure rapid revisions to existing treaties is to be negotiated, open to all states; however, states will take their own decisions whether to ratify the convention, and it remains to be seen whether it will have a core package of provisions that must be accepted as a package, or be an optional list.

Hence, although its first stage is completed, the BEPS project entail a period of major changes in tax rules at every level, creating considerable uncertainty and risk. The approach chosen - to provide tax authorities with stronger tools, mainly to disallow deductions and to adjust transfer prices - will exacerbate the problem of uncertainty, since the proposals generally entails increased complexity, as well as depending on general principles involving subjectivity and discretion in their application. This will place considerable responsibility on both the tax officials charged with applying them, and companies and their tax advisers who must decide how to comply.

The main areas in which new rules or significant revisions will be introduced are:

a) Detailed templates have been agreed for MNEs to file in each country a Master File and a local file, to make it easier for tax authorities to audit transfer pricing. Also from 2017 every MNE with a turnover higher than US$1bn will be required to file a Country-by-Country Reporting (CBCR) with the tax authority where its parent is resident, to be sent automatically to every other country where it
lists a taxable entity; there is also a secondary mechanism for direct local filing if the country of the parent does not obtain or share the report. The CBCR is to be confidential to tax authorities, and must be used only for risk assessment. It must include a listing of every entity in the group, their country of formation and residence, and principal activity as well as a breakdown for each country of revenue, profit before income tax, income tax paid and accrued, number of employees, stated capital, retained earnings and tangible assets.

b) Deduction will be denied for payments to the extent that (i.e. in proportion that) they are not included in the income of the recipient, if this is because there is a different treatment in the countries involved in classification of the entity (e.g. it is considered to be a company in one country but a partnership in the other), or of the instrument (e.g. treated as debt in one but equity in the other). If the country of the payer does not deny a duplicate deduction or tax the payment; and taxation in the country of the payee has been adopted as the rule in the EU, under an amendment to the parent-subsidiary directive. The regulations proposed are highly complex, especially to deal with abstruse arrangements, e.g. imported mismatches, so may not be considered a high priority in smaller countries. They may also lead to attempts by tax planners to devise even more complex structures to avoid them.

c) Some chapters of transfer pricing guidelines have been extensively revised. The main effect is to give tax authorities greater powers to adjust prices of transactions between related parties, so that they reflect the actual functions performed, assets deployed, and risks assumed by the various parties. The intentions is the disallow attribution of significant profit to entities within a corporate group claiming to perform activities, such as management of intellectual property or financial management, unless they can be shown to have the genuine capacity to do so, while those transmitting capital (cash boxes) would get only a routine return. However, there is scope for considerable discretion, and hence disagreement, in evaluating functions, and especially deciding where risk is borne.

d) Countries are recommended to establish a fixed cap for deduction of interest, within a range of 10%-30% of either EBIT or EBITDA, with the possibility for the company to choose a group ratio if it is higher. This safety valve may make it easier for countries that already have a fixed cap to reduce it (a number of countries currently have a 30% cap, the US 50% plus specific deductions). Many countries are likely to change their rules along the lines recommended - especially those that currently apply thin capitalization rules, which have been found to be ineffective - but since the report allows considerable flexibility, the rules are likely to vary significantly.

e) Tax incentive or preferences will be scrutinized under a peer-review system through the Forum on Harmful Tax Practices, with a strengthened requirement to show substantial economic activity in the country, and a nexus between expenditure on that activity and the income benefiting from the preference. An initial review found 16 innovation box regimes as wholly or partially non-compliant, and these should be revised. At the same time, the clarification of criteria is likely to encourage other countries to introduce regimes, and several have already announced their intention to introduce innovation boxes (e.g. Ireland, Italy and Switzerland). A procedure has also been agreed for automatic exchange of information on tax rulings between tax authorities, aiming to prevent sweetheart deals.

f) Revisions are proposed to the tax treaty definition of a permanent establishment (PE), which defines taxable presence. These will make it more difficult for a firm to avoid attributing profit from sales in a country if it has an affiliate or agent there that concludes the contracts, or performs sales-related functions, unless they are merely "preparatory or auxiliary".

g) Countries are encouraged to introduce requirements for disclosure of aggressive or abusive transactions, arrangements or structures, either by their promoters or users or both, with recommendations for rules targeting international schemes. Arrangements for exchange of information and cooperation between tax authorities regarding such schemes will be strengthened and extended.

References:


