International Journal of Applied Research 2017; 3(8): 176-179

International Journal of Applied Research

ISSN Print: 2394-7500
ISSN Online: 2394-5869
Impact Factor: 5.2
IJAR 2017; 3(8): 176-179
www.allresearchjournal.com
Received: 11-06-2017
Accepted: 15-07-2017

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Black money and tax havens

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Abstract
Black money is a socioeconomic evil. The existence of a rapidly growing black money in any economy has disastrous consequences and economies all over the world takes initiative to curb generation of black money. People & Corporations globally are able to lower their overall effective tax rates by extending operations in offshore tax havens. A tax haven is a country or place with very low effective rates of taxes. A tax haven in most cases additionally provides financial secrecy.
Thus, the leitmotif of this paper is to ascertain the role that the tax havens play in the international arena in light of the generation of black money and ways to curb it. The paper will attempt to analyse how use of tax haves helps people and corporations to lower their tax liabilities. The paper provides a description of various efforts that have been introduced so far to tackle this issue.
The paper also throws light on the incidents which aroused controversies regarding the sources of unaccounted funds invested by people from all around the world through formation of shell companies in tax haves like Panama that was disclosed later on. The paper concludes with certain overarching observations.

Keywords: Tax havens, financial secrecy, black money, demonetisation

1. Introduction
'Black money' refers to the funds in respect of which taxes have not been paid. Any unaccounted money that is concealed from the taxing authorities gives rise to black market, also known as 'underground economy'. In March 2018, the amount of Indian black money in Swiss and other offshore banks was estimated to be 1500 billion US dollars. As of 2017, domestic black money is estimated to be around 6-8% of our GDP which is mainly invested in real estate, construction, and the service sector.
A tax haven is a country or place with very low effective rates of taxes. A tax haven in most cases additionally provides financial secrecy. Countries such as Luxembourg, Cayman Islands, Ireland, Switzerland, Bermuda, Hong Kong, Jersey, Bahamas, and British virgin islands are some popular tax havens. These countries benefit by attracting foreign businesses that create jobs for its residents. Despite a nominal tax rate, these countries end up earning substantially more tax revenue that it would otherwise. The government of such areas supplement government revenues through various sources. For instance, tax havens like Cayman Islands charges very high indirect taxes such as customs and import duties which makes cost of living very high. Further, Government of such areas benefit from having thousands of companies registered in their jurisdictions. It is because tax haven governments charge a registration fee on all newly incorporated companies and partnerships. These entities also have to pay renewal fee every year to be recognized as an operating company. Additional fees are also levied in such jurisdictions on specified companies like companies in financial services sector. Some tax havens such as Switzerland which enjoy a vibrant tourism industry are able to create an extra revenue source in the form of departure taxes too.

2. Black Money: A Concept Note
Inherent features of Indian taxation system such as widespread corruption, lack of strict punishment for the offenders, process of public procurement, multiple taxes, high rates etc lead to tax evasion which gives rise to a parallel black economy. Common practice of Indian corporations practicing transfer mispricing also gives rise to a shadow economy. By under-invoicing their exports and over-invoicing their imports from tax haven countries such as Hong Kong or Singapore, the promoters and investors of such public limited companies are

Able to earn black money abroad. Some other sources of black money are Trade Mispricing, under-invoicing of inventories, over-invoicing of assets such as plant and machinery, illegal holding of precious gems, metals and illegal activities like smuggling, prostitution where there are no records of how funds are generated and used.

Various efforts taken so far by the Government to tackle black money are as follows-

1. Efforts have been taken to reduce excessive tax rates and high transactions cost which creates economic environment that incentivises tax evasion.
2. Efforts have been taken to curb corruption by frequent monitoring of government offices, instituting timely redressals and by enacting whistle-blower policy.
3. Following recommendations from the OECD on curbing black money, the Indian government decided to ban old notes and change them with new 500 and 2000 rupee notes.
4. Successive waves of economic liberalisation have encouraged compliance and tax revenue for the government overtime.
5. Various tax amnesty schemes have been introduced. These schemes provide a limited time opportunities to taxpayers to pay a defined amount in exchange for forgiveness of a tax liability relating to a previous tax period without fear of criminal prosecution. These schemes help to bring black money into main stream and increases future compliance. Some of the most successful tax amnesty schemes are:

- Gold Bond Scheme, 1993- This scheme mobilised minimum 500 grams gold from tax evaders and issued bonds in return. Interest equivalent to Rs. 40 was to be paid. The gold was to be returned after 5 years. The scheme was able to mobilise 40 tonnes of gold which played a crucial role of bolstering the country's reserves during balance of payment crises of 1991.
- Voluntary Disclosure of Income Scheme, 1997- The scheme provided for disclosure of funds either as cash or assets, whether in India or abroad. The government netted Rs. 10,000 crore through this scheme.
- Income and Assets Declaration Scheme- As per this scheme introduced in budget 2016-17, declarants of unaccounted income could legalize their possessions by paying a tax of 45% inclusive of GST. 64,275 people came forward to declare Rs. 65,250 crore of black money under this scheme.
- Pradhan Mantri Garib Kalyan Yojana, 2016- The scheme provided for declaration of income in the form of cash or bank deposits. As per this scheme, person making the declaration was to pay 50% in taxes and surcharges and park a quarter of the total sum in a non-interest bearing deposit for four years.

1. Systematic reforms have been introduced in sectors of Indian economy such as gold trading, real estate, equity trading market, mining permits, etc that are very prone to underground economy than others.
2. Introduction of tax deducted at source and introduction of Money Laundering Act, 2002.
3. Section 90 of the Income tax act, 1961 allows India to enter into tax avoidance treaties with other countries which helps to address the issue of Round Tripping. In that regard, the indian government has entered into various double tax avoidance agreements (DTAA's) with Singapore, Mauritius, etc.
4. In 2007, Vodafone bought Hutchinson group and entered Indian markets. The deal was executed in Cayman Islands. Later in September 2017, the Indian government claimed over US$2 billion in taxes and sent a legal notice to Vodafone in that regard. Vodafone claimed that since the transaction was executed between two foreign firms outside India, the transaction was not taxable. The government on the other hand claimed that the deal was taxable as the underlying assets involved were located in India. On 20 January 2012, the Supreme Court gave the verdict in favour of Vodafone. In this regard, General anti-avoidance rule (GAAR) was presented in the parliament by Pranab Mukherjee who stated that its objective was to counter aggressive tax avoidance schemes. It will be effective from April 1, 2017. GAAR being implemented in the direct tax code helps to deal with laws meant to circumvent taxes. It gives more power to officials on how to treat a suspicious transaction in books of accounts. It could also be used to target Participatory notes. It will thus help to reduce circulation of Black Money.
5. Some institutions have been specifically instituted to combat black money. For instance, Central Board of Direct Taxes (CBDT) under Ministry of Finance to oversee direct tax administration and is primarily responsible for combating black money. Similarly, for indirect taxes we have Central Board of Excise and Customs in place. Additionally, financial Intelligence unit is a national agency set up in 2004 for combating money laundering and terrorist financing. Recently, the Indian government constituted a Special Investigation Team for Black money on directions of the Supreme Court.

3. Use of tax havens to lower tax liability

Corporations globally are able to lower their overall effective tax rates by extending operations in offshore tax havens. For instance, Goldman Sachs group was found to hold its funds offshore in around 905 subsidiaries in tax havens in 2017. These include 41 in Mauritius, 52 in Ireland, 183 in Luxembourg and 511 in Cayman Islands. Similarly, Apple is able to avoid billions of tax by holding its cash reserves in Jersey, a tiny island off the coast of France.

Many companies are able to avoid taxes on the money earned by starting operations in a tax haven country. Through the use of such shell companies they are able to minimize tax liabilities by influencing the prices at which they transfer raw material, inputs, etc among the subsidiaries.

For instance, X ltd is a holding company which owns subsidiaries in country A and B. Production of its products takes place in country A and sales take place in country B. Assume tax rate in country A and B to be 10% and 20% respectively. Futher, if we assume cost of production in country A to be Rs.100, Sale price in country B to be 150 and Transfer price among the subsidiaries in both countries to be Rs. 120, the total tax liability will be:

Table 1: Shows Country A and Country B

	Country A	Country B
Cost	Rs.100	Rs.120
Sales Price	Rs.120	Rs.150
Profit	Rs.20	Rs.30
Tax Rate	10%	20%
Tax Liability	Rs. 2	Rs. 6

So, total tax liability for the company as a whole will be Rs. 8. However, if the holding company sets up a subsidiary in a tax haven country then its total tax liability will be largely minimised. In such a case, if the subsidiary located in a haven country enters the picture and the transfer of the product between Country A and B passes through this subsidiary, the total tax liability will be as follows:

Table 2: Shows Country A Subsidiary Located IN the Tax haven Country B

	Country A	Subsidiary Located IN the Tax haven Country	Country B
Cost	Rs.100	Rs.102	Rs.148
Sale Price	Rs.102	Rs.148	Rs.150
Profit	Rs.2	Rs.46	Rs.2
Tax Rate	10%	0%	20%
Tax Liability	Rs. 0.2	Rs.0	Rs. 0.4

So, by setting up its operations in the host country, the corporation will be able to minimize its tax liability from Rs. 8 to Rs. 0.6.

4. Role of tax havens in generation of black money and ways to curb it

One of the most common practice to pool the black money employed by people and corporations has been to stock their money in tax havens. After the 1900s, there has been an increased use of tax havens by corporate entities to lower their global tax obligations. The financial secrecy provided by tax havens pertaining to the foreign investment they receive helps people to hide and earn returns on the quantum of black money they possess.

One of the incidents that throw light on this issue was the controversy regarding the sources of funds invested in Panama that was disclosed through the panama papers. Huge quantum of unaccounted money was found invested by around individuals all over the world in various shell companies located in Panama. The Panama Papers are 11.5 million leaked documents that detail financial and attorney–client information for more than 214,488 offshore entities. Panama is a tax haven country. According to panama laws if you create a company in panama, it is not necessary to disclose its original owners. A group of international journalist in 2016 disclosed the list of such investors whose identity was earlier hidden. Around 500 Indian citizens including reputed Indian actors, politicians and businessperson were on that list like Amitabh Bachan, Aishwarya Rai Bachan, etc. As per Indian law, an individual can at maximum transfer US$250,000 for education, medical expenses, etc. The amount that was found invested which was mostly unaccounted money exceeded this legal limit by huge margins. The government ordered an inquiry, and subsequently announced that it constituted a special multi-agency group comprising officers from the investigative unit of the Central Board of Direct Taxes and its Foreign Tax and Tax Research Division, the Financial Intelligence Unit and the RBI.

On similar grounds, Switzerland which is considered as "grandfather of bank secrecy" has emerged as one of the largest offshore financial centers and tax havens in the world since the 1990s because of their banking secrecy laws that prohibit the disclosure of client information under a variety of federal, cantonal and civil policies. The banks in Switzerland offers their clients numbered bank accounts such that the identity of the holder is replaced with a multi-digit number known only to the client and select private bankers. However, the names of the client are not completely anonymous as they are subject to limited, warranted disclosure by the bank. To open such type of account, clients have to pass through a multi-stage clearance procedure and provide sufficient proof to the bank regarding lawful origins of their assets. Owing to the financial secrecy provided to holders of such accounts, "Swiss Banks" have emerged as one of the most popular shelters of black money.

5. Indian Scenario

In India, there has been a common tendency to keep the illicit wealth abroad since the 1960s owing to the high marginal rate of taxation- sometimes as high as 90%. The Associated Chamber of Commerce and Industry estimates reveal around US$2 trillion of illicit funds stashed abroad by Indians. In recent years, large number of Public Interest Litigation cases on the issue of tax havens has led to the constitution of Special Investigation Team (SIT) by the Indian government in compliance with the Supreme Court's directives. In addition, India is an active member of the Financial Action Task Force and the G20. It has entered into DTAAs with around 85 countries.

Futher, in a step forward, India has entered into various 'Exchange of Information Agreements' which provides for the participating countries to engage in sharing relevant information related to legal entities and citizens of partner countries available within their own jurisdiction, with the respective government authorities of those individuals and entities. India has signed around 17 Tax Information Exchange Agreements (TIEAs)**,** most notably with secrecy jurisdictions like jersey, Bahamas, Cayman Islands, and British Virgin Islands. Similarly, India signed automatic exchange of information (AEOI) provided that both countries would collect data in accordance with the global standards in 2018 and exchange it from 1 January, 2019 onwards.

Last but not the least, the implementation of GST from July 1, 2017 and demonetisation of all ₹500 and ₹1,000 banknotes of the Mahatma Gandhi series by the Government of India in November 2016 has played a crucial role in curbing domestic black money. Being a reform for indirect taxes, increased transparency caused due to implementation of GST has led to the reduced practice of under reporting of incomes by tax payers and has increased tax base for both indirect and direct taxes which has resulted in reduction of generation of black money in the economy. GST requires extensive usage of Aadhar and PAN which have made it easier for the tax authorities to track the transactions. Though alcohol has remained outside the GST net, other major sources of illicit money such as real estate and precious metals have been busted. GST has largely been successful in creating a self-policing environment. The dual monitoring structure within GST, which involves the Centre and the states also curbs income tax evasions because even if one set of tax authorities fails to detect evasion, there is the chance that the other overseeing authority may not. This has resulted in improving tax compliance.

6. Conclusion

Black money is a socioeconomic evil. Generation of black money in a nation leads to a parallel black money which ruins its economic development. It leads to a loss of revenue to the government and widens the gap between the rich and the poor. Generation of Black money has adverse policy related consequences too. Creation of underground economy distorts the estimates of savings and consumption of nations to the national income and measurement of other macroeconomic variables which results in inaccurate policy making and planning considerations. In this regard, efforts should be taken to prevent the common practice employed by people and corporations to pool the black money by stocking it in tax havens.

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