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Barkha Jamwal
Assistant Professor, College of Vocational Studies, University of Delhi, India

Correspondence
Barkha Jamwal
Assistant Professor, College of Vocational Studies, University of Delhi, India

A study on the secret world of tax havens

Barkha Jamwal

Abstract
Tax havens are the areas or the countries which impose little or no taxes on the earnings of foreign players in relatively stable economic and political environment, working in a system providing "financial secrecy". This paper aims to study the impact of Tax Havens globally, how do these actually work and why are they considered legal. In order to avoid tax liability, countries either plan their investment in tax havens or they sign a Double Tax Avoidance Treaties with the countries which enable companies to pay little or no taxes in one country and at the same time avoid paying higher taxes in another country. Mauritius is famous for its zero tax imposition on incomes and India has signed a treaty with this country. This treaty however, is now being amended in order to limit black money and reduce tax avoidance in the system. The Paper also talks about the Panama Papers which showed how wealthy people ranging from Big Politicians to Actors hide their Black money to avoid tax liability. Even one of the biggest corporate governance failures of Enron in 2001 was a result of obscure way in which Tax Havens operate. For this paper, secondary data is used from various journals, articles and newspapers

Keywords: Tax havens, financial secrecy, double tax avoidance treaties, panama papers, Enron

Introduction
Sustainability in the business can be achieved only when the corporation is provided with the suitable growth environment which gives adequate strength and power to the business to carry on its activities. Since the under developed nations lack world class infrastructure and at times even lack basic amenities like clean water, proper health care facilities, sanitation, education, food and shelter, it is the duty of the government of these nations to use the taxes collected from individuals and multinationals carrying their business activities here to the development and growth of the nation. But due to the existence of Tax Havens which are considered as the heavenly bodies and act as a shelter to those who want to avoid / evade their tax liability, the poor nations are not able to develop. Such entities by using the Tax havens rip the developing and poor nations of the revenue that could have arose from the tax paid by corporate and individuals had the tax havens not existed. Naturally, the taxes imposed by developing nations will be higher as compared to the taxes imposed by developed nations. Since it is easy to set up a business in a developing nation, which offers land, labor and abundant raw materials at low cost, the multinationals are happy to set their productive business here. But at the same time they are not ready to pay higher taxes imposed by such nations, thereby they trick the payment of such tax by forming a shell company or a subsidiary in a tax haven nation.

Objective of the Study
- How do tax havens operate
- To analyze the impact of tax havens on the developing economies and poor nations.
- How dodging of tax by multinationals adversely affect the non-tax havens where actual economic activity takes place

Cases showing how tax havens have been misused.

Research Methodology
The secondary data from various journals, newspaper articles and government sites is taken for the research purpose.

Tax Havens and Its Features

Tax havens are the countries providing favorable environment for outside investors in the form of:

- Little or no tax rates on incomes and investment of investors
- These areas/countries provide Secrecy Laws in the form of banking and financial opaqueness
- They also provide stable political, economic and financial environment which gives a boost to foreign investors.
- Generally it is found that in these areas called as tax havens there is no substantial Business activity carried out and the institutions exist only for the name sake.
- There is little or no transparency of activities carried out in these areas.

It is usually found that tax havens are small areas and most of them are islands situated in secluded places, for example: Cayman Islands, Netherlands, Luxembourg, Virgin Islands, Cook Islands, Bermuda, Andorra, Bahrain, Panama, Switzerland, Mauritius, Bahamas etc

OECD has specified the list of countries specified as tax havens as those who commit to the standards set by OECD in regard to the transparency norms. The countries who do not comply with the transparency standards set by OECD fall under the list of Uncooperative Tax Havens. In the light of recent political commitments made by Andorra, Liechtenstein and Monaco to implement the OECD standards of transparency and effective exchange of information and the timetable set for the implementation, the OECD's Committee on Fiscal Affairs has decided to remove all three jurisdictions from its Uncooperative Tax Havens. (www.oecd.org)

As per Moody's : The Cayman Islands' (Aa3 stable) government bond rating balances very high per capita gross domestic product (GDP), very strong institutions and a comparatively low debt burden with a small, slow-growing economy that is highly dependent on tourism and financial services. (www.caymancompass.com, 2016)

Bermuda, Switzerland, is also given high investment grade rating by the credit agencies: This shows that the biggest tax havens offer strong governance standards. According to a 2016 report by Citizens for Tax Justice, 367 companies in the Fortune 500 had subsidiaries in the tax haven nations around the globe.

Some of the biggest tax havens

- Bermuda: According to Oxfam's 2016 list of world's worst corporate tax havens, Bermuda ranked number 1, as it offers zero percent corporate tax rate and no tax on Personal income as well. Many U.S. MNCs benefitted by landing their earnings in Bermuda in the form of subsidiaries.
- Cayman Islands: It is the 2nd worst tax haven according to Oxfam list.
- Netherlands: It is a top EU tax haven with more than half of Fortune 500 companies having their subsidiary in Netherlands.
- Luxembourg: Like Netherlands, Luxembourg is the second Benelux country known for its business friendly laws that help investors to trick the taxes.
- Singapore: It is a hub of MNC's subsidiaries and offers a nominal and reasonable corporate tax rate.
- Mauritius: Mega MNCs are known to have subsidiaries located in this island located in Indian Ocean. It offers low corporate tax and no withholding tax.
- Switzerland: It provides dual benefit of utmost banking, financial secrecy and low tax Rates. Morgan Stanley, Goldman Sachs, JP Morgan Chase, Citigroup, Pepsi etc are known to have their subsidiaries here.

How Tax Havens Affect the Developing and Poor Countries

It is seen that most of the Tax haven nations are developed and attract investments from developing nations. These offshore nations deprive the developing nations to spend the fiscal budget on providing basic amenities and welfare facilities like clean water, food, shelter, education, sanitation, health care facilities and basic infrastructure meant for benefitting the general public, as these nations lose millions of revenues to be earned from taxes to the tax havens. Hence, these tax havens/offshore centers hinder one of the main objectives of Poverty reduction in developing nations, thereby creating a global poverty problem.

The losses to emerging economies due to tax havens are huge and can't be quantified. MNCs park their funds into tax havens and avoid paying any taxes on the income earned in the home country (non tax haven), thereby depriving the home country's government of the revenue by tax collection. Developing country's citizens lack high quality essential services due to low tax collection, as the MNCs seek investment in Tax havens to dodge taxes in the home country, where real economic activity takes place. Tax evasion and tax avoidance through tax havens is one of the major impediments to development of such emerging nations.

It is a common perception among policy makers and academics that the presence of tax haven economies harms other countries particularly in the developing world, since they (i) attract foreign income from these economies and thus strip them of tax revenues (ii) increase tax competition behaviour, and (iii) offshore wealth holdings by high net worth individuals may furthermore increase income inequality in developing countries and undermine broader tax morale and the culture of tax compliance. (www.ictd.ac)

The Oxfam report highlights the fiscal cost of tax havens and also that such loss in revenue to non-tax havens means underdevelopment and high poverty issues. Also, tax havens play no meaningful role in the world economy beyond minimising tax paid by the MNCs and as such no Productive activity takes place either in Tax haven nation or in the non-tax haven area.

Hence, the global tax dodging is starving and ripping out the developing countries around the world of the much needed funds to have an access to essential services and developmental activities. The government is then forced to impose other taxes on the incomes of people, to collect money, which further create a burden on the people of that country.

Modus Operandi of Companies Using Tax Havens to Dodge Tax

The multinationals can use tax havens to evade their tax liability in various ways, some of which are mentioned below:

By forming Shell Companies: It was revealed in the Panama Papers, that most of the multinationals had set up "Shell Companies" in the tax haven nations, which showed little or no productive/economic activity. For example, let's say a Multinational company in India sets up a "Shell company" named 'ABC' in Cayman Island (tax haven area). ABC operates with little or no economic activity and do not employ any man or machinery. It just operates for the name sake. The MNC then invests or gives loan to 'ABC' in Cayman Islands. This could be regarded as investment going out from India to the tax haven. 'ABC' which is a shell company in Cayman Islands sets up a fully functional subsidiary in a developing country say, India. 'ABC' then provides its subsidiary with a loan to set up its operations (which shows an investment going from a Tax Haven to a developing country). Subsidiary then exaggerates the cost of debt (and other costs) which it has to pay to the 'ABC' hence reducing the profit earned in the developing country. Also the interest which the subsidiary has to pay to 'ABC' is not taxed as it is located in a tax haven. (THE HIDDEN BILLIONS HOW TAX HAVENS IMPACT LIVES AT HOME AND ABROAD, 2016) This 'Round tripping of money' back into the same country, but with less imposition of tax liability is possible only with the help of Tax Havens, which drastically reduces the revenue (that could have arisen from the taxes) to the government.

In this way the MNCs form shell companies which in turn may invest in the same developing country(as shown in the example) or in the different developing country.

Some of the main allegations on the shell companies is that they have the outward appearance of being a legal business, but are just empty shells. They do nothing but manage money, while hiding the identity of who owns it.

Transfer Pricing: Transfer pricing is fixing the price of goods, machinery or services sold between related entities like a parent and a subsidiary. For example if the parent company sells machinery to a subsidiary for a price, then such price is called transfer price.

The Parent company (located in non-tax haven area) can transfer or sell the goods to its Subsidiary (located in a tax haven) at very low prices. Parent company hence shows very low profits earned in non-tax haven area, due to low sale proceeds and high cost of production, which reduces its tax liability. Subsidiary in turn sells the goods to the Parent at a normal rate or inflated rate/price, thereby earning huge profits which are not taxed. The Parent company in turn shows high cost of production hence reducing the total amount of taxable profits. Transfer pricing is basically a problem of developing nations which do not have sufficient expertise and resources to identify transfer prices.

Cases Showing Misuse Of Tax Havens

Tax havens are used to conceal the business activities that are being carried out in these areas, thereby, promoting the criminal and terrorist related activities. These offshore entities encourage global financial crimes by providing secrecy norms. It may even lead to 'Money Laundering' as the monies earned or transferred are not accounted for.A new report finds that around the world the extremely wealthy have accumulated at least $21 trillion in secretive offshore accounts. That's a sum equal to the gross domestic products of the United States and Japan added together. (www.forbes.com, 2012)

Panama Case

This case relates to leakage of information from one of the most secretive companies, a law firm known as Mossack Fonseca, located in Panama. The firm hid papers and records of some genuine and some illegal activities like money laundering, fake ownership records kept to evade tax liabilities of individuals as well as firms. It involves illegal and unaccounted money of wealthy, rich and noble people ranging from Big politicians across the globe to the Actors to Sports persons and to the Corporate giants.

Officials in ED told The Indian Express that over the past two months, they have sent 137 "advisories" under Section 37 of FEMA to Indians named in the Panama Papers. (www.indianexpress.com, 2017) Some important facts related to Panama Paper disclosure:

- The 11.5m documents were obtained by the German newspaper Sueddeutsche Zeitung and shared with the International Consortium of Investigative Journalists (ICIJ)
- 2.6 TB data leaked by anonymous hacking of server of the law firm, from abroad.
- Almost 40 years of data revealed from 1977.
- Over 14,000 middlemen involved (such as banks, law firms, etc.) in incorporating these companies for clients.
- Included information on more than 214,000 offshore entities, including companies, trusts and foundations.
- 200+ countries/ territories involved
- 29 forbes-listed billionaires named: like Lionel Messi
- 12 current or former country leaders involved: including the President of Ukraine, King of Saudi Arabia, Prime Minister of PakistanNawaz Sharif, late father of UK Prime Minister David Cameron, Iceland's Prime Minister, Sigmundur Gunnlaugsson and many others.
- 140 other politicians/associates including members of British Parliament, associates of The Chinese Politburo and associates of Vladimir Putin were included.
- Scandal also covers world governing body of Football, FIFA.
- Actors like Amitabh Bachchan and Jackie Chan are also there in the list.
- Professional footballers
- The leak has also revealed that more than 500 banks, including their subsidiaries and branches, registered nearly 15,600 shell companies with Mossack Fonseca. (www.bbc.com, 2016)

The Panama Paper data leak covers a wide range of Entities and persons many of whom may have parked their money in such tax haven for legitimate reasons like: First, businessmen may store money offshore, so that it is not subject to theft by local criminals. Second, some countries have restrictions on amount of hard money that the local people/companies can carry hence they end up landing their money offshore in order to store it.

It is only after the detailed and in depth investigation is carried out by the tribunal on the suspected entities, can the allegations be made on the persons/corporations who are proved to be in charge of the criminal/illegal activity or for tax evasion/avoidance purpose.

Enron Case

One of the biggest corporate governance failures that shook the world was the collapse of Energy, Commodities and Services Company based in Texas- ENRON in 2001. This corporate giant used around 881 subsidiaries in tax havens, including 692 in the Cayman Islands, 119 in the Turks and Caicos, 43 in Mauritius and 8 in Bermuda, to avoid paying taxes for 4-5 years.Enron shares which were worth $90.75 at their peak in August 2000 and dropped to $0.67 in January 2002. (www.edition.cnn.com, 2016) Its CEO, CFO and auditor were the center of the crime and were charged with heavy probing orders by SEC. It was after thismajor corporate and accounting scandal that Sarbanes Oxley Act, 2002 came into force. Therole of boards of directors in overseeing and role of independent auditors who review the accuracy of corporate financial statements was increased with the implementation of SOX, to prevent any other major corporate governance failure from taking place.

Now the Question Arises That How Do Tax Havens Make Money Since They Do Not Charge Much From Investing Entities

It might appear to be a paradoxical situation, but the tax havens are the nations that are small and have well developed infrastructure facilities. They kill competition from countries charging high taxes by charging negligible/ no tax on incomes, hence attracting huge volume of transactions. Since the volume of transactions is huge their total composite profit in the form of fees/ little tax collected becomes huge. The tax havens are in this way able to earn large amount of profit as compared to the nations who charge high taxes on income of entities and individuals.

Why Are Tax Havens Considered Legal

While tax havens are considered as a bad practice by many, it is regarded as a healthy practice by others. People argue that one cannot declare a region as illegal if it is providing tax benefits and other financial benefits to its investors. It in a way promotes competition and keeps a check on non tax haven countries from charging too much via taxes.

Suggestions

What Can Be Done To Reduce Negative Impact of Tax Havens

- The practice of transfer pricing can be curbed by an initiative of government which ensures that the transfer pricing takes place at an ‘arms-length price’. This is being adopted by Australian government.
- Also, the income of the corporate should be taxed according to the percentage of productive activity carried out in the particular countries. Since, most of the Corporations in Tax Havens just appear on the paper for the name sake and they are not engaged in any physical/productive activity. Hence taxing the incomes or profits of companies according to the level of activity they are engaging in could save the nations from dealing with shortage of tax revenue due to excessive investment in Tax Havens.
- Government of non-tax haven nations should amend the Double Tax Avoidance Agreements with the tax havens so that the round tripping of money is checked onto.
- The government of non-tax haven countries should not charge exorbitantly high tax rate on income on multinationals as it discourages those entities to pay the high taxes and they end up dodging the tax.

Conclusion and Findings

The tax havens are the small areas/nations, which have well developed infrastructure and are attractive to the corporations for providing low/no tax benefit with the banking and financial secrecy norms. The tax havens could have been used in a positive way but the evidences show that these are used to exploit the poor nations by not paying taxes where income is earned and are used for terrorist and money laundering activities. It has become a hub of global financial crimes where trillions of dollars of money is hidden and is unreported.

It is clear that the existence of Tax Havens deteriorate the development process of poor and developing nations, since the Multinationals in the developing nations avoid paying higher taxes in these areas and end up landing their profits in Tax Havens. Cases like Panama Leaks and Corporate Governance failures like Enron and Satyam are also evident of the fact that tax havens are considered by the corporations as the areas where they can do anything and which will remain unaccounted for. Tax havens are considered as the Parasites on the tax bases of non-tax haven nations. The government fiscal policy of the non-tax havens gets largely impacted which is mainly used for the welfare of public and for the development of the nation. Hence these tax havens hinder the developmental activities of the emerging nations which charge taxes to fund the government revenue.

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